

Reflections on the Tax Working Group's Process, Principles and Prescriptions for Tax Reform

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Bob Buckle
Pro Vice-Chancellor and Dean of Commerce
Victoria University of Wellington and
Chair of the Tax Working Group
<http://www.victoria.ac.nz/sacl/cagtr/twg/>

PREAMBLE: Headline TWG Messages

- Status quo is not an option for NZ tax system;
- A significant reform package is required;
- TWG proposed a framework, with options for changing the tax mix and broadening the base;
- We have a once-in-a-generation opportunity for meaningful tax reform;
- That can provide a fairer tax system that is less damaging to economic growth.

PROCESS of the TWG

- Independent group, working with officials to enhance policy development process;
- Victoria University (CAGTR), Treasury and IRD collaboration endorsed by Ministers;
- A new and open process involving:
 - Series of meetings;
 - Commissioning and reviewing research;
 - Publishing deliberations; engaging media; informing public;
 - Public conference and publishing a report.
- “A new science of making policy”? (Colin James, *Dominion Post* 22nd Feb. 2010).

PRINCIPLES of a Good Tax System...

Important step was to agree on principles to guide a process of “rational policy analysis” (John Creedy, March, 2010):

- Efficiency and growth;
- Equity and fairness;
- Revenue integrity (minimise uncertainty – future taxes);
- Fiscal cost (applied fiscal neutrality constraint);
- Compliance and administration costs;
- Coherence of the tax system.

and recognise “value judgements necessary to determine the priorities and respective weightings of these objectives”.

.....and some constraints and rules of thumb

- Revenue taxes, not corrective taxes;
- Broad-base, low-rate (BB-LR);
- Base-broadening with an eye on 'principles';
- Taxes paid should, broadly, reflect ability to pay (comprehensive income) rather than benefits received.

PROBLEMS with the NZ Tax System

NZ's tax system was once regarded as one of least distortionary in OECD - no longer the case.

3 critical, and related, problems:

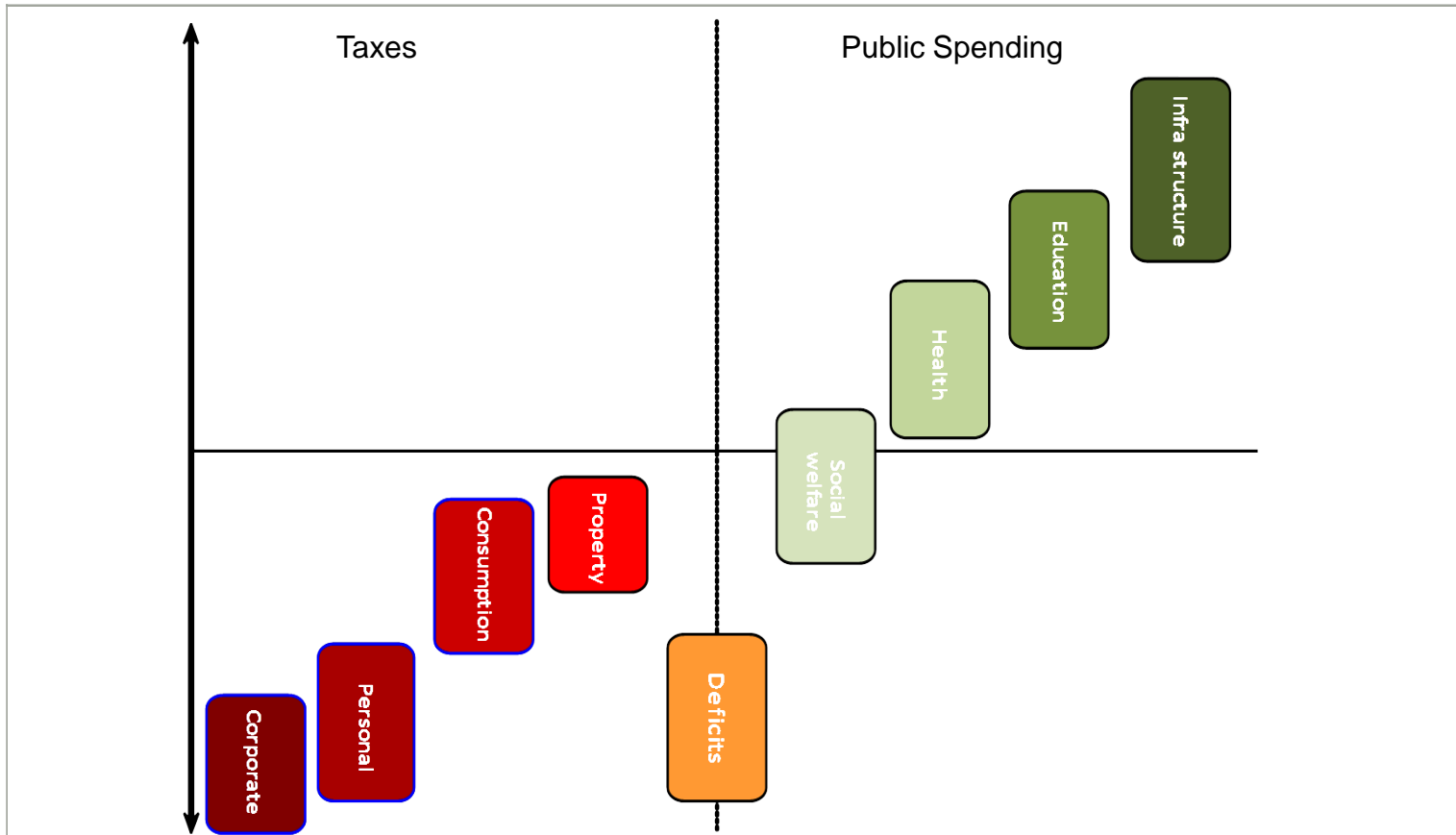
- Reliance on taxes most damaging to growth;
- Lack of integrity, fairness and coherence;
- Tax base is not sustainable.

that require system-wide reform.

