Submission

by

BusinessNZ

to the

Tax Review 2001 Panel

on the

Tax Review 2001

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Tax Review 2001

1. Introduction

1.1 This submission is made on behalf of Business New Zealand, incorporating regional employers' and manufacturers' organisations. The regional organisations consist of the Employers' and Manufacturers' Association (Northern), the Employers' and Manufacturers' Association (Central), Canterbury Manufacturers' Association, Canterbury Employers Chambers of Commerce, and the Otago-Southland Employers' Association. Business New Zealand represents business and employer interests in all matters affecting the business and employment sectors.

1.2 The Issues paper prepared by the Tax Review 2001 Panel provides some useful insights on tax issues and the most effective ways of collecting the tax revenue required by the Government. There is recognition that the tax system has an impact on economic growth and that there are inaccurate perceptions of the role of the tax system in improving equity in our society.

1.3 However it is disappointing that more analysis was not included in the issues paper on the share of income tax paid by high-income earners or estimates of the shares of GST paid by income group. Similarly there was not any economic assessment of the overall impact of the tax system on the rate of economic growth or growth in per capita incomes.

1.4 One of the functions set out for the review was "to examine and inquire into the structure and effects of the present tax system in New Zealand". The Panel however, has advised that it considered the terms of reference limited it to only considering options that resulted in no change in the overall level of tax collected.

1.5 Key issues on which there needs to be much greater debate include whether changes to the level of tax collected or the way in which it is collected could result in a higher level of sustained economic growths. Options which need to be considered further are:

- whether reducing the share of tax as a proportion of total economic activity (tax to GDP ratio) would contribute to higher GDP growth.
- whether reducing the share of total tax revenue collected on income (company and personal) would contribute to higher GDP growth.

2. Specific Issues

2.1 Proportional Tax Structure

2.1.1 The Panel is quite critical of the economic and compliance costs impacts from the introduction of the new 39% tax rate and notes that the new rate has had very minimal impact on income redistribution in New Zealand. We endorse these criticisms, particularly in terms of the increased compliance costs faced by business as a consequence of the introduction of the 39% tax rate.

2.1.2 We support the proposed move to a more proportional tax structure and agree the proposed two-tier structure is a significant improvement over the current four-tier structure. We would however, note that much of the Panel's concern about opportunities for tax minimisation through different forms of legal entity would be best addressed by a fully proportional tax structure for personal income and company tax.

2.1.3 Targeted tax concessions for low income earners would still be possible under a fully proportional tax structure and would need to be improved to minimise the impacts of the proportional tax structure on lower income individuals. It is easy to show that even under a proportional tax structure high income tax payers would continue to pay a large share of total tax revenue. It should be noted that a key policy issue which affects the level of income redistribution in New Zealand is the extent to which government benefits and services are targeted to low income earners or are available on a universal basis. If government services and benefits are provided on a more targeted basis this would also improve the level of income redistribution in New Zealand.

2.1.4 Statistics New Zealand data, from their tax database, shows that the top 15% of income earners (those earning more than $41,796 pa) pay 63% of personal income tax revenue, while the top 10% of income earners (those earning more than $49,855 pa) pay 52% of personal income tax revenue. Any change to a more proportional tax structure will still result in higher income earners paying a high share of total personal income tax revenue.

2.1.5 Recommendation

That income tax be collected on a more proportional basis but with targeted tax credits for low-income earners remaining.

2.2 Weight Between Expenditure and Income Taxes

2.2.1 We endorse the Panel's view that the weight between expenditure and income tax should change, with an increased proportion of the total tax collected through expenditure taxes. The Panel suggests that if the Government is increasing tax it should preferably be done through an increase in the GST rate and if it is reducing tax it should be done through a reduction in tax rates. While we agree with this we believe there would be economic gains from a more immediate move to reduce the share of tax revenue collected through direct taxes.

Tax Source	Estimated Revenue Year to June 2001	% Share of Total Tax Revenue
Direct Taxation	$Million	
Individuals	17,057	47%
Companies	4,768	13%
Other Direct Taxation	1,811	5%
Total Direct Taxation	**23,636**	**65%**
Indirect Taxation		
GST	8,982	25%
Excise and other Indirect Taxes*	3,712	10%
Total Indirect Taxation	**12,694**	**35%**
Total Tax Revenue	**36,330**	**100%**
Tax Revenue per Capita	9,579	

*Includes direct user charges such as Road User Charges, Petrol Tax (road use related) and Motor Vehicle Licensing fees.

2.2.2 The Panel notes that the total costs imposed by tax on the economy would be reduced somewhat if relatively more reliance were placed on GST. This issue was also noted in the recent OECD review of the New Zealand economy. It noted that a high proportion of New Zealand tax revenue comes from income tax, the highest share in the OECD.

2.2.3 We agree that reducing the share of tax revenue from income tax would reduce the cost of tax on the economy, and so would contribute to an improvement in economic growth levels. We also believe that reducing the share would improve the incentives for savings, without the need for targeted savings concessions.

