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IMAGINATION UNTAXED: A COMMENTARY ON THE
BUSINESS TAX REVIEW 2006

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

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1. Overview

In this paper, the options outlined in *The Business Tax Review: A Discussion Document* (the discussion document) are examined in the context of the post-1984 tax reforms; the high quality Tax Review 2001 (the McLeod Review); and the government's objective of raising New Zealand's per capita income to the top half of the OECD range.

The Business Roundtable welcomes the government's willingness to examine a reduction in the rate of company tax, but personal tax also needs to be reduced. It is opposed to the possible tax concessions outlined in the discussion document. Their adoption would constitute an undesirable departure from the 'broad base, low rate' strategy that the McLeod Review and all governments from 1984 to 1999 have endorsed.

Many, if not most, in the business sector want the government to concentrate on meaningful personal and corporate tax reductions to boost productivity and economic growth, and to improve competitiveness, particularly with Australia. An alternative tax proposal advanced by a broad coalition of business groups is summarised.

The balance of this paper is presented in 4 sections. The next section (section 2) sets the scene by examining the 1984-1999 tax reforms, the McLeod Review, and relevant tax policies put forward by political parties at the 2005 general election. The discussion document is examined in section 3. An alternative tax strategy is presented in section 4. The conclusions are contained in section 5.

2. Setting the scene

2.1 The 1984-1999 reforms

Tax reform has been a focus of public policy since 1984. The efficiency of the tax system has been substantially improved. We now have two main taxes, income and GST, which conform more closely with sound tax principles.

The income tax base was broadened by reducing or abolishing many corporate and personal tax exemptions and concessions, for instance for investment, fringe benefits, and savings through superannuation funds. The imposition of excessive tax on income earned through companies was addressed through the imputation system.

The introduction of GST almost 20 years ago broadened the indirect tax base and enabled a range of highly discriminatory indirect taxes, including a narrow sales tax and certain stamp duties, to be abolished.

The broadening of direct and indirect tax bases enabled lower and less disparate statutory rates of tax to be applied. This approach is encapsulated in the phrase, 'broad base, low rate'. It enhances efficiency by reducing the extent to which taxes distort consumption and investment patterns, given the government's revenue requirement.

There has been considerable interest in tax reform in other countries, including Australia, Canada and the United States, since the mid-1960s. The broadening of tax bases, particularly the income tax base, reductions in high rates of income tax, and the adoption of value-added taxes (like GST) have been common themes.

New Zealand's tax reforms since 1984 arguably stood out, however, in three main respects. First, they were based on a first principles analysis and were not unduly constrained by political commitments to protect vested interests. Secondly, they were more comprehensive and extensive than those of most comparable countries. Thirdly, they were undertaken as part of a comprehensive economic strategy aimed at boosting productivity and thereby lifting the rate of economic growth.

2.2 The McLeod Review

The McLeod Review undertook the first formal stocktake of New Zealand's tax system since the post-1984 reforms. The group's report is widely respected by tax professionals and the business community.

The McLeod Review "addressed all the major elements of the New Zealand tax system".¹ It reported that the tax system was generally sound – a rare finding for inquiries of its type because they are usually established when major change is overdue.

The Review endorsed the thrust of the post-1984 tax reforms:

We conclude that radical restructuring is not required. The broad architecture of the tax system is sound ... We generally conclude that the ... reform programme has been a success and should not be reversed.²

Of particular significance in relation to the current review of business tax, the McLeod Review observed:

The broad base low rates approach developed over the last twenty years is sound and should be continued. New Zealand reforms should focus on incremental improvements to what we have, and *there should be a prejudice against deviation from this approach, so that exceptions are only made where a substantial burden of proof is discharged.*³

The following assessment by the Review is also important in that context:

... good tax policy design would ideally align the company, trust and top individual marginal income tax rates. Any alternative opens the tax system to abuse, complexity and distortion. This puts a severe constraint on designing a good rate structure.⁴

This was an implicit criticism of the increase in the top personal rate of income tax to 39 percent from April 2000 which severed the alignment of the top personal, company and trust tax rates. Several of the government's tax measures since 1999, such as the attribution rule which applies to certain income from personal exertion, had to be introduced as a consequence of setting the company rate below the top personal rate of tax.

The Review's key recommendation proposed the adoption of a lower and flatter income tax scale. It suggested:

... a move to a two-step personal income tax scale (18% up to \$29,500 and then 33 percent) as the direction of possible reform. The company and trust rate would then be aligned to the 33 percent rate.⁵

¹ McLeod, Robert *et al* (2001), *Tax Review 2001: Final Paper*, Letter of Transmittal, <http://www.treasury.govt.nz/taxreview2001>.

