THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Where to From Here for Tax Reform?

Date:	18 December 2009	**Report No:**	T2009/2714

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Identify** what further advice you would like on tax reform arising from this report **Refer** this report to the Prime Minister, the Associate Ministers of Finance and the Minister of Revenue	22 January 2010 23 December 2009

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Bill Moran	Manager, Tax Strategy	[withheld – privacy]	[withheld – privacy]	✓
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Minister of Finance's Office Actions (if required)

None.

Enclosure: **No**

Treasury Report: Where to From Here for Tax Reform?

Executive Summary

Over the last year, the Treasury has contributed to the ground-breaking public review of the tax system by the Tax Working Group, which has included the contestable analysis of issues and options for reform, and the Group's considered advice on how to maximise the tax system's contribution to faster economic growth.

Their work and our own analysis have led us to some firm conclusions about how best to change the tax system to maximise growth.

Our strong preference on the direction of tax reform is informed by the growing international literature and evidence on minimising the collection of taxes that have the most negative effects on growth. These are taxes on the incomes of corporates and individuals. We suggest that the corporate tax rate and the top personal tax should be reduced, with greater reductions in corporate tax rates than personal tax rates.

There are now good theoretical reasons to reduce taxes on corporates, and considerable evidence that this is now how countries are designing their tax systems. Headline corporate rates are now well below New Zealand's in many OECD countries.

The tax system can also tilt incentives towards higher rates of savings which in the longer term will permit higher growth without increasing our external vulnerability.

There is a strong case for reducing and removing the distortions in how we tax capital and capital gains.

Other aspects of corporate tax, like depreciation and thin capitalisation rules, would benefit from a stricter application of economic principles to their design and implementation.

There are also very good grounds to set the top personal rate as low as is feasible, and minimise as far as practicable the gap between corporate rates and the top individual rate and trustee rate.

There are also good reasons to reduce the dependence on income taxes and broaden the bases that we tax to include property.

For tax design principles and to counterbalance some of the revenue losses of reductions in individual taxes, we suggest increasing GST. This may require compensation for lower income individuals, but even if net revenue gains are not great, we would still support a GST increase to encourage more savings and less consumption.

We have moved away from supporting an aligned system. Although there are strong integrity and administrative benefits of alignment, we've been persuaded that the environment in which we now find ourselves leads to the conclusion that lower non-aligned rates would give us a better economic return.

Our initial preference is for a 33/33/27 system as a starting point, with the shifts designed as set out above. GST could be set at 15%.

There are equity considerations that Ministers must bring to bear in making decisions. We have tried to reflect on these as well. Our preference is to design measures that improve the perceived overall fairness of the system; we need the system to be perceived to be fair and durable, because the tax system is one of our most important institutions. Some equity measures might be better implemented in other areas of government spending. It is not clear that the present tax and welfare systems are optimal from a fairness perspective.

We are proposing first steps in a path away from our previous preference for an aligned system. Although the direction is clear enough, there are some fundamental system choices and important design issues to be worked through before we can propose an endpoint. There is strong logic leading to a system that taxes capital and labour differently – the dual or "Nordic" approach- rather than one that taxes corporates and individuals differently as New Zealand's system does now. But there are no free lunches; the transition, administrative and equity issues are not straightforward as the Nordic countries have found. The major consideration is that individuals with the same income would face different tax burdens, depending on whether that income was essentially "labour income" or "capital income". There would need to be broad community support for that idea.

The findings of the Tax Working Group's review of the tax system will be published in January 2010. There may well be further insights that should be taken into account in developing a potential tax package for Budget 2010. Similarly, the recommendations of the Henry Review for reform of the Australian tax system are likely to have implications for New Zealand tax reform, and will need to be considered as well. The tax-specific recommendations of the Capital Markets Development taskforce and the 2025 taskforce should not be overlooked either.

Recommended Action

We recommend that you:

a **note** that Treasury is less committed to rate alignment as a central goal of tax reform and has a stronger view that rate alignment, if achieved, probably would not be sustainable over the medium term, due to differing pressures on corporate and top personal tax rates;

b **note** that Treasury has a stronger view that pressure to reduce corporate tax rates will build sooner rather than later and that stronger integrity measures should form part of any tax reform package;

c **note** that Treasury has a stronger interest in exploring the merits of moving in the longer term to a dual tax scale with different rates for labour and capital income for growth and efficiency and integrity reasons;

d **note** that Treasury's preference is for an initial 33/33/27 tax reform package in Budget 2010, with supporting moves in base broadening, GST, and changes to the treatment of depreciation and thin capitalisation rules;

e **note** that the Tax Working Group will be publishing a report of its findings of the tax system in January 2010 and our preference for tax reform should be considered alongside the Group's findings and other reviews with implications for the tax system, including the Capital Markets Development taskforce, the 2025 taskforce and the Henry Review;

f **identify** what further advice you would like us to provide on tax reform and Working for Families issues arising from this report;

g **note** the summary at annex A provides a suggested agenda for discussion of tax reform options; and

h **refer** this report to the Prime Minister, the Associate Ministers of Finance and the Minister of Revenue.

Agree/disagree.

Bill Moran
Manager, Tax Strategy
for Secretary to the Treasury

Hon Bill English
Minister of Finance

Treasury Report: Where to From Here for Tax Reform?

Purpose of Report

1. The purpose of this report is to outline key insights Treasury has taken from the 2009 tax debate, including the tax conferences, the Tax Working Group, the Capital Markets Development taskforce, the 2025 Taskforce and the Henry Review. We outline potential Budget 2010 reform packages that are informed by those insights.

Structure of Report

2. The overview focuses on key motivations for tax reform, and an overview of our thinking now versus 12 months ago. We then discuss the rationale for reform and some of the evidence for the effect of taxes on growth.

3. The paper then turns to policy choices. We assume any package will be broadly fiscally neutral. Therefore we initially focus on the most challenging aspect of a fiscally neutral package – revenue raising options.

4. As aligning the top personal, trust and company tax rates is current government policy we then spend some time on the merits of alignment versus other approaches.

5. We also touch on the potential for reforming Working for Families and the need to deal with existing weaknesses in the system irrespective of choices regarding the ambition of a reform package.

6. Lastly, we focus on the 2010 budget, including a suggested approach to a 2010 budget package, made up of a mix of more immediate and longer-term reforms.

7. This report takes spending levels as given; you have received other advice on the important issue of the role of expenditure control in reducing current and future tax burdens.

Overview

8. The purpose of any tax reform is ensure that the collection of revenue is done in an efficient, equitable and sustainable manner, consistent with the policy priorities of the government. Tax reform is not an end in itself, but as tax has pervasive effects on behaviours and prices across the economy, tax reform can make a significant contribution to government strategic objectives (and conversely not aligning the tax system with government objectives will make those objectives harder to achieve). In particular tax reform can contribute significantly to the government's productivity and growth priorities by reducing the deleterious effects of tax on the day to day decision-making of investors, savers, workers, those contemplating work options or migration options, and those in education and training.