Problem 1: Reliance on taxes most damaging to growth and narrow base:

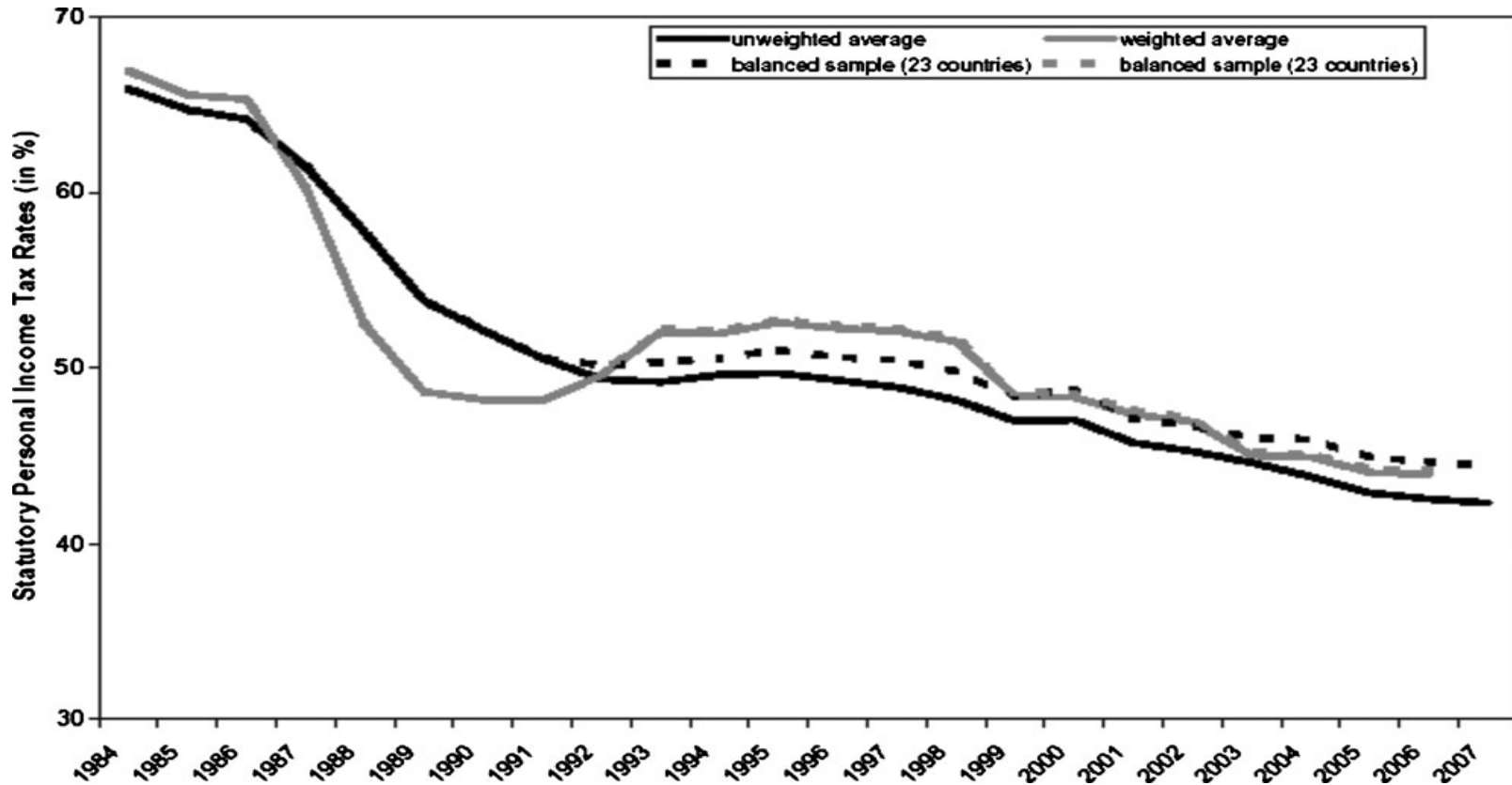
- 70% of total tax revenue from personal and company taxes which are most harmful to growth;
- Personal and corporate tax rates becoming less internationally competitive;
- WfF has introduced very high EMTRs (effective marginal tax rates);
- Hole in taxation of capital manifest, e.g., in high investment/low taxable returns in property market.