² *Ibid*, p I.

³ *Ibid*, p II (emphasis added).

⁴ *Ibid*, p VII.

⁵ *Ibid*, p VII.

Even so, the Review warned that:

At these tax rates ... New Zealand would be likely to remain an unattractive destination for internationally mobile capital and people.⁶

2.3 The 2005 election

Tax reductions were a feature of the 2005 election. Personal and company tax cuts were advocated by the National Party but were opposed by the Labour Party. New Zealand First and United Future campaigned for a company tax rate of 30 percent. United Future went further, proposing a series of measures designed to provide:

... tax benefits for every taxpayer, for every family, for all companies, every business, all superannuitants, every property owner and every charitable and not-for-profit organisation in New Zealand.⁷

United Future's tax policy also states that its aim is to:

Further lower tax rates, as economic conditions allow, with the goal of establishing a tax rate which is comparatively flat.⁸

Labour's confidence and supply agreements with New Zealand First and United Future respectively committed the government to:

Conduct a review of the current business taxation regimes with the view of ensuring the system works to give better incentives for productivity improvements and improved competitiveness with Australia.⁹

The speech from the throne following the 2005 election stated:

The review of the structure of corporate taxation ... will ... be designed to take a wide-ranging look at our current system of corporate taxation with an emphasis on practical signals to lift productivity.¹⁰

In December 2005 the minister of finance stated:

Although the scope of the review is still being considered, we envisage some very bold measures emerging. It will not be a matter of tinkering with the tax

⁶ *Ibid.*

⁷ Copeland, Gordon (2005), 'Tax Cuts: Comparing Labour, National, UF', press release, 29 August, <http://www.scoop.co.nz/stories/PA0508/S00750.htm>.

⁸ <http://www.unitedfuture.org.nz>

⁹ New Zealand Labour (2005), 'Confidence and Supply Agreement with New Zealand First', <img.scoop.co.nz/media/pdfs/0510/LabourNZF.pdf> and New Zealand Labour (2005), 'Confidence and Supply Agreement with United Future', <img.scoop.co.nz/media/pdfs/0510/LabourUF.pdf>.

¹⁰ Cartwright, Silvia (2005), 'Speech from the Throne', 8 November, <http://www.scoop.co.nz/stories/PA0511/S00104.htm>.

rules.¹¹

At the opening of parliament in February 2006, the prime minister placed the business tax review in the context of the government's programme of economic transformation or economic growth:

Economic transformation has always been central to this government's economic policy ...

We are passionate about New Zealand and its potential – and we'll do whatever we can to see this country succeed. Now it's time to move to the next level in the economic transformation agenda ...

The top priorities will be:

- The major review of the structure of business taxation ...¹²

In the light of these signals a comprehensive and thorough business tax review, focused on tax reductions, was widely expected.

3. The discussion document

3.1 The options

The discussion document outlines a range of options on which submissions are sought. None of the options is proposed or recommended by the government. They represent a menu from which the government may select.

The most significant option is a reduction in the company rate of tax to 30 percent – the same rate as Australia's company rate – at a cost of \$540 million. A 'deep' cut to the company tax was considered but rejected by the government. According to the discussion document, submissions on a deep cut are welcome but submitters should make it clear how they propose to fund it. An increase in GST and the introduction of a payroll tax were also ruled out in the discussion document.

Other options relate to tax base and compliance issues. They include the following (the government's estimate of cost is noted where it is included in the discussion document):

¹¹ Cullen, Michael (2005), 'Timetable for Business Tax Review', press release, 20 December, www.beehive.govt.nz/Print/PrintDocument.aspx?DocumentID=24661

¹² Clark, Helen (2006), 'Prime Minister's Statement to Parliament 2006', 14 February, <http://www.scoop.co.nz/stories/PA0602/S00173.htm>

- targeted tax concessions for research and development (\$45-\$350 million), export market development and enhancing skills in the workforce;
- a relaxation of loss continuity rules where certain 'upfront' expenditure is incurred, for instance for petroleum exploration or development, and forestry development;
- the introduction of tax deductions or amortisation allowances for certain spending of a capital nature which is not presently deductible (which the discussion document terms 'blackhole spending') at a cost of \$150-\$300 million;
- an increase in depreciation loadings in excess of economic rates of depreciation for new assets from the current 20 percent to 30 or 40 percent (\$120-\$230 million), and/or an extension of the 20 percent loading to second-hand assets (\$90 million);
- a reduction in current depreciation loadings to 10 percent or their abolition (saving \$120-\$250 million);
- an increase in a range of thresholds, for instance for the write-off of low value assets (\$170 million) and assets that have been depreciated to a low value, and for fringe benefits.