9. Over the last 12 months we have provided a great deal of reporting and briefing on tax design issues. This report is not intended to revisit that work. Its key aim is to outline how Treasury's thinking has evolved over that period. Compared to 12 months ago we:

   - Now think the tax system is more broken than we thought, and see the pressures for reform as more pressing, rather than a medium-term prospect;

- Have stronger concerns that the current system is more damaging than it needs to be;
- Have a stronger view that the system needs greater designed-in flexibility to respond to differing pressures for rate reductions or revenue increases over time;
- Are less committed to rate alignment as a central goal;
- Have a stronger view that rate alignment, if achieved, probably would not be sustainable over the medium term, due to differing pressures on corporate and top personal tax rates;
- Have a stronger view that pressure to reduce corporate tax rates will build sooner rather than later;
- Have a clear view that stronger integrity measures (reducing tax-driven recharacterisation of income between entities, people and taxable/non-taxable income types) should form part of any tax reform package;
- Have a stronger interest of exploring the merits of moving in the longer term to a dual tax scale (different tax rates for labour and capital income) as an efficiency and potential integrity measure;
- Have reaffirmed that measures that reduce the effect of tax on capital allocation decisions (e.g. base-broadening including more consistent capital gains taxation, appropriate depreciation rates) are good in themselves, as well as helping fund tax rate reductions;
- If durability requires a higher top tax rate, have become more relaxed about the its level, but only if the threshold can be pushed out to the multiple of average wages typical in many other OECD countries (perhaps north of $150,000);
- Have become more concerned that taxing nominal (as opposed to real) returns may damage our savings and investment patterns by more than previously thought;
- Continue to see a shift away from income taxes towards GST as desirable, while being concerned that a GST increase would prove counter-productive if it broke the broad national consensus around a comprehensive GST base; and
- Continue to see some form of land tax as desirable from an efficiency viewpoint, which would shift the burden of New Zealand tax revenue-raising towards less mobile tax bases, while recognising transitional and distributional difficulties.

Rationale for Reform

Personal and corporate income tax rates

10. It is generally known that corporate income tax rates have been falling around the world in the last 20 to 30 years. It is less well appreciated that top rates of personal income tax have also been falling. For example, evidence from a sample of 'high income' (predominantly OECD) countries shows that whereas the weighted average top marginal rate of personal income tax was 58.0% in 1981-85, it had fallen to 42.7% in 1991-95 and 38.9% by 2001-05 (Peter, Buttrick and Duncan, 2007). This is likely to reflect in part the increasing awareness of the disincentive effects that high personal rates have on labour market participation, acquiring training and earning higher taxable incomes. The increasing international mobility of highly skilled labour may also have played a role.

11. New Zealand's top personal rate, as with its corporate rate, has often been ahead of the international trend, falling from 66% in 1986 to 33% in 1990. However it rose to 39% in 2000 before being reduced to 38% in 2009 cutting in a comparatively low level. As a country with one of the most internationally mobile labour forces in the OECD, especially for skilled labour, New Zealand has to be especially aware of how highly it taxes its labour force. And with effectively a single labour market with Australia, both countries' tax treatment of earnings is important for potential migrants net-of-tax income comparisons. Largely because of Australia's tax-free zone at low income

levels, Australia typically takes a smaller amount of income in personal income tax than New Zealand does, at all income levels up to around $200,000.

Taxes, savings and growth

12. In addition to the downward international trend in personal and corporate income tax rates, evidence increasingly supports the view that higher levels of both corporate and personal income tax rates are especially harmful for economic growth (OECD, 2008). Since faster growth can arise from both investment and higher productivity, the evidence from OECD countries that high corporate rates discourage both investment and productivity improvements further supports the case for lower corporate tax rates (Arnold, 2009). In addition international and New Zealand evidence points to the ease with which higher income taxpayers can avoid high top marginal income tax rates with adverse effects on measured income levels and tax system integrity.

13. Recent evidence shows that the downward trend in corporate tax rates is associated with the increasing openness of many economies via globalisation, with investment and companies becoming more sensitive to international differences in business costs including taxation levels (Devereux, Lockwood, and Redoano, 2008). Whereas effective marginal rates of company tax affect decisions to expand domestic investment, the *average* rate is increasingly important for corporate decisions around where to locate their investment, and the *statutory* rate affects where they declare their profits (e.g. the incentive for 'profit shifting' via transfer pricing or where companies allocate their debt etc).

14. At a macro level, New Zealand finances its investment through a mixture of domestic savings and fairly heavy reliance on foreign borrowing. Though the level of New Zealand's domestic savings, and how it is determined, continue to be the subject of debate, there are good reasons to encourage increases in domestic savings rates. For example, where increased foreign borrowing stimulates higher domestic interest rates, economic growth can be adversely affected.

15. The main difference between the share of tax revenue collected from income taxes in New Zealand and other OECD countries is that other OECD countries collect more of their revenue using social security taxes which tax only labour income (and exclude interest income, for example). This will tend to discourage savings in New Zealand relative to other OECD countries.

16. This evidence suggests a reform package involving a switch away from personal and corporate income taxes and towards greater use of broad-based consumption taxes such as GST. International evidence also provides a strong case supporting lower income tax levels (without necessarily raising GST) as a growth-enhancing policy. However, in the current environment broadly revenue-neutral tax changes may be required to avoid growth of fiscal indebtedness, unless major reductions in public expenditure are envisaged.

17. Other features of our reform advice include:

- In the absence of New Zealand initiating a reduction in its corporate tax rate, future changes are likely to be shaped by international developments. In particular we should be willing to at least match any Australian rate reductions;
- The Henry review's likely advice to reduce corporate tax rates is a response to the long-run global decline in statutory company tax rates, so although timing and magnitude of an Australian response are unclear, the long run direction is clear;
- Top personal tax rates should be reduced to the 30-33% range and cuts to lower personal tax rates made to the extent that revenue-positive measures allow;
- Reducing top personal and company rates should be the focus of tax cuts without necessarily aligning top personal and trust rates with the corporate rate;

- In this case, integrity measures should feature strongly; e.g., it would be best to align the top personal tax rate and the trust rate;
- The revenue-positive elements could include some or all of a GST increase, land tax, and broadening the income tax base; and
- Initial steps are consistent with both the two likely longer term outcomes – either retaining a non-aligned system (company tax rate lower than top personal tax rate) or moving to something like a dual tax system (a flat rate of tax on capital income alongside a progressive tax scale for labour income) – enabling progress to be made without waiting for perfect clarity of the desired end-state.