Growth effects of taxes and public expenditures



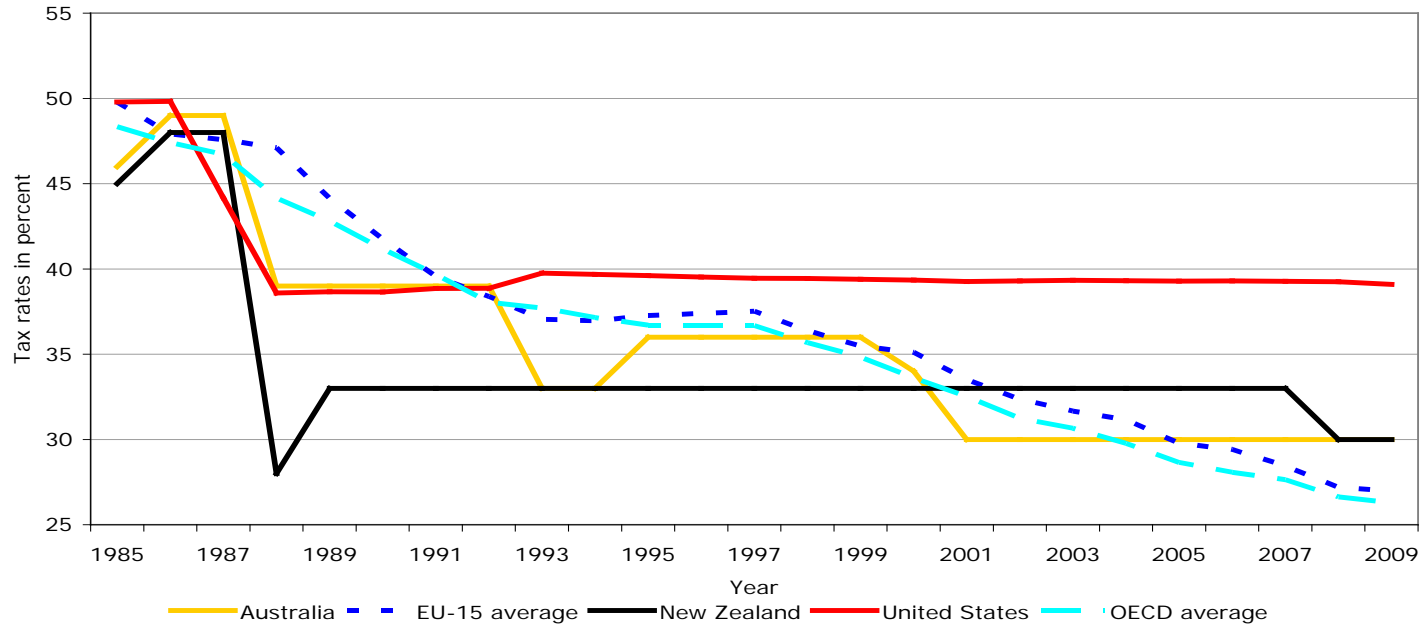
Source: Treasury

Trends in top statutory personal income tax rates in OECD countries, 1984-2007



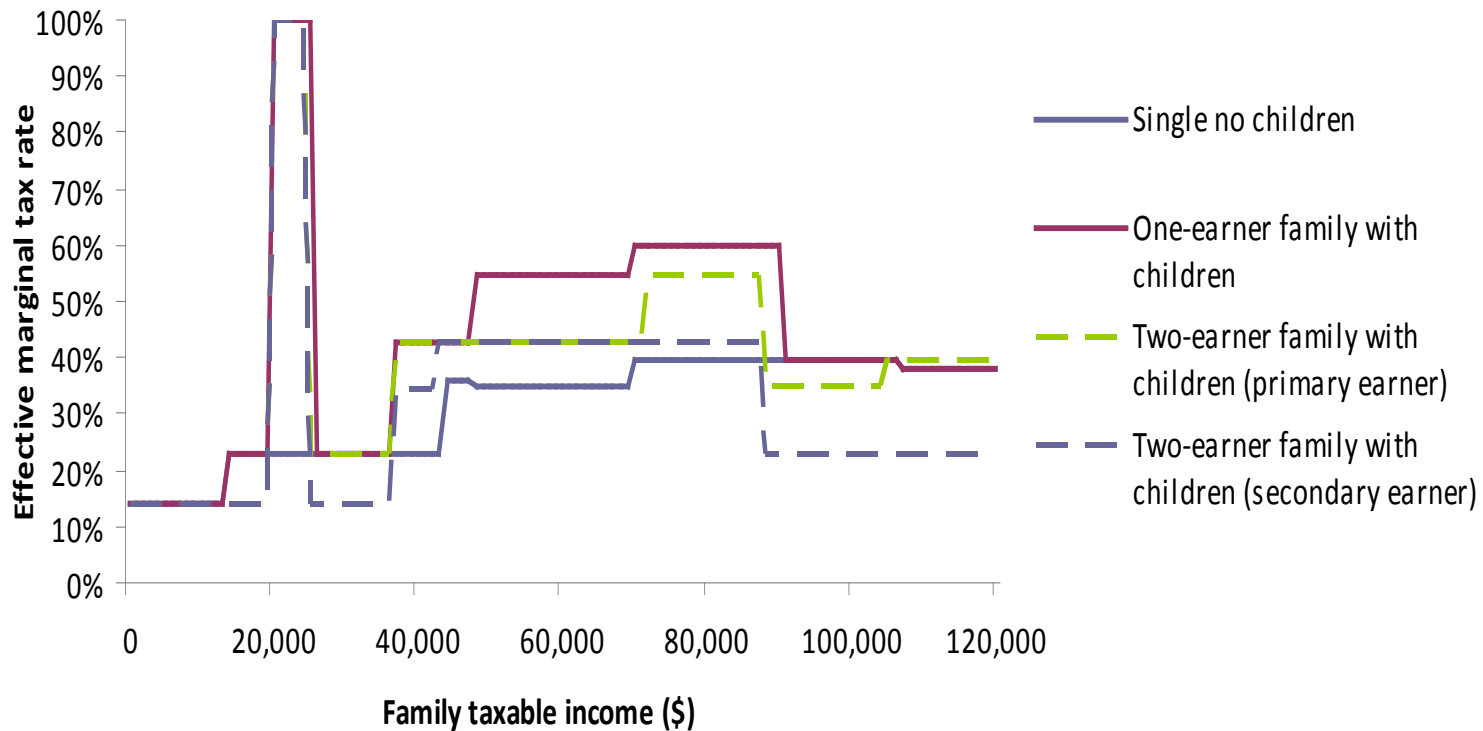
Source: Lorentz (2008)

