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**Business Tax, Business Law and Business
Performance**

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BUSINESS TAX, BUSINESS LAW AND BUSINESS PERFORMANCE

The biggest and oldest debate in economics and politics is about the role of government. No serious participant in this debate has ever contended that there isn't a positive role for government. There are many decisions in a modern society that cannot be made privately and must be made through the political process. The argument is not about whether there should be government rules and functions; it is about what role the government should play.

The relationship between the individual and the state is the basic issue in politics. Free citizens have always been concerned to limit the powers entrusted to governments. The unique characteristic of government is its power to coerce. In the economic sphere this takes such forms as the appropriation of income in the form of taxation, constraints over economic decisions by regulation, or the direct ownership of economic resources.

Government creates the business environment. Its regulations, taxes and general policies set the boundaries for business performance. Good government is essential for good business - for fostering competition, for setting clear and consistent rules for trade and for efficiently providing public infrastructure.

But government can go too far. It often attempts to control private behaviour too tightly. It can act in ways that reduce competition and thereby make the economy less productive, and that confer benefits on particular groups in the community at the expense of others. Usually it does so at the behest of those who can work the political system to their advantage. Like any other group, business will seek government favours if given the opportunity. An important role of the government is to keep the market functioning - to referee the competition, but by and large to refrain from becoming a player.

In recognition of the harmful effects of excessive government intervention, there have been moves in New Zealand and around the world in the past decade or so to halt and reverse the growth in government spending and taxation, deregulate markets and privatise government business enterprises. The common goal behind all these moves has been to reduce constraints on productivity and improve economic performance. Close scrutiny of many spending programmes and regulations revealed that they were barriers to wealth creation. Former policies were either discarded or better quality ones put in their place.

In today's open global economy, the margin of tolerance for policies that undermine wealth creation is increasingly narrow. Governments face a stern test: will their interventions enhance or constrain profitable investment? If they get it wrong, industries will be stunted in their growth or vote with their feet. Not even giant corporations can cope with government-imposed burdens: their markets are attacked by competitors whose governments have avoided productivity-reducing policies. We are seeing an international competition for quality government administration - at least among those countries striving for growth in incomes and jobs.

China, which I visited a fortnight ago, is a leading example in this category. There is an all-out drive to remove the stifling government controls that have held China back. At present some 50 percent of Chinese firms are state-owned, 30 percent are collectives and the rest private. As the Vice-Minister of Finance put it on his visit here last week, the surest thing about China is that the state enterprise sector will shrink. The government has committed itself to no increases in taxes for the rest of the decade. Industrial growth, including foreign ventures, is explosive. There are now more than a million millionaires in China, and wealth is spreading fast. This is the real world that New Zealand is dealing with.

Economies are usually destroyed by a thousand cuts, not by one reckless blunder. Evidence of the destructive effects of regulations and controls takes years to accumulate. Despite the trends in countries such as China, some in New Zealand still maintain that state enterprise works as well as private enterprise. They are not on their own: as recently as 1989, the doyen of economic textbook writers, Paul Samuelson, was still arguing that:

"... the Soviet economy is proof that, contrary to what many skeptics had earlier believed, a socialist command economy can function and even thrive;" and

"What counts is results, and there can be no doubt that the Soviet planning system has been a powerful engine for economic growth."

By 1989 most Russians were aware that the Soviet economy was collapsing around them. Why do some economists continue to buy into nonsense long after it is recognised as such by ordinary people?

An authoritative statement of mainstream economic thinking on government intervention by the most recent Nobel laureate in economics, Gary Becker, is worth quoting at some length.

"Up to the mid-1970s, the vast majority of economists, let alone other academics, were not convinced that big government hampered economic growth and prosperity. After all, the Soviet Union and other communist countries appeared to be growing faster than the rest of the world. Many experts on the Soviet economy even agreed with Krushchev's boast in the late 1950s that its economy would overtake that of the United States.