2.2.4 We agree with the questions raised by the Panel about claims that GST was a regressive tax and so was less effective in redistributing income. As noted early, there is little difference between redistribution impacts through a progressive or proportional income tax structure. The advantage of GST however, is that it has greater coverage of expenditure in the New Zealand economy than coverage of income by current tax structures.

2.2.5 It would have been useful to have seen an analysis of Household Economic Survey data and whether estimates could have been made of the amount of GST paid by income group. It is our view that such analysis will show that a significant proportion of GST revenue is paid by high-income households. It is also clear that GST is a important part of a tax system designed to redistribute income to lower income households. There is a concern that some high income household expenditure will miss the GST net (such as overseas holidays). However, there is also expenditure on services such as education and health care where high income households are more likely to be paying GST on private services while low income households are more likely to be using publicly funded services, not subject to GST.

2.2.6 The recent report by the Ministerial Panel on Business Compliance Cost noted that:

> "The majority of submissions praised the simplicity of GST, at least for small unsophisticated businesses, and voiced a desire for a major policy shift toward indirect taxation, or reflecting that similar simplicity in the income tax system."

The simplicity of GST reflects its proportional nature as well as the lack of additional payments (student loans, court fines, etc.) that are collected with the PAYE system on incomes.

2.2.7 <u>Recommendation</u>

That the share of direct taxation as a proportion of total tax revenue be reduced.

2.3 <u>Housing</u>

2.3.1 We endorse the need to review the tax treatment of owner occupied housing but have serious concerns with the simplistic methodology proposed in the issues paper. It is recognised that the issues involved are not simple and that more comprehensive measures for taxing the economic gains from housing could involve significant measurement and compliance cost issues.

2.3.2 Essentially there are two issues of concern from an economic viewpoint.

1. The lack of tax on capital gains and the lack of any inflation adjustment to income gains from other investments has resulted in significant tax advantages for investment in housing in times of high inflation.

2. The economic benefits of home ownership (the implied or imputed rental value) compared with other rental options or forms of investment. In simplistic terms this can be explained using the example of a person with $100,000 to invest. They can either use the money to:

   - purchase a house and enjoy the benefits of shelter provided;
   - invest the money and use the investment return to rent suitable accommodation.

2.3.3 The person opting to invest the money however faces tax on their investment return so has less money to spend on rental accommodation while the person owning their own accommodation receives those accommodation benefits tax free.

2.3.4 During the 1970's and 1980's high inflation levels results in strong growth in property prices and a realisation that investment in property had significant advantages over other forms of investment. The gain in the value of housing was not taxed and in addition other forms of investment were taxed on nominal rather than real (inflation adjusted) gains.

2.3.5 We noted in our submission to the initial stage of the tax review that a capital gains tax would have been very useful during this high inflation period but such a tax was now less relevant for several reasons:

- low inflation for the last decade has also resulted in much slower growth in house prices;
- real after tax returns from other investments have improved because of the narrowing in the difference between nominal and real returns;
- the introduction of GST in 1986 resulted in significant reductions in the top marginal tax rate on income and also reduced the share of income tax as a percentage of total tax.

2.3.6 The lack of any tax on the imputed rental value of owner-occupied housing however still remains an issue which is encouraging an over-investment in housing. It is widely accepted that our economic performance in the past would have been better if we had invested less in housing and more in other more productive assets. It is also likely that this over-investment in housing has resulted in a higher cost of equity capital, reducing the returns from investment in productive assets.

2.3.7 It should also be noted that the proposed tax on housing stock will in part become a tax on unpaid work spent on upgrading and maintaining the existing housing stock. While this may have merit from an economic viewpoint it could be perceived negatively from an equity viewpoint.

2.3.8 <u>OECD Options</u>

The latest OECD Economic Survey of New Zealand noted:

> "Preferential tax treatment of owner-occupied housing is widespread among OECD countries, but it could have more adverse effects in New Zealand than elsewhere, since private pension saving is not subsidised as in other countries. Hence, there is not the same amount of pension assets to be invested in productive capital formation. This is a consequence of the New Zealand tax system being more neutral with respect to pension saving than elsewhere, but still not fully neutral. The high concentration of households' wealth in housing assets may also imply an undesirable macroeconomic exposure to the performance of the housing market. A "first-best" solution to reduce the "oversaving" in housing would be to align the tax treatment of such savings with that of any other savings instrument (imposing neutrality *vis-à-vis* more

productive saving). This would require taxing the imputed rental value, while allowing mortgage interest as well as depreciation and maintenance costs to be deducted".

2.3.9 It was further noted in the review document that mortgage interest should only be deductible against the imputed rental value.

