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**Toward a More Efficient  
Taxation System in New  
Zealand**

**Annabelle Mourougane**

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## ABSTRACT/RÉSUMÉ

### Toward a more efficient taxation system in New Zealand

After the radical reforms undertaken in the 1980s, the NZ tax system has long been regarded as one of most efficient within the OECD, and is based on a comprehensive income approach. Looking forward, the country will require a tax regime that helps the economy to continue raising living standards, supports savings and investment and copes with emerging pressures such as increasing geographic mobility of labour and capital. In this context, it will be important to have in place a clear long-term direction for the tax system to guide reforms. There are at least two broad options that are worth considering: adapting the system within a comprehensive income approach or adopting a dual income tax system. Future changes to the tax system need to be consistent with the approach ultimately adopted. In any case, a number of limitations of current tax bases will need to be tackled.

*JEL classification:* E62, H2

*Keywords:* New Zealand, taxation, comprehensive income approach, dual income system, expenditure tax

This Working Paper relates to the 2007 OECD Economic Survey of New Zealand ([www.oecd.org/eco/surveys/nz](http://www.oecd.org/eco/surveys/nz)).

\* \* \* \* \*

### Vers un système fiscal plus efficace en Nouvelle-Zélande

Après les réformes radicales entreprises au cours des années 80, le système fiscal néo-zélandais est considéré depuis longtemps comme l'un des plus efficaces de la zone OCDE. A l'avenir, le pays aura besoin d'un régime fiscal qui aide l'économie à élever le niveau de vie, soit favorable à l'épargne et à l'investissement et puisse faire face à des pressions émergentes telles que la mobilité géographique croissante du travail et du capital. Dans un tel contexte, il sera important d'avoir en place une direction claire sur le long terme pour guider les réformes du système fiscal. Au moins deux options méritent considération : adapter le système dans le cadre d'une approche de revenu global ou bien adopter un système de taxation dual. Les changements futurs du système fiscal devront être cohérents avec l'approche finalement adoptée. Dans tous les cas, il sera nécessaire de modifier un nombre de limitations des bases de taxation actuelles.

*Classification JEL :* E62, H2

*Mots clés :* Nouvelle-Zélande, taxation, approche de revenu global, système de taxe dual, taxes à la consommation

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## **Toward a more efficient taxation system in New Zealand**

By  
Annabelle Mourougane<sup>1</sup>

### **1. Introduction**

The design of the tax system is crucial as taxation impinges on most aspects of economic activity. Having a well-functioning tax regime is of particular importance for New Zealand as the country needs to compensate for its small size and remoteness. At the same time, only revenues that are needed to fund worthwhile programmes should be raised and they have to be levied as efficiently as possible. Pressures to spend the comfortable fiscal surplus have been mounting. The government has announced the forthcoming Budget will include changes to business taxes to take effect from 1 April 2008. At the current juncture, large tax cuts beyond those already planned would be counter-productive as they would inject further stimulus in the economy (OECD, 2007a).

Looking forward, the tax regime needs to cope with several long-term challenges. Potential detrimental effects of relatively high taxes on savings and investment are a source of concern. Demographic changes associated with population ageing will increase fiscal pressures, particularly in the areas of health and superannuation expenditure. Globalisation and the associated increase in mobility of labour, capital and profits will continue to place pressure on ensuring that New Zealand's tax policies allow the economy to attract and retain the factors the country needs.

This paper analyses the current taxation system and proposes changes that would make it more suitable to future needs. It starts from the position that New Zealand's tax system deviates relatively little from a comprehensive model. However, other tax approaches that tax capital income at a lower rate may be attractive, given the high deadweight costs of capital taxation in a dynamic framework. The paper first underlines the benefits that would flow from a coherent and strategic long-term direction for the tax system. Two possible options are then discussed in turn: adapting the current model within the comprehensive income framework or adopting a dual income approach. Extending the latter approach to an extreme case where capital is not taxed at all would move the system toward an expenditure-based regime. The paper then analyses a series of measures that would minimise the shortcomings of the current system. The last section summarises policy recommendations.

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1. The author is Economist at the OECD Economics Department. The author is indebted to Mark Blackmore, Bert Brys, Peter Bushnell, Andrew Dean, Christopher Heady, Peter Jarrett, Brock Jera, Benedikt Jensen, Val Koromzay, Deborah Roseveare for many helpful discussions and comments on the draft. Special thanks go to Françoise Correia and Heloise Wickramanayacke for excellent technical assistance.

## 2. The present tax system

The NZ tax system (Box 1) has been described as one of the simplest amongst the OECD countries (Leibfritz *et al.*, 1997; OECD, 2000), although policy changes since 2000 have added complexity. The tax burden is relatively low compared to most Western European countries but higher than, for example, in Australia, Japan, Canada and the United States (Figure 1). It has increased steadily since the beginning of the decade. Tax revenues rose from 34.4% of GDP in 2000 to 35.6% in 2004.<sup>1</sup> This stems from growing personal and corporate income tax flows and has come about in spite of stable statutory rates of corporate and personal income taxes over the period. Higher tax ratios reflect stronger economic growth, which has boosted both firms' profitability and household incomes, as well as bracket creep, whereby taxpayers have moved into higher brackets as their nominal incomes have risen. Fiscal drag may thus have strengthened automatic stabilisation.

New Zealand raises over 60% of its tax revenues from taxation levied on incomes and profits (Figure 2).<sup>2</sup> This proportion is higher than anywhere else in the OECD, but this reflects the absence of payroll and social security taxes.<sup>3</sup> While its individual income tax take is relatively high compared to the OECD, its taxation on income and payroll is average once social security contributions and payroll taxes are taken into account. Indeed the total tax wedge on labour in New Zealand is one of the lowest in the OECD (OECD, 2007b). The top personal tax rate of 39% is currently one of the lowest in the world, but the top rate is applied from a comparatively low level of incomes – above 1.5 times the average wage in New Zealand compared with 2.4 times the average wage, on average, in OECD countries. Currently, 12% of the population are in the top tax bracket.

### Box 1. Main features of the NZ tax system

#### Personal income tax

Personal income tax is progressive with three brackets and non inflation-indexed thresholds that have not changed for seven years (Table 4.1), during which time household incomes have risen by about 30%.

Table 1. Personal income tax brackets

Taxable Income NZD	Percentage of the population (18 and older)	2006/07 statutory personal income tax rate	2006/07 effective marginal rate
0 – 9 500	} 75	} 19.5%	15%
9 501 – 38 000			21%
38 001 – 60 000	13	33%	33%
Over 60 000	12	39%	39%

Note: NZD 38 000 is close to 0.9 times the average wage and NZD 60 000 to 1.5 times the average wage.

A low-income "rebate" of 4.5 cents per dollar applies to the first NZD 9 500 of income. For income between NZD 9 500 and NZD 38 000, the rebate is gradually withdrawn, resulting in an effective marginal tax rate of 21% over that range. New Zealand has no local income tax.

The Working for Families package provides income support to almost all families with household incomes less than NZD 70 000 a year, many families with annual incomes up to NZD 100 000 and some larger families on higher incomes.

#### Social security contributions and payroll tax

New Zealand does not have social security contributions or payroll tax, except for the Accident Compensation Corporation levy on employers that is set at NZD 1.30 per NZD 100 of payroll, on average. Levies are risk-adjusted across different industries.

### **Corporate tax**

There is a single tax rate of 33% for resident and non-resident firms. Trusts are also taxed at 33%. From the point of view of corporate funding, the neutrality of the system is enhanced by an imputation system.

### **Cross-border tax treatment**

Income earned by a foreign branch of a NZ company is consolidated with that earned by the parent company and taxed in New Zealand. In the case of income earned abroad by a subsidiary, the system distinguishes between controlled foreign investment (Controlled Foreign Company or CFC) and portfolio investments (Foreign Investment Funds or FIF). These regimes tax the income that residents accumulate in foreign entities that are resident in any other country. Under the FIF rules residents are taxed on a deemed return of 5% of the value of the offshore shares (the "fair dividend rate"). The FIF regime does not apply to most investments in Australian listed companies. Under the CFC rules individuals and corporations are subject to tax on their pro-rata share of the annual total income of CFCs in which they own an income interest of 10% or more. The CFC regime does not apply to the so-called "grey-list" countries (Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States). Investors in foreign companies resident in these countries pay tax only on dividends. The CFC regime and the grey list are currently under review.

Income derived from New Zealand is subject to tax. Non-residents are essentially taxed on the same basis as residents, subject to any limitation imposed by virtue of a double tax agreement.

### **Capital gains tax**

There are no capital gains taxes as such in New Zealand. However, income tax is applied on capital gains if they are part of the taxpayer's "usual activity". For instance, capital profits from the sale of land are brought within the income tax net in a variety of circumstances. Resident companies are taxed on all gains derived from certain types of financial arrangements and from certain property transactions. These gains are taxed at the standard corporate tax rate.

### **Consumption tax**

New Zealand has an almost perfectly neutral value added tax system, owing to the single uniform Goods and Services Tax (GST) rate of 12.5% and the virtually complete absence of exemptions. Since 2005 a zero-rating system has been introduced for financial services. Housing services (e.g. renting a residential dwelling) are exempt from GST, as well as the supply of fine metals, penalty interest and donated goods and services sold by non-profit bodies. In October 2006, the government proposed to extend the exemption to registered owners of holiday homes, home-stays, farm-stays and serviced apartments.

### **Property tax**

The only local taxes on land are the so-called "rates" charged by local and regional authorities on residential and commercial properties. Rates vary by location and are based on property use (*i.e.* residential or commercial) and on an annual assessment of the property's value in relation to current market values. Each local authority, after consulting with their community, can decide which basis to use or can use a mix of these bases. The Local Government Rating Act 2002 provides a number of options for setting rates: general rates (all ratepayers pay for all or part of a particular council service and what each ratepayer pays depends on the assessed value of their property relative to the value of other properties), targeted rates (the cost of a service or function is met by a particular group of ratepayers) and/or uniform annual general charges (flat dollar charge per property, where all properties pay the same for a delivered service regardless of the value of the property). A combination of these rates can also be used. The Rates Rebate Scheme was established in 1973 to provide a subsidy to low-income homeowners on the cost of their rates. An inquiry on local rating is underway with the aim to improve local funding.