Moreover, economies appeared to be doing very well in several European countries where government spending was an unusually large share of income. And comparisons of the productivity of government and private enterprises operating in the same industry did not show unambiguously that government enterprises were less efficient.

All this evidence has changed radically during the past 15 years. The good performance of communist regimes was built with mirrors, for it is now clear that these economies did very badly after 1965 or so. West German taxpayers have discovered, to their dismay, that most factories in East Germany, the supposed industrial powerhouse of the communist bloc, are worthless in the modern economic world... .

The Asian tigers, with their general reliance on free economies, have risen to economic prominence during the past 20 years. And advocates of an extensive government presence have stopped citing Sweden, for that country slipped badly during the 1980s - the Swedish example of a 'middle way' turned out to be badly flawed.

Differences among the growth records of the tigers, Chile, the communist bloc, and others have had a far greater impact on popular perceptions about the consequences of widespread government intervention than countless theoretical discussions of the effects of bad economic incentives...

The evidence from careful comparisons of state and private enterprises also shifted decisively in favour of private enterprise. For example, a recent World Bank study of a dozen privatizations in several countries finds that they almost always led to greater efficiency, even when the private firms retained considerable monopoly power... .

I believe it is accurate to conclude that the various kinds of evidence which have become available during the past 20 years convincingly show that at least beyond some point, government intervention in the economy greatly retards economic growth... . National plus local government spending in some 50 non-communist countries went from an average of about 32 percent of GDP in 1972 to 36 percent in 1980 to 40 percent in 1985. I believe this contributed to sharp decline in world economic growth in the 1970s and 1980s from the previous two decades."

As Becker's figures indicate, government spending and the taxation required to finance it is the single largest form of intervention in modern economies. In effect, some 40 percent of national income on average is being appropriated from the private sector - firms and households - for use or direction by the government. New Zealand is above the 40 percent average. A shrinking share of after-tax income remains in private hands. This constrains the ability of firms to invest and grow. It also constrains the ability of households to make ends meet, save, and avoid dependence on the state.

Government spending programmes can confer benefits but they do not come free: they also involve costs for the community. The most obvious ones are the wasteful use of resources in many public sector organisations. We have seen dramatic evidence of the inefficiency of former government trading departments with the moves to corporatisation and privatisation. This is continuing, as the rise in Telecom's share price indicates: Telecom's success in cutting costs has improved its profitability despite a greater than expected loss in market share due to strong competition. Over the next couple of years we are likely to see similar efficiency gains from the changes in the health sector. Other costs include the crowding out of private sector substitutes for government-provided goods and services, the wasteful diversion of resources into lobbying for government favours, the administration and compliance costs associated with government activities and the effects of welfare programmes on economic behaviour. The cumulative costs can exceed the benefits of government activities.

A further economic cost which is much less well recognised arises from the changes in behaviour induced by taxation. These costs occur when consumers switch from highly taxed to lightly taxed goods, or firms employ less satisfactory means of production. Decisions on work effort, savings, investments and risk taking are all affected. The losses created, known as deadweight losses, involve a sacrifice in national income - they make New Zealand poorer.

The Business Roundtable is undertaking a major study this year into the deadweight costs of taxation in New Zealand. Overseas studies typically show that they are between 20 cents and 3 dollars for every extra dollar of tax raised. If the figure for New Zealand were 50 cents, a 1 billion dollar reduction in tax collections would cause overall national income to go up by half a billion dollars. Supposing all the gains went to wage and salary earners, they would enjoy an increase in real disposable incomes of around 4 percent from the tax cuts plus a further 2 percent from the increase in the national cake. These are significant numbers with major implications for public policy which are rarely, if ever, taken into account at present.

One obvious implication is that the value of public projects needs to exceed the simple revenue cost involved. For example, instead of an investment in defence capability needing to provide benefits valued at a dollar (in present value terms) for each dollar spent, it is likely that the benefits should be at least \$1.20 to justify an additional dollar of spending.