2.3.10 In addition to taxing the imputed rental value the OECD proposed that:

1. Income tax be reduced as a share of total tax revenues collected.

2. A comprehensive capital gains tax be introduced (we already have a partial capital gains tax on some forms of investment)

Tax Panel Options

2.3.11 The Panel proposes use of the Risk-Free Return Method to tax returns to housing while avoiding the problems it perceived with the approach proposed by the OECD. It noted:

> "Under this approach, the annual opening value of a property for RFRM purposes could be based on property valuations undertaken for rating purposes. The taxable value would be reduced by the amount of any debt secured over the property. Mortgage interest would not be separately deductible. There would also be no need to deduct depreciation or repairs and maintenance expenses since the risk-free rate of return is assumed to be net of all expenses."

2.3.12 The Panel proposed that tax payable in respect of assets that were subject to the Risk-Free Return Method would be calculated as:

Value of net assets as beginning of the tax year
X
Inflation-adjusted risk-free rate of return
X
Investor's tax rate

2.3.13 The capital value for rating purposes is proposed to be used for calculating the value of the housing stock at the beginning of each year but it is not clear how this takes account of depreciation or repair and maintenance expenses, since threes will vary significantly by household.

Problems with the Tax Panel's Approach

2.3.14 There appear to be real problems with the simplistic approach proposed by the Panel.

- If the tax is effective, then investment in housing will not be as risk free as an investment in Government Bonds because of the risk of a fall in house prices.

- It is not clear that $100,000 invested in Government Bonds is equivalent to $100,000 invested in housing. Repairs and maintenance are essential to maintain the value of a $100,000 investment in housing and it is not clear why the Panel believes they should not be deductible. If there is a moderate or high level of inflation, housing is likely to prove a more attractive investment than Government Bonds but in an environment with nil inflation or falling house prices Government Bonds could be more attractive.

- It is proposed to measure equity in the house as the difference between the capital value and the remaining mortgage on the property. However, since most small business loans are secured by way of a mortgage over the owner’s residential property so it may not be straightforward determining the level of equity for individuals. If interest deductibility was available, the small business owner is likely to have already deducted interest as a business expense so would not be in a position to also deduct it for housing.

<u>Conclusions on Taxing Housing</u>

2.3.15 One of the arguments by the Tax Panel for the proposed tax is that the benefits of home ownership primarily go to wealthier households, as a much higher proportion of lower income households are in rental accommodation. However, current expenditure of $867 million on the Accommodation Supplement is greater than the proposed tax. The supplement is available for renting and home ownership and is accessible by all people on low incomes. It is therefore difficult to argue for the tax on the basis of equity.

2.3.16 The introduction of the Risk-Free Return Method, with an inflation adjustment, for other forms of investment will reduce some of the benefits from investment in housing. However, the tax-free status of housing will always encourage a level of over-investment, particularly during periods with higher inflation.

2.3.17 The proposal for the tax on the capital value of housing is very simple, but it is not clear why deductions for depreciation or repairs and maintenance are not proposed. In addition, the OECD proposals for interest deductibility up to the value of implied rental appears preferable to the Panel’s proposal to define equity as the difference between the capital value and the remaining mortgage on the property.

2.3.18 The concepts of a tax on housing are poorly understood so considerable education and debate will be required to gain public support for the concept. Major problems include

- a poor understanding of the economic costs of home ownership, from either an individual’s or overall community perspective;
- a lack of understanding of return on equity concepts;
- a lack of trust that the housing tax will be offset by reductions in personal tax;

- the lack of certainty in measuring the overall economic benefits from a tax on housing.
- Like FBT the compliance costs may be very high in relation to the revenue raised.

Recommendations

2.3.19 There needs to be much more debate on the most effective form of tax on housing, the economic merits of introducing a tax on equity or imputed rental and the costs of introducing an additional tax.

2.3.20 If it is decided to introduce a tax on housing, we support the OECD proposals for deductibility for depreciation and maintenance costs as well as mortgage interest up to the total value of the imputed rental.

2.3.21 We note that the expected revenue from a tax on housing is likely to be small as a share of total tax revenue. As a consequence, the compliance costs for a tax on housing may outweigh the economic benefits of the tax.

2.4 Capital Gains Tax

2.4.1 There are some good economic arguments for introducing a more comprehensive capital gains tax (we already have a limited form of capital gains tax) when looking at our past economic performance over the last 30 years. High general inflation levels in the 1970's and 1980's, and high inflation in property values until the mid 1990's, suggest a capital gains tax might have had a positive impact on reducing real interest rates, and the misallocation of resources, which occurred over that period.

2.4.2 Looking to the future, however, there are real concerns about whether capital gains can be taxed equitably, and the high compliance costs involved in introducing a capital gains tax. In addition, it would appear the ongoing adoption of a strict monetary policy target for inflation has reduced the likelihood of a long period of unsustained rises in capital asset values. Furthermore, our proposals for reducing the level of the corporate tax rate and the average level of tax on personal incomes would reduce the economic arguments for a capital gains tax.

