tax review 2001

Letter of Transmittal

12 October 2001

Hon Dr Michael Cullen
Minister of Finance

Hon Jim Anderton
Minister of Economic Development

Dear Ministers

We are pleased to provide our Final Report of the Tax Review. This is in accordance with our Terms of Reference following the release of our Issues Paper and two rounds of public consultation.

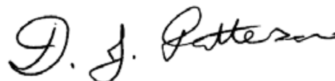
We would like to acknowledge the important contribution that submitters made to the Tax Review. We were very pleased with the extent of public participation in the process and with the general calibre of the written and oral submissions we received.

The scope of the Review was extremely wide, and we believe that we have addressed all the major elements of the New Zealand tax system.

We consider that New Zealand's tax system compares quite favourably with tax systems of other countries but believe that much can be done to improve it. We hope that our recommendations contribute to that improvement. In particular, we strongly encourage New Zealand governments to continue the tradition of tax policy education and consultation in order to promote good reform and to mitigate the prospect of ill-conceived reform.

Yours sincerely

Robert McLeod



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tax review 2001

Final Report

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Table of contents

Overview i

Introduction 1

Chapter One – The New Zealand tax system since 1981 5

Chapter Two – Frameworks 19

Chapter Three – Tax bases 25

Chapter Four – Eco-taxation 43

Chapter Five – Carbon taxation 51

Chapter Six –Tax rates 57

Chapter Seven – Entities 69

Chapter Eight – International taxation: taxing income from inbound and offshore investment 75

Chapter Nine – Savings 93

Annexes:

Annex A - Housing 95

Annex B – Cash-flow taxation 99

Annex C - Carbon taxation 107

Annex D – RFRM examples 121

Annex E - International taxation – inbound investment by non-residents 133

Annex F - International taxation – offshore investment by residents 153

Annex G - Data from chapter one 163

Annex H - Terms of reference 167

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OVERVIEW

Introduction

This Review was asked to consider whether the architecture of our tax system is adequate for today's needs. We conclude that radical restructuring is not required. The broad architecture of the tax system is sound. That contrasts with the conclusions of the last general review of our tax system – the 1982 McCaw Report. Reporting almost twenty years ago, McCaw concluded that the then tax system needed a major overhaul. We generally conclude that the subsequent reform programme has been a success and should not be reversed.

The essential questions of tax policy design do not change. The main issues now are the same as they were for McCaw, namely:

- the level of tax ;
- the appropriate bases for tax;
- the detailed definition of those bases; and
- the rates of tax that should apply.

Our Issues Paper presented our analysis on each of the above key questions. The Review has considered submissions received on the Issues Paper and the Report sets out our conclusions. The Report should be read in conjunction with the Issues Paper.

Our approach has been to focus on key elements that together make up our system of taxation. We have examined linkages between these different aspects of the tax system and the ways they can better contribute to raising revenue at lowest feasible cost consistent with equity goals.

From a national welfare perspective, many of the gains from earlier tax reforms have already been realised. But problems with the tax system remain and many defy easy solution. In addressing these problems we have tried to base our analysis on clear principles and available evidence, and to identify the trade-offs involved. At times, this approach has led us to conclusions that are controversial – indeed, we were encouraged by the robust debate our Issues Paper engendered.

We hope that this Report will be subject to rigorous scrutiny and lively and open-minded debate, and thereby contribute to improving New Zealand's tax system.

The New Zealand tax system since 1981

When considering how to apply tax rules to given tax bases, there are two broad models that governments can adopt. Tax can be levied on narrow bases that reflect numerous exemptions and concessions. Alternatively tax can be levied on broad tax bases. The broad tax base approach allows for low tax rates whereas the narrow base approach necessitates high rates. Over the last twenty years New Zealand has moved from narrow bases with high rates to broad bases taxed at lower rates. Over the same period, the level of government expenditure as a proportion of national income has declined somewhat and this has taken some pressure off the tax system.

A well-functioning tax system works best the lower the revenue level it is required to collect, the broader the base to which it applies, and the lower the rates at which it is levied.

The early 1980s – narrow bases, high rates and insufficient revenues

In the early 1980s, the tax system was in disarray. It was characterised by narrow bases, high tax rates, and a heavy dependence on income tax. One of the main reasons for the narrow base in 1981 was the provision of incentives or concessions for activities seen as having social or economic merit. Revenue collected fell short of the government's expenditure commitments.

The introduction of GST in 1986, and the reforms undertaken at about the same time to restore the credibility of the company tax, have allowed a better and more sustainable balance in the tax mix to be achieved. In particular, there has been a decreasing reliance on income tax (especially individual income tax), and an increased role for consumption taxes (in particular, GST).

Base broadening and lower tax rates

One of the most significant features of the individual income tax in 1981 was the highly progressive tax rate scale. While the statutory income tax rates were clearly higher overall in 1981 than they are today, effective rates were often substantially lower than the statutory rates due to the substantial rebates that were available to individual taxpayers.

The introduction of GST, the removal of personal income tax concessions and a broader company tax base in the mid-1980s took a lot of pressure off the personal income tax scale. This enabled lower personal income tax rates overall, with the higher rates applying at relatively higher income levels.

The company income tax rate in 1981 was 45 percent for resident companies and 50 percent for non-resident companies. Despite the subsequent reduction of the rate to the current rate of 33 percent, taxes on companies now account for 15 percent of total revenue, compared with only five percent in 1981. In other words, much greater revenue is now obtained from companies even though company tax rates have been substantially reduced. This was achieved by removing company tax concessions and avoidance opportunities.

The broad base low rates approach developed over the last twenty years is sound and should be continued. New Zealand reforms should focus on incremental improvements to what we have, and there should be a prejudice against deviation from this approach, so that exceptions are only made where a substantial burden of proof is discharged. This does not mean that tax incentives can never be used. Analysis of any such concessions should be measured by reference to the tax sensitivity of the activity for which concession is sought and net positive externalities produced by the activity.

A cautious approach is justified because reduced tax revenues from tax incentives have to be made up elsewhere. Furthermore, tax incentive policy can easily become politicised with resources being captured by concentrated interest groups. Any exceptions to a broadly neutral approach can be a thin end of a wedge and unravel an overall general approach. For example, there did not seem to be an appreciation among the submissions that favoured the greater use of tax concessions that this inevitably narrows the tax bases and leads back towards the 1981 model, for which there is, in our view, little support.

Another important lesson of the last twenty years of tax reform has been how different tax reforms are interwoven. For example, the imputation system relied on company tax reforms removing most concessions since imputation depends on credits being generated by tax paid at the company level. It also relied on the alignment of the company rate and the top personal rate to ensure that there was no tax advantage in retaining earnings within a company. The reduction in personal income tax rates was in turn partly funded by the higher tax revenue collected from companies as a result of the post-1981 reforms. Our Report should be read bearing these linkages in mind.

Tax bases

New Zealand raises revenue in three main ways: through income tax, GST and excises. Other taxes are minor in terms of revenue collection. Our Terms of Reference require us to consider whether we should retain, extend or reduce these various forms of taxation in New Zealand. We are also required to consider whether new taxes should be introduced to complement or replace existing ones.

Income tax, capital gains and RFRM

New Zealand's income tax base is broad by international standards but falls short of being fully comprehensive in two notable respects: (i) the absence of a comprehensive tax on capital gains and (ii) the non-taxation of owner occupied housing.

We do not consider that New Zealand should adopt a general realisations-based capital gains tax. We do not believe that such a tax would make our tax system fairer and more efficient, nor do we believe that it would lower tax avoidance or raise substantial revenue that could be used to reduce rates. Instead, such a tax would increase the complexity and costs of our system.

In our Issues Paper, we suggested the possibility of using a Risk Free Return Method as a means of addressing specific problems arising from the current treatment of capital gains.

Briefly, the basic Risk Free Return Method (RFRM) is calculated as follows:

Net asset value at the start of the year

x

Statutory risk-free real rate of return

x

The investor's tax rate

Our recommendation is that the RFRM method be considered for the specific problem of disparate tax treatment of different savings entities. This continues the past approach of dealing with specific capital gains issues as they arise.

Owner-occupied housing

One of the more controversial issues with respect to the income tax base has been the tax treatment of housing. The OECD report on the New Zealand tax system identified this as a major anomaly in our system. The central concern was that our tax system causes a bias in favour of investing equity in a

home. Those renting pay rent out of after-tax income. Likewise, people with mortgages pay interest from after-tax income. In contrast, people without mortgages earn what amounts to a tax-free return on the equity they have invested in their owner-occupied dwellings. This encourages people to apply savings to owner-occupied housing in circumstances where higher overall (fully-taxed) yields can be obtained from alternative investments.

We continue to reject the OECD view that housing should be taxed on imputed rental income and capital gains with deductions for mortgage interest, depreciation and repairs and maintenance. In our Issues Paper, we raised the possibility of applying the Risk-Free Return Method to tax the net equity-component of owner-occupied and rental houses. However, that approach met with such widespread opposition that no government is likely to implement it in the near future. Unfortunately, no more viable way of making this aspect of the tax system fairer and less distortionary has been identified. Accordingly, we do not recommend that the government take this proposal further at this point.

Other tax bases

We do not support implementing a general wealth tax in New Zealand, nor reintroducing an estate duty. We conclude that neither of these taxes would fill a gap in the income tax base.

We recommend that the Government not implement a cash-flow tax, given the severe transitional problems that would arise.

In the Issues Paper, we indicated our support of the overall design of GST and did not propose any significant changes. In particular, we did not believe that a strong case could be made for either narrowing the GST base or for taxing some goods or services at lower rates. We have not altered our view of GST, and do not recommend any material reform.

We endorse our original recommendations that gift and cheque duties be repealed.

We do not support the introduction of a financial transaction tax, first, because of harmful cascading effects, and secondly, because we do not consider it a superior substitute for GST.

We do not support the introduction of a tax on short-term foreign exchange flows popularly known as a Tobin Tax, as we believe that the goal of reducing exchange rate volatility by means of a Tobin-type tax is misguided. We are also unconvinced that a Tobin tax imposed by a single country would be effective in furthering such a goal.

Tax mix

Our overall perception is that New Zealand's current tax mix is broadly right. By having two main tax bases, overall revenue flows are relatively stable, even where one or other tax base fluctuates.

We noted in the Issues Paper that economic decisions are less distorted by GST than by income tax. Accordingly, we believe that any overall increase in tax should be implemented through GST. By contrast, any reduction in tax should be focused on income tax. This would achieve a minor movement in the mix towards GST implemented in an incremental way.

Excises and duties

Excises and duties are imposed on four categories of spending: alcoholic beverages, tobacco, gaming, and petrol. These taxes account for about $2.8 billion, or 8.3 percent of total tax revenue (including matching customs duties on imports). These narrowly based taxes were of interest to the Review because although they raise a significant amount of revenue, they seem out of step with the low rate, broad base approach taken in respect of our other tax bases.

Historically, high levels of excise taxes have been justified as good revenue raisers. However, this is not a sustainable rationale for narrowly based indirect taxes when GST offers an excellent broad based, low rate, alternative. Indeed, in our Issues Paper we concluded that excise taxes were difficult to justify on either tax efficiency or tax equity grounds.

From the standpoint of our policy framework, this suggests that the case for the excises must rest on the notion that they correct market mis-pricing. For motor spirit, that case will be difficult to sustain for both petrol and diesel (in view of their inconsistent tax treatment). For tobacco and gaming, present levels of taxation appear indefensible on externality grounds (even if the social spending argument were accepted). We believe that the levels of alcohol excise that could be justified on externality grounds are likely to be well below those currently applied in New Zealand.

On tax policy grounds, we have a strong preference for the transparent approach to taxation exemplified by GST, which makes tax burdens independent of how New Zealanders choose to spend their money. In our view, the current excise and duty regime cannot readily be justified on conventional tax policy grounds. As a matter of tax principle, the general revenue component of these taxes should be replaced by an increase in GST. At a minimum, the many anomalies in this area of the tax system should be subject to further review.

Eco-taxation

New Zealanders value access to the natural environment. The accessibility of much of our coast, rivers, mountains and other features of our natural environment is highly valued and jealously guarded.

As the intensity of use rises, however, increasing pressures placed on environmental resources begin to degrade their value. At some point, the development of instruments that allow competing uses to be more rationally balanced, one against another, becomes worth the cost. These instruments include access rights to environmental resources that are freely exchangeable, regulatory regimes, and taxes and charges.

We were encouraged by submissions to consider a greater role for taxes to further the enjoyment of environmental as well as other resources and amenities. We assess the role of taxes alongside the other instruments to ensure that an appropriate mix of approaches is used that is suited to the environmental issues facing New Zealand.

The proportion of tax revenue collected from eco-taxes in New Zealand is about half the average for the OECD. This does not necessarily mean that New Zealand lags in the appropriate use of these instruments. Virtually all of the difference between the OECD average and New Zealand can be explained by New Zealand’s lower taxes on petrol, diesel and motor vehicles.

We noted in the Issues Paper, the three conditions that favour the use of taxes designed to reduce adverse environmental impacts to their optimal level. These conditions are:

- The impact of the adverse activity or use (however each unit is measured) should be *uniformly distributed,* and the impact of each unit should be the same;
- The adverse activity or use must be *measurable* to be able to apply the tax; and
- The *marginal net damage of the activity must also be measurable* to be able to set the level of the tax.

While a range of submissions called for a variety of national levies, few examples were provided that satisfied the criteria. This is not surprising given the

localised nature of most environmental issues New Zealand faces.

The Review was unable to identify instances where new eco-taxes at the national level could be considered an effective means of addressing environmental concerns facing New Zealand. It follows that we do not favour proposals to target and move towards predetermined levels of tax revenue from national eco-taxation. For similar reasons, we do not consider that national quotas or similar regimes are appropriate to New Zealand circumstances. Such measures also fail to satisfy the criteria noted earlier for a nationally applied eco-tax.

Where, on the other hand, environmental concerns are highly localised, as they currently appear to be in New Zealand, measures such as carefully designed eco-charges applied at the local level can be appropriate.

Carbon taxation

The government referred to the Tax Review the question of whether New Zealand should implement a carbon tax. It has announced that if, as a result of the tax review process, a decision was taken to proceed with a carbon charge, it would not be implemented until after the next election.

New Zealand is a party to the 1994 UN Framework Convention on Climate Change which aims to stabilise atmospheric concentrations of greenhouse gases at a level that avoids dangerous anthropogenic (human-induced) interference with the world climate system.

It is widely agreed that, because stabilisation of greenhouse gas concentrations will require very large reductions in the rate of greenhouse gas emissions, atmospheric concentrations of these gases are likely to rise for much of this century. Countries will need to adapt to the global climate consequences of rising greenhouse gas concentrations.

New Zealand has indicated that it will ratify the Kyoto Protocol which commits New Zealand to reducing its greenhouse gas emissions to 1990 levels (New Zealand's “Initial Assigned Amount” under the Protocol), as an annual average over the five years 2008-2012 (the “first commitment period”).

The Review does **not** support unilateral action by New Zealand to mitigate global warming.

The Review's analysis of carbon tax is therefore predicated on the assumption that New Zealand ratifies the Kyoto Protocol (and that the Protocol comes into force).

In the context of a transition to the regime of carbon emissions trading by legal entities presently proposed for New Zealand, the Review does **not** recommend the pre-2008 imposition of a carbon tax.

At the same time, the Review continues to believe that a broad-based carbon tax, aligned to international carbon prices, and including the agricultural sector, merits consideration as New Zealand's central Kyoto measure for the first commitment period.

Under New Zealand conditions, and by comparison with the alternative of carbon trading by legal entities, a carbon tax combined with government emissions trading (to cover residual excess emissions from non-forestry sectors) is considered to offer the prospect of more efficient outcomes at lower costs of monitoring and compliance.

In particular, the Review notes that commitment to broadly-based carbon taxation should assist in averting potentially very costly disputation over the initial allocation of carbon credits.

Tax rates

In New Zealand, most redistribution occurs through government spending. The distribution of taxpayers does not permit large amounts of redistribution through rate scale progression. We argue in Chapters Six, Seven and Eight that good tax policy design would ideally align the company, trust and top individual marginal income tax rates. Any alternative opens the tax system to abuse, complexity and distortion. This puts a severe constraint on designing a good rate structure.

One option is to move to a single income tax rate that applies to all income and all taxpayers. However, that would have an adverse effect on lower income earners, some of whom already face high effective marginal tax rates because of the abatement of various benefits and tax credits. Given this, the option of reducing the company and top personal tax rate is difficult given the required level of tax revenue. We have suggested, in Chapter Six, a move to a two-step personal income tax scale (18% up to $29,500 and then 33 percent) as the direction of possible reform. The company and trust rate would then be aligned to the 33 percent rate.

At these tax rates, however, New Zealand would be likely to remain an unattractive destination for internationally mobile capital and people. Hence, as well as considering a reduction in tax rates faced by non-resident investors, Chapter Eight recommends that immigrants not be taxable on offshore income for at least seven years. In addition, that chapter recommends that there be a maximum liability for tax of $1 million that any individual is required to pay in any income year. We consider it likely that this measure would be fiscally positive thereby addressing any equity concerns that it might raise.

Proportionality versus progressivity in the personal income tax scale

The two objectives of the personal income tax are to generate revenue for the government and reduce income inequality.

This raises the difficult question of how the income tax rate scale should be designed to collect the required revenue efficiently while contributing to income redistribution. In considering this question, the Review has had regard to the effectiveness of the current scale and its interaction with the welfare system, possible changes to the scale, and the economic, social and administrative effects of such changes.

In New Zealand, most redistribution occurs through government spending. The distribution of New Zealand’s high- and low- income taxpayers is such that it does not permit large amounts of redistribution through additional rate scale progression.

Only 200,000 taxpayers earn more than $60,000, compared with 1.65 million on less than $30,000. It takes eight dollars in tax from each person in the high-income group to provide one dollar for each person in the low-income group.

The real engine for income redistribution is the payment of more tax as income rises, coupled with the pattern of government expenditure on benefits, education and health.

If an increase in progressivity is desired, it is best achieved through an increase in targeted spending, not an increase in the progressivity of tax rates.

Tax scale design

The tax scale has limited ability to help low-income earners through progressivity, and in doing so creates expensive inefficiencies.

The Review considers that a proportional scale offers substantial benefits over a progressive one in terms of efficiency, administration costs and avoidance.

However, a proportional scale would result in income losses to low-income earners. Also, many New Zealanders value the progressivity delivered through the tax system.

The Review's analysis points towards a two-rate scale that retains some progressivity while reducing its cost, and simultaneously, minimises the loss that low-income earners would suffer if the system moved to a simple proportionate scale. We suggest a two rate scale of 18 percent / 33 percent with a threshold at $29,500.

Taxable unit

Tax can be assessed on either family or individual income. Currently, the tax scale is based on individual income while social assistance is based on household income. The Issues Paper found that individual-based taxation is the best approach in a diverse and changing society. On balance, the Review still considers individual-based taxation is the best approach, and notes that the less progressive the tax scale, the less significant this issue becomes (and *vice versa*).

Taxation and the benefit system

The welfare system targets cash payments (income) to beneficiaries. As they move into work and their income rises, they pay more tax and they also lose part of their benefit. Their effective marginal tax rate (EMTR) comprises both payments, and may reach high percentages. High EMTRs affect people's decisions. They may, for example, decide the net incremental gain is insufficient to warrant working full-time.

The tax and benefit system work together. However, the tax system provides a basic "platform" for the benefit system. The current tax-benefit regime may be more complicated than it needs to be. However, changes to the tax system will have little impact on this complexity. Changing benefit rates or abatement regimes has a much greater potential to affect EMTRs, but reform of the benefit system is beyond the scope of the Review.

Some submissions suggested more targeting of expenditure, but this means that more people would face higher EMTRs as they try to move out of benefit dependency. Less targeting means a lower level of assistance to needy people. There are no easy answers.

Some submissions recommended paying a universal basic income to every New Zealander, based on age and residence. While this has theoretical attractions, the high tax rates required to fund such a regime and the incentive effects of the payment make it impractical.

Company tax rate

We raised the issue of an appropriate corporate tax rate in the Issues Paper. We emphasised that establishing the nominal company tax rate relative to other tax rates is not an easy task. We consider the key guiding principles to be that:

- The top personal marginal tax rate and the company/entity tax rate should be as close as possible. This minimises the incentives to either distribute or retain income within companies.
- The corporate tax rate has the highest commercial visibility amongst tax rates, and therefore has an important impact on investor perception. In response to this principle, some countries have deliberately reduced their company tax rate significantly below the top personal marginal tax rate with a view to attracting and retaining capital. This principle has to be balanced against that in the above paragraph.

- The trustee rate should be aligned with the top personal marginal tax rate.
- The company rate should not be significantly above the corporate tax rates of key jurisdictions with which we compete for scare resources, such as Australia.
- Efficiency costs are highest at the top end of a rate scale, encouraging lower rather than higher top marginal rates (and therefore entity rates).
- New Zealand has a relatively broader tax base than most other OECD countries meaning that relatively more tax is raised per unit of the tax rate.

Our recommendations on tax rates are:

- the top personal tax rate should be reduced from 39 percent to the corporate tax rate (currently 33 percent);
- the trustee rate should be set equal to the top personal marginal tax rate, namely 33%.

We note that since the Government moved to increase the top personal marginal tax rate from 1 April 2000, the Australian government has moved its corporate rate from 36 percent to 34 percent for the year ending 30 June 2001, and to 30 percent thereafter. These developments will be an ongoing source of pressure towards a re-examination of our rate structure in terms of the above principles. In particular, it is likely that these and future developments overseas will continue the pressure towards reducing the company tax rate over time. Chapter Eight sets out specific proposals with respect to tax rates on inbound investment.

Entities

Aligning the tax treatment of entities to reflect common features of economic substance offers the potential to reduce the economic costs of the tax system.

Companies, trusts and partnerships

Companies, trusts and partnerships are the most common form of taxable entities. Differences in the tax treatment of different business entities that share common underlying features creates opportunities for people to 'shop around' various entity-based tax regimes.

To address this, a common framework for the tax treatment of widely-held and closely-held entities is proposed. To the extent feasible, widely-held entities would be treated under a company tax model while closely-held entities would be treated under a partnership model.

But there should be no radical change in the short-term. Instead, the move to greater alignment of various entity-specific regimes should occur progressively over time as these regimes are subject to the normal process of periodic review.

Saving and investment entities

We have specifically considered the taxation of savings and investment entities (SIEs) as a result of our Terms of Reference and submissions. We note that this sector attracts various tax treatments at both the entity and international levels. We also note that a substantial percentage of the company tax is collected from this sector.

We recommend that the Government consider a special tax regime for SIEs based on the application of an RFRM mechanism. We recommend the RFRM because it provides a comprehensive and consistent method of income taxation on an inflation-adjusted basis. Furthermore, we consider that comprehensively taxing financial assets at their riskless opportunity costs will tax less than the returns expected by the managers and owners of such assets. The application of the RFRM approach to SIEs is also consistent with our proposal to apply the same approach to net equity interests in publicly listed offshore investment funds and retail offshore unit trusts. These two proposals should achieve better consistency in the taxation of portfolio investment.

International

The policy issues in international tax are complex and the taxes in this area can impact on mobile individuals and companies who are sensitive to tax. Thus, it is important that New Zealand makes the best possible policy decisions in this area.

Investment in New Zealand by non-residents

We consider investment by non-residents under two headings: foreign direct investment ("FDI") representing a 10 percent or greater equity interest in the company/New Zealand assets; and portfolio investment, being a less than 10 percent equity investment or debt investment by a non-resident with no equity interest or a portfolio equity interest.

Foreign direct investment

We regard increased levels of FDI as essential if a real attempt is to be made to increase significantly GDP per capita. We believe the government should consider a reduction in New Zealand tax impost on companies to the extent owned by non-resident investors.

We have developed two options for consideration:

- Option One: An 18 percent company tax rate to the extent a New Zealand company is owned by non-residents, with two percent NRWT for FDI investors and repeal of the FITC (foreign investor tax credit) regime. This approach imposes different rates of company tax according to whether the company is owned by residents or non-residents. It does not distinguish between "new" and "existing" investment/activities and it does not distinguish between types of activities. Officials' static budget estimate is that Option One has a fiscal cost of approximately $460 million per year;
- Option Two: An 18 percent company tax rate for investment by non-residents in "new" activities. This approach would involve the same differentiation between resident and non-resident ownership as for Option One, but it would distinguish "new" from "existing" activities. Officials estimate that Option Two has a static budget cost of no more than $50 million per year.

The 18 percent rate has been chosen so that New Zealand "stands out more from the crowd" as a destination for investment by non-residents.

We recommend that the government consider implementing Option One or Option Two. We are satisfied that Option Two should be net national welfare enhancing, provided that the distinction between "new" and "existing" activities can be drawn in a long-term sustainable manner. Further work should be undertaken as to the feasibility of this distinction. If not sustainable over time, Option Two should be analysed as if it were a phased introduction of Option One.

We have not reached unanimous agreement within our time constraint as to whether Option One increases net national welfare. Further work should be undertaken before a final judgement is made.

If a tax reduction of the proposed type is implemented, we believe the government should simultaneously consider whether it can improve non-tax policies to ensure that New Zealand maximises the benefit it receives from the tax reduction and achieves quality FDI for New Zealand.

Portfolio investment by non-residents

Our preference is that, if Option One or Option Two are implemented, the 18 percent company tax rate should also be applied for non-resident portfolio investors. This regime would be implemented with a 15 percent NRWT and an extended FITC regime. This is technically

somewhat different to the approach we have recommended for FDI investment.

Taxation of income earned by residents offshore

The issues in the taxation of outbound investment are also complex and defy neat solutions. We recommend:

- application of the RFRM method for all portfolio investments in offshore listed entities and offshore retail unit trusts. The RFRM method would apply whether such investments were in grey list or non-grey list jurisdictions.
- that an individual with no previous connection to New Zealand who becomes a resident of New Zealand for tax purposes should only be taxed on their New Zealand-sourced income for the first seven years after they first become a resident.
- the maximum level of tax imposed on a single individual in any one year should be capped at $1 million. People earning income at these levels are of critical importance to New Zealand as a result of their international connections and ideas.
- consideration of rules to prevent the use of the conduit regime to enable borrowing to make certain offshore investments and achieve a reduced New Zealand tax liability on New Zealand source income.

A key issue we were unable to resolve is whether New Zealand should seek to tax offshore income as earned or more generally defer tax until repatriation. The current rules are an unhappy compromise and there remains considerable dissatisfaction with the present position. The tension is between the desire for the tax system not to produce tax incentives for residents to invest offshore and the fact that the international standard adopted by other countries (an active/passive regime) is founded on such an incentive. The concern is that New Zealand's failure to follow the international standard produces significant losses for the country because it contributes significantly to decisions by non-residents not to migrate to New Zealand and by residents to leave New Zealand.

We have recommended the $1 million tax cap and the seven year exemption from tax on foreign source income for new migrants as partial solutions. Even with these rules, there remain issues for NZ corporates and emerging entrepreneurs.

We have not reached a final recommendation as to a regime, but we do suggest a way forward.

We have considered the active/passive approach, which would defer New Zealand tax on active offshore earnings until repatriation, and for which business interests advocate. We do not embrace it with enthusiasm because of its distortionary effect towards offshore investment and the definitional issues it poses. But there are real issues of the costs to New Zealand of not following this international standard. Our suggestion is that the government engage in further dialogue with interested parties to determine whether agreement can be reached on a broad outline of an active/passive approach. We have also suggested a framework for that dialogue.

If progress of this type cannot be achieved, the only other suggestions we have are to reduce the magnitude of this issue over time by reducing the corporate tax rate, and consider whether the RFRM method can be introduced as an alternative method that can irrevocably be elected by taxpayers subject to the CFC/FIF regime.

New Zealand benefits from our openness to international labour and capital markets. That openness offers potential rewards from improvements to our international tax rules.

The taxation of inbound and outbound investment is a critical issue for New Zealand's economic future and is one where welfare-enhancing reform is desirable.

Savings

There has been considerable debate in recent years about whether New Zealand has a savings problem. There has also been debate about the appropriate tax treatment of savings. Since 1988, the policy has been to tax income from savings in the same way as other forms of income, such as business income.

National and private savings

When looking at the impact of 'savings' on the current and future wellbeing of New Zealanders, the most relevant measure is national savings; that is, the sum of private and government saving. On examining the available evidence and the reasons why people save, it is not clear to us that New Zealanders save too little.

Even if it were considered desirable for New Zealanders to save more, there is little evidence that changes to the tax system will induce higher savings, other than by redistributing income from those who are less like likely to save (typically poorer households) to those who are more likely to save (typically wealthier households).

The tax system will also influence the absolute level of saving to the extent it affects the level of national income. To this end, it is important to avoid introducing or exacerbating tax distortions that would result in lower quality savings and investment choices.

Retirement savings

In reaching this conclusion we have noted that there is little evidence that most New Zealanders are currently making inadequate provision for their retirement. New Zealand's system of universal superannuation cannot be ignored in this context: it seems reasonable to conclude that virtually all current recipients of New Zealand Superannuation who have a mortgage-free home and relatively modest savings consider themselves to have at least a 'medium' standard of living.

We therefore take the view that, against the backdrop of universal provision of New Zealand Superannuation, most New Zealanders would not be well served by being induced or compelled to make additional retirement provision at the expense of living standards during their working lives.

We also note that higher private savings could only lower the cost of New Zealand Superannuation if a future government were to reintroduce income-testing or means-testing. But, by reducing the payoff to retirement saving, income-testing would by itself detract from incentives to make private provision for retirement. In this respect, the starting point in New Zealand is very different to that in countries such as Australia that abate state-provided pensions against private retirement incomes. Countries that abate pensions have a compensating motive to provide savings incentives or to legislate for compulsory saving in an effort to offset the saving distortion resulting from abatement.

INTRODUCTION

The Review's approach

Our Terms of Reference required us to review the tax system and advise the government of an appropriate framework for policy. We adopted a medium-term outlook and focused on the key elements of the tax system. We also examined the tax system as an entire interactive system and tried to base our analysis on robust principles and empirical evidence.

As expected, our Issues Paper provoked vigorous debate in a number of contentious areas. In our final Report, we state our conclusions on the matters presented in the Issues Paper in light of submissions.

Our final conclusions will no doubt provoke further debate and some disagreement. Designing a tax system involves trade-offs between competing and conflicting objectives, which requires a combination of a principled framework and sound judgement. We hope that our Report will make a valuable contribution to New Zealand's tax design.

Consultation process

Our Terms of Reference required an inclusive process providing an opportunity for the public and key stakeholders to have input. We undertook a comprehensive consultation process throughout the course of the Review.

The submissions brought many issues to our attention, challenged us to carefully consider the robustness of our analysis, and provided a strong indication of public sentiment on various aspects of tax policy. We trust that the consultation process was also of benefit to submitters, by increasing their awareness of the difficult trade-offs inherent in tax policy design and their understanding of our reasons and conclusions. An open and inclusive consultation process contributed significantly to our thinking.

We conducted two rounds of public consultations. The first round, at the beginning of this year, sought to gauge the full range of public views on the best framework to underpin tax policy. We received 197 written submissions and heard oral submissions from five group submitters. These submissions formed an important input into the Issues Paper released on 20 June 2001.

The second round of consultations was based on our Issues Paper. There was significant interest in the Issues Paper and we were pleased to receive 245 submissions and to meet with 20 group and individual submitters.

External consultant

As part of the consultation process, we commissioned Professor Alan Auerbach to review the Issues Paper and to visit New Zealand to work with the Review and meet key stakeholders.

Professor Auerbach is the Robert D. Burch Professor of Economics and Law, University of California, Berkeley, and Director of the Burch Centre for Tax Policy and Public Finance. Professor Auerbach's report and subsequent discussions contributed to clarifying and helping much of our analysis.

Professor Auerbach prefaced his report by stating that "*New Zealand's current tax system already conforms more closely to the standard objectives of taxation than do the tax systems of many other developed countries. Thus, New Zealand's tax system is not obviously in need of major overhaul. Still, any tax system, including New Zealand's, has its flaws and inconsistencies, and seeking improvement is a worthwhile objective*." Our focus was inevitably on seeking improvements, despite the fact that there is much to commend the existing New Zealand tax system.

Professor Auerbach's report is available on our website: www.taxreview2001.govt.nz

Second stage of Tax Review program

Our report completes the first stage of the government's tax review program. As set out in the Terms of Reference, stage two will analyse the conclusions in our report to enable the government to establish a set of workable proposals to put before the New Zealand public leading up to the 2002 general election.

Content of the Report

Our Report should be read as a supplement to the Issues Paper. We comment on the submissions received, outline the key elements of our analysis, state our conclusions, and make final recommendations.

In Chapter One, *The New Zealand Tax System Since 1981,* we discuss the historical development of the New Zealand tax system, noting that it has undergone significant reform since the McCaw Report in 1982. Understanding the logic and analysis that underpinned such reforms is a necessary pre-requisite to any review of the New Zealand tax system. This chapter describes the key tax reforms since the McCaw report and their underlying rationale.

In Chapter Two, *Frameworks*, we set out the key elements of the framework that underpins much of our analysis. Some submissions placed significant emphasis on improving New Zealand's competitiveness through the tax system, particularly in the context of the pervasive use of incentives by overseas tax regimes. We have sought to address the questions of competitiveness and incentives in more detail than in the Issues paper.

In Chapter Three, *Tax Bases*, we examine what New Zealand currently taxes and might tax in the future.

Chapter Four, *Eco-Taxation*, examines the topical and discrete issue of 'eco-taxes'; namely, taxes designed to improve the environment as well as raise revenue.

Chapter Five, *Carbon Taxation,* examines the issues of 'carbon taxes' being taxes designed to address carbon emissions in the context of the commitments under the Kyoto Protocol.

Chapter Six, *Personal Tax Rates*, addresses tax rates, with the main emphasis being on the appropriate rate of tax on personal income.

Chapter Seven, *Entities*, focuses on how the different forms of taxable entity should be taxed and the tax rates that should be applied to them.

Chapter Eight, *International Tax,* examines international tax; namely, how New Zealand should tax income across international borders.

Chapter Nine, *Savings*, is the final chapter addressing the taxation of savings.

Acknowledgements

A number of people deserve special mention and acknowledgement for their assistance.

We thank all submitters for their efforts and the generally high standard of their submissions.

We thank Professor Auerbach for assisting us with the Review and for his valuable comments and report.

We thank officials from both the Treasury and the Inland Revenue Department for their technical and administrative support.

We thank our Secretary, Colin Lynch, for managing and administering the Review.

Finally, we thank various professional colleagues for their technical and administrative support.

CHAPTER ONE
THE NEW ZEALAND TAX SYSTEM SINCE 1981

Introduction

1.1 The Review's Terms of Reference referred to the overhaul of the New Zealand tax system that has occurred since the early 1980s. That overhaul has been characterised by the broadening of tax bases and the flattening of tax-rate scales. Our Terms of Reference point to the criticism that has been levelled at this change. In particular, the tax system we have now has been seen by some as inadequate, both in terms of redistributing income and meeting the challenges New Zealand faces in a world without economic borders. One of the key questions for this Review is whether the move towards broader tax bases with flatter tax rate scales is the model that New Zealand should continue with.

1.2 In considering this question, it should be remembered that many of the tax reforms arose out of limitations of the tax system in the early 1980s. At that time, our tax system was heavily dependent on income tax. Furthermore, because of pervasive tax concessions for the self-employed and companies, most of the tax burden fell on employees. The reliance on taxing employee income created a narrow base that needed high tax rates (up to 66 percent) to raise the necessary revenue. The income tax was supplemented by a wholesale sales tax, but this was also levied on a narrow base with variable and, at times, high tax rates (up to 60 percent).

1.3 Twenty years ago, New Zealand's tax system could be characterised as a 'narrow-base, high-rate' system, in contrast to the 'broad-base, low-rate' model we have since adopted. One of the main reasons for the narrow base was the provision of incentives or concessions for activities seen as having social or economic merit. Some submissions to this Review suggested we revert to such a system. However, that tax system was widely seen as unfair and inefficient and it was increasingly unable to meet the government's revenue requirements. These concerns led to the 1982 McCaw tax review[1] and the tax reforms that followed that review. In reviewing this history, this Review endorses the post-McCaw tax reforms towards broader tax bases and a flatter tax-rate scale. This chapter explains why, by comparing the tax system as it was in the early 1980s with the tax system as it is now.

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1 See the report of the *Task Force on Tax Reform*, April 1982.

The McCaw Committee

1.4 The McCaw Committee was the last general and independent review of the New Zealand tax system. It was appointed because of a widespread view that, by the beginning of the 1980s, New Zealand's tax system was failing. It was not raising sufficient revenue to meet the government's expenditure requirements. The system was increasingly seen by the public as unfair and lacking in integrity. Tax avoidance seemed rife. Economic commentators saw high tax rates and uneven rules as significantly contributing to New Zealand's poor economic performance.

1.5 The McCaw Committee's report largely agreed that these concerns were justified. The Committee made a number of recommendations that, together, constituted a call for a substantial programme of tax reform. The more significant of these recommendations were:

- a less progressive personal income tax scale with fewer and lower tax rates;
- bringing fringe benefits of employees into the tax net;
- a review of the wholesale sales tax and serious consideration of the possibility of introducing a value-added tax along the lines of GST;
- better integration of the company and individual tax systems;
- a review of the tax concessions for superannuation and life insurance;
- a review of company tax concessions, and reduction of those concessions where appropriate; and
- indexation of the company tax base to adjust for the effects of inflation.

1.6 The direction of reform indicated by McCaw was adopted by later governments, especially after the election of the Labour government in 1984. A driving idea behind that reform programme was to create a more transparent tax system, where tax rates are lower but apply more consistently in practice. This contrasts with a tax system with variable and often high tax rates, which were substantially offset by a complex set of concessions and opportunities for tax avoidance. The aim was a more honest system that would lead to economic decisions being made more on their economic merits, rather than being determined by the pursuit of tax advantages.

1.7 As a result, over the last twenty years, New Zealand's tax system has been radically transformed for the better, as we illustrate in the sections below.

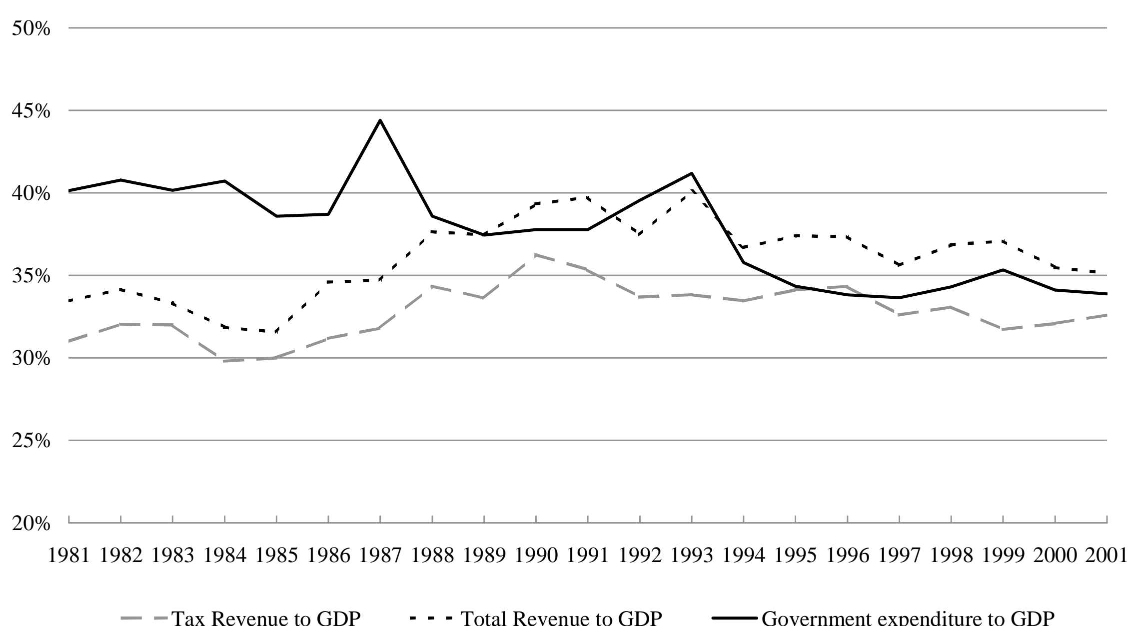
Tax level

1.8 Ultimately, the level of tax society requires is determined by the level of government expenditure. However, the two need not match exactly each year. Tax collection can be kept lower than government expenditure for a period if the government borrows to meet the shortfall, but any such borrowing eventually needs to be repaid, creating the need for higher future taxes. Conversely, where tax collection is higher than government

expenditure, the surplus can be used to repay amounts the government has borrowed or retained for contingency spending (for example, in response to a large-scale natural disaster or to pre-fund anticipated superannuation commitments).

1.9 Since 1981, the level of central government expenditure has fallen from about 40 percent of GDP to about 34 percent of GDP now. This has taken some pressure off the tax system. However, another significant change has been that tax revenue has increased from about 31 percent of GDP in 1981 to about 34 percent now. As Figure 1.1 below shows, these changes to the government's revenue and expenditure have shifted the government's fiscal position from a substantial deficit through most of the 1980s to a surplus from the early 1990s onwards.[2]

Figure 1.1 – ***Central government revenue and expenditure as percentages of GDP from 1981 to 2000***



Sources: Statistics New Zealand, The Treasury

1.10 Creating a tax system that is able to meet the government's expenditure requirements has been a major achievement of the last 20 years.

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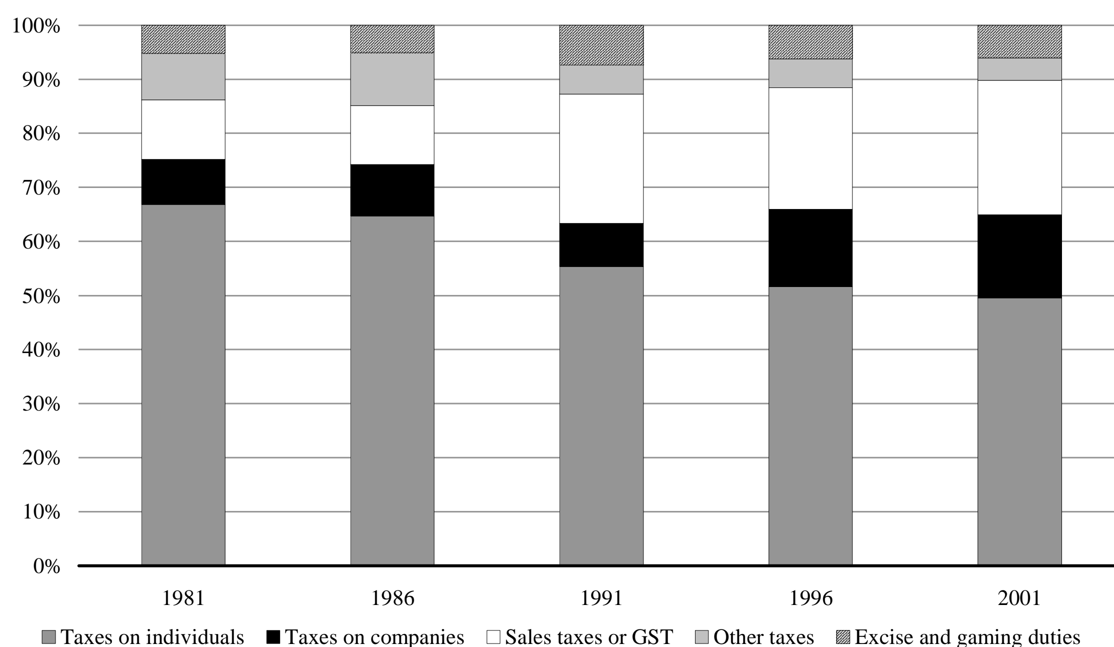
2 The official figures in this graph reflect not only actual changes in tax collected but also changes in the government's accounting practice. Two major accounting changes, reflected as spikes in the graph, are the inclusion of certain major projects in government expenditure from 1987 and the shift to accrual accounting in 1993. Other changes include the decision to gross up and tax welfare benefits, the decision to treat family assistance credits as government expenditure rather than as tax refunds and the inclusion of GST in government expenditure. Similarly, the fact that superannuation payments are taxed as gross income rather than reduced and exempted from tax affects both the tax figures and the expenditure figures. Even with these caveats, it is clear that New Zealand no longer suffers the persistent budget deficit that characterised the late 1970s and early 1980s.