Trends in statutory company tax rates in OECD countries, 1985-2009



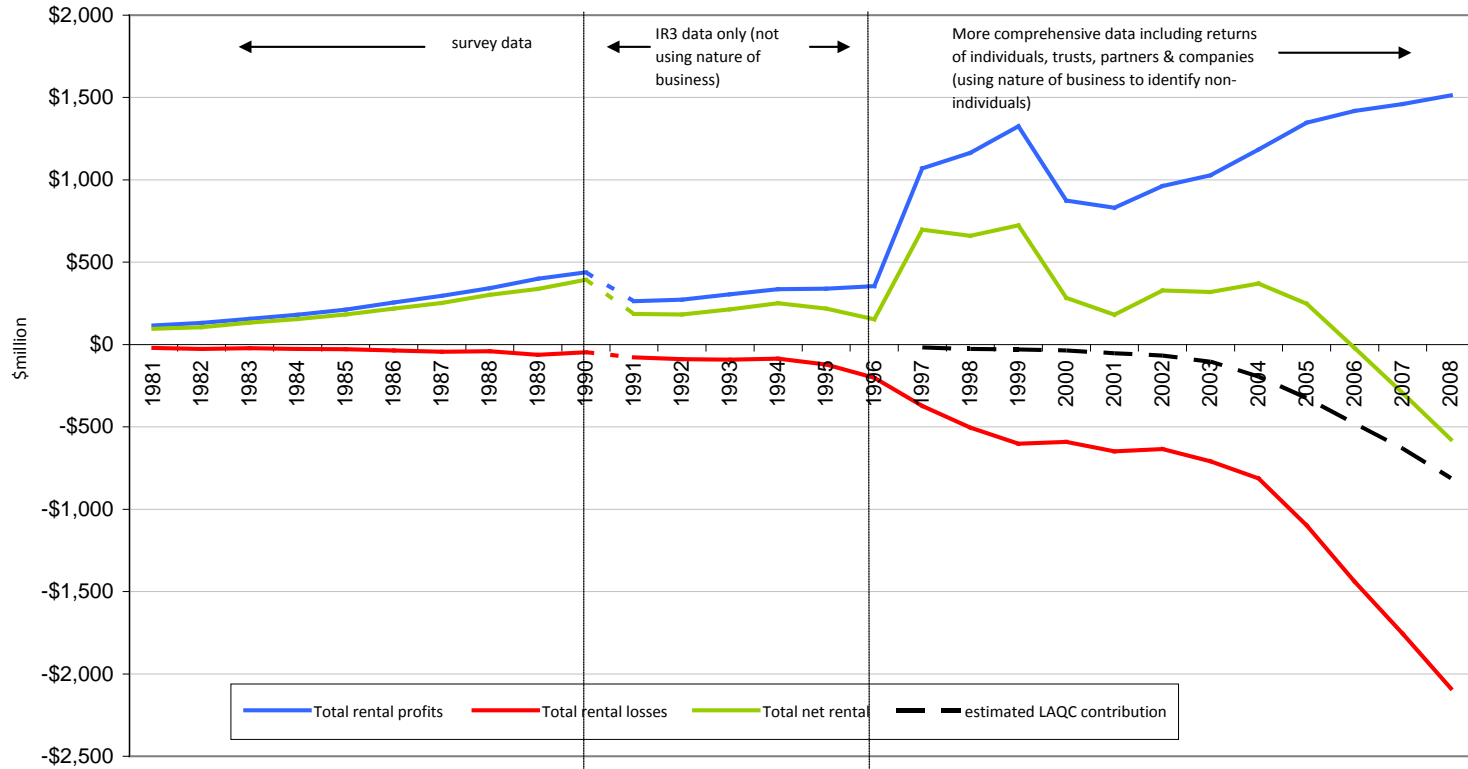
Source: OECD

Effective marginal tax rates (EMTRs) under the current tax system



Source: Treasury

Rental housing income, 1981 to 2008



Source: Inland Revenue Department

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"I outsmarted the IRS. I didn't
make a cent last year!"

Problem 2: Lack of integrity, fairness and coherence:

Differences in tax treatment of entities provides potential to divert income and reduce tax liabilities.

- Opportunities vary across income groups;
- Distorts investment decisions;
- Can be used to shelter income from various taxes or enable people to receive social support;
- Policy intent of tax legislation not always clear;
- Problems accentuated by non-alignment (of top personal, corporate and trust rates).



"Tax Lawyer of the Year!"