18. The revenue-positive elements will drive the ambition and timing of any reforms. With any fiscally neutral package the phasing and scale of any reforms will be driven by the timing and magnitude of the revenues from the revenue-positive elements of the package.

Finding More Revenue to Fund Tax Cuts

19. There is no perfect tax, or tax system. Getting the right mix of taxation is about balancing five key, sometimes opposing, objectives:

    - *Efficiency and growth* - taxes that distort decisions, and the economy's growth potential, as little as possible;
    - *Equity* - tax burdens that reflect social expectations of horizontal and vertical equity (fairness);
    - *Fiscal integrity* - minimising the extent to which people alter their structuring and reporting of income for tax reasons;
    - *Compliance & administration* - citizens understand their rights and obligations; IRD and compliance costs are as low as possible; and
    - *Revenue* – raising enough money to fund government spending.

20. The current system functions better than that of many other countries. Nonetheless the reasons the current system fails against these objectives can largely be traced to three deliberate tax design choices:

    - A heavy reliance on personal and corporate income taxes, which the OECD and others assess as particularly damaging to growth (the tax mix);
    - Taxable income excludes significant economic income, including most capital gains, raising significant fairness and efficiency issues (the income tax base); and
    - The move away from the old 'aligned' standard 33% top personal, trust and company rate has been accompanied by insufficiently robust integrity and enforcement measures. This has undermined at least four and perhaps five objectives (the marginal objective being *revenue* – it raised more revenue, but with significant leakage).

21. Although debate tends to focus on the first two issues, the work this year has underlined the importance of the last point. Any principles-based tax policy, whether involving alignment or non-alignment, will be built on sand unless it addresses the coherence and integrity problems that afflict the current system. Restated, the current system of rates and bases does not need to be as damaging as it currently is.

22. In addition, Treasury has identified two issues as more being potentially more significant than we considered 12 months ago:

    - Depreciation: our depreciation regime may not be not meeting its policy goal of applying economic depreciation rates (with a 20% loading for most assets). The tax depreciation rates may be significantly higher than current policy would

require. If confirmed, this has a high fiscal cost and skews investment allocation in the economy in a way likely to reduce economic performance.

- Taxing nominal returns: income tax is applied to nominal, not real returns. Although long identified as a weakness, few countries have moved to tax real returns, and reforms in this direction in other countries have struggled, due to the complexity and fiscal cost.

23. Moving to tax real returns would reduce tax distortions on savings, investment and borrowing, and could be accompanied by the indexation of personal tax thresholds, which would reduce the effects of fiscal drag on taxpayers. The expected net effect would be higher net savings and a less distorted pattern of savings and investment. The revenue consequences of such a change are unclear at this stage, and could be revenue-positive or revenue negative overall as reduced tax revenue from lenders (based on real interest income) will be partially or entirely offset by increased tax revenue from borrowers (whose tax deductions based on real interest rates will be less). We think moving to tax real returns deserves further consideration, however this would be a complex reform that would require careful research and implementation to determine the desirability and practicality of applying it in the New Zealand context. We recommend more work on this issue over a longer time frame (other options discussed elsewhere also preferentially reduce taxes on savings, for instance a income tax-GST switch, or a dual tax system).

24. We understand the primary focus of any tax reform programme will be to boost NZ productivity, subject to not breaching Government distributional objectives. Therefore any efficiency-enhancing reform package must necessarily be guided by the rule that the gains from reducing tax in one place exceed the cost of imposing higher taxes elsewhere. Potential sources of relatively low-cost extra tax revenue include:

- Broadening the income tax base (including taxing capital gains more comprehensively);
- Income tax base maintenance measures;
- Increasing the rate of GST; and
- Introducing a new more efficient tax, of which a land tax is the most efficient.

Income tax initiatives

25. Officials recently reported on the potential revenues and revenue phasing of a range of base broadening and base maintenance measures (T2009/2514 refers). We have yet to discuss these options in detail with Ministers. From a tax policy perspective an ambitious base-broadening package could include some or all of:

- more consistently subjecting capital gains to tax;
- removing the 20% depreciation loading;
- removing depreciation on buildings for buildings that don't depreciate; and
- reducing the thin-capitalisation threshold for foreign-owned companies from 75% to 60%.

26. This would represent a coherent reform package. Broadening the taxation of capital gains would reduce a significant tax bias in the current tax system. We would recommend a general broadening to capture property, shares and intellectual property. Although the primary goal is to improve the allocation of capital in the economy, this would help address concerns regarding tax-subsidised property investment in particular.

27. We see other options to this end, such as loss ring-fencing and RFRM as currently proposed, as significantly inferior. If a mechanism such as RFRM is introduced we

consider it (or a similar accruals-based tax) should be used as a withholding tax against the final calculation of tax liability on sale. This would ground RFRM within current tax design principles, and would be better than a realisation-based system alone. Pulling forward the tax cash flows via an accruals mechanism would also enable earlier, larger tax rate reductions than would otherwise be the case.

28. However, any accrual tax, including RFRM, will face taxpayer resistance as it places regular cash flow demands on taxpayers that are not reflected in the cash flows of the underlying investment. This resistance may not be insurmountable, for instance local body rates are charged annually and any accrued withholding tax on capital gains would likely be of a lesser magnitude than current rates bills. These cashflow issues lead us to recommend, at a minimum, a realisation-based taxation of capital gains, with an accruals component also being worth consideration.

29. Regarding the family home, the NZ evidence is that taxing capital gains is actually regressive if the family home is included, becoming significantly progressive if the family home is excluded. In addition US evidence (discussed by Len Burman during his visit) suggests that while lock-in problems from taxing capital gains are generally minor, the exception is the family home, where tax can materially influence decisions to sell. Exempting the family home is the most straight forward solution to these issues. If there were concerns that exempting the home excessively advantaged high income households the exemption could be capped. We can report further on options to cap the exemption if you wish.

30. While NZ already taxes capital gains in a number of areas (e.g. in many land transactions, dealing in shares), the approach is inconsistent and uncoordinated, resulting in the same form of income being taxed in different ways, at different rates, or not at all. Our broad arguments around a more consistent tax treatment can be generalised on three fronts:

- *For improved efficiency.* A good tax system attempts to minimise the impact of tax on economic decisions (e.g. saving, investing, consuming, working). Taxing all forms of income in a similar manner is critical to ensuring decisions are made on the basis of underlying economic merits, rather than because of tax preferences. Not taxing capital gains does three things:
  - It artificially encourages investment in assets producing capital returns by making these investments relatively more attractive (for tax reasons only).
  - It biases the choice of one business vehicle over another.
  - It acts as a disincentive for entrepreneurship and innovation.