Tax mix

1.11 The way tax revenue is collected is determined by the mix of tax types that is used. Figure 1.2 below shows the changing composition of the tax base at selected intervals between 1981 and 2001. It reflects clearly the decreasing reliance on income tax (especially individual income tax) and the increased role of consumption taxes (in particular, GST). Excises have remained relatively constant over this period, while other taxes, such as stamp duty, have declined.

Figure 1.2 – ***Changing composition of New Zealand's tax base from 1981 to 2001***



1.12 In 1982, McCaw and others saw our tax system as being excessively reliant on income tax, and especially on income tax levied on the employed through the Pay As You Earn (PAYE) system. McCaw noted that the share of total tax collected from personal income tax had increased since 1960 from 43 percent to nearly 69 percent. This was not the result of any deliberate policy decision, but rather the result of the combination of a highly progressive tax scale and inflation, which pushed middle-income earners into higher tax brackets. Middle-income earners were increasingly feeling that they were meeting an excessive share of the tax burden and were demanding tax reductions. Yet, at the same time, the tax system as a whole was still failing to raise enough tax to cover the government's expenditure requirements.

1.13 The introduction of GST in 1986 and the reforms undertaken at about the same time to restore the credibility of the company tax have allowed a better and more sustainable balance in the tax mix to be achieved. The contribution of individuals' income tax to the total tax collected has fallen to about 50 percent, closer to the level it was in 1960.

Individual income tax

1.14 The change in the tax mix took a lot of pressure off the personal income tax scale. This was combined with the removal of a number of personal income tax concessions, which made significant reforms to the income tax scale possible.

1.15 As we have noted, one of the most significant features of individual income tax in 1981 was the highly progressive tax-rate scale. This is shown in Table 1.1 below, with the income brackets in both 1981 dollars and wage-indexed 2001 dollars.

Table 1.1 – *1981 Statutory Tax Rate Scale*

Taxable income (1981 dollars)	Taxable income (2001 dollars)[3]	Statutory rate
$0	$0	0%
$1-$5,000	$1-$11,600	14.5%
$5,001-$11,683	$11,601-$27,000	35.0%
$11,684-$16,266	$27,001-$37,600	48.0%
$16,267-$22,000	$37,601-$50,900	55.0%
Over $22,000	Over $50,900	60.0%[4]

1.16 By contrast, the current scale is much flatter, with lower rates overall and with the high rates applying at relatively higher income levels, as is shown in Table 1.2.

Table 1.2 – *2001 Tax Rate Scale*

Taxable income (2001 dollars)	Statutory rate	Effective rate (including low-income rebate)[5]
$0	0%	0%
$1-$9,500	19.5%	15%
$9,501-$38,000	19.5%	21.0%
$38,001-$60,000	33.0%	33.0%
Over $60,000	39.0%	39.0%

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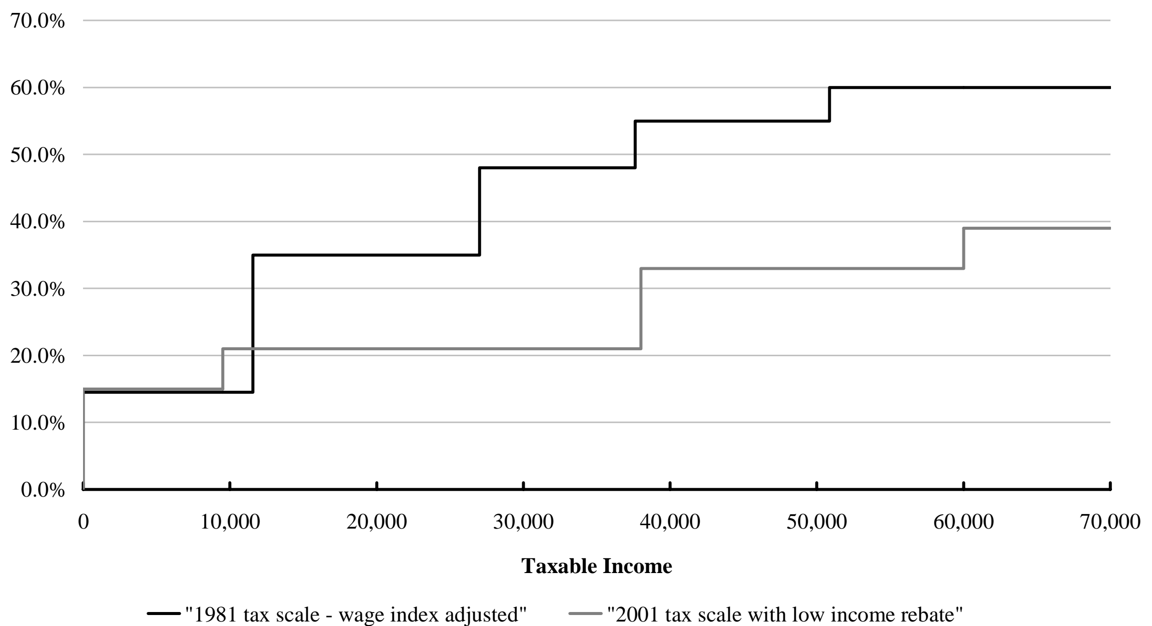
3 These income thresholds were constructed using a combination of the Prevailing Weekly Wage Rates Index and Statistics New Zealand's Labour Cost Index. The base used was 1000 as at December 1992, giving a 1981-indexed equivalent of 496.849503 and a 2001-indexed equivalent of 1149. Using these figures, a 1981 income of $5000 is equivalent to $5000 x 1149 / 496.849503 = $11,563 in 2001 dollars, which we have rounded to $11,600 for the purposes of this discussion.

4 The introduction of a 10 percent 'surtax' in October 1982 increased the top marginal rate to 66 percent.

5 The low-income rebate applies only to labour income, New Zealand Superannuation and veterans' pensions. It is received at 4.5 cents per dollar on the first $9,500 of eligible income and is abated against total income at 1.5 cents per dollar between $9,501 and $38,000.

1.17 Figure 1.3 clearly shows the difference between the two scales, with the statutory rates rising much more steeply than the 2001 rates at comparable income levels:

Figure 1.3 – ***Marginal Tax Rates 1981 (wage index adjusted) versus 2001***



1.18 While the statutory income tax rates were much higher overall in 1981 than they are now, it must be borne in mind that effective rates were often substantially lower than the statutory rates, due to the large variety of rebates that were available to individual taxpayers.

1.19 Some rebates still exist today (for example, the donations and housekeeper rebates). However, most of the rebates in existence in 1981 were removed over the following decade. Rebates relating to variable pay (overtime, shift work and back-pay rebates) were removed in 1983. The rates rebate was removed in 1986. A new housing rebate on mortgage interest for first-home owners was introduced in 1982, but removed in 1989.

1.20 Rebates related to family structure (the spouse rebate, separated spouse rebate, low-income family rebate and young family rebate) were reformed in 1983 (into the principal income earner rebate and the family rebate) and were removed entirely in October 1986 in a major package of tax reform that included the grossing up and taxation of welfare benefits, the introduction of family support, tax-rate reductions and the introduction of the income under $9,880 rebate. Some of these changes also served to compensate low-income families for the increased cost of living due to the introduction of GST at the same time.

1.21 In addition to the various rebates, there were also a number of exemptions and gaps in the income tax base, and many of these were also addressed in the reforms of the 1980s. A major gap was the fringe benefits that were provided by employers to employees tax-free. Fringe benefits were an attractive and increasingly common way of reducing the tax burden on employee income in the face of high marginal tax rates. The fringe

benefit tax was introduced in 1985 to plug this gap. The fringe benefit tax collected in 1999 totalled $323 million. At a tax rate of 49 percent, this represented income of individuals of $660 million that would not otherwise have been taxed. These figures represent a minimum; to the extent that the fringe benefit tax provides employers with a disincentive to offer benefits in this form, the value of benefits offered in 1999, and thus the amount of income tax foregone, might have been even higher in the absence of the tax.

1.22 Two income exemptions were available to workers in 1981. The 'standard deduction' for work-related expenses reduced taxable income by a minimum of $52 per person (or two percent of total gross earnings) - more if actual expenses were greater. It reduced 1981 taxable income by $126 million, an amount that grew to $257 million in 1988, when the exemption was removed. More substantial was the exemption for contributions to life insurance and superannuation schemes. This exemption reduced 1981 taxable incomes by $485 million. By 1988, it was estimated that the concessions provided to superannuation and life insurance, including the income tax exemption for pension superannuation schemes, cost the government $800 million in foregone tax revenue[6]. By 1989, these privileges were removed and superannuation and life insurance were taxed under the TTE regime, which better reflects the general income tax treatment for savings.

1.23 The removal of tax concessions helped pay for the lowering of income tax rates. The top marginal tax rate was reduced from 48 percent to 33 percent and the middle rate from 30 percent to 28 percent, measures that cost approximately $1 billion per annum. The rate scale was made flatter, with only two steps, but with the low-income rebate providing relief to those on low incomes. The resident withholding tax on interest and dividends was introduced and the $200 exemption for income from these sources removed. The changes to the tax treatment of interest raised approximately $200 million, while most of the remainder of the $1 billion cost of the 1987-89 income tax-rate reductions was paid for by the removal of superannuation tax concessions.

1.24 The changes to the tax system undertaken during the 1980s were substantial. While lowering of statutory tax rates is a part of the story, it is not the whole story. The broadening of the income tax through the introduction of resident withholding tax and fringe benefit tax and the reduction of rebates and exemptions was one means by which the lowering of income tax rates was made possible. Another was the broadening of the overall tax base through the introduction of GST. Far from simply reducing the tax burden on the wealthiest New Zealanders, these changes resulted in a more equitable distribution of the tax burden across all New Zealanders. While it is quite possible that some groups paid roughly the same proportion of tax as they had done before, the moves towards a more equitable tax system also, undoubtedly, made many people better off.

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6 Source: Government Economic Statement, 17 December 1987.

Company tax

1.25 The company income tax rate in 1981 was 45 percent for resident companies and 50 percent for non-resident companies. Despite the subsequent reduction of the rate to the current rate of 33 percent, taxes on companies now account for 15 percent of total revenue, compared with only five percent in 1981. In other words, much greater revenue is now obtained from the company sector, even though company tax rates have been substantially reduced.

1.26 This was achieved by removing company tax concessions and avoidance opportunities, which effectively broadened the company tax base. In 1981, accelerated depreciation rates of 20-30 percent applied in the first year of ownership of a range of assets, including plant and machinery, employee and tourist accommodation, building improvements for meat and fish-export hygiene purposes, hotels, motels and new farm buildings. The tax foregone in 1984 due to accelerated first-year depreciation was $91 million – approximately $198 million in today's dollars.

1.27 Accelerated first-year depreciation was by no means the only tax concession available in the early 1980s. In 1984, when the government's programme of tax reforms began in earnest, there was a plethora of special allowances and tax credits. Table 1.3 shows the most important ones and their respective fiscal costs (unadjusted).

***Table 1.3*[7]**

Special Allowances	**Tax Costs**
First-Year Accelerated Depreciation	$91m
Increased Exports – goods	$51m
Export Investment	$11m
Regional Investment	$5m
Farming/Fishing Investment	$8m
Energy Conservation	$4m
Industrial Development	$5m
Total Allowances	**$175m**

7 Source: IRD.

Table 1.3[7]	
Export Subsidies (as refundable income tax credits)	**Tax costs**
Goods	$237m
Services	$4m
Overseas Projects	$3m
Tourist Services	$11m
EMDI (export market development initiative)	$146m
Tourist Promotion	$33m
Total Credits	**$434m**

1.28 The total fiscal cost of these special allowances and credits was substantial, representing 42 percent of the total income tax that could be collected in the absence of the concessions. This is part of the reason why income tax rates (and particularly individual rates) had to be so high. However, an additional problem was that the concessions were available only for certain types of business activity, which meant that effective tax rates varied enormously between those businesses that were able to access the concessions due to the nature of their activities and those that could not.

1.29 Recent calculations of the effective company tax rate currently faced by companies indicate that the effective rates across industries are significantly more consistent. One study[8] calculated that the effective company tax rates for investments in plant, industrial buildings, land or inventory ranged between 29.2 percent and 33 percent. However, investments in two other specific sectors, research and development and mineral mining, were well outside this range.

1.30 Another study[9] concluded that, even taking into account the different rates of inflation and differing methods of financing, the current tax system provides significantly more even effective tax rates across different investments than the tax system of the early 1980s. The effective tax rates across construction, plant and machinery, transport, electrical equipment, livestock, inventories and land have converged since 1981.

1.31 Figure 1.4 below shows the expansion of the company tax base since 1981. While the expansion is due in part to the government's adoption of the accounting practice of including the tax liabilities of state-owned enterprises in the base, the greater part of the expansion of the base can be attributed to tax policy changes that have increased the effectiveness of company taxation. There has been an ongoing programme of base maintenance, with a few such measures in every tax bill for a number of years. The more significant measures have been:

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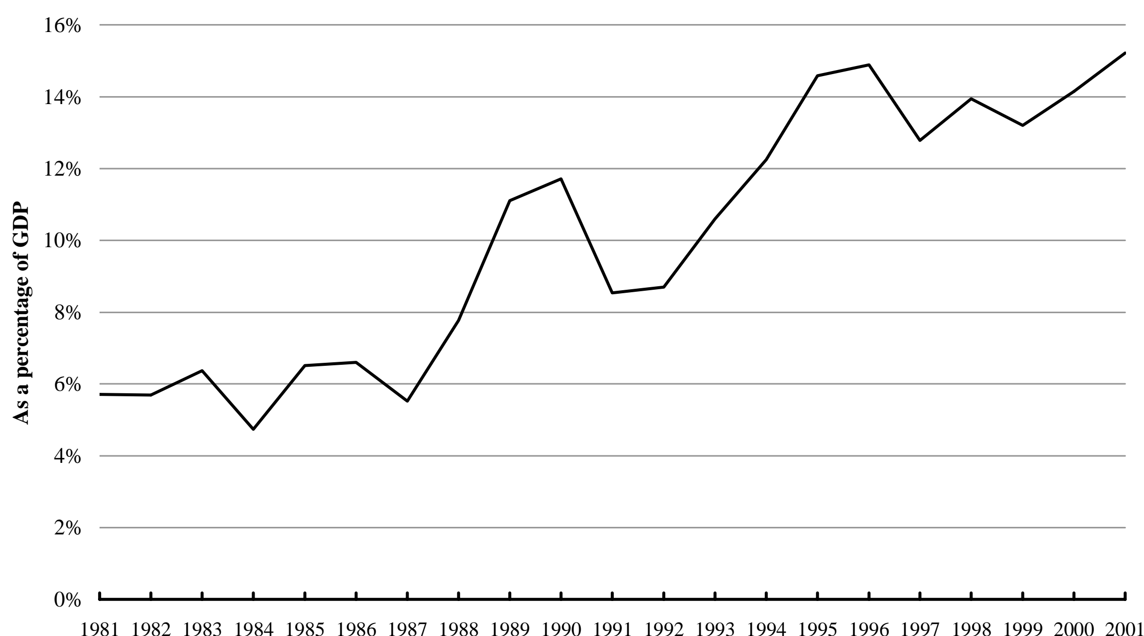
8 Arthur Andersen, *An International Perspective*, 1998.

9 Treasury Working paper 99/12, *Effective tax rates on capital – Changes 1972-1998.*

- the accrual rules introduced in 1987, which brought debt and similar instruments into comprehensive rules for determining income and expenses. These prevented companies from deferring interest and similar income, while bringing forward interest and similar expenses;
- the international tax rules introduced between 1988 and 1993. These ensured that offshore income of companies was taxed. The need for such rules was not commented upon by the McCaw Committee. This is probably because the lack of international tax rules was not a concern in the pre-1984 economy, which had strict exchange controls, as well as numerous other tax concessions for the corporate sector; and
- the removal of the inter-corporate dividend exemption in 1992. This removed the ability of companies to pay tax-free dividends outside 100 percent-commonly owned groups.

Figure 1.4 – ***Growth in the company income tax base relative to GDP (Expenditure)***



1.32 The above discussion understates the extent to which the taxation of companies has been rebalanced since 1981. Company taxation is levied to ensure that an appropriate tax is levied on the company owners – the shareholders. Thus, in considering company taxation, it is also necessary to consider how shareholders are taxed. In 1981, in theory, New Zealand had a classical company tax system under which companies were taxed (at a 45 percent rate) and then the after-tax corporate income was fully taxed again (at individual rates up to 60 percent in 1981) when distributed to shareholders as a dividend. This could produce a combined tax rate of 78 percent. Because of this high rate, the McCaw Committee recommended that consideration be given to better integrating the company and personal tax systems.

1.33 As with so much of the 1981 tax system, the high tax rates applied to some more than to others because there were various exceptions. As we have noted, companies often paid no tax because of tax concessions. Moreover, although dividends were generally fully taxable in shareholders' hands, with no credit for any tax paid at the company level, there were a number of ways that dividend taxation could be avoided. One was simply to pay no dividends. There was an excess retention tax to prevent this, but this was complex and often easy to avoid. Other ways to avoid dividend taxation were to pay dividends out of capital gains or to issue bonus shares. Subject to certain rules, neither approach resulted in dividend taxation.

1.34 This aspect of the tax system was removed when imputation was introduced in 1988. Under imputation, a shareholder receives a credit for tax paid at the company level, thus avoiding the high rates of effective taxation that previously could apply to dividends. While this was a substantial reduction in tax for those who previously paid these high rates of tax, imputation was accompanied by a number of measures that ensured that most company distributions were taxable. Thus, for many, the reforms imposed tax on income previously outside the tax net.

Sales tax

1.35 In 1981, the wholesale sales tax involved a single standard rate of 20 percent, but there were multiple effective rates – 0, 10, 20, 30, 37.5, 40, 50 and 60 percent. Because of boundary problems with the classification of goods, similar goods were often subject to different rates on an arbitrary basis. For example, school bags (that is, bags with the words 'school bag' on them) were taxed at a lower rate than other bags. There were various use- and user-based exemptions, and some types of goods were exempt, either as the result of political lobbying or for income distributional reasons.

1.36 The multiple rates and numerous exemptions created significant economic distortions. Since the tax levied on each wholesale sale was calculated on a price that included the tax already levied at previous steps, the tax also cascaded. This artificially inflated the retail prices of goods that required several steps of production over the prices of those that did not.

1.37 Furthermore, Treasury calculated that the base that was actually taxed represented 39 percent of the potential wholesale sales tax base, and only 23 percent of the total consumption base, since all services and all value added by retailers were excluded from the base.[10] This very narrow tax base meant that wholesale sales tax was not capable of raising significant revenue. In 1981, it raised 10 percent of total revenue.[11]

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10 Economic Management, Treasury, 1984.

11 Source: IRD.

1.38 The wholesale sales tax system was replaced with GST in 1986 in order to broaden the tax base, raise extra revenue so that income tax rates could be lowered, make the tax system fairer and reduce the scope for avoidance and evasion. With its single rate and few exemptions, the GST creates fewer distortions, and the provision of input credits removes much of the tax-cascade problem. Record-keeping is relatively simple and provides for a more robust and transparent paper trail. GST is also able to raise considerably more revenue than the wholesale sales tax. In 2001, GST raised approximately 25 percent of total tax revenue.[12]

Excises and gaming duties

1.39 New Zealand has excise duties on tobacco, alcohol and petrol. Over the last 20 years, the excise duty base has remained relatively stable and the rates have increased steadily.

1.40 New Zealand currently has four gaming duties. These are totalisator duty, lottery duty, gaming machine duty and casino duty. Totalisator duty and lottery duty both operated in 1981. However, the gaming machine and casino duties were introduced in 1992 as new forms of gaming became available.

1.41 The contribution of excise and gaming duties to total tax revenue has remained relatively constant, at around six percent over the last 20 years.[13] This is in contrast to the majority of the other taxes in New Zealand, which, as we have discussed, have been subject to major reforms, and whose contributions to the total tax revenue have varied significantly over time.

Other IRD taxes

1.42 In 1981, other revenue taxes (stamp, cheque, estate and gift duties and land tax) raised a total of $105 million. This equates to $312 million in 2001 dollars. Since then, land tax, stamp duty and estate duty have been repealed. In the year ended June 2001, only cheque duty and gift duty remain, and these taxes raises $11 million and $2 million respectively.[14]

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[12] Source: IRD.

[13] Source: IRD. Note that this figure excludes matching customs duties, which now account for about 80 percent of customs duty receipts.

[14] Source: IRD. We note also that another transaction tax, the approved issuer levy, was introduced in 1991 and, in the year to June 2001, it raised $53 million.

Conclusion

1.43 One of the key issues in tax policy design is the level of tax to be collected. As we have noted, this is primarily determined by the level of government expenditure. Over the last 20 years, the level of government expenditure has not changed dramatically. Among OECD countries, New Zealand remains about average in its level of tax. Some OECD countries do have much higher levels of government expenditure. This tends to be funded by high rates of VAT or GST or by high payroll taxes on middle-income earners.[15] Submissions received by this Review did not suggest that there is widespread support for New Zealand to move down this path.

1.44 Some submissions did, however, indicate support for a greater use of tax concessions and penalties to achieve social or economic objectives. This is a second key tax policy design issue. In order to fund any given level of government expenditure, governments have the choice of raising revenue from broad bases taxed at low rates or narrow bases taxed at high rates. The current system developed over the years since McCaw represents the broad-base, low-rate model. The 1981 system represents the narrow-base, high-rate model.

1.45 There did not seem to be an appreciation among the submissions favouring the greater use of tax concessions that this inevitably narrows the tax bases. Over time this may lead back to the 1981 model, for which there is, in our view, little support. For example, while tax concessions for superannuation were supported by some, we do not think there is any support for paying for such concessions by reintroducing the pre-1988 tax scale with individual rates up to 48 percent.

1.46 We conclude that the current tax system developed over the last 20 years of reform is sound and should be continued. Obviously, it can be improved, but New Zealand reforms should focus on incremental improvements to what we have. Two major issues raised by McCaw (tax indexation and capital gains taxation) were considered in 1990,[16] but no proposals on these issues have been implemented. As we indicated in our Issues Paper, we still do not see large-scale reforms in these areas as desirable. An important lesson of the last 20 years of tax reform has been how different tax reforms are inherently connected. For example, the imputation system relied on company tax reforms removing most concessions, since imputation relies upon credits being generated by tax paid at the company level. It also was based on the alignment of the company rate and the top personal rate so that there was no tax advantage in holding earnings within a company. The reduction in personal income tax rates this entailed was in turn partly funded by the higher tax revenue able to be collected from companies as a result of the post-1981 reforms. The remainder of our Report should be read with this in mind.

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15 For example, in addition to comparatively high income tax rates, Denmark has a VAT at a rate of 25 percent. The result is that Denmark's ratio of tax to GDP is comparatively high (49.5 percent in 1997, according to OECD Revenue Statistics, 1998).

16 Consultative Document on the Taxation of Income from Capital, 1990.

CHAPTER TWO
FRAMEWORKS

Introduction

2.1 In Chapter One, *Frameworks*, of the Issues Paper, we outlined a framework that should guide tax reform, emphasising the generally accepted principles of efficiency and fairness. We also emphasised a crucial distinction between the legal and economic incidence of a tax, recognising that the burden of a tax does not just fall on whomever pays the Inland Revenue Department. A tax will inevitably cause a change in prices and thereby redistribute its burden. We elaborated on four universal principles of fairness, before explaining the conventional method of assessing the efficiency costs of taxation in terms of *marginal excess burden*.

2.2 In Chapter One, *Frameworks*, of the Issues Paper, we also discussed the distinction between revenue and corrective taxes. Revenue taxes have the principal purpose of raising revenue without disturbing peoples' behaviour. Corrective taxes, on the other hand, are designed to ensure that peoples' decisions are based on the full costs (prices) of their activities. In other words, corrective taxes attempt to mitigate market imperfections. We sounded caution in the use of corrective taxes because of the difficulty of measuring or predicting their effects. We concluded the chapter by inviting submissions on tax avoidance law, the tax policy process and the question of a specialised tax court.

Submissions

2.3 Some submissions emphasised the linkage between national taxes and the level of government spending (for example some submissions promoted a cap on taxes/government spending to 30 percent of GDP). It has not been our task to analyse the efficiency of Government expenditure. Without such an analysis, it is not possible to draw conclusions in relation to the appropriate ratio of Government spending/taxes to GDP. We agree as a general principle that lower spending would reduce pressure on the tax system allowing rates to be cut. We were asked to develop recommendations about the cheapest and fairest way of collecting a targeted amount of revenue. A key point to note, however, is that (ignoring initial fixed costs) the marginal cost per dollar of taxes rises with each dollar of tax imposed, such that the last dollar spent by government and raised in taxation is the most costly dollar. In terms of economic efficiency, the goal is to equate the societal costs and benefits of the last dollar of tax raised. In this regard, it

is always worthwhile for governments to keep in mind the trade-off on the last $1-$2 billion of expenditure, such as the impact on tax rates. For example, a $1 billion cut in government spending would enable the top personal and corporate tax rates to be cut to around 31 percent. A $2 billion reduction would allow both rates to be cut to around 28 percent. Obviously, given that we have not analysed the efficiency of Government spending, we are not in a position to recommend such a trade-off. The point is that government should be focused on that trade-off when it makes its judgements.

2.4 Most submissions did not take issue with the general principles of Chapter One, *Frameworks*, of the Issues Paper. However, some considered that they placed too much emphasis on economic theory rather than modern realities. Critics were keen to see a new approach, with a strong focus on lessons from either history or successful economies. Some submitters clearly consider that there is a lack of consensus about the effectiveness of economic frameworks, or that a focus on them has not coincided with a satisfactory performance of the New Zealand economy in recent times.

2.5 We believe that principled frameworks are a prerequisite to designing effective tax policy. We also consider that the principles advanced in support of a particular framework only stand until displaced by a framework that enables better explanation and prediction. We also observe that frameworks that guide national tax reforms are inherently economic in nature.

2.6 We endorse the framework in Chapter One of the Issues Paper. New Zealand's tax system is generally highly regarded by international commentators. The key feature of our tax system that attracts positive commentary is the broadness of the tax base, which facilitates a lower average tax rate than is otherwise possible. While it is true that New Zealand's personal tax rates are lower than those of many OECD countries, it is important to emphasise that the comparison should be between effective tax rates, such as those exemplified in Table 4.6 of the Issues Paper. The effective tax rate is a combined measure of tax base and rate. For example, it is possible for a low nominal rate applying to a broad base to tax more heavily than a high nominal rate applying to a narrower base.

2.7 We received a number of submissions that supported designing a more proactive tax system to encourage economically beneficial activities, as well as enable New Zealand to be more internationally competitive. In contrast, we did receive a submission from a major business organisation rejecting such an approach in favour of a neutral tax treatment across a broad base, with as low a tax rate as possible.

Incentives and international competitiveness

2.8 A useful starting point is to define what is meant by the terms tax incentives and international competitiveness. We define a tax incentive as either:

- an explicit reduction in taxes otherwise applying to defined activities or taxpayers by reducing the tax rate, narrowing the tax base (either through enhanced deductibility or exempting revenues) or rebating a nominal tax liability; or
- an explicit subsidy for defined activities or taxpayers via the tax system (such as a refundable credit or a reduction in other taxes).

2.9 We interpret the term *international competitiveness* to mean increasing New Zealand's ability to attract and retain scarce resources, particularly skilled labour and capital, in the face of world demand for those resources. Some submitters argue that tax incentives should be used to increase New Zealand's international tax competitiveness. At the same time, governments need to be very careful about implementing any incentive, even on the basis of international competitiveness. Specific tax incentives for selected industries would certainly help them compete against imports or in foreign markets. Targeted tax incentives would attract labour and capital into export and import-substitute industries. From the nation's perspective, however, the targeted tax concession would draw labour and capital away from other industries and reduce their comparative advantage. Those industries that survive international competition without tax incentives are likely to reflect New Zealand's comparative advantage in international trade. We need not be the best in the world at producing any product to be comparatively better at producing that product. Our exploitation of this comparative advantage is how New Zealand will benefit most. We certainly do not want a tax system that penalises industries that reflect our comparative advantages in international trade. Unfortunately, specific tax incentives, even for internationally successful industries, can distort New Zealand's comparative advantage and lower national welfare.

2.10 Being cautious about the question of international competitiveness does not mean, however, that some such measures will not be beneficial. For example, our recommended tax cap for individuals is designed to retain and attract skilled labour. We have also reflected this issue in our discussion of international tax and, in particular, the taxation of capital imports. We also note that previous tax reforms have responded to these same considerations; namely, the reduction in withholding taxes on capital imports and the introduction of the international conduit regime.

2.11 The issues of incentives and competitiveness can be considered in terms of the distinction between revenue and corrective taxes. As mentioned, revenue tax has the primary goal of raising revenue to finance government spending. The design objective of a revenue tax is to meet this revenue target whilst minimising the marginal excess burden of the tax or, more simply, whilst minimising the behavioural impact of the tax. In theory, the lowest cost (or efficient) revenue tax is not a broad-base, low-rate tax. The theoretically optimal tax is one that taxes activities according to their varying responses to the tax (referred to as tax elasticity or tax sensitivity). Should the government attempt to calibrate taxes according to such elasticities? In practice, such an approach is constrained by principles of fairness and by our inability to reliably measure the tax sensitivity of particular activities. For these reasons, tax policy has retreated to the theoretically second-best (or, practically, first-best) option of getting tax rates down across as broad a base as possible.

2.12 In contrast to revenue tax, the principal design objective of a corrective tax is to ensure that private decisions take into account all social costs and benefits. This is based on a theory of *externalities*, which recognises that market actors tend to ignore any costs or benefits that do not come home to them but fall only on third parties. If such external costs or benefits are not impounded into market prices, national resources will not necessarily flow to their best use. A practical difficulty with the externality theory, however, is that such effects are pervasive, and it is generally impossible to measure either the relevant external effects or the effects of the intervening government measure. Many economists argue that government intervention typically worsens rather than improves national welfare because of infirmities of the political market. These concerns about externality-based interventions are compounded by the fact that the widespread existence of externalities provides a platform for practically any lobbyist's reform agenda.

2.13 Against this background, the case for tax incentives, including measures to improve New Zealand's international competitiveness, should be evaluated first by reference to the tax sensitivity of the activity for which a concession is sought and secondly by reference to whether that activity produces net positive externalities. The tax sensitivity argument is usually central to concerns over international competitiveness. For example, if investors regard Australia as a substitutable investment location for New Zealand, the argument is that Australia's tax laws directly affect New Zealand's ability to attract foreign investment.

2.14 For the reasons given, we prefer a broad-base, low-rate overall approach. There should be a prejudice against deviation from this approach, so that exceptions are made only where a substantial burden of proof is discharged. This cautious approach is justified because:

- reduced tax revenues from tax incentives have to be made up elsewhere;
- tax incentive policy can easily become politicised, with resources being captured by concentrated interest groups; and
- any exceptions to a broadly neutral approach can be a thin end of a wedge and unravel an overall general approach. For example, many submitters to our review argued for tax incentives across a large number of activities and industries without identification of how this should be financed.

2.15 At the same time, we acknowledge that our tax system does reflect some elasticity and externality issues. For example, New Zealand's foreign investor tax credit (FITC) and approved issuer levy (AIL) regimes involve the deliberate reduction of withholding taxes on non-residents on the principal basis that such tax bases are highly elastic and our taxes will not therefore stick to them. They will instead be passed back to New Zealand borrowers, incurring avoidable welfare losses (excess burden) in the process. National welfare is therefore enhanced by directly removing or reducing the tax directly. An example of a response to externality considerations is the tax treatment of research and development.

Tax avoidance

2.16 We received limited discussion on the subject of tax avoidance. We understood that there was no general disagreement with what we said about the matter in the Issues Paper. The question of the extent to which tax avoidance law should explicitly incorporate a doctrine of substance arose in discussions.

2.17 We reiterate our view that the state of tax avoidance law and practice remains unsatisfactory. We consider that the starting point for any improvement is to better define the objectives of tax policy in this area. Much of the focus in legal literature is positive, rather than normative, in nature. A positive analysis of existing law and practice is important but should be distinguished from the question of what the law should be. We have not undertaken detailed work on the issue of tax avoidance. However, we have studied the report of the last Valabh Committee on the subject and are in general agreement with the direction and thinking of that report. We note that the government is yet to act on the avoidance recommendations in that report. We also note that the Valabh Committee recommended that the substance of an arrangement be one of the factors to be taken into account in determining whether a subject arrangement constitutes tax avoidance.

Tax policy process

2.18 In the Issues paper, we discussed the way in which tax policy is made in New Zealand commenting in particular on the Generic Tax Policy Process (GTPP). The GTPP is the set of guidelines used by New Zealand governments since 1995 to initiate and implement tax reform. The essence of GTPP is the systematic development of tax policy in a very consultative environment.

2.19 Submissions generally supported our view that GTPP has been a success and has allowed tax policy in New Zealand to develop more rationally and smoothly than in many other countries. As we indicated in the Issues Paper there is possibly room for improvement especially in the strategic phase of GTPP. By this we mean that governments should be conscious of the inter-relationships between different tax proposals and develop the tax system in a coherent way. For example, the desirability of changes to specific tax rates or rules should be assessed on the basis of how they impact on the whole tax system not just aspects of it. We hope that this review will help provide a framework for doing this.

2.20 The Issues Paper also raised the possibility of an annual tax expenditure statement and greater independent analysis of tax issues. There are attractions to an annual tax expenditure statement that would place tax concessions on the same transparent basis as government expenditure. However, we recognise that there are difficulties with the idea. What for example should the base be to determine what is a tax concession? Overseas experience suggests that this can involve considerable resources to produce spurious numbers. Nonetheless we believe that this is a concept that should be considered further

by the government. There was some support in submissions for greater independent analysis of tax issues although this seems to require such analysis to be privately and not publicly funded. As such it is a challenge for the private sector to take up.

Specialised tax courts and managing litigation

2.21 We did not receive a significant number of submissions on the question of whether there should be a specialised tax court. While there was no significant opposition to that possibility, there was also no substantial advocacy for it. We consider that a tax specialist court is appropriate at the lower levels of the court hierarchy, but consider that it is less appropriate for appellate courts. First, we perceive that there are benefits in ensuring that tax precedents are not dominated by a few judges. Secondly, we consider that tax law is best administered by judges with a broader commercial focus. We are also not inclined to recommend forcing all taxpayers through an additional level of the court hierarchy by obliging commencement at the Taxation Review Authority. We consider it more likely that such a reform would increase the legal costs of resolving tax disputes and lengthen queues in that many cases currently being initiated at the High Court are likely to be appealed from the Authority if initiated there.

2.22 We also raised the question of whether the Commissioner should be in control of selecting tax cases and barristers to litigate. We understand that the Crown Solicitor has overall responsibility for this at present. In our opinion, the Commissioner should be in complete control of these matters because he faces the best incentives to ensure that tax litigation strategy is consistent with the policy and fiscal objectives of tax administration.

CHAPTER THREE
TAX BASES

The tax mix

3.1 The Issues Paper noted that New Zealand raises revenue in three main ways: through income tax, GST and excises. Other taxes are minor in terms of revenue collection. Our Terms of Reference require us to consider whether we should retain, extend or reduce these various forms of taxation in New Zealand. We are also required to consider whether new taxes should be introduced to complement or replace existing ones.

3.2 GST and excises both tax consumption expenditure. While the GST is a broad-based tax levied comprehensively on expenditure at a uniform 12.5 percent, the excises are levied at high rates on narrow bases, with no clear rationale for the different imposts applied. In broad terms, about one third of tax revenue is derived from taxes on expenditure and most of the remainder is on income.

3.3 Our overall perception is that our tax mix is broadly correct. While the tax mix differs quite markedly across countries, New Zealand's is close to the OECD average. The New Zealand tax mix has the advantage of keeping overall revenue flows relatively stable, even if one or other base fluctuates over time.

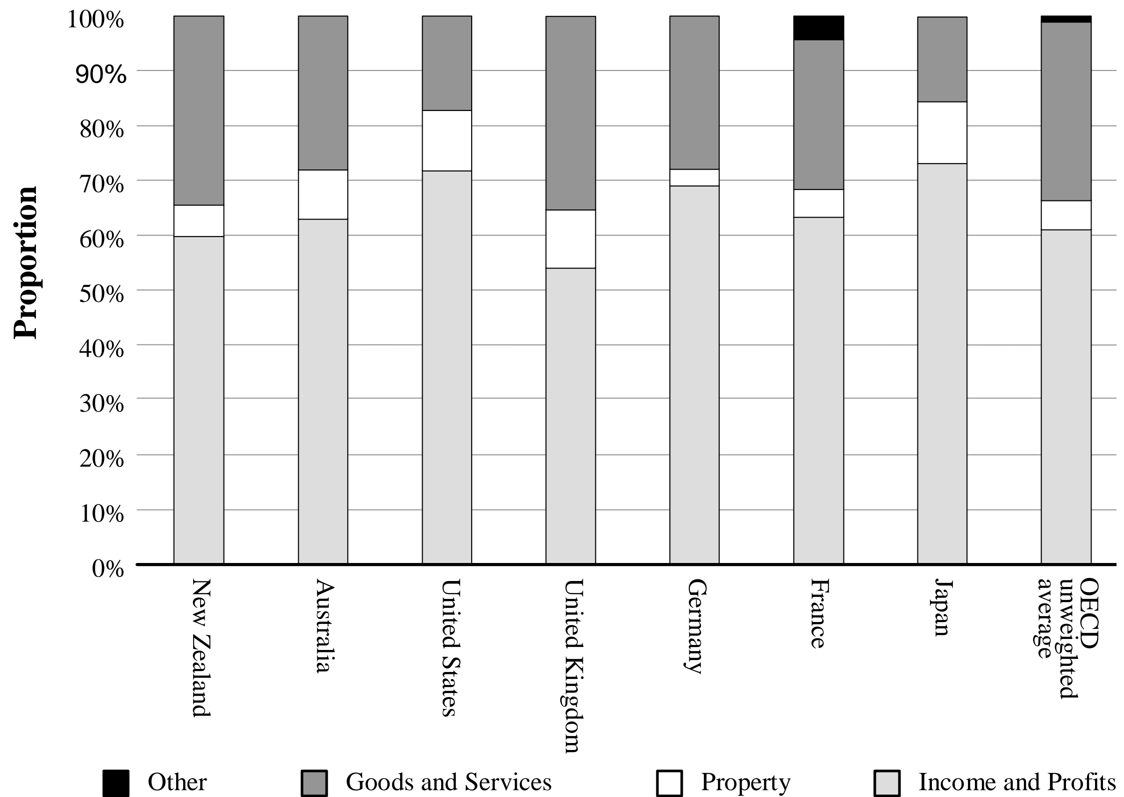

Figure 3.1 – ***Tax Mix Across Selected Countries***

Source: OECD Revenue Statistics 1965-1997. 1998 Edition, p79.

3.4 Our view on the tax mix was generally supported by submissions. Some submissions supported shifting the tax burden away from income tax more to GST, but this was balanced by other submissions that sought the opposite outcome. We can see no clear case for major change.

3.5 Nevertheless, we made the point in the Issues Paper that economic decisions are distorted less by GST than by income tax. Accordingly, we believe that any overall increase in tax should be implemented through GST. By contrast, any reduction in tax should be achieved through a reduction in income tax. This would move the mix towards GST in an incremental way.

3.6 We focus in more detail below on the particular taxes that make up our tax system.

Income tax, capital gains and RFRM

Introduction

3.7 New Zealand's income tax base is relatively broad by international standards but falls short of being fully comprehensive in two most notable respects: (i) the absence of a comprehensive tax on capital gains and (ii) the non-taxation of residential housing. We deal with the non-taxation of residential housing in the next section.

3.8 The Issues Paper made the point that our income tax base already captures a wide range of gains (and losses) in the value of assets. The first question we considered was whether capital gains should be taxed on a more comprehensive basis by introducing a separate capital gains tax, as was recommended by the OECD in its 2000 Economic Survey of New Zealand. We concluded, however, that the disadvantages of taxing capital gains on a realisation basis outweighed any theoretical benefits from extending the base in this way.

3.9 We then explored two alternative options to a separate capital gains tax.

- *option 1: Continue the practice of including particular capital gains in the income tax base*: We suggested that New Zealand could continue the current practice of including capital gains in the income tax base as and when issues arise. This approach could be applied to target specific problems such as offshore investments and inconsistent treatment of savings vehicles;
- *option 2: Adoption of RFRM:* This involves a more fundamental approach to the removal of distortions generated by the absence of a comprehensive capital gains tax. The central idea is to tax certain assets where a start-of-year value is available (designated investment vehicles and residential housing) on a statutory risk-free rate of return. This would address the current, inconsistent, treatment of savings vehicles, both onshore and offshore. This approach should achieve the result that would arise if the funds invested in those assets had instead been invested in risk-free government bonds - minus the component of that return that merely compensates for inflation. (If applied today, the rate would be about four percent.) The tax liability would be calculated as follows:

Net asset value at the start of the year

x

Statutory risk-free real rate of return

x

The investor's tax rate

Submissions

3.10 Submissions were mixed on the preliminary question of whether New Zealand should introduce a separate capital gains tax. Some submitters opposed a separate capital gains tax, in principle. However, other submitters recognised that the absence of a separate capital gains tax creates problems that need addressing.

3.11 We received a large number of submissions on the risk-free return method (RFRM) proposal. There was cautious interest in the RFRM approach and some agreement that the idea might warrant further analysis. Submitters' main concerns were as follows:

- RFRM is an unfair tax to the extent that it gives rise to cash-flow problems for a taxpayer if the asset does not generate sufficient cash to meet the tax obligations. This can arise if the actual returns to assets differ from the deemed return;
- RFRM will create a distortionary incentive in favour of assets with a regular income stream. Alternatively, it will encourage investors to 'gear up' their assets to minimise

the tax burden. Submitters also said that, unless the tax was comprehensive across all assets:

  - the costs would outweigh the benefits;
  - it would be difficult to combat avoidance; and
  - it would create incentives to invest in tax-preferred assets; and

- the design of the RFRM will need to:
  - interface appropriately with the imputation regime;
  - address the holding of assets for part years; and
  - address transitional issues.

Other concerns were that:

- the requirement to value assets will increase taxpayer compliance costs;
- RFRM may not be a creditable tax in foreign countries; and
- the government will not lower other taxes to compensate taxpayers for the new tax.

Analysis and recommendations

3.12 We said in the Issues Paper that there were a number of important issues that would need to be addressed before a decision could be taken to introduce an RFRM. These included:

- the scope of the regime;
- isolation of attributable debt;
- the integration of RFRM with company tax;
- liquidity issues; and
- within-year portfolio changes.