### **Inheritance tax and other**

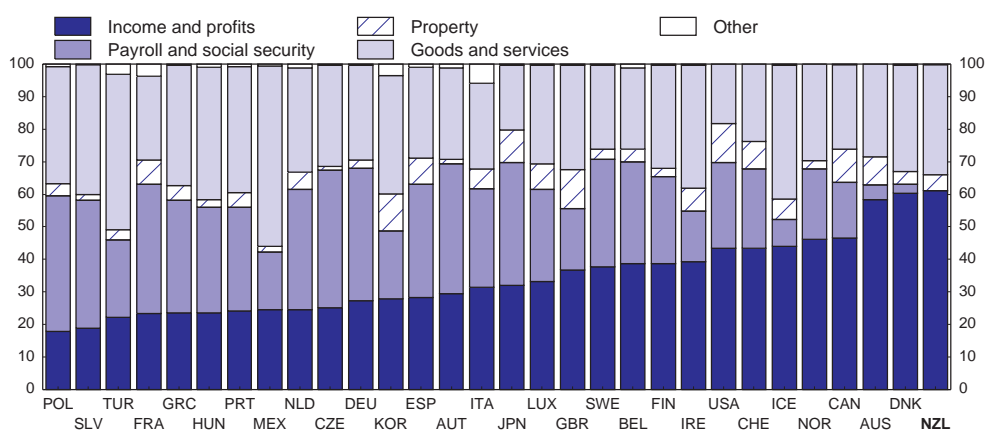
New Zealand does not apply separate inheritance tax or stamp duties. The rate of gift duty depends on the value of the gift. This duty is in the process of being modified.

Figure 1. Total tax revenue  
Per cent of GDP, 2004



Source: OECD (2006), Revenue Statistics 1965-2005, 2006 Edition, OECD Paris.

Figure 2. Tax mix in OECD countries  
Per cent of total tax revenue, 2004



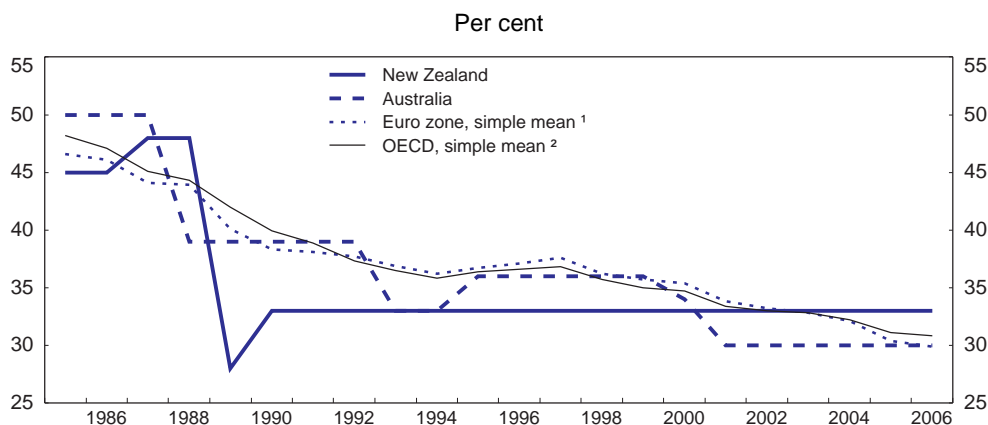
Source: OECD (2006), Revenue Statistics 1965-2005, 2006 Edition, OECD Paris; <http://dx.doi.org/10.1787/366725334503>.

New Zealand's advantage of a relatively low corporate rate has eroded over time (Figure 3). Starting from a position where the country benefited from a significant tax advantage, the trend decline in the statutory rates in many OECD countries has led to a situation where the NZ rate is now higher than Australia's, and, more generally, several percentage points above the OECD average. The differential



would be even more pronounced when compared to small OECD countries or to the preferential rates applied by many OECD countries to small firms.

Figure 3. Trends in statutory corporate tax rates



1. Luxembourg excluded.
2. Using 17 OECD countries; New Zealand excluded.

Source: Institute for Fiscal Studies; IRD (2005), Briefing for Incoming Minister; OECD, tax database.

The remaining fiscal revenue is derived from indirect taxation – including the goods and services tax, and excise and customs duties – and local property taxes. Value-added taxes are levied more efficiently in New Zealand than in other OECD countries, as they are raised through a single uniform GST rate of 12.5% with very few exemptions. Property taxes (“rates”) provide the major source of revenue for funding local government expenditure (around 56% of operating revenue in the year ended June 2005). The average increase of rates from 2006 to 2016 per household is projected to be around 60% (from around NZD 2 250 to NZD 3 600 on an annual basis), including inflation assumptions (Ministry for Local Government, 2007). The projected increases are strongly influenced by the significant investment many Councils expect to make in network and community infrastructure and will vary over different local authorities and over different kinds of ratepayers, depending on the rating policies adopted by each Council.

The effectiveness of the tax system collection is reported to be high by OECD standards. It is estimated that the Inland Revenue Department collects some NZD 123 for every NZD 1 spent (OECD, 2006b). This places New Zealand at 8<sup>th</sup> amongst the OECD countries.

### 3. A long term direction for tax reform

The NZ government has adopted a gradual approach to reforming the tax system whereby improving business and international taxation is considered the first priority. It has announced that lower personal income taxes could be a subsequent step.

Major changes to tax systems that require an increase in some taxes to contain the fiscal cost may best be developed and implemented within a long-term strategy. *First*, this ensures all the proposed changes are consistent and will result in a more coherent tax system. *Second*, it makes the changes easier for the general public to accept, since it would be possible to offset the losses that specific groups may incur (Owens, 2005). *Third*, it allows the government to set out clearly its ultimate objectives, helping taxpayers to adapt to planned changes. In this context, the designers of an optimal tax strategy should seek to find an appropriate balance between improving the efficiency of the whole system and, depending on the country’s social preferences, satisfying some equity criteria (Box 2). Identifying and developing the most appropriate

long-term strategy will take time. Any tax changes in the interim need to be carefully designed so as to minimise the risk that they would be inconsistent with the approach ultimately adopted.

### Box 2. Efficiency, equity and simplicity of tax systems

It is important to have criteria against which tax systems can be assessed. Usually, assuming a certain level of revenue that needs to be raised, tax policy seeks to strike the best possible balance between efficiency, equity and simplicity. Obviously, the weights on each of these criteria will differ according to the country's social choices and specificity. In addition to these criteria, consideration should also be given to transition costs.

#### Efficiency

So long as taxation affects incentives, it distorts economic behaviour (savings, investment, consumption and labour supply) in the short and the long term. The tax system should minimise discrimination in favour of, or against, any particular economic choices, except when there are clear externalities. In practice, this means building tax systems substantially around broad bases and minimising differences between tax rates. The actual effects of higher taxes depend on how sensitive labour supply and personal savings are to changes in the tax rate, which may vary with income and over time, as well as between countries. Understanding the magnitude and nature of the deadweight losses (sometimes called excess burden) is important for assessing the true cost of increased government spending and for shaping the appropriate structure of taxes.

Deadweight losses rise with the square of the tax rate (Creedy, 2003). Diewert and Lawrence (1994) found that the deadweight costs associated with labour taxation (primarily taxation on the income of wage earners and the self-employed) in New Zealand were around 18% for the marginal dollar of income tax revenue raised and around 14% of the marginal dollar of consumption tax revenue raised. More recent estimates of deadweight losses are higher (Bates, 2001; Feldstein, 2005). A cost-benefit guide used by the Treasury for new spending recommends a rate of 20% as a default deadweight loss value in the absence of an evidence-based value (NZ Treasury, 2005). Although these costs are not insignificant, they are still moderate compared with estimates of deadweight costs found for other countries, which are typically in the range of 10 to 100% (Diewert and Lawrence, 1994; Leibfritz *et al.*, 1997).

However, most of these estimates have been made using static analysis, *i.e.* the analysis is limited to estimating the current impact of a change in tax. Most of the time, revenue estimates are also implicitly constrained to assume no change in GDP, thereby ignoring any feedback effect of a change in taxation on economic growth. A number of economic studies have questioned these simplistic assumptions and have suggested the assessment should be done from a life-cycle and a general-equilibrium perspective (Feldstein, 2006). In particular, it is important to incorporate the impact of tax on human capital formation (Driffil and Rosen, 1983). Using these concepts, taxes on capital are found to be more distortionary than those on consumption (Baylor and Beauséjour, 2004) or on labour (Feldstein, 2006).

#### Equity

The distributional impact of taxes across the population raises issues of equity to which most countries give some weight, even if it entails costs in terms of economic efficiency. Tax systems usually aim to achieve two forms of equity.

Horizontal equity implies that taxpayers in an equal situation should be taxed in an equal manner, the main difficulty being to define what constitutes an "equal situation". From a practical perspective, an example could be that the tax on a given level of total income should be the same regardless of how this income is generated, hence that one should rely on a comprehensive definition of income for tax purposes. A corollary would be that tax allowances and tax credits that are not directly linked to the generation of that income would not be compatible with the objective of horizontal equity. However, if equity is evaluated in a dynamic framework (*e.g.* ensuring generational equity), then expenditure taxation can achieve horizontal equity, whereas a comprehensive income approach does not.

Vertical equity is a very normative concept, whose definition can differ from one user to another. According to some, the objective of vertical equity is that taxpayers in better circumstances should bear a larger part of the tax burden as a proportion of their income. This implies that the distribution of after-tax income should be narrower than the distribution of before-tax income, and that the average tax rate should be increasing with income. Others would interpret vertical equity as corresponding to a proportional income tax (*i.e.* a flat tax rate). Again, in practice the interpretation of this definition depends on the extent to which countries want to diminish income variation and whether the criteria should be applied to income earned in a specific period or to lifetime income.

### Simplicity

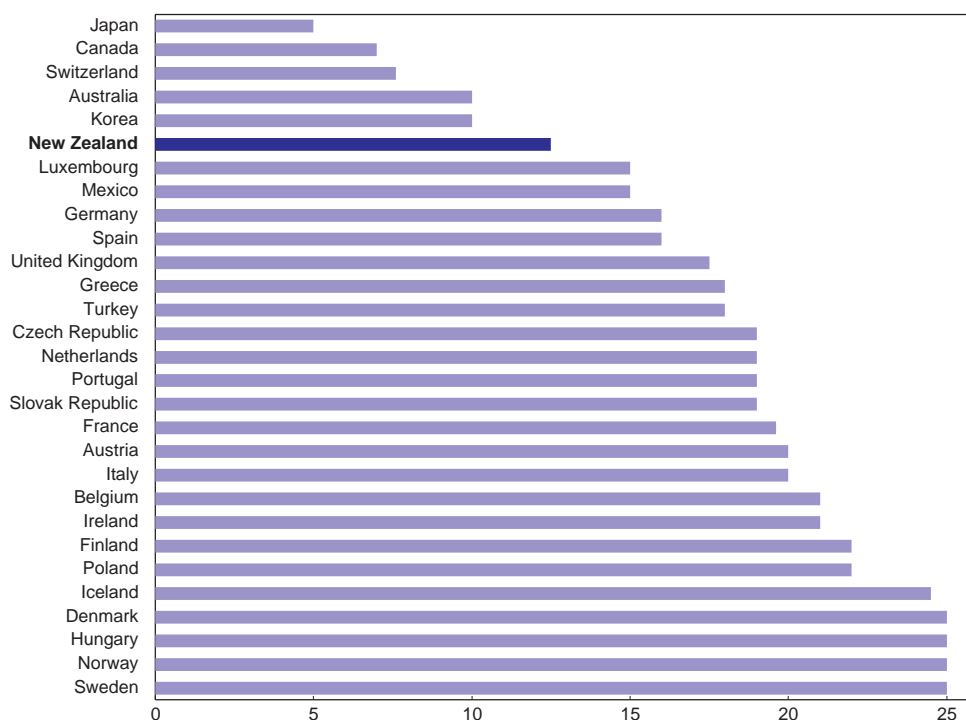
The practical issues of enforceability of tax rules and costs arising from compliance are important considerations. Those are both affected by, and have implications for, the efficiency and public perceptions of the fairness of tax systems. In particular, the tax system quickly gets more complicated when it is also used to redistribute income and as a vehicle for delivering benefits to specific groups or to encourage certain behaviour. Complexity also favours tax planning, which will have deadweight losses for the economy as a whole.