- *For revenue base integrity and sustainability.* Allied to the efficiency point above, a more comprehensive tax treatment helps prevent erosion of the tax base (e.g. through re-characterisation of income);

- *For improved equity.* By not taxing capital gains, a person with fully-taxed income (e.g. wages/salary) will be taxed more heavily than a person that has some capital income, even though they may have the same means. Not taxing the capital income of wealthy individuals also reduces the progressivity of the tax system.

31. The removal of the depreciation loading and removal of depreciation on buildings that don't depreciate would result in tax depreciation rates that are better aligned with economic depreciation rates, helping reduce tax-induced distortions in investment. Combining a broader taxation of capital gains with removing the depreciation on buildings that don't depreciate would also provide an automatic mechanism for any loss on sale of a building to be recognised as a capital loss, so addressing any concerns that might arise from denying loses on sale to building owners, who will sometimes make real losses.

32. In addition, work Treasury commissioned by Jack Mintz, an internationally respected tax economist, suggests that our base rates of depreciation may be significantly higher than is required to deliver the current (desirable) policy goal of economic tax depreciation rates. If this result is confirmed, further reductions in tax depreciation rates, with attendant fiscal savings, may be possible without changing the policy aim of setting tax depreciation rates to reflect economic depreciation.

33. We would see these reforms as scoring well on efficiency and growth, equity, fiscal integrity and revenue grounds. The conclusion on compliance and administration is more mixed – broadening the tax base simplifies some elements of compliance and administration, but also introduces new transactions to the tax system, increasing compliance costs for those taxpayers.

34. There are choices around the implementation and phasing-in of changes to capital gains taxation and depreciation rates. Broadly, these options trade-off the extent to which rules are changed on assets taxpayers already own against the immediacy of the fiscal benefit. In the case of some taxpayers, such as property trusts, decisions regarding the phasing of changes to depreciation will worsen their tax and commercial positions.

35. Thin capitalisation rules apply to foreign-controlled entities in New Zealand. They limit the scope for excessive debt deductions in NZ. There are special rules for foreign-controlled banks. The rules allow interest deductions on debt representing up to 75% of the value of the assets of the NZ entity (or above 75% if the debt percentage of the New Zealand group does not exceed 110% of the worldwide group's debt percentage).

36. The 75% thin capitalisation safe harbour is arbitrary and is based on judgement and compromise. Commercial levels of debt vary between companies and sectors but commercial debt contracts tend to impose on New Zealand borrowers a much lower debt-to-tangible asset ratio. This, coupled with the recent credit crisis, may suggest that the current 75% threshold is generous. Reducing this to 60% would better align with commercial debt/equity ratios, and bring in revenue. This change would not apply to trading banks, to which separate thin capitalisation rules apply.

GST

37. GST currently imposes relatively low economic costs. Therefore the total cost of the tax system could be reduced if GST were increased and income taxes reduced. Due to its comprehensive coverage and roughly equal burden across the income range, it also scores well (better than most think) on equity measures. As David Lange once said, even the drug dealers pay it.

38. If an increase of the GST rate to 15% is matched by benefit and superannuation increases, aimed at maintaining the real value of transfer payments, about 87% of the increased GST revenues will be available for further discretionary tax cuts. If, in addition, compensating income tax reductions are made for incomes below $48,000, about 85% of the increased GST revenues will be committed to compensating measures so the shape of the GST-income tax swap largely determines itself if full

compensation applies. We would recommend focussing the package to the greatest extent possible on growth rather than distributive goals. A growth focus would imply smaller reductions at low incomes and greater reductions for full-time workers. However, even if a GST-income tax swap trades off some potential growth benefits for distributive goals we would still support such a swap, which would help rebalance the tax mix away from income taxes and towards consumption taxes, thereby improving savings incentives.

39. Our largest concern with increasing GST is the risk that increasing the rate will rekindle the largely settled national debate about whether GST should apply to staples such as food, power and rates. We would strongly advise against increasing the GST rate if doing so required reducing its base. Reducing the GST base would greatly weaken the policy rationale for increasing the rate. Exempting some items would make GST more distorting, and reduce or eliminate the revenues available for income tax reductions.

40. Therefore, we would recommend increasing GST to the extent it is possible to do so without disturbing the broad public acceptance of a comprehensive GST base.

41. We see an income GST-income tax swap as scoring well on efficiency and growth, fiscal integrity, revenue, and compliance and administration grounds. The conclusion on equity is less definitive, but (contrary to public perceptions) in aggregate a GST increase does not worsen equity, and by capturing income that avoids the income tax system it improves some measures of equity.

Land Tax

42. Land taxes are usually considered the least-damaging real-world tax because the imposition of the tax does not alter the supply of land, only its price. Therefore from an economic efficiency perspective, land taxes are very attractive. In addition the Mintz report noted that at present land is relatively lightly taxed *"With a positive inflation rate, land is always taxed the lowest among other types of assets. This is because the sole cost of holding land is the leveraged financing cost; the interest deductions, unadjusted for inflation, provide a significant tax subsidy for holding leveraged assets."* (Mintz then goes on to note that taxing real rather than nominal income would remove the current tax subsidy of land).

43. However, as land taxes reduce land prices, land taxes can impose large windfall losses on existing holders of land. Although in aggregate land holdings are roughly proportional to income, individual circumstances vary greatly. This creates significant transitional issues, including difficulties for taxpayers with relatively high land holdings for their income (including retirees, farmers and investors in real property) or relatively low equity stakes in their land (owners of highly geared properties). There will also be implications for Maori land, including land transferred to Maori as part of Treaty settlements.

44. We see land tax as scoring well on efficiency and growth, fiscal integrity, revenue, and compliance and administration grounds. Land taxes score less well on equity due to the transitional losses to land owners and the highly varied relationship between income and land holdings, and the inequity implicit in taxing only one form of wealth. A land tax on increments in value after a certain introduction date could ameliorate these issues.

45. Although these distributional effects are not unique to land taxes (many tax changes create windfall winners and losers, for instance a GST increase penalises existing wealth) a land tax has the potential to impose large costs on large groups of taxpayers. Therefore we consider a land tax, if introduced, would need careful consideration of the transitional issues.

Corrective Taxes

46. As we focus on revenue taxes we have not included potential extra revenues from corrective taxes such as excises and environment taxes.

What is Achievable?