The analysis also has implications for the amount of redistribution from rich to poor which it makes sense to undertake, because wealth overall is lowered. And it has implications for the choice of the tax base. Different methods of taxation have different deadweight costs, and these increase with higher tax rates at an accelerating rate. Thus the broader the tax base the lower the tax rate and the lower the deadweight losses in aggregate.

One finding from the study to date is that New Zealand taxes capital income heavily and that there has been a large increase in the tax on capital income since 1985. This may be generating significant economic costs, particularly in view of the international mobility of capital and the sensitivity of investment decisions to differences in national tax rates. Indeed it is arguable that attempts to tax capital income earned in New Zealand by non-residents merely result in the tax being shifted on to resident taxpayers and raise the cost of capital in New Zealand. This was a prime reason for the government's decision in 1991 to effectively remove the non-resident interest withholding tax and there is an equally strong case for the removal of non-resident withholding tax on dividends.

Such economic costs are the main ones focused on in studies of deadweight losses, but even the administration and compliance costs of taxes can be very high. A recent study by the Institute of Policy Studies of the compliance costs of business taxes in New Zealand came up with two main conclusions:

- they are very large and cumulative in their impact, being several times the administrative costs of the Inland Revenue Department and in total equivalent to about 2.5 percent of GDP - an enormous sum; and
- they are very regressive, individually and collectively, and fall with disproportionate severity on smaller firms.

The study also found that the compliance costs of business income tax were over two and a half times that of GST per dollar of revenue raised.

In the light of such findings, the government's preoccupation with imposing new and extended forms of business tax seems questionable, to say the least. There is no evidence that large amounts of revenue are 'missing' from the business sector. Business tax collections are rising again as the economy emerges from recession and are projected to grow by a third over the next 3 years. Moreover, with the shift from the classical system of company taxation to imputation, it is no longer correct to think of a separate company tax. For New Zealand investors the company tax is largely a withholding tax on profits, and any 'missing' revenue will be at least partly recouped through personal income tax.

Compared with a financial deficit of \$3 billion, any 'missing' business tax revenue is likely to be a drop in the bucket. By 1989, following the major reforms of the 1980s, the OECD judged that the tax system in New Zealand was "probably the least distorting in the OECD." Subsequent attempts to tinker with it have been something of a case of trivial pursuit. The dubious moves on business entertainment have involved enormous effort and are now estimated to yield only \$35 million. By comparison, a member of the New Zealand Fire Service Commission, which is funded from compulsory levies and taxes, has estimated that around \$40 million could be saved in that government organisation alone. How much government effort has gone into realising those savings? I suggest the government's priorities as between expenditure reductions and revenue raising have become seriously misplaced and that taxes have again become the soft option.

The fundamental conclusion on fiscal policy is that New Zealand's situation with respect to government spending, deficits and debt continues to cast a long shadow over the economic outlook. Our real interest rates remain high and our credit rating is still under threat. Major policy adjustments are still needed to get the budget into a surplus position and reduce our debt ratios. Tax increases are not the answer; they would merely harm the economy. There are still many low quality and poorly targeted areas of government expenditure that should be addressed instead. At present there is little sign that any political party is coming up with adequate solutions and there are many indications of thinking which would make the problem worse. The electorate should be demanding real answers in this year's election campaign, failing which the hard-won gains of recent years could rapidly be dissipated.

Turning to business law and regulation, the analysis goes on similar lines. Some government regulation confers benefits, but it is also costly for business and the economy. Again the major costs of regulation are the economic costs of resource misallocation, rent seeking and the stifling of innovation. But costs are also incurred in administering and complying with the regulations, and in supplying information to the regulators.

One study of the annual cost of regulation in Australia came up with an estimate of between A\$23 billion and A\$47 billion. An estimate for the United States put it at roughly 8 percent of GDP, or \$392 billion per annum. If the costs were the same for New Zealand as for the United States as a percentage of GDP, they would amount to nearly \$6 billion or some \$6000 dollars per household every year.