Source: OECD (2006c), NZ Treasury (2005).

In the case of New Zealand, growth-enhancing tax reforms could be designed without compromising long-run fiscal sustainability. The amplitude of potential tax cuts has been publicly debated, largely in the context of a comfortable public surplus. But room for major tax cuts beyond current plans is limited. *First*, it would be inappropriate at the current juncture to inject further fiscal stimulus in the economy. *Second*, fiscal pressures are mounting and will need to be addressed. Significant reforms should be undertaken and those are rarely revenue-neutral as losers often need to be compensated for the losses they incur. At the same time, it is important that the cost of reforms do not endanger the country's ability to manage future health and ageing-related spending. This could be done either by making tax reforms within a close-to-neutral fiscal envelope or finding offsetting reductions in public spending.

Figure 4. Standard VAT rates

As at 1st January 2005



Source: OECD (2006), Consumption Tax Trends, 2006 Edition, OECD, Paris.

A higher GST rate would make room for income tax cuts. The rate of GST is low in New Zealand by international norms (Figure 4), the standard rate of VAT in OECD countries (other than the United States, where there is none) varying from 5% in Japan to 25% in some Nordic countries and Hungary. However, New Zealand has the broadest base of all OECD countries, as measured by the C-efficiency ratio<sup>4</sup> (OECD,

2006d). As a result, the gap between New Zealand's effective consumption tax rate and that of other OECD countries is somewhat smaller than the comparison of standard rates might suggest. NZ Treasury ready reckoners suggest that a moderate increase in the GST rate would bring substantial additional revenues: these could be used to finance other measures to improve the efficiency of the tax system (Table 2). For example, lifting the GST rate from 12.5% to 15% would more than offset the fiscal cost of cutting the corporate rate to the Australian level and of flattening the personal income tax schedule by reducing the top rate to 33%.

In New Zealand, the GST is an efficient, low, flat rate tax with few exemptions. A further shift from income to consumption taxation would increase the efficiency of the tax system. In addition, a shift toward consumption taxation increases consumption possibilities over the life cycle, by lowering distortions on savings decisions. Indeed, as income taxes are generally levied on a base that includes savings and income from savings, a revenue-neutral move towards consumption tax would make taxation more neutral between present and future consumption.<sup>5</sup> Such a shift would have little effect on the total amount of tax paid by an average worker but would reduce the marginal effective tax rate and thereby increase incentives to work for some people, because direct taxes are generally progressive while indirect taxes are close to proportional (Heady, 2006).

Table 2. Fiscal costs of selected tax changes<sup>1</sup>

	Measures	Full-year effect NZD million
Increase the rate of GST	Increase from 12.5 to 15%	2 225.0
Increase in environment taxes	Increase total environment taxes by 50%	511.0
	10 cents per litre increase in excise duty on petrol	50.0
Decrease in personal income tax	One-thousand dollar increase in all brackets	-175.0
	One percentage point decrease in all rates	-790.0
	Lower top rate from 39% to 33%	-780.0
Decrease statutory corporate rate <sup>2</sup>	Decrease from 33% to 30%	-660.0
Using the "operating allowance" for tax initiatives <sup>3</sup>	Allowance for the 2008/09 fiscal year	~2 000.0

1. Such estimates give only a rough approximation of the fiscal costs as they do not incorporate second-round effect of tax changes on employment, household disposable income and economic growth.

2. This includes the effect on company tax revenue from the company tax rate change and the imputation credits offset if personal rates are not modified when the company rate is.

3. Each year of the fiscal forecasts includes an allowance for new operating initiatives, which can be utilised for both spending and tax initiatives. However, it has tended to be dominated by new spending over recent years.

Source: OECD calculations using impacts from the NZ Treasury ready reckoner, Half Year Economic and Fiscal Update 2006 and OECD Revenue Statistics data.

Raising the GST tax rate from 12.5 to 15% would probably have only very modest redistribution effects, as the increase in the amount of tax paid (relative to total consumption) would be of the same order of magnitude for persons in the higher income range as for persons in other bands (Table 3). The rise in GST rate would, nonetheless, display some regressivity if the amount of tax paid is expressed in terms of net income rather than total expenditure. Indeed, analysis from the NZ Treasury indicates that such a rise in GST would increase the percentage of net income subject to GST from 22% to 26% for the lower income

decile and only from 6% to 7% for the top income decile. But this regressivity would be reduced if the analysis was done on a lifetime approach.

Table 3. **Impact of an increase in GST from 12.5 to 15%**

By income group of households, NZD

	Additional amount of tax paid per week by income bracket		
	under 38 000	Between 38 000 and 60 000	above 60 000
Food	2.2	3.3	5.1
Housing (less rent and mortgage)	1.0	1.9	2.8
Household operation	1.8	2.5	3.9
Apparel	0.3	0.7	1.3
Transportation	1.8	3.3	5.4
Other goods	1.2	2.2	3.8
Other services (excluding financial services)	1.5	2.2	4.6
Total (excluding rent and mortgage)	9.8	16.0	27.0
Total (as a percentage of total expenditure)	2.0	2.0	2.0

Source: OECD calculation using NZ statistics on average weekly expenditure.

A number of countries have dealt with this perceived regressivity by introducing multiple rate schedules, with lower rates being applied to basic necessities such as food and clothing.<sup>6</sup> However, this option is suboptimal, as it would increase the complexity and lower the neutrality of the current GST. It would be preferable to maintain the unique rate and use the revenues generated by the GST hike to provide, for example, a modest payable lump sum per capita credit on personal tax.<sup>7</sup> Another alternative could be to provide additional social benefits to lower-income groups. However, such measures would need to be designed properly, so that they do not significantly worsen incentives to work.

#### 4. Two broad approaches for tax reform

This section discusses two possible strategic approaches to addressing long term challenges facing the tax system and help to raise living standards. Each alternative has merits and drawbacks and involves difficult trade-offs between the criteria of efficiency, equity, simplicity, and transition costs. The ultimate choice of tax system is also influenced to some extent by the total level of spending required for policy initiatives. This section also includes a discussion of pure expenditure taxation, which is untested in practice but contains useful insights to consider when designing tax policy in a long term context. It will be important to assess which option is best suited to New Zealand's specific long-term needs.

##### 4.1. *First option: adapting the system within a comprehensive income approach*

The NZ regime was initially designed as a pure comprehensive system with broad tax bases, flat and relatively low tax rates. All or most (cash) income<sup>8</sup> less deductions (from either capital or wage income) were taxed according to the same progressive rate schedule. Since the beginning of the decade, however, some complications have been grafted onto the system. The introduction of the 39% top personal tax rate put an end to the existing alignment of the top personal tax rate with the trust and company rates. The tax system has also increasingly been used for other policy objectives. It has been utilised to deliver assistance to families through the Working for Families package. Moreover, preferential tax treatments to certain sectors or saving vehicles have been introduced.

Responding to long-term pressures would require lowering rates, flattening the tax schedule and aligning tax rates. This would enhance the efficiency and the simplicity of the system. Such a system could

come close to achieving static efficiency, while trying to ensure a fair distribution of the tax burden. In a pure comprehensive model, the lack of income-shifting possibilities would also reduce administrative costs. In practice, no existing system taxes all types of income in an equal manner so that there are always possibilities for arbitrage behaviour. But, the NZ system has attempted to minimise these distortions by maintaining rates as low as possible by taxing a broad base. The further a country's tax regime departs from the 'broad base, low tax' principle, the higher arbitrage behaviour and administration costs there will be.

The comprehensive income approach is the basic model followed by many OECD countries, but it encompasses a number of limitations. *First*, for those whose savings comes from earned income, tax is first paid on income set aside as savings and then on returns from that savings. As a result, when tax rates are high, the system is less likely to achieve dynamic efficiency than other regimes that levy less tax on savings. When tax rates are low, the gains of having a lower static deadweight loss (compared to other systems that tax labour more heavily) need to be evaluated against the dynamic efficiency losses stemming from the taxation on savings. *Second*, a number of implementation issues arise with respect to the taxation of capital income, for instance regarding the valuation of capital gains for taxation purposes.

#### **4.2. *Second option: moving to a dual income tax system***

The objective of raising living standards in the long run may also be served by more fundamental changes to the tax system. By treating all income in a given period in the same way regardless of its source, a comprehensive income tax system taxes consumption in the future more heavily than consumption today. In contrast, a dual income tax (DIT) system taxes labour income at a higher rate than capital income and thus treats consumption in different periods more neutrally. DIT systems, combining progressive taxation of labour income with a fairly low flat tax on corporate and capital income, were introduced in Finland, Norway, Sweden and, to a lesser extent, Denmark in the early 1990s.

A basic principle of the dual income tax is neutrality across all forms of capital income. Capital gains are taxed and taxable business profits correspond as closely as possible to true economic profits. This implies that accelerated depreciation and other special deductions from the business income tax base have to be avoided. When the dual income tax was introduced in the Nordic countries, the business income tax base was broadened considerably. Moreover, an ideal dual income tax would tax the returns to pension saving and housing investment at the general capital income tax rate. In practice, the Nordic countries have not managed to go that far, but Denmark and Sweden have imposed flat taxes on the return to pension savings at roughly half the level of the ordinary capital income tax rate. They have also tried to make up for missing taxes on imputed rents *via* a property tax on owner-occupied housing, but the latter has recently been cut in Sweden.

In terms of efficiency, a move from a comprehensive income tax to a dual income tax would reduce inter-temporal efficiency losses and increase lifetime consumption possibilities. By generally allowing lower taxes on capital income, DIT systems also reduce the required rate of return on capital for investment projects. It is also easier to include all forms of capital income in the tax base. If, for some reason, some types of capital income are excluded from the tax base, the implied distortions would be lower because tax rates on other forms of capital income are relatively low. DIT systems may also inhibit the flow of capital offshore, a consideration that is likely to become more important with increased mobility of capital tax bases.<sup>9,10</sup> Lastly, there is less incentive to engage in seeking tax breaks for particular forms of business income.

However, the net efficiency gains of moving to a DIT system depend on how the revenue gap created by lowering the tax rate on capital is financed. It could be offset by reductions in government spending, raising the GST rate, increasing taxes on earned income or some combination of these alternatives. The net

efficiency gains would depend on the scale of deadweight losses associated with each tax as its rate changes, as well as the extent to which different taxes affect the international mobility of capital and labour. This is ultimately an empirical question.