3.13 On the issue of liquidity, for instance, we said that special rules may need to be devised to extend some form of relief to cash-strapped taxpayers. Submissions confirmed our view that there are a number of key design matters that will need to be resolved prior to implementation.

3.14 Nothing we have received by way of submissions has altered our view expressed in the Issues Paper that New Zealand should not adopt a general realisation-based capital gains tax. We believe that such a tax would not necessarily make our tax system fairer and more efficient, would not lower tax avoidance and would not raise substantial revenue that could be used to lower tax rates. Instead, any such tax would be more likely to increase the complexity and costs of our system. The experience of other countries (such as Australia, the UK and the US) supports that conclusion.

3.15 Nevertheless, we also remain of the view that the absence of a tax on capital gains does create tensions and problems in specific areas. A particular concern is the extent to which savings decisions seem to be dominated by tax considerations that stem from essentially the capital gains issue. These considerations include whether an individual should hold shares directly or through an intermediate investment entity, whether that entity should be an active or passive fund and whether investments should be offshore or onshore and, if offshore, in what countries. This needs to be addressed in some coherent manner.

3.16 We consider that the RFRM method could be used to achieve more coherence in this area. We think that the practical issues with that method raised by submissions can be addressed if the ambit of the regime is appropriately limited. This is discussed further in Chapter Seven, *Entities*. We do not recommend extending the RFRM method beyond this area until experience with such a regime proves its basic workability.

3.17 Our recommendation is that the RFRM method be considered for the specific problem of disparate tax treatment of different savings entities. We do not see the income tax system as having such deep-seated problems that the RFRM method should be applied in a more universal way. This then, is a continuation of the past approach of dealing with the capital gains issue as specific problems are identified.

Owner-occupied housing

Introduction

3.18 The Issues Paper raised a number of concerns with the current tax treatment of housing. Our central concern is that these rules are skewed in favour of those with a mortgage free house. Those renting have to pay rent out of after-tax income, while those with mortgages are denied a deduction for interest paid and, therefore, have to meet interest costs out of after-tax income. Those without mortgages, on the other hand, receive material tax benefits, relative to a world without taxes.

3.19 The nature of this tax benefit for mortgage-free home owners is that people with savings in the form of shares or a bank account are taxed on the interest or dividends earned from those investments. By contrast, people who own a house have the benefit of occupancy (an alternative return), plus any gains realised on resale, tax free.

3.20 Not only is this system unfair, but the tax concession for owner-occupied housing alters the behaviour of New Zealand savers in favour of home ownership. In this country, housing accounts for more than 70 percent of total household savings, compared with less than 50 percent of the average of all OECD countries. Money goes into home ownership that might otherwise have been invested in assets that improve economic growth and lift the incomes of all New Zealanders.

3.21 The OECD's response to this in its 2000 Economic Survey of New Zealand was to recommend that New Zealand should tax both capital gains and the value of occupancy (imputed rental) for owner-occupied homes, with deductions for mortgage interest, depreciation, repairs and maintenance.

3.22 In the Issues Paper, we said that we did not favour the OECD proposal of a tax on imputed rental income or capital gains for houses. Other countries that tax imputed rental income often provide major concessions and exemptions and keep rates at very low levels. Moreover, since interest is deductible, the outcome is often a greater tax benefit on housing than owner-occupiers enjoy here from the exclusion of owner-occupied housing from the tax base.

3.23 However, we did think that the RFRM might provide a potential way of taxing owner-occupied and rental houses. Briefly, under this approach, property valuations for rating could be used, net of all debt secured on the property - so that mortgage interest (and any other expenses) would not be deductible.

Submissions

3.24 The housing tax issue was highly controversial. While some submitters supported applying the RFRM approach to housing for the same reasons outlined in the Issues Paper, the overwhelming response was negative. We have identified and responded to the detailed issues raised in submissions in Annex A. The main issues raised by submitters can be summarised as follows:

- home ownership is viewed as a social good. Historically, New Zealanders have invested in home ownership for a multitude of reasons, including (i) to provide a basic necessity of life - shelter; (ii) as the only alternative to renting accommodation; and (iii) as the only means by which many New Zealanders are forced to accumulate any savings. There is a perception that many New Zealanders are not motivated to increase their wealth or avoid tax when they purchase a home. Accordingly, imposing tax may not alter investment behaviour;
- a tax may create cash-flow problems. This will be exacerbated where taxpayers have made their own improvements to houses. It will also be exacerbated in times of inflation;
- the current level of housing investment cannot be undone, and people have to live in a house;
- housing is already taxed by way of rates;
- taxpayers finance the purchase of their homes through after-tax income; and
- imposing RFRM on housing increases taxpayers' compliance costs. This may outweigh the benefits of curing the distortion. There is also a concern that the tax could easily be avoided and would be costly to administer.

Analysis and recommendation

3.25 We discuss the specific question about the taxation of housing benefits in Annex A, as well as commenting on some of the key issues here. The tax treatment of owner-occupied housing is controversial in many jurisdictions.

3.26 Writing of the "myths, misunderstanding and confusion (that) abound when it comes to tax policy", leading US tax economist David Bradford has observed that:

> *"The mortgage interest deduction is widely perceived as the major subsidy to home ownership. Actually the basic subsidy is the exemption from tax of the income that the homeowner realises in the form of direct services from the home, such as shelter. By making this subsidy more widely available, the mortgage interest deduction probably makes the system fairer."*[1]

3.27 The US tax system allows mortgage interest to be deducted by owner-occupiers. By not providing mortgage interest deductibility, the New Zealand tax system raises more revenue and significantly constrains the extent to which the exemption of imputed income derived by owner-occupiers induces excessive housing investment. At the same time, the denial of interest deductibility severely distorts patterns of household asset accumulation because, when mortgage interest is not deductible, repayment of the home mortgage dominates the accumulation of assets whose returns are subject to tax.

3.28 On balance, we do not favour extending mortgage interest deductibility to home buyers, though we agree that to do so would make the tax system fairer.

3.29 We believe that the correct approach to addressing the unfairness of the present system, the incentives it creates for those who are mortgage-free to overinvest in owner-occupied housing, and the portfolio distortions induced among those who are paying off their mortgages, is to broaden the income tax base by taxing the imputed investment income earned by those who have equity in their homes.

3.30 We believe that the method suggested in the Issues Paper (taxing home-owner equity at an imputed risk-free real rate of interest) represents a fair, practical and compliance cost-effective approach to correcting this significant gap in the income tax base. This cannot be said for the alternative approach recommended by the OECD.

3.31 Since most households pay off their homes over many years, the distribution of housing equity (and therefore the distribution of access to the tax concession) at any point in time provides an unreliable guide to the lifetime incidence of the home-owner equity concession.[2] As we noted in the Issues Paper, any reform should recognise this important dimension and include appropriate transitional rules.

3.32 Some submissions drew attention to the use, in many parts of New Zealand, of capital rather than unimproved value as the basis for rating. We acknowledge that this form of rating discourages property improvement.[3] However, it does so across the board, both

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1 Bradford, David F., *Untangling the Income Tax*, Harvard University Press, 1986, p 2.

2 For example, the high levels of housing equity achieved by many older New Zealanders on modest incomes provide an unreliable guide to the extent to which the concession flows to the less well off.

3 It is understood that ratepayer polls have consistently favoured rating on the basis of unimproved values and that the movement in recent years towards capital value rating has taken place without direct ratepayer consultation. We received submissions claiming that local authorities have been encouraged by central government to move towards capital value rating.

among those who are paying off a mortgage, among those who own their own homes outright, and among those investing in rental properties.

3.33 A rational approach would broaden the income tax base to include the income derived directly by owner-occupiers from housing equity, along the lines we have suggested, while at the same time encouraging local governments to return to rating systems based on unimproved values.

3.34 Nevertheless, we believe that, for successful implementation, any base-broadening tax measure must have a reasonable prospect of public support. Accordingly, we do not recommend that the government take this proposal further at this point. We adopt the same position in respect of rental properties except that if government decides to implement an RFRM mechanism to defined savings and investment assets (in terms of recommendations in Chapter Seven, *Entities*), we recommend that the government defer its decision on whether to apply RFRM to rental properties until after it has been tested, in line with our comments at paragraph 3.16 above.

Wealth taxes

Introduction

3.35 In the Issues Paper, we rejected the notion of a general wealth tax for New Zealand. In a modern society, income or expenditure are more appropriate and more effectively applied bases for taxing according to ability to pay. Moreover, imposition of a general wealth tax, even at the low rates typically observed, would significantly raise the effective rate of taxation of income from capital.

3.36 There can, however, be a case for a selective wealth tax if some gap in the income or expenditure bases could be identified that a wealth tax could fill.

3.37 We also rejected the reintroduction of an estate duty. Estate duty was generally circumvented by taxpayers prior to its repeal in 1993. Moreover, we suspect some New Zealanders would avoid the tax by becoming domiciled in another jurisdiction, such as Australia, where there is no estate duty.

3.38 Our conclusion was that neither of these taxes are needed to fill a gap in the income tax base.

Submissions

3.39 We received a few submissions expressing support for the introduction of a wealth tax or the reintroduction of estate duty. Most submissions supported the conclusions we reached. No submissions identified a gap in the income or expenditure tax bases that a wealth tax could fill. No submissions supporting estate taxation dealt with the avoidance concerns we raised with such a tax.

Analysis and recommendations

3.40 We recommend that the government does not introduce a wealth tax or an estate tax, for the reasons given in the Issues Paper.

Cash-flow tax

Introduction

3.41 The Review considered the proposal to convert business income taxation to a cash-flow tax basis. This form of business taxation has received considerable academic endorsement and has been periodically proposed by a number of countries.

3.42 The fundamental objective of this reform is to remove the wedge between gross-of-tax and net-of-tax rates of return created by existing capital income taxation.

3.43 In principle, this wedge could be removed by abolishing the corporate income tax while exempting income from capital earned by unincorporated enterprises and income earned by individuals on their savings. However, that approach would involve a substantial revenue cost and would require complicated rules to distinguish exempt capital income from taxable labour income arising in closely-held companies and unincorporated enterprises.

Advantages of cash-flow taxation

3.44 By contrast, the conversion of capital income taxation to a cash-flow basis offers the prospect of:

- retaining the flow of tax derived from the accumulated capital stock (while exempting income arising from net additions to the capital stock);
- buttressing the taxation of labour income (by preventing its recharacterisation as (untaxed) income from capital);
- preserving the significant tax revenues collected from existing foreign-owned capital in New Zealand (while exempting returns on new foreign investment); and
- encouraging saving (by providing tax-free rates of return on all forms of new saving).

3.45 A particular attraction of the cash-flow tax is that it would greatly simplify the measurement of business income by removing:

- the need for depreciation rules, trading stock rules and the accruals regime;
- definitional problems at the capital/revenue boundary and the need for complex timing rules governing the recognition of income and the spreading of expense;
- investment biases in favour of important areas such as forestry and housing, which are favoured under existing income tax rules; and
- indexation of the tax base to avoid taxation of purely inflationary gains.

3.46 The changes required to convert business taxation to an R-base cash-flow tax (the form most commonly proposed) are straightforward. Under this tax:

- depreciation deductions and other capital allowances would be replaced by expensing; that is, by immediate deductibility of outlays on capital acquisitions;
- trading stock rules would be replaced by deductibility for acquisitions;
- revenues from all sales, including those from sales of capital assets, would be included in the tax base; and
- deductions for interest and similar financing costs would be abolished and interest receipts would not be taxed in the hands of lenders.

Submissions

3.47 Support for a cash-flow tax was expressed by a wide range of interests. Some considered that our Issues Paper had too lightly dismissed its many advantages.

3.48 For that reason, we have elected to set out (in Annex B) a more detailed analysis of the acute transitional difficulties that we consider would be created by a move to this tax.

3.49 Other submissions advocated that taxation on a cash-flow tax basis be available as an option for small businesses. We do not favour this option because it is not comprehensive. While simplifying business income calculations, it would distort investment incentives. Moreover, the boundary that would need to be drawn between two different approaches to tax accounting would, over time, create large compliance costs for significant numbers of taxpayers.

Analysis and recommendations

3.50 The severe transitional problems that the move to a cash-flow tax would create arise from the large part of the capital stock that is debt-financed. After the introduction of a cash-flow tax, holders of debt will be able to avoid paying net cash-flow tax when liquidating their assets to finance consumption, while those holding real assets or equity positions in those assets at the time of the transition will not. The severity of these problems for the transition to a business cash-flow tax is further examined in Annex B.[4]

3.51 In addition, a cash-flow tax would create ongoing revenue risks. An example of the revenue risk is that, since the rules would allow full deduction of capital outlays as they occur, the government would, in a practical sense, be providing one-third or more of the equity in ventures with uncertainty over whether taxable cash inflows would materialise in future years. Foreign firms could engage in investments in New Zealand, creating losses through their initial capital outlays, and structuring their affairs so that future cash inflows were received in another jurisdiction.

3.52 The Review does not see a case for moving business income taxation to a cash-flow basis, due to the difficult transitional problems involved and the ongoing risks posed by

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4 We see no solution to these transitional problems short of moving to a comprehensive personal expenditure tax (which would create its own, though arguably less severe, transitional problems). We note, however, a primary objective of converting business taxation to a cash-flow basis is to avoid the complex record-keeping required of individual taxpayers under a personal expenditure taxation.

immediate deductibility of capital expenditures. These latter concerns are particularly relevant in a cash-flow tax system in which taxpayers face high and variable tax rates and in which many transactions will involve parties outside the New Zealand tax base.

3.53 We do not recommend a cash-flow tax for small business as a means of meeting tax simplification objectives.

Goods and services tax

Introduction

3.54 In the Issues Paper, we indicated that we were comfortable with the overall design of the GST and did not propose any significant changes. In particular, we did not believe that a strong case could be made for either narrowing the GST base or for taxing some goods or services at lower rates.

Submissions

3.55 We received a variety of submissions on GST. Some submissions supported the status quo. Some submissions advocated an across-the-board increase in the GST rate. Some submitters favoured a reduction in the current GST rate. Yet others recommended differential rates or exemptions for essential items such as food (or particular types of food).

3.56 As we observed in our Issues Paper, New Zealand's GST is regarded as setting an international benchmark for expenditure taxes. This is because it is viewed as a broad-based, low-rate, fair and efficient tax. We remain of the view that the use of multiple rates or exemptions for particular items to address concerns about regressivity would be a backward step. It would serve to create considerable additional costs (including increased taxpayer compliance costs) and anomalies. Also, as we noted in the Issues Paper, concerns about regressivity can be overstated. We referred to studies in that Paper that show that GST is roughly proportional to income for the 80 percent of households in the middle of the income distribution.[5]

Analysis and recommendations

3.57 The Review endorses the analysis of GST in the Issues Paper. We recommend no significant change be made to GST. However, as we said in the Issues Paper, options for improving the treatment of financial services and imported services should continue to be explored.

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5 See Lewis G. An Analysis of the Distributional Impact of Cutting the Rate of GST. The Treasury, 9 June 1995. To obtain a robust estimate of GST incidence (less influenced by transitory income effects) Lewis excluded the 15 percent of households consuming more than 150 percent or less than 30 percent of their total income.

Gift duty

Introduction

3.58 In the Issues Paper, we said that gift duty should be abolished. Gift duty raises only $1.6 million a year, but involves significant compliance costs. Its rationale has been eroded by other tax changes in the past 20 years. Where it does still, to a minor degree, protect the tax base, other less expensive options should be developed.

Submissions

3.59 Only a few submissions supported the retention of gift duty. This was usually advocated in conjunction with support for reinstating estate duty or the introduction of a wealth tax.

Analysis and recommendations

3.60 We endorse our original recommendation that gift duty be repealed, for the reasons given in the Issues Paper.

Stamp and cheque duties

Introduction

3.61 In the Issues Paper, we said that we agreed with the repeal of stamp duty in 1998. We also said that cheque duty should be repealed. As we explained, cheque duty is easily avoided by using alternative methods of payment such as cash, electronic payments, credit cards, debit cards or direct payment authorisations.

Submissions

3.62 Submissions supported the repeal of cheque duty.

Analysis and recommendations

3.63 We endorse the analysis in the Issues Paper. Cheque duty raises only about $10 million per annum. We recommend the repeal of cheque duty.

Financial transactions tax

Introduction

3.64 In the Issues Paper, we rejected the suggestion that GST should be replaced with a financial transactions tax (FTT).

3.65 An FTT imposes tax on the withdrawal of funds from certain accounts, but the economic impact of the tax is actually on the use of those funds – that is, the purchase of goods and services. Consequently, the base of an FTT is similar to our GST base.

3.66 The main concern we have with an FTT is its 'cascading' effect. As we explained in the Issues Paper, the major difference between an FTT and a GST is that an FTT does not provide for an input tax credit. This means an FTT taxes the full price of the good or service at each stage of production rather than the amount of value added at that stage of production. Consequently, the price of an item depends on the number of intermediate transactions that occur in the manufacture or sale of the item. In the Issues Paper, we provided an example of how this leads to the undesirable result of similar goods being subject to different effective tax rates.

Submissions

3.67 Some submitters were unconvinced by our analysis and said that further consideration should be given to the possibility of introducing an FTT as a replacement or partial replacement of GST and/or income tax. These submitters consider that:

- an FTT is fairer, or less regressive, than GST;
- FTT has the advantage of applying to financial transactions that are not included in the GST base;
- the cascading effects can be mitigated by (i) businesses minimising the number of intermediate transactions; (ii) imposing low rates of FTT; and (iii) implementing FTT gradually; and
- the cascading effects are offset by the reduction in compliance costs.

Analysis and recommendations

3.68 We are not convinced that the harmful cascading effects of an FTT can be offset or minimised in the ways suggested by submitters.

3.69 We see no reason to believe that an FTT would be less regressive than GST.

3.70 While financial services are exempt from GST, this is not necessarily to their advantage. This is because banks are denied input credits on supplies of financial services so that these are, in Australian parlance, 'input-taxed'. Though financial services are thereby undertaxed where they are supplied direct to final consumers, these services are also supplied to businesses. Where financial services are supplied to registered persons, input taxation creates a tax cascade that disadvantages these supplies.

3.71 Applying an across-the-board FTT with cascading effects is not a satisfactory solution to this problem. The treatment of financial services under GST is under review and that review should proceed.

3.72 We do not believe that any reduced compliance costs from FTT would offset the substantial disadvantages of such a tax.

3.73 We do not recommend the adoption of an FTT.

Tobin tax

Introduction

3.74 We did not support the adoption of the Tobin tax in the Issues Paper.

3.75 The Tobin tax is a low-rate tax levied on all foreign exchange transactions to dampen currency speculation. The idea is that the tax will have the effect of discouraging currency speculation and thereby stabilise exchange rates.

Submissions

3.76 There was limited support for the introduction of a Tobin tax, although some submitters supported further investigation of the tax.

Analysis and recommendation

3.77 We do not support adoption of a Tobin type tax, for the same reasons given in the Issues Paper. As we said in that Paper, we believe that the goal of reducing exchange rate fluctuations is misguided. Nor are we convinced that a Tobin tax would achieve this result.

Excises and duties

Introduction

3.78 Excises and duties are imposed on four categories of spending: alcoholic beverages, tobacco, gaming and petrol. These taxes raise around $2.8 billion (after adjustment for matching customs duty and induced GST).[6]

3.79 As noted in Chapter One, excises and gaming duties represent the only major revenue-raising taxes not reformed over the past 20 years. The area lacks firm policy foundations. In consequence, anomalies and inconsistencies abound.

3.80 Our Issues Paper observed that existing excises and duties are difficult to defend on conventional tax policy criteria of efficiency and equity. At current rates, many appear to be associated with very high levels of marginal excess burden (deadweight costs of the last dollar of revenue).

3.81 Available evidence suggests that these taxes are highly horizontally inequitable and, in some cases, highly regressive. The alcohol excise and gaming taxes are expected to have a disproportionately severe impact on the minority of individuals (and their families) experiencing drinking or gambling problems.

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6 Our Issues Paper isolated the component of petrol excise that matches the road user charges levied on diesel vehicles, but added to the formal gaming duties the implicit regulatory taxes levied on lotteries and non-casino gaming machines. Together, these adjustments leave this total broadly unchanged.

3.82 The large revenue-raising role played by these taxes is difficult to defend now that GST provides a broadly-based, more efficient, and far more transparent alternative.

3.83 By comparison, excises and duties are levied in ways that have no policy rationale consistent with generally accepted tax policy frameworks.

3.84 We have, for example, been unable to discover the tax policy principles that support the exemption of diesel fuel, and especially diesel fuel used on roads, from the 21c/litre general revenue excise applied on petrol.

3.85 We have been unable to discover why spirits are taxed at rates, per volume of alcohol, almost twice that of other alcoholic beverages.[7]

3.86 We are unable to understand how large gaming duties (and even larger implicit gaming taxes diverted directly to community purposes) can be justified in view of available evidence on the low and falling incidence of problem gambling in New Zealand (and the absence of evidence that these heavy taxes ameliorate such problems).

3.87 We have found no externality estimates that can explain why New Zealand cigarette excise contributes close to $6 to the price of a packet (available overseas estimates of ‘external effects’ appear very low and sometimes negative).

Submissions

3.88 Some submissions strongly favoured excise taxation on the grounds that spending on alcohol, tobacco and gaming could be classified as discretionary or luxury items. We note that many other categories of spending have that characteristic.

3.89 Many submissions thought that tax policy should be used to encourage healthier lifestyles (without identifying the levels of taxation implied by this approach). Some submitters dissented from this view.

3.90 A number of submissions were received from health sector organisations. Though these submissions make reference to externalities, we believe that the ‘health policy’ approach to taxation and the framework adopted by the Review are irreconcilable.

3.91 The views of the Ministry of Health were broadly representative of health sector groups.

3.92 The Ministry argued that excises on alcohol and tobacco could be "*seen as a way for external costs to be met by the creators of those costs*". "*(M)ost importantly however, they are part of an integrated strategy with a "demerit good" objective to reduce the underlying causes of a number of health problems.*"

3.93 The large discrepancy between estimates of tobacco-related health costs (estimates at about $225 million per annum) and revenue from tobacco excise (about $950 million in 1999/2000 after GST adjustment) was not addressed by submissions. Nor was account

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7 Ameliorated, for some, by the availability of duty-free shopping (said to represent over 25 percent of dutiable spirits consumption).

taken of the long (average) lag between the payment of tobacco taxes and the incidence of health costs.

3.94 Our Issues Paper asked why, if excess health costs are to be selectively recovered from smokers or drinkers, savings in other areas of social spending such as New Zealand Superannuation should not also be taken into account.[8] Submissions did not address this question.

3.95 While the Ministry recognised that "*It is sometimes argued that consumers of tobacco and alcohol products make rational choices based on perceived benefits and costs,*" it noted that "*cognitive dissonance and dependence may prevent rational decision making*" and that *consumers are not always aware of the risks due to biased media images.*"

3.96 Importantly, the Ministry believes that:

> *"There is no evidence of any beneficial effects from smoking.*[9] *Beneficial effects from gambling and consumption of alcohol are only at low levels of consumption."*

3.97 Consistently with the health policy approach, the Ministry of Health asked the Review to advocate that:

> *"Current tobacco and alcohol excise taxes and duties on gaming be at least retained at their current levels (and that) periodic investigation of the value and appropriateness of increases in excise be made", while informing the Review that "the Ministry believes that increases in excise taxes – especially tobacco products and high alcohol products – will be appropriate in the future".*

3.98 The health policy approach differs markedly from the efficient pricing approach to corrective taxation. The latter sees merit, under appropriate conditions, in taxes that 'correct' market pricing for carefully measured external effects. By contrast, the health policy approach seeks regular and substantial tax increases, since these can always be relied upon to deliver additional health benefits through the further suppression of consumption.

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8 The question finds support in a recent survey that notes that: "*There has been a spirited economic debate about the optimal Pigouvian taxes on smoking and to a lesser extent drinking. The issue is particularly difficult because it is not even clear whether these goods have negative external costs. Although smokers use more medical services for smoking-related illnesses than non-smokers, they also die at younger ages. As a result, smokers pay into social programs such as Social Security and Medicare throughout their working lives, but collect much less in old age.* " This survey notes that US estimates of smoking externalities are in general lower than US tobacco taxes (which average about $0.75 per pack). See Cutler, David M, "Health Care and the Public Sector", March 2001, pp11-12, forthcoming in *Handbook of Public Economics*, North Holland.

9 This perspective, which was echoed in other submissions, takes a pharmacological view of consumption. Our policy framework is broader. For 13 "benefits of using tobacco as perceived by users" and 13 "drawbacks", as well as a list of health risks, see the web site of former US Surgeon General C. Everett Koop (www.drkoop.com/wellness/tobacco/library/pg00056.asp).

Analysis and recommendations

3.99 We endorse the conclusion of our Issues Paper that the present levels of excises cannot be justified on tax efficiency or tax equity grounds.

3.100 From the standpoint of our policy framework, this suggests that the case for the excises must rest on the notion that they correct market mis-pricing. For motor spirit, that case will be difficult to sustain for both petrol and diesel (in view of their inconsistent tax treatment).

3.101 As noted in our Issues Paper, we do not consider that the compensatory correction of incentives created by health system pricing (or other forms of social spending) provides a robust tax policy framework.[10]

3.102 For tobacco and gaming, present levels of taxation appear indefensible on externality grounds (even if the social spending argument were accepted).

3.103 In the case of alcohol, the question turns on the most appropriate form of intervention. While external harm can be identified (for example, in alcohol-related third-party road trauma and public disorder), targeted instruments are available (and are being successfully used) to address these problems. The relevant tax policy question must be: what additional contribution can then be made by excise taxes, which, because they apply uniformly to all units consumed, suppress beneficial as well as harmful consumption.

3.104 Since we would abstract from health system costs (which we do not believe provide a robust basis for corrective indirect tax policy), we believe that the levels of alcohol excise that could be justified on externality grounds are likely to be well below those currently applied in New Zealand.

3.105 On tax policy grounds, we have a strong preference for the transparent approach to taxation exemplified by GST, which makes tax burdens independent of how New Zealanders choose to spend their money.

3.106 In our view, the current excise and duty regime cannot readily be justified on conventional tax policy grounds. As a matter of tax principle the general revenue component of these taxes should be replaced by an increase in GST. At a minimum, the many anomalies in this area of the tax system should be subject to further review.

10 The Ministry of Health did see bounds to a regime of life-style modification, noting that, although "*in principle taxation can be used to support public health by making healthy products, activities and services cheaper and unhealthy products activities and services more expensive*" there are natural limits to this policy, since " ... *it is not possible to categorise all products, activities or services as wholly healthy or unhealthy.*" Ministry of Health, Paper for Tax Review, August 2001.

CHAPTER FOUR
ECO-TAXATION

Introduction

4.1 New Zealanders value their access to the natural environment. The accessibility of much of our coast, rivers, mountains and other features of our natural environment is highly valued and jealously guarded.

4.2 As the intensity of use rises, however, increasing pressures placed on environmental resources begin to degrade their value. For example, growing recreational use of our coasts, the pressures associated with urban development, the commercial significance of access to transport facilities and traditional uses by iwi, place competing demands on many harbours. At some point, the development of instruments that allow competing uses to be more rationally balanced, one against another, becomes worth the cost.[1] These instruments include:

- *the definition of use or access rights to environmental services that are freely exchangeable.* In New Zealand, tradable quotas are used to manage most major commercial fish stocks. In the US, tradable quotas were used during the phase-out of leaded petrol and, more recently, for the control of sulphur dioxide emissions. An international trading regime has been proposed for allowable greenhouse gas emissions under the Kyoto Protocol;
- *regulatory regimes that redefine property rights*, such as restrictions on the use of environmental property (like air and water resources) associated with the ownership and use of land. The Resource Management Act 1991 (RMA) is an important statute under which regulatory conditions are applied to avoid, mitigate or remedy adverse environmental effects; and
- *taxes and charges* that directly or indirectly price the use of environmental services.

4.3 All of the above instruments can have desirable properties when used in appropriate ways and New Zealand has, at times, led the world in their use. The system of road user charges for diesel vehicles introduced in New Zealand in 1977 provides one example;

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1 It would be wrong to conclude from this that environmental conditions must deteriorate over time. Though New Zealand's rising population adds to pressure on environmental resources, growing wealth increases the importance placed on environmental values. Thus some believe that "*Water quality in most of our larger rivers is probably the best that it has been this century.*" *Making every Drop Count, The National Agenda for Sustainable Water Management – Action Plan*, Ministry for the Environment, February 2000.

the robust framework for conserving fish stocks by allocated individual tradable quotas to major commercial fisheries offers another.

4.4 However, new measures to mitigate adverse environmental impacts are never easy to implement, since they require existing users to forgo or restrict activities previously taken for granted. These groups will often vigorously resist the introduction of environmentally superior solutions.

4.5 We were encouraged by submissions to consider a greater role for taxes to further the enjoyment of environmental as well as other resources and amenities. We assess the role of taxes alongside the other instruments, to ensure that an appropriate mix of approaches is used that is suited to the environmental issues facing New Zealand.

The Resource Management Act 1991

4.6 The RMA provides for the use of a wide range of instruments, including statutory controls, economic incentives and the establishment of voluntary agreements and partnerships. The focus of the Act is on the effects of activities and it requires the examination of a broad range of environmental impacts. In broad terms, proposed land and resource uses need to mitigate adverse effects through the use of best practice-methods.

4.7 The RMA devolves significant responsibility to territorial local authorities (district or city councils), who grant consents in line with rules in district plans. Regional councils have prime responsibility for the management of water bodies and discharges of contaminants, and for land management for soil conservation purposes. They also share responsibility for coastal management. Central government can set national standards on noise, contaminants and air quality. Standards, policies and plans developed under the Act must meet the requirements of necessity and cost effectiveness.

4.8 To provide certainty, the main focus of the RMA is on the environmental impact of new development. Resource consents constrain the activities of users only to the extent necessary to avoid or mitigate adverse environmental impacts. Beyond this, users are able to benefit from their use of environmental resources without charge.[2] By contrast, where activities are restricted by taxes or charges, a greater proportion of the benefits of use will be transferred from those who enjoyed them previously to the wider community.[3]

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2 Note, however, that coastal consents can be subject to charges and that development consents can require that land is set aside for community purposes.

3 As we discussed in Chapter One, *Frameworks,* of the Issues Paper, the economic incidence of the benefits and burdens of taxes or of the advent of property rights is complex and is shared between consumers, users and others (such as employers and employees). For example, the 'forward shifting' onto consumers of the impact of reduced output that results from a regulatory restriction, eco-tax or property right, such as a transferable quota, will depend on the responsiveness of consumers to changes in prices for the affected commodity. If consumers are very responsive (demand is price elastic), then little forward shifting will occur. For further background, see Buchanan, James M and

4.9 Similar redistribution issues can arise between existing users and those allocated new property rights when this approach is used to address environmental concerns. Appropriately targeted regulatory interventions therefore have the potential of being more readily accepted.

4.10 However, the RMA has also been criticised on the grounds that it imposes undue costs, uncertainties and delays in respect of resource consent proceedings under the Act, and for the consequences of (what are presented to be) the irresponsible exercise of rights of appeal. This partly reflects the tendency under the RMA to strike a balance among a very wide range of interests in environmental outcomes by using regulatory mechanisms that provide little opportunity or incentive for 'winners' to compensate 'losers'.

Eco-taxes, eco-charges and the 'double dividend'

4.11 Eco-taxes are taxes levied through the national tax system, while eco-charges refer to local authority usage fees, such as those levied on water supply and waste disposal.

4.12 Some submissions called for comprehensive ecological tax reform, which would raise the proportion of revenue collected by eco-taxes towards pre-determined targets over a period of years. Some submissions pointed to the introduction of a range of new environmental taxes and charges by a number of European countries during the 1990s. We note that these initiatives tend to be characterised by a large number of exemptions for specific industries, sectors or products, designed to address concerns over competitiveness or for other economic, social or distributional reasons.[4]

4.13 The proportion of tax revenue collected from eco-taxes in New Zealand is about half the average for the OECD.[5] This does not necessarily mean that New Zealand lags in the appropriate use of these instruments, however. Virtually all of the difference between the OECD average and New Zealand can be explained by New Zealand's lower taxes on petrol, diesel and motor vehicles.[6]

4.14 Some submissions expressed support for a theoretical presumption that eco-taxes can deliver a 'double dividend':

- the first dividend is the environmental benefits that accrue from the eco-tax; and

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Gordon Tullock, "Polluters Profits and Political Response: Direct Controls versus Taxes." *American Economic Review*, 1975, 65; pp139-47.

4 The OECD notes that its "*database shows around 1000 exemptions for 235 identified environmentally related taxes*. See *Environmentally Related Taxation in OECD Countries: Issues and Strategies*," Policy Environment Committee Paris, 21-23 March 2001, p 71.

5 *Op cit*, pp46-50. The OECD comparison of revenues from environmentally related taxes excludes revenue from fees and charges because of lack of data.

6 The OECD/EU database on environmentally related taxes reveals that, notwithstanding recent green tax reform in some European countries, traditional taxes on petrol, diesel and motor vehicles raise over 90 percent of the revenue from the taxes that the OECD classifies as "environmentally-related". Refer to *ibid* p48.

- the second dividend is the benefits that accrue from lower distortions due to a reduction of existing taxes that new eco-taxes can finance. This second dividend has been termed the 'revenue recycling' effect of eco-taxes. The importance of this effect is not challenged.

4.15 However, it is now widely recognised that there is a third effect initially neglected by proponents of the double-dividend presumption. This effect, now commonly termed the 'tax interaction effect', arises out of the marginal excess burden imposed by the addition of the eco-tax to the existing tax system.

4.16 In an optimal tax system, the *additional* excess burden of the last dollar of tax imposed on any margin will exactly offset the *reduced* excess burden made possible by the recycling of the revenue raised. The revenue recycling effect focussed on by proponents of double dividends then cancels the tax interaction effect, leaving no net secondary benefit from rebalancing the tax system. Under these conditions, the benefit of an eco-tax can be judged solely by reference to any environmental benefits that accrue.

4.17 In practice, of course, tax systems are not necessarily 'optimal'. Accordingly, the capacity of eco-taxes to bring secondary benefits will depend on the taxes in question and the adjustments to the tax system that occur following their introduction. We discuss below criteria that can guide these judgements in a national and local context.

Eco-taxes or quotas applied at a national level

4.18 We noted in the Issues Paper, the three conditions that favour the use of taxes designed to reduce adverse environmental impacts to their optimal level. These conditions are:

- the external impact of the adverse activity or use (however each unit is measured) should be *uniformly distributed* and the impact of each unit should be the same;
- the adverse activity or use must be *measurable* to be able to apply the tax; and
- the *marginal net damage of the activity must also be measurable* to be able to set the level of the tax.

4.19 New Zealand forms a single market. This means that eco-taxes at a national level will, of necessity, be uniform across units of consumption of the taxed commodities. External damage, on the other hand, will typically not be uniformly mixed. The relevance of this to New Zealand was recognised by the Ministry for the Environment in its submission to the Review:

> "*New Zealand has a somewhat different set of environmental issues from most countries. Our major problems are not regional air pollution or generalised water contamination. Air and water problems are more local in nature. We do however face more serious issues of agricultural pollution of surface and ground water and habitat protection and are behind other OECD countries in some areas of regulation.*"[7]

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7 Tax Review 2001, Submission from the Ministry for the Environment, p 11.

4.20 Moreover, as noted in the Issues Paper, because of the high costs of measuring adverse impacts in order to tax them, eco-taxes imposed at the national level will typically need to be levied on some product proxy, such as an input to, or output of, the production process (such as taxes on fertiliser, pesticide or butterfat, recommended by some submissions). This further reduces the prospect that such eco-taxes, levied nationally, will produce net benefits to New Zealand.[8]

4.21 While a range of submissions called for a variety of national levies, few examples were provided that satisfied the criteria noted earlier. This is not surprising, given the localised nature of most environmental issues that New Zealand faces.

4.22 Setting aside the case of carbon taxation, the Review was unable to identify cases where new eco-taxes at the national level could be considered an effective means of addressing environmental concerns facing New Zealand.[9] It follows that we do not favour proposals to target and move towards predetermined levels of tax revenue from national eco-taxation. For similar reasons, we do not consider that national quotas or similar regimes are appropriate to New Zealand circumstances.[10] Such measures also fail to satisfy the criteria noted earlier for a nationally applied eco-tax.

Eco-charges and other measures applied at a regional or local level

4.23 Where, on the other hand, environmental concerns are highly localised, as they currently appear to be in New Zealand, measures such as carefully designed eco-charges applied at the local level represent potentially sound policy.[11] Submissions nominated waste levies, water levies and special levies to extract resource rents as potential eco-taxes. Tax subsidies to land-owners to encourage the preservation of bio-diversity were also suggested.

4.24 We comment on these below but note, as a general observation, that eco-charges (or subsidies) levied at a local level should, in general, still be assessed against the three criteria noted earlier, with those now applied in a localised context. Where eco-charges

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8 The OECD has recently argued that eco-taxes "*may still be a useful instrument to change behaviour in the right direction, even if the optimal outcome is not achieved*". (*OECD Economic Outlook*, June 2001, p 69). Such a presumption can exist for eco-taxes levied at sufficiently low levels. In practice, however, the case for very low taxes is greatly weakened when account is taken of the disproportionate administrative and compliance cost burden imposed by special taxes levied at very low rates.

9 As noted, we see carbon taxation as the leading exception. Its merits as an instrument to meet New Zealand’s obligations under the Kyoto Protocol are discussed in Chapter Five.

10 For example, measures such as “virgin material depletion quotas” and “virgin material import ceilings” canvassed by the Waste Minimisation and Management Working Group in *Towards a National Waste Minimisation Strategy,* December 2000, Appendix 3.

11 Stavins R. N. "Experience with Market-Based Environmental Policy Instruments" (forthcoming in *The Handbook of Environmental Economics*, North Holland) provides a comprehensive survey of the market-based environmental instruments applied in a very large number of countries.

at a local level do not meet the design criteria, alternative measures, such as regulation, that are targeted more closely at the precise cause of harm are preferred.

Water management

4.25 About 85 percent of New Zealanders receive urban water supply and waste sewage assimilation services (sewage and stormwater) from local authorities. Water contamination is controlled under the RMA through Regional Plans and the granting of discharge permits (which may stipulate minimum standards of water quality and flow).

4.26 Charges for metered water use apply in the Auckland region and the Tasman district. Householders can opt into metering and use-related charges in Wellington. We support these local forms of water charging, although we note that the introduction of charges is often controversial. As noted earlier, this is because, even though user charges may enhance overall community welfare, their introduction will inevitably result in winners and losers.[12] It is our view that these trade-offs are best made at the local level. We also note that schemes for stormwater and wastewater charging are under active discussion. The development of innovative and sensitive eco-charges is to be encouraged.

Solid waste disposal

4.27 Local authorities have responsibility for solid waste management and currently recover slightly less than half their costs of meeting these responsibilities through user charges. A significant number of authorities are moving waste charging away from rates, however, and some innovative user-charging schemes are emerging.

4.28 This trend towards user charges is encouraging. However, there are risks of setting these charges too high (thereby encouraging illegal dumping) or too low (thereby encouraging excessive waste) in the long term. These risks are reduced if charges are set to reflect full costs at a local level. We see little need for a national levy or charge in this context.[13] Such a levy will have little impact on the waste generation and disposal activities of households and firms in those local areas where waste disposal is not explicitly priced. At the same time, problems would be created by such a levy for the 25 percent of councils where charging has become the established policy. Overall, the environmental impact of landfills appears to be satisfactorily addressed by existing environmental regulation and the allocation of responsibility for waste disposal to local government bodies.

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12 These objections may decline over time, however. For example, the Tasman District Council noted that, while metering attracted initial opposition, support strengthened as the metering of water increasingly came to be regarded as improving equity among water users (see Tasman District Council Submission quoted in Parliamentary Commissioner for the Environment, *Ageing Pipes and Murky Waters: Summary of Submissions* www.pce.govt.nz/reports p 15).

13 Such as a national 'waste minimisation' levy (see Ministry for the Environment, *Towards a National Waste Minimisation Strategy*, 2000, p 23).

Toxic substances and hazardous waste

4.29 The Hazardous Substances and New Organisms Act 1996 requires classification by toxicity of a range of substances with adverse environmental and health impacts. While this Act also makes provision for environmental user charges, in areas of high risk, strict regulatory controls rather than taxation appears to be the strongly preferred approach.

4.30 The scale of environmental damage potentially associated with accidents arising when hazardous substances are transported can leave companies found liable unable to meet the damages implied. The Ministry for the Environment has recommended to the Review that compulsory insurance against environmental accidents be required of those transporting hazardous substances (similar regimes already applying to oil and chemical companies operating in international waters). The Review finds merit in this suggestion.

Biodiversity protection

4.31 Some submissions proposed tax incentives to encourage desirable biodiversity protection by landowners; for example, where they agree to set aside parts of their property that are ecologically sensitive or unique. Bio-diversity protection proposals by landowners seeking government assistance should be carefully scrutinised on a case-by-case basis. Direct assistance is then preferable and more easily tailored to individual circumstances than subsidies delivered through the tax system. Direct assistance has the further desirable property that its budget costs are explicit rather than hidden. It should also be noted that tax breaks are of lower value to companies with substantial tax losses (who may also have opportunities to protect biodiversity) and that, under the New Zealand imputation treatment, any tax concessions will be clawed back when dividends are paid.

4.32 The Review therefore recommends against using the tax system to facilitate specific agreements with property owners to further biodiversity objectives.

Resource rentals

4.33 Some submissions called for eco-taxes to extract rents from users of natural resources. Suggestions include energy resources levies, levies on mineral mining and charges on commercial fish landings. It is important to distinguish these charges from charges related to costs imposed by the use of resources, such as waste charges discussed earlier. The Review favours user charges in appropriate circumstances.

4.34 Taxes that efficiently extract resource rents are specifically designed to have minimal impact on economic decision making. They will therefore have minimal environmental impact. The OECD practice of classifying such resource levies as environmental taxes without regard to their design is puzzling.

4.35 As noted in the Issues Paper, the case for levying resource rent taxes cannot be judged independently of the process through which existing rights to resource use have been created.

Recommendations

4.36 The role of a carbon tax as a central instrument to meet New Zealand's Kyoto obligations (in the event that the Protocol is ratified by New Zealand and comes into force) is discussed in Chapter Five (and further examined in Annex C).

4.37 With the exception of that tax, we have been unable to identify new forms of taxation that satisfy the conditions for effective eco-taxation set out in our Issues Paper. In reaching this conclusion, we have been strongly influenced by the highly localised nature of the environmental issues confronting New Zealand.

4.38 It follows that we do not see a comprehensive program of ecological tax reform as suited to New Zealand at this point in time.

4.39 At the same time, we strongly support the continuing movement towards greater use of eco-charges at the local and regional level. We see local charges, such as waste disposal levies and water charges based on use, as an important means of confronting users with the opportunity costs of activities with environmental impacts.

CHAPTER FIVE
CARBON TAXATION

Carbon taxation

Introduction

5.1 The Government referred to the Tax Review the question of whether New Zealand should implement a carbon charge. It has announced that if, as a result of the tax review process, a decision were taken to proceed with a carbon charge, the charge would not be implemented until after the next election.

Issues Paper

5.2 New Zealand is a party to the 1994 UN Framework Convention on Climate Change, which aims to stabilise atmospheric concentrations of greenhouse gases at a level that avoids dangerous anthropogenic (human-induced) interference with the world climate system.

