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To: Minister of Finance

## **AIDE MEMOIRE: DELIVERING ON THE GOVERNMENT'S GOALS REQUIRES LOWERING THE COMPANY TAX RATE**

The purpose of this aide-memoire is to elaborate on previous Treasury advice regarding the role of the company tax rate in the current tax package. The currently proposed tax package will hit companies with a range of revenue demands, with no offsetting reductions in the company tax rate. This would see the package failing – indeed acting counter to – core growth goals Ministers set for it.

Boosting growth, investment and productivity, and supporting firms, were central messages in the Prime Minister's 9 February statement to Parliament:

- “New Zealand actually has the opportunity to come out of the recent downturn in a better position than many other countries and be well placed to attract investment, build productive firms and create jobs.”
- “Overall, our economic policies are aimed at shifting the economy more towards exports and productive investment, and away from consumption and borrowing.”
- “We are of course acutely conscious that New Zealand's wealth is ultimately generated by the private sector - by the small firms, the big companies, and the sole traders who generate the jobs, the profits, and the return on investment that drives our economy. It is these businesses which will ultimately bring about the step change in the New Zealand economy.”
- “The Government agrees with the Tax Working Group that New Zealand relies heavily on the taxes most harmful to growth, particularly corporate and personal income taxes”
- “...we need a tax system that encourages saving and boosts the productivity of investments.”

The current package increases the tax burden on firms by over \$800 million per year and has the effect on average of raising average effective tax rate on companies to the equivalent of 33% on the tax base as currently defined. Treasury is concerned that the effect this will be:

- an increase in the cost of capital; and
- reduced inflows of capital by non-residents.

This will mean slower capital growth and lower productivity improvements. The incidence of some of the tax on non-residents will be borne by domestic factors, for example, by slowing future real wage growth.

Inland Revenue has raised a number of arguments against reducing the company tax rate. These are:

### **Economic Rents**

Inland Revenue indicates that much foreign investment is location-specific economic rents, and we can tax these profits at little economic cost. If they are pure rents the incidence of the tax may be borne by the non-resident shareholders, and taxing the rents amounts to a wealth transfer from non-residents to New Zealand.

However, while some foreign investment may consist of location-specific economic rents, that clearly will not be the case for all investments and there is no reason to assume New Zealand has more sources of location-specific economic rents than any other country. Inland Revenue cites anecdotal evidence of non-resident firms earning higher average rates of return than domestic firms and cites this as evidence that they are exploiting location-specific economic rents. However, the evidence cited does not support the conclusion that location-specific economic rents are present because domestic firms should be able to exploit the rents just as readily as non-resident firms. It is more likely to be reflective of the fact that foreign multi-nationals may be able to exploit more efficiencies such as economies of scale than domestic firms. Many foreign multi-nationals may be earning firm-specific economic rents, but unlike location-specific economic rents, there is an economic cost to taxing these.

Despite the fact that many multi-national firms earn above marginal returns on their cross-border investments, most countries still strive to reduce their company tax rates in order to attract the investment. International studies show a strong correlation with lower effective company tax rates, higher foreign investment, and improved economic performance.

### **Allowing depreciation for industrial buildings will be more effective for attracting investment than reducing the company tax rate**

This argument is hard to reconcile with the prior: that foreign firms earn large amounts of location-specific economic rents, and therefore there is little benefit to reducing the tax on them. Inland Revenue argue that removing depreciation on industrial buildings is likely to discourage investment in capital-intensive industries.

The removal of building depreciation is being done in an effort to make the tax base more neutral so that there is neither over-investment nor under-investment in capital-intensive industries. There are efficiency gains to both making the tax base more neutral *and* reducing the company tax rate. We note that the proposal to remove building depreciation is carefully prescribed to apply only to buildings with a useful life of 50 years or more, so depreciation should be allowed on genuinely depreciating industrial buildings anyway.

### **Coherence and the tax rate on savings vehicles**

Inland Revenue has raised a concern that the proposal to reduce the company tax rate to 28% will increase incoherence because the proposal includes retaining the 30% top tax rate for collective savings vehicles temporarily while officials report back after the Budget on whether and how to adjust them. This issue needs to be kept in perspective:

- The 30% rate for savings vehicles proposed is only temporary while officials report back;
- It is likely to be addressed before the beginning of the next income year (1 October 2010 at the earliest); and
- There is a simple solution – reduce the tax rate on collective savings vehicles to be the same as the company tax rate (28%). This would continue the status-quo position and would cost only \$14 million per year because the only currently uncosted portion would be to reduce the top PIE rate to 28%.

### *Discussion*

Historically, collective savings vehicles have always been taxed at the company tax rate, with no clawback on distribution. Superannuation funds have been taxed as trusts (33%, reduced to 30% when the company rate fell) with no tax on distribution. Unit trusts have been taxed as companies (at 33%, then 30%) and investors have been able to access their funds by selling units to the manager for a tax-free capital gain, so they avoided the clawback that would occur if they received a dividend. One of the reasons the PIE regime has a capped tax rate at the company tax rate is to maintain consistency of the taxation of PIEs and other collective savings vehicles. The popularity and transparency of the PIE regime, however, has made this ability to earn savings income at the company tax rate more apparent and has led to calls to remove the capped tax rate. Officials have reported, however, that this is not a straightforward issue as there are other savings vehicles (unit trusts and superannuation funds) that have the same advantage and they would have to be addressed too if there was to be a serious effort to remove the ability of individuals to earn savings income at the company tax rate.

The company tax report proposes that if the company tax rate is reduced to 28%, the taxation of collective savings vehicles (PIEs, superannuation funds, and life insurance policyholder income) remain at 30% while officials consider the issue. However, the tax rate of unit trusts will automatically fall to 28% as they are deemed to be companies for tax purposes, and Category A GIFs (a minor savings vehicle) will also fall to 28% for technical reasons relating to imputation. This is meant to be a temporary position and officials will report back after the budget. The reduction of the company tax rate would apply from the 2011/12 income year which would begin, at the earliest, from 1 October 2010, so there is time to address this before the new rate comes into effect.

While Treasury needs to discuss the matter with Inland Revenue and report back jointly, offhand we consider that it would be difficult to effectively tax savings income at the personal tax rate, as that would involve increasing the tax rate that currently applies to PIEs, superannuation funds, life insurance policyholder income, and unit trusts, plus designing surtaxes or other measures to address saving in other savings vehicles. Note that this would be the case **regardless** of whether the company tax rate is reduced to 28% or remains at 30%.

The simpler and more natural path would be to allow the tax rate of savings vehicles fall to match the company tax rate. This is already incorporated into the costing for a company tax reduction as it would apply to unit trusts (since they are deemed to be companies for tax purposes) and also for superannuation funds and life insurance policyholder income. The cost of allowing this for PIEs would be modest (approximately \$14 million per year). This would maintain the “incoherence” of savings income earned directly by individuals being taxed at a higher rate than if earned

through a collective vehicle, and this “incoherence” would be maintained **regardless** of whether the company tax rate is reduced to 28% or remains at 30%.

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