New Zealand has made considerable progress in removing many forms of regulation, particularly economic regulations which restricted entry to markets or controlled prices. Crucial steps here have included the reduction in trade barriers, the deregulation of financial markets and the removal of exchange controls, and the recent labour market reforms. Labour market reform alone has been estimated by the Bureau of Industry Economics in Australia to be capable of lifting Australia's annual growth rate by a full percentage point.

There is still work to be done in each of these areas. Protection for some industries in the economy is still very high - car assembly, for example, benefits from an effective consumer subsidy of \$2 for every \$1 of value added. In the banking sector we have lapsed back into some undesirable forms of prudential regulation which keep on giving rise to implicit forms of government liability, as in the case of the DFC collapse and the current kiwifruit industry crisis. And in the labour area, the Employment Court appears determined to sabotage the government's labour reforms by its ever-increasing intrusions into the terms of employment contracts.

Many of the other forms of protectionist commercial regulation have been swept away, with highly visible benefits to the public in industries such as airlines, taxis and telecommunications. By far the most controlled area of the private sector is now agricultural marketing. On the basis of work done by our organisation, I suspect the gains from competition and innovation in the producer board structures would probably rival those from a freeing of world agricultural trade. Our organisation has also argued for the removal of the outmoded regulations which restrict pharmacy ownership and raise the costs of pharmaceutical products, and we are commencing a study of the regulation of the legal profession. Recent inquiries in Australia have highlighted a number of restrictive features of legal practice which raise the costs of legal services to business and other users. The area of professional regulation in general remains to be addressed.

In some areas of industry regulation, the reform process is not yet complete and the costs still being imposed on business and the economy are substantial. The welfare loss from the pricing distortions arising from the kiwi share in Telecom has been estimated to amount to \$500 million per annum from telephone services alone, much of that taking the form of over-priced services to business. There may be a need for some form of monitoring of local service charging, but the kiwi share is a very crude form of price control. The business sector is also being taxed to pay for the cross-subsidies arising from the New Zealand Post monopoly on postal services. And the trans-Tasman maritime 'accord', which the government has applied little energy to breaking, is responsible for keeping annual real disposable incomes in New Zealand some \$50 million lower, according to a recent study, than they would otherwise be. As a recent article in *The Australian Financial Review* noted:

"There is now less pressure on the Australian government to review the trans-Tasman accord following the New Zealand government's recent decision not to take action against the agreement which confines trans-Tasman cargo to Australian and New Zealand-crewed ships."

Running in parallel with a worldwide trend to remove anti-competitive regulation has been a growth in social, environmental and consumer protection forms of

business regulation. The economic costs of some of these new forms of regulation rank with those that have been reduced through deregulatory initiatives.

In the United States, the costs of environmental regulations were estimated in one study to amount to nearly US\$100 billion a year. They appear to be mounting in New Zealand under the Resource Management Act. Some of the requirements of the Act are absurd. For example, the Electricity Corporation was required to obtain a discharge consent for discharging one litre of water per minute from a drill hole associated with the Rangipo power station. This consent has nine conditions and stringent monitoring conditions attached, which cost \$6,000 a year in administration.

The dangers of this kind of regulation generating costs well in excess of benefits are illustrated by United States experience. The ban on asbestos in the United States has been estimated to cost US\$111 million for every premature death averted. This may be compared, for example, with the figure of \$2 million that we are prepared to spend on road safety to save a life. Do we know the costs of asbestos regulations in New Zealand? Surely they should have been quantified before we went down a similar path. The story on hazardous waste land disposal in the United States is even worse - some US\$4 billion for every death averted. Has the Ministry for the Environment, which is promoting action on hazardous wastes, assessed the costs of such initiatives?