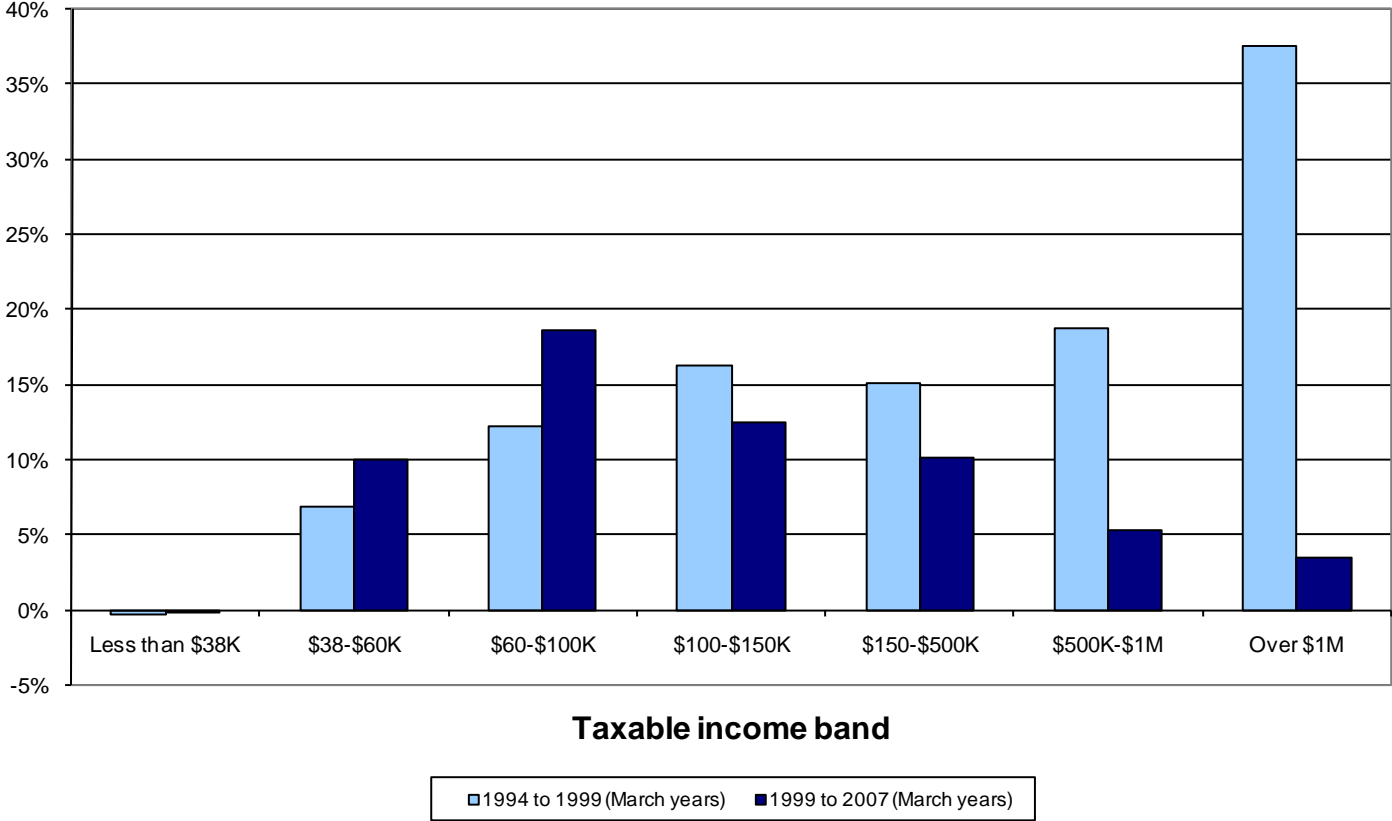
I'd like to thank the IRS, without
whose incomprehensible regulations
I wouldn't have a job.

Tax entities and tax rates

Investment entity	Marginal tax rate
Individual	0%-38% depending on level of taxable income.
Portfolio Investment Entity (PIE)	0%, 19.5% or 30%. ¹
Company	30%, then marginal personal income tax rate of shareholder (0-38%) on payment of a dividend.
Trust	Trustee income - 33%. Beneficiary income - generally marginal tax rate of beneficiary (0%-38%).
Qualifying company/Loss attributing qualifying company	30%. However, there may be claw-back on payment of dividend to high marginal tax rate recipient.
Partnerships	Marginal tax rate of each individual partner.
Superannuation funds	33% or 30% if widely held.