5.3 There is no dispute that greenhouse gas concentrations have increased and there is a widespread consensus that the global average air surface temperature has increased by about 0.6°C (±0.2°C) over the past century. However, many aspects of climate change science remain highly uncertain.[1]

5.4 Notwithstanding these uncertainties, it is widely agreed that, because stabilisation of greenhouse gas concentrations will require very large reductions in the rate of greenhouse gas emissions, atmospheric concentrations of these gases are likely to rise for much of this century. Countries will need to adapt to the global climate consequences of rising greenhouse gas concentrations.

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1 The National Academy of Sciences' report *Climate Change Science, An Analysis of Some Key Questions*, Committee on the Science of Climate Change, National Academy Press, Washington D.C., June 2001, provides a useful summary. See also the *Testimony of Richard S. Lindzen before the US Senate Commerce Committee* (1 May 2001). Professor Lindzen, an IPCC lead author and an author of the National Academy of Science report, claims that: "*In point of fact there may not have been any significant warming in the last 60 years*." His further claim that "*Kyoto, fully implemented, will have little detectable impact on climate regardless of what one expects for warming*" is one from which there appears to be no scientific dissent.

5.5 New Zealand has indicated that it will ratify the Kyoto Protocol, which commits New Zealand to reducing its greenhouse gas emissions to 1990 levels (New Zealand's "Initial Assigned Amount" under the Protocol), as an annual average over the five years 2008-2012 (the "first commitment period").

5.6 The Kyoto Protocol provides for emissions trading (by Parties to the Protocol and legal entities) as a flexible mechanism to assist them in meeting their obligations in a cost-effective manner.

5.7 Under Kyoto, New Zealand is expected to receive large greenhouse gas emissions credits (additional assigned amount) in respect of carbon sequestered, during the first commitment period, in New Zealand forests planted on unforested land after 1990. These carbon sink credits are estimated to add about 36 percent to New Zealand's Initial Assigned Amount.

5.8 As a result, business-as-usual projections are for New Zealand's emissions, net of forestry credits, to be well under its Kyoto target (equivalently stated, New Zealand's gross emissions will be well below the sum of its Initial Assigned Amount and its Kyoto forest credits).

5.9 The Government has, however, announced that it will:

- not use carbon sink credits to shield emitters;
- develop policies that provide comparable incentives to reduce emissions across different sectors; and
- implement a practical program that keeps as low as possible the social and economic costs of achieving these Kyoto obligations.

5.10 The Review interprets these announcements to mean that New Zealand will, to the extent that this is practicable, expose New Zealand emitters to the international price for carbon credits.

5.11 Though this will place significant adjustment pressures on the New Zealand economy, it is virtually certain that New Zealand will remain a net supplier of carbon credits to other countries in the first commitment period.

5.12 At the same time, it appears unlikely that gross emissions will be reduced to 1990 levels at anticipated international carbon prices. <u>Excluding the forestry sector</u>, New Zealand will therefore be a net buyer of carbon credits.

5.13 The Issues Paper noted that New Zealand has an unusual greenhouse gas emissions profile, which is very heavily weighted towards non-CO_2 gases such as methane and nitrous oxide (currently about 60 percent of total New Zealand emissions). Most of these emissions come from the agricultural sector.

5.14 It was also noted that New Zealand's extensive use of 'clean' hydro-electricity (about 70 percent of total) and extensive use of gas-fired generation suggests that New Zealand will have relatively high marginal costs of abatement of CO_2 emissions. Recent modelling, which has been referred to the Review, confirms previous findings on this question (see Annex C).

5.15 With 55 percent of New Zealand's greenhouse gas emissions being agricultural emissions of ruminant methane and nitrous oxide, the efficient inclusion of this sector appears central to the policy decisions not to shield emitters and to apply broadly comparable abatement incentives across sectors. Revised forecasts of New Zealand emissions in the first commitment period (see Annex C) do nothing to alter that conclusion.

5.16 The Issues Paper considered the role that a broad-based carbon tax, encompassing agricultural as well as fossil fuel and waste sector emissions, could play in assisting New Zealand in meeting its commitments in the event that it ratifies the Kyoto Protocol.

5.17 It concluded that:

> *"…the Review considers that a carbon charge satisfies the important conditions for effective eco-taxation at the national level. The problem is certainly a national one. Satisfactory taxable proxies appear to exist for the great bulk of emissions whose impact (marginal damage) will be clearly defined by the national reporting system established under New Zealand's Kyoto commitments. Broad coverage of the regime will ensure that abatement costs are minimised by equalising marginal costs of abatement on all important margins. The price established by international carbon credit trading prior to the first commitment period is expected to provide guidance on the level at which to set (and periodically adjust) a carbon charge. Emissions Trading will provide the government with a flexible mechanism to meet New Zealand's legally binding Kyoto obligations.*
>
> *Because of New Zealand's inability to take meaningful unilateral action to affect global climate change we would not favour the introduction of a carbon charge prior to ratification by New Zealand of the Kyoto Protocol. Following that, imposition of a charge prior to the first commitment period may be desirable but only after international carbon markets begin to give clearer indications of the likely price of carbon (emissions abatement). It would be desirable for meaningful debate over the feasible, fair and efficient coverage of a national carbon charge, consistent with the government's Kyoto commitments, to begin immediately."*

Submissions

5.18 The Review received submissions questioning whether a carbon tax met the conditions identified by the Review for effective eco-taxation. Some submitters queried whether the agricultural sector could be effectively included under a carbon tax. Submissions raised the question of carbon taxation in the pre-Kyoto period in the event that the Government confirms the 'in principle' decision to make emissions trading a central instrument in the first commitment period. Concerns were expressed about the status of proposed Negotiated Greenhouse Agreements (NGAs) under a pre-Kyoto carbon tax.

5.19 The Review's response to these questions and analysis of these issues is included in Annex C. Our recommendations are summarised below.

Analysis and recommendations

5.20 The Review does **not** support unilateral action by New Zealand to mitigate "global warming".

5.21 The Review's analysis of carbon taxation is therefore predicated on the assumption that New Zealand ratifies the Kyoto Protocol (and that the Protocol comes into force).

5.22 Given this, it is assumed that New Zealand's actions will be directed towards the announced government objective of keeping the social and economic cost of achieving New Zealand's Kyoto obligations, as defined under the Protocol, as low as possible.

5.23 The Government has proposed entering into a series of NGAs with large firms who will undertake, or support, greenhouse gas emission reductions in the pre-Kyoto period. Those entering into these agreements have been promised that their commitments will be recognised in the design of a pre-Kyoto carbon tax.

5.24 In the context of a transition to the regime of carbon emissions trading by legal entities currently being considered for New Zealand, the Review does **not** recommend the pre-2008 imposition of a carbon tax.

5.25 In particular, the Review does not consider that a pre-Kyoto carbon charge is required to reduce the cost to New Zealand of 'myopic' pre-Kyoto investment decisions by those not covered by NGAs.

5.26 Unlike the UK Climate Change Levy (a narrowly based energy tax that is substantially discounted to participants under UK Climate Change Agreements), the form of carbon taxation that has been suggested as suitable under New Zealand conditions cannot be directly rebated to parties to NGAs. It will therefore be difficult to integrate such a carbon charge with those agreements.

5.27 The administrative and compliance costs of imposing a carbon tax as a temporary measure in the years 2003-2007 are difficult to justify. Existence of the tax is likely to complicate rather than clarify the already difficult question of the allocation of Assigned Amount Units prior to the establishment of a carbon-trading regime.

5.28 At the same time, the Review continues to believe that a broad-based carbon tax, aligned to international carbon prices and including the agricultural sector, merits consideration as New Zealand's central Kyoto measure for the first commitment period.

5.29 Under New Zealand conditions, and by comparison with the alternative of emissions trading by legal entities, a carbon tax combined with government international emissions trading (to cover residual excess emissions from non-forestry sectors) is considered to offer the prospect of more efficient outcomes at lower costs of monitoring and compliance.

5.30 In particular, the Review notes that commitment to broadly based carbon taxation should assist in averting potentially very costly disputation over the initial allocation of carbon credits.

5.31 If a broad-based carbon tax is selected as New Zealand's central Kyoto instrument, there will be obvious administrative merit in imposing the tax somewhat before the beginning of the first commitment period. Preparations for its introduction could be interpreted to meet New Zealand's commitment to show "demonstrable progress" in meeting its Kyoto targets by 2005.

Chapter Six
TAX RATES

Personal tax rates

Introduction

6.1 In Chapter Four, *Tax Rates*, of the Issues Paper, the Review identified the two objectives of personal income tax as generating revenue for the government and reducing income inequality.

6.2 This raises the difficult question of how the income tax-rate scale should be designed to collect the required revenue efficiently while contributing to income redistribution. In considering this question, the Review has had regard to the effectiveness of the current scale and its interaction with the welfare system, possible changes to the scale, and the economic, social and administrative effects of any changes.

6.3 The personal tax-rate scale has undergone significant change over the last 20 years, with a move away from multiple-rate scales and high marginal tax rates towards a smaller number of rates, with less variation in the rates. The flattening of the scale was accompanied by a broadening of the income tax base through the reduction in the number of concessions.

6.4 The status quo has four rates: 15 percent to $9,500; 21 percent to $38,000; 33 percent to $60,000; and 39 percent above. The Review identified a number of problems with the current four-rate scale. The gap between the top rate and middle rates provides a strong incentive to split income, reduces the accuracy of withholding systems for interest and dividends and complicates the taxation of superannuation funds.

6.5 The 15 percent rate to $9,500 increases complexity, particularly withholding for beneficiaries trying to work, and raises the marginal tax rate faced by most taxpayers (including beneficiaries). The $9,500 threshold is a poor proxy for need; low-income families have incomes well above the threshold and receive other assistance. Taxable income below $9,500 often indicates secondary income, self-employment or part-year income.

6.6 The 39 percent rate above $60,000 sends a negative signal to mobile, high-skilled taxpayers, and also creates a gap between top personal rates and the tax rate on entities such as companies. This creates an incentive for individuals to ensure income in excess of $60,000 is earned through an entity paying 33 percent tax. The Review's observation is that use of companies and trusts to shelter income is increasing in the wake of the introduction of the 39 percent rate. More generally, multiple tax rates encourage avoidance, increase complexity and disadvantage people who earn income unevenly.

Submissions

Proportionality vs progressivity

6.7 Submissions canvassed the range of arguments for and against proportionality and progressivity. There was also support for a tax free zone and a two-rate scale.

6.8 There are philosophical arguments for and against proportionality and progressivity; each can be described as 'fair'.

6.9 Proportionality is much simpler. It resolves issues of different treatment of different taxpayers, allows withholding at the correct final rate, provides more consistent treatment over time and among taxpayers with variable incomes over time, and solves both the unit of taxation and the taxation of superannuation fund issues.

6.10 Progressivity is not the main driver of redistribution. This is shown below with the chart from the Issues Paper comparing tax payments and receipt of government spending on a household income basis under progressive and proportional taxation.

6.11 Figure 6.1 below shows the contribution of personal tax scale progressivity to redistribution, compared with a proportional tax that raises the same amount of revenue.[1] The fiscally neutral proportional tax rate is 25 percent, including corporate taxes. Allocating spending and taxes to households requires a large number of assumptions and estimates. However, the overall picture is clear.

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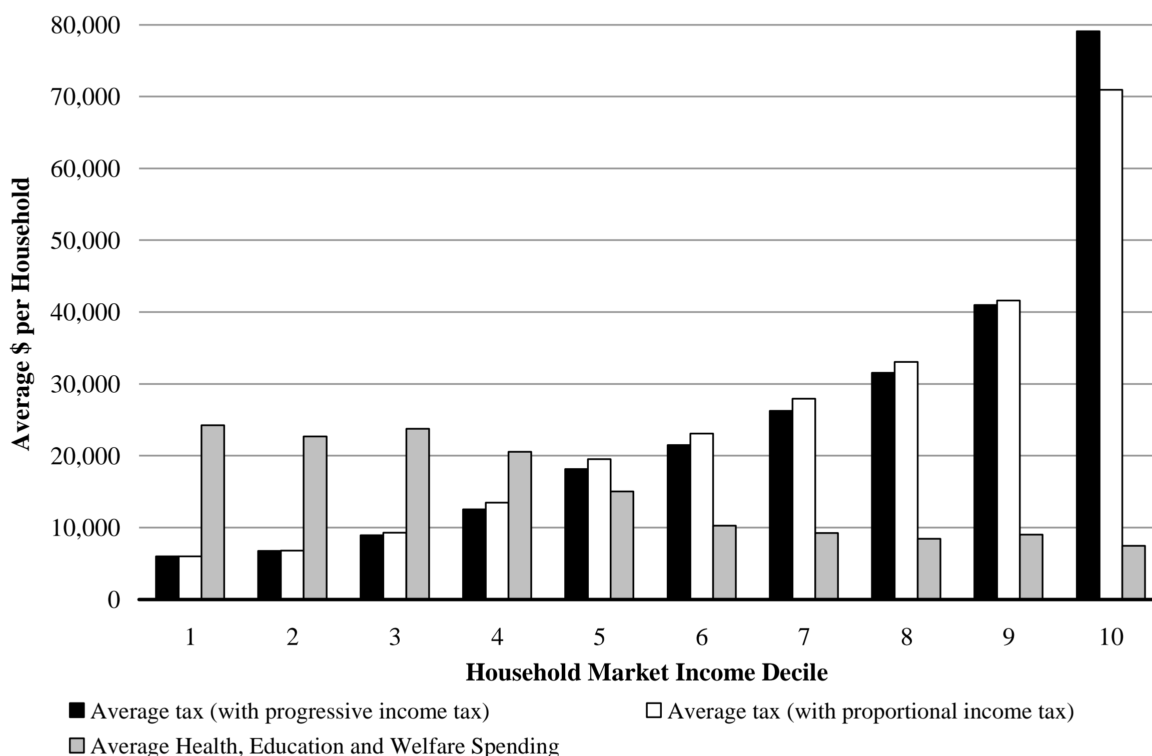
1 The chart shows government spending on benefits, health and education per household, and total tax per household under the current tax scale and under a proportional personal tax scale (holding other taxes constant) for each market income decile of the population (that is, taking the population of households, arranging it in order of income, and dividing it into ten equal-sized groups). The fiscally neutral proportional tax rate is 25 percent, including corporate taxes. This is a static calculation: it just multiplies current incomes by 25 percent and does not allow for change in behaviour or reductions in administrative costs.

Figure 6.1 – ***Average Health, Education and Welfare Spending and Average Tax per Household by Household Market Income Decile***



6.12 Significant income redistribution takes place. The households that have the lowest market incomes pay the least tax but receive the greatest direct benefit from government spending.

6.13 The amount of tax paid under the current progressive scale and under a proportional rate of 25 percent is roughly the same for most deciles. Under progressivity, extra tax is clearly being taken from people in the highest decile, allowing slightly lower taxation of people in deciles two through nine. Decile one is unaffected, as people here have no market income. The real engine for income redistribution is the payment of more tax as income rises, coupled with the pattern of government expenditure on benefits, education and health.

6.14 It shows that households with the highest incomes pay the most tax and receive the least benefits, under either proportionality or progressivity. The small effect of progressivity is shown by the small difference between the "average tax (with progressive income tax)" and "average tax (with proportional income tax)" columns.

6.15 The Review notes the large benefits of proportionality, and the small contribution of progressivity to redistribution. Progressivity is retained in the Review's recommendation because many New Zealanders value progressivity, and the fiscally-neutral removal of progressivity would impose static losses on low-income earners.

Low taxable income as a proxy for need

6.16 Submissions sought clarification of the claim in the Issues Paper that, while poor people have low taxable incomes, low taxable income is not a good proxy for need.

6.17 Beneficiaries have their benefits set net of tax, so only their non-benefit income is affected by tax rates. Low-income working families receive a variety of forms of assistance, which offset the impact of tax, depending on their income. Many people with low taxable income are not needy. These include second-income earners in middle- and high-income households, some self-employed, and people with income for only part of a tax year (for example, immigrants and emigrants).

6.18 Given that income is a poor indicator of need, proposals for a tax-free zone poorly target those in need and have large fiscal costs. These fiscal costs would raise marginal tax rates for most taxpayers.

1990s tax cuts

6.19 Submitters pointed out that the 1990s tax cuts (the status quo) reduced the tax burden on middle-income earners relative to other taxpayers and gave a windfall gain to high-income earners, reducing their average but not their marginal tax rate. A suggested response was to return to the pre-cuts (1988) scale, adjusted for inflation. The Review does not support this proposal because it would involve significant marginal and average tax increases for most taxpayers and would increase the tax take. It also gives weight to a previous status quo, rather than trying to design a better tax scale.

Recommendations

6.20 There is no such thing as a perfect tax scale; all involve value judgements and trade-offs among simplicity, revenue, marginal rates, redistribution and static effects[2] relative to the status quo.

6.21 Submissions suggested the status quo after the 1990s tax cuts should not be the benchmark determining the shape of the future tax scale. The Review agrees that there is nothing innately 'right' about any particular status quo. However, the status quo at any point in time is relevant, because people arrange their affairs and expectations on prevailing rules. For this reason, tax change proposals are often described in terms of static change from the status quo ("$x per week more/less at an income of $z"). The Review has sought to develop potential tax scales that are an improvement on the status quo. Our suggestion falls between the 1988 and 2001 scales.

6.22 Against this background, the Review suggests a two-rate tax scale with a threshold in the vicinity of $29,500 per annum and rates of 18 percent and 33 percent.

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2 Static effects: changes in current after-tax income, not taking into account incidence or changes in behaviour.

6.23 Moving from a four-rate scale to a two-rate scale addresses many of the concerns with a four-rate scale, but it is not costless. Removing the low rate and lowering the threshold create static losses (ignoring changes in behaviour) relative to the status quo. Removing the high rate reduces revenue, though this is partially offset by the lower threshold.

6.24 The implications of 18%/33%/$29,500 relative to the status quo are set out below.

Simplification

6.25 The proposal is simpler, removing the issues arising from the steps at $9,500 and $60,000.

Lower threshold

6.26 The location of the threshold at $29,500 instead of $38,000 reflects clarity about the objectives of a low rate: $29,500 is a broad subjective indicator of 'low income', and the objective of a two-rate scale is favourable treatment of low-income earners. The lower threshold also sustains the average taxes collected from high-income earners, while allowing their marginal tax rate to fall.

Static effects

6.27 The proposal creates static gains and losses for taxpayers relative to the status quo. Most of these are small: the largest losses are $5.48 per week at $9,500 and $13.56 per week at $38,000. Details of these static effects are set out below.

Static effects: Beneficiaries

6.28 Beneficiaries have their benefits adjusted to offset changes in tax. This means they are affected by the tax rate only on income above their gross benefit level. Most gross benefits exceed the $9,500 threshold (for example, DPB, married unemployed). This means beneficiaries are better off: they are fully compensated for the tax increase below $9,500 and they get the benefit of the 18 percent rate (instead of the current 21 percent) above $9,500 if they work.

6.29 Beneficiaries with gross benefits below $9,500 (for example, single unemployed) have the effect on their benefit removed, but pay an additional three cents per dollar tax, up to a gross income (including benefit income) of $9,500. Since gross benefits are close to $9,500, the maximum effect is very small: about $10 per year for a single person unemployed for a whole year.

Static effects: Superannuitants

6.30 New Zealand Superannuation would be increased to offset the tax change. As Superannuation is greater than $9,500, working superannuitants would have a small tax cut. Unlike other taxpayers, superannuitants currently get the benefit of the 15 percent rate to $9,500 for their investment income. This benefit would be lost.

Static effects: Low-income working families

6.31 Most families in this position are entitled to Family Tax Credit assistance, so would not be adversely affected. Taxpayers with incomes between $19,000 and $32,500 would be slightly better off.

Static effects: Middle-income earners

6.32 Taxpayers between $32,500 and $72,500 have static losses. This reflects the partial undoing of the 1990s cuts to middle-income earners and has a maximum cost of $13.56 per week (compared to the $45 per week gain from the 1990s cut) at $38,000 per week.

Static effects: High-income earners

6.33 Taxpayers above $72,500 gain in static terms relative to the status quo. Under the status quo, the top 10 percent of taxpayers pay 14.5 percent of the personal tax take. Under the proposal, this falls to 12.8 percent.

Static effects: Other

6.34 The people who may be affected by the small increase in tax liability from removal of the 15% step (maximum $5.48 per week) are secondary earners, students (depending on adjustments to student allowances), self-employed, some single people with low full-time earnings, and people with one-off low incomes (people entering or leaving the tax base part way through the tax year).

6.35 Thus, most of the people at first glance adversely affected by the change (beneficiaries, superannuitants, low-income families) are not adversely affected, and most of those who are affected are not ‘needy’.

6.36 Nevertheless, the government may find any low taxable income static losses unacceptable. If so, compensation could cost about $300 million and would increase complexity and effective marginal tax rates for people who may already face effective marginal tax rates (EMTRs) higher than the statutory rate.

Marginal tax rates

6.37 The proposal provides a lower marginal tax rate (18 percent vs 21 percent) between $9,500 and $29,500 (a range with many taxpayers and much abatement of social assistance). People with incomes between $29,500 and $38,000 have their marginal tax rate raised from 21 percent to 33 percent as a result of the lower threshold. This increase will raise the EMTRs by 12 percent for those people who are also members of households facing abatement of family assistance. People above $60,000 have their marginal tax rate drop from 39 percent to 33 percent.

6.38 As the current 15 percent rate applies only to labour income, the effect of the proposal on investment income for taxpayers with a total income below $29,500 is to reduce the tax rate from 19.5 percent to 18 percent.

Comment

6.39 The proposal simplifies the system, reduces marginal tax rates for mobile skilled labour, and retains progressivity, targeted more closely on relevant low-income earners.

6.40 The static effects are small relative to either the 1990s changes or the effects of everyday changes in prices such as in petrol and interest rates.

6.41 However, the proposal foregoes the benefits of proportionality and retains a large gap between the rates. Alternative two-rate scales are possible, with different trade-offs: a smaller gap between the rates, a lower top rate and larger static losses for some taxpayers.

Taxable unit

6.42 Tax can be assessed on either family or individual income. Currently, the tax scale is based on individual income, while social assistance is based on household income.

6.43 We stated in the Issues Paper that individual-based taxation is the best approach in a diverse, changing society. Concerns with particular household characteristics (for example, dependant children) are best addressed through existing targeted policies, such as family tax credits. As well as creating as many anomalies as it resolves, household taxation is not well targeted.

6.44 Submissions were both for and against the assessment of tax based on individual income. Submissions highlighted the inequities that can arise under both individual and household assessment and noted that the issue disappears under a proportional tax.

6.45 On balance, the Review still considers that individual-based taxation is the best approach, and notes that the less progressive the tax scale, the smaller the issue becomes (and vice versa).

Taxation and the benefit system

6.46 Targeting of benefits invokes abatement as people move from benefits to work. Abatement generates EMTRs higher than the statutory tax rate. EMTRs show the percentage of an additional dollar of income ‘lost’ in tax and abatement. High marginal rates distort people’s decisions. Of the 2.5 million taxpayers, about 250,000 taxpayers face EMTRs in excess of 50 percent. Addressing EMTRs requires balancing adequacy of income, fairness, incentives and fiscal cost.

Submissions

EMTRs

6.47 Submissions raised the difficulties high EMTRs pose for people moving from benefits to work, or working part-time while on a benefit. A suggested solution to high EMTRs was to ease abatement.

6.48 The problems with easing abatement are that beneficiaries end up with higher incomes than working people, more people are caught by abatement, the fiscal cost is greater and less needy people receive assistance.

6.49 Submissions also questioned the small role of taxation in EMTRs and emphasised the links between the tax and benefit systems.

6.50 The current tax-benefit regime may be more complicated than it needs to be. However, changes to the tax system will have little impact on this complexity. Changing benefits rates or abatement regimes has a much greater potential to affect EMTRs, but reform of the benefit is beyond the scope of the Review.

6.51 The two-rate tax scale proposal simplifies the system and reduces EMTRs for most recipients of income-tested assistance by three percentage points, from 21 percent to 18 percent.

Universal basic income

6.52 Submissions reiterated the case for a universal basic income (UBI).

6.53 A UBI provides a fixed sum to each citizen. Key attractions of this idea are its simple administration and avoiding EMTRs from abatement. There are also philosophical arguments for a UBI (everyone has a right to a basic income; a basic income reflects a return to collective wealth) and against (people have a right to the fruit of their labour).

6.54 There are three practical problems with all UBI proposals, namely:

- a UBI provides people with money (which gives them purchasing power over goods) without supporting the production of the goods to be purchased with the money;
- income distribution: New Zealand has few high-income people and many low-income people. Each dollar taxed off the few people at the top of the distribution has to be divided among many people at the bottom. This, in turn, means either the UBI has to be low or the tax rate to fund it has to be very high; and
- churn: The people in the middle of the income distribution pay half their income in tax and receive the same amount back as UBI. Much of the high tax rates of a UBI scheme is required to take money from middle- and high-income people and give it back to them, worsening their incentives without increasing their net income. This means we get the costs of high tax rates without the benefits.

6.55 A UBI has theoretical attractions, but the high tax rates required to fund it and the incentive effects of the payment make it impractical.

Child benefit

6.56 Submissions recommended the introduction of a universal child benefit. In particular, they suggested making the current $15 per week child tax credit for working families universal. New Zealand currently has targeted (abated) child benefits. The advantage of a universal child benefit is the removal of EMTRs and administration cost from abatement. A claimed benefit of universality is improved child welfare. This is not the case for a conventional income-targeted benefit (for example, Family Support), as low-income families already get the targeted benefit.

6.57 Extending the child tax credit to middle- and high-income families has the drawbacks of high cost (about twice the cost of a targeted benefit) and significant churn (the families getting the benefit would pay much of the tax to pay for it), and that almost all the benefit would go to middle- and upper-income families. The high cost may lead to reduced payments for low-income children as the rate of universal benefit is reduced to control cost, thus reducing assistance to low-income families relative to a targeted regime.

6.58 The current Child Tax Credit, although targeted on income, is not paid to beneficiary families. Extending the child tax credit to beneficiary families would give them more money. However, the point of the Child Tax Credit was to make working families better off relative to beneficiary families. This would be undone by extending the payment to beneficiaries. Extending the child tax credit to beneficiaries is a benefit policy issue, involving a trade-off between income, incentives and fiscal cost.

Increasing targeting

6.59 Some submissions suggested increased targeting of spending, to reduce churn. Churn describes the situation when people paying taxes receive goods or services from the government which they could have bought directly. The universal child benefit discussed above is a good example of churn.

6.60 As we have seen, targeting reduces churn, lowers spending and thus the overall tax burden and associated marginal tax rates. It also makes the tax/benefit system more redistributive. However, increasing targeting would increase the number of people facing high EMTRs. There are also non-tax reasons for universal provision of some government spending items.

Company tax rate

6.61 We raised the issue of an appropriate company tax rate in the Issues Paper. We emphasised that competing considerations complicate the choice of a company tax rate. In particular, to the extent company tax is attributable to New Zealand residents, there is a very strong case for aligning the company tax rate with the top marginal tax rate. But alignment would not necessarily be appropriate if it resulted in a company tax rate that was materially out of step with international norms, particularly if foreign investors were motivated by ‘headline’ rates of company tax.

Submissions

6.62 A number of submissions from business groups argued for a reduction in the company tax rate in order to attract and expand investment in New Zealand. One submission questioned our conclusions on the impact of the company tax rate on New Zealand's international competitiveness, arguing that "with the New Zealand company 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 company tax rate in New Zealand is now above the OECD rate."

6.63 Some submissions questioned the case for aligning the company tax rate with the top personal marginal tax rate, noting that most other countries (including Australia) have top personal rates that are significantly above the company rate.

Analysis

6.64 We consider the key guiding principles in determining an appropriate corporate rate to be that:

- the top personal marginal tax rate and the company tax rate should be as close as possible. This minimises the incentives to either distribute or retain income within companies. Such an incentive would potentially create an inequity between self-employed and employees. This is particularly important in the New Zealand context because of the small scale of businesses operating here and the large number of self-employed. As a submission noted, over the period 1996 to 2000 the number of people in self-employment has increased by 51 percent while total employment has increased by 15 percent.
- the company tax rate has the highest commercial visibility amongst tax rates, and therefore has an important impact on investor perception. In response to this principle, many countries have deliberately reduced their company tax rate significantly below the top personal marginal tax rate, with a view to attracting and retaining capital. This principle has to be balanced against that in the above paragraph. If the trend towards lowering taxes on capital relative to taxes on labour continues, this will result in increasing pressure towards widening the gap between the company tax rate and the top personal marginal tax rate;
- the trustee rate should be aligned with the top personal marginal tax rate;
- the company rate should not be significantly above the company tax rates of key jurisdictions with which we compete for scare resources, such as Australia;
- efficiency costs are highest at the top end of a rate scale, encouraging lower rather than higher top marginal rates (and therefore entity rates); and
- New Zealand has a broader tax base than most other OECD countries meaning that relatively more tax is raised per unit of the tax rate.

Recommendations

6.65 Our recommendations on tax rates flow from these guiding principles, namely that:

- the top personal tax rate should be reduced from 39 percent towards the company tax rate (currently 33 percent);
- the trustee rate should be set equal to the top personal marginal tax rate, namely 33 percent; and
- the personal rate scale should be based on a two-step progression.

6.66 We note that since the Government moved to increase the top personal marginal tax rate from 1 April 2000, the Australian government has moved its corporate rate from 36 percent to 34 percent for the year ending 30 June 2001, and to 30 percent thereafter. These developments will be an ongoing source of pressure towards a re-examination of our rate structure in terms of the above principles. In particular, it is likely that these and future developments overseas will continue the pressure towards reducing the company tax rate over time. In Chapter Eight, *International Taxation,* we set out a specific proposal with respect to tax rates on inbound investment by non-residents.

CHAPTER SEVEN
ENTITIES

Introduction

7.1 We discussed the tax treatment of entities in Chapter Five, *Taxable Entities and Their Tax Treatment*, of our Issues Paper. The key idea in the Issues Paper was to distinguish closely-held entities (which should be taxed on a partnership basis) from widely-held entities (which we suggested be taxed on a company basis, the principal feature of which is a dividend tax regime). A key reason for this approach was to reduce the number of differential tax treatments of substitutable entities.

Submission

7.2 Submissions were largely against this reform on the principal bases that such a reform was too radical, or would not substantially reduce differential treatments, or that a partnership treatment is theoretically correct for all entities.

Analysis and recommendations

7.3 We doubt that it is practicable to apply a single tax framework to all entities. We believe it is appropriate to apply a partnership treatment where feasible; otherwise, a company treatment should apply. We believe it is appropriate to apply a company (or withholding tax treatment) to entities where ownership is widely dispersed and a partnership treatment infeasible.

7.4 Once these two basic tax treatments are accepted, we disfavour giving widely-held entities a choice between them because tax considerations are likely to dominate the choice of entity.

7.5 We therefore recommend that tax policy distinguishes between widely-held and closely-held entities and applies an actual or approximate corporate tax model to the former and a partnership tax model to the latter. In this chapter, we focus only on matters we wish to clarify or amend in respect of what we said in Chapter Five, *Taxable Entities and Their Tax Treatment*, of the Issues Paper. The key rules we propose are presented in Table 5.3 of the Issues Paper, which we reproduce here as Table 7.1:

Table 7.1 – *The Boundary Between Widely- and Closely-Held Entities*					
Entity	**Closely-held defined as…(say)**	**Widely-held defined as…(say)**	**Look through rules for closely-held**	**Transition into/or out of closely-held regime**	**Key rules**
Trusts	5 or fewer *sui juris* arm's length ultimate beneficiaries have either received distributions from the trust or have fixed interests in the trust's income. Beneficiaries within the 1st degree of relationship would be counted as one person	Not a closely-held trust	Shareholders of any corporate beneficiary would be included in beneficiary count. No widely-held company, widely-held trust or widely-held partnership would be able to be a beneficiary	At outset no need for equivalent of qualifying company election tax (QCET) to enter closely-held regime, since there will be no untaxed reserves. Untaxed reserves should be deemed to be available subscribed capital.[1]	Distributions to a new beneficiary will trigger change of status to widely-held.
Company	Existing qualifying company rules	Not a qualifying company	Same as qualifying company No widely-held company, widely-held trust or widely-held partnership would be able to be a shareholder	Same as qualifying company	
Partnership	5 or fewer *sui juris* arm's-length partners. Partners within the 1st degree of relationship would be counted as one person A partnership where all partners are widely-held entities	Not a closely-held partnership	Shareholders of any corporate partner or the beneficiaries of any partner that is a trust would be included in the partner count No widely held partnership, widely held company or widely-held trust would be permitted to be a partner	At outset no need for equivalent of qualifying company election tax (QCET) to enter regime, since there will be no untaxed reserves. Untaxed reserves should be deemed to be available subscribed capital.	The definition of a partnership for tax purposes would be extended to cover associations of persons that are co-investing or co-operating through agencies or syndicates under an integrated arrangement. Joint ventures would not be partnerships and would be treated as forming part of the principals' operations.

1 Thereafter, an 'entry' tax if a widely-held trust (or partnership) becomes a closely-held partnership will depend on whether these entities are subject to the company (imputation) regime. If they are, then any untaxed 'revenue' reserves will be subject to a 'QCET' type entry tax, if the entities become closely-held.

7.6 As mentioned in the Issues Paper, the current qualifying trust tax treatment is an approximation of the partnership approach, except that trustee income attracts a final withholding tax rate of 33 percent. In principle, we consider that setting the trustee tax rate equal to the highest personal marginal tax rate would better reflect a partnership treatment.

7.7 Our recommendation to proceed with a closely-held/widely-held distinction raises a question of transition. We consider it would be too radical to immediately make this wholesale change. We prefer a more measured approach, whereby tax policy is guided by this distinction in the development of any future entity tax reform ordinarily arising in the work program. For example, this recommendation should be considered as part of the government's current reviews of the taxation of Maori Authorities and charities.

7.8 In principle, it is preferable to tax the income of both widely-held and closely-held entities at the marginal tax rate of the ultimate beneficial owner. However, in a corporate tax regime, this alignment can only be approximated, given that there is a timing difference between when an entity and its dividends are taxed. The longer the time period between the entity deriving and distributing the income, the greater this misalignment. Also, where owners sell entities with retained earnings, there is an effective arbitrage of tax rates on those retained earnings between the old and new owners. Furthermore, trustee owners are currently an effective block to the alignment of tax rates between the entity and its beneficial owners. We therefore recognise that there are inevitable limitations to aligning tax rates.

Savings and investment

7.9 In our Issues Paper, we raised the question of aligning the tax rates of long-lived savings and investment vehicles such as superannuation and life insurance entities. Our view is that rate alignment is an important objective but should be compromised if the compliance costs of alignment outweigh the benefits. For example, where there is a long time period between the derivation and distribution of income, such as with life insurance and superannuation funds, subjecting entity income to a final entity tax by exempting distributions is preferable.

7.10 In our Issues Paper we also raised the question of whether a taxable dividend regime should be applied to entities where the beneficial ownership of retained income is vague (such as in a discretionary trust). In principle, we consider that imputation systems (with a view to aligning entity and owner tax rates) can be applied to such vehicles at the time of distribution to beneficial owners. We accept that continuity and streaming issues arise under such an approach. However, we consider that an imputation mechanism subject to these weaknesses can still be superior to simply applying a final entity withholding tax.

7.11 We also raised the question of whether in a corporate tax model, dividends should be deductible. From the viewpoint of taxing resident shareholders, we consider that a dividend deduction regime meets the policy objectives sought in an imputation regime. The practical constraints of a dividend deduction regime focus on whether it can be confined to resident shareholders only and whether avoidance concerns can be met. We consider that the government should evaluate the desirability and feasibility of a dividend deduction system.

7.12 We have specifically considered the taxation of savings and investment entities (SIEs) as a result of our Terms of Reference and submissions. We note that this sector attracts multifarious tax treatments at both the entity and international levels. We also note that a substantial percentage of the company tax is collected from this sector. We have recommended in Chapter Eight, *International Taxation*, which addresses international tax reform, that all net equity interests in publicly listed foreign investment funds and retail unit trusts ("Foreign Portfolio Investments" (FPIs)) calculate tax using the Risk Free Return Method (RFRM), which we described in our Issues Paper. This method calculates the annual taxable income as the opening market value of the net investment times an inflation-adjusted risk-free rate of return, irrespective of the actual rate of return.

7.13 The reason why we prefer the RFRM for FPIs is that it provides a comprehensive and consistent method of income taxation on an inflation-adjusted basis. Furthermore, we consider that comprehensively taxing financial assets at their riskless opportunity costs will tax less than the returns expected by the managers and owners of such assets. As such, it may be perceived -*ex ante*- as a tax concession. For these same reasons, we recommend that this reform be considered for domestic SIEs generally, as well as FPIs.

7.14 There are three general approaches to designing a RFRM regime. The first, where we consider the changes to be simpler and narrower, (hereinafter referred to as the "Asset regime"), would focus on an appropriate asset definition only, such as marketable or listed shares. The RFRM would not be applied to an entity, but to defined assets only. Under this approach, holders of such assets would be subject to RFRM on a market value or surrogate basis. An RFRM imputation mechanism would be designed to prevent multiple taxation via a chain of corporate shareholders.

7.15 The second approach applies RFRM to a specifically defined entity only (SIEs), and not to specific assets or other non-SIE entities. We refer to this regime as the "Entity regime". The SIE would be defined by reference to the nature of its assets and to its principal purpose of being a saving or investment vehicle. Under such a regime, we recommend a general definition supplemented by a list of specific inclusions and exclusions. The general component of the definition could be defined to mean ***any widely-held resident entity that has the main purpose of carrying on any saving or investment activity for investors.*** A design question is whether the definition should be wide enough to catch interposed passive holding or conduit entities. The SIE would pay RFRM tax on the value of its shares and would not be subject to ordinary income tax. It would pay dividends with RFRM imputation credits to prevent multiple taxation via a chain of interposed companies.

7.16 The third approach, which we refer to as the “Mixed regime”, is a combination of the two above-mentioned regimes. First, it applies RFRM to an SIE as defined, as per the Entity regime. However, it also applies RFRM tax to holders of specified assets, as per the Asset regime. Again, an imputation mechanism would be designed to prevent multiple taxation.

7.17 We demonstrate working models for each of these three regimes (supported by diagrams and spreadsheets) in Annex D Parts: D1, D2 and D3. It would be important, however, for specific proposals to be developed as part of a dedicated consultative process if government decided to progress this RFRM initiative.

7.18 An imputation mechanism is common to all regimes. The mechanism could operate as follows:

- Any companies paying RFRM or receiving dividends with RFRM imputation credits would maintain an RFRM imputation credit account (RFRM ICA) to record RFRM tax and credits. These credits could be attached to RFRM dividends onpaid.
- All resident corporate recipients of RFRM dividends would be exempt tax on those dividends. Any RFRM credits attached to RFRM dividends received could be used to relieve RFRM tax. Imputation credits attached to ordinary dividends received could also be used to relieve RFRM tax and would convert to being RFRM credits. Any imputation credits or RFRM credits used to relieve RFRM tax would be creditable to the corporate recipient’s RFRM ICA.
- RFRM imputation credits could only be attached to RFRM dividends received directly or indirectly from either an SIE (under the Entity or Mixed regimes) or shares subject to RFRM under the Asset regime. SIEs would therefore maintain an ordinary dividend account recording net dividends from non-SIEs, whereas non-SIEs would maintain an RFRM dividend account recording net dividends from SIEs.
- Any non-corporate taxpayer receiving RFRM dividends will make a tax adjustment calculation by taking any attached RFRM imputation credits, grossing them up by dividing by the company tax rate and calculating a tax credit by multiplying that gross amount by the difference between the company rate and taxpayer’s marginal tax rate. This credit would be applied to reduce the taxpayer’s other taxes, or any unused credit could convert to a tax loss.

7.19 The complexity of any RFRM design arises because of the objectives of merging with the standard income tax, aligning with the tax rates of the ultimate beneficial owners, and to prevent multiple taxation through a chain of companies. It may be possible to consider applying a flat tax rate to RFRM dividends and exempting them thereafter, bearing in mind what we said about long-lived vehicles in paragraph 7.9 above. Consideration would have to be given to the question of multiple (or cascading) taxation where an SIE or taxable RFRM shares sat above other SIEs or RFRM shares in a shareholding chain.

7.20 A number of RFRM design issues should be considered. First, there is the question of whether RFRM dividends must have all RFRM available credits attached. The reason is that an unimputed RFRM dividend is effectively exempt as no tax adjustment is made by the ultimate recipient. This would enable payers of RFRM dividends to lock in the company rate on RFRM income and avoid top-ups for higher tax rate owners. At the same time, this position can also be achieved by simply retaining income. This matter has some parallels with ordinary imputation. A further consideration is whether inter-corporate RFRM dividends should be at least fully imputed with either ordinary imputation credits or RWT credits to mitigate the re-emergence of a preference share market in the presence of exempt inter-company dividends. Consideration should also be given to whether there should not be a limit to the extent of RFRM credit attachment with a view to allowing RFRM tax to flow more quickly to ultimate owners without having to disgorge substantial retained earnings.

Charities and Maori Authorities

7.21 We consider that reforms to the taxation of charities and Maori Authorities should remain subject to the specific reform processes currently underway. We have provided relevant Officials with copies of submissions that we received on these topics. Given the timing of the government's review of charities and Maori Authorities, we believe it would be pre-emptory for us to develop recommendations in relation to those matters beyond the general principles we have enunciated for all entities.

CHAPTER EIGHT
INTERNATIONAL TAX: TAXING INCOME FROM INBOUND AND OFFSHORE INVESTMENT

Introduction

8.1 In this chapter, we focus on:

- taxation of income earned by non-residents in New Zealand (inbound investment) – see paragraphs 8.5 to 8.45. Our recommendations commence at paragraph 8.39; and
- taxation of income earned by residents from offshore (offshore investment) – see paragraphs 8.46 to 8.76. Our recommendations commence at paragraph 8.73.

8.2 The international tax policy issues are complex and these taxes can impact on mobile corporates and high-worth individuals, so the stakes are high.

8.3 Globalisation is challenging the ability of governments to tax income from capital but, in our view, the time has not yet come for New Zealand to stop taxing income from capital.

8.4 We have assumed a base understanding of the Issues Paper, Chapter Six, *International Taxation: Taxing Income from Inbound and Offshore Investments*. This chapter summarises our approach and recommendations. Some of the analysis on which we have relied and the alternatives we have considered are addressed in more detail in annexes, namely:

- Annex E, which relates to inbound investment and provides supplementary material in support of the Review's framework, demonstrates New Zealand's effective tax rate on non-residents under the current rules, and analyses the policy options in detail; and
- Annex F, which analyses in more detail policy options in respect of offshore investment.

Taxation of income earned by non-residents in New Zealand

8.5 We divide investment by non-residents into two types: foreign direct investment (FDI), representing a 10 percent or greater equity interest in the company/New Zealand assets; and portfolio investment, being a less than 10 percent equity investment or debt investment by a non-resident with no equity interest or a portfolio equity interest.

The policy framework proposed by the Review in the Issues Paper

8.6 New Zealand is a small, open, capital-importing nation. The result of its small size and openness is that the rate of return for investments in New Zealand can be influenced by how New Zealand taxes non-residents.

8.7 This can, in particular, be seen in the case of debt investments. Non-resident lenders will be willing to invest funds in New Zealand only if they receive a return after paying New Zealand tax that is at least equal to that they could achieve elsewhere.