DIT systems deliver horizontal equity when evaluated on the basis of lifetime income in a way that would not be achieved if only one income period is considered, as taxpayers with a different mix of capital and labour income are taxed differently. The introduction of a lower proportional tax rate on capital income would diminish the tax code's vertical equity as well, because income from capital tends to be concentrated in the upper income brackets. But as DIT systems allow for a progressive schedule to be applied on labour income, a degree of income redistribution could still be delivered through the tax system. However, this would imply less redistribution from those on high incomes generated from capital than from those earning the same income in wages and salaries.

A particular limitation of DIT systems is that they can incite small firms and the self-employed to reclassify their labour income as capital income. To prevent this, an income-splitting rule needs to be defined to ensure that investment in business assets is treated in the same manner as other forms of investment. This can be done by imputing a rate of return to the business assets of proprietorships, partnerships and farms and by taxing only this return as capital income. In practice, it will be important to carefully assess the pros and the cons of adopting a dual income system in New Zealand, where the share of small business in the economy is very high.<sup>11</sup> In this context, it would be interesting to draw on experience from a country such as Norway, where the issue of the treatment of small businesses has been closely looked at (Box 3). The issue of transitional costs should also be investigated.

#### Box 3. The treatment of small firms in Norway's dual income tax system

Since labour income is taxed more heavily than income from capital, a DIT system gives the taxpayer an incentive to misrepresent labour income as capital income. This option is mainly open to owners of small firms who work in their own business. To prevent such income shifting, the Norwegian tax rules that existed until 2006 required that the income of the self-employed and of 'active' owners of corporations be separated into a capital income component and a labour income component (the so-called *split model*). The capital income component was calculated as an imputed return on the value of the business assets in the firm's tax accounts. The residual business profit was then taxed as labour income (up to a certain ceiling beyond which the profit was again categorised as capital income). This system worked reasonably well for the self-employed, but not for so-called active owners of small companies. Indeed, many Norwegian owner-managers were able to reclassify their labour income and to have all of their income taxed at the low capital income tax rate.

Because of these problems, in 2006 the Norwegian parliament replaced the problematic income-splitting system by a so-called shareholder income tax. This is a personal residence-based tax levied on that part of the taxpayer's realised income from shares (dividends plus realised capital gains) that exceeds an imputed after-tax rate of interest on the basis of his shares. In principle, the shareholder income tax will be neutral, since it exempts the normal (risk-free) return from tax, and realisation decisions are not distorted by the tax. Shareholder income in excess of the imputed normal return is supposed to be taxed as ordinary capital income. Rates have been set so that at the margin, the total corporate and personal tax burden on corporate equity income will be roughly equal to the top marginal tax rate on labour income. Hence corporate owner-managers will gain nothing by transforming labour income into dividends and capital gains. However, it remains to be seen whether the new Norwegian shareholder income tax will provide a complete solution to the problem of income shifting.

Source: Sørensen (2006) and OECD (2006c).

The limiting case of DIT when capital is not taxed at all is a proxy of a direct expenditure tax. In theory EET and TEE regimes<sup>12</sup> deliver the same post-tax income for individuals under some particular assumptions such as that the discount rate is equal to the rate of return, and that contributions and withdrawals are subject to the same marginal income tax rate (Yoo and de Serres, 2004). However, an EET

system is likely to collect more revenue than a TEE system and so does not require such a large increase in other taxes to balance the budget. Indeed, shifting to a TEE system completely exempts income from the current (at the time of the changeover) stock of personal wealth, while an EET regime still subjects it to tax (to the extent that it is consumed).

In an expenditure tax, the tax base is consumption of final goods and services or income minus savings broadly defined, which includes savings at the company level. In contrast to indirect consumption tax, direct expenditure tax allows for a progressive tax schedule. In practice, there are two ways to implement a direct expenditure tax: a cash-flow tax or a yield-exempt tax. In the cash-flow tax method, a consumption tax is imposed only on that part of personal and corporate incomes that are used for consumption. Savings, as well as interest income and other returns on capital, are tax-exempt until they are withdrawn and spent. In the yield-exempt method, all forms of labour income are subject to tax, while earnings from capital income are tax-exempt.

A move from a comprehensive income tax to a direct expenditure tax would, in theory, have a positive effect on welfare (Katz, 1999). More precisely, a direct expenditure tax system has a number of advantages:

- Direct expenditure taxation eliminates the taxation of savings experienced by individuals and businesses under an income tax system. As such, a switch to an expenditure tax is expected to raise returns to savers and reduce required returns for investors, boosting equilibrium capital intensity and hence income levels. Most empirical studies (in particular for the United States) have concluded that the effect of switching to an expenditure tax would have only a small impact on savings (Freebairn and Valenzuela, 1998). Although a move to direct expenditure tax would be expected to stimulate investment, the amplitude of the response remains uncertain.
- An expenditure tax will remove most of the differences in effective tax rates on different savings and investment vehicles. By reducing non-neutralities existing in the current tax system (*e.g.* the tax preference for owner-occupied housing over business investment), a direct expenditure tax would allow a more efficient mix of investment options.
- It is easier to measure an expenditure tax base, which is equal to total consumption, than a comprehensive income tax base, which requires the measurement of capital income and of the return to human capital investments on an accrual basis. Because it is simpler and has fewer ambiguous boundary issues than an income tax system, an expenditure tax is likely to be more resistant to tax avoidance.

Despite these advantages, this option has never been fully implemented anywhere in the OECD, although most Member countries have some elements of direct expenditure taxation in their systems.<sup>13</sup> One of the main difficulties in implementing a pure expenditure-based tax system is that it may be difficult to raise a sufficient amount of revenue. Because savings are tax-exempt, rates in an expenditure tax system would have to be increased for the change to be revenue-neutral. This would increase the static deadweight cost, which has an exponential relationship with the rates and would thus reduce the overall benefit of not taxing savings. There may also be some resistance to adopting an expenditure-based system, because it is often wrongly perceived as a tax on labour that distorts work versus leisure decisions and can discourage labour force participation. However, in a life-cycle perspective, individuals can be better off with a tax on labour income rather than on saving (Feldstein, 2006). A switch to an expenditure tax would also redistribute the tax burden from those with positive to those with negative savings (*i.e.* generally from high to lower income individuals). Maintaining the current distributive pattern would require that the expenditure tax schedule be more progressive than the current income tax schedule. Lastly, such a tax change would be likely to have significant transition costs (Katz, 1999).



## 5. Issues to consider within current tax bases

Although the current tax system is for most part well designed within a comprehensive income approach, it suffers from a number of shortcomings that reduce its efficiency and sometimes add unnecessary complications. This section lists the main limitations and suggests ways of improvements. It discusses in turn, personal income tax, the taxation of investment income and environmental tax policy.

### 5.1. *Optimising the taxation of income*

Recent changes, in particular the gradual phasing-in of the Working for Families package, have eased the problem of welfare traps for sole parents and couples where one person receives unemployment benefits. But because of the interaction between tax rates and the abatement of tax credits and welfare benefits, effective marginal tax rates (EMTRs) faced by single-income households in the abatement ranges remain very high, reducing their incentives to increase hours worked, upgrade skills or take on greater responsibility. The package has also augmented disincentives to work for second-income earners (see OECD, 2005).

A number of measures could help to lower these disincentives to work. *First*, family assistance programmes could rely more on universal benefits, rather than on income-tested measures. In order to limit fiscal costs, these benefits could be targeted to families with children below the age of five, as it is easier for parents with school-age children to take up a job. This measure would be particularly useful to strengthen incentives to work for sole parents.<sup>14</sup> *Second*, income-tested benefits could be replaced by childcare and after-school care subsidies, which are found to have stronger effects on incentives to work than child benefits (Jaumotte, 2003). It is worth noting that income-tested benefits have two competing objectives - improving work incentives and reducing child poverty - and thus inevitably involve trade-offs. In any case, the benefits of increased incentives to work financed by fiscal transfers need to be weighed against the adverse incentives from the additional taxes required to pay for those transfers.

Flattening the personal income tax schedule could also be useful to reduce high EMTRs. This could be achieved by broadening the tax brackets or through a reduction in the number of brackets (or equivalently, a reduction in the number of effective tax rates). The latter option has been used in many OECD countries to flatten their income tax schedules.<sup>15</sup> The cost of the changes is estimated to be significant and can vary markedly from one option to the other (Table 4.4).

Over the years, bracket creep has affected nearly all taxpayers. For instance, the percentage of the population (above 18 years old) facing the 39% rate rose from 5% in 2000 to 12% in 2006. This stems from the fact that income tax thresholds have not been modified since 2000, while incomes have risen by about 30% over the same period. Against this background, the 2005 Budget introduced a policy of adjusting the low-income-earner rebate and personal income tax thresholds for 2% inflation every three years. But the first adjustment will come into effect only on 1 April 2008. Adjustments for inflation are common in OECD countries and most of the time are made on a periodic basis (OECD, 2006c).

Table 4. Revenue impact of flattening the income tax schedule

Full year effect, NZD millions

	Direct effect	With offset from GST, excise and company rate <sup>2</sup>
Changes in thresholds		
three thresholds (NZD 9 500, 45 000 and 60 000)	-700.0	-625.9
increase top threshold by NZD 5 000	-100.0	-82.9
Changes in tax rates		
two effective rates at 15% and 33% <sup>1</sup>	-2 820.0	-2 790.7
three effective rates at 15%, 33% and 39% <sup>1</sup>	-2 040.0	-2 011.1
four effective rates 15%, 19%, 29% and 33%	-1 880.0	-1 860.8
four effective rates 15%, 19%, 29% and 39%	-1 100.0	-1 081.0
lower top rate from 39% to 33%	-780.0	-779.8