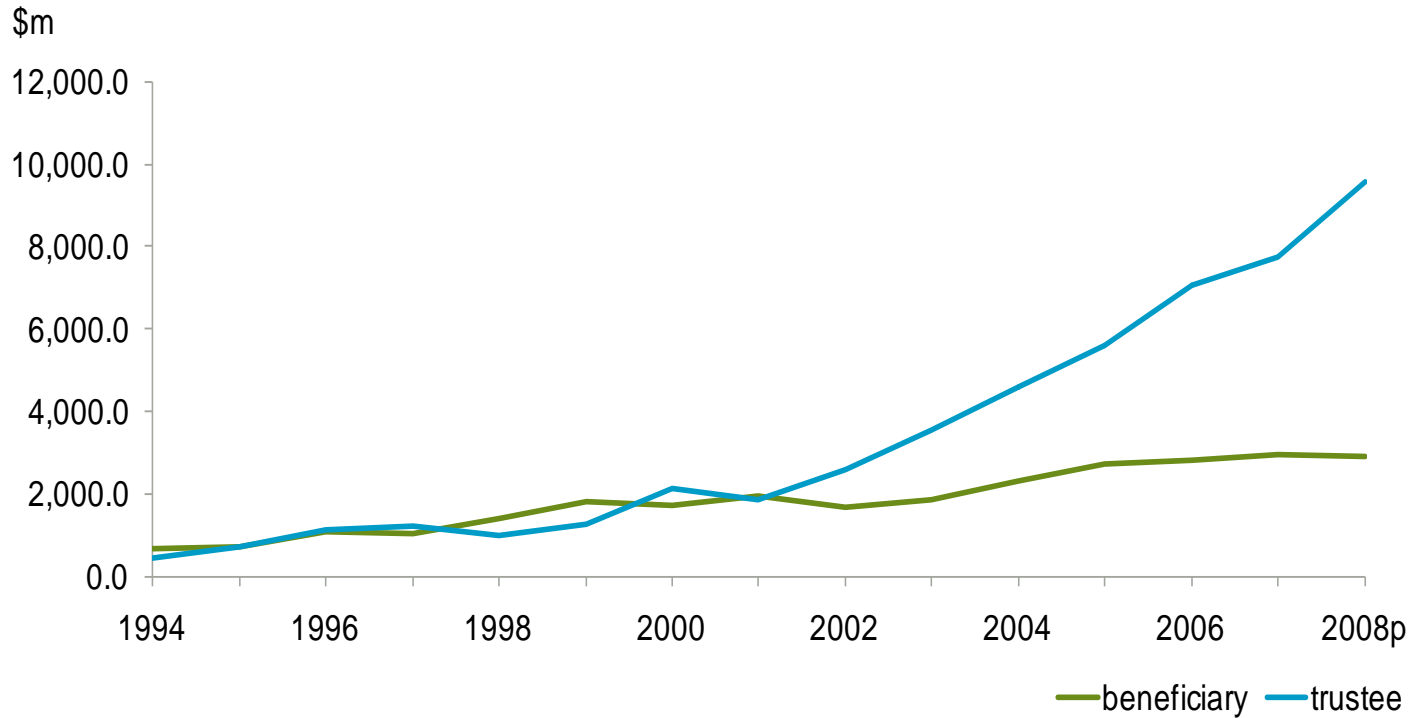
¹ PIEs will be 0%, 12.5%, 21% or 30% from 1st April 2010.

Average annual growth in numbers of individual taxpayers at different income levels



Source: : Inland Revenue Department

Trend in trust income



Source: : Inland Revenue Department

Examples of behaviour to reduce tax or increase benefit entitlement:

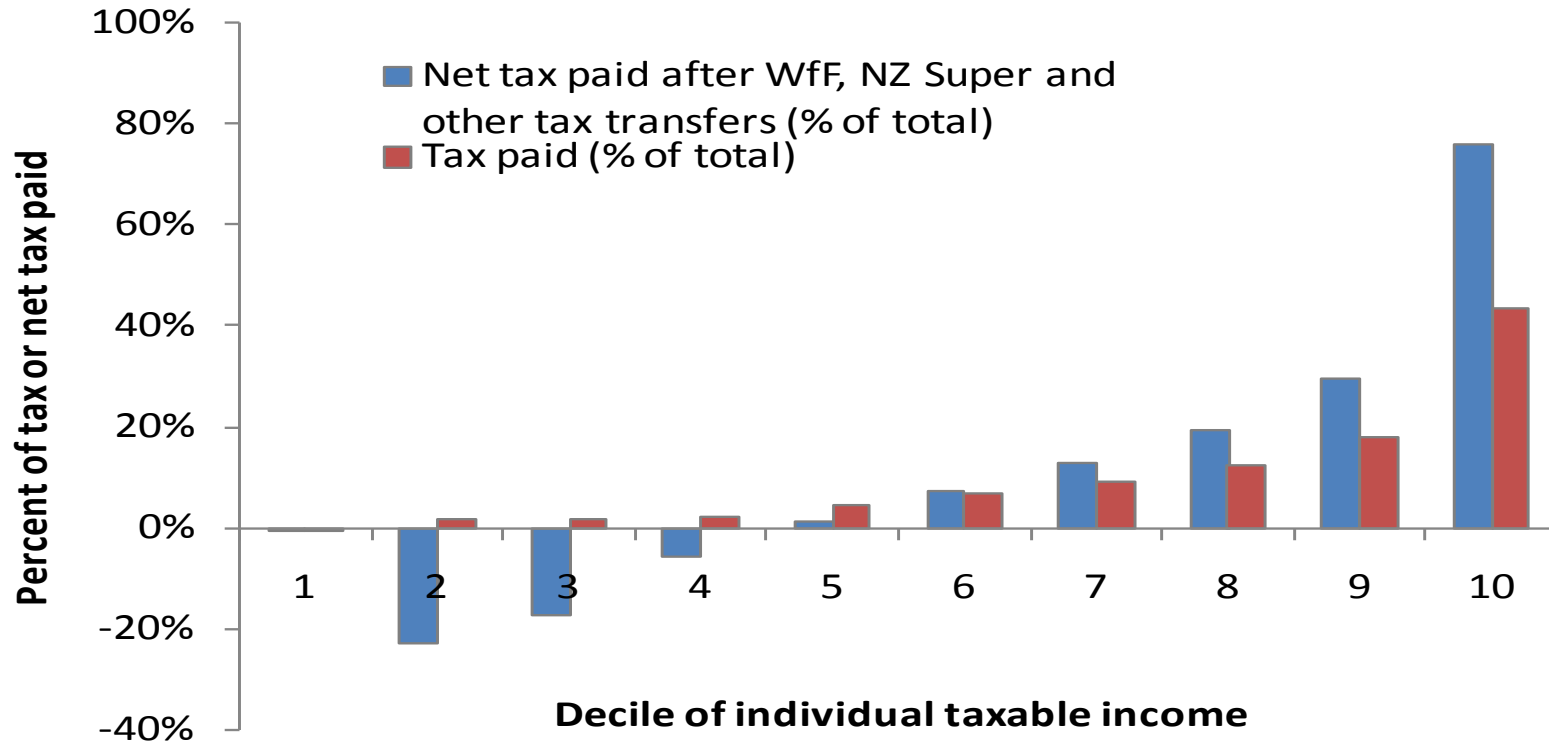
- The use of a trading company owned by a trust. Income accumulating in trusts and distributions from trusts of amounts that have previously been taxed at 33% as trustee income are not counted as income for WfF purposes. This means that substantial receipts by beneficiaries of trusts are not taken into account in determining their WfF entitlements.
- Employees of closely-held companies who maximise fringe benefits instead of receiving taxable wages and salary. These fringe benefits can be close substitutes for cash - for example, the use of an employer's credit card and do not reduce an employee's WfF entitlement.
- Individuals investing in Portfolio Investment Entities (PIEs) rather than a normal bank account because distributions from PIEs are not taken into account in determining WfF entitlement.
- 9,700 families with rental losses who receive WfF tax credits.¹ Rental losses from investment properties are not added back in determining WfF entitlement.