Without doubt, a steady stream of wealth-reducing regulations is continuing to roll off the government's conveyor belt. Some appear to be politically motivated, such as the mandatory country of origin labelling requirements which are to come in this year. These were promoted by protectionist lobbies and were found to be unjustified by all the government's advisers and an independent study. In a similar category was the decision by the banks to establish a banking ombudsman in response to consumer lobbying and to head off the risk of regulations. In the first 6 months of the scheme, only around a dozen relevant complaints were received.

It is hard to keep the regulators and information gatherers at bay. There has been a creeping re-regulation of the finance sector with the Reserve Bank's policies for banking supervision, which are now costing the banks \$5 million a year plus internal expenses and arguably adding to banking system risk. Banks are incurring annual costs of \$3 million a year to provide information to state agencies, and \$17 million to collect interest withholding tax. All these costs end up being met by bank customers, not by bank shareholders who can take their funds elsewhere.

Sooner or later regulators tend to generate their own workload to justify their existence. This has been the case with the Ministry of Consumer Affairs, which has promoted the Consumer Guarantees Bill which is presently before the House. This is based on faulty economic analysis and would harm consumers, particularly low-income individuals, and the economy in general.

This example brings out a general issue in business law reform. At a similar conference to this one 18 months ago, a speaker from our organisation was criticised on the grounds that our analysis would allegedly exclude any form of regulation of business conduct, such as the current Sale of Goods Act. The criticism could not have been more misplaced: that Act is a classic example of a sound and simple piece of legislation which has successfully governed market transactions and stood the test of time. Much of the rest of our commercial law is in the same category. Many of the so-called reform initiatives of recent years stand to make it worse.

This is particularly the case with our company and securities laws. When some contestable advice was finally introduced into this area in 1991, in the form of a Ministerial Working Group, it dismissed many of the myths that had been promoted by regulatory activists. For example, it noted that it is misleading to characterise the New Zealand market as unregulated, that our company law is fundamentally similar to British law in key respects such as directors' duties, that our accounting standards are as good as or better than those of other jurisdictions, and that our disclosure regime for the issue of new securities is simple but effective. It stated that there was no evidence that the government's economic growth or market efficiency objectives would be furthered by the adoption of the Securities Commission's proposals for takeover law reform, and put this issue last in its recommended work programme. The Working Group's key conclusion was that highest priority should be given to the enforcement of existing law. It saw enforcement as the real problem that needed to be addressed.

I believe the lessons of experience in this area can be summed up in two quotations. The first is from Khrushchev:

"Politicians are the same all over. They promise to build a bridge where there is no river."

The second is from Thomas Jefferson:

"The execution of the laws is more important than the making of them."

A relatively simple and low cost body of business law will serve New Zealand well. With the upturn in the economy and in investment levels, those who jumped on the Geoffrey Palmer bandwagon and clamoured for regulations to restore confidence in the New Zealand market are looking foolish. As one top corporate lawyer in Australia was recently reported as saying:

"Whenever I have a big US client looking at setting up a base in the region I tell them to seriously consider New Zealand. I mean, who does Australia think it is kidding? Here we are, with this tin-pot economy down in the bottom of the Pacific, with arguably the world's most convoluted and expensive companies regime. A multinational can set up its regional headquarters in New Zealand and operate under New Zealand laws - and the legislation there is one-fifth of the length of ours - and yet they can operate in Australia in the same way as an Australian company. It makes a lot of sense."

The history of efforts to bring in a new Companies Act is a sorry tale. What began as the best quality initiative in the business law reform programme has suffered a fate described by one of its architects as "the revenge of the regulators." Advice available to our organisation suggests that if the Bill proceeds in its present form it would be an unfortunate step backwards from the 1955 Companies Act. It would do much for the business of professional advisers but little to reduce business misconduct.