47. An ambitious 2010 package featuring the following reforms could raise significant revenues in 2011/12 and beyond.

Table 1: Revenues (in $m) on an indicative 2010 package (from T2009/2514)[1]

Revenue Measure	2010/11 $m	2011/12 $m	2012/13 $m	2013/14 $m	2014/15 $m	Steady State $m
Tax capital gains on realisation, excluding family home	$0	$29	$172	$501	$738	$5,543
Remove 20% depreciation loading	$62	$428	$550	$612	$637	$637
Remove depreciation for buildings, 5 year phase in (& losses on sale disallowed)	$62	$498	$760	$1,034	$1,326	$1,326
Reduce thin cap threshold of 60%	$44	$177	$177	$177	$177	$177
Land tax at 0.25%	$0	$228	$910	$910	$910	$910
Increase GST to 15% (net of compensating NZS and benefits only)	$0	$530	$2,200	$2,305	$2,405	$2,405

48. These revenues could finance significant reform packages. Revenues of around $2 billion are needed to fund a shift to 30-30-30 or to 33-33-25. More ambitious reforms would require more extra revenue. These costs are best-case as they assume no change to the 12.5% and 21% rates and thresholds.

Table 2: Fiscal cost, in millions, of different packages of personal, trust and company rates[2]

Top Personal and Trust Tax Rate	Company Tax Rate		
	30%	27%	25%
38%, trust 33%	$0	$600	$1,000
33%	$800	$1,400	$1,800
30%	$2,000	$2,500	$2,900
27%	n/a	$3,700	$4,100
25%	n/a	n/a	$4,900

1 Assumes 1 April 2011 implementation. Note revenues from some reforms influence revenues from other reforms so the figures cannot be simply added together, eg removing depreciation for buildings will reduce capital gains revenues. The revenue estimates shown here ignore such interdependencies. All revenues figures are nominal and, other than CGT, do not assume any form of grandparenting.

2 Also indicative figures are shown for 2011/12 March year, assuming 1 April 2011 implementation. The figures exclude second round effects.

Should Alignment Remain an Objective?

49. A key strategic choice is whether to align the top personal, trust and company tax rates. Alignment deals with many (but not all) of the integrity problems of the current system. Alignment at a maximum rate of 30/30/30 is United Future policy and a medium-term goal of the confidence and supply agreement between the National Party and Act. Alignment has been a consistent theme of Treasury and IRD tax policy advice for many years, and IRD continue to push strongly for alignment.

50. However this year Treasury's thinking on this issue has evolved along these lines:

- Alignment's many attractions have previously made it our default position;
- Packages resulting in alignment at 30-30-30 are fiscally achievable;
- Australia's company rate is currently 30%; however the Henry review is hinting at a company tax rate of 25-27%;
- The Australian move is a response to the long-run global decline in statutory company tax rates, so although timing and magnitude of an Australian response are unclear the long run direction is clear;
- Although there are strong arguments to keep our tax rates on labour relatively low (labour force participation, skills acquisition, internationally mobile labour force), company and personal tax rates face different pressures;
- At present our gap between personal and company tax rates, at 8 cents, is low by OECD standards (6th-lowest of 20 countries analysed by Mintz);
- We probably have more to lose than gain by having a company tax rate greater than Australia's;
- Therefore we should consider matching the Australian corporate tax rate, even if doing so results in a non-aligned regime (alignment at 25%-27% requiring much more ambitious reform than achieving a company tax rate at that level);
- Therefore the system should be designed to cope with non-alignment, even if alignment is achieved in the short-term;
- Further, for the same fiscal cost of 30-30-30, a better fit with the longer-term shape of the tax system would be to move straight to a package such as a 27% corporate tax rate and, say, a 33% top personal and trust rate;
- If we accept non-alignment as a permanent feature of the tax system, we need to determine if the best long-term answer is to simply have a lower corporate tax rate, or to move to a full dual tax system.

51. The key judgement is a view that alignment is not sustainable in the medium term, as the company and personal tax rates have markedly different pressures and dynamics driving them. If this is accepted, the rest naturally follows.

52. Part of the attraction of alignment is because the move away from the old standard 33% top personal, trust and company rate has not been accompanied by sufficiently robust integrity and enforcement measures. A system designed to work with one tax rate for higher-income taxpayers and companies now works with many. Different tax rates can apply to the same economic income when it is earned via different entities. Personal taxes, partnerships, PIEs, trusts, LAQCs, QCs and companies provide taxpayers with a range of choices with different tax rates and different levels of integration with their other tax affairs and with social assistance targeting, such as

Working for Families and student assistance. This has created unnecessary complexity, reduced efficiency, undermined fairness and, unless addressed, means the system does not deliver the flexibility to deal with future funding pressures and international developments (such as lower company tax rates).

53. Any principles-based tax reform, including simply retaining the current rates and bases, will be compromised unless it addresses the coherence and integrity problems that afflict the current system.

54. There are three broad options to address these integrity problems:

- Rate alignment- simply align as many rates as possible, say 30-30-30.
- Improved integration- better attribute all income to the taxpayer, so any incorrect taxation in the entity is relatively quickly rectified by attributing the taxable income to its owner.
- Clearer, more robust boundaries- for instance between widely held companies and companies that are taxpayer alter-egos, or between labour and capital income (e.g., a dual tax system).

55. Therefore if the government moves away from alignment as a medium-term goal, any reform package will need to contain measures to improve integration and provide clearer more robust boundaries to help address the problems caused by non-alignment. We discuss these integrity issues later in this report.

56. Simpler rate structures, such as a fewer number of tax rates, a flatter personal tax rate structure, and aligned taxes across different entities, also help integrity and tax administration and simplification initiatives, as mismatches between withholding taxes and correct final personal tax liabilities largely stem from the progressive scale of tax rates.

57. Lastly, non-alignment gives greater scope to make efficiency-improving reforms without increasing the average tax rates on savings and investment. Most of the base-broadening measures target capital (e.g. capital gains, depreciation, thin capitalisation). Rate alignment distributes the benefits of that broadening across all taxpayers through lower rates, implicitly increasing tax rates on capital. This is undesirable, given our focus on improving savings and investment. If rates remain non-aligned, increased revenues from the broader capital tax base can be better targeted to reducing tax rates on capital. This is more desirable.

How about quasi-alignment (aligning the second from top rate at the company rate)?

58. Another option that has been suggested is to align the second-from-top rate (the current 33% rate) with the company tax rate. This has attractions if fiscally affordable, but raises much the same fiscal issues as aligning the top tax rate. If the threshold for the top tax rate is extended to match Australia – say $150,000 or so – the fiscal cost of aligning the current 33% rate will be very close to the cost of aligning the top tax rate, as the extra revenue of a higher top tax rate above $150,000 will be minimal. If, however, the threshold is not markedly increased, the simplicity and administrative advantages of aligning the rates will be very modest, as the aligned rate will only apply over a narrow income range (currently $22,000). Also, the pressure to separate the rates in the face of continuing downward pressure on global corporate tax rates will continue.

59. Two advantages of this option over alignment are that retaining a higher top tax rate may help address concerns that excessively low top tax rates are inequitable or unsustainable, and it may be a step on the way to a more comprehensive shift to a dual tax system, with capital taxed at the aligned rate. However it would only reduce, not eliminate, the integrity problems caused by a non-alignment.