The fiscal parameters within which the review is being conducted have not been disclosed, although the discussion document states that the government's revenue strategy seeks to maintain the tax to GDP ratio at around current levels. The implication is that the measures proposed can only be funded from other tax changes or a windfall increase in the tax to GDP ratio.

3.2 Comment on the options

The government's broad objectives of improving productivity and competitiveness, especially with Australia, and boosting the rate of economic growth warrant support. Most people would welcome higher incomes and the opportunities that growth provides.

Despite statements by the government since 1999 that lifting New Zealand's per capita income above the OECD median is a top or main priority, Treasury's forecasts of GDP per capita indicate that it is falling well short of this objective. This is no surprise because the government has failed to establish a credible growth strategy. Its policies have been focused on the redistribution of income, with programmes such as Working for Families, rather than on the creation of wealth.

The tax options outlined do not constitute a growth strategy. Lower government spending relative to GDP and hence a lower overall tax burden should form part of such a strategy. But an effective growth strategy needs to address government regulation and the ownership of state enterprises as well as the levels of spending and taxation. Such a strategy would improve the competitiveness of New Zealand producers by lowering their costs, for instance for inputs bought from state-owned enterprises.

The government's willingness to examine the rate of company tax is welcome. However, a small cut in the rate of company tax (with no change in personal tax) and Muldoon-like tax concessions with no change in the overall tax burden would, at best, have a minor impact on productivity or the rate of economic growth.

3.3 The company tax rate option

Although the New Zealand's company rate of tax was set well below that of the average for the OECD when it was first applied in 1989/90, other countries have subsequently reduced their rates. It now lies between the OECD weighted and unweighted average rates.

A reduction in the rate of company tax alone is likely to have a limited effect on the level of investment for the following reasons:

- The interaction of personal and company rates of tax affect the level of domestically financed investment. If the personal rate of tax exceeds the company rate of tax, the effective rate of tax on new equity-financed investment is the personal rate of tax. A taxpayer on the top personal rate of tax earns a dollar of income, pays 39 cents in tax and

then invests the net income through a company. If a dollar of income earned through a company is distributed to an individual shareholder on the top rate of tax, the effective rate of tax on that income is also 39 percent. In these circumstances, a reduction in the company rate of tax with no change in the personal tax rates has no direct effect on the effective rate of tax payable on new investment and thus can have no direct impact on the level of investment. People on high personal tax rates supply most savings.

- Company income that is not distributed initially bears only the company rate of tax. As a result existing companies are encouraged to retain income and reinvest when the rate of tax paid by their shareholders exceeds the rate of company tax. Thus a reduction in the company tax rate with no change in personal rates of tax would encourage existing companies to expand relative to new companies. This is an unwarranted bias.
- Although most business activity is conducted through companies, unincorporated enterprises such as sole traders and partnerships may account for between 20 and 40 percent of all such activity (depending on the measure used). Unincorporated enterprises are particularly prominent in the primary and service sectors. A reduction in the company rate of tax can have no direct impact on their investment decisions. It may, however, encourage such sole traders and partnerships to incorporate for tax reasons rather than genuine business reasons.
- The required rate of return on investment with an open capital market can be no higher than the world rate of return grossed up for domestic taxes, otherwise there is scope for arbitrage. Company tax is the main domestic tax on inward foreign investment. Thus a lower rate of company tax would tend to lower the required rate of return on new investment generally and would lead to higher investment than otherwise (other things being equal). To the extent that the effective rate of tax on domestic investment is not reduced (for instance, because the personal rate of tax is binding), higher investment is likely

to be accompanied by a reduction in domestic investment and an expansion of foreign investment.

- Most businesses that operate through incorporated entities in two or more countries have some flexibility as to where they report their net income for tax purposes. They take account of home and host country tax regimes. From a New Zealand perspective, the interaction of Australian and New Zealand tax arrangements is particularly important. If the New Zealand company tax rate is higher than Australia's rate, firms operating on both sides of the Tasman will tend to report their income in Australia and *vice versa*. A reduction in the New Zealand company tax rate relative to the Australian rate would be a step in the right direction but it would be vulnerable to further moves by Australia which is cutting taxes generally. Thus the option of a 30 percent company rate is likely to be insufficient to stop the erosion of the New Zealand tax base over the medium term.