This is not a big company perspective: in comparative terms, major businesses would at least be better off relative to smaller ones since they have more resources to cope with the requirements of the Bill. However, it would be a major burden on small

businesses, and the transitional costs are estimated to amount to at least \$100 million. Why put the business sector to such expense for a measure which entails costs and no net benefits? I suspect that when the implications of the proposals are better known they will lead to the kind of revolt that we have seen over business tax measures. I believe the government would be better advised to start again with the Bill, and with associated measures such as financial reporting and takeovers, with the benefit of contestable advice. There is no urgency about this legislation despite its long gestation period, and it would be irresponsible to push it through for the sake of political appearances.

Instead, any gap in the legislative programme arising from the deferment of these Bills, and others such as the Consumer Guarantees Bill that are in need of repair, could be filled by amending legislation on the Commerce Act. For several years our organisation has argued that the deficiencies in this Act and its administration are the worst black spots in New Zealand business regulation. The Ministry of Commerce, which fought tooth and nail against changes to the Act, has accepted most of the arguments in the latest review, and the government has accepted the review committee's recommendations.

It would now be desirable for these recommendations to be implemented without delay. This would help prevent further economic harm resulting from a poorly constructed statute, though it would be cold comfort to the many New Zealand businesses that have suffered substantial losses under the Act in the past. There is an issue of accountability here on the part of those who have advised governments and administered the legislation.

There is also still a serious problem with the quality of enforcement of the Commerce Act. Numerous Commerce Commission decisions on major cases are being overturned by the High Court. Overseas experts have been struck by the Commission's capacity to get even elementary decisions wrong, such as the Fisher and Paykel exclusive dealing case. The Commission has also been on the wrong side of the arguments on voluntary clearance for mergers and on the economic efficiency focus of the Act.

With economic deregulation and the extent of competition now prevailing in practically all markets in the economy, I find myself in agreement with Owen Jennings who recently argued that the Commission's role could be reduced to about 10 percent of its present scope. This downsizing should be accompanied by a quality upgrading of the small number of staff resources needed to handle the difficult analytical cases which should constitute its residual business. The wrong balance between quantity and quality at present is leading the Commission to apply surplus resources to exercises like the recent inquiry into Telecom. Not only did it get a rap over the knuckles by the High Court for exceeding its authority but the report it produced was a lightweight piece of work.

I conclude by underlining the point that the common feature of business tax and business regulation is that, carried beyond a certain point, they undermine business performance. An economy with high levels of debt and a high level of unemployment is in no position to carry unjustified costs.

It is important to recognise that when costs are passed on to business, they are passed on to everyone in the community. They take the form of higher prices, less profitable

firms and lost jobs. Business is not a separate sector that has unlimited capacity to absorb costs. It is what we are all involved with - it generates our jobs and our wealth.

In today's world of open borders and international competition, jurisdictions that impose heavy taxation and regulatory burdens are suffering increasing penalties. California, formerly a magnet for industry and commerce, is now a highly taxed and highly regulated economy and industry is fleeing the state. German firms are moving their investments offshore to Asian locations for the same reasons. New Zealand is attracting international investment because of its improved competitive position and some comparative advantages in its taxation and regulatory regimes. But we may be about to naively throw away some of those advantages instead of building on them by, for example:

- concentrating on resolving our fiscal problems through reducing government expenditure, not increases in taxation;
- removing taxes on foreign income earned in New Zealand so as to lower the costs of capital and increase investment;
- pressing on with regulatory reforms in areas like agricultural marketing to strengthen competition and innovation;
- abandoning proposals for reforms of business law which would involve costs in excess of any conceivable benefits, and restart work on them on a timetable that would allow the job to be done properly; and
- introducing much more contestable advice into tax and business law reform to remedy the indifferent results in both fields in recent years.

In this election year there will be many proposals which run counter to the analysis I have outlined to you. There is still far too little community understanding of the harm caused by 'tax, spend and regulate' policies. New Zealand's prospects are still in the balance, and we could slide back into major difficulties very quickly. You understand the needs of business, and share a responsibility to make them known. If enough people explain the realities, and often enough, the point may just get home.