2.4.3 There are also major business concerns that a capital gains tax can significantly discourage business restructuring. Attempts to restructure a business in some overseas economies can result in significant capital gains tax liabilities and lead to tax decisions dominating the restructuring processes. The absence of a comprehensive capital gains tax is perceived to be a significant benefit to New Zealand business in this respect and also from a competitive position with other OECD countries.

2.4.4 Recommendation

That a comprehensive capital gains tax not be introduced.

2.5 Excise Tax and Gaming Duties

2.5.1 We agree with the concerns of the Panel about the effectiveness of existing excise taxes and gaming duties in changing the behaviour of individuals. While there may be negative economic impacts from smoking or alcohol consumption it is not clear that the current selective taxes are very effective in changing behaviour. They are important revenue items so there can be an implication of a conflict of interest between effective measures that influence behaviour and the need to raise less revenue from other tax sources.

2.5.2 We therefore have reservations about the focus in the terms of reference on the concept that the tax structure can be effective in changing undesirable behaviour. It is clear, for example, that an increase in the tax on petrol would have little impact on reducing petrol consumption or increasing public transport patronage. This can be seen from the very small change in retail volumes for petrol despite a significant rise in petrol prices over the last 18 months. Similarly, it is clear that the tax on tobacco had to be coupled with subsidies for products to help people give up smoking in order to see a change in behaviour.

2.5.3 There are other limits too to targeting undesirable behaviour through the tax system, because of its broad nature. The introduction of a tax on petrol would, for example, disadvantage people in rural communities and small towns that had no access to public transport. Even in the major cities the level of access to public transport is quite varied because of the restricted nature of the routes, particularly outside the peak travel times. While a significant tax on petrol would result in an increase in public transport patronage, it would appear that most people would be disadvantaged because they had no viable way of changing their behaviour because of external factors outside of their control.

2.5.4 We support the concept of user charges and so support the dedicated road tax that is currently collected on petrol. With a significant backlog of road construction and public transport projects waiting to be funded, which have high positive benefit ratios, there would be considerable economic merit in reallocating the petrol excise tax to the roading account

Recommendations

2.5.5 That existing petrol excise tax be designated for roading purposes.

2.5.6 To support a more thorough review of the effectiveness of excise tax and gaming duties and alternative options for influencing undesirable behaviour.

2.6 Company Tax

2.6.1 We believe the Panel's arguments for maintaining the company tax rate of the top personal tax rate are very weak and ignore the economic benefits of reducing the corporate tax rate.

2.6.2 It is clear that a single tax rate on income, which was aligned with the corporate tax rate, would provide a very simple tax structure and offer the least degree of distortion or potential for inequity. However, if a two-tier structure for income taxes is adopted along the lines proposed by the Panel it is not clear the company tax rate should be automatically set at the top personal tax rate.

2.6.3 We believe there is strong economic justification for a significant reduction in the level of the corporate tax rate. Previous research has shown that cutting the rate of corporate tax provides more gains in higher economic growth than other forms of tax cuts. The key reason for this result is the high level of profits that are reinvested (saved) in New Zealand businesses. Reducing the level of the corporate tax rate increases the level of profit which can be reinvested in the business, allowing it to increase capacity or purchase more up-to-date and competitive equipment.

2.6.4 This is particularly relevant in New Zealand because of the small scale of business operating here. The 2000 Statistics New Zealand annual business survey showed there were 17,634 businesses with 6-9 full-time equivalent employees and 17,702 enterprises with 10-49 full-time equivalent employees. In contrast there were just 2,750 enterprises with more than 49 full-time equivalent employees. These small businesses have difficulty raising funding from external sources so profits retained in the business are their main form of funding.

2.6.5 It is also relevant to note the significant increase in business activity being carried out by the self-employed in New Zealand, who as a consequence face personal tax rates on their income, with a marginal tax rate of 19.5% on income up to the current threshold of $38,000. Over the period from 1986 to 2000 the number of people in the "self employed, not employing others" category has increased by 51% while total employment increased by 15%.

2.6.6 It should be noted too that lowering the corporate tax rate may have little impact on Government revenue since a lower tax rate would encourage overseas companies to pay tax here. The level of tax revenue from corporate tax has grown significantly in New Zealand since being cut from 48% to 33%. With the Australian corporate tax rate being cut to 30% there is a risk we will see a fall in corporate tax revenue if our rate remains at 33%, or is raised under some on the Panel's options for moving to a two-tier personal tax structure.

2.6.7 It is important to note too that if the company tax rate is reduced below the top marginal tax rate for individuals, some of the corporate tax cut will be recovered through higher income tax revenue from individuals. We are not sure what proportion of the corporate tax cut would be recovered through higher personal tax revenue as we have insufficient information on dividend payments or the tax status of recipients of dividend income.

2.6.8 We have recommended adoption of a 20% corporate tax rate primarily for international competition reasons. These are discussed further in section 3 of the submission.

<u>Recommendation</u>

2.6.9 That the corporate tax rate be reduced to 20%.

2.7 International Tax Issues

2.7.1 The panel devoted a significant part of the issues paper to the tax treatment of overseas investors in New Zealand and the earnings from investment overseas by New Zealanders. The debate on whether a lower tax rate on New Zealand income of non-resident investors has merit was especially useful.