1. Those previously taxed at 21% are taxed at 15%.

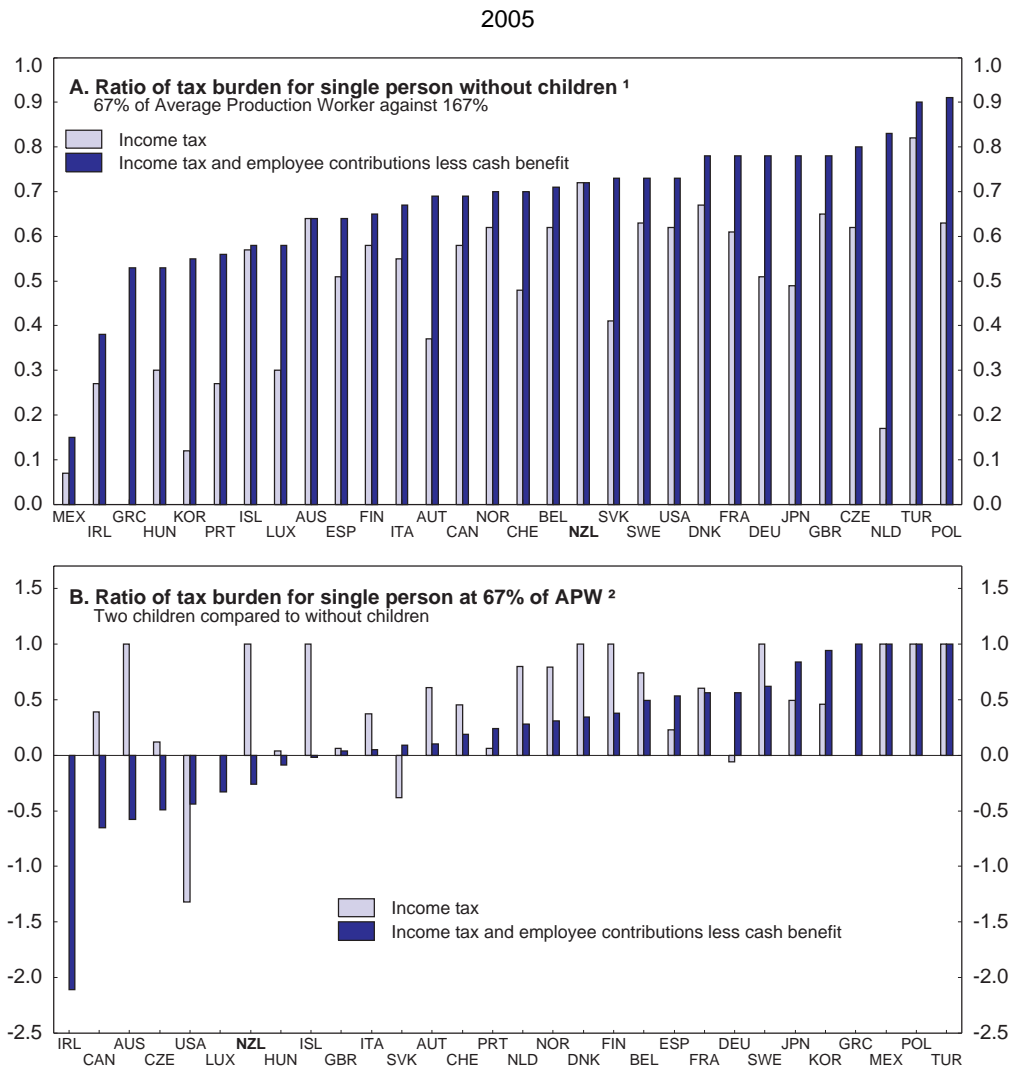
2. Lower tax means individuals have more disposable income and hence spending goes up. This results in an increase in GST and excise duties on petrol. With higher sales, profits increase and so do company taxes. Estimations of these offsets are included in this column.

Source: OECD calculations using the NZ Treasury ready reckoners.

Lowering the top rate is likely to increase incentives to work for high income earners, who also experience relatively high EMTRs, especially if they qualify for Working for Families support<sup>16</sup>, while having only a moderate effect on public revenues. Moving back to the rate alignment of corporate, income trusts and top personal tax rates would have the additional advantage of putting an end to income-sheltering activities, which can create a perception of unfairness and erode the overall integrity of the tax system. Such activities have developed significantly since the introduction of the 39% top rate, as evidenced by the huge amount of income that has been diverted to trusts to benefit from lower tax rates (IRD, 2005).<sup>17</sup>

These alternative options will have differential impacts on the income distribution and might end (or even reverse) the trend towards increased progressivity observed since the beginning of the decade.<sup>18</sup> However, personal income tax is not the principal instrument through which redistribution is achieved in New Zealand: most of the redistribution occurs from households without children to households with children and through cash benefits rather than through personal income tax rates (Figure 5).

Figure 5. Indicators of progressivity



1. Progressivity is assessed by comparing the burden faced by single persons earning two-thirds of the average wage with the burden faced by their counterparts earning five-thirds of the average wage.
2. Progressivity is assessed by computing the ratio of the burden faced by single persons with two children to the burden faced by single persons without children.

Source: OECD (2006), Taxing Wages 2004/2005, 2005 Edition, OECD Paris.

## 5.2. Removing inconsistencies in the taxation of investment income

### Corporate taxation

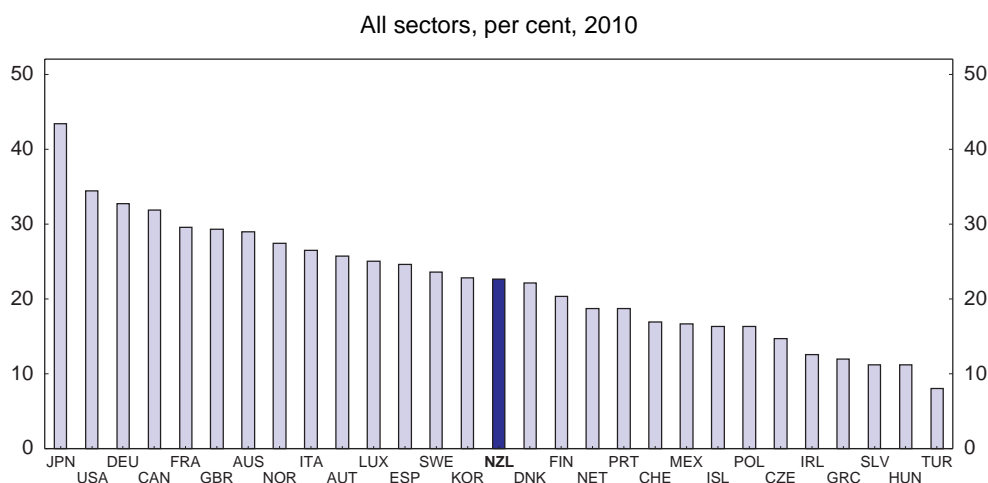
Corporate taxes can distort firms' financing and investment behaviour in a number of ways, including the financing of investment and the choice of legal form (Heady and Brys, 2006). In addition, a corporate tax rate higher than those of New Zealand's trading partners creates incentives to stream profits to countries that have lower tax rates by, for example, transfer-price manipulation. Moreover, higher company taxes in New Zealand encourage domestic companies to relocate or be established elsewhere. They also discourage internationally mobile firms from locating their businesses in New Zealand.

Although statutory tax rates are now higher than the OECD average, marginal effective rates on capital are expected to be average by the end of the decade, assuming current policy settings (Figure 6).<sup>19</sup> They are, nevertheless, projected to be higher than in many other small OECD countries and emerging economies.

Concerns about the loss of international competitiveness of the NZ tax system have been growing, and the government proposed a number of measures in its 2006 Business Tax Review. The measures include: a reduction in the company tax rate to the Australian rate of 30% (from 33%); targeted tax credits for R&D activities, export market development activities and skills training; the deferral of losses from significant upfront expenditure to allow losses to carry through a shareholder change;<sup>20</sup> the deduction for a wider set of “black hole” expenditures;<sup>21</sup> the modification of the depreciation loading on new assets; and a number of tax compliance measures.<sup>22</sup>

Many of these changes, such as the compliance measures, the deferral of losses and the deduction for black hole expenditures are likely to improve the efficiency and the simplicity of the tax system. It is also important to ensure that the depreciation allowed by the tax codes closely approximates economic depreciation, which is the decrease in the value of a productive asset that occurs because the asset is steadily less productive as it ages. Depreciation rates were modified in 2005 to better reflect the economic depreciation of assets, and different rates have been applied to short-lived and long-lived assets. However, a “loading” of 20% continues to be added to the depreciation rate for most new assets so that they depreciate more rapidly.<sup>23</sup> This reduces the bias that favours investment in longer-lived assets. But this loading introduces a distortion between new and second-hand assets. Moreover, the rationale for this additional loading is not clear, if depreciation rates are set appropriately. It introduces unnecessary complication, and it would be preferable to eliminate it.

Figure 6. Marginal effective rates on capital



Source: Pastry A., J. Lester and D. Lemay, "An International Comparison of Marginal Effective Tax Rates on Business Investment in the Manufacturing Sector", paper presented at the 2006 Society of Government Economist (SGE) Conference, Washington DC.

The proposed cut in the corporate tax rate to the Australian level would certainly have beneficial short-term effects: it would help to improve the competitiveness of NZ-based companies in international markets, reduce incentives for NZ firms to shift profits away from the country and boost capital productivity by lowering distortions that impede corporate capital from being allocated to its most efficient use. Despite these positive short-term effects, the proposed measure may not be sufficient to markedly spur investment and promote long-term economic growth.<sup>24</sup> Indeed, the cut will affect only firms operating in

corporate form. In addition, although the statutory corporate rate attracts a lot of attention from the general public, it is only a partial indicator of the incentives produced by the tax environment faced by firms.

A cut in the corporate tax rate should not be made in isolation as it would have implications for the design of the wider income tax structure. The usefulness of the imputation system is likely to be questioned if corporate tax rates are to be lowered even further (Annex 1.A1). Indeed, the need to remove double taxation of dividends may be less acute when corporate tax rates are low, while the granting of credits to resident and non-resident shareholders reduces corporate tax revenues. Moreover, lowering the corporate rate will also encourage firms to finance investment with retained earnings (rather than by issuing new equity), unless an adjustment is also made on the tax on dividends at the personal level. Finally, lowering the corporate rate with no change on the top personal income tax rate will favour income-shifting. More fundamentally, there is a need to go further than the measures announced in the Business Tax Review.

#### *Preferential exceptions to general tax rules*

Over the years, there has been a move toward granting more exceptions, constituting a break with the “broad base, low rate” policy endorsed in the 2001 Tax Review (McLeod *et al.*, 2001). Non-neutral tax policies that are unevenly applied to various activities encourage New Zealanders to devote resources to less-taxed activities, rather than to those that generate the greatest economic returns. This can induce a sectoral misallocation, as tax preference is given to certain types of investments.<sup>25</sup> Another risk is that, because targeting requires more information than is normally available, incentives are often given too widely by subsidising activity that would take place anyway. Targeted measures also increase the compliance and administration costs. They also generate intensive lobbying from special interest groups pressing for tax concessions for their particular sector. In this context, it would be useful to level the playing field by removing existing taxation preferences.

The tax exemption for employer contributions to registered superannuation schemes is a further departure from the comprehensive income approach. In the latter system, any employer contribution to a superannuation fund for the benefit of an employee is liable for tax. The exemption was introduced in the context of KiwiSaver to incite employers to invest in superannuation schemes and give them more choice in the way they remunerate their workers. While this might seem attractive by providing some tax advantages to savings, it nonetheless introduces non-neutrality by only favouring one particular type of savings and can induce switching between savings instruments. Over the life cycle, it can be seen as a tax exemption for employees and erode the tax base.