60. Despite there being strong arguments for pro-growth tax reforms that ideally reduce higher tax rate the most, and at a minimum reduce tax burdens proportionally across the income range, reforms in the last decade or so all had a strong focus on distributional outcomes. The cumulative impact has been to reduce the tax burdens on those earning between the minimum and average wage of over 35%, with much more modest gains, and eventually losses, further up the income scale. A worker on $120,000 has, since 1996, had tax reductions of less than 5%, while a taxpayer earning over $147,000 is paying more tax today than in 1996.

61. This demonstrates the difficulty successive governments have faced in reducing top tax rates. However, in a context where base-broadening measures are targeting owners of capital, it is essential to reduce the rates faced by owners of capital, in order to avoid the base broadening resulting in increases to New Zealand's average tax rates on capital. Options such as dual tax systems may be one way to achieve this.

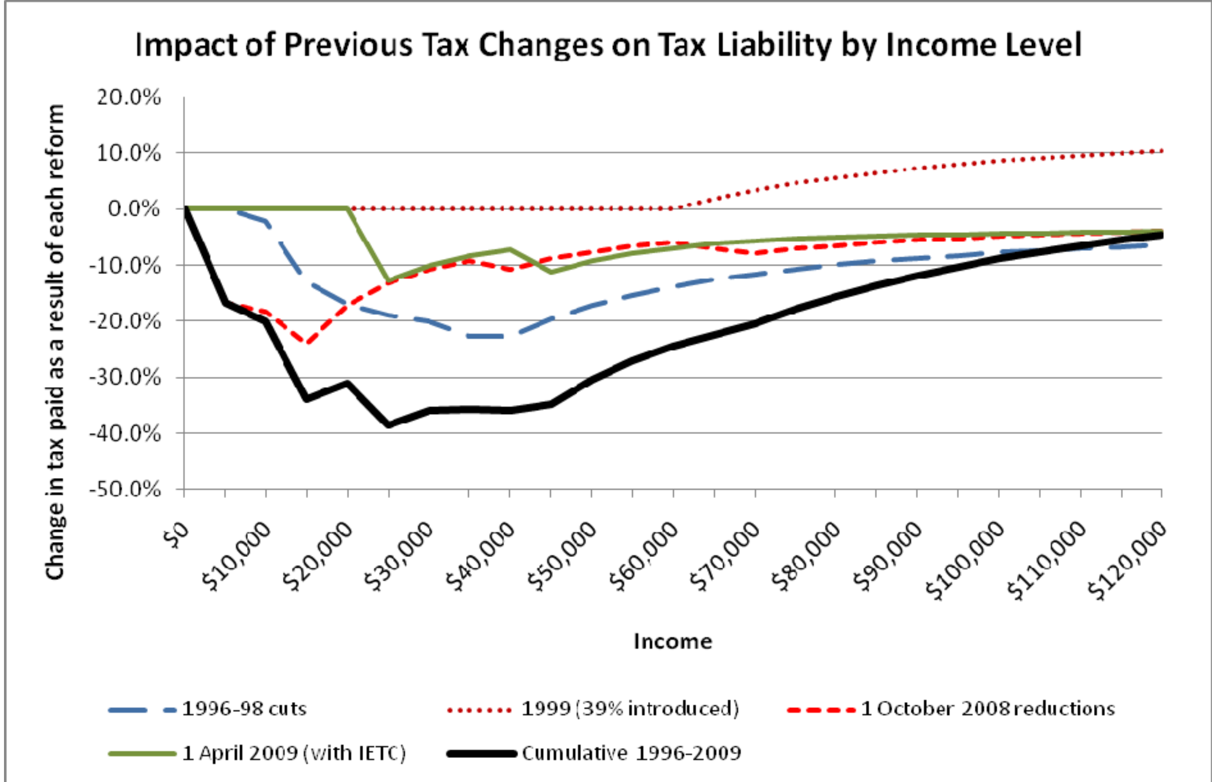


Figure 1: Impact of Previous Income Tax Cuts on Tax Liabilities

Working for Families

62. Tax rate reductions may create an opportunity for fiscally positive contemporaneous reform of Working for Families (WFF) aimed at reducing transfers to higher income and rorting households.

63. Abatement of WFF high up the income scale leads to high effective marginal tax rates for some families and therefore adverse work incentives.

64. WFF is a complicated system, with various payment amounts depending on numbers and ages of children, and work status of parents. Therefore income tax reductions alone do not automatically open the way for directly offsetting changes to WFF, given the systems differ in terms of targeting and assessment units.

65. Treasury considers a fundamental rethink of WFF, including its interaction with both the tax and benefit systems, is required to make gains in terms of a better targeted, more

work-incentive focussed regime. Without that, a series of smaller, integrated changes may be possible to make some fiscal gains over time. These include the consideration of:

- Not indexing the abatement threshold;
- Only indexing rates for those below the abatement threshold;
- Grandparenting rates such that they become independent of the age of children; and
- Alternative abatement regimes, such as increasing the abatement rate above a second threshold, or once the Family Tax Credit has fully abated.

66. Such changes should be considered in the broader context of where WFF should move to (in terms of its balance of objectives) over time, and administrative feasibility and simplicity.

Integrity Measures

67. Before the increase in the top personal tax rate to 39%, the tax system was said to be coherent and had integrity because taxpayers could not easily avoid their income being taxed at the rate that was intended to apply. No matter how income was diverted into another entity, the income was always taxed at 33% (although this rate alignment did not address the difficulties caused by the non-taxation of capital gains).

68. Since the top personal rate was increased to 39% (now 38%), the system has been said to lack integrity because income earned on behalf of an individual could be earned through a trust or company and taxed at 30% or 33%. This includes both capital income and effectively labour income of a person providing professional services.

69. Some integrity measures have been adopted, such as the personal services attribution rule, but anecdotal evidence indicates that they have had limited effect. Court decisions have illustrated that it has been difficult for IRD to use provisions such as the general anti-avoidance rule to prevent individual income from being taxed at a low rate by being diverted into other entities.

70. If we are to have a tax system which is expected to be non-aligned for a long period, then integrity measures are needed to ensure that the tax system operates as intended and is viewed as fair. However, the design of such measures depends critically on the underlying objective behind having a lower company tax rate than personal tax rate:

- If the objective is to reduce the tax rate on *non-residents*, in order to attract capital imports, then measures would be needed to prevent diversion of both capital and labour income of residents; however
- If the objective is to reduce the tax rate on *capital income* of both residents and non-residents, due to a concern that the efficiency costs of taxing capital income are higher than the efficiency costs of taxing labour income, then measures would be needed to systematically tax capital income at the capital rate and labour income at the labour rate, no matter through which entities the income may flow (the "dual" system).