2.7.2 It would however, appear that some of the stronger arguments for a lower tax rate for overseas investors in New Zealand could be applied also to the benefit of a lower tax rate for domestic investors in New Zealand.

2.7.3 We believe therefore that much more extensive debate is needed by the business sector on whether there are economic advantages from taxing overseas investors at a lower rate than domestic investors in New Zealand. It is clear that New Zealand is heavily dependant on significant capital inflows as a consequence of our over-investment in housing. This level of indebtedness and the taxation of income from investments in New Zealand both impact on the rate of return expected by investors in New Zealand. Effective tax policy for New Zealand housing could impact significantly on the level of demand for foreign investment and the risk premium for New Zealand investments. Foreign deposits in the M3 financial institutions have financed much of the growth in investment in housing over the last decade. It is therefore not clear whether a blanket incentive for foreign investment in New Zealand has economic merit. To this extent there is a need to differentiate between active and passive investment in New Zealand.

2.7.4 We believe there are also significant problems with the Controlled Foreign Company Regime (CFC) and the Foreign Investment Fund (FIF) Regime which apply to the outward investment by New Zealanders and New Zealand owned companies. We endorse the recommendations put forward in the 19 March 2001 Tax Review submission by PricewaterhouseCoopers. These are summarised below.

2.7.5 We also support the need for further analysis of the benefits from the introduction of the risk-free return methodology for the taxation of investment returns but note significant work on developing this is required. In the shorter term we believe there would be benefit from reform to the CFC and FIF regimes.

Recommendations

2.7.5 Controlled foreign company regime. We endorse:

- Introducing an active / passive distinction;
- Addressing the issues created by New Zealand's rules to ring-fence controlled foreign company losses by jurisdiction; and
- Removing the grey list or enlarging it.

2.7.6 Foreign investment fund regime. We endorse:

- Decreasing compliance costs by increasing the de minimis threshold to a realistic level i.e. $1 million;
- Amending the foreign superannuation scheme rules; and
- Introducing an exemption for publicly listed companies.

2.8 Savings

2.8.1 We have already covered in Section 2.6, arguments for reducing the corporate rate of tax because of the positive impact that change would have on the level of savings in the business sector.

2.8.2 The position appears to be less clear over the relationship between the tax structure and personal savings levels. While it could be expected that a reduction in income tax levels would increase the level of savings, the experience in recent years would not appear to support this view. However, several factors seem to have influenced the long term decline in the savings level:

- the generosity of the current superannuation scheme has reduced the pressure on people to save individually for their retirement. The recent moves to re-link New Zealand superannuation to average earnings levels will continue to limit the extent to which individuals will consider they need to improve their savings level; and

- the strong appreciation in the price of housing has encouraged an excessive level of investment in the housing sector. Government sector rental changes in the early 1990's, high immigration levels and the perceived tax advantages for investments in the sector contributed to the high level of investment in the sector in the 1990's.

2.8.3 Recent changes in the housing sector, particularly the reduction in state sector rentals, should have positive longer-term impacts on savings levels. In addition, we believe that changes to personal tax rates we have proposed should reduce the perceived tax advantages of investment in housing. It is also clear that some individuals who invested in housing in the 1990's found that the imposition of tax on property sales removed any of the expected tax advantages. There is already some evidence from The WespacTrust

Household Savings Indicator and Reserve Bank data that New Zealanders have begun to broaden their investment savings, with growth in unit trusts and other managed investments as well as capital indexed funds.

2.8.4 The recent OECD review of the New Zealand economy notes that a high proportion of New Zealand tax revenue comes from income tax, the highest share in the OECD. We believe reducing this share will improve the incentives for savings but that, once again, tax cannot be looked at in isolation to other factors that impact on savings.

2.8.5 It is also clear from analysis of factors contributing to New Zealand's poor growth performance that it has been poor investment choices rather than lack of savings that has been much more important to our poor performance. We therefore need to focus more on policies that encourage more effective use of our existing savings than policies to encourage a higher level of savings. We believe many of the changes we are advocating in this submission will provide greater rewards for investment in productive assets than our current tax structures.

Recommendations

2.8.6 That there be no targeted incentives for savings.

2.8.7 We support further analysis of the benefits from the application of the risk-free return methodology to the taxation of investment returns.

2.9 Environmental Taxation

2.9.1 We welcome the Panel's caution about the perceived economic or environmental benefits from the introduction of a carbon charge or other forms of eco-taxes. We agree that the appropriate burden of proof on those advocating eco-taxes should be identical to the burden on those seeking concessionary tax treatment for particular activities or sectors. We also agree the initial presumption should always be against the introduction of selective taxes.