Looking forward, the major risk is to head further away from a broad tax base. Indeed, the government has recently proposed targeted tax credits for firms that invest in R&D, exporters, or those that provide skills training (NZ Treasury and IRD, 2006a, 2006b and 2006c). The proposals’ economic rationale is that there are wide benefits to the country when businesses invest in these activities and that investing firms do not capture all of these benefits themselves. The proposed R&D tax credit is expected to be available to a broad group of firms but will generate treatment differences between small and large companies, those that have taxable income and those that do not, and those who carry out R&D overseas and others. Moreover, if tax credits are adopted, it will be necessary to scale back the provision of grants through which most assistance to R&D is currently provided, as there is a risk otherwise of providing more assistance than could be justified by the spillover argument.<sup>26</sup>

Developing well-designed export and skill training tax credits is likely to be difficult; little guidance can be found in the economic literature or international experience. While recognising the importance of not restricting this assistance to specific firms or sectors, the government has proposed to limit export tax credits to small firms, which would reduce their incentives to grow. In addition, it is not clear whether these new credits would be more efficient than the current Market Development Assistance Scheme, for

which additional credits were allocated in November 2006.<sup>27</sup> The proposal of introducing tax credits for firms that provide skills training will not be restricted to certain types of training, organisation types or sectors and could be useful to promote investment in human capital and thus foster productivity. However, it would be difficult to limit the extent of deadweight losses usually associated with this type of scheme. More generally, it would be preferable to limit the use of the tax system as an instrument to deliver other policy objectives, as this is likely to complicate the whole system, reduce its efficiency and open up rent-seeking activities.

### *Offshore investment taxation*

The current system encourages domestic firms to relocate their headquarters outside of New Zealand if they plan to expand their active businesses in third countries or otherwise to stay small and local. Indeed, stricter rules than in other OECD countries are applied on controlled foreign companies (CFCs) reflecting New Zealand's choice to put more weight on neutrality considerations between investing domestically and abroad and less emphasis on competitiveness of domestic firms operating in foreign markets. New Zealand's foreign investment fund (FIF) rules for portfolio investment have been more stringent in some cases and more generous in others with respect to international treatment of offshore portfolio investment.

Current tax rules also provide an incentive to tilt NZ offshore investments to the so-called "grey-list" countries, when better overall returns may be available in countries that do not receive similar concessionary tax treatments. Indeed, "grey-list" countries have been exempted from CFC and FIF rules, and investors in foreign companies resident in these countries pay tax only on dividends.<sup>28</sup> In contrast, many offshore portfolio investments in other countries were subject to a taxation of full economic income. Finally, international taxation rules created unfair advantages for direct investors over other savers who use managed funds and are taxed on those funds' earnings.<sup>29</sup> These anomalies have been removed since 1 April 2007 with the adoption of the fair dividend rate of taxing offshore portfolio investments.

Against this background, the government has proposed to relax the CFC rules.<sup>30</sup> This proposed change is welcome as it would bring the relevant NZ rules into line with international norms. It would also put NZ companies on a more equal footing by removing an additional tax cost not faced by firms based in comparable jurisdictions. The government has also introduced a new set of rules that aims to remove the difference in treatment between savings vehicles (IRD, 2006b).<sup>31</sup> While the changes reduce the distortions between managed funds and direct investment by taking a consistent approach to income, certain features of the new rules could cause some difficulty. *First*, it still appears more advantageous to invest directly rather than through a managed fund, as individuals will have the advantage of a variable rate and pay no tax in years when a loss is incurred. On the other hand, other factors may indicate a preference for investing through funds instead of individually, such as being taxed at 33% instead of 39%. *Second*, the credibility of the proposal has been questioned by the announcement of a special deal for an individual large group.<sup>32</sup> *Finally*, a number of other issues are unresolved or have emerged: the new rules are likely to increase compliance costs; the choice of a 5% inflation-adjusted risk-free rate of return has been questioned as relatively high<sup>33</sup>; and, more generally, there is the risk that the proposed system is judged too complicated by small investors.

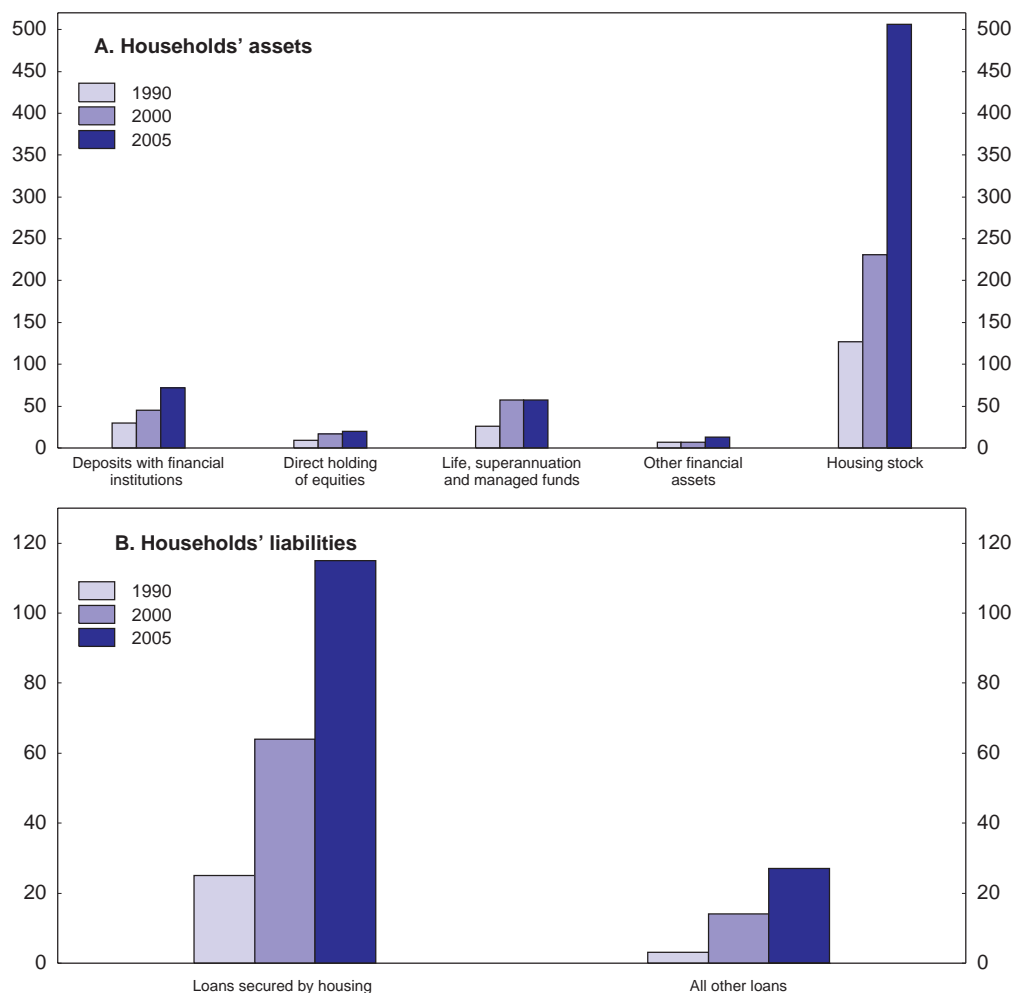
### *Levelling the playing field between financial and housing investment*

Housing is by far the most important asset in the wealth portfolio of New Zealanders (Figure 7). Indeed, as gains in house prices have generally exceeded the returns on financial assets, households have elected to build up housing equity, rather than saving some of their income in other forms.<sup>34</sup> This may reflect a tax advantage on owner-occupied housing compared to financial investments: financial investments are taxed on income and in some cases on capital gains while owner-occupied housing is

exempt from taxation (other than the local property tax), though the lack of deductibility of mortgage interest may compensate for this treatment. This may also reflect taxation of capital gains on managed funds investments. At this stage, it is not completely clear how the recent changes to the Portfolios Investment Entity (PIE) tax regime are going to affect investment in housing: on the one hand, the number of listed real estate entities could rise and inject money in the housing sector, but on the other hand, tax changes may also incite domestic investors to invest more in financial assets and less in housing. Overall, the non-taxation of capital gains of financial assets is the more significant change and the net effect should be to reduce any tax distortion favouring investment in housing over investing in financial assets. By contrast, the set up of KiwiSaver is expected to accentuate the bias in favour of housing, by assisting home ownership. However, as almost all KiwiSaver accounts will use the PIE tax regime, the non-taxation of capital gains on equity investment should be an incentive to invest in financial assets instead of housing.

Figure 7. Household sector net worth

December years, NZD billions



Source: Reserve Bank of New Zealand.

However, because only investors with completely equity-financed houses benefit from the full advantage of the housing's preferential tax treatment as the mortgage interest is non-deductible, the overall tax preference that benefits owner-occupied housing in New Zealand is not large compared to that in other

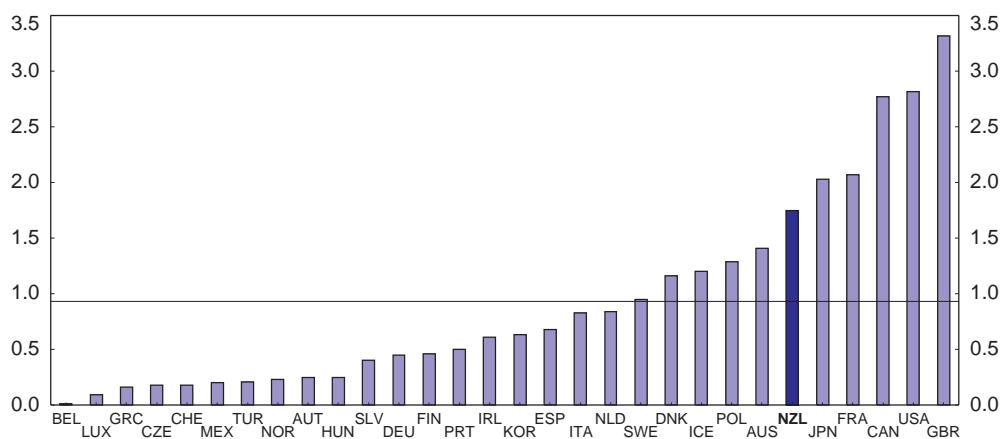
OECD countries.<sup>35</sup> Nevertheless, the ability to deduct expenses for repairs and maintenance and interest related to rental properties against total income increases incentives to accumulate housing assets.<sup>36</sup>

Tax advantages for owner-occupiers offered in other countries are often motivated by social policy objectives – to assist low- and middle-income groups in acquiring a home. However, they risk favouring higher income groups, who can afford the investment to qualify for the tax subsidy. More importantly, this preferential treatment diverts capital away from possibly more productive uses and distorts the allocation of savings between different vehicles. From a microeconomic perspective, there are also risks in households putting too much of their wealth into housing. It can take time to turn an illiquid asset like a house into cash, should the need arise. Moreover, there is a risk regarding the valuation of housing assets. While there have not been any large downward adjustments to nominal house prices in New Zealand in the past, such changes could occur in the future.