In discussing trans-Tasman tax rates, the discussion document correctly observes that statutory rates of tax are not the "whole story" as far as competitiveness and productivity are concerned. It refers to Australia's capital gains tax, state payroll taxes and stamp duties. The document fails, however, to note that the ratio of total spending to GDP – the best overall measure of the tax burden – is much lower in Australia than in New Zealand. The OECD expects Australia's spending ratio to be 34.8 percent in 2006 compared with 42 percent for New Zealand. These ratios take spending at all levels of government into account. In discussing relative tax burdens in New Zealand and Australia, the minister of finance persistently ignores this key point.

Personal rates of tax, which the government has put outside the scope of the business tax review, must be examined contemporaneously with the company rate because they are inter-related. Other rates of tax such as the trustee and fringe benefit rates and the rates payable on earnings through savings vehicles must also be considered for the same reason.

3.4 Tax base options

By 1984 the company tax was raising little revenue because the base had been eroded by a plethora of tax exemptions and concessions. Most were subsequently removed for good reason. Tax concessions mean tax rates or taxes on other activities need to be higher to maintain the same level of government revenue.

The discussion document offers no plausible argument for believing that targeted tax incentives would contribute materially to higher productivity or improve overall competitiveness with Australia. Spillover benefits, which research and development, export market development and enhancing skills are said to generate, are ubiquitous. Most do not warrant government action. Some of the affected activities are already subsidised. The government would need to show that the benefits of intervention outweigh the cost. One test might be whether the benefit would be greater if taxes were simply cut. The discussion document does not come close to discharging the burden of proof for departing from the broad base, low rate approach endorsed by the McLeod Review.

If the government subsidises a particular activity it can expect that investment in the activity will expand. However, that does not necessarily mean that overall output or productivity is increased. High subsidies may lead to waste, for instance 'over-investment' in plant and machinery. Research and development might be undertaken under contract overseas and the commercialisation of any worthwhile discoveries might take place in another country. A recent Australian Treasury paper concluded that "The effectiveness of direct support and tax concessions in influencing R & D is unclear." It also found that the relationship between R & D spending and the generosity of the tax system towards research spending is, if anything, "negative across countries."¹³

Some options such as tax incentives for export market development and skills enhancement are so poorly developed that elementary information on them is not included in the discussion document. Export market

¹³ 'R & D picture not so black—Treasury', *Australian Financial Review*, 12 December 2005.

development expenditure would soon include thinly disguised overseas holidays such as trips to the Olympics and other sporting and cultural events. An army of tax officials would be required to police allowable expenditure. Even if such an army were raised, the concessions may give rise to scandals just as subsidies and lax spending rules in the tertiary sector gave rise to twilight golf and radio sing-along courses, and would undermine the integrity of the tax system.

By putting dubious tax concessions on the table, the government is inviting lobbying for other concessions. The pre-1984 income tax base was not eroded by a single decision but gradually by many decisions over time. PriceWaterhouse Coopers tax partner John Shewan recently observed that over 90 tax concessions were listed in a 1981 *Tax Information Bulletin*.

The National Party's finance spokesperson, John Key, included an immediate write-off for all research and development spending and investment in plant and machinery, a differential rate of tax for new businesses and a special low rate of tax for new greenfield operations in defined high-growth sectors in a list of the top 10 issues that should have been addressed in the review.¹⁴ Such an approach is diametrically opposed to the broad base, low rate strategy that the McLeod Review and all governments from 1984 to 1999 endorsed.

Some specific points on other options are as follows:

- Economic rates of depreciation should be deductible for tax purposes. Loadings beyond such rates are a subsidy for investment in particular assets and should be withdrawn rather than increased. The abolition of the present loading could help fund meaningful tax cuts.
- The cost of depreciation options should be computed in present value terms over the life of the affected assets and not over the first five years, which is grossly misleading.
- Concessionary deductions for capital spending in the initial years and restrictive loss carry forward rules cause the problem which the

¹⁴ Key, John (2006), 'Speech to 'Mood of the Boardroom'', press release, 8 August.

'upfront' spending option is intended to address. The concessions should be removed and the loss carry forward rules should be revisited on a principled basis.

- The 'blackhole' spending is generally of a capital nature, which should not be deductible, just as related gains are not taxable.
- The options related to tax compliance are trivial. A far more serious effort to reduce compliance costs is warranted. The best strategy would be to move toward a lower and flatter tax structure, ideally with a single rate.
- There is no need to introduce new taxes like a payroll tax or to increase GST. Forecast growth in spending should be reduced to fund tax cuts.