¹ This number was obtained from the Household Expenditure Survey (HES), Department of Statistics, New Zealand.

Problem 3: Tax base is not sustainable:

- Compliance is likely to be affected by perceptions that the system is unfair;
- International competition for capital and labour, especially from Australia, will impact on the sustainability of corporate and personal tax rates;
- Fiscal drag is quickly pushing average wage earners toward the top personal tax rate. This will increase incentives to divert income toward lower taxed entities.

Distribution of personal tax & transfers



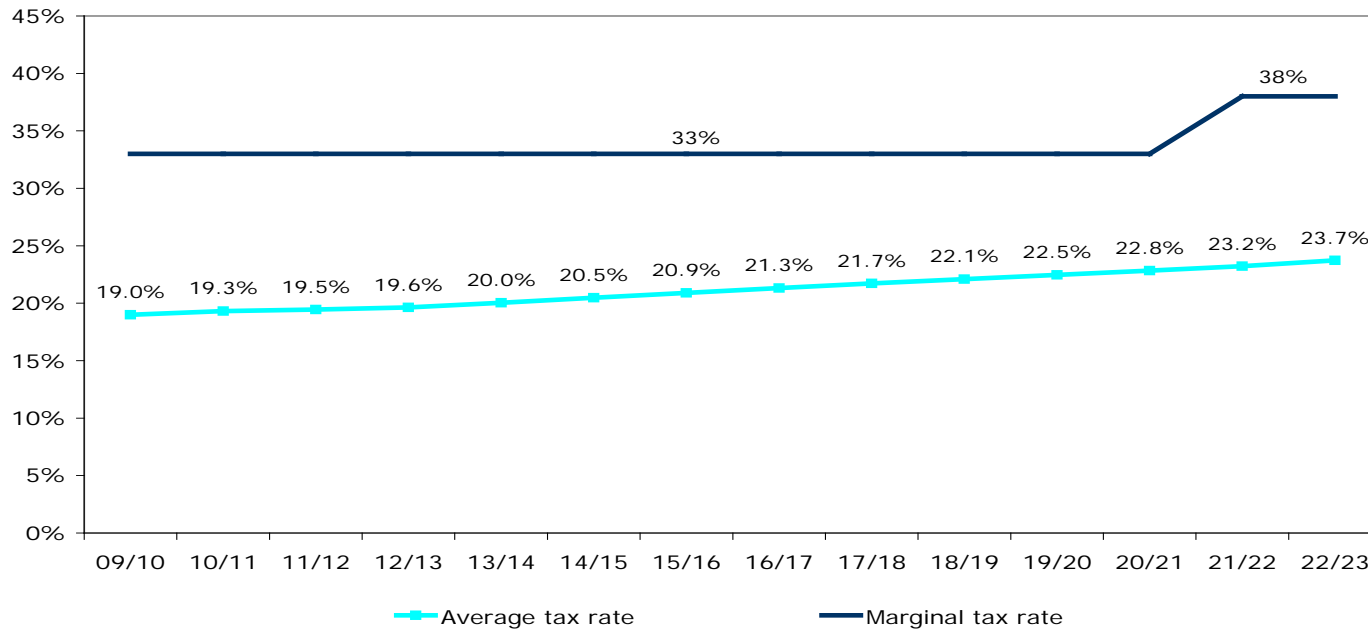
Comparison of taxes paid in New Zealand and Australia by salary and wage earners (single with no children)



Source: Treasury

Fiscal drag and future tax rates for the average full-time income earner

Average and marginal tax rates for average labour income (only) earner with no children (June years)



Source: : Treasury – Budget 2009 and Inland Revenue calculations

PRESCRIPTIONS: Options for Reform

TWG had to consider several system-wide issues:

- “Alignment” or “non-alignment”; and
- If “non-alignment”, can effective measures be introduced to resolve integrity problems? Options considered:
 - Classical system - with low company rate, no imputation, and rates of personal tax at current levels backed with measures to prevent sheltering of income.
 - Dual income tax system - which distinguishes ‘labour’ and ‘capital’ income separately rather than distinguishing personal from corporate income, as adopted in some Nordic countries.
 - A dual income tax system with allowance for corporate equity
 - A non-aligned system combined with supplementary measures.