Traditional taxation instruments are likely to fail to lower the tax advantage of housing over financial assets. Imposing a tax on realised capital gains on housing would do so but is likely to generate substantial lock-in effects. By contrast, introducing a national property tax on top of the existing local property taxes could be attractive. At the moment the amount of property tax levied is higher than in most OECD countries (Figure 8), but there is no tax on land. A national property tax on land existed in New Zealand but was abolished in 1989, following the collapse on land values. Setting up a new national tax on land is thus likely to be challenging from a political point of view, but it would have the advantage of being a relatively efficient way to raise revenues, as it would apply to an immobile tax base. Such a tax would need to be carefully designed so as to avoid traditional problems, including risks of the tax falling disproportionately on some asset-rich low-income groups such as pensioners or farmers.

Figure 8. **Immovable property taxes**

Per cent of GDP, 2004



Source: OECD (2006), Revenue Statistics database.

One possibility to remove part of the bias toward housing investment would be to modify the current interest and expense for repairs and maintenance deductibility for rental properties and make the deduction against rental income rather than total income as is currently the case. This would move New Zealand closer to standard procedures in other OECD countries and could lower incentives to invest in rental housing. But this would also be a further departure from a comprehensive income approach. A move to a dual income system would help to address this problem, by limiting deductions to rental income.

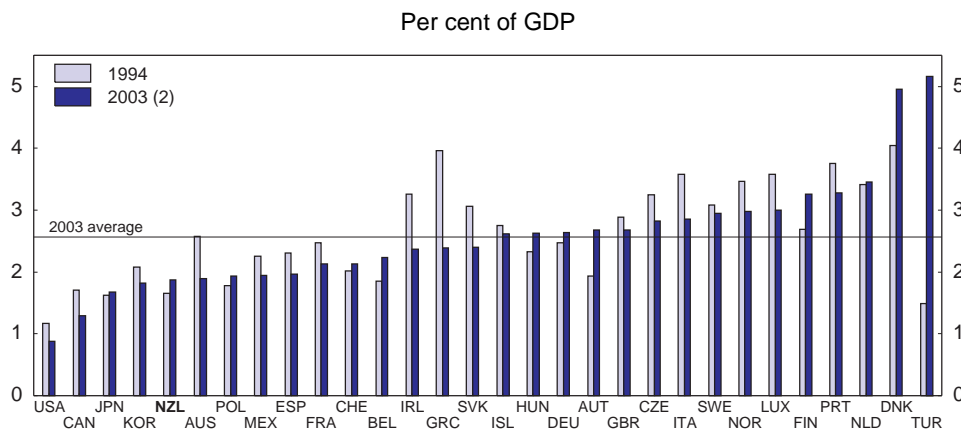


Another option would be to explicitly link the availability of deductions for interest, repairs and maintenance on investment in housing for business purposes to capital gains taxation. This would allow a self-selection process: if individuals choose to benefit from the deduction, then they would be subject to capital gains taxation. Otherwise they could choose not to apply for the deduction and to be exempt from capital gains tax. The distortions to the composition of saving and investment implied by the absence of comprehensive capital gains tax would be less acute if New Zealand were to move to a dual income approach that would allow it to have a lower tax rate on capital income.

### 5.3. Taxation and environmental policy

Revenues from environmentally-related taxes are low in New Zealand compared to other OECD countries (Figure 9). Past attempts to raise such taxes – for instance, the proposal to introduce a CO<sub>2</sub> tax of NZD 15 per tonne – have been abandoned, increasing uncertainty in investment decisions in some sectors such as energy. Moreover, some aspects of the current tax system are inconsistent with the country's espoused wish to adopt environmentally friendly policies. For instance, there is no tax on diesel fuel in New Zealand, while unleaded gasoline is taxed.<sup>37</sup>

Figure 9. Revenues from environmentally-related taxes<sup>1</sup>



1. Data refer to revenues from environmentally-related taxes for pollution control.
2. 2002 for Australia and the Slovak Republic.

Source: OECD (2006), Consumption Tax Trends, 2006 Edition, OECD Paris.

The government has recently stressed the importance of developing a strategic Climate Change policy. As part of the draft National Energy Strategy, it has proposed a range of policy options to encourage low-emissions energy supply and a transition to greenhouse gas pricing, including a narrow based CO<sub>2</sub> charge that would apply only to the electricity sector (Ministry of Economic Development and Ministry for the Environment, 2006). These options are only for a transition period. For the post-Kyoto period, the government has mentioned a greenhouse gas charge as one possible measure for reducing greenhouse gas emissions. Other possibilities include voluntary and directive regulatory measures, although the NZ authorities have also indicated their preference to use economically efficient price-based measures applied to key sectors. However, decisions in this matter are pending until the international policy framework is clarified.

Designing and implementing an efficient environmental tax policy is difficult. However, the OECD has singled out a number of desirable features a system should have, using lessons from international experience (Box 4). Drawing on this experience, increasing environment-related taxes and encouraging the

development and application of environmentally friendly technology would allow the country to achieve its environmental objectives in a more efficient way.

#### Box 4. International experience with the design of environmental tax policy

Experience over recent decades has proven that environmentally-related taxes can be effective and efficient instruments for environmental policy. Countries should strive for the broadest possible tax bases and limit exemptions and other special provisions to ensure cost-efficient emissions reductions. A broader reform strategy might make it easier to get acceptance for the tax from affected parties. This strategy has been used in many countries that have introduced green tax reforms. In general, political acceptance can be strengthened by creating a common understanding of the problem at hand, its causes and effects, and the impacts of possible alternative instruments that could be used. One way to build such a common understanding is to involve relevant “stakeholders” in policy formulation, for example through broad formal consultations and/or in committees or working parties preparing new policy instruments.

#### Sectoral competitiveness

Experience has shown that the following factors affect the impacts of environmental taxes on sectoral competitiveness:

- Different firms within a given sector will not be affected in the same way by any use of economic instruments, due to the different input combinations and the resulting differences in emissions profiles.
- Related markets bear some of the impact of a given policy on a particular sector. A part of any initial burden placed on a sector is likely to be shifted backward to input suppliers and forward to customers.
- The larger the group of countries that put similar policies in place, the smaller the impacts on sectoral competitiveness.
- Protecting the competitiveness of energy-intensive sectors through the recycling of tax revenues back to those sectors is likely to lower the environmental effectiveness of the policy as a whole.

#### Income distribution

Most studies show that environmentally-related taxes, and especially energy taxes, can have a regressive impact on the income distribution of households, although most do not include many of the indirect effects from price increases on taxed products. Regressive impacts from implementing environmental taxes are often softened by exemptions or rate reductions, but these can lower the effectiveness of the environmental tax. Cuts in other taxes or through the social security system are preferable, as they can maintain the price-signal mechanism of the tax while mitigating its negative impact on low-income households. In some cases the distributional concerns have not been addressed at all, or have surfaced late in the process and tackled in an *ad hoc* fashion. This might lead to strong opposition and failure to implement effective environmental measures and implies higher costs to society than necessary. To ensure that distributional concerns are properly addressed, Member countries could introduce mechanisms into the decision-making process whereby such impacts are explicitly analysed.

#### Administrative costs

It is possible to design a number of economic instruments for environmental policy that have relatively low administrative costs. For example, taxes on petroleum products are usually levied on a limited number of petroleum refineries and depots, and hence are relatively simple to administer and enforce. However, many economic instruments actually used for environmental policy involve a large number of special provisions that increase administrative costs. Such mechanisms are often introduced for non-environmental reasons, mainly to address competitiveness or income-distribution concerns. A lesson that can be drawn is that there often seems to be a trade-off between the size of the administrative costs and measures to create a “fair” or “politically acceptable” scheme.

Source: OECD (2006e).

## 6. Conclusions and policy recommendations

This paper has examined several aspects of the NZ tax system where improvements could be made to enhance efficiency and ensure the system will help the economy raise its living standards in the long term. In this respect it would be desirable to assess the direction the tax system should take over the long term, taking into account challenges such as the increasing globalisation of capital and labour and encouraging investment and savings.

Two broad strategic choices are available. The *first option* is to pull the tax system back towards the comprehensive income tax approach, with a single broad income base and low tax rates. This approach would imply unwinding recent measures by removing the gap between the top marginal income tax rate and the corporate rate, redesigning assistance to families so that high effective marginal tax rates are avoided and removing the exemption for employer contributions to superannuation. Over the long term it implies responding to pressures by reducing rates and ensuring alignment, and further broadening tax bases where possible. The *second option* would be to shift to a dual income tax system where capital income is taxed at a lower rate than labour income. This would involve two separate income tax bases, for capital income and for labour income. This approach would require well-designed rules to ensure that labour income is not reclassified as capital income, especially by owners of small businesses, although this requirement depends on the margin between the two tax rates. When considering the option of reducing taxation on capital income, it is worth noting that in the limiting case where capital income is not taxed at all, this system would in effect have the characteristics of an expenditure tax. Under this approach the tax base effectively becomes consumption instead of income, even though it would still be collected as direct taxation through administrative systems resembling the present Pay-As-You-Earn arrangements.

These options should be evaluated carefully against the criteria of efficiency, equity, simplicity, transition costs and the ability to address the key long term challenges facing New Zealand. These concepts are themselves evolving, with considerably more emphasis now being placed on inter-temporal dimensions than in the past. Assessing alternatives based on these criteria according to their impact over time rather than in a single period can in some cases make the comprehensive income approach look less attractive than the dual income alternatives. In addition, assessments need to be made within a general equilibrium framework.

Developing a longer term direction for the tax system will take time. Any changes in the interim should be designed to be consistent with the ultimate choice of strategy. Policy recommendations are provided below (Box 5).

### Box 5. Policy recommendations for the tax system

The following recommendations for improving the tax system would help to ensure that it makes the largest possible contribution to raising the country's living standards over time.

- Develop a long term strategy for the tax system. Assess which of the following two broad alternatives would deliver the greatest net benefits to the country within an inter-temporal, general equilibrium framework according to the criteria of efficiency, equity, and simplicity, transition costs and the ability to address the long term challenges facing the economy:
  - A purer comprehensive income tax, with a single broad income base and low tax rates; or
  - A dual income tax, with separate tax bases and tax rates for capital and labour income.
- Examine the merits of changing the following features of the existing system:

- Lower the high effective marginal tax rates associated with the Working for Families package. Shifting to higher subsidies for childcare and out-of-school care for working parents would be one option.
- Reduce the top marginal income tax rate and align it with the trust and company rate.
- Enhance the neutrality of corporate tax by removing the loading in the depreciation procedure. Assess the relative costs and benefits of having an imputation system.
- Limit exemptions to the corporate tax base. Remove current preferential tax treatment for certain activities or industries and resist the introduction of new tax exemptions. If R&D tax credits are adopted, scale back grants to avoid providing excessive support to R&D.
- Adopt the proposed changes to the CFCs regime and pursue efforts to harmonise the tax treatment of managed funds and individual investors for offshore investments.
- Level the playing field between investment in housing and financial assets. This could include modifying the current ability to deduct expenses for repairs and maintenance and interest payments for rental properties so that it is only deductible against rental income rather than all income. Another measure would be to explicitly link the use of deductions for depreciation, repairs and maintenance on investment in housing for business purposes to a clear liability for capital gains taxation.
- Set up a national property tax.
- Rely more on indirect consumption tax for raising revenue by increasing the GST rate.
- Design a consistent policy on environmental taxes that contributes to delivering environmental objectives at the minimum economic cost.