8.8 As a result, higher New Zealand taxes will mean non-residents will require a higher before-tax rate of return from their New Zealand investments. By driving up the required return from investment, New Zealand taxes raise the cost of capital to New Zealand businesses and lower the amount of investment.

8.9 In these circumstances, the tax on the non-resident is not borne by the non-resident, but is passed on to other factors of production (for example, to labour in the form of lower wages). That is, the *economic incidence* of the tax falls on New Zealanders, rather than the non-resident on whom the tax is legally imposed.[1] In this case, New Zealand's economic position can be improved by imposing additional tax directly on the residents, who are already bearing the burden of the tax, and removing or not imposing any distortionary tax on the non-resident. Reducing the distortionary New Zealand tax in these circumstances produces a higher level of foreign investment in New Zealand and lowers the cost of capital for New Zealand businesses.

8.10 However, our Issues Paper noted that there are clearly cases where non-residents will not shift in full the incidence of taxes imposed by New Zealand onto New Zealanders:

- the first is where a foreign government allows a foreign tax credit for the New Zealand tax. In this case, to the extent of the foreign tax credit allowed, it is foreign treasuries that bear the incidence of New Zealand taxes rather than the non-resident investor; and
- the second is where the non-resident is earning 'economic rents' and is, to some degree, not sensitive to the New Zealand tax.

8.11 Our Issues Paper recognised that, in principle, New Zealand should impose tax on the non-resident in these cases to the extent the non-resident would bear the incidence of the

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1 See the section on *Determining who pays taxes* in Chapter One, *Frameworks*, of our Issues Paper for a more extensive discussion of the issue of incidence.

tax. We recognised that there were real difficulties in differentiating between taxpayers who were sensitive to New Zealand tax and did not bear its full incidence and taxpayers who were less sensitive to New Zealand tax and bore the incidence of some portion or all of the New Zealand tax.

8.12 In addition, our Issues Paper raised a third issue as to whether there were political and economic obstacles to a tax framework in which New Zealand investors in a New Zealand business are subject to a higher rate of New Zealand tax than a non-resident investing in that or a similar business.

8.13 Subject to further consideration of these three issues, in our Issues Paper we proposed lowering the New Zealand tax rate on foreign equity investment into New Zealand in accordance with the above economic framework. We suggested that the lower effective company tax rate should, in principle, be achieved by lowering the statutory tax rate on income from non-residents' equity investment.

Policy options raised in our Issues Paper

8.14 We outlined in our Issues Paper a proposal to reduce the company tax rate to between 15 percent and 20 percent, to the extent a company is owned by non-resident investors (referred to in this chapter and in our Issues Paper as Policy Option One).

8.15 We also raised the possibility of targeting the low company tax rate only to new investors, or foreign-owned businesses in certain types of industries, or foreign-owned businesses located in export development zones. We indicated that we would consider these alternatives further.

8.16 With respect to portfolio investment, we raised the possibility of increasing the approved issuer levy (AIL) on interest paid between non-associates from two percent to three percent. We also questioned whether the 15 percent to 20 percent regime should be extended to portfolio equity investors. Finally, we questioned whether the FITC should be increased.

Submissions on framework and policy options

8.17 Most submissions in this area were from business interests. Most submissions favoured lowering the New Zealand tax burden on non-New Zealand residents.

8.18 Some submissions raised questions about differential treatment in favour of non-resident investors over resident investors. This issue was raised in only a few submissions. One submission thought that the economic consequences of differential treatment should be considered further.[2] One submission generally opposed investment by non-residents.

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2 We address the differential tax treatment issue further in Annex E.

8.19 Most submissions preferred that the lower effective tax rate for non-resident investors be delivered by a lower statutory company tax rate to the extent of non-resident ownership (Policy Option One). Of those who expressed a view, most submissions preferred not to target tax reductions at specific industries/sectors.

8.20 One submission saw issues in the complexity of Policy Option One and the potential for resident ownership of New Zealand companies to be diluted over time.

8.21 Some submissions preferred a general lowering of the corporate rate for all companies, regardless of ownership. But, of these submissions, most supported Policy Option One, if it did not prove practical to lower the general company tax rate to a significant extent.

Our final policy framework

8.22 We regard increased levels of FDI as essential if a real attempt is to be made to significantly increase GDP per capita. Reducing New Zealand's tax burden on non-resident investment would result in additional investment by non-residents, though the magnitude is uncertain.

8.23 Appropriate additional FDI in New Zealand can provide jobs for New Zealanders, raise New Zealanders' work skills, transfer technology to New Zealand, provide access for New Zealand-made products to the non-resident's international marketing network and provide opportunities for New Zealand entrepreneurs. Perhaps the most important benefit to New Zealand of an increase in quality FDI is the raising of the New Zealand population's entrepreneurial, managerial and scientific skills (that is, human capital).

8.24 The key question is whether, in the aggregate, such a policy of reducing taxes on non-residents would produce a net national benefit. This depends critically on the extent of any proposed reduction, to whom it should apply, and the mechanism by which it should be delivered.

8.25 Important factors in forming policy are the three factors raised in our Issues Paper: economic rents, foreign tax credits, and the economic consequences of a tax differential between residents and non-residents. In Annex E, we have provided a more detailed analysis of these factors, and we summarise our views here.

8.26 It is not possible to restrict tax on non-residents to precisely the level of foreign tax credits allowed, because:

- a general rule to that effect would be problematic under other countries' rules and would result in widely disparate rates of New Zealand tax;
- foreign tax credit rules vary considerably across countries and according to the particular position of individual investors; and
- any principle of taxing to the extent of foreign tax credits is muddied further by the tax laws of all key countries from which New Zealand sources foreign investment. These countries generally have rules exempting their residents' New Zealand income or deferring tax until repatriation.

All that can be done is to set an overall tax rate, having some regard to likely availability of credits to some non-resident investors.

8.27 Furthermore, non-resident investors who earn economic rents and are not sensitive to New Zealand tax are not readily identifiable – all we know is that, to some extent, some non-residents are prepared to bear the burden of New Zealand tax:

- as a general rule, portfolio investment is likely to be more sensitive to New Zealand tax than FDI;
- much existing FDI is a 'sunk cost' and thus is, in general, unable to be quickly withdrawn. It is therefore less sensitive to New Zealand taxes. New Zealand raises significant amounts of revenue in respect of FDI;
- FDI directed towards exploiting New Zealand markets or New Zealand's natural resources is expected to be less sensitive to New Zealand taxes;
- new FDI primarily directed towards manufacturing/research and development in relation to export market exploitation is likely to be more sensitive to New Zealand tax; and
- empirical evidence is that, over time, FDI has generally become more sensitive to host-country tax burden. We believe that it is likely that the tax sensitivity of FDI will increase further over time.

Policy options

8.28 In Annex E, we address in detail the range of policy options for delivering a lower tax rate to non-resident investors. The key options we have focused on are:

- an 18 percent company tax rate to the extent that a New Zealand company is owned by non-residents (with two percent NRWT for FDI investors and repeal of the FITC regime, and 15 percent NRWT with an extended FITC regime for portfolio investors) – referred to as Policy Option One. This approach imposes different rates of company tax according to whether the company is owned by residents or non-residents. It does not distinguish between 'new' and 'existing' investment/activities or between types of activities;
- an 18 percent company tax rate for investment by non-residents in new activities (either new activities or certain significant expansions of existing activities), with the same NRWT rules as above – referred to as Policy Option Two. This approach would involve the same differentiation between residents and non-residents as for Policy Option One, but would distinguish between new and existing activities; and
- a low tax rate/tax incentives for investment by non-residents in targeted sectors – referred to as Policy Option Three. This might, for example, involve an 18 percent company tax rate for investment by non-residents in export-oriented companies or within certain development zones, or for companies in certain industries. Alternatively, tax incentives might be granted to non-resident investors in particular sectors (either for new activities or for any activities in the industry or sector).

8.29 Policy Option Two (reduction for new activities only) has quite some attraction. We have suggested the 18 percent rate (with two percent NRWT) having regard to the foreign tax credit and economic rent issues and with a view to achieving a rate that is designed to attract investment by 'standing out more from the crowd'[3]. Subject to being able to design a satisfactory mechanism for quarantining new activities from existing" ones, we believe that this policy would be net national welfare enhancing. The benefits to New Zealand of additional foreign investment, including tax thereon, should exceed revenues foregone on new investment that would, in any event, have occurred at existing tax rates.

8.30 This approach restricts windfall gains to existing non-resident investors. Officials estimate that this option also has a small fiscal cost based on the static analysis used for government budgeting purposes, being a maximum of $50 million each year.

8.31 However, this approach is not complication free. Maintaining the distinction between new and existing activities may prove difficult and create definitional and compliance issues.

8.32 The most promising version among those included in Policy Option Three (18 percent rate for non-residents in export-oriented industries on the grounds that this has high tax sensitivity) may well be challengeable under GATT. Within our framework, we have expressed a preference, as a general rule, for avoiding targeting industries. This means that we do not prefer this or the other policies raised under Policy Option Three.

8.33 This leaves Policy Option One as the real alternative to Policy Option Two. Policy Option One has lower compliance and administrative costs because it eliminates the new/existing activity distinction. It also eliminates any issues created by not extending the regime to existing non-resident investors. But it does involve significant fiscal cost. Officials' budget estimate of fiscal cost, on a static basis, is $460 million per annum.

8.34 The question is whether we can conclude that Policy Option One increases net national welfare. This is a question of judgement on which, within our time constraints, we have not reached unanimous agreement or conclusion. It depends on personal judgements on a number of factors, which cannot be quantified with mathematical precision:

- the degree of sensitivity of new non-resident investment to New Zealand income tax and, in addition, the extent to which New Zealand can be regarded as being in competition with other countries whose use of low tax rates/tax incentives and grants are 'pervasive'. For example, much of Asia offers an even lower tax environment for non-residents than our proposal. New investment resulting from the tax rate reduction could be expected, over time, to generate additional tax revenue at the new tax rates, but we cannot predict with any certainty how much;

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3 We note Australia's recent renegotiation of its double tax treaty with the USA, under which withholding taxes on dividends have been eliminated or reduced to 5% according to the extent of the shareholding (Australian withholding was already zero on fully-franked dividends).

- the extent of the risk of existing non-resident investors withdrawing over time and the extent to which this can be reduced by lowering New Zealand tax impost (recognising that in a large number of instances existing investment is a sunk cost that is not tax sensitive); and
- the extent to which the current tax paid by non-resident investors will continue to be paid by investors. The validity of current anecdotal evidence of a greater degree of debt-financing of existing FDI so as to reduce the current New Zealand tax burden should be tested; and
- the nature and quality of new non-resident investment that can be expected to be responsive to the New Zealand tax reduction.

Specific issues for portfolio investment by non-residents

8.35 It might be suggested that the 18 percent statutory rate not apply to non-resident portfolio investors:

- FDI is likely to produce long-term technology and knowledge transfer and links to international export markets that are not present to the same degree with portfolio investment; and
- the compliance costs involved in implementing a corporate tax regime that differentiates between New Zealand and non-New Zealand resident ownership are greater in the case of companies with a large number of portfolio non-resident investors, who are also likely to change shareholdings with greater frequency than FDI investors.

8.36 Consultation on this subject would be desirable at the implementation phase. However, at this stage, our preference would not be to draw qualitative lines as to the type or quality of non-resident investment. We also note that it is likely, as a general rule, that non-resident portfolio investment is more sensitive to tax burden than FDI. For these reasons, we prefer an approach that would extend the 18 percent rate to non-resident portfolio investors. If Policy Option Two is to be adopted, further consideration should be given as to whether the resulting regime for portfolio investment would become too complex.

8.37 We prefer that the 15 percent NRWT and FITC regimes be retained for portfolio investors. This is different to the approach we have recommended for FDI investment (repeal of the FITC regime and introduction of a two percent withholding tax). The regime for non-resident portfolio equity investors would therefore work in the following way (for the purposes of this example, we have assumed a company with 20 non-resident portfolio investors, each with a five percent shareholding, and, for purposes of simplicity, we have considered their position in the aggregate where full company income is distributed):

Table 8.1		
Company Taxable Income		$1000
Company Tax At Statutory Rate		$180*
Company Income After Tax		$820
Distributions	$820	
Plus Supplementary Distribution	$126	
	$946	
NRWT 15%		$142
Cash Return To Non-Resident		
Portfolio Investor After Tax		$804

* Company Tax at statutory rate of 18 percent ($180), reduced by foreign investor tax credit equal to the amount of the supplementary distribution of $126 = $54 final company tax.

The division of tax between company tax and NRWT may be adjusted to place more weight on the company tax, if desired.

8.38 In our Issues Paper, we raised the possibility of increasing the cost of AIL on interest to non-associates to three percent. We believed this might emphasise the withholding tax option where credits are available to the non-resident. Some submissions opposed this step. We recommend retaining the AIL at two percent.

The Review's recommendation as regards inbound investment

8.39 We believe the government should consider a reduction in New Zealand tax impost on companies to the extent owned by non-resident investors. We have considered a range of policy options and prefer two of those – Policy Option One and Policy Option Two. Both involve a company tax rate to the extent of non-resident ownership in the vicinity of 18 percent, with a two percent NRWT. Policy Option One applies to all non-resident investors. The budget estimate on a static basis is that Policy Option One has a fiscal cost of approximately $460 million per annum. Policy Option Two is restricted to non-residents investing in new activities. Policy Option Two has a small fiscal cost on the static budget analysis of no more than $50 million for each year.

8.40 We are satisfied that Policy Option Two (requiring a distinction between new and existing activities) should be net national welfare enhancing, provided that the distinction between new and existing activities can be drawn in a long-term, sustainable manner. This proviso requires that rules can be drafted to maintain a credible division between "new" and "existing" businesses. If they cannot, Policy Option Two would effectively become Policy Option One over time. In that case, it should be assessed at the outset as if it were a phased introduction of Policy Option One.

8.41 Within the timeframes we have had, we have not reached unanimous agreement as to whether Policy Option One is net national welfare enhancing.

8.42 At the level of principle, we prefer Policy Option Two because it targets the rate reduction at new investment. However, this preference relies on a workable distinction between new and existing activities. If this distinction cannot be drawn in a workable way, a decision remains on introducing Policy Option One.

8.43 We recommend that the government consider implementing Policy Option One or Policy Option Two. Further work should be undertaken to determine whether Policy Option One improves net national welfare. Further work should also be undertaken to determine the sustainability of the new/existing distinction required by Policy Option Two.

8.44 If a tax reduction of the proposed type is to be implemented, we believe the government should simultaneously consider whether it can improve non-tax policies in a way that maximises the benefit to New Zealand from the tax reduction and achieves quality FDI for New Zealand. The type of policy areas that might be considered include investment promotion agency policy, immigration policies as regards pro-actively targeting skilled labour and efforts to improve education and skill levels in New Zealand's labour force. We recognise that the government is already making efforts in these and other relevant areas.

8.45 The 18 percent rate under consideration (with two percent NRWT) produces a maximum effective tax rate for non-resident investors of 14.82 percent. This is likely to be near the actual effective tax rate for non-residents (because the package includes rules relating to associated-party debt financing by FDI investors). This compares with a maximum effective tax rate for non-resident investors under current law of 21.5 percent. But, under current law, there is greater variability in tax rates, depending on the non-resident's attitude to tax structuring. This variability produces a range of effective tax rates between approximately 9.25 percent and 21.5 percent. The current average effective tax rate for non-residents is likely to be somewhere between 15 percent and 20 percent.[4]

Taxation of income earned by residents from offshore[5]

Summary of economic principles

8.46 The residence principle suggests that residents should be taxed in New Zealand at the same rate on all their world-wide income as it accrues, receiving a tax deduction (rather than a credit) for foreign taxes. The simple notion underpinning this theory is that taxes

4 See Annex A of our Issues Paper for calculations. These calculations assume no availability of foreign tax credits and assume an effective tax rate equal to the statutory rate of 33 percent.

5 Annex C of our Issues Paper provides a summary of the current law and defines relevant terms used here, such as CFC and FIF, which we assume are understood.

paid to the New Zealand government contribute to New Zealand's national welfare, but taxes paid to foreign governments do not.

8.47 Another way of putting the principle is that it is in New Zealand's national interest for residents to invest offshore only where offshore investments yield a higher rate of return after paying foreign taxes than that for corresponding investments in New Zealand before paying New Zealand taxes (see our Issues Paper, Chapter Six, Example 6.1).

8.48 A different approach is 'capital export neutrality', which, where countries persist in source-country taxation, as they presently do, promotes world welfare. Under this approach, resident investors should choose the best investment anywhere in the world, regardless of taxes. In effect, this approach suggests New Zealand should tax foreign source income as income is derived, with a tax credit allowed for foreign tax.[6]

8.49 Because of double-taxation agreements entered into by New Zealand, which require New Zealand to provide credits for foreign taxes, the residence principle cannot be adopted in full by New Zealand.

8.50 A second-best approach is the 'see-saw' principle, under which the average net New Zealand tax rate on New Zealanders' foreign-sourced income plus the net effective tax rate on New Zealand-sourced income earned by non-residents should be approximately equal to the tax rate on New Zealanders' New Zealand-sourced income. By "net" tax, we refer to the tax after allowing for foreign tax credits.

8.51 The see-saw principle suggests an inverse relationship between the rate of New Zealand tax on non-residents' New Zealand-sourced income and the rate of New Zealand tax on residents' offshore income. For example, if the tax rate on inward FDI is raised too high, New Zealand will forego foreign investments that would return more than the true marginal cost of funds. Reducing the tax on offshore investment by residents in accordance with the see-saw principle offsets this inefficiency by encouraging offshore investment. Thus, the see-saw principle implies that the foreign-sourced income of New Zealanders should be taxed at a lower rate than domestic income, to the extent that New Zealand's cost of capital is raised by taxes on non-residents earning New Zealand-sourced income. (See our Issues Paper, Chapter Six, Examples 6.2 and 6.3.)

The policy framework proposed by the Review in the Issues Paper

8.52 Our Issues Paper suggested the following policy framework:

- the residence principle, allowing only a deduction for foreign tax (rather than a credit), cannot be implemented in full as a result of constraints in New Zealand's tax treaties. We raised two possibilities as regards foreign tax credits:
  - the first involved generally retaining the status quo. This option involved allowing tax credits as required by New Zealand's tax treaties and allowing tax credits for foreign taxes paid in non-treaty countries in the same way as for treaty countries.

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6 In practice, credits are limited to the extent of the tax in the investor's country of residence.

This was on the grounds that disallowance of foreign tax credits in respect of investments in non-treaty countries would create a significant distortion between investment in treaty and non-treaty countries. Furthermore, credits for foreign taxes paid by foreign branches of New Zealand companies and required to be given under tax treaties support the availability of underlying foreign tax credits for companies to a similar extent as allowed under current law[7]; and

  - the second was a fundamental change in direction in the form of the RFRM method, which would, in effect, disallow foreign tax credits but tax a risk-free return expected, on average, to be below actual returns;

- we noted that it is not possible to apply the see-saw model in a mathematical sense. This was because of real difficulties in identifying the extent to which credits for New Zealand taxes were available across jurisdictions and for specific non-residents, because of difficulties in determining an implicit impact on the cost of capital as a result of New Zealand taxes, which vary across different types of instruments;
- we accepted the desirability of some broad measure of balance of the type suggested by the see-saw model in the New Zealand tax on residents' offshore income and that on non-residents' income from New Zealand. In the extreme case of no tax on non-residents' New Zealand-sourced income and no tax on residents' offshore investment income, New Zealand tax on investment income might be largely eliminated. Non-residents would invest in New Zealand in large quantities and pay no New Zealand tax and residents would move capital offshore and pay no New Zealand tax;
- we accepted that individuals and companies can change residence and that the last 10 years has seen increased mobility across jurisdictions. We observed that New Zealand's tax regime in relation to offshore investment in non-grey-list countries is significantly more aggressive in imposing tax than the range of standard practices in other countries. We expressed concern that, by being outside the range of other countries' practices, the New Zealand regime might well produce excess burden/deadweight losses. Costs to New Zealand would include non-residents who decided not to move to New Zealand as a result of its tax regime, and residents seeking to invest offshore who might choose to change residence as a result of New Zealand's tax regime; and
- with respect to offshore investment by portfolio investors in listed companies and retail unit trusts, we expressed concern about differential tax treatment under the FIF regime; in particular, between grey-list and non-grey-list investments.

Policy options considered in our Issues Paper

8.53 Our Issues Paper raised three key design issues:

- timing of income inclusion: should offshore income of residents be included in the New Zealand tax calculation when derived offshore (the 'accrual' basis; that is, at the same time as New Zealand-sourced income is taxed) or only when it is repatriated to New Zealand?;

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7 We proposed continuing the current law that foreign tax credits cannot be passed through New Zealand companies to their shareholders. We are satisfied that this is the international standard and do not address the issue further (except as regards the Australian triangular taxation issue – see Annex F). Submissions have raised a slightly different issue of foreign tax credit availability in respect of certain US pass-through entities treated as companies for New Zealand tax purposes. We have not been able to consider this issue in detail.

- foreign tax credits: where not required to do so by New Zealand's double-tax agreements, at the time when offshore income is taxed in New Zealand, should New Zealand unilaterally allow tax credits for foreign tax paid and, if so, to what extent?; and
- taxation of capital gains: are special rules for taxing capital gains required for offshore equity investments in non-grey-list countries, as compared to New Zealand investments and grey-list investments?

8.54 Our Issues Paper raised the following policy options:

- repeal of the grey list, provided a satisfactory alternative to the current CFC and FIF regimes could be found;
- introduction, on a broad scale, of the RFRM method for all foreign investments, using accounting reserves or another method as a proxy for market value, where the investments were not listed;
- introduction of an active/passive distinction for countries other than those on a black list. Income in the active category would not be taxed until repatriated to New Zealand. Passive income and all income from black-list jurisdictions would be attributed and taxed in New Zealand as accrued/derived. Restrictions on certain deductions attributable to offshore investments would be required if the active/passive regime were to be adopted. This would be combined with application of the RFRM method for investments in listed offshore companies and retail unit trusts;
- an exemption from CFC/FIF regimes for persons not domiciled in New Zealand; and
- an annual tax cap for individuals of, say, $1 million.

Submissions received on the policy framework and policy options

8.55 Submissions in this area were from business interests. Most submissions favoured introducing an active/passive regime so that the CFC/FIF regimes would be more targeted as an anti-avoidance regime. Some submitters recognised that this would involve restrictions on interest expense attributable to tax-deferred offshore investment. Some submissions suggested that the modified CFC regime set out in Table 6.5 of our Issues Paper was too complex or did not go far enough.

8.56 The majority of submissions opposed repealing the grey list, but some submissions thought an active/passive rule would enable its repeal. Other submissions favoured an extension of the grey list – for example, that the grey list might be extended to incorporate all OECD countries with which New Zealand has a double tax-treaty (and, for some submitters, where the company tax rate is at least 20 percent).

8.57 Other suggestions included an increase in the de minimus exemption from the FIF regime from $50,000 to a higher level (ranging from $100,000 to $1 million). An exemption from the FIF regime for investments in all companies listed on recognised stock exchanges was also proposed. Some submitters supported substituting the RFRM method for the deemed rate of return method in the FIF regime.

8.58 Most submissions opposed broad application of the RFRM approach for offshore investment, but a number of submissions supported its application in the context of listed investments and retail unit trusts.

8.59 One significant exception to the general tenor of submissions by business interests was the New Zealand Business Roundtable's submission, which did not favour introduction of an active/passive regime. That submission preferred further exploration of a broader application of the RFRM approach (questions that required consideration were whether taxing the lower rate of return under the RFRM might incentivise foreign investment and the potential effect on our tax-treaty network).

8.60 Submissions commenting on the $1 million tax cap and the exemption from the CFC/FIF regimes for non-domiciles often supported the general approach, sometimes suggesting consideration of different caps or mechanisms. Some submitters raised issues of equity and the possibility of abuse.

The Review's policy framework

Investment in offshore companies (other than listed offshore companies and retail unit trusts)

8.61 We confirm the broad policy framework in our Issues Paper. As will be seen, we have not, at this stage, recommended broad implementation of RFRM for all foreign investments and have, accordingly, adopted the approach built on the availability of foreign tax credits as per the current law (see the status quo approach to foreign tax credits in paragraph 8.52 above).

8.62 Having resolved this philosophy on foreign tax credits, the key remaining difficulty is the tension between two objectives:

- the New Zealand tax system should not result in a lower aggregate tax burden (foreign tax and New Zealand tax) for offshore investment than New Zealand investment. As a result, resident investors should choose the best investment anywhere in the world, regardless of taxes (broadly consistent with the capital export neutrality approach). This suggests taxation in New Zealand of offshore income as it accrues, regardless of the source of the income or the nature of any intermediary entity that derives it; and
- resident companies and individuals who wish to invest offshore should not be forced to question whether they should remain resident in New Zealand by virtue of a significantly higher burden of New Zealand tax on offshore investment than the range of standard international practice in other countries. This is particularly the case because companies/individuals seeking to make offshore direct investments are likely to be in the most mobile group of residents. The difficulty is that other countries have generally adopted an exemption system (that is, exempting from tax offshore investment income earned through offshore companies by residents) or a deferral system (under which offshore investment income earned through offshore companies by residents is taxed only on repatriation to the resident). Both these systems potentially incentivise offshore investment by way of a home-country tax burden that is lower than for local investments that are taxed when income is derived.

8.63 We believe these two objectives are largely irreconcilable. At least, we have not been able to reconcile them. On the one hand, New Zealand does not want to induce our most mobile taxpayers to consider moving from New Zealand. On the other hand, New

Zealand does not wish to adopt a built-in tax incentive that causes people who remain in New Zealand to see a tax advantage in investing offshore rather than in New Zealand. But, it is precisely this type of system, that produces a tax incentive to invest offshore, that is the international standard.

8.64 In addition, the complexity of the rules and the compliance costs imposed on taxpayers (particularly where branch equivalent tax calculations are required) should be taken into account when deciding the nature of the rules. If significant compliance costs are involved for taxpayers, the national interest supporting the chosen tax design must justify those costs.

Investment in listed offshore companies and retail unit trusts

8.65 We believe it is desirable to achieve consistency in the way New Zealand taxes offshore companies/unit trusts of this type. Under current law, the New Zealand tax burden varies significantly between grey-list and non-grey-list entities and New Zealand-based unit trusts.

The current rules compared with the Review's framework

Investment in offshore companies (other than listed offshore companies and retail unit trusts)

8.66 Where income from grey-list countries has been taxed at the general statutory rates operating in the grey-list country, the current grey list is supported by our framework. Attributing income from grey-list entities to residents would produce significant compliance costs but no real revenue for the government. This is because, within our framework, New Zealand would allow tax credits for grey-list country taxes.

8.67 However, even within the narrow grey list, there are concerns that some entities may achieve low rates of grey-list country tax, so that the rationale for the grey list may not apply.

8.68 For non-grey-list investments, the level of foreign tax may or may not be sufficient when credits are allowed in New Zealand to eliminate the New Zealand tax liability. Where tax is paid in a non-grey-list country to an extent sufficient to eliminate the New Zealand tax liability, the current CFC/FIF rules, in principle, allow an ultimate outcome similar to that for the grey list and consistent with our framework. But compliance costs are significantly higher outside the grey list because New Zealand tax calculations are required.

8.69 For non-grey-list investments where foreign tax paid is not sufficient to eliminate New Zealand tax liability, the rules generally require attribution of income on an accrual basis, with the result that residual New Zealand tax liability arises as the offshore income arises (under the CFC or FIF regime). This raises the dilemma addressed at paragraphs 8.62 to 8.63 above in our discussion of the framework.

Investment in listed offshore companies and retail unit trusts

8.70 The current rules do not achieve consistency of treatment across the range of investment entities. New Zealand-managed unit trusts will generally be fully taxed on all investments, whether such investments are grey list, non-grey list or New Zealand

companies. New Zealand-based passive tracking funds, by virtue of IRD rulings, are not subject to tax on gains from New Zealand investments or from investments tracking grey-list indices by portfolios of shares. Grey-list managed funds are not taxed to residents who invest directly, even where only low tax is payable in the grey list (for example, certain UK and Australian unit trusts).

8.71 The current rules are not consistent with the framework.

Policy options for offshore direct investment by residents

8.72 In Annex F, we address in more detail the policy options we have considered further. These options are:

- broad application of the RFRM method generally for all offshore investment, which we do not recommend at this stage;
- retention of the status quo, except for introduction of RFRM for listed offshore investments and retail unit trusts;
- retention of the grey list and introduction of a passive/active regime, together with RFRM for listed offshore investments and retail unit trusts. The regime is detailed in Annex F; and
- a lower general company tax rate or a lower company tax rate for offshore investment.

The Review's recommendations on offshore investment

8.73 We recommend:

- application of the RFRM method for all portfolio investments in offshore-listed entities and offshore retail unit trusts. The RFRM method would apply whether such investments were in grey-list or non-grey-list organisations. In Chapter Seven, *Entities,*, we have addressed this in more detail. We explain there how the system might work where investments in such entities are made through intermediary companies or entities. More detailed work in relation to fiscal impact would be required in relation to this recommendation. There is expected to be an increase in the revenue from investments in grey-list retail unit trusts and an expected reduction in tax for New Zealand resident managed unit trusts. Determining the fiscal impact will require comparison between the current law fiscal position which varies with market performance, and the position under RFRM, which is independent of market performance. IRD/Treasury advise that, because the use of RFRM is driven by a desire to achieve consistency of taxation of portfolio investment, the consequential denial of foreign tax credits on dividend income should not jeopardise New Zealand's treaty relationships;
- that an individual with no previous connection to New Zealand who becomes a resident of New Zealand for tax purposes should be taxed only on their New Zealand-sourced income for the first seven years after they first become a resident;
- the maximum level of tax imposed on a single individual in any one year should be capped at $1 million. People earning income at these levels are of critical importance to New Zealand as a result of their international connections and ideas; and
- consideration of rules to prevent the use of the conduit regime to enable borrowing to make certain offshore investments and achieve a reduced New Zealand tax liability on New Zealand-sourced income.

8.74 The key remaining issue is whether New Zealand should seek to tax offshore income as earned or more generally defer tax until repatriation. We do not recommend a broad application of RFRM for offshore investment at this stage. However, we believe the current CFC and FIF rules to the extent applying to direct offshore investment require further consideration. They are an unhappy compromise and our sense is that there remains considerable dissatisfaction with the present position.

8.75 We have not reached a final recommendation on a regime, but we do suggest a way forward:

- we do not embrace the active/passive distinction with enthusiasm, because of its distortionary effect on offshore investment. If most other countries used a system that was similar to New Zealand's current system, we would not even consider the active/passive approach. So the only question is whether New Zealand needs to depart from sound economic principle, as a result of the effect of an international standard adopted by most other countries that is founded on an active/passive approach or an approach based on a broad list of qualifying countries excluded from income attribution;
- our suggestion is that the government engage in further dialogue with business interests to determine whether agreement can be reached on a broad outline of an active/passive approach. We believe an approach of the type outlined in Policy Option Two (attached in Annex F) be considered for purposes of this process;
- in the course of that dialogue, business interests will need to:
  - acknowledge that such an approach would require rules allocating, at the least, a portion of group interest expense to offshore investments and deferring or denying deductions in respect of such expense;
  - recognise that compliance costs and complexity arise with that approach and assess whether they are justified;
  - consider their attitude if in fact the passive/active approach results in greater tax for business interests than the status quo; and
  - when considering the design of a passive/active regime, be prepared to look beyond their own self-interest and co-operate in achieving a regime that emphasises national welfare; and
- in the course of that dialogue, IRD and the Treasury will need to address:
  - the significance of the distortion an active/passive regime would create in favour of offshore investment for those who remain New Zealand residents. It would be useful to understand whether other countries that have the regime have developed concerns about the extent of distortion, and whether the small range of investment opportunities in New Zealand creates greater concerns about a distortion towards offshore investment than in other countries;
  - the extent of any distortion in favour of offshore investment suggested by the see-saw principle;
  - if a regime of the type we suggest for taxation of inbound investment by non-residents is to be enacted, whether there are heightened concerns with introducing an active/passive regime on investment offshore by residents; and
  - whether New Zealand businesses should be concerned, in the absence of an active/passive regime, at their ability to compete in low-tax jurisdictions (Asia, in

particular) where investors from other countries obtain the benefit of tax deferral under an active/passive regime.

8.76 If progress of this type cannot be achieved, the only other suggestions we have are:

- to reduce the magnitude of this issue over time by reducing the company tax rate; and
- to consider whether the RFRM method can be introduced as an alternative method that can irrevocably be elected by the taxpayer under the CFC/FIF regimes. This would seem to alleviate tax treaty concerns – New Zealand taxpayers would not be denied credits by statute but, by electing the RFRM method, may not choose to claim them. The other issues outlined in our Issues Paper (Chapter Six) as regards a broader application of the RFRM method would need to be addressed before enacting this optional use of RFRM.

CHAPTER NINE
SAVINGS

Introduction

9.1 There has been considerable debate in recent years about whether New Zealand has a savings problem. There has also been debate about the appropriate tax treatment of savings. Since 1988, the policy has been to tax income from savings in the same way as other forms of income, such as business income.

9.2 We noted the following preliminary views in the Issues Paper:

- when looking at the impact of savings on the current and future well-being of New Zealanders, the most relevant measure is national savings; that is, the sum of private and government savings. On examining the available evidence and the reasons why people save, it was not clear to us that New Zealanders save too little;
- even if it were considered desirable for New Zealanders to save more, there is little evidence that changes to the tax system will induce higher saving, other than by redistributing income from those who are less likely to save (typically, poorer households) to those who are more likely to save (typically, wealthier households);
- the tax system will also influence the absolute level of saving to the extent it affects the level of national income. To this end, it is important to avoid introducing or exacerbating tax distortions that would result in lower-quality savings and investment choices; and
- while the risk free return method (RFRM) is not concessionary, it would potentially be more ‘savings friendly’ than current rules. Most significantly, it would only tax real, rather than nominal, returns to saving.

Submissions

9.3 A number of submissions disputed our conclusions. Others, however, agreed with us. The main points raised in submissions were:

- a number of submissions disputed the Review’s conclusion that New Zealand does not necessarily face a savings problem. None, however, cited any supporting evidence other than a claimed consensus among relevant experts that there is a problem;
- submissions also argued that tax concessions for saving could result in markedly higher private savings, thereby reducing the government’s future superannuation obligations. These submissions did not, however, make explicit the reasoning underpinning this argument;

- some submissions suggested we had placed insufficient emphasis on existing discrepancies in the tax treatment of different savings vehicles; and
- the question was raised whether New Zealand's persistent current account deficit could be taken as evidence of a savings problem. While it is a truism that, holding other things equal, the current account deficit would be smaller if national savings were larger, it must be remembered that the current account is the result of many influences. These include New Zealand's trading performance, which is, importantly, influenced by world prices; the shifting stance of monetary policy; and the desire of foreigners to invest in New Zealand (which must be accommodated by the current account). The fact that New Zealand's trend deficit last quarter was less than a third of the (record) level reached only eighteen months ago highlights the difficulty of using the current account as a policy guide.

Analysis and recommendations

9.4 We endorse the analysis and recommendations in the Issues Paper.

9.5 In reaching this conclusion, we have noted that there is little evidence that most New Zealanders are currently making inadequate provision for their retirement. New Zealand's system of universal superannuation cannot be ignored in this context; it seems reasonable to conclude that virtually all current recipients of New Zealand Superannuation who have a mortgage-free home and relatively modest savings consider themselves to have at least a medium standard of living.[1] It also seems reasonable to conclude that a substantial portion of the 5-10 percent of retirees who believe they have less than a medium standard of living would simply not have had any capacity to save much prior to retirement, irrespective of the level of incentives provided. We therefore take the view that, against the backdrop of universal provision of New Zealand Superannuation, most New Zealanders would not be well served by being induced or compelled to make additional retirement provision at the expense of living standards during their working lives.

9.6 We also note that higher private savings could lower the cost of New Zealand Superannuation only if a future government were to reintroduce income-testing or means-testing. But, by reducing the payoff to retirement saving, income-testing would by itself detract from incentives to make private provision for retirement. In this respect, the starting point in New Zealand is very different to that in countries such as Australia, which abate state-provided pensions against private retirement incomes. Countries that abate pensions have a compensating motive to provide savings incentives or to legislate for compulsory saving in an effort to offset the saving distortion resulting from abatement.

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1 See Ministry of Social Policy, *Living Standards of Older New Zealanders*, 2001.

ANNEX A
HOUSING

Questions and answers

Question 1 - Why did the Review raise this issue in its Issues Paper?

Our terms of reference state:

The Tax Review has been appointed to carry out a public review into the tax system so that the government has an appropriate framework within which to build tax policy.

The functions of the Review will be:

(a) to examine and inquire into the structure and effects of the present tax system in New Zealand;

(b) to formulate proposals for improving that system, either by way of making changes to the present system, abolishing any existing form of tax, or introducing new forms of tax;

We invited submissions on these terms of reference in December 2000. We received some submissions stating that the current tax treatment of owner-occupied housing needed addressing.

The OECD reported on the New Zealand economy in November 2000. It stated that housing investment was tax favoured in New Zealand and that this had resulted in a substantial over-investment in housing.

Question 2 - How does owners' equity in housing get a tax break?

People have to either rent or own their homes. Assume you rent a home that has a market value of say $200,000, and assume you will (typically) pay the landlord non-deductible annual rent of around $10,000, being around five percent of the market value of the home. Now, assuming you had $200,000 of your own money (equity), you could invest that at an interest rate of say five percent, and assuming a 33 percent tax rate, obtain an after-tax return of 3.35 percent. Alternatively, you could avoid the rent by buying your own home, and in effect obtain an after-tax return of five percent. So ignoring other factors, tax will encourage home investment.

Take another example. You borrow $100,000 at eight percent and use some personal equity to buy your own home. You then win a lottery of $100,000. As above, you could invest this prize for an after-tax interest return of 3.35 percent. Alternatively, you could avoid the non-deductible eight percent interest by paying off the mortgage: equating with an after-tax return of eight percent. Again, ignoring other factors, tax will encourage home investment.

The key point is that the tax system distorts these housing decisions.

Question 3 - Has this distortion actually altered the extent of owner occupied housing investment in New Zealand?

The OECD pointed out that the stock of New Zealand owner occupied houses is about 1.5 times that of other major OECD countries.[1] We estimate the New Zealand owner occupied housing stock at $125 billion. This translates into extra housing investment of approximately $40 billion. Such a surplus comprises c40 percent of GDP and c84 percent of all foreign direct investment in New Zealand.

Question 4 - How costly is the distortion?

If New Zealand has an extra investment of c$40 billion in housing stock, this could generate certain financial returns of c$1.6 billion, or c1.6 percent of GDP, assuming a riskless rate of return of four percent. This would be reduced by the loss of benefits from the surplus housing stock, which will arguably be smaller than its opportunity cost, because by definition, home investors will have directed that extra capital to superior investments on the basis of their individual non-tax distorted cost/benefit analyses.

Question 5 - Why single out houses as opposed to other private assets, such as vehicles and paintings?

The reason for focusing on housing is because of the relative materiality of the housing stock in New Zealand.

Question 6 - Do any other countries tax housing benefits?

Yes. There are nine European countries that do, including Sweden, Norway, Switzerland, and the Netherlands.

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1 OECD, 2000, OECD *Economic Surveys November 2000*: New Zealand, p 125.

Question 7 - Given that people have to live in houses, isn't the focus on who owns/finances the houses, rather than the actual quantity of houses?

The tax distortion explained above alters people's decisions about the amount they invest in houses, including the quantity of new houses that are built, housing upgrades and extensions, and whether they sell. It will also alter people's decisions about price brackets and which suburb they live in.

Question 8 - What about the fact that people buy or rent their houses out of their tax paid income?

People also fund investments in stocks and bonds out of post-tax income, but are still taxed on the income generated by those investments. Our income tax system focuses on the returns to assets rather than on how assets are created or acquired.

Question 9 - Even if there is a tax benefit for house ownership, isn't housing a good thing that should be encouraged?

We have simply noted that as a result of the tax system, in the aggregate people make different housing decisions than they otherwise would. This is not to say that houses are bad, nor is it to say that a tax incentive should be given to housing.

Question 10 - What about the fact that some people use their house to secure finance for their businesses?

The issue is not that houses produce benefits, whether by way of accommodation or assisting the raising of capital. We know that houses produce benefits, including any over-investment in housing. The issue simply is that the tax system changes housing decisions. In the absence of tax considerations, some people will rightly factor the ability to raise finance for their businesses into the decision to buy their house.

Question 11 - What about the argument that if there is a housing benefit, it will have caused house prices to rise, such that people who now buy their houses actually get no such tax benefit because they pay a higher price?

We agree that part of the tax concession will get capitalised into house prices to thereby erode the tax benefit accruing to marginal (late) home buyers. However, in the long term, the supply of housing is highly elastic, such that marginal home buyers will still capture material tax benefits. The land upon which houses are built is in fixed supply so that tax benefits arising on this part of the housing asset will be capitalised into land value. Furthermore, even where there is such a capitalisation process, there are still two negative economic effects. First, house prices are artificially higher than they would otherwise be as a result of the impounded tax benefit. Secondly, the country has a higher housing stock than it would otherwise have.

Question 12 - The Issues Paper states that the current concession is regressive. What does that mean?

As explained above, the tax benefit attaches to home equity. It does not attach to the debt component of homes because of the non-deductibility of related interest. Nor does it attach to those who pay rent. Poorer people typically have mortgages or rent their homes. As also mentioned, the tax concession artificially inflates house prices, which makes it harder for poorer people to buy homes. Accordingly, the current tax treatment favours richer people.

Question 13 - What about the fact that people do not get a cash-flow from their house?

The absence of a cash flow from the house is a problem that we raised and said required further consideration. We also discussed some possible approaches, such as a staged implementation or a roll up of tax liability. To give an order of magnitude, under an RFRM approach, and assuming a 25 percent average tax rate and an RFRM rate of return of four percent, every $100,000 of home equity would promote an annual tax liability of $1,000.

Question 14 - What about the fact that people already pay rates on their home?

Local government rates are a means of collecting prices from households for services provided to them. We accept, however, that house values is a poor proxy for services consumed but it is true that the rating base was developed for this purpose. Some submissions drew attention to the use, in many parts of New Zealand, of the capital rather than unimproved value as the basis of rating. We acknowledge that this form of rating discourages property improvement. However, it does so across the board, both among those who are paying off a mortgage, among those who own their own homes outright, and among those investing in rental properties. A rational approach would broaden the income tax base to include income derived directly by owner-occupiers from housing equity, along the lines we have suggested, while at the same time encouraging local governments to return to rating systems based on unimproved values.

Question 15 - What did you actually recommend in the Issues Paper and what has the Review actually recommended?

We put the matter up for public discussion in the Issues Paper. The OECD had reported on the New Zealand economy in November 2000 and recommended a tax on the imputed benefits from housing. It stated that housing investment was tax favoured in New Zealand and that that had resulted in a substantial over-investment in housing. We stated our disagreement with the OECD’s proposed method of dealing with this issue. We also said that any such tax would be conditional on it being applied to income tax reductions. We estimated the house tax base to be around c$750 million.

The public reaction was overwhelmingly negative. No government is therefore likely to be able to get a public mandate to implement such a measure at this point. At the same time, the Review has raised the profile and understanding of this important issue.