2.9.2 It is clear that considerable caution is required in considering whether the introduction of eco-taxes is appropriate because:

- There is still considerable international debate about the theory of global warming or the speed at which it is occurring. While it is unlikely there will be agreement on this in the immediate future there is a need for greater caution in implementing tax policies which could have significant negative impacts on economic growth and our standard of living.

- At the same time there is general agreement that there is economic value from making more efficient use of resources, including energy. Structural and regulatory problems can present barriers to more efficient use that will not be solved by tax policy.

- New Zealand's industry structure results in a high level of energy intensity while our topography and low population density impacts on fuel use in the transport sector. The implication of these factors is that a high level of energy is required to produce each dollar of GDP compared with the majority of our trading partners. Care is therefore required that any tax changes proposed provide adequate encouragement for more effective use of those resources rather than just punishing their use.

- There are serious questions about the effectiveness of tax structures for changing behaviour. The Panel debates this issue much more extensively in the section on excise tax. There is no evidence for example that the current excise tax on petrol has encouraged greater public transport use or more extensive car pooling.

- International competition concerns make it essential that New Zealand does not attempt to lead the world in punishing these "bad" high energy intensity industries when they constitute such an important share of our total output (GDP)

- Caution is also required because of the likely gap between commitments by our trading partners and implementation of those commitments. The are ample examples in other world forums, such as the WTO and OECD, where individual countries have introduced financial assistance measures that were not consistent with agreed commitments.

2.9.3 As with the housing tax there are also serious doubts that revenue from new taxes will be used to reduce taxes from other sources. There are also concerns over whether the government will abide by earlier commitments that industries reducing emissions on a voluntary basis would not be subject to carbon taxes.

2.9.4 Key issues which need to be considered for the introduction of any new eco-taxes are:

- They should be applied to all sectors of the economy.

- Tax policy should not be the primary mechanism for encouraging lower emissions or reduced carbon use.

- There needs to be a high level of transparency to show that any new revenue raised is used fully for income tax reductions.

- There be a rigorous analysis of the compliance costs involved and the expected benefits.

2.9.5 There is considerable concern that the review did not specifically mention Negotiated Greenhouse Agreements. There was an understanding in the business sector that the achievement of voluntary reductions in emissions would lead to exemption from any carbon charges introduced. We recognise that businesses that have reduced their emissions will face a lower carbon charge but this does not fully compensate the business for the reductions made. There is clearly a need for the Government to urgently clarify this issue before proceeding with further work on Negotiated Greenhouse Agreements.

Recommendations

2.9.6 That no eco-taxes be introduced while there is a lack of any international consensus of the basis for their application.

2.9.7 That debate on the introduction of a national carbon charge be based on the following principles:

- They should be applied to all sectors of the economy.
- Tax policy should not be the primary mechanism for encouraging lower emissions or reduced carbon use.
- There needs to be a high level of transparency to show that any new revenue raised is used fully for income tax reductions or for the targeted purpose of reducing greenhouse gas emissions (such as targeted incentives).
- There be a rigorous analysis of the compliance costs involved and the expected benefits.
- The calculation of externalities should determine the level of the tax imposed.

2.10 Other Forms of Taxation

2.10.1 We agree with the Panel's recommendations that remaining gift duties and cheque and stamp duties should be abolished. There is very little revenue involved and the compliance costs involved in collecting these taxes mean they should be removed as soon as possible.

2.10.2 We also support the Panel's opposition to new forms of tax such as wealth tax (although the housing tax proposed would be a form of wealth tax), a financial transactions tax or Tobin tax.

2.10.3 We argued in our earlier submission that a Financial Transactions Tax (FTT) would be less neutral for exporters than their current status under GST, and could also disadvantage local business activity. If the tax was applied to every financial transaction involved in producing goods or services for the domestic market, the cumulative impact of the tax would be greater than for goods or services imported directly by a local retailer or other business.

2.10.4 There are significant concerns with the operation of Fringe Benefit Tax (FBT), both in terms of the high compliance costs involved and also the way in which private benefits are calculated. It has been suggested that FBT should be scrapped because of the small amount of revenue but we recognise the integrity of the income tax structure could be threatened if the value of fringe benefits was not recognised by the tax structure. We however believe it is more appropriate for the tax on fringe benefits to be paid by employees rather than by employers as at present. This would simplify the taxation of fringe benefits, particularly when employees are on ore than one tax tier.

2.10.5 There also needs to be a greater reliance on a cost benefit analysis of any extensions to the coverage of FBT. There is a concern that revenue has been pursued at any cost without any focus on the major revenue risks and costs of enforcement or compliance for the business sector.

2.10.6 We fully endorse the concerns of the Ministerial Panel on Business Compliance Costs and their recommendations for a first principles review of FBT. Important issues which need to be addressed are:

- whether fringe benefits can be taxed through the PAYE system, based on the value of their cash benefit to employees;

- the basis for calculating the benefit to individuals of non-wage benefits.