71. Either approach requires very different integrity measures.

72. The first approach would require, for example:

- Taxing trust income at the personal rate;
- Taxing savings vehicles, such as PIEs at the personal rate; and/or
- Taxing capital gains from the ownership of shares, preferably on a accrual basis; and/or

- Taxing excess retentions (undistributed income) of some companies.

73. The second approach would require, for example:

- Taxing all capital income at the capital rate, no matter how earned;
- Taxing labour income at the labour rate, no matter how earned; and
- Where capital and labour income are earned together, separating the labour income from capital income by imputing a return to capital and treating the remainder as labour income.

74. The second approach, the dual approach, would require time to develop as it is a greater shift from our current approach, so initially we would be likely to recommend the first approach towards achieving integrity. However, we note that if the first approach is desired, it will effectively be impossible to ensure that all capital income earned by individuals is taxed at the individual rate unless capital gains on shares were taxed.

75. Finally, there would be some logic from an integrity perspective in raising the PIE rate (at present 30%) to the chosen top personal rate. However, that would provide perverse signals, and would not be consistent with the overall message of accelerating growth through higher savings. We will provide further advice to you on this issue in due course.

Direction of Future Tax Reform

76. Some indicative options for tax reform are outlined in Annex A. These include two aligned options, three non-aligned options, and three dual options. Based on our assessment of the trade-offs between the different options, we see the direction of tax reform as follows:

77. Retaining a non-aligned system because:

- this allows a deeper cut to the corporate tax rate than an aligned option, at less cost;
- it is more likely to endure, as it has flexibility to evolve to handle several alternative tax systems, including a response to anticipated changes in foreign tax rates;

78. Of the 3 non-aligned options, we prefer the 33-33-27 option (including changes to other personal tax rates) as a first step towards long term tax reform because:

- it is affordable and easy to do;
- it provides flexibility for future tax changes, including a move to a dual tax system (with a top labour tax rate of, say, 30% or 33 and a single capital tax rate of, say, 20%) or an aligned system at 27%, or further reductions in the company tax rate, eg to 25%;
- compliance and administration is simpler – imputation is retained, and little system change is needed for IRD or taxpayers. The gap between personal and corporate tax rates is smaller and the top personal tax rate is aligned with the trust rate.

79. In terms of revenue-raising and base broadening, a 33-33-27 option could be funded by:

- an increase in the rate of GST to 15%; this would support a change in tax mix to allow reductions to personal tax rates and hence to encourage savings; and
- the phasing out of depreciation on buildings that don't depreciate and removing accelerated depreciation loadings, which would help reduce tax-induced distortions to investment, and, changes to the thin capitalisation rules, which would limit the scope for excessive debt deductions by foreign-controlled entities in New Zealand.

80. At the same time the extension of the current taxation of capital income through the introduction of a comprehensive capital gains tax (excluding the family home) and a land tax would support a switch to non-mobile tax bases and system integrity and provide revenue for ongoing tax reform over the next 5-10 years. We are open to and relaxed about grandfathering options in order to build support for base broadening options.

2010 Budget Package

81. A potential Budget 2010 tax package could be one that takes effect from 1 October 2010 or 1 April 2011. As businesses have different balance dates, some changes could apply on an income year basis.

82. The Budget 2010 package could have the following features:

- a 5% reduction to the top personal tax rate to 33% and a 3% reduction to the corporate tax rate to 27%, which would cost $1.4 billion per annum on a steady state basis without a change to thresholds;
- an increase in GST to 15% with compensating changes to transfer payments and reductions to personal tax rates (exact shape of tax rate reductions depending on how growth, distributional, and compliance and administration objectives are balanced);
- removal of 20% depreciation loading, which would generate savings of $637 million per annum on a steady state basis;
- phasing-out of depreciation on buildings that don't depreciate (the level of savings would depend on whether losses were disallowed; if they were, this option would generate savings of $1.326 billion per annum on a steady state basis; we would expect that allowance would need to be made for "real" losses, so the actual figure could be much lower than this –possibly half of this);
- reduction of thin cap threshold to 60%, which would generate savings of $177 million per annum on a steady state basis;
- integrity measures aimed at LAQCs, QCs, PIEs and trusts;
- selected other base maintenance and base broadening measures.

83. Along with this would be the announcement of a broader package of more comprehensive reforms from a future date or dates (providing more time for more complex issues) supporting a move towards a desired end state.

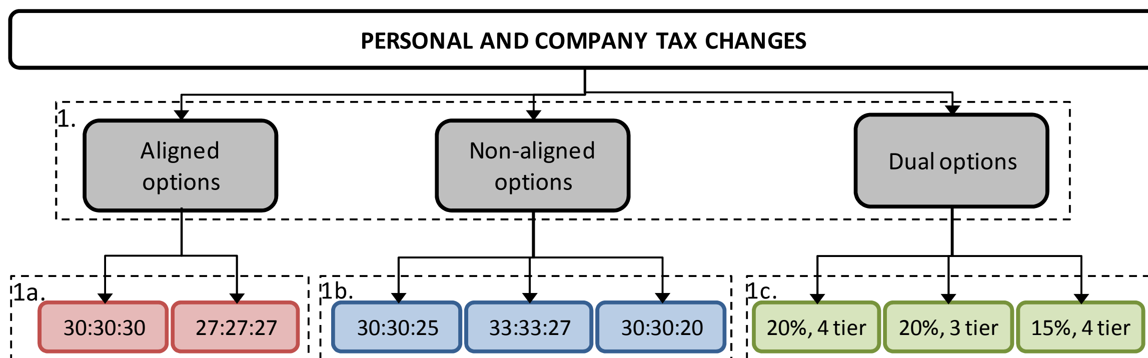
84. The package could include:

- more comprehensive taxation of capital gains (excluding the family home); and/or
- a low rate (eg, 0.25%) land tax;
- more comprehensive integrity measures;
- further lowering of personal and corporate tax rates, including a possible move to a single rate of tax on capital and the indexation of the tax system from a certain date.

85. We intend providing you with further advice before Budget 2010 on the long term direction of tax reform.

Tax Working Group

86. The Tax Working Group is due to report to you, and publically release their report, in mid-January. While the group appears to have a strong consensus that significant reform is required, the final shape of its findings is still unclear. There is some indication that the group has yet to find an agreed position on the issue of aligned versus non-aligned tax scales, and on how and the extent to which capital gains should be taxed more comprehensively.