The tax options outlined in the discussion document have proved to be anything but "very bold", "far reaching" or "major". The quality of policy analysis reflected in the discussion document is easily the lowest since 1984. The minister of finance's assertion that the business tax review "is the largest re-think of the business tax regime in nearly twenty years" is hard to take seriously.¹⁵

4. An alternative tax strategy

In April this year the Business Roundtable, Chambers of Commerce and Federated Farmers, with the support of the Institute of Chartered Accountants, jointly indicated to the government what they hoped would come out of the business tax review. The submission focused on reductions in personal, company and other tax rates and was designed to:

- improve incentives for investment, employment and productivity;
- encourage economic growth;
- improve the attractiveness of tax structure internationally; and

¹⁵ Cullen, Michael (2006), 'Speech Notes for Address to Tauranga Chamber of Commerce Lunch', press release, 16 August.

- be fiscally responsible.

A feasible medium-term objective is to reduce the company and top personal rates to 25 percent or below. This was advocated by the Business Roundtable in a submission to the McLeod Review. The business organisations' proposal was designed as step toward that objective.

The joint submission proposed that the company rate of tax would be reduced to 25 percent by 2009/10 and the top and middle personal rates would be reduced to 28 percent. The recommended rates of tax are set out in the table below.

Proposed Tax Reductions

Tax Rates	Present	2007/08 and 2008/09	From 2009/10
	%	%	%
Company	33	30	25
Top personal	39	35	28
Middle personal	33	30	28

The Business Roundtable would prefer the top personal and the company tax rates to be aligned but that was not included in the compromise package. One factor was that each 1 cent reduction in the top tax rate costs \$130 million.¹⁶

The tax rate changes were estimated to cost about \$4.4 billion or 2.7 percent of GDP a year on a static basis once they were fully implemented. This estimate did not take account of the second-round effects on economic growth of lower taxes. When such dynamic factors are taken into account, its cost over the medium term was estimated to be reduced to \$3.3 billion.

We proposed that the tax cuts be funded as follows:

¹⁶ The proposal was developed before the 2006 budget was presented. The 'ballpark' cost of the package has not been revised.

- \$2 billion from provisions made in the 2005 budget for new spending or tax measures through to 2009/10 inclusive. This would commit about 35 percent of such provisions.
- \$0.5 billion from lower spending or lower tax concessions.
- \$1.9 billion from a lower surplus and hence higher debt than forecast. The debt to GDP ratio would be about 1 percent higher than otherwise.

The minister of revenue, Peter Dunne, stated that the package would require deep cuts in some government services.¹⁷ This is not the case:

- The tax cuts would largely replace new spending proposals that might otherwise be approved. Rather than use most of the provisions for new policies on additional spending, 35 percent would be diverted to growth-enhancing tax reductions.
- Only \$0.5 billion would come from lower spending or a reduction in existing tax concessions like the depreciation loading. It is not credible to suggest that low quality spending of \$0.5 billion could not be found within a budget of about \$50 billion.
- A move towards a lower surplus and a slightly higher level of debt would not be imprudent in present circumstances. The government is currently over-taxing the community by budgeting for large operating surpluses and expanding its assets.

The personal and business cuts outlined in the package would make a significant contribution to raising productivity and growth, while being fiscally responsible. From both a business sector and an overall community perspective, the package is a much better option than those contained in the discussion document.

¹⁷ *Trans Tasman*, 27 July 2006.

5. Conclusion

In summary:

- The Business Roundtable welcomes the government's willingness to examine a reduction in the rate of company tax but personal and other business taxes also need to be reduced.
- It is opposed to the possible tax concessions that are outlined in the discussion document. There are no compelling grounds for such concessions and their adoption would constitute a decisive break with the 'broad base, low rate' policy that the McLeod Review and all governments between 1984 and 1999 have endorsed.
- Businesses want the government to concentrate on meaningful personal and corporate tax reductions.
- The tax proposal jointly advanced by representative business groups would reduce the top and middle personal tax rates to 28 percent and reduce the company rate to 25 percent by 2009/10. It would boost productivity and economic growth, and improve competitiveness.
- The Business Roundtable would prefer to see the top personal and company tax rates aligned.
- The proposed tax cuts can be financed without cutting spending on essential government services. However, they require a slower rate of growth in new spending.
- While a credible growth strategy should include personal and business tax cuts, changes in regulatory, ownership and other policies are also required to increase New Zealand's trend growth rate.