## Notes

1. Provisional data suggest the ratio increased to 36.6% in 2005 (OECD, 2006a).
2. Such tax revenues were 61.1% of total taxation in 2004, while the unweighted OECD average was only 34.4%. Amongst the other OECD countries, only Denmark had a ratio above 60%.
3. ACC levies are not included in payroll and social security data.
4. The C-efficiency ratio is the share of VAT revenues to consumption divided by the standard rate, expressed as a percentage.
5. Effects of such a move on external trade would depend on whether the switch is made from corporate or other direct taxes: a move from corporate taxes to GST may increase NZ firms' competitiveness in international markets, while a move from property or personal income tax to GST would be expected to have little effect.
6. Some (for example, several Canadian provinces) provide a sales tax rebate based on taxable income.
7. This means that the value of the credit is payable to the taxpayer to the extent that its value exceeds the tax that would otherwise be due.

8. In principle under a pure comprehensive income approach, all income should be taxed including that which is generated by home production and other forms of unpaid work. In practice, income from unpaid work is not taxed under a comprehensive approach or under any alternative taxation model.
9. Sørensen (1998) offers another interesting argument why capital income might be taxed at a proportional rate and labour income at progressive rates under the dual income tax. Traditional income tax systems allow investment in human capital, which takes the form of foregone (taxable) wage income, to be fully expensed, while investment in physical capital does not enjoy this favourable tax treatment. This unfavourable tax treatment can be counteracted by progressive taxation of labour income and proportional taxation of capital income. Another argument is related to adjustment to inflation: personal income tax systems usually tax the nominal return to capital, even though the inflation premium just compensates for the erosion of the real value of the assets. A lower personal capital income tax rate might then offset the higher tax burden as a result of the taxation of the nominal return on savings and investment.
10. However, a counter-argument would be that for countries with high rates of migration, labour may in fact be a more mobile factor than capital and more sensitive to tax changes than owners of capital. In this case, a cut in the tax rate on capital accompanied by a rise in taxes on labour might, in fact, shrink the total tax base.
11. Statistics New Zealand reports that in February 2006, 64% of all enterprises had no employee and more than 20% had between 1 and 5 employees.
12. Savings vehicles include usually three transactions that can be subject to taxation: when a contribution is made to the saving instrument, when investment income and capital gains accrue to the savings vehicles and when funds are withdrawn. In an EET system both the fund contributed and the accrual return on accumulated funds are exempted from taxation, but the benefits are treated as taxable income upon withdrawals. In a TEE system, only contributions are taxed.
13. Some recent measures such as the tax exemption for employer contributions to the KiwiSaver can be seen as moves toward an expenditure tax.
14. Indeed, sole parents have faced very little pressure to find a job since the 2003 removal of the work test.
15. Slovakia and some other possible future Member countries have gone so far as to adopt a completely flat tax or at least a system with only one non-zero statutory rate.
16. Estimations using the IRD calculator of family assistance and other data from Benefits and Wages suggest that a single-earner family with 2 children aged 4 and 6, earning 1.5 times the average wage or more would face EMTRs close to 60%. This calculation incorporates the latest changes made to thresholds and abatement rates of the Working for Family package. Average EMTRs for high-income earners are now relatively high by international standards, while they were amongst the lowest in the OECD before the implementation of the Working for Families package.
17. However, the gap between the top personal rate and the corporate rate is not large by international standards.
18. A particular definition of progressivity is used here: the ratio of the burden faced by single persons earning two-thirds of the average wage to the burden faced by their counterparts earning five-thirds of the average wage.
19. The effective marginal tax rate (EMTR) on capital is a forward-looking indicator that measures the extra return that an investment would need to earn to pay taxes, over and above the rate of return needed to make the investment worthwhile if there were no taxes.
20. This corresponds to an extension to a wider set of expenses than the Budget 2005 R&D measures.

21. “Black hole” expenditure is expenditure that proves worthless or leads to an asset which falls in value over time, and is neither immediately deductible nor amortisable. Examples are the demolition of a building or the cost of certain feasibility studies.
22. This includes increasing low-value asset write-off thresholds, reducing compliance costs for assets that reach a low depreciated value, and increasing the threshold for taxpayers allowed to submit an annual Fringe Benefit Tax return.
23. For instance, the straight-line depreciation rate of 40% becomes 48% with the loading for computers and software.
24. Unfortunately, the empirical literature provides few indications on the order of magnitude of the tax elasticity to capital formation. Hassett and Hubbard (1997) concluded that, according to most studies they surveyed, the elasticity of investment to its user cost ranged between -0.5 and -1.0, suggesting some substantial influence of taxes on investment behaviour. However analyses based on micro data find taxes have a much lower impact (see, for instance, Chirinko *et al.*, 1999). Overall, it is likely that the effect of taxes will depend on the precise specification of the user cost of capital and the relative weight placed on taxes in the user-cost specification. There is also some evidence that corporate tax may influence outbound FDI stocks, but the amplitude of the impact will depend on parent and host countries’ specificities (Egger *et al.*, 2006).
25. These investments are immediately deductible.
26. There is evidence of the existence of an inverted-U shaped relationship for the impact of public subsidies on private R&D (Guellec and van Pottelsberghe de la Potterie, 1997), implying that the provision of too much support could lower the overall efficiency of policy.
27. The scheme can be used for marketing-related expenditure related to entering or promoting a better position in an international market. The scheme covers up to 50% of a firm’s eligible international market expenditure. Expenditure covered includes market visits, in-market representation, advertising and promotion, marketing collateral, trade fairs and events and market research. In November 2006, a NZD 33.75 million boost was announced to the Market Development Assistance Scheme. The funding will be spread over fifteen months from January 2007. Support for the scheme will amount to NZD 40.6 million in the 2006/07 financial year and to NZD 45.6 million in 2007/8.
28. Over 70% of outbound portfolio investment goes into grey-list resident entities.
29. For instance, managed funds are taxed at the corporate rate (33%) while direct investors can be taxed at the top marginal personal income rate (39%). Direct investors taxed on Australian share gains, whereas managed funds are exempt. Direct investors in grey list companies generally were not taxed on capital gains, while managed funds generally were taxed on capital gains as income from share trading. This anomaly has been removed since 1 April 2007 with individuals and managed funds both being taxed on their offshore investments by the fair dividend rate.
30. The government has proposed a relaxation of the current CFC rules by introducing an active/passive distinction: offshore active income would be exempted from accrual taxation, and passive income would continue to be taxed as it accrues. Consideration will be given to whether the active/passive distinction should apply in respect of foreign branches and non-portfolio interests in FIFs. A possible reduction in non-resident withholding taxes, which are levied when a non-resident derives interest, royalties or dividends from New Zealand, is also under consideration. This could encourage inward investment and could benefit NZ firms investing offshore if reciprocal arrangements are applied.
31. In December 2006, a new set of rules was adopted to modify the current treatment of offshore share investments where the investor owns 10% or less of the foreign entity in which such “portfolio” investment is placed. *First*, the grey list will be removed for portfolio investments; only the exemption for Australian

investments will stay. As a result, under the new proposal the non-grey-list countries will be taxed on a fair dividend rate instead of capital gains. *Second*, individuals will be taxed on a maximum of 5% of the value of their offshore shares in a given year. Individual investors would be able to pay tax on a fair rate lower than 5% if they can show that their offshore portfolio share investments made a return of less than 5%. Where an individual investor's shares make a negative return, no tax would be payable. *Third*, managed funds will be taxed on 5% of the opening value of their shares. This is essentially a risk-free-rate-of-return method. The new rules would not apply to individuals' investments below NZD 50 000 (total cost) into companies listed on a recognised stock exchange in a country with which New Zealand has a double tax agreement. Government estimates suggest these changes will cost NZD 140 million per year.

32. In May 2006 the government announced that NZ shareholders in the Guinness Peat Group could be granted a five-year "holiday" from the proposed NZ tax regime for offshore share investments. No final decision has yet been taken on this matter.
33. The proposed 5% was justified on the ground that historical returns on equity investments have averaged around 9% in the last 20 years. However, the 2001 Review proposed 4% as an inflation-adjusted risk-free rate of return, and PricewaterhouseCoopers' submission to the Committee suggested 3%.
34. Some psychological factors may also be put forward: NZ households are said to be reluctant to invest in financial savings following their experiences in the late 1980s and at the beginning of the current decade.
35. Indeed, in many other OECD countries mortgage interest payments often result in tax deductions against the highest marginal income tax rate, which favours extensive debt-financing of the property.
36. In most other OECD countries, these expenses are deducted from income on rental properties.
37. There is, however, an additional road user charge applied to diesel-engined vehicles so that the total tax wedges on petrol and road use of diesel do not usually differ by a large amount.

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*Annex 1.A1***Imputation systems in OECD countries****The NZ imputation system**

The imputation system was introduced to make sure that, as far as possible, company profits are taxed only once, at the marginal tax rate of the company's shareholders. It lets companies pass on to their shareholders credits for the NZ income tax paid by the company, the credit depending on company tax paid (Table A.1.1). This means that shareholders get the benefit of the income tax that the company has paid.

Table A.1.1. **Net after-tax dividend for the shareholder under the imputation system.**

	<b>Previous NZ system</b>	<b>Imputation system</b>
<b>Tax on company</b>		
Company profit	1 000	1 000
Tax at 33%	330	330
After-tax profit	670	670
Dividend paid to shareholders	670	670
Retained earnings	Nil	Nil
<b>Tax on shareholder</b>		
Dividend received	670	670
Imputation credit	Nil	330
Taxable amount	670	1 000
Tax at 33%	221	330
Less imputation credit	Nil	330
Tax payable by shareholder	221	Nil
<b>Result for shareholder</b>		
Cash dividend received	670	670
Less tax payable	221	Nil
Net dividend after tax	449	670

Source: IRD (2006a).

Imputation applies to income tax paid by NZ resident companies for all income years from 1989 onwards. The imputation rules were amended in 2003 to allow Australian companies to elect to maintain an imputation credit account in New Zealand. These changes were made to address the double taxation on certain trans-Tasman investments by allowing electing companies to pass on imputation credits for NZ tax paid to their shareholders.

The system almost fully removes the double taxation of domestic income of domestic shareholders and is relatively neutral with respect to the corporate financing decision. Imputation credits are only for resident shareholders. The system maintains similar tax treatment between non-resident and resident shareholders through the foreign investor tax credit (FITC) rules.

### **Comparison with other OECD countries**

Full imputation systems are not common within the OECD. Only Australia has a similar dividend imputation system. Most other OECD countries relieve double taxation of dividend income by using a credit system (where the credit does not depend on company tax paid) or by having a modified classical system with a reduced rate on dividends. In recent years, countries in the European Union have moved away from imputation systems for legal reasons and to remove the distortion the system induces between resident and non-resident shareholders.

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