2.10.7 This last point will require more extensive research and consultation on how private benefits are measured. We believe, for example, that employer provision of medical insurance for employees has significant public benefit by reducing demand for publicly funded health services. Employees with medical insurance are often referred on to privately provided services, even when publicly funded services are available, so are increasing the availability of publicly funded services. There is therefore a balance of private benefit and public benefit from these policies, particularly the “surgery only” policies. There are concerns too over the calculation of private motor vehicle benefits and the lack of any adjustment for work related travel in the same region as the workplace or adjustments for depreciation.

2.10.8 There are a number of significant tax issues that need to be resolved between Australia and New Zealand as a consequence of the high level of foreign direct investment in each country and the high level of labour force movement between both countries. Some work has finally commenced on the issue of imputation of tax credits but at this stage this only covers the “triangular tax” issue (when New Zealand residents invest in Australian companies, which have New Zealand investments) and not the level of Australian tax paid by New Zealand investors on other assets. Both countries have only been willing to consider the direct cost of any reform to address these issues, without considering the broader economic gains from strengthening the CER agreement. The business sector has become very frustrated by the lack of progress in this area so welcome the options put forward by the Panel for discussion.

2.10.9 There are also concerns about the New Zealand tax treatment of an individual’s Australian superannuation savings if they take up residency in New Zealand. These concerns have not been addressed in the issues paper.

Recommendations

2.10.10 Remaining gift duties, cheque and stamp duties should be abolished as soon as possible.

2.10.11 We oppose introduction of a wealth tax, financial transactions tax or Tobin tax.

2.10.12 There should be a first principles review of Fringe Benefits Tax.

2.10.13 Fringe benefits should be taxed through the PAYE system.

2.10.14 CER tax issues must be given higher priority, even on a unilateral basis by New Zealand.

3. International Competitiveness

3.1 The issues paper is very weak in its coverage of whether the tax system is an important factor in the international competitiveness of New Zealand business. We noted earlier that we disagree with the Panel's view that it could not consider changes to the total share of tax collected.

3.2 The recent OECD review of New Zealand noted that New Zealand has a tax revenue to GDP ratio similar to the OECD average. However, our three principal trading partners (Australia, Japan and the United States) all have tax revenue to GDP ratios of around 30% or lower, well below the OECD average. This is an important issue for New Zealand because the strong growth in manufactured exports over the past 40 years has substantially changed the pattern of trade for New Zealand.

3.3 In 1940 88% of New Zealand's exports went to Britain and a similar proportion of our imports were produced by Britain. By December 2000 just over 5% of total exports went to Britain while less than 4% of imports came from Britain. In 1940 manufactured (Basic Manufactured Series (BMS) exports contributed less than 1% of total receipts, but by December 2000 their share had grown to 45%.

3.4 There has been a substantial shift in our trade to trade partners in the Asia - Pacific:

% Share - Total Exports

	1940 %	**1970 %**	**2000 %**
Australia	3	8	20
USA	4	15	15
Japan	0	10	13
UK	88	36	5
Other Counties	5	30	44

Total	100	100	100

3.5 The concentration on the Asia - Pacific region is even more marked for the manufacturing sector, with close to 90% of manufactured exports sold there. This means the lower tax revenue to GDP ratios in our close trading partners are more important than the overall OECD average, which is influenced by high tax revenue to GDP ratios in Europe.

3.6 The change in trade patterns has also been closely reflected in changes in the source of foreign direct investment in New Zealand, and by the destination of New Zealand foreign direct investment abroad. In 1999 36% of foreign direct investment in New Zealand came from Australia, while 20% came from the United States. The United Kingdom still holds an important position but in 1999 its share was just 13%.

A recent Economist magazine (24 February 2001, page 123) summarises a recent KPMG survey of corporate tax. It noted:

"Despite international efforts to curb tax competition between countries trying to attract internationally mobile firms, corporate tax rates are falling throughout the rich world: the average rate has dropped from 37.5% in 1996 to 33% now. Ireland's rate is just 20% (the lowest in the OECD apart from Hungary's, at 18%). But the low tax rates do not necessarily mean a low tax burden. That depends on allowances and on the definition of the tax base to which the rate is applied."

3.7 With the New Zealand corporate tax rate now at the OECD average, and with very few exemptions in the New Zealand tax structure, it is highly likely that the effective corporate tax rate in New Zealand is now above the OECD rate. Most of the tax scale options provided for a small reduction in the top marginal tax rate but a more substantial reduction may be required to improve our competitiveness. Reducing our overall level of tax as a share of GDP is required if more significant reductions in tax rates are to be achieved.

Recommendation

3.8 That New Zealand move to lower its tax revenue to GDP ratio below 30% by 2010 through:

- Adoption of economic policies that will enhance the long term sustainable rate of economic growth; and
- Better targeting of Government benefits and services.

Recommendations

1. That income tax be collected on a more proportional basis but with targeted tax credits for low-income earners remaining.

2. That the share of direct taxation as a proportion of total tax revenue be reduced.

3. There needs to be much more debate on the most effective form of tax on housing, the economic merits of introducing a tax on equity or imputed rental and the costs of introducing an additional tax.