PRESCRIPTIONS: Options for Reform

- Whether rates on existing tax bases should increase or decrease (including GST);
- Whether base-broadening measures should apply comprehensively or selectively. Options considered:
 - Extending taxation of capital gains;
 - Land tax and property taxes;
 - RFRM (on real property or subset – rental property);
 - Comprehensive capital charge;
 - Depreciation allowances;
 - Thin capitalisation rules;
- Whether greater effort and legislation to deal with compliance and integrity problems is warranted;
- Whether institutional reform required.

...implying a range of possible scenarios with differing fiscal cost, growth, and distributional implications. E.g:

“Aligned” and “non-aligned” examples (Fiscal Cost in 2009/10 tax year - \$ billions)			
30-30-30	27-27-27	30-30-25	33-33-27
\$1.6	\$3.1	\$2.3	\$1.1

Additional \$2.0 billion if lower level tax rates (21% and 12.5%) also reduced by 2 percentage points

Base-broadening and revenue-raising Options (Fiscal revenue in \$ billions)						
GST (increased to 15% with automatic adjustments to benefit and superannuation levels)	CGT (fully implemented, accrual based estimate; assumes 2% property inflation, excl owner occupied housing)	Land Tax (0.5% tax rate)	RFRM (on residential rental property)	Remove depreciation on buildings (assumes no loss offset if sold at loss)	Remove depreciation loading on new assets (excl buildings)	Thin capitalisation rules chanced (from 75% to 60%)
\$1.9	\$4.5	\$2.3	\$0.7 (+ \$0.15 from saved losses)	\$1.3	\$0.3	\$0.2

PRESCRIPTIONS – Recommendations

- Alignment of company, top personal, trust and PIE rates; but at the very least
- Top personal, trust and PIE rates the same; and
- Reduce personal tax rates across the board; and
- Company rate internationally competitive (+ imputation);



PRESCRIPTIONS – Recommendations

- Raise GST (and continue to apply broadly); &
- More comprehensive CGT (*some members*); or
- Low-rate land tax (*most members*); or
- RFRM on residential rental properties (*most members*); &
- Remove 20% tax depreciation loading on new P+E;
- Remove tax depreciation on buildings that do not depreciate;
- Change thin capitalisation rules;
- Institutional changes for tax policy advice;
- Institute a review of welfare policy.

POST-SCRIPT

- Government in large part accepted the TWG's framework and recommendations (see PM's statement to Parliament, 9th Feb. 2010):
 - Need for systematic change recognised
 - Reducing all personal tax rates, and
 - Increasing GST (with compensation)
 - Alignment of top personal and trust rates
 - Concerned with holes around taxation of property (and perhaps other base-broadening measures, but have yet to make this clear)
 - Concerned with competitiveness of corporate tax rate (esp. with Australia)
- “Officials alone wouldn't have delivered what the TWG did with its mix of views and expertise”
(John Whitehead, 1st April, 2010).

and while tax reform is not all that matters.....



POST-SCRIPT

- Subsequent “modelling” results consistent with TWG claim that the tax mix matters:
 - Werner Schule (2010) “Potential contribution of fiscal policy to rebalancing and growth in New Zealand”, IMF Working Paper:
 - Revenue-neutral shift in taxes from labour and capital to consumption using IMF’s Global Integrated Monetary and Fiscal Model (GIMF), increases real investment, employment, real exports (via increase in REER) and GDP and corporate and household wealth.
 - Adolf Stroombergen (March 6th, 2010):
 - Revenue-neutral rise in GST of 15% funding a uniform proportional 10% reduction in all personal income tax rates using a cge model, increases employment, real incomes and, while household spending rises, household saving rises to fund a lift in aggregate investment. Affordable compensation to those households that pay no income tax but would be subject to higher GST.

POST-SCRIPT

- The GST confusion:

- Base for GST is expenditure - incidence is proportional in terms of expenditure and life-time income (but regressive in terms of current income). Nevertheless, some groups disadvantaged unless compensated, especially those with limited income earning ability.
- NZ GST is broad-based and efficiently designed. TWG recommended retaining broad-base – e.g: removing exemptions for “food” makes almost no difference to the distribution of the tax but loses 20% of GST revenue.
- Raising GST allows more revenue to be raised from non-residents (currently about 5% of private GST revenue), and
- Effective way to tax high income or high wealth individuals.
- Was recommended as part of a package of reforms. NZIER (Insight, 13/2010) used 2007 Household Expenditure Survey to assess impact effect on households disposable incomes by household income groups of reduction in income tax rates (to 10/19/30/33) and rise in GST to 15%.

POST-SCRIPT

- There seems to be widespread public support for tax reform:
 - Shape NZ's January 2010 polling showed:
 - 79% of respondents think the tax system needs reforming (5% don't);
 - 65% think the present tax system is unfair (11% don't);
 - 56% think lowering top personal tax rates and broadening bases will improve NZ's attractiveness to people and investors (12% don't).

POST-SCRIPT

- Sandford's (1993) criteria by which successful tax reform should be judged:
 - Extent to which the tax reforms met the objectives the reformers set themselves;
 - The sustainability of the reforms;
 - The extent to which the tax reforms had desirable or undesirable by-products.
- “Experience suggests that tax reviews rarely lead to successful tax reform” (Chris Evans and Rick Krever, 2009) on tax reviews in Australia.
- Will the TWG process fare any better?
- Will we satisfy Sanford's criteria?