ANNEX B
CASH-FLOW TAXATION

Cash-flow taxation

Introduction

B.1 The Review considered the proposal to convert business income taxation to a cash-flow tax basis. The fundamental objective of this reform is to remove the wedge between gross-of-tax and net-of-tax rates of return created by existing capital income taxation.

B.2 In principle, this wedge could be removed by abolishing the corporate income tax while exempting income from capital earned by unincorporated enterprises and income earned by individuals on their savings. However, that approach would involve a substantial revenue cost and would require complicated rules to distinguish exempt capital income from taxable labour income arising in closely-held companies and unincorporated enterprises.

Advantages of cash-flow taxation

B.3 By contrast, the conversion of capital income taxation to a cash flow-basis offers the prospect of taxing, in perpetuity, income attributable to the existing capital stock (while exempting that arising from net additions to the capital stock).

B.4 Business income taxation on a cash-flow basis would simultaneously buttress the taxation of labour income by preventing its recharacterisation as (untaxed) income from capital.

B.5 Unlike exemption of capital income, a cash-flow tax should preserve the significant tax revenues collected from existing investments in New Zealand by non-residents, while exempting returns on new investment.

B.6 Private saving should be encouraged under a cash-flow tax since savers will receive tax-free rates of return on all forms of new saving.

B.7 A particular attraction of the cash-flow tax is that it would greatly simplify the measurement of business income by:

- removing the need for depreciation rules, trading stock rules and the accruals regime;
- removing definitional problems at the capital/revenue boundary and the need for complex timing rules governing the recognition of income and the spreading of expense; and
- correcting investment biases in favour of important areas such as forestry and housing, which are tax-favoured under existing income tax rules.

B.8 Unlike the conventional economic income tax, a cash-flow tax does not require indexation to avoid taxation of purely inflationary gains.

The R-base cash-flow tax

B.9 While alternative forms of cash-flow tax are possible, the one most frequently discussed is the so-called R-base tax.[1]

B.10 Under the R-base tax:

- depreciation deductions and other capital allowances would be replaced by expensing; that is, by immediate deductibility of outlays on capital acquisitions;
- trading stock rules would be replaced by deductibility for acquisitions;
- revenues from all sales, <u>including those from sales of capital assets</u>, would be included in the tax base; and
- deductions for interest and similar financing costs would be abolished and interest receipts would not be taxed in the hands of lenders.

B.11 At the level of the firm, an R-base cash-flow tax would therefore look rather like the GST but with a deduction for wages paid.[2]

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1 An alternative is the (R+F)-base cash-flow tax. Under this tax, cash-flow treatment is extended to debt financing transactions (borrowings and interest received are assessable, debt repayment and interest paid are deductible). The Meade Report (*The Structure and Reform of Direct Taxation*, Institute for Fiscal Studies, 1978) and David F. Bradford, *Untangling The Income Tax*, Harvard University Press, 1986, discuss both forms of tax. These sources do not explicitly discuss issues raised by the transition to these taxes.

2 In contrast to the GST, export sales would not be zero rated, while imported inputs would be deductible against the tax. Under the cash-flow tax, deductions are allowed for input costs independently of evidence of input tax payments.

B.12 Dividend exemption, rather than imputation would provide the most appropriate means of integrating corporate and shareholder taxation under a cash-flow tax.[3] While the corporate cash-flow tax could also be a final tax for foreign equity investors, the option of retaining non-resident dividend withholding taxes might be considered.

B.13 Under the cash-flow tax, losses should be cashed out, or otherwise carried forward with interest at a deemed riskless real rate of return.

Investment neutrality

B.14 For a marginal investment, an R-base cash-flow tax is equivalent to the exemption of capital income from tax. Because a marginal investment has the present value of its subsequent net cash flows equal to its initial cost, taxation of those net cash flows at the same rate that an immediate deduction is provided for the cost of the investment will leave investment decisions unaffected.

B.15 This can be seen by considering a real investment whose net cash flows, when capitalised at a pre-tax rate of return, have a present value of $100. This investment will be marginal for a zero-rate taxpayer if its cost is $100. Under the cash-flow tax, taxpayers on a tax rate of 33 percent (and using the same discount rate as the zero-rate taxpayer since interest is non-assessable and non-deductible) would value the post-tax cash flows at only $67. However, the investment would also be marginal for these investors since, for them, the post-tax cost will be reduced from $100 to $67 once account is taken of the tax value of the immediate deduction available for the cost of the investment. In the same way, investors on a tax rate of 20 percent will value the post-tax cash flows at $80 but will need to contribute only $80 of its $100 cost once account is taken of the tax value to them of the deduction of the cost of the investment.

B.16 Under the cash-flow tax, the government effectively subscribes a (tax-rate-determined) fraction of any real investment and takes a corresponding fraction of subsequent net cash flows, including the cash flows arising whenever real assets are on-sold. The higher the investor's tax rate, the larger the government's equity participation.

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3 To see this, consider the situation of an individual on a 20 percent tax rate with the option of investing in real assets valued at $100 either directly or through a corporate entity. Assume that the gross-of-tax rate of return is 10 percent per annum and that the company tax rate is 33 percent. After taking into account the immediate tax deduction provided by expensing, the direct investment option requires an outlay of $80 for a post-tax stream of income of $8 per annum. Acquisition of the same real asset via investment in corporate equity would require an outlay of only $67 (after taking account of the 33 percent deduction available to the corporation) and would provide post tax returns of $6.70 per annum if dividends are exempt. In each case, the return received by the investor is equal to the gross-of-tax rate of return of 10 percent per annum. By contrast, an imputation regime would inappropriately provide an up-front investment deduction at the company tax rate for an investment whose subsequent net cash flows would ultimately be taxed in the shareholder's hands at a 20 percent tax rate.

B.17 It may be noted that:

- investment incentives (for unincorporated enterprises) under a cash-flow tax can be distorted by a marginal rate progression under the personal tax scale;
- unexpected changes in rate of cash-flow tax will produce windfall capital gains and losses; and
- anticipated changes in tax rates will distort the timing of investment decisions;
- a cash-flow tax would require special rules to govern sales of on-going businesses between taxpayers on different tax rates (and to parties outside the tax base); and
- because interest is non-assessable and non-deductible, an R-base cash-flow tax would not succeed in taxing the existing capital base of financial institutions (whose gross revenues are substantially derived from the margin between lending and borrowing rates).

Corporate asset valuation

B.18 Under an R-base cash-flow tax, financial assets, such as corporate equity and all forms of debt, are not ’qualifying assets’ and therefore do not receive cash-flow tax treatment. Unlike real assets, they do not receive expensing. Correspondingly, all cash flows returned from such assets are exempt in the hands of shareholders and those who subscribe to debt.

B.19 This implies that under an R-base cash-flow tax, fully equity-financed corporations are expected to sell at a corporate tax-rate-determined discount to their real asset backing. From a balance sheet perspective, this discount is accounted for by the present value of the company’s future cash-flow tax liabilities (equal to the product of the company tax rate and the market value of those real assets).[4] For debt-financed corporations, the combined market value of debt and equity plus the present value of future cash-flow tax liabilities will tend to equal real asset backing.

B.20 For corporate enterprises formed after the introduction of a cash-flow tax, this valuation discrepancy reflects the implicit equity contribution provided by the government in the form of up-front expensing deductions for real capital acquisitions. For corporations in existence at the time the cash-flow tax is introduced, it reflects also the present value of the government’s tax claim on the future cash flows attributable to the real capital stock existing at the time of the transition.[5]

B.21 Despite its many attractions, the cash-flow tax poses a number of apparently intractable problems, both in respect of the transition to such tax and on an on-going basis.

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4 Notice that liquidation of the corporation would subject sales of physical and intangible assets to cash-flow tax at 33 percent, leaving only $67 of every $100 available for distribution to creditors and shareholders. Under the income tax, most liquidating distributions can be made free of tax.

5 Under an economic income tax that is imputed to ultimate shareholders, such tax valuation effects are removed as shareholders on higher tax rates capitalise lower post-tax cash flows (after deduction of economic depreciation) at lower post-tax rates of interest (recall that interest is assessable and deductible under an income tax but not under the cash-flow tax).

Transitional problems

B.22 The implications of the transition to an R-base cash-flow tax can be illustrated by assuming that pre-tax cash flows and pre-tax rates of interest remain unchanged.[6] Because the taxation of interest receipts is removed by the transition to cash-flow taxation, assets must be revalued after the transition so that they provide their owners with after-tax rates of return equal to those formerly available pre-tax.

Asset Valuation

B.23 On these assumptions, the market prices of real assets that are not tax-favoured by current income tax rules can be expected to remain essentially unchanged at the time of transition. After the transition, although taxpayers will place a lower value on the discounted cash flows of real assets the higher their tax rate, the correspondingly larger expensing deductions available to higher bracket taxpayers when they acquire such assets will ensure equal (and essentially unchanged) asset valuations.[7] Downward pressure on the market prices of real assets should therefore be avoided.[8]

B.24 It is important to notice that although the market prices of existing real assets are not expected to fall, those who realise such assets for purposes of consumption will face a net cash-flow tax penalty. Such asset realisations would have been exempt under the income tax.[9] In aggregate terms, this wealth effect is captured by the fall in the discounted cash flows of existing real assets and is an unavoidable implication of a switch to cash-flow taxation.

B.25 A particular problem of the transition to an R-base cash-flow tax is that this tax penalty is not even-handedly distributed across those who own debt and equity claims on the real capital stock.

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6 Though these assumptions are adopted for purposes of illustration, it is reasonable to assume that in a closed economy pre-tax interest rates will be related to marginal yields on the existing capital stock. In the short-term, pre-tax interest rates would therefore be expected to stay unchanged with post-tax returns rising as interest income is removed from the tax base. In an open economy, such as New Zealand, that levies very small net non-resident interest withholding taxes, it is again reasonable to assume that post-tax interest rates will rise.

7 Paragraph B.15 describes real asset valuation under a cash-flow tax.

8 By contrast, the prices of real assets that are tax-favoured by current income measurement rules can be expected to fall below their replacement cost, pending the rebalancing, over time, of the proportion of the capital stock invested in these assets. Similarly, real assets for which offshore interests are marginal investors might rise in price across the transition.

9 Note that taxpayers switching between real assets (of equivalent value) will face no net cash-flow tax liability. For taxpayers switching from real into financial assets (for example, debt), the lower net price realised after application of the cash-flow tax (and the lower amount thus available to be on-lent) will be compensated by the absence of taxation of interest received under the cash-flow tax (until the time when these assets are realised for consumption). Taxpayers with a sufficiently distant consumption horizon will gain from the tax switch.

B.26 The accruals rules aim to ensure that the income tax treatment of debt instruments does not systematically alter their valuation, regardless of the time pattern of cash flows that such assets provide or the tax rates to which taxpayers are subject. Because all financial cash flows are exempt under an R-base cash-flow tax, it can be expected that the market values of debt instruments will be unaffected by the transition to a cash-flow tax.

B.27 As noted above, under cash-flow taxation, companies will be valued at a corporate tax-rate-determined discount to their asset backing. At a 33 percent company tax rate, the market value of a fully equity-financed company would be expected to fall to 67 percent of its former value at the time of the transition. This impact on corporate equity values subjects shareholders (who suffer no direct cash-flow tax liability when they sell their shares to finance consumption) to the same wealth effects as experienced by those holding real assets directly in unincorporated businesses.

B.28 The proportional fall in the equity value of companies financed partly by debt will be correspondingly larger. At a 33 percent company tax rate, companies geared to the extent of more than 67 percent of the value of their real assets at the time of the transition could expect to see the value of their equity drop towards zero. These consequences replicate for equity holders in geared firms the consequences of transition for owners of unincorporated enterprises who have borrowed to acquire real assets.

B.29 In short, in the switch to an R-base cash-flow tax, the total wealth effects of the transition (which are related to the size of the real capital stock) are concentrated entirely upon equity owners. Holders of debt will suffer no loss in wealth and so unambiguously gain from the removal of the taxation of interest.

Impact on Post-Tax Cash Flows

B.30 These strongly asymmetrical impacts can also be seen by looking at the implications of a switch to cash-flow taxation for the after-tax cash flows of businesses.

B.31 While businesses will be taxed as now on their sales receipts and would receive the same deductions for current expenses, they would lose existing depreciation deductions. In return, they would receive immediate write-off for new capital expenditure and for replacement investment. While the cash-flow consequences of immediate write-off for replacement investment should broadly balance the loss of depreciation deductions at the level of the economy as a whole, the impact at the level of the individual firm will depend on the composition of its capital stock.[10]

B.32 Moreover, with the move to a cash-flow tax, firms would lose interest deductibility in respect of their existing borrowings, while lenders would no longer be taxed on their

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10 Consider two, otherwise identical, fully equity-financed airlines. At the time of the transition, one of them has recently scrapped its aircraft and acquired a new fleet and the other is about to do the same. Shareholders in the latter airline will almost entirely avoid the wealth consequences of the transition (provided that its sinking fund financial reserves are not held as equity in other enterprises).

interest receipts. The severe cash-flow difficulties that will confront those holding heavily debt-financed real assets is a consequence of the transfer from bond holders to equity investors of the former's share of the aggregate tax flow of tax revenue collected from the real capital stock existing at the time of the switch to an R-base cash-flow tax.[11]

B.33 It is sometimes suggested that the asymmetric treatment of debt and equity interests at the time of the transition could be dealt with through a forced renegotiation of existing fixed-interest debt contracts. Difficult (if not impossible) as this would be to achieve, the suggestion misconstrues the problem. Even those businesses borrowing at variable interest rates, or whose debt is due to be refinanced at the time of the transition, cannot expect to find the interest rates at which they can borrow to be lower as a result of the move to a cash-flow tax.

B.34 The Meade Report[12] examined an R-base cash-flow tax that preserves deductibility and assessability of interest payments at an assumed 'uniform' tax rate equal to the corporate rate (non-resident interest withholding tax would also need to be charged at this rate).

B.35 This proposal, though providing temporary relief for those who have borrowed on fixed terms, would not provide a long-term solution to their difficulties. This follows because, under an R-base cash-flow tax, *universal* deductibility and assessability of interest at a single standard tax rate would raise pre-tax interest rates by the amount required (the reciprocal of one minus the tax rate) to ensure exactly the same post-tax interest rates as would apply when interest is non-assessable and non-deductible.[13] Accordingly, the cash-flow difficulties faced by debt financed firms would become apparent as soon as existing fixed interest contracts required refinancing.

'Announcement Effects'

B.36 In consequence of the asymmetrical wealth transfers of a surprise transition to a cash-flow tax, it must be expected that severe 'announcement effects' would be created by a pre-announced tax switch. Debt finance prior to the date of the transition is obviously to

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[11] This transfer is avoided under the switch to an (R+F)-base tax because this tax retains existing flows of tax only in respect of that fraction of the capital stock that was equity financed prior to the switch. While this ameliorates the discrimination between those providing debt and equity finance (at considerable cost to government revenue), it does not remove it. Under the (R+F)-base tax, bondholders are explicitly given 'free entry' into the cash-flow tax regime rather than acquiring it at the expense of equity holders. The incentive to hold debt instruments rather than equity at the time of the switch remains.

[12] *The Structure and Reform Direct Taxation*, Institute for Fiscal Studies, 1978, pp155-156.

[13] Besides not solving the problems faced by geared investors who lose their interest deductions at the time of the transition, this approach lacks transparency since post-tax interest rates would now equal the pre-tax (risk-adjusted) yield on real assets. Accordingly, interest deductibility would need to be extended to borrowers (such as those borrowing to invest in owner-occupied housing) who do not enjoy it under present tax rules, in order to leave them in the same position. The tax treatment of non-resident lenders would be incompatible with the letter (though not the spirit) of existing international double tax treaties. Finally, the proposal would only be neutral in its impact on effective interest rates if all taxpayers faced the same tax rate.

be avoided by firms (and equity holders) but will be a strongly preferred asset for investors.[14]

B.37 More fundamentally, given the levels of existing corporate and personal tax rates, many taxpayers would have a large incentive, prior to the transition, to move existing real assets into the hands of entities outside the tax base (or to those within the tax base but on low tax rates), since they could then obtain the benefit of expensing deductions after the transition (thus effectively receiving 'new capital' tax treatment for what is effectively 'old capital').

On-going revenue risks

B.38 In addition, a cash-flow tax would create on-going revenue risks. By allowing immediate deductibility for new investment, the government would in effect provide almost a third of the total capital to new corporate ventures (and a still larger proportion of total equity finance in ventures partially financed by debt) without exercising any control and with uncertainty over whether taxable cash flows would materialise in future years.

B.39 Experience has shown that immediate deductibility for investment outlays can create severe revenue risks, particularly when the assets for which deductions are claimed are difficult to value and are acquired from parties outside the tax base (or on lower tax rates than those claiming the deductions). Foreign firms could undertake investments in New Zealand, creating losses through their initial capital outlays, and structuring their affairs so that future cash flows were received in other jurisdictions.

B.40 The Review does not see a case for moving business income taxation to a cash-flow basis, due to the difficult transitional problems involved and the on-going risks posed by immediate deductibility of capital expenditures. Despite attracting considerable interest in certain jurisdictions (compare the Hall-Rabushka proposal in the US), such a regime is as yet untried, providing little international experience of the potential compliance and administrative costs involved, the full range of opportunities for tax avoidance, and thus the ultimate effect on revenue.

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14 While announcement effects can be expected in any move towards 'consumption' taxation, the introduction of a business cash-flow tax presents an unusually large range of opportunities to escape the incidence of the tax. At the same time, the rates at which the tax would apply offers large incentives to take advantage of these opportunities.

ANNEX C
CARBON TAXATION

Introduction

C.1 The context for the Review's examination of the merits of carbon taxes has three distinct elements:

- New Zealand's unique greenhouse gas profile and emission trends;
- the evolving terms and conditions of the Kyoto Protocol; and
- New Zealand policy development on the implementation of the Kyoto Protocol.

C.2 These matters require updating in light of recent developments. In addition, the Review has considered studies referred to us by officials. This Annex also responds to key questions and issues raised by submissions on the Issues Paper.

C.3 A key aspect of New Zealand's climate change policy is the commitment not to use the carbon sink credits to shield emitters.

C.4 This policy has led to the 'in principle' decision to make (an unspecified fraction of) Kyoto forest credits available to the owners of these forests (or to landowners) and to allow most or all of these credits to be traded internationally. Accordingly, the discussion below is focussed primarily on the non-forestry sector. As noted in the Issues Paper, forestry could, alternatively, be included in a carbon tax regime, by making carbon sequestration subsidies available to owners of Kyoto forests and taxing land use change out of forestry (at carbon tax-equivalent rates).

Update

Forecast New Zealand emissions

C.5 Officials have advised the Review that they have revised estimates of New Zealand business-as-usual emissions during the first Kyoto commitment period (2008-2012).

C.6 CO_2 emissions are still forecast to be around 39 percent above 1990 levels. However, whereas emissions of methane and nitrous oxide, primarily from agriculture, were previously forecast to fall by 8 percent for methane and 3 percent for nitrous oxide, aggregate non-CO_2 emissions now have a 2010 forecast range of 0 to 20 percent above 1990 values.[1]

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1 This increase in forecasts is driven by rising stock numbers and also by increases in estimated New Zealand emissions of both methane and nitrous oxide per animal due to improved animal performance.

C.7 At the illustrative international price of carbon credits of $50/tC used in the Issues Paper, this raises New Zealand excess emissions (excluding Kyoto forest credits) at unchanged behaviour from the previously estimated $90 million per annum to a range of $130-180 million per annum.[2]

The Kyoto protocol

C.8 The recent Bonn meeting (COP6 Part II, 16-27 July 2001) prepared the way for ratification of the Kyoto Protocol to proceed without the US.[3] Finalisation of legal drafting is planned for COP7 at Marrakech (29 October-9 November 2001).

C.9 Significant decisions at Bonn include caps on the amount parties can allow to be traded out of their national registries (amounts in these registries cannot fall below the lower of 90 percent of Initial Assigned Amount or 100 percent of five times[4] the most recently reviewed inventory) and provision for significant additional allocations of credits in respect of pre-Kyoto forestry and land use change. It now appears that the Protocol may not include legally binding sanctions since these are opposed by Australia, Russia and Japan.

C.10 The global warming that would be prevented by 2050 if all countries were to meet their original Kyoto targets in the first commitment period (and then stabilise their emissions from that point) has been estimated to be of the order of 0.07°C.[5] Without US participation, this figure will now be much lower again. The gross disparity between what even full compliance with Kyoto targets could achieve and the difficulties that can be expected in decoupling greenhouse gas emissions from economic growth with currently available technologies, has undoubtedly influenced the US decision not to ratify the Kyoto Protocol.

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2 At a price of $50/tC, Kyoto forest credits were estimated to be worth about $355 million per annum in the first commitment period, but this may be reduced by new accounting methodologies proposed in Bonn.

3 The Kyoto Protocol comes into force only after ratification by 55 nations, including Annex B nations that accounted for 55 percent of Annex B emissions in 1990. The Clinton Administration had indicated that it would not submit the Kyoto Protocol to the US Senate for ratification unless it met the Senate's 1997 precondition of meaningful participation by developing countries. The Bush Administration has announced that it will not seek ratification of the Kyoto Protocol, citing the requirement to cut domestic emissions by 30 percent on business-as-usual projections as too stringent and the availability of Eastern European "hot air" credits as too uncertain. The world's five largest emitters are the US (23 percent), China (14 percent), Russia (8 percent), Japan (5 percent) and India (4 percent). China and India do not have Kyoto commitments. Ratification by both Russia and Japan is necessary for the Protocol to come into force.

4 The factor five accounts for the five-year commitment period.

5 See Wigley T.M.I, "The Kyoto Protocol: CO_2, CH_4 and climate implications", *Geophysical Research Letters*, Vol. 25, July 1, 1998. Wigley concluded that: *"The Protocol, therefore, even when extended as here, can be considered as only a first and relatively small step towards stabilising the climate. The influence of the Protocol would, furthermore be undetectable for many decades"* p 2288. On Wigley's estimates, global warming prevented by Kyoto could not be reliably detected by ground-based thermometers and is of the same order of magnitude as the margin of error (0.01°C) in satellite measurements. Global warming prevented, after 100 years by permanent adherence to the original Kyoto targets, is estimated by Wigley at only around 0.14°C.

International carbon prices

C.11 The probable impact of recent Kyoto developments is to reduce the anticipated price of carbon emission credits during the first commitment period. The withdrawal of the US and modifications to articles 3.3 and 3.4 of the Protocol significantly reduce net demand for these credits. Against this, US support for trading as a mechanism has also been removed and further pressures on the availability of Eastern European "hot air" credits might be expected.[6]

C.12 On balance, it appears that the Review's indicative figure for these credits of NZ$50/tC is now at the high (rather than the low) end of the range (but has been retained for the illustrative calculations in this report).[7]

C.13 However, many sources of uncertainty remain to be resolved. International carbon prices could conceivably turn out to be much higher if compliance with Kyoto targets by major Annex I countries is poor, and if EE/FSU credits turn out not to be available or are in part withheld from world markets. It is also possible that a lack of commitment to international emissions trading by large emitters could prevent the emergence of a broad international market.

Economic impacts of a carbon tax

C.14 The Review has been provided with a recent study of the impact of a carbon tax commissioned by the Pre-2008 Cross-Sectoral and Price Measure Working Group of the New Zealand Climate Change Program.[8]

C.15 In this study, carbon charges of $10, $30 and $50/tC were modelled, with most runs using $30/tC. This level of carbon charge generates reductions in CO_2 emissions of around 3 percent, rising to about 5 percent at $50/tC.

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6 These "hot air" credits arise because estimated business-as-usual emissions in 2010 for Eastern European and Former Soviet Union (EE/FSU) countries are estimated at 250-430MtC per annum below their Kyoto targets. The upper end of this range is little different from excess emissions forecast for Annex I countries excluding the US and the EE/FSU. Availability of the EE/FSU credits will be conditional on international approval of national inventories and reporting systems developed by these countries. An early post-Bonn estimate of the implied price of carbon credits in 2010 of $US15($NZ37)/tC is derived in Nordhaus W.D. *The Economics of the Kyoto-Bonn Accord* (compared to an estimate of $US55($NZ134)/tC with US participation). The Nordhaus estimate makes no allowance for the (up to) 55MtC additional carbon sink credits agreed in Bonn.

7 The figure of $NZ50/tC used in the Issues Paper translates into increased retail prices of around 3.3c/litre of petrol, 0.7c/kWh for residential electricity, $32/tonne of coal and 2.7c/m^3 of natural gas, and carbon charges of $5.60, $25 and $37 per annum for sheep, beef and dairy animals. The fuel and energy price estimates are based on Ministry for the Environment, *Paper for Tax Review: Environmental Taxes*. The estimates for agriculture are based on emissions factors quoted in *Managing Greenhouse Gas Emissions: The Agriculture Sector*, Emissions Trading Working Group, May 2001, pp7-8 and allow for nitrous oxide as well as methane emissions.

8 *The Economic Effects of Low-level Carbon Charges*, Infometrics Consulting, June 2001. Earlier studies commissioned by the government include *International Climate Change Policy; Economic Implications for New Zealand*, Stephen Brown, ABARE, July 1997, and *Impacts on the New Zealand economy of commitments for abatement of carbon dioxide emissions*, Centre for International Economics, Canberra and Sydney, November 1997.

C.16 While impacts on most industries are minor, energy and energy intensive sectors experience marked declines in gross output. These sectors include coal mining, petroleum, electricity generation (especially from fossil fuels), iron and steel, aluminium and other metals, paper and printing. For some industries (cement and wood processing, provide examples), there are questions over how accurately the model captures likely impacts upon them.

C.17 Significant expansions of agricultural output are noted that will reduce the reduction in aggregate greenhouse emissions. Evaluation of impacts on non-CO_2 greenhouse gases were not requested by the report's Terms of Reference and were not reported. As noted in the Issues Paper, the pattern of inter-sectoral adjustment, which arises when the agricultural sector is also exposed to international carbon prices, does not yet appear to have been examined.

C.18 Various revenue-recycling options were examined and, except where these involve reductions in narrowly-based taxes such as the general revenue component of petrol excise, their industry impacts are broadly similar. Macro-economic impacts of the revenue recycling options are recognised to be highly dependent on the (essentially arbitrary) labour market and external account closures assumed by the model. The Review does not consider comparison of these options to provide a reliable guide to desirable directions of tax reform.

C.19 The small aggregate emissions reductions emerging from this study support the conventional view that New Zealand's low-cost CO_2 emissions abatement opportunities are very limited. The study confirms the view that, at likely international carbon credit prices, New Zealand's least cost option will be the purchase of carbon credits to cover a large fraction of its excess emissions (exclusive of forestry).

Domestic policy directions

C.20 Domestic policy development has focused on a domestic carbon emissions trading regime to be integrated into a regime of international emissions trading by legal entities. Sectoral consultations in the first half of this year on potential emissions trading points of obligation emphasised the many critical aspects of policy design that remain to be finalised.

Carbon Credit Allocation

C.21 For instance, the extent to which New Zealand carbon credits (Assigned Amount Units[9] or AAUs) allocated under a domestic/international carbon-trading scheme to legal entities would be grand-parented (rather than auctioned), and to whom, has not been agreed. At the illustrative price of carbon of $50/tC used in the Issues Paper, the annual

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9 Assigned Amount Units are the proposed Kyoto emissions trading unit and represent one tonne of CO_2 (or CO_2-equivalent) emissions (=12/44 tonnes of carbon).

value of New Zealand's Initial Allocated Amount (19.9MtC per annum) is of the order of $1 billion per annum or $5 billion for the first commitment period. No agreed equitable basis for allocation of this sum appears to have been developed.

C.22 It can be expected that in the transport and energy sectors the (cash or opportunity) costs of AAUs will be substantially passed forward into prices. In some sectors, the increase in total costs to firms and consumers will exceed the value of emissions units (electricity generation provides an example). While in many circumstances the case for auctioning AAUs is therefore strong, the question of AAU allocation is likely to be highly divisive.

C.23 It will be difficult to conduct effective auctions until key aspects of the domestic and international emissions trading regimes have been determined. Moreover, unless effective domestic monitoring and compliance regimes can be devised, AAUs will have little value. For this reason, and because auction values will be difficult to predict until closer to the first commitment period, the revenue potential of a program of early sale needed to underpin forward trading of AAUs will be highly uncertain.

Forestry

C.24 In forestry, while all conversions of land from forestry add to New Zealand's carbon emissions, and will presumably be required to be covered by carbon credits (or be liable for carbon tax), there is a stark contrast between the situation of owners of Kyoto forests, who receive credits for carbon sequestered in the first commitment period, and owners of pre-Kyoto forests, who receive no credits. The government has made an 'in principle' decision that forestry credits will be internationally tradable and that owners will receive an unspecified portion of these credits. The decision to allow these Kyoto credits to flow through to owners would appear consistent with a decision to auction AAUs (or impose a carbon tax) in other sectors.

C.25 Significant compliance cost issues are, however, likely to arise in forestry since it is believed that most Kyoto forests are of small size and are owned by private landowners and syndicate investors.[10] Carbon credit allocation and trading is therefore likely to have high monitoring and compliance costs in this sector. In view of these costs, it has been suggested that owners of Kyoto forests be allowed to opt out of this system for the first commitment period. Note, however, that at the recent Bonn meeting, New Zealand secured international agreement that liability for Kyoto forests that are not replanted will be limited to carbon credits that accrue in the first commitment period. If this concession flows through to Kyoto forest owners, it should attenuate incentives to maintain these forests beyond the first commitment period.

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10 See *Forest Sinks and the Kyoto Protocol, An Information Document*, New Zealand Climate Change Program, June 2001.

Agriculture

C.26 In agriculture, it has been mooted that industry-level bodies might be established across broad agricultural sectors, that these be allocated AAUs and that they be required to levy farmers to recover the costs of *excess* emissions.[11]

C.27 It has been suggested to be an advantage that: "*a levy to cover only excess emissions would cost much less per unit of output than the full cost of all emissions and hence would have less effect on competitiveness*".[12] It has been further suggested that to avoid any risk that "*such a system could create incentives to reduce stock numbers and output in order to free up emission units for sale ... the government could make the initial allocation of emission units non-transferable*.[13]

C.28 Such schemes appear to be calculated to ensure that producers in these sectors do not face the same marginal cost of emissions abatement as other sectors, instead (at best) exposing stocking decisions to a fraction of the international price of carbon.

C.29 These schemes are unlikely to result in efficient abatement incentives between sectors and may well generate perverse incentives within the agricultural sector. Indeed, under rules of this sort, if falling stock numbers were to provide a sector with excess credits, farmers could face a financial incentive to increase stock numbers, and thus measured emissions, notwithstanding the substantial cost of these emissions at the national level.

Compliance Costs

C.30 There are grounds for concern about the scale of monitoring costs that could be implied by some forms of emissions trading.

C.31 The legal obligation to surrender emissions units will closely resemble the responsibility to pay taxes and will require some basis of verification under audit. Under either a tax or emissions-trading regime, there will be very strong compliance cost grounds for placing the point of obligation or tax for fossil fuels at the point of importation or production.[14] Hybrid schemes with multiple points of obligation are likely to involve very high compliance costs.[15]

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11 See *Managing Greenhouse Gas Emissions: The Agriculture Sector*, Emissions Trading Working Group, May 2001, pp7-8.

12 *Op cit*, p 7.

13 *Op cit*, p 8.

14 The virtual necessity of upstream points of obligation is emphasised in a recent US CBO study. See *An Evaluation of Cap-And-Trade Programs for Reducing Carbon Emissions*, Congressional Budget Office, June 2001.

15 Compare the scheme of multiple points of obligation canvassed in *Technical Design Issues for a Domestic Emissions Trading Regime for Greenhouse Gases*, Ministry for the Environment, August 1998, p 37.

C.32 The important objective of basing the national greenhouse inventory on 'sound science' may be moving such accounting ahead of feasible schemes of emissions monitoring (or carbon taxation).[16] Since records of carbon tax paid (or emissions units surrendered) are likely to form the core of any national emissions reporting system, there are strong practical reasons to integrate the design of New Zealand's emissions accounting and emissions trading (or carbon taxation) mechanisms.

C.33 Compliance costs are likely to be lowest under systems closely integrated with existing systems of tax administration.

Risks in Emissions Trading

C.34 For a domestic emissions trading regime, coupled to international carbon credit trading by legal entities, to work well, major countries must establish and demonstrate a strong commitment to similar regimes.

C.35 EU commitment to international carbon credit trading remains in doubt. If major countries fail to adopt policies that effectively restrain their emissions, and if access to EE/FSU credits is restricted, very high international carbon prices could result in countries that have pre-committed to emissions trading. At that point, such a commitment could pose severe risks for the New Zealand economy for which no obvious remedies will exist.

Pre-Kyoto policy

C.36 There has been considerable discussion of broad-based policy measures that might be adopted prior to the first commitment period. The government intends replacing the previous Voluntary Agreements (that expired in December 2000) with a series of Negotiated Greenhouse Agreements (NGAs) committing signatories to undertake or support greenhouse gas emission reductions in the pre-Kyoto period. A vital question has been whether a low-level carbon tax should simultaneously be used to provide pre-2008 incentives for emissions reduction to affected parties not covered by NGAs.

'Investment Myopia'

C.37 It has been argued that in the absence of a pre-Kyoto carbon tax, so-called 'myopic' agents (outside NGAs) may make long-lived investment decisions that are insufficiently attuned to the likelihood of increased energy prices in the first commitment period.

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16 Emissions (of NO_x and CO_2 as well as SO_2) by US fossil fuel power plants participating in SO_2 emissions trading are monitored by certified equipment, with results electronically reported on a quarterly basis. This model could only be applied to a very small proportion of New Zealand greenhouse gas emissions.

C.38 A number of studies commissioned by the government on this question have been forwarded to the Review.[17] These studies agree that the question should be evaluated in terms of minimising the costs to New Zealand of its Kyoto commitment. The studies note the difficulties of identifying and targeting myopic behaviour. The estimates of the costs of myopia they derive are (for the most part) very small and are based on international carbon prices of $50-100/tC, which might be considered high in the light of recent developments in Kyoto negotiations.

C.39 A further obstacle to efficient pre-Kyoto investment decisions is continuing uncertainty over the basis on which AAUs will be allocated to emitters under the proposed emissions-trading scheme. So long as significant grand-parenting of emissions units to legal entities is considered likely, long-lived investment (or dis-investment) decisions can be affected as plant and equipment, which would otherwise be shut down or upgraded to cleaner technology, is kept running in the hope of attracting grants of valuable emission units.

C.40 The government announcement that grand-parenting would not take into account events post-1995 (when the Working Group on Climate Change Policy was established)[18] was intended to counter these inappropriate incentives, but this undertaking may become less credible with the passage of time.

C.41 At present, these sources of uncertainty are overshadowed by uncertainty over the final form of the Kyoto Protocol and whether, and on what terms, EE/FSU "hot air" credits will be available to international carbon markets.

C.42 The Review considers that the case for the early imposition of carbon taxation on the grounds of investment myopia is not well established. If carbon taxation were anticipated to be the central instrument in the first commitment period, perverse incentives created by grand-parenting possibilities should be largely averted. The same should be true once AAUs have been allocated under a system of carbon-credit trading.

Negotiated Greenhouse Agreements

C.43 NGAs are planned to involve large firms covering about 15 percent of New Zealand emissions. Those entering into these agreements have been promised that their commitments will be recognised in some way in the design and application of a pre-Kyoto carbon charge.

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17 *Greenhouse Gas Policy Timing, Report to Ministry of Commerce*, New Zealand Institute of Economic Research, May 1999; *Early Action Simulations, Results from G-Cubed*, Centre for International Economics, Canberra and Sydney, March 2000; *Policy Timing, Comments on NZIER report to Ministry of Commerce, Final Report*, Centre for International Economics, Canberra and Sydney, September 2000; *Greenhouse Emissions Policy Timing, A Review of Report by NZIER and the Centre for International Economics*, Geoff Bertram, Victoria University and Simon Terry Associates Ltd, November 2000.

18 See *Climate Change, Domestic Policy Options Statement*, Ministry for the Environment, January 1999, p 74.

C.44 This undertaking resembles that provided under the UK Climate Change Levy, announced in the March 1999 budget, and introduced on 1 April 2001. The UK levy applies to electricity, gas, coal and LPG used in industry, commerce and the public sector. Firms in energy intensive sectors, whose industry associations have entered into Climate Change Agreements setting challenging energy efficiency targets, receive an 80 percent discount on the levy.

C.45 The UK model does not appear workable in New Zealand. This is because carbon taxes suggested as suitable under New Zealand conditions[19] have been designed not as energy taxes *per se* but as taxes on fossil fuel inputs into energy generation. Moreover, they have not been confined to the energy sector. Instead, it has been envisaged that the tax would be levied at points of importation or production of fossil fuels and would therefore include virtually all uses of these fuels (except export or re-export) and would include a range of industrial process and waste sector emissions. Moreover, it is widely recognised that because thermal power is typically the marginal source of supply, the impact of a carbon tax on electricity prices will exceed the carbon tax revenue collected from this sector.

C.46 In these circumstances, it will be difficult to determine a transparent basis on which to rebate to signatories of NGAs part or all of the carbon taxes to which they are not directly subject.

Submissions on the Issues Paper

C.47 The Issues Paper considered the role that a broadly-based carbon tax could play, as the central instrument assisting New Zealand to meet its commitments in the event that it ratifies the Kyoto Protocol. It noted that, of the new taxes proposed by submissions, only a carbon tax appeared to meet the conditions for effective eco-taxation at a national level.[20]

C.48 This conclusion was based on the following considerations:

- it is considered that the prices that will be set in international carbon credit markets should provide a firm basis for determining the efficient level of the carbon tax;
- there appear to exist effective emission proxies that would provide workable bases for a carbon tax (here it is envisaged that the emissions accounting defined by New Zealand's National Reporting System established under the Kyoto Protocol will provide effective bases for broad-based carbon taxation across all major sectors);
- it is considered that, in New Zealand's circumstances, minimisation of compliance and transactions costs, broadly defined, are likely to favour the use of carbon taxation over the alternative of domestic/international emissions trading by legal entities; and

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19 See *The Design of a Possible Low-Level Carbon Charge, A Working Paper*, The Treasury, April 1997.

20 It is noted that under the Kyoto Protocol, Parties are not restricted in the choice of domestic measures they use to meet their commitments.

- under a carbon tax aligned to international prices, the government's undertaking to hold sufficient assigned amount to cover total emissions for the commitment period would need to be met, as necessary, by purchases of the requisite assigned amount from other Parties or legal entities.

C.49 Submissions were concerned with the justification for a carbon tax and the practicality and effectiveness of applying it to the agricultural sector. While accepting of the three conditions for effective national eco-taxation proposed by the Review, some submitters argued that these conditions were not met by the carbon tax proposed in the Issues Paper.

Harm to New Zealand

C.50 Some submissions argued that there could be no case for a carbon tax unless it could be demonstrated that global warming will harm New Zealand and that the damage to New Zealand averted by the tax exceeds the costs it would impose. These objections are understandable but lose force when it is recognised that New Zealand is a participant in the climate change policy process and intends to ratify the Kyoto Protocol. New Zealand will assume specific obligations under that Protocol and has made further commitments not to use Kyoto forestry credits to shield its emitters. Public policies (such as a carbon charge) are instruments for managing those obligations. Under Kyoto, harm is not directly defined in environmental terms, but in terms of the cost to New Zealand of meeting those commitments.

Measurement of Marginal Damage

C.51 Similarly, it has been suggested that carbon taxation does not satisfy the conditions identified by the Issues Paper for effective eco-taxation because the marginal damage caused by global greenhouse gas emissions cannot be measured. Once again, this objection is reasonable but misunderstands the issue. From New Zealand's perspective, the marginal cost of emissions (per unit of equivalent carbon) in the first Kyoto commitment period will be determined by the international price of carbon credits. This is the price at which New Zealand will be able to acquire emissions units to meet its Kyoto target and it is the price at which New Zealand will be able to sell surplus emissions units in the event that it is able to reduce emissions below Kyoto targets.[21]

C.52 For New Zealand, the price of carbon credits under Kyoto becomes an international price in some respects resembling that of other tradeable commodities. Since the New Zealand government will be able to trade carbon credits at this price, it provides the benchmark against which efficient emissions abatement by New Zealand should be measured. The policy task in New Zealand is to ensure that this price impacts decisions on the widest range of relevant margins but does so in a compliance cost-effective manner.

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21 As noted in the Issues Paper, New Zealand is almost certain to be a net seller of carbon credits in the first commitment period since emissions, after allowance for credits earned through carbon sequestration in Kyoto forests, will be well below 1990 levels. This remains true even after the recent upward revision in forecast agricultural emissions.

Agricultural Emissions Proxies

C.53 It has been argued that uncertainty surrounding the generation of emissions in agriculture makes it unreasonable to include this sector under a carbon charge. The Review accepts that the certainty of the relationship between feasible taxable proxies and ultimate CO_2 emissions is much higher for fossil fuels than for non-CO_2 emissions. However, this difference does not appear to be relevant to the efficient response by New Zealand to its Kyoto obligations.

C.54 Prior to the first commitment period, New Zealand will need to have submitted and received international approval for a National Inventory and Reporting System that will apply, unaltered, over the whole of the first commitment period. For the purposes of efficient greenhouse gas taxation, the determinants of emissions adopted by this system (for example, stock numbers, stock emissions factors etc) are all that is required to resolve uncertainty.[22]

C.55 While it is recognised that the emissions factors that are finally adopted under the National Reporting System may differ from those currently used, once accepted under the Protocol, those estimates will no longer be uncertain in the sense relevant to efficient policy design. Moreover, the fact that these factors will necessarily differ from actual emissions at the individual farm level will then be irrelevant. New Zealand's performance under Kyoto, and the aggregate emissions trading that will be required for the government to satisfy its Kyoto commitments, will be assessed on the basis of reported emissions, not in terms of unmeasured and unreported actual emissions.

C.56 It is therefore efficient for the bases of carbon taxation to be aligned with the National Reporting System wherever compliance costs do not make this impracticable. The incentives established by taxing ruminant methane and CO_2 emission proxies are considered to be closely aligned to the incentives that would be established by the direct taxation of emissions, even if this were practicable.

C.57 It may be noted that the cost to New Zealand of excess methane and nitrous oxide emissions will be determined also by the Global Warming Potential (GWP) used to convert other greenhouse gases into their CO_2 equivalents. The Kyoto Protocol (Article 5.3) leaves the determination of these GWP values unspecified. In view of the different atmospheric lives of greenhouse gases (which are themselves sensitive to the modelling approach), the GWPs cannot be uniquely determined but will vary with the time horizon in question.[23] This major source of indeterminacy will also be resolved, for the

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22 For example, Table 1 of the document *Managing Greenhouse Gas Emissions: The Agriculture Sector*, Emissions Trading Working Group, May 2001 (drawn from the *National Inventory Report*, April 2000) provides imputations of methane and nitrous oxide emissions to stock numbers and land under cultivation.

23 Given New Zealand's greenhouse gas profile and emissions trends, it is notable that in the simulations under taken by Wigley (*op.cit.* p 2287), the conventional GWP used for methane underestimates the effectiveness of methane reductions by 40 percent at a time horizon of 100 years.

purposes of emissions trading or carbon taxation, by the National Reporting System submitted by New Zealand.

Emissions Abatement in Agriculture

C.58 It has been further argued, in relation to agriculture, that carbon taxation is inappropriate since a lack of substitution possibilities mean that adjustment of stock numbers or land under cultivation is the only feasible response, whereas fossil fuel users can take steps to substitute out of fossil fuel usage. However, agriculture does have scope to substitute between different types of activity with different emission intensities: ruminant livestock can be substituted for non-ruminants, livestock for arable crops, up to and including the earning of sink credits in forestry.