1. Tradeoffs between alignment, non-alignment, and dual options:

- Alignment offers integrity (and horizontal equity and administration) advantages, and allows cuts to personal income tax rates. It does not enable deep cuts to the corporate tax rate, or flexibility to respond to changing international/political concerns.
- Non-alignment allows deeper cuts to the corporate rate, limited cuts to personal tax rates, and flexibility to respond to international/political concerns. It does not offer the integrity advantages of alignment (and so its impact on horizontal equity and administration costs is more limited)- and the greater the degree of non-alignment the greater the integrity problems. A non-aligned system targets the reduction of capital tax toward non-residents.
- Dual systems allow consistent taxation of capital income at a low rate, but do not reduce rates of tax on labour. They allow some flexibility to respond to changing circumstances, and have additional compliance and administration costs, requiring additional integrity measures. Dual systems allow a reduction in capital tax for both residents and non-residents.

1a. Tradeoffs within the alignment options:

- Alignment at 30% comes at a lower fiscal cost than alignment at 27%, and reduces the progressivity of the tax system less than alignment at 27%. No change to the corporate tax rate.
- Alignment at 27% provides greater cuts to individuals' EMTRs and reduces the corporate tax rate, but costs more than alignment at 30% and reduces the progressivity of the tax system further.

1b. Tradeoffs within the non-alignment options:

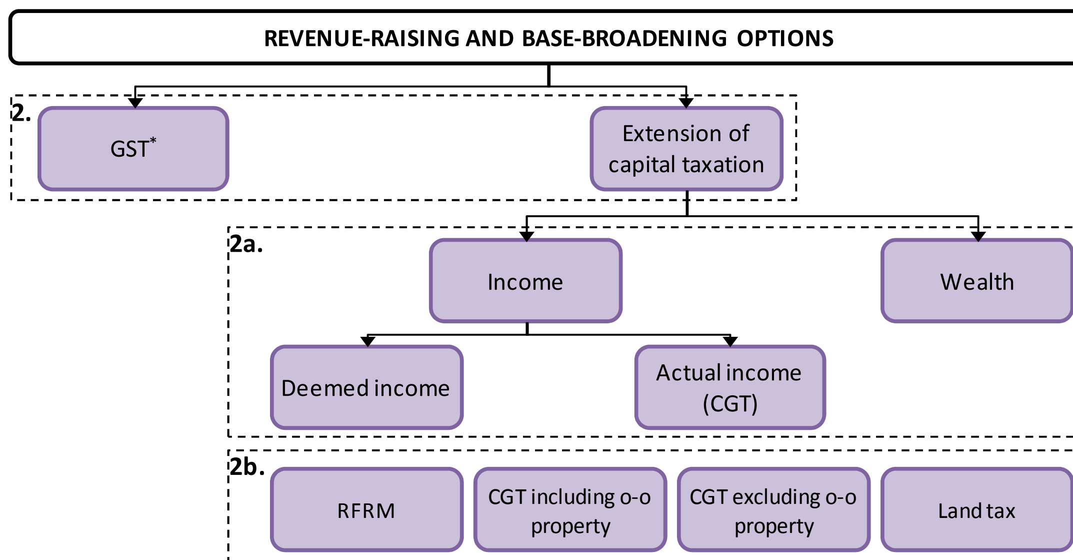
- 30:30:25 and 33:33:27 retain imputation, but allow different degrees of cuts to company and personal tax rates, at increasing fiscal cost (and decreasing progressivity of the tax system). The 33:33:27 option retains flexibility for a number of possible future changes.
- 30:30:20 removes imputation, meaning domestic investment may be double taxed. It allows a deeper cut to the company tax rate, but is more costly than the other non-aligned options.

1c. Tradeoffs within the dual options:

- 20% and a 4-tier rate, when compared with 20% and a 3-tier rate, has a higher fiscal cost, but is better on equity grounds. 15% and a 4-tier rate is more expensive than either option, allows a deeper cut to the company tax rate, and is marginally better on equity grounds than the 20% 3-tier, but worse than the 20% 4 tier option.

Conclusions

- In the short-term, moving to a non-aligned system is preferred, because:
  - This allows a deeper cut to the corporate tax rate than an aligned option, at less cost.
  - It provides flexibility to respond to anticipated changes in foreign company tax rates.
  - It does not involve the substantial compliance and administrative costs of implementing a dual based tax system (but may provide useful experience of integrity measures to "shore up" the difference between the personal and corporate tax rates).
- Of the non-aligned systems, 33:33:27 is preferred because:
  - It provides flexibility for future changes- including a dual system (with a top rate of 30%), or an aligned system at 27%. It also allows a lower company tax rate of 25% as required.
  - Compliance and administration is simpler- imputation is retained, and little system change is needed for IRD or taxpayers. The gap is the smallest and consequently easier to manage.



2. Tradeoffs between the broad options:

- As GST is an existing tax, a GST increase does not broaden the tax base but involves less administration and compliance costs than other options. GST is more likely to impact savings behaviour, whereas capital options are directed more at behavior around investments.
- Capital options broaden the base (but require the implementation of new tax bases, increasing compliance and administration costs), and may remove/reduce distortions in the current base.

2a. Within capital taxation, there are three main ways capital can be taxed:

- Capital taxation can apply to deemed income, actual income, and wealth or stock of capital
- These methods can be applied across a range of bases, ranging from land, to real property, and to business assets. Generally, as the base is broadened revenue increases and opportunities for tax planning and arbitrage decrease.

2b. Of the options considered in extending capital taxation:

- A land tax is an efficient base, allowing additional revenue at low economic and administrative cost. Its main equity impact is the drop it causes in land values on implementation. Like RFRM it may cause cash flow difficulties. It provides immediate revenue (as does GST).
- RFRM is effectively an "accrual" form of deemed capital gains, and improves the taxation of economic income. It may cause cash flow difficulties for investors. It is likely to involve grandfathering so revenue will be delayed.
- Realised capital gains taxes do not cause cash flow problems, and further improve the taxation of economic income. As above, they are likely to involve require grandfathering which delays revenue, and will be more volatile in revenue flows.
  - A CGT that includes o-o property reduces distortions, and increases revenue significantly. It is less progressive than a CGT excluding o-o property, and lock-in impacts are likely to be higher.
  - A CGT that excluded o-o property is more progressive, and reduces lock-in concerns. It does not raise as much revenue, and tax bias toward owner-occupied property will remain.

Conclusions

- A change in GST, even if little revenue is received after compensation, may be useful to effect a change to the tax mix to encourage savings.
- A realisation-based capital gains tax on all property (excluding owner-occupied) is supported due to its impact on system integrity, its increase in progressivity, and the broadness of the base relative to the RFRM proposed. Although the revenue is delayed, the full revenue is not required for the 33:33:27 option, and interim funding could be derived from a land tax or "other" base broadening options. It also provides option for further reform or consolidation as it reaches steady state.

* If those on lower incomes are compensated fully for an increase in the GST rate, this reduces the amount of revenue received from an increase. However, this may still be a desirable option if a change in the tax mix is desired.