4. If it is decided to introduce a tax on housing, we support the OECD proposals for deductibility for depreciation and maintenance costs as well as mortgage interest up to the total value of the imputed rental.

5. We note that the expected revenue from a tax on housing is likely to be small as a share of total tax revenue. As a consequence, the compliance costs for a tax on housing may outweigh the benefits of the tax.

6. That a comprehensive capital gains tax not be introduced.

7. That existing petrol excise tax be designated for roading purposes.

8. To support a more thorough review of the effectiveness of excise tax and gaming duties and alternative options for influencing undesirable behaviour.

9. That the corporate tax rate be reduced to 20%.

10. Controlled foreign company regime. We endorse:
    - Introducing an active / passive distinction;
    - Addressing the issues created by New Zealand's rules to ring-fence controlled foreign company losses by jurisdiction; and
    - Removing the grey list or enlarging it.

11. Foreign investment fund regime. We endorse:
    - Decreasing compliance costs by increasing the de minimis threshold to a realistic level i.e. $1 million;
    - Amending the foreign superannuation scheme rules; and
    - Introducing an exemption for publicly listed companies.

12. That there be much more extensive debate on whether there are economic advantages from taxing overseas investors at a lower rate than domestic investors in New Zealand.

13. That there be no targeted incentives for savings.

14. We support further analysis of the benefits from the application of the risk-free return methodology to the taxation of investment returns.

15. That no eco-taxes be introduced while there is a lack of any international consensus of the basis for their application.

16. That debate on the introduction of a national carbon charge be based on the following principles:

    - They should be applied to all sectors of the economy.

    - Tax policy should not be the primary mechanism for encouraging lower emissions or reduced carbon use.

    - There needs to be a high level of transparency to show that any new revenue raised is used fully for income tax reductions or for the targeted purpose of reducing greenhouse gas emissions (such as targeted incentives).

    - There be a rigorous analysis of the compliance costs involved and the expected benefits.

    - The calculation of externalities should determine the level of the tax imposed.

15. Remaining gift duties, cheque and stamp duties should be abolished as soon as possible.

16. We oppose introduction of a wealth tax, financial transactions tax or Tobin tax.

17. There should be a first principles review of Fringe Benefit Tax.

18. Fringe benefits should be taxed through the PAYE system.

19. CER tax issues be given higher priority, even on a unilateral basis by New Zealand.

20. That New Zealand move to lower its tax revenue to GDP ratio below 30% by 2010 through:

    - adoption of economic policies that will enhance the long term sustainable rate of economic growth; and

    - better targeting of Government benefits and services.

Table 1

Income by income group (five percent groups) and estimated income tax paid

2000/01 financial year

INCOME CATEGORY:	Mean Taxable Income	Mean Tax Paid	Number of people	% share of total income tax	Estimated Total Income Tax
	$	$			$
$0 - $527	96	-947	146,488	-0.82%	-138,724,136
$528 - $2667	1,530	-209	146,492	-0.18%	-30,616,828
$2668 - $5335	3,991	-107	146,449	-0.09%	-15,670,043
$5336 - $7826	6,688	232	146,517	0.20%	33,991,944
$7827 - $9414	8,665	614	146,504	0.53%	89,953,456
$9415 - $10174	9,897	1,683	146,453	1.45%	246,480,399
$10175 - $11572	10,670	1,517	146,483	1.31%	222,214,711
$11573 - $12792	12,147	1,860	146,508	1.61%	272,504,880
$12793 - $13625	13,410	2,263	146,517	1.95%	331,567,971
$13626 - $15352	14,494	1,694	146,450	1.46%	248,086,300
$15353 - $18077	16,650	1,917	146,525	1.65%	280,888,425
$18078 - $21231	19,651	2,606	146,489	2.25%	381,750,334
$21232 - $24781	22,994	3,379	146,474	2.92%	494,935,646
$24782 - $28560	26,681	4,281	146,470	3.69%	627,038,070
$28561 - $32431	30,466	5,175	146,494	4.47%	758,106,450
$32432 - $36762	34,536	6,116	146,526	5.28%	896,153,016
$36763 - $41795	39,173	10,370	146,477	8.95%	1,518,966,490
$41796 - $49854	45,507	13,604	146,507	11.74%	1,993,081,228
$49855 - $66006	56,459	17,788	146,480	15.35%	2,605,586,240
$66007 – high	121,270	42,040	146,502	36.28%	6,158,944,080
All people	24,749	5,794	2,929,803	100.00%	16,975,278,582

$41796 and above	Top 15%	63.37%	10,757,611,548
$49855 and above	Top 10%	51.63%	8,764,530,320

Mean taxable income and mean tax paid for 2000/01
using the 2000/01 effective marginal tax rates to calculate theoretical tax paid
and adjusting the 1998/99 taxable income to represent 2000/01 taxable income

SOURCE: Business NZ / Statistics NZ