C.59 More fundamentally, the argument fails to recognise that efficient emissions abatement requires policies that provide incentives to equate marginal costs of abatement on extensive as well as intensive margins of adjustment. Moreover, in the case of greenhouse gas emissions, it is widely recognised that limited input substitution opportunities make adjustment at the level of industry output significant for sectors other than agriculture.

Agriculture and Research

C.60 It was suggested that research might be an appropriate way of delivering agricultural greenhouse gas reductions in the pre-Kyoto period. While this may prove correct, to date improved animal genetics and farm management, and further research into their effects, have delivered increased agricultural emission factors.

Cash Costs and Opportunity Costs

C.61 Some commentators appear to believe that grand-parenting of AAUs to emitters might serve to blunt the impact on firms and industries of the incentives to adjust output provided by exposure to international carbon prices. This outcome is unlikely to be supported in practice unless AAU allocations are subject to some form of conditionality.

C.62 Once tradeable AAUs have been allocated, the impact of international carbon prices on firms' decision making should be largely independent of whether firms have received them free of charge, have been required to purchase them from the government, or have acquired them from third parties either at home or abroad.

Policy recommendations

C.63 Information available since the publication of the Issues Paper has strengthened our view that a broadly-based carbon tax should form the central component of New Zealand climate change policy during the first commitment period. This tax should be adjusted in line with international carbon prices (so long as the Kyoto Protocol appears to be functioning as intended) and should be supported by whatever level of government

emissions trading is then required to meet New Zealand's Kyoto commitments over the first commitment period.

C.64 We believe the tax should be applied to a wide range of compliance cost-effective greenhouse gas proxies. These proxies have been identified for carbon dioxide (and minor greenhouse gases),[24] and livestock numbers should provide reasonable proxies for emissions of ruminant methane. Consideration should be given to adjusting livestock taxes to account for nitrous dioxide emissions associated with agriculture, in line with the rules incorporated in the National Reporting System.

C.65 The tax should be levied at a rate equivalent to the price of carbon credits faced by the government in international markets, in order to cover any shortfall in required purchases of carbon credits.

C.66 Although the tax is designed to apply in the first commitment period (2008 to 2012), there could be administrative advantages in introducing the tax somewhat prior to this. Preparations for its introduction could be considered to meet New Zealand's commitment to show "demonstrable progress" in meeting Kyoto targets by 2005.

C.67 We do not support the introduction of a temporary low-level carbon tax prior to the introduction of an emissions-trading regime. The tax administration and compliance costs implied by the short-term imposition of a carbon tax do not appear justified by concerns over myopic investment behaviour.

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24 See The Treasury, *The Design of a Possible Low Level Carbon Charge for New Zealand*, April 1997.

ANNEX D1
RFRM – ASSET REGIME

D.1 The following rules exemplify a possible broad design of an asset regime, under which RFRM applies to specified assets. For the purpose of this example, we will define the asset as shares held in an SIE:

- A New Zealand resident shareholder in a listed SIE would pay RFRM tax on the market value of the shares reduced by any interest bearing debt owed by the shareholder (up to a nil balance).
- A New Zealand resident shareholder in an unlisted SIE would pay RFRM tax on the accounting value of the shares reduced by any interest bearing debt owed by the shareholder (up to a nil balance).
- Non-resident taxpayers would not be subject to the RFRM regime and would be subject to existing rules.
- Interest payable on money borrowed to buy shares in an SIE would be deemed to be non-deductible in order to prevent the deduction of risky interest rates against riskless rates of return.
- A resident corporate shareholder in an SIE can maintain an RFRM imputation credit account (RFRM ICA) which records RFRM tax that can be attached to RFRM dividends onpaid.
- All resident corporate recipients of RFRM dividends would be exempt tax on those dividends. Any RFRM credits attached to RFRM dividends received can be used to relieve any RFRM tax. Imputation credits attached to ordinary dividends received can also be used to relieve any RFRM tax. Any imputation credits or RFRM credits used to relieve RFRM tax can also be credited to the corporate recipient's RFRM ICA.
- RFRM imputation credits can only be attached to RFRM dividends received directly or indirectly on shares in a corporate SIE. Resident companies can maintain an RFRM dividend account recording net dividends originating from shares in an SIE.
- Any non-corporate taxpayer receiving RFRM dividends will make a tax adjustment calculation by taking any attached RFRM imputation credits, grossing it up by dividing by the company tax rate and calculating a tax credit by multiplying that gross amount by the difference between the company rate and taxpayer's marginal tax rate. This credit can be applied to reduce the taxpayer's other taxes or any unused credit will convert to a tax loss.

D.2 This explanation accompanies the attached diagram and calculation sheet.

D.3 The company at the bottom of the shareholding chain derives taxable income of $1,000, pays tax of $330, and pays a fully imputed dividend of $670 (imputation credits $330) to its 100% holding company (HC1).

D.4 HC1 does not hold shares in an SIE and is therefore not subject to RFRM tax. HC1 derives taxable income of $2,500, pays tax of $825, reduced to $495 by the imputation credit received of $330. HC1 pays to its wholly owned holding company (HC2) an RFRM dividend of $1330, and an ordinary dividend of $670 with attached imputation credits of $330.

D.5 HC2 holds shares in an SIE and is therefore subject to RFRM tax. The market value of HC1's shares is $2,500 and so it pays RFRM tax of $33 (2500*0.04*0.33). HC2 offsets (and still carries forward) ordinary imputation credits received of $33 against the $33 RFRM (which is credited to HC2's RFRM ICA). HC2 derives taxable income of $4,000, pays tax of $1,320, reduced to $990 by the imputation credit of $330. HC2 pays to its wholly owned holding company (HC3) an RFRM dividend of $5,330 with RFRM imputation credits attached of $33, and an ordinary dividend of $670 with attached imputation credits of $330.

D.6 HC3 holds shares in an SIE and is therefore subject to RFRM tax. The market value of HC2's shares is $100,000 and so it pays RFRM tax of $1,320 (100000*0.04*0.33). HC3 offsets (and still carries forward) RFRM imputation credits received of $33 against the $1,320 RFRM. HC3 derives taxable income of $2,000, pays tax of $660, reduced to $330 by the imputation credit received of $330. HC3 pays to its individual shareholder an RFRM dividend of $3,330 with RFRM imputation credits attached of $1,320. HC3 pays an ordinary dividend of $1,670 with attached imputation credits of $660.

D.7 The individual shareholder does not hold shares in an SIE. The individual shareholder calculates taxable income, including ordinary net dividends and attached imputation credits, but excluding RFRM dividends and attached imputation credits. In the example, taxable income is $3,330 and income tax is $500. Unused imputation credits are $160 (660-500) which are converted to a tax loss to carry forward of $486 (160/0.33). The individual shareholder receives RFRM imputation credits of $1,320,which converts to underlying taxable income of $4000 (1320/0.33) and on which personal tax would have been $600 (4000*0.15). The excess tax of $720 (1320-600) is converted to a tax loss to carry forward of $2,182 (720/0.33).

Asset regime

Individual

- Taxable income $3,330, income tax $500 offset by ICs of $660
- $1,320 RFRM ICs received, grossed up to income of $4,000
- Tax on RFRM ICs is $600, leaving $720 excess RFRM ICs to be converted to carried forward tax losses

RFRM dividend
$3,330 + $1,320 RFRM ICs

Ordinary dividend $1,670 + $660 ordinary ICs

Parent Company (HC 3)

- Taxable income $2,000, income tax $660 reduced to $330 by offset of ICs of $330
- Holds specific shares worth $100,000
- RFRM tax $1,320 reduced to $1,287 by offset of $33 RFRM ICs

RFRM dividend
$5,330 + $33 RFRM ICs

Ordinary dividend $670 +$330 ordinary ICs

Listed SIE (HC 2)

- Taxable income $4,000, income tax $1,320 reduced to $990 by offset of ICs of $330
- Holds specified shares worth $2,500
- RFRM tax to pay $33 offset by ordinary ICs of $33

RFRM dividend $1,330

Ordinary dividend $670 + $330 ordinary ICs

Unlisted SIE (HC 1)

- Taxable Income $2,500, income tax $825 reduced to $495 by offset of ICs of $330

Ordinary dividend $670 + $330 ICs

Non SIE

- Taxable income $1,000
- Pays tax $330

ASSET REGIME	Bottom Company	Next Company HC1	Next Company HC2	Parent Company HC3	Individual	*Consol RFRM Payable*	*Consol RFRM Cash=*	*Consol I/Tax Payable*	*Consol I/Tax Cash=*
Ordinary Dividends									
Received		670	670	670	1670				
Paid	670	670	670	1670					
RFRM Dividends (from asset)									
Received			1330	5330	3330				
Paid		1330	5330	3330					
Ordinary Income Tax									
Taxable Income	1000	1500	3000	1000	1000				
Ord Div Received		670	670	670	1670				
Imputation Credits Attached		330	330	330	660			-1650	
Taxable Income	*1000*	*2500*	*4000*	*2000*	*3330*				
Tax Rate	*33%*	*33%*	*33%*	*33%*	*15%*				
Income Tax Payable	330	825	1320	660	500			3635	
Imputation Credits Available		330	330	330	660				
Imputation Credits Used		330	330	330	500				
Tax Paid	330	495	990	330					2145
RFRM Tax									
Market Value			2500	100000		100000			
Tax Base @ 4%			100	4000		4000			
Tax Rate	*33%*	*33%*	*33%*	*33%*	*33%*	*15%*			
RFRM Tax Payable			33	1320		600			
RFRM Imputation Credits Avail.			33	33	1320				
RFRM Imputation Credits Used			33	33					
RFRM Tax Paid				1287			1287		
Ordinary ICA									
Opening Balance									
Tax Paid	330	495	990	330					
Imputation Credits Received		330	330	330	660				
Imputation Credits to RFRM ICA			33				33		
Imputation Credits Attached	330	330	330	660					
Closing Balance		495	957						
IC Ratio	*49.25%*	*49.25%*	*49.25%*	*39.52%*					
RFRM ICA									
Opening Balance									
Tax Paid				1287					
Imputation Credits Received				33	1320				
Imputation Credits from ICA			33						
Imputation Credits Attached			33	1320					
Closing Balance									
IC Ratio			*0.62%*	*39.64%*					
Summary									
ICA Losses					486				-161
RFRM ICA Losses					4000		-720		
Totals						***600***	***600***	***1985***	***1985***

ANNEX D2
RFRM - ENTITY REGIME

D.8 The following rules exemplify a possible broad design of an entity regime, under which RFRM applies to an SIE only and not to shares held in an SIE. An imputation system is still required to prevent multiple taxation where an SIE hold shares in an SIE:

- A listed SIE would pay RFRM tax on the market value of its own shares (including units).
- An unlisted SIE would pay RFRM tax on the accounting book value of its shareholders' funds.
- Non-resident taxpayers would not be subject to the RFRM regime and would be subject to existing rules.
- Interest payable on money borrowed to buy shares in an SIE would be deemed to be non-deductible in order to prevent the deduction of risky interest rates against riskless rates of return.
- A corporate SIE can maintain an RFRM imputation credit account (RFRM ICA) which records RFRM tax that can be attached to dividends paid.
- All resident corporate recipients of RFRM dividends would be exempt tax on those dividends. Any RFRM credits attached to RFRM dividends received can be used to relieve RFRM tax. Imputation credits attached to ordinary dividends received can also be used to relieve RFRM tax. Any imputation credits or RFRM credits used to relieve RFRM tax are also credited to the corporate recipient's RFRM ICA.
- RFRM imputation credits can only be attached to RFRM dividends received directly or indirectly from a corporate SIE. SIEs would therefore maintain an ordinary dividend account recording net dividends originating from non-SIEs, whereas non-SIEs would maintain an RFRM dividend account recording net dividends originating from SIEs.
- Any non-corporate taxpayer receiving RFRM dividends will make a tax adjustment calculation by taking any attached RFRM imputation credits, grossing it up by dividing by the company tax rate and calculating a tax credit by multiplying that gross amount by the difference between the company rate and taxpayer's marginal tax rate. This credit can be applied to reduce the taxpayer's other taxes or any unused credit will convert to a tax loss.

D.9 This explanation accompanies the attached diagram and calculation sheet.

D.10 The company at the bottom of the shareholding chain is not an SIE. It derives taxable income of $1,000, pays tax of $330, and pays a fully imputed dividend of $670 (imputation credits $330) to its 100% holding company (HC1).

D.11 HC1 is an SIE and is therefore not subject to ordinary income tax. The accounting value of HC1's own shares is $2,500 and it pays RFRM tax of $33 on this (2500*0.04*0.33). HC1 could offset any available imputation credits against the $33, in which case, HC1's ICA would be debited but the same would be credited to HC1's RFRM imputation credit account. HC1 pays to its wholly owned holding company (HC2) an RFRM dividend of $1,330 with RFRM imputation credits attached of $33, and an ordinary dividend of $670 with attached imputation credits of $330.

D.12 HC2 is an SIE and is therefore not subject to ordinary income tax. The market value of HC2's own shares is $100,000 and so it pays RFRM tax of $1,320 (100000*0.04*0.33). HC2 can offset (and still carry forward) RFRM imputation credits received of $33 against the $1320. HC2 pays to its wholly owned holding company (HC3) an RFRM dividend of $5,330 with RFRM imputation credits attached of $1,320, and an ordinary dividend of $670 with attached imputation credits of $330.

D.13 HC3 is not an SIE and is therefore subject to ordinary income tax only. HC3 derives taxable income of $2,000, pays tax of $660, reduced to $330 by the imputation credit received of $330. HC3 pays to its individual shareholder an RFRM dividend of $3,330 with RFRM imputation credits attached of $1,320. HC3 pays an ordinary dividend of $1,670 with attached imputation credits of $660.

D.14 The individual shareholder cannot be an SIE and does not hold shares in such an entity. The individual shareholder calculates taxable income, including ordinary net dividends and attached imputation credits, but excluding RFRM dividends and attached imputation credits. In the example, taxable income is $3,330 and income tax is $500. Unused imputation credits are $160 (660-500) which are converted to a tax loss to carry forward of $486 (160/0.33). The individual shareholder receives RFRM imputation credits of $1,320,which converts to underlying taxable income of $4000 (1320/0.33) and on which personal tax would have been $600 (4000*0.15). The excess tax of $720 (1320-600) is converted to a tax loss to carry forward of $2,182 (720/0.33).

Entity regime

- Taxable income $3,330, income tax $500 offset by ICs of $660
- $1,320 RFRM ICs received, grossed up to income of $4,000
- Tax on RFRM ICs is $600, leaving $720 excess RFRM ICs to be converted to carried forward tax losses

Individual

RFRM dividend $3,330 + $1,320 RFRM ICs

Ordinary dividend $1,670 + $660 ordinary ICs

- Taxable income $2,000, income tax $660 reduced to $330 by ICs of $330
- Investments $100,000

Parent Company (HC 3)

RFRM dividend $5,330 + $1,320 RFRM ICs

Ordinary dividend $670 +$330 ordinary ICs

- Investments $100,000
- RFRM tax $1,320 partly offset by $33 RFRM ICs
- $1,287 RFRM tax to pay

Listed SIE (HC 2)

RFRM dividend $1,330 + $33 RFRM ICs

Ordinary dividend $670 + $330 ordinary ICs

- Investments $2,500
- $33 RFRM tax to pay

Unlisted SIE (HC 1)

Ordinary dividend $670 + $330 ICs

- Taxable income $1,000
- Pays tax $330

Non SIE

ENTITY REGIME	**Bottom Company** **NonSIE**	**Next Company HC1** **SIE**	**Next Company HC2** **SIE**	**Parent Company HC3** **NonSIE**	**Individual** **NonSIE**	***Consol RFRM Payable***	***Consol RFRM Cash=***	***Consol I/Tax Payable***	***Consol I/Tax Cash=***
Ordinary Dividends									
Received		670	670	670	1670				
Paid	670	670	670	1670					
RFRM Dividends (from SIEs)									
Received			1330	5330	3330				
Paid		1330	5330	3330					
Ordinary Income Tax									
Taxable Income	1000			1000	1000				
Ord Div Received				670	1670				
Imputation Credits Attached				330	660			-990	
Taxable Income	*1000*			*2000*	*3330*				
Tax Rate	*33%*			*33%*	*15%*				
Income Tax Payable	330			660	500			1490	
Imputation Credits Available				330	660				
Imputation Credits Used				330	500				
Tax Paid	330			330					660
RFRM Tax									
Market Value		2500	100000			100000			
Tax Base @ 4%		100	4000			4000			
Tax Rate	*33%*	*33%*	*33%*	*33%*	*33%*	*15%*			
RFRM Tax Payable		33	1320			600			
RFRM Imputation Credits Avail			33						
RFRM Imputation Credits Used			33						
RFRM Tax Paid		33	1287				1320		
Ordinary ICA									
Opening Balance									
Tax Paid	330			330					
Imputation Credits Received		330	330	330	660				
Imputation Credits to RFRM ICA									
Imputation Credits Attached	330	330	330	660					
Closing Balance									
IC Ratio	*49.25%*	*49.25%*	*49.25%*	*39.52%*					
RFRM ICA									
Opening Balance									
Tax Paid		33	1287						
Imputation Credits Received			33	1320	1320				
Imputation Credits from ICA									
Imputation Credits Attached		33	1320	1320					
Closing Balance									
IC Ratio		*2.48%*	*24.77%*	*39.64%*					
Summary									
ICA Losses					486				-161
RFRM ICA Losses					4000		-720		
Totals						***600***	***600***	***500***	***500***

ANNEX D3
RFRM - MIXED REGIME

D.15 The following rules exemplify a possible broad design of a mixed regime, under which RFRM applies to both SIE's and to shares held in an SIE:

- A listed SIE would pay RFRM tax on the market value of its own shares (including units).
- An unlisted SIE would pay RFRM tax on the accounting book value of its shareholders' funds.
- A New Zealand resident shareholder in a listed SIE would pay RFRM tax on the market value of the shares reduced by any interest bearing debt owed by the shareholder (up to a nil balance).
- A New Zealand resident shareholder in an unlisted SIE would pay RFRM tax on the accounting value of the shares reduced by any interest bearing debt owed by the shareholder (up to a nil balance).
- Non-resident taxpayers would not be subject to the RFRM regime and would be subject to existing rules.
- Interest payable on money borrowed to buy shares in an SIE would be deemed to be non-deductible in order to prevent the deduction of risky interest rates against riskless rates of return.
- A corporate SIE can maintain an RFRM imputation credit account (RFRM ICA) which records RFRM tax that can be attached to dividends paid.
- All resident corporate recipients of RFRM dividends would be exempt tax on those dividends. Any RFRM credits attached to RFRM dividends received can be used to relieve RFRM tax. Imputation credits attached to ordinary dividends received can also be used to relieve RFRM tax. Any imputation credits or RFRM credits used to relieve RFRM tax are also credited to the corporate recipient's RFRM ICA.
- RFRM imputation credits can only be attached to RFRM dividends received directly or indirectly from a corporate SIE. SIEs would therefore maintain an ordinary dividend account recording net dividends originating from non-SIEs, whereas non-SIEs would maintain an RFRM dividend account recording net dividends originating from SIEs.
- Any non-corporate taxpayer receiving RFRM dividends will make a tax adjustment calculation by taking any attached RFRM imputation credits, grossing it up by dividing by the company tax rate and calculating a tax credit by multiplying that gross amount by the difference between the company rate and taxpayer's marginal tax rate. This credit can be applied to reduce the taxpayer's other taxes or any unused credit will convert to a tax loss.

D.16 This explanation accompanies the attached diagram and calculation sheet.

D.17 The company at the bottom of the shareholding chain is not an SIE. It derives taxable income of $1,000, pays tax of $330, and pays a fully imputed dividend of $670 (imputation credits $330) to its 100% holding company (HC1).

D.18 HC1 is an SIE and is therefore not subject to ordinary income tax. The accounting value of HC1's own shares is $2,500 and it pays RFRM tax of $33 on this (2500*0.04*0.33). HC1 could offset any available imputation credits against the $33, in which case, HC1's ICA would be debited but the same would be credited to HC1's RFRM imputation credit account. HC1 pays to its wholly owned holding company (HC2) an RFRM dividend of $1330 with RFRM imputation credits attached of $33, and an ordinary dividend of $670 with attached imputation credits of $330.

D.19 HC2 is an SIE and is therefore not subject to ordinary income tax. The market value of HC2's own shares is $100,000 and so it pays RFRM tax of $1320 (100000*0.04*0.33). HC2 can offset (and still carry forward) RFRM imputation credits received of $33 against the $1320. HC2 pays to its wholly owned holding company (HC3) an RFRM dividend of $5,330 with RFRM imputation credits attached of $1320, and an ordinary dividend of $670 with attached imputation credits of $330.

D.20 HC3 is not an SIE and is therefore subject to ordinary income tax as well as RFRM tax on any shares held in an SIE (namely HC2). HC3 holds listed shares in HC2 and must therefore calculate RFRM tax on its market value, being $1,320 (100000*0.04*0.33). HC3 can offset (and still carry forward) RFRM imputation credits received of $1,320 against the $1320. HC3 pays to its individual shareholder an RFRM dividend of $3,330 with RFRM imputation credits attached of $1,320. HC3 pays an ordinary dividend of $1,670 with attached imputation credits of $660.

D.21 The individual shareholder cannot be an SIE and does not hold shares in such an entity. The individual shareholder calculates taxable income, including ordinary net dividends and attached imputation credits, but excluding RFRM dividends and attached imputation credits. In the example, taxable income is $3,330 and income tax is $500. Unused imputation credits are $160 (660-500) which are converted to a tax loss to carry forward of $486 (160/0.33). The individual shareholder receives RFRM imputation credits of $1,320,which converts to underlying taxable income of $4000 (1320/0.33) and on which personal tax would have been $600 (4000*0.15). The excess tax of $720 (1320-600) is converted to a tax loss to carry forward of $2,182 (720/0.33).

Mixed regime

- Taxable income $3,330, income tax $500 offset by ICs of $660
- $1,320 RFRM ICs received, grossed up to income of $4,000
- Tax on RFRM ICs is $600, leaving $720 excess RFRM ICs to be converted to carried forward tax losses.

Individual

RFRM dividend
$3,330 + $1,320 RFRM ICs

Ordinary dividend $1,670 + $660 ordinary ICs

- Taxable income $2,000, income tax $660 reduced to $330 by ICs of $330
- Investments $100,000
- RFRM tax $1,320 offset by $1,320 RFRM ICs received

Parent Company (HC 3)

RFRM dividend
$5,330 + $1,320 RFRM ICs

Ordinary dividend $670 +$330 ordinary ICs

- Investments $100,000
- RFRM tax $1,320 partly offset by $33 RFRM ICs
- $1,287 RFRM tax to pay

Listed SIE (HC 2)

RFRM dividend $1,330 + $33 RFRM ICs

Ordinary dividend $670 + $330 ordinary ICs

- Investments $2,500
- $33 RFRM tax to pay

Unlisted SIE (HC 1)

Ordinary dividend $670 + $330 ICs

- Taxable income $1,000
- Pays tax $330

Non SIE

MIXED REGIME	**Bottom Company** **NonSIE**	**Next Company HC1** **SIE**	**Next Company HC2** **SIE**	**Parent Company HC3** **NonSIE**	**Individual** **NonSIE**	***Consol RFRM Payable***	***Consol RFRM Cash=***	***Consol I/Tax Payable***	***Consol I/Tax Cash=***
Ordinary Dividends									
Received		670	670	670	1670				
Paid	670	670	670	1670					
RFRM Dividends									
Received			1330	5330	3330				
Paid		1330	5330	3330					
Ordinary Income Tax									
Taxable Income	1000			1000	1000				
Ord Div Received				670	1670				
Imputation Credits Attached				330	660			-990	
Taxable Income	*1000*			*2000*	*3330*				
Tax Rate	*33%*			*33%*	*15%*				
Income Tax Payable	330			660	500			1490	
Imputation Credits Available				330	660				
Imputation Credits Used				330	500				
Tax Paid	330			330					660
RFRM Tax									
Market Value		2500	100000	100000		100000			
Tax Base @ 4%		100	4000	4000		4000			
Tax Rate	*33%*	*33%*	*33%*	*33%*	*33%*	*15%*			
RFRM Tax Payable		33	1320	1320		600			
RFRM Imputation Credits Avail			33	1320					
RFRM Imputation Credits Used			33	1320					
RFRM Tax Paid		33	1287				1320		
Ordinary ICA									
Opening Balance									
Tax Paid	330			330					
Imputation Credits Received		330	330	330	660				
Imputation Credits to RFRM ICA									
Imputation Credits Attached	330	330	330	660					
Closing Balance									
IC Ratio	*49.25%*	*49.25%*	*49.25%*	*39.52%*					
RFRM ICA									
Opening Balance									
Tax Paid		33	1287						
Imputation Credits Received			33	1320	1320				
Imputation Credits from ICA									
Imputation Credits Attached		33	1320	1320					
Closing Balance									
IC Ratio		*2.48%*	*24.77%*	*39.64%*					
Summary									
ICA Losses					486				-161
RFRM ICA Losses					4000		-720		
Totals						***600***	***600***	***500***	***500***

ANNEX E
INTERNATIONAL TAXATION: INBOUND INVESTMENT BY NON-RESIDENTS

PART A: Supplementary material relevant to the Review's framework

Broader policy context relevant to final determination of Review's tax framework

E.1 The government seeks to achieve transformation to a so-called 'knowledge economy' and, in that context, a target has been suggested of rejoining the top half of OECD nations in per capita GDP. To achieve this objective within, say, a 10-year period is likely to require real GDP per capita in New Zealand to grow over the next 10 years at an annual rate of 4.6 percent to 7.4 percent. This assumes that other OECD countries grow at their average historical growth rates over the period 1970-1999. New Zealand's annual average growth rate in real GDP per capita in that period was .76 percent (that is, one sixth of the lowest required estimate of 4.6 percent). In that period, the OECD as a whole had an average annual growth rate in real GDP per capita (purchasing power parity measure) of two percent per annum. In the period 1990-1999, New Zealand's real GDP per capita (purchasing power parity) grew at 1.66 percent, compared to the OECD's 1.74 percent.[1]

E.2 The enormity of the required climb back starkly illustrates how far New Zealand's performance has fallen relative to other OECD countries. The objective is, to say the least, bold.

E.3 To make significant progress towards the suggested target, New Zealand will require significant additional foreign investment.

E.4 We recognise an argument currently being considered that New Zealand's small size, location and scale may mean that it should, as a matter of economic policy, endeavour to target particular sectors and areas of speciality. Even if non-tax policies are targeted

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1 *Climbing the OECD Ladder – What does New Zealand have to do?* P. Mawson and G. Scobie, The Treasury, 2001.

in this way, we recommend that, as a general rule, the income tax system is not founded on such targeting of particular sectors by lower tax rates/incentives. In Chapter Two, *Frameworks,* we explain this general rule and the circumstances in which rare exceptions might be made for narrowly targeted tax incentives for particular sectors/activities.

Supplementary analysis in support of framework

E.5 To what extent is investment by non-residents in New Zealand sensitive to the New Zealand tax burden, and to what extent is this relevant?

E.6 In many, if not most, cases, FDI decisions are driven primarily by considerations other than taxation including: labour availability, labour skills, existence of quality suppliers, infrastructure, local factor costs, natural resources, market size and market growth. Agglomeration effects may be important – firms in an industry may locate near to each other or to their markets, or in research and development clusters.

E.7 Early surveys concluded that multinational companies did not regard taxation as a major factor influencing decisions to invest. Key non-tax factors were regarded as the most important in determining investment location. Tax policy has been ranked low in the list of important factors (for example, in a Fortune/Deloitte & Touche survey in 1997, taxes ranked 13th in a list of 26 factors). Accordingly, tax policy has not been seen as the most influential factor in site selection.

E.8 However, there is now a growing body of empirical evidence suggesting that location of FDI has become increasingly sensitive to host country taxation. The evidence supports the propositions that:

- tax alone cannot induce successful long-term FDI where non-tax factors are such that a country does not match up against alternative locations;
- competition among countries for FDI is frequently regional in nature; that is, as a general rule, for a given investment, it will not be a choice between location in Europe or Australasia;
- when choosing between alternative locations within a region where non-tax factors are more or less equivalent, relative tax and non-fiscal incentives between alternative locations can prove decisive in a significant number of cases; and
- tax sensitivity is higher for multinational companies establishing export-oriented business in a host country than for those seeking to exploit the host country market or location-specific advantages such as natural resources.

E.9 The following emphasises the point:

> *"The available international evidence implies that investment location and tax avoidance activity are more responsive to tax rate differences than is typically implied by domestic evidence. Taking the international evidence at face value, it follows that governments seeking a combination of adequate tax revenue and*

efficient economic performance are well advised to impose low taxes on mobile factors such as FDI."[2]*; and*

"Empirical work using improved data measuring FDI offers convincing evidence that host country taxation does indeed affect investment flows. Moreover recent work finds host country taxation to be an increasingly important factor in locational decisions. This relationship is not surprising given the gradual pervasive reductions over time in non-tax barriers to FDI flows, including the abolition of investment and currency controls, and the resulting globalisation of production.

A precise estimate of the foreign direct investment (FDI) response to a given amount of tax relief cannot, however, be made with a high degree of certainty given that a number of theoretical and empirical issues remain unresolved. In other words, the empirical results to date are suggestive, but more work needs to be done to improve and verify the accuracy of elasticity estimates".[3]

E.10 However, given that competition for FDI is likely to be regional and that New Zealand is distant even from Asian markets, it is not clear which region New Zealand is in for purposes of competing for mobile FDI. Accordingly, the extent to which New Zealand can succeed in overcoming its market size and distance by tax and non-tax policies to attract FDI is not entirely clear.

E.11 Marginal non-resident investors influenced by a New Zealand tax-rate reduction will reduce the cost of capital for New Zealand businesses.

E.12 However, the key issue is whether the expected national benefits from additional investment by non-residents resulting from a reduction will exceed the amount of New Zealand tax to be foregone on income from existing investment by non-residents. This requires a judgement on the sensitivity of foreign investment to New Zealand tax.

Economic rents

E.13 A non-resident earning 'economic rents' is, by definition, prepared to continue investment in New Zealand and bear the economic incidence of a tax without responding; that is, to conduct the same level of activity in New Zealand as they would otherwise have conducted without the tax. Economic rents, in this sense, may exist in the case of non-residents who seek to exploit natural resources only obtainable in New Zealand (for example, mining companies) or of non-residents who have unique capabilities, brand names or other special assets that enable them to exploit the New Zealand market in a manner that leaves them impervious to a degree of New Zealand tax. In the New Zealand context, the economic rent factor is significant because:

- a Treasury sectoral breakdown of investment income from FDI shows that around 70-85 percent of investment income outflows in the current account are earned from

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2 James R. Hines Jr, "Lessons from Behavioral Responses to International Taxation", *National Tax Journal,* Vol. 52, No. 2, June 1999, p 319.

3 W.S. Clark, "Tax Incentives for Foreign Direct Investment: Empirical Evidence on Effects and Alternative Policy Options", *Canadian Tax Journal*, 2000, Vol. 48, No. 4, p 1176.

domestically oriented sectors. Thus, historical foreign investment into New Zealand has tended to be by non-residents seeking to exploit opportunities in the New Zealand market, rather than use New Zealand as a base for exporting to other markets; and

- for these investors, a reduction in New Zealand tax may lead to increased profit for the non-resident but no significant additional investment by them in New Zealand. If the tax reduction does not spur significant new investment from existing non-resident investors, the policy would rely for its success on attracting new non-resident investors.

Foreign Tax Credits

E.14 Where the non-resident's home country taxes New Zealand-sourced income and grants tax credits for New Zealand tax paid, New Zealand should impose tax. In these circumstances, New Zealand tax imposed is not borne by the non-resident; rather, its economic incidence falls on the foreign treasury. In this case, the New Zealand tax does not affect the cost of capital in New Zealand. Where New Zealand does not tax to the level of the available tax credit for the non-resident investor, the foreign treasury reaps the benefit.

E.15 However, in practice, this principle cannot be applied. It is not possible to enact a law imposing tax only to the extent of the foreign tax credit available to the non-resident (foreign laws sometimes deny credits for such 'soak-up taxes'; moreover, such a regime would result in a widely varying and uncertain New Zealand tax impost on New Zealand-sourced income of non-residents).

E.16 Moreover, the effective availability of foreign tax credits varies across jurisdictions, types of investment and investors, making it impossible to target with any real precision non-residents who can benefit from tax credits.

E.17 In particular:

- non-residents whose home country exempts foreign-sourced income obtain no foreign tax credit benefit and so view New Zealand tax as a real cost;
- most jurisdictions that allow foreign tax credits tax foreign-sourced 'active' business income of their nationals only when the income is repatriated. Accordingly, these non-residents would benefit from an ability to retain income within New Zealand at a lower tax rate than that in their home country. Where deferral of foreign tax is allowed in the manner described, imposition of New Zealand tax reduces the deferral benefit even where, ultimately, a credit is allowed. How significant this is will depend on the propensity of non-residents to reinvest earnings into further New Zealand-based investment. This may not be high because of the small size of the New Zealand market and limited nature of New Zealand's human and natural resources;
- most jurisdictions that allow foreign tax credits impose restrictions that will 'bite' to varying degrees across taxpayers. For example, pooling of foreign-sourced income for purposes of credit calculation may operate to either restrict or enhance credits for New Zealand tax. Some countries also have rules requiring allocation of home-country expenses (such as interest) in calculating the allowable foreign tax credit. The result is that availability of foreign tax credits may vary quite considerably

across jurisdictions and by reference to the particular situation of the individual taxpayer. Credit availability cannot be determined simply by comparing the statutory tax rates of New Zealand and the non-resident's home country;

- where imputation regimes similar to New Zealand's do not allow credits for foreign tax to be passed through to shareholders, non-resident corporate investors may further discount the benefit of any foreign tax credit they obtain at the non-resident corporate level for New Zealand tax paid;
- availability of foreign tax credits allowed to non-resident investors will vary according to whether the investment is debt or equity and whether the investor is a 'portfolio' or 'direct' investor. Portfolio investors obtain, at best, foreign tax credits for New Zealand withholding taxes, but not for underlying company tax. Direct investors may obtain foreign tax credits for both underlying New Zealand company tax and withholding tax; and
- even where foreign tax credits may technically be available, multinational companies should generally be assumed to have an objective of minimising New Zealand tax. This is because their present foreign tax credit position is vulnerable to a change in their economic circumstances or to changes in foreign tax credit rules in their home country. By minimising New Zealand taxation, a non-resident multinational maximises its flexibility to deal with any changes in position or law. Local imputation credit systems and patriotism may also gives rise to a preference for tax to be paid in the multinational's country of residence.

E.18 Given this degree of variability in tax credit availability, all that can be done is to set a general effective rate of tax for non-residents and have regard, in a broad sense, to the existence of foreign tax credits.

Taxing New Zealand-owned Businesses At A Higher Rate Than Businesses Owned By Non-Residents

E.19 Is a tax regime in which lower-taxed non-residents operate alongside higher-taxed New Zealand residents politically achievable and economically desirable?

E.20 The issue is presented starkly where the non-resident investor owns a business operating in New Zealand that is competing with a New Zealand-resident owner for a share of the New Zealand market. How will the New Zealand-resident owner view a New Zealand government that appears to advance the interests of the foreigner over those of the resident? Regardless of the individual resident's views, does a lower tax burden for the non-resident enhance New Zealand's national welfare?

E.21 Such a tax regime does not seem as problematic where a non-resident invests in New Zealand as a production location for products that are destined for export. Even if there are New Zealand businesses seeking to export to the world market:

- the national benefit to New Zealand from the location of the non-resident in New Zealand seems more obvious than in the case of the non-resident here to exploit the New Zealand market; and
- any harm to the business interests of New Zealand residents appears more remote, given the existence of other foreign-based suppliers to the world market.

E.22 We consider it would not be economically undesirable to apply a lower tax rate to non-residents, notwithstanding issues of relativity to resident owners. Our analysis is as follows:

- there is already a lower New Zealand tax burden for non-resident investors than for New Zealand-resident investors within our current regime, as a result of the ability to introduce debt financing with a lower than 33 percent New Zealand tax burden. Indeed, a lower host-country tax burden for non-residents is inevitable for any country that allows tax deductions for interest expense and whose tax treaties limit withholding tax on interest. Most countries operate in this way;
- we are not aware of evidence that the effective lower tax rates for non-residents have had a significant adverse impact on New Zealand business. Although we have requested submissions on this subject, we have not received strong submissions opposing the course of action we propose. We do recognise that greater focus might be applied to the question if it were implemented;
- explicit rules that differentiate tax rates according to whether persons are resident or non-resident are not a fundamental change to the existing position[4];
- there is a result in economics known as Samuelson's Invariant Valuation Rule,[5] which shows that different taxpayers taxed at different marginal rates will be prepared to pay prices unaffected by their tax rates for income-earning assets. In practice, we also do not observe different taxes leading to competing firms charging different prices for goods. This is because, in competitive markets, prices are not set on the basis of 'cost plus'. Rather, prices are set by the interaction of supply and demand. The lower tax rate does enable the non-resident to accumulate retained earnings and financial strength at a faster rate than the higher-taxed New Zealand resident. The result is that some opportunities may arise to the non-resident that would not be available to the resident.
- in many instances, the economic incidence of the New Zealand tax does not actually fall on the non-resident (that is, the burden of the tax is borne by New Zealanders in the form of, for example, lower wages for labour). Where this occurs, a reduction in the tax rate on the non-resident or a reduction in the tax rate relative to tax rates on residents should not be viewed as conferring an advantage on the non-resident. All the tax-rate reduction does in this case is reduce the burden that would otherwise, in any event, be passed on to residents. New Zealand is better off without the tax on the non-resident by virtue of the lower cost of capital and increased foreign investment that arises from reducing the tax on the non-resident; and
- any New Zealand tax distortion is correctible by the foreign tax position of the non-resident investor by imposition of foreign tax. It is the foreign tax rules that determine whether the non-resident has an advantage over the resident after all taxes. If a foreign country allows exemption/deferral for New Zealand investment by its residents, it is, in effect, subsidising the non-resident to invest here and it is that subsidy, not any New Zealand tax differential, that produces the advantage for the non-resident.

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4 We note that there may be less concern with the introduction of debt to reduce New Zealand tax burden than with our proposed approach of lowering the statutory tax rate on income from equity because, in the case of debt finance, any reduction in New Zealand tax is frequently offset by increased foreign taxes on the interest income.

5 Named after a paper by economist Paul Samuelson, "Tax Deductibility of Economic Depreciation to Ensure Invariant Valuations", Journal of Political Economy, 1964, 72, D. pp604-606.

E.23 We cannot provide assurance that there will never be a situation where a lower tax rate for non-residents leads to disadvantage for a resident in a competing business. However, having considered the matter from the perspective of national welfare, we do not view that possibility as a barrier to implementing this type of regime.

PART B: Effective tax rate under current law

E.24 New Zealand has already made considerable progress in reducing the domestic cost of capital by lowering the rates of tax on non-resident debt investment through the AIL rules. In addition, tax on non-resident equity investments has been reduced through the effective elimination of additional tax on repatriation by virtue of the FITC rules.

E.25 However, the statutory tax rate on income from equity investment remains high relative to the effective tax rate and there remain significant differences in rates applying to investment by way of debt and equity. The result is considerable variability in tax impost.

E.26 This is shown in the following table:

Table E.1 – *Current Law: Effective Tax Rates Applying to Non-Residents*[1]

	Minimum ETR (%)	Maximum ETR (%)
Portfolio Debt	0[2]	1.34%[3]
Portfolio Equity	21.18%[4]	33%[5]
Direct Investment (weighted average)	0[6]	Rough Estimate 15.75% to 21.5%[7]

NOTES

[1] All calculations assume that the underlying effective New Zealand tax rate is 33 percent. Discrepancies in the tax base mean this will, in general, be only approximately correct.

[2] Assumes that NRWT is withheld on interest (10 percent or 15 percent) and a full foreign tax credit is available in the foreign jurisdiction.

[3] Assumes that AIL is paid by the issuer (two percent) and a tax deduction is available to the issuer in respect of the AIL.

[4] Assumes that the FITC regime is used, that a full foreign tax credit is available for NRWT on dividends and that no foreign tax credits are available for underlying company tax. The 21.18 percent is the corporate level tax after application of FITC, with the 11.82 percent dividend withholding tax assumed to be allowed as a foreign tax credit in the foreign jurisdiction before having regard to type of financing.

[5] Assumes that no foreign tax credit is available for NRWT on dividends or for underlying corporate tax.

[6] Assumes that a full foreign tax credit is available for NRWT on interest and dividends and for underlying company tax.

[7] Assumes that no foreign tax credit is available. The current thin capitalisation rules allow debt to finance up to 75 percent of total capital for the enterprise. The 15.75 percent is calculated assuming 75 percent associated party debt financing (that is, no natural level of external debt), as follows: (.75 x 10% NRWT) + (.25 x 33%) = 15.75 percent. The 21.5 percent is calculated as follows: it assumes a 'natural' level of external debt-to-equity ratio of, say, 50:50, with the result that the non-resident can capitalise the company with 50 percent external debt, 25 percent related-party debt and 25 percent equity. Ignoring differences in yields, the

weighted average effective tax rate on the non-resident's investment is (.5 x 10%) + (.5 x 33%) = 21.5%. These calculations do not take account of differences in yields on debt and equity or avoidance behaviour by non-residents. For example, tax reduction arrangements may allow third party debt to be 'stacked' against the New Zealand enterprise or back-to-back arrangements may be used, with the result that AIL is paid on 75 percent external debt financing and the effective tax rate is 9.25 percent: (.75 x 1.34%) + (.25 x 33%) = 9.25%.

PART C: Detailed analysis of policy options[6]

E.27 We outline below the possible options. This section is by way of analysis only. Our recommendations are in Chapter Eight. In all cases, the tax rates discussed are indicative – they are not 'magic' invariable numbers.

Policy Option One: 18 percent company tax rate to extent New Zealand company owned by non-residents; two percent NRWT on distributions for FDI; 15 percent NRWT and extended FITC for portfolio investors

Description of the Regime

E.28 The regime under Policy Option One is as follows:

- New Zealand-owned companies: the tax rate for companies owned solely by New Zealand residents throughout the year is assumed to be 33 percent;
- foreign-owned companies: the tax rate for companies owned solely by non-residents throughout the year would be 18 percent;
- mixed ownership: provided that the conditions in paragraph E.30 are satisfied, where a company was partly owned by non-residents and partly owned by residents during a year:
  - the company would measure percentage resident and non-resident ownership at the end of each quarter in the year and average the results, producing an average 'resident percentage ownership' and a 'non-resident percentage ownership' for the year; and
  - the company's tax liability would be its taxable income multiplied by the general company tax rate multiplied by the resident percentage ownership, plus taxable income multiplied by 18 percent multiplied by the non-resident percentage ownership; and
- ownership would be measured by reference to ordinary equity interests (financing equity, such as fixed-rate preference shares, would not be taken into account).

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6 Much of the material in this Annex relies on a review of, and draws from, published materials, including in particular the following: "How Tax Policy and Incentives Affect Foreign Direct Investment: A Review", by J. Morisset and N Pirnia of the Foreign Advisory Service of the World Bank Group, mimeo; "Lessons from Behavioural Responses to International Taxation", J.R. Hines Jr, *National Tax Journal*, Vol. 52 No. 2 June 1999, p 305; "Taxes and the Location of Production: Evidence From a Panel of Multinationals", M.P. Devereux, R. Griffith, *Journal of Public Economics* 68,1998, pp335–367; W.S. Clark, "Tax Incentives for Foreign Direct Investment: Empirical Evidence on Effects and Alternative Policy Options", *Canadian Tax Journal*, 2000, Vol. 48, No. 4 1138; V. Tanzi and H.H. Zee, *Tax Policy for Emerging Markets: Developing Countries*, IMF Working Paper, March 2000; J. Mintz, T. Tsiopoulos, *Fiscal Incentives for Investment and Innovation*, Oxford University Press, 1995, Chapter 12 "Corporate Income Taxation and Foreign Direct Investment in Central and Eastern Europe".

E.29 For example, suppose the general company tax rate is 33 percent and consider a company that is 60 percent owned by non-residents and has taxable income of $1,000. Its tax liability would be ($1,000 x 40% x 33%) plus ($1,000 x 60% x 18%), or $132 plus $108 equals $240, giving an overall effective rate of 24 percent.

E.30 Prerequisite for mixed ownership company qualifying for low rate: the prerequisites for applying the rule in the case of mixed ownership would be that, within six months of the end of the relevant income year:

- the company would distribute to non-residents only (including a special holding company owned by a non-resident), by way of supplementary dividend, an amount equal to the tax saving for foreign equity investors; that is, the difference between the taxable income attributable to non-resident investors taxed at the standard corporate rate and that amount taxed at 18 percent; or
- the company would issue to non-residents only (including a special New Zealand holding company owned by a non-resident), by way of a non-pro rata non-taxable bonus issue, shares having a value equal to the tax saving for non-resident equity investors.

E.31 Two alternative approaches for dealing with the mixed ownership company and confirming the economic benefit of the tax reduction to the non-residents intended to receive it are:

- a special pass-through election regime in which the New Zealand company with a special holding company shareholder (for a non-resident FDI investor) could elect for its income to be taxed to its shareholders (the special holding company and New Zealand corporate investors). Tax would then be paid at the differential rates at the shareholder level, with the special holding company qualifying for the lower rate; and
- a mixed ownership company would pay the general company tax rate at all times. However, non-resident owned companies would be eligible to enter into a special holding company regime where, so long as the New Zealand company had paid New Zealand tax on earnings attributable economically to the special holding company, the special holding company received a tax refund to reduce the net tax paid on taxable income ultimately accruing to the overseas owners.

E.32 We have not dwelt further on the precise mechanism. We are confident one of these regimes can operate effectively. These requirements would be designed to confine the economic benefit of the tax-rate cut to the non-resident investors intended to receive it.

E.33 Who is resident/non-resident? For the purposes of these rules:

- a resident-shareholder company owning shares in another New Zealand company would be deemed to be a New Zealand-resident shareholder for purposes of determining the New Zealand company's tax liability (even if the New Zealand-resident shareholder itself has foreign shareholders), unless it is a special holding company (see below);
- a special holding company would be a New Zealand-resident company owned 100 percent directly or indirectly by non-residents throughout the year; and
- a non-resident company would be treated as resident if it was controlled by/significantly owned by residents. Clearly the rules cannot enable a resident to

reduce tax liability in relation to a New Zealand operation by holding shares directly or indirectly through a non-resident company or trust;

- residents should not be encouraged to move offshore in order to reduce the New Zealand tax burden on their investments. Either New Zealand domiciles/persons born in New Zealand or individuals resident in New Zealand at any time six years prior to the relevant income year would be treated as New Zealand residents for purposes of the rules; and
- a statutory framework for certification by shareholders of non-resident status would probably be desirable.

E.34 Distributions:

- distributions/bonus issues to a special holding company would not be taxable for New Zealand tax purposes; and
- distributions by the New Zealand company or by a special holding company would be subject to a two percent dividend withholding tax.[7] The FITC regime would not apply to FDI, so the two percent withholding tax would be an additional tax cost.

E.35 Sales of shares between calculation dates and bonus issue/dividend dates: mechanisms would need to be considered to deal with non-residents who sell their shares between the time they are counted as non-residents for purposes of measuring ownership and the time the distribution is paid/bonus shares are issued/tax liability is paid. The conduit relief regime addresses similar issues.

E.36 Tightening of withholding tax rules in respect of interest on debt so as to prevent avoidance by FDI investors: this regime is contemplated in the context of the following rules, which are designed to ensure payment of withholding tax on interest in appropriate circumstances:

- NRWT, generally at 10 percent under tax treaties, would be retained on interest paid between associated persons. We view this as important because, in many situations, debt-finance by associates of the New Zealand company can be a form of disguised equity – so it is desirable not to have too great a differential between tax imposed on interest paid to an associate and returns on equity. The desire to close the differential between the New Zealand tax burdens on associated debt and equity leads us to reject use of the AIL treatment for borrowings from associates. The differential between the New Zealand tax burdens on non-resident debt and equity cannot be eliminated while New Zealand continues to allow deductions for investment interest expense; and, for reasons of revenue constraint, the New Zealand tax burden on equity cannot be reduced to the 10 percent limit for withholding tax on interest in most of New Zealand's tax treaties;
- different considerations may apply in assessing whether the AIL should be extended to associated borrowing in the case of debt finance provided by foreign-owned banks and finance companies to New Zealand affiliate banks/finance companies. We have not addressed this;

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7 The government should also investigate whether an AIL-type regime might be adopted. Under such a regime, dividends might be subject to a two percent AIL on registered shares or a five percent NRWT.

- back-to-back arrangements inserting non-associated intermediaries between an ultimate non-resident associated lender and a New Zealand borrower (particularly those involving ‘set-off’ of the deposit and the advance involving the intermediary) should not qualify for the two percent AIL. This is designed to buttress the associated person rule;
- early 1990s NRWT elimination structures involving, for example, prepaid interest and discounting of the note to a non-resident and use of branch structures should be eliminated;
- the NRWT rules should be amended to ensure that an AIL or NRWT liability is triggered whenever a New Zealand borrower is accruing an interest deduction under the accrual rules in respect of debt finance provided by a non-resident. For example, AIL or NRWT liability would arise as discount is accrued by a New Zealand issuer on a debt instrument issued at a discount;
- where controlled by a non-resident (a similar test to that for applying the thin capitalisation rules would be applied), a New Zealand company or branch could use the AIL regime only in respect of third-party debt up to a level of, say, 50 percent of total capital. Such a rule would be designed to ensure that external debt is not stacked into New Zealand operations by non-resident group treasuries to avoid the 10 percent withholding tax. Thus, the representative company could have a capital structure as follows:

Table E.2		
	% of Capital	**Tax Treatment**
Third party debt	50%	(NZ tax = 2% AIL or 10% NRWT)
Associated debt from non-residents	25%	(NZ tax = 10%)
Equity	25%	(NZ tax = 18% plus 2% NRWT)

- this issue may be less significant in the context of an 18 percent company tax rate – with a low-rate jurisdiction, it seems likely the non-resident group could find other countries against which to allocate external debt. Nevertheless, it seems preferable to address the issue explicitly. Special rules would be required for banks and finance companies.

E.37 We recommend introducing these rules only in the context of the 18 percent corporate tax regime we propose. We do not recommend this approach in the context of the current 33 percent corporate tax regime.

Qualitative Analysis of Policy Option One

E.38 Policy Option One applies a different company tax rate for non-resident investors and resident investors. It does not distinguish between activities by sector. It does not distinguish between new and existing investment. It does not distinguish between non-resident investors that seek to use New Zealand as a base to exploit international markets and those that are here to exploit the New Zealand market or New Zealand's natural resources; that is, all non-residents are treated in the same way regardless of their expected sensitivity to tax.[8]

E.39 Policy Option One delivers the tax reduction to non-resident investors in a way that is true to the economic theory with respect to cost of capital. However, because it does not seek to differentiate between tax sensitive and non-tax sensitive non-residents, it does result in some tax loss without economic benefit. Some non-resident investors reap windfall gains, particularly existing investors who need to be in New Zealand – they committed to New Zealand under the current tax regime and thus were prepared to accept the higher tax burden under that regime.

E.40 This approach avoids the worst definitional, administrative and compliance difficulties that come with trying to apply a reduced rate to targeted activities or only to non-residents with high tax sensitivity.

E.41 To the extent possible from a tax perspective, Policy Option One addresses concerns about existing non-resident investors gradually quitting their investments in New Zealand if the current New Zealand tax burden is retained.

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8 We note that the benefits of rate reduction are offset in part by lower benefit from depreciation allowances and an increase in the after-tax cost of debt finance.

E.42 The Treasury and IRD's advice is that:

- Policy Option One can be implemented without breaching New Zealand's obligations to the World Trade Organisation and, in particular, under GATT; and
- This option should not be affected by the OECD's Harmful Tax Competition Project.

Effective NZ tax burden for non-residents under Policy Option One

E.43 Using the approach in paragraph E.26 above, the minimum and maximum effective tax rates applying to non-residents for FDI would be expected to be:

Table E.3

	Minimum ETR (%)	Maximum ETR (%)
Direct investment	0%[1]	14.82%[2]

NOTES

[1] 0 percent assumes that a full foreign tax credit is available.

[2] (.5 x 10%) plus (.5 x 18%) plus (.5 x 2% x .82) = 14.82%. We assume use of external finance up to the 50 percent cap proposed and that this eliminates the ability to 'stack' external debt to reduce the New Zealand company tax rate. In this case, 50 percent of the remaining finance up to the thin cap 75 percent maximum could be expected to be associated-party debt triggering the 10 percent withholding tax liability. The remaining 50 percent would be equity bearing the 18 percent tax burden, plus a two percent withholding tax on dividend repatriation. (These calculations do not take account of differing yields.)

Review's selection of 18 percent rate with two percent withholding tax

E.44 The aim has been to produce a New Zealand tax burden on foreign investment that is designed as a rough approximation to encourage additional foreign investment and reduce New Zealand's cost of capital, but still collect New Zealand tax to an extent likely to qualify for foreign tax credits or where, for other reasons, the non-resident is not sensitive to the tax. Because of the mobility and tax sensitivity of the type of FDI New Zealand is likely to seek to attract, we have sought a tax rate that "stands out more from the crowd".

E.45 We believe a rate in the vicinity of an 18 percent statutory rate and a 14.82 percent maximum effective rate should achieve these objectives. Obviously, this is not a 'magic' invariable number.

Fiscal cost of implementation

E.46 There are three factors at work in Policy Option One:

- first, the statutory rate in relation to equity investment is being reduced significantly and this produces a fiscal cost relative to the status quo;
- second, a two percent withholding tax would be introduced in relation to FDI, which is additional to the corporate tax; and
- third, there is a considerable tightening of the regime surrounding withholding tax on associated party debt.

E.47 These last two factors will produce an increase in tax relative to the status quo.

E.48 For budgeting purposes, estimates of the net fiscal cost of the proposed regime have been calculated by officials as approximately $460 million, assuming application to non-resident portfolio investors as well.

E.49 This estimate is based on a 'static' analysis. It assumes that New Zealand companies are, in aggregate, currently 33 percent owned by non-residents; in the absence of the tax reduction, all existing non-resident investors would continue to hold their investments in New Zealand; and no economic growth occurs as a result of the tax reduction. It also does not take account of the effects of potentially significant behavioural change if New Zealand comes to be regarded as a low-tax jurisdiction. This estimate is not an attempt to quantify the likely effect of the policy, but is designed as a conservative projection that the government can rely on for budgeting purposes.

Policy Option Two: 18 percent company tax rate for new activities or significant expansions of existing activities to Extent New Zealand company owned by non-residents

Description of the Regime

E.50 This option would make the same distinction in company tax rate based on ownership of ordinary equity as for Policy Option One. Accordingly, for companies to whom the regime is applied, this regime would have the same features for distinguishing between resident and non-resident owners as Policy Option One (paragraphs E.28 to E.34 above).

E.51 However, in Policy Option Two, the 18 percent rate is not available to all companies owned by non-residents. The rate would be available only to new companies incorporated after the effective date and engaged in new activities (that is, activities commenced after the effective date) or in significant expansions of existing activities undertaken by other group members.

E.52 Existing companies that were not eligible for the regime, even though owned by non-residents, would be subject to the general corporate rate.

E.53 Transfers after the effective date of activities existing at that date would not qualify for the 18 percent rate. So, new non-resident owners resulting from post-effective date mergers or acquisitions of companies engaged in existing activities at the effective date would **not** qualify for the 18 percent rate.

E.54 We have in mind that:

- each newly incorporated company wishing to qualify for the 18 percent regime would apply to the IRD for advance confirmation that it qualified for the 18 percent rate by virtue of its new activity;
- the IRD, working with guidance from the relevant investment promotion agency, would be required to approve or reject the application within, say, a two-month period of filing of the application. The application would contain the company's explanation of why it qualified for the benefits of the regime as a new activity or

significant expansion and how the new operation related to any existing business of the group;

- provided full disclosure was made, the IRD's advance approval of the 18 percent rate would be binding; and
- the new company would be required to deal with other group members on an arm's length basis, so as to reduce the risk of transfers of income from higher-taxed existing companies to the lower-taxed new company. The new company would be approved for application of the 18 percent regime only if it was capable of separate operation from any existing group members.

Qualitative Analysis of Policy Option Two

E.55 The objective is to target the lower 18 percent tax rate more narrowly at new investment by non-residents, which is more likely to be sensitive to tax. We acknowledge that the new/existing distinction is not a perfect barometer of tax sensitivity. The objective is:

- relative to a general tax reduction for all non-resident investors, to restrict windfall gains that would accrue to non-residents already invested in New Zealand and who are less sensitive to New Zealand tax. Such existing non-resident investors appear to be 70-85 percent invested in exploitation of New Zealand's natural resources or exploitation of the New Zealand market; and
- to lower the fiscal cost to the government of the policy relative to a tax reduction for all non-resident investors. Where it is not clear how much new FDI will follow, it may be wise to endeavour to test this before reducing taxes significantly on existing businesses owned by non-residents.

E.56 The main issues with this option are:

- additional definitional, administrative and compliance difficulties in administering a 'new' versus 'existing' approach. These include the need to segregate business expansions from existing businesses in a way that would not naturally occur as a purely business matter. An example of the definitional difficulties include how to classify a biotechnology company creating intellectual property. If the company is in existence at the effective date, will new technology developed after the effective date be regarded as a new or existing activity? If the regime is to prove sustainable over time, the rules will need to be designed and implemented in a way that maintains the credibility of the 'new' and 'existing' distinction;
- a strong incentive for taxpayers to engage in the creation of new activities or the 'creative redesignation' of existing activities as new activities; and
- a possible reaction from existing non-resident investors, by reason of the failure to extend the new regime to them. The explanation that existing non-residents would otherwise have reaped windfall gains relative to the position that existed when they committed to New Zealand should prove acceptable. The position as regards existing non-resident investors may also be assisted if New Zealand moves to reduce its general company tax rate (for example, to align it with that of Australia).

E.57 If Policy Option Two is to be analysed as a sustainable medium-term policy, the rules for distinguishing new and existing activities, and the manner of their implementation, must genuinely restrict conversion of existing businesses into new businesses and that must be understood by all to be the policy.

E.58 If a sustainable distinction between new and existing activities cannot be made, the distinction may break down over time as more and more businesses are transformed into new businesses relative to the position at the effective date. In this case, the distinction would have to be viewed as transitional, leading ultimately to adoption of the 18 percent rate for all non-resident owned businesses, but allowing some time for New Zealand to absorb the budgetary impact. If this transitional approach was to be taken, a preliminary step to its adoption should be a determination that Policy Option One increases national welfare.

E.59 If Policy Option Two is pursued, consideration should be given to whether it should be enacted for a limited period of, say, 10 years. This raises the same objection as that raised below in terms of tax holidays, but may marginally increase the government's ability to assess the effectiveness of the policy at the end of the period and consider whether it should be continued.

E.60 The Treasury and IRD's advice is that:

- Policy Option Two can be implemented without breaching New Zealand's obligations to the World Trade Organisation and, in particular, under GATT; and
- this option should not be affected by the OECD's Harmful Tax Competition Project.

Effective New Zealand tax burden for non-residents under Policy Option Two

E.61 For new activities and significant expansions of activities by non-residents, the minimum and maximum effective tax rates would be as for Policy Option One (see paragraph E.43 above).

Fiscal Cost of Implementation

E.62 Officials estimate that this option has a small fiscal cost on the static analysis used for government budgeting purposes of a maximum of $50 million each year. This calculation assumes no growth in FDI and treats existing flows of FDI as if they were all "new" investment.

Policy Option 3: 18 percent company tax rate for non-resident investment in export-oriented companies/development zones or for companies in certain industries; or specially tailored tax incentives for certain targeted industries

Description of the Regime

E.63 The most promising option of a range of targeted options to attract non-resident investment is an 18 percent statutory tax rate for non-resident investment in a company:

- that supplies more than 75 percent of its goods or services to international markets (perhaps excluding suppliers of natural resources located in New Zealand); or
- at least 75 percent of whose activity is the supply of research/development services with respect to technology/products of which at least 75 percent is expected to be supplied to international markets.

E.64 Qualification for the regime, as for Policy Option Two, would require advance IRD approval (with guidance from the relevant investment promotion agency). Provided full disclosure was made, the IRD's approval would be binding. The 18 percent rate would apply to companies to the extent of non-resident ownership as for Policy Option One (see paragraphs E.28 to E.34 for the rules required for distinguishing between resident and non-resident owners).

E.65 Given the likely sensitivity of all non-resident investment of this type, such a regime should apply to all non-resident investment of the qualifying type, whether existing at the effective date or not.

Qualitative Analysis of Policy Option 3

E.66 This approach seeks to attract non-resident investment that is sensitive to tax, while attempting to restrict the fiscal cost of significant tax reductions with respect to existing investment by non-residents. Again, the distinction made in defining qualifying investment is not a perfect barometer of tax sensitivity.

E.67 The main issues with this option are:

- additional definitional, administrative and compliance difficulties in administering the distinction between qualifying and non-qualifying activities;
- the effect is a tax distortion in favour of non-resident investment directed to exploitation of international markets, with resulting additional resources allocated to this area;
- whether politicians are able, over time, to continue limiting the regime to non-residents; and
- the real risk that this policy could be viewed as a breach of the WTO Agreement on Subsidies and Countervailing Measures. Article 3 prohibits "subsidies" contingent on export performance. Before this approach could be implemented, more detailed advice would need to be obtained on this point. The Treasury and IRD believe that Policy Option 3 is not affected by the OECD's Harmful Tax Competition Project.

Effective New Zealand Tax Burden of Policy Option 3

E.68 For qualifying activities by non-residents, the minimum and maximum effective tax rates would be as for Policy Option One (see paragraph E.43 above).

Fiscal Cost of Implementation

E.69 Given the strong potential for the most promising of these options to breach GATT obligations, we have not explored the fiscal cost of implementation.

Variations

E.70 Variations to this approach might provide the 18 percent statutory rate for companies located in certain industrial development zones. We prefer to avoid this approach so that decisions on location of businesses within New Zealand are made on an economic assessment, without an explicit influence via the tax system.

E.71 Another approach might involve a higher general corporate rate with specially tailored tax incentives for certain targeted industries (for example, refundable research and development credits or tax credits related to cost of labour). For reasons we have outlined in Chapter Two, *Frameworks*, we do not prefer a broad approach of this type as a means of reducing effective tax rates.

Other options we have considered and rejected

Additional accelerated tax depreciation and investment tax credits for non-resident investors

E.72 A major reason for this approach is that it enables new investment to be targeted for a lower effective tax rate. This objective is also achieved with a reasonably low administrative burden. The regime would apply to new property installed after an effective date. Windfall gains to existing non-resident investors are avoided because they retain the same depreciation allowances etc as at the time they made their original investment.

E.73 The degree of benefit from accelerated tax depreciation (even including the possibility of deductions in excess of purchase price) varies with the tax rate and with the taxpayer's tax position. For example, start-up taxpayers who are not expected to be in a taxpaying position do not benefit as much as current taxpayers in existing businesses.

E.74 Investment tax credits, again, can be targeted to benefit only new investment and avoid the windfall gains to existing investors that generally apply to tax-rate reductions. The start-up taxpayer can benefit if the credit is a refundable one. This option tends to provide greater benefit to entities acquiring shorter-lived assets than to those acquiring longer-lived ones. There is the possibility of allowing investment tax credits on an incremental basis, where expenditure exceeds a base level. The idea is to try to target the incentive on expenditure that would not have occurred without the tax relief. Even in this case, taxpayers may have reduced expenditure in anticipation of the regime, so that the base is lower.

E.75 We do not recommend these options because:

- we believe it will prove more difficult politically and practically to quarantine the benefits of accelerated depreciation/investment tax credit to non-resident investors alone. It is highly likely that, even if this approach commenced as a cost-effective way to lower the effective tax on new investment by non-residents, it would end up, by virtue of political pressure, being available to all investors;
- we favour the greater transparency, in terms of signalling, of a lower statutory rate; and
- this approach favours fixed-asset-intensive industries, rather than service industries.

Tax holidays

E.76 This approach targets a zero tax regime to newly established firms for a specified time period (say, five years), after which the ordinary tax rules come into play. The tax holiday may be targeted at qualifying sectors/activities. This approach is more attractive to business with profits in early years of operation, rather than those requiring long-term capital commitments. We do not recommend this approach because of the desire to

focus on long-term, high-quality, sustainable FDI. Our impression is that this approach is more likely to attract ‘incentive-shopping’ FDI, which is more likely to exit following the expiry of the tax holiday.

Reduction in general company tax rate (irrespective of residence of owners)

E.77 Revenue constraints prevent a lowering of the general company tax rate to the level that we believe is desirable in respect of FDI. In addition, this approach would not be well targeted as a means of reducing the tax burden for non-resident investors.

Retention of current tax rates (33 percent) and significant expenditure on grants through an IPA

E.78 An adequately funded investment promotion agency with the ability to make grants to attract foreign investment may well be critically important. But, in our view, it is unlikely to be sufficient on its own. We believe that a lower company tax rate for investment by non-residents is necessary if New Zealand is to “stand out more from the crowd” and have a realistic opportunity to attract significant investment by non-residents on the scale required.

ANNEX F
INTERNATIONAL TAX: OFFSHORE INVESTMENT BY RESIDENTS

Detailed analysis of policy options

Policy Option One: broad application of RFRM for offshore investment

1 The RFRM is described in detail in Annex A of the Issues Paper. We do not recommend enacting the RFRM as a broad measure applicable to all offshore investment. There are significant issues that would need to be addressed in detail before enactment of such a reform could be supported (see the issues raised in our Issues Paper, Chapter Six, *International Taxation: Taxing Income from Inbound and Offshore Investment*). Corporate taxpayers have, moreover, expressed a high degree of unease with the approach if applied to a broad extent in the manner suggested in Options Two and Three of our Issues Paper.

2 However, we do recommend implementing the RFRM approach in the context of portfolio investment in listed offshore companies and retail unit trusts (whether or not located in the grey list). Depending on the outcome of the dialogue we propose as regards the active/passive approach, RFRM may also be inserted into the FIF regime as an alternative to the deemed rate of return method.

3 If RFRM is enacted in the context of portfolio investment in listed offshore companies and retail unit trusts, we believe that experience with the regime should be monitored. Armed with that experience and with taxpayers' greater familiarity with the concept in practice, consideration can then be given to whether the regime should be applied more broadly.

Policy Option Two: retention of current grey list; passive/active (with expense allocation); RFRM for listed offshore investments and retail unit trusts

Description of the Regime

4 We have not addressed the detail of an active/passive regime. All such regimes are complex, but most countries have been prepared to adopt them and there are models that can be used. The aim, if at all possible, should be for a less complex regime than those existing in other countries. Some portion of the complexity may be avoidable, given the small scale of the New Zealand economy.

5 In resolving the detail of any active/passive regime, real care is required as regards active businesses conducted in unlisted but lower-tax jurisdictions than New Zealand. The balance between avoiding barriers to residents remaining in New Zealand and incentivising offshore investment would need to take account of New Zealand's particular circumstances.

Table F.1 – ***Type of Investment in Foreign Company***

Type of New Zealand investor	Interest in listed Offshore company (or Retail Unit Trust)	Income Interest in CFC[1]	Unlisted Offshore (but not an income interest in a CFC)
Individual, Trust and Company (listed or unlisted)	If 30% or greater interest = as for income interest in CFC If less than 30% interest = RFRM method (by reference to market value)	Grey list = status quo: no tax until repatriation; deemed UFTC upon repatriation provided 10% voting interest Branch equivalent method for: (i) passive category for non-listed jurisdictions; (ii) all income from black-list jurisdictions Active category from non-listed = taxed only on repatriation to New Zealand	Grey list = status quo: no tax until repatriation; deemed UFTC upon repatriation provided 10% voting interest If 30% or greater interest other than grey list = as for income interest in CFC If less than 30% interest: (i) current FIF for black list and for passive category in non-listed jurisdictions; (ii) for active category in non-listed jurisdictions = taxed only on repatriation to New Zealand

6 The approach we have suggested adopts some distinctions on a jurisdiction basis (the current grey list, the black list and non-listed jurisdictions). The CFC/FIF regimes then frequently divide into entity and transactional approaches. The entity approach involves examining the activities/income of the entity. If the activities/income exceed a certain 'active' threshold, no income is attributed; if it falls below the threshold, all income is attributed. For the regime to operate in a practical way, it seems likely that this entity approach is preferable to a transactional approach. The transactional approach is more complete (but less susceptible to abuse) because it requires each transaction or class of transaction to be categorised as 'passive' or 'active'.

[1] We have noted in Chapter Eight, *International Taxation: Taxing Income from Inbound and Offshore Investment*, that, in principle and without regard to the international standard, we are not attracted to an active/passive distinction. But pragmatism and regard to the international standard suggests further dialogue on this issue. We have thought it desirable to outline the type of regime that we believe should be the subject of that dialogue.

7 Policy Option Two does not adopt an expanded grey list, but retains the current one. We are concerned that a broader grey list conferring a blanket deferral of New Zealand tax until repatriation would be considerably more susceptible to abuse than the current regime.

8 Rules would be required to allocate New Zealand expenses (particularly, and perhaps exclusively, interest) to offshore investments, including those in the grey list, and to disallow or defer deductions for expenses of a New Zealand group of companies so allocated to offshore investments. We have not addressed these rules in any detail (another option is to apportion such expenses for purposes of foreign tax-credit calculation).

9 Rules of this type are required because, although the imputation regime provides a strong incentive to maximise New Zealand tax,[2] we would not recommend relying solely on that incentive as protection against use of offshore investments to reduce a company's New Zealand tax on New Zealand-sourced income.

10 Otherwise, the position as regards FDWP, tax credits, BETA accounts etc for the "income interest in CFC" and "unlisted offshore" categories would remain substantially similar to those applicable under current law.

Qualitative analysis of Policy Option Two

11 Policy Option Two suffers from the defects of all passive/active regimes in that it potentially subsidises offshore investment by residents (who would remain in New Zealand without the passive/active rule) to the detriment of investment in New Zealand.[3] This subsidy arises because, while New Zealand-sourced income is currently taxed to the resident, New Zealand tax on offshore income is deferred until repatriation to New Zealand.

12 This regime does not create a tax incentive to invest offshore where tax credits for the offshore tax on offshore income would eliminate New Zealand tax liability. In this case, the active/passive regime merely operates to reduce compliance costs.

13 However, the particular concern from New Zealand's national economic perspective is that active businesses, for which New Zealand may grant the benefit of deferral, may be taxed at an effective rate that is lower than the New Zealand effective rate. In this case, if New Zealand provides the deferral benefit, it encourages offshore investment by residents and offshore location of productive activities relative to investment and production in New Zealand. The timing advantage is perceived to be significant, even if reversed on repatriation of earnings to New Zealand.

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2 Imputation credits are available only for New Zealand tax actually paid.

3 This, in addition to the defect from a national welfare maximisation perspective of allowing tax credits for foreign taxes, is contrary to the residence principle. But, for reasons addressed above, we put this defect aside.

14 However, failure to provide the deferral benefit gives New Zealand's most entrepreneurial and wealthy individuals and New Zealand companies that expand internationally a real tax reason to leave New Zealand. This issue has been of growing concern over the last 10 years as a significant number of New Zealand's top companies have migrated out of New Zealand and, more recently, a significant number of New Zealand's most wealthy individuals have left.

15 We must recognise that major non-tax factors are at play, leading to greater concentration/agglomeration in major centres. New Zealand's tax regime cannot overcome those factors. But we believe it is important that New Zealand's taxation of offshore investment does not provide a reason for departure from New Zealand.

16 Even if the remaining companies with significant offshore investments are currently small in number, it is important that New Zealand does not have a tax environment that is a barrier to relocation to New Zealand or a barrier to New Zealand-resident companies or high net-worth individuals using New Zealand as a base for international expansion.

17 We suggest below two other principles that, in part, address the issue for non-domiciles seeking to move to New Zealand temporarily and very high-income individuals. (See Policy Options Four and Five). These rules alone do not address the full extent of the issue. Adoption of those rules would leave New Zealand-listed corporates and early- to mid-stage entrepreneurs who are seeking international expansion subject to the full rigour of the regime. These are the remaining persons/entities most vulnerable to departure in response to New Zealand's current rules.

18 In conclusion, the active/passive regime places the emphasis on retaining residents and accepts some distortion of investment decisions for those who would, in any event, have remained resident.

Possible increase in tax from implementation

19 Officials have advised us that, although it is not possible to determine the exact figure, the amount of New Zealand income tax collected from companies under the CFC and FIF regimes over the last five years is not more than a maximum of $100 million per year and may well be less than this amount.[4]

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4 This estimate is derived as follows. The aggregate amount of gross taxable income from non-grey list investments under the CFC/FIF regimes, from trading grey list investments by resident managed funds and from certain other overseas contracting income has ranged from $800 million to $1.4 billion over the last five years. It has averaged approximately $1 billion per annum. This figure is **gross** taxable income before expense deductions and before tax credits allowed for foreign taxes. Approximately 50 percent of the $1 billion is attributable to the trading of New Zealand resident investment vehicles. As a result, gross taxable income under the CFC and FIF regimes (not attributable to the managed funds industry) has been approximately $500 million per annum. Foreign tax credits allowed and attributable to this income are approximately $40 million per annum. Assuming no deductible expenses arise in respect of this gross income a total estimated New Zealand tax liability from CFC and FIF income would be approximately $125 million, ie, 33 percent of $500 million less $40 million. It seems reasonable to assume expenses at the very least sufficient to reduce New Zealand tax liability to no more than $100 million per annum.

20 We note, however, that this does not mean that the fiscal cost of repealing the current regime would be limited to this amount. As we suggest in Chapter Eight, an active /passive regime creates a tax incentive for residents to invest offshore. It would be necessary to consider the extent to which fully taxed New Zealand source income would be transformed into deferred and tax credited offshore income as a result of a change to an active/passive regime.

21 We understand that approximately 80 percent of all direct and portfolio offshore equity investment by New Zealanders is into grey list jurisdictions and that, even if the grey list was repealed, so long as tax credits were provided in the same manner as under the current law no significant tax would be collected from the equity portion of those grey list investments.

22 On a static analysis, the enactment of an active/passive regime along the line contemplated in Policy Option Two could increase taxes for New Zealand. This comes about because the active/passive regime could, in our view, only be enacted with expense allocation rules of the type we signalled (at least as regards to interest expenses). These rules would deny/defer tax deductions that are in practice currently claimed without limit by New Zealand companies (including interest expenses allocated to financing grey list and active investments).

23 The Treasury and IRD's concern with the active/passive approach has always been:

- the long-run distortion towards offshore investment for residents who would otherwise have carried on their activity and paid tax in New Zealand; and
- the artificiality and potential unsustainability of the active/passive boundary, resulting in continual to and fro, as policy makers seek to maintain the boundary and taxpayers seek to fall on the active side.

Policy Option Three: lower general corporate rate or lower corporate rate for offshore investment

24 Professor Auerbach has added the useful insight that an argument for the passive/active distinction is really an argument for lower taxes in general on potentially mobile residents. If New Zealand wishes to encourage mobile investors and companies to remain in New Zealand, one possibility is to lower taxes generally on all income (foreign- and New Zealand-sourced). If the tax rate can be lowered across the board, the concept is that both objectives in Chapter Eight, paragraph 8.62 can be achieved. For example, relative to companies with a 30 percent tax rate and an active/passive international regime, the New Zealand corporate rate might be 25 percent, reflecting the broader base.

25 We see practical difficulties with this approach:

- first, a reduction in the general company tax rate of the magnitude required to achieve the objective is likely to involve considerable tax-revenue loss. That tax-revenue loss would be disproportionately large for the objective sought. It would also almost certainly result in abandonment of the important objective of alignment of the corporate and top personal tax rates. We believe that the present offshore investment

objective is not in itself sufficient to justify this approach. We address these issues separately in the broader context of tax rate design in Chapter Six, *Tax Rates*; and

- second, even with this approach, New Zealand would remain outside the international standard and organisations with a strong offshore focus might still view alternative active/passive regimes as preferable to the New Zealand approach.

26 We have considered one other possibility: excluding until repatriation the income of all entities subject to a general company tax rate in their country of residence at least 85 percent of the New Zealand rate; together with a concessionary, say, 20 percent company tax rate for investment in all other foreign entities.

Policy Option Four: attracting high net-worth individuals to New Zealand: exemption from application of CFC/FIF regimes

27 In our Issues Paper, we raised the possibility of introducing a 'domicile' rule into the international tax regime, under which individuals who are New Zealand residents but not domiciled in New Zealand would be exempt from our FIF and CFC rules. This regime would apply to persons who had never been tax resident in New Zealand.

28 This contrasts with the current law, whereby all residents are subject to tax on their world-wide income from the moment they become a resident. As a deliberate matter of policy, it is easy to gain, but difficult to lose, residency status for tax purposes. A person is resident in New Zealand if they pass one of two tests:

- they have a "permanent place of abode" in New Zealand, even if they have another permanent place of abode elsewhere; or
- they are present in New Zealand for more than 183 days in aggregate in any 12 month period.

29 The domicile rule in New Zealand is provided in the Domicile Act 1976. Under that Act, a person acquires a new domicile if s/he is in a new country and intends to live indefinitely in that country. This domicile continues until a further new domicile is acquired. Thus, it is possible that a person could move to New Zealand, and for all practical purposes be a New Zealander, but still not have formed the requisite intention to live in New Zealand "indefinitely".

30 Our policy objective in raising this issue was to seek to define a class of persons who, while resident in New Zealand, had not yet formed a sufficient connection with New Zealand to justify taxation of their world-wide income. We particularly had in mind people who had never had any previous connection with New Zealand and who move here for less than a certain period of years.

31 Submissions and our subsequent analysis have pointed out that there may be anomalies in using domicile for the purpose we intended.

32 While we continue to be of the view that New Zealand should adopt a rule whereby individuals can be resident in New Zealand but not be subject to New Zealand tax on

their world-wide income, we have doubts that simply applying a test based on domicile is appropriate.

33 We, therefore, state the principle we recommend and leave the government to develop the appropriate rule. The principle is:

> *That an individual with no previous connection to New Zealand who becomes a resident of New Zealand for tax purposes should be taxed only on their New Zealand-sourced income for the first seven years after they first become a resident.*

Policy Option Five: attracting and retaining high-net-worth individuals: a tax cap

34 In the Issues paper, we raised the possibility of a 'tax cap', under which New Zealand would limit the annual tax liability of individuals to a certain, very high level. We suggested a figure of $1 million in tax.

35 This proposal was directed at both attracting high-income non-residents who may be tempted to locate to New Zealand and retaining wealthy residents, who are also increasingly mobile.

36 We received a range of submissions on this proposal, many supporting it or other alternative caps and some raising equity concerns.

37 Within the context of the entire tax system, the fiscal cost of this proposal is moderate.

38 While recognising that the proposal does have equity implications, we believe that it is justified. We emphasise the considerable commercial benefits New Zealand obtains from business and other connections of people in this group, as well as their direct contribution to the economy.

39 A subsidiary issue is whether the cap should apply to income received directly or should extend to income earned by a person in companies they own. The practical expression of this issue is whether imputation credits should be refundable.

40 In principle, they should, if the policy is to cap income tax payments regardless of the form in which that income is earned.

41 The alternative would be to limit the cap to income earned directly (or possibly, within the individual's wholly-owned group or entities). The difficulty here is that such a rule could be circumvented: a high-income individual could very simply arrange their affairs so as to always earn income in a form that would be tax deductible to their companies, such as interest on debt, and exempt in their hands as a result of the cap.

42 As to the level of the cap, this is largely a matter of judgment. Set out below is the fiscal cost of a range of options:

Table F.1 – *Fiscal Impact of the Tax Cap*

Income Level	Fiscal Cost If Imputation Credits Refunded	Fiscal Cost If Imputation Credits Not Refunded
$1m	$145m	$52m
$2m	$72m	$21m
$2.6m	$54m	$12m
$5m	$25m	$2.2m
$5.2m	$24m	$2m
$10m	$14m	$0m

43 We recommend the original proposal of setting the cap at $1 million of tax paid per year, which equates to an income of $2.6 million at current rates.

44 We leave the detail to be considered later. If an imputation credit refund approach were to be adopted, it would be important that this did not enable tax to be refunded for periods prior to the effective date. In addition, it would be important to ensure that refunding imputation credits in this case did not place New Zealand in breach of the non-discrimination article in its tax treaties. Alternatively, if imputation credits were not to be refunded, a maximum debt-equity ratio might be set for purposes of the regime.

45 Finally, we have in mind that persons qualifying for the benefit of this regime should register/file an election with the IRD. One condition of the tax cap would be that the taxpayer would prospectively lose the benefit of the exemption for life if found by a court to have knowingly entered into an arrangement, after the effective date of the regime, that is found to have involved tax avoidance and in which arrangement the taxpayer's tax status was a material factor.

Additional matters

Conduit relief

46 We briefly addressed conduit relief in our Issues Paper (Chapter Six, *International Taxation: Taxing Income from Inbound and Offshore Investment*). We confirm the conduit principle, although its effect is not likely to be as significant if an active/passive regime is adopted.

47 We acknowledge that the regime we propose in relation to inbound investment has the effect of a reduction to two percent withholding tax on conduit investment by FDI investors. But it retains 15 percent withholding for portfolio investors. We have not been able to consider this in depth, but our instinct is that this is simply the necessary corollary of retaining the FITC regime for portfolio investment.

48 We have asked for submissions on whether New Zealand-resident companies controlled by non-residents should be able to reduce their New Zealand tax liability on New Zealand-sourced income by borrowing to make offshore investments. We have received no submissions on this subject. Our view is that, in principle, this result is not

appropriate, at least in some cases. Difficult definitional and drafting issues arise and we leave them to be addressed under the normal tax reform process.

Australian and triangular issues

49 We note that Australian and New Zealand officials are working on a consultative document that should be released later this year. We support this initiative, but accept that final decisions have yet to be made.

Foreign trust rules

50 We have not reviewed this regime in detail. We note that practitioners generally find this regime intricate in its crafting. In a number of instances, it has also tended to overshoot its intended mark, but erring on the side of the IRD. We are not aware of significant problems from a revenue perspective under this regime.

ANNEX G
DATA FROM CHAPTER ONE

Revenue and expenditure	*March years*		*June years*		
	1981	**1986**	**1991**	**1996**	**2001**
Source Deductions	4,013	7,464	10,122	12,539	13,703
Net Other Persons	700	1,643	2,570	2,760	3,081
Residents' Interest			1,028	984	990
Residents' Dividends			83	30	83
Fringe Benefit Tax		104	485	327	342
Taxes on Individuals	**4,713**	**9,211**	**14,288**	**16,640**	**18,199**
Company Income Tax	585	1,270	1,762	4,063	4,831
Non-Residents' Income		86	277	491	760
Foreign Source Dividends			18	59	71
Taxes on Companies	**585**	**1,356**	**2,057**	**4,613**	**5,662**
Estate, Gift Duty and Land Tax	51	84	277	2	2
Total Direct Taxation	5,349	10,651	16,622	21,255	23,863
GST			6,163	7,262	9,126
Sales Tax	776	1,553			
Sales Tax or GST	**776**	**1,553**	**6,163**	**7,262**	**9,126**
Excises Duties	324	647	1,821	1,875	2,010
Gaming Duties	46	79	83	126	206
Customs Duty	349	742	505	843	648
Stamp Duty	54	127	78	216	61
Other Indirect Taxes	152	437	525	656	824
Total Other Indirect Taxes	**925**	**2,032**	**3,012**	**3,716**	**3,749**
Total Indirect Taxation	1,701	3,585	9,175	10,978	12,875
Total Taxation	7,050	14,236	25,797	32,233	36,738
Other Revenue	558	1,565	3,213	2,826	2,754
Surpluses from SOEs				-2	103
Total Revenue	7,609	15,800	29,010	35,058	39,595
Total Expenditure	9,133	17,672	27,577	31,743	38,186
GDP - Expenditure	**22,755**	**45,673**	**73,018**	**93,884**	**112,717**
Tax Revenue to GDP	31.0%	31.0%	35.3%	34.3%	34.3%
Total Revenue to GDP	33.4%	34.5%	40.1%	37.3%	37.3%
Government expenditure to GDP[1]	40.1%	38.7%	42.6%	33.8%	33.8%
Company taxes to GDP	2.6%	3.0%	2.8%	4.9%	5.0%
Company tax base to GDP	5.7%	6.6%	8.5%	14.9%	15.2%

[1] *Break in govt expenditure series in 1987.*

NOTE: Break in GDP Expenditure series in 1988
Shifted from March year to June year from 1989 and 1990

Tax mix

	March years		*June years*		
	1981	**1986**	**1991**	**1996**	**2001**
Total Individual Income Tax	4,713	9,211	14,288	16,640	18,199
Total Corporate Tax	585	1,356	2,057	4,613	5,662
Estate and Gift Duty and Land Tax	51	84	277	2	2
Total GST and Sales Tax	776	1,553	6,163	7,262	9,126
Excise and Gaming Duties	370	726	1,904	2,001	2,216
Other Indirect Taxation	555	1,306	1,108	1,715	1,533
Total	**7,050**	**14,236**	**25,797**	**32,233**	**36,738**
Taxes on individuals	67%	65%	55%	52%	50%
Taxes on companies	8%	10%	8%	14%	15%
Sales taxes or GST	11%	11%	24%	23%	25%
Excise and gaming duties	5%	5%	7%	6%	6%
Other taxes	9%	10%	5%	5%	4%
Total	**100%**	**100%**	**100%**	**100%**	**100%**

NOTE: Shifted from March year to June year from 1989 and 1990

Company tax base

March years	**1981**	**1982**	**1983**	**1984**	**1985**	**1986**	**1987**	**1988**	**1989**
Company Income Tax	585	667	850	702.7	1113	1270	1221	2026	1903.2
Non-Residents' Income		36	55	44	51	86	138	164	200
Foreign Source Dividends									12
Total	585	703	905	746.7	1164	1356	1359	2190	2115.2
Company Tax Rate	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.28
Company Tax Base	1300	1562.22	2011.11	1659.33	2586.67	3013.33	3020	4866.67	7554.29
GDP - Expenditure	**22,755**	**27,465**	**31,555**	**35,007**	**39,710**	**45,673**	**54,725**	**62,655**	**68,016**
Company Income Tax	6%	6%	6%	5%	7%	7%	6%	8%	11%

NOTE: Shifted from March year to June year from 1989 and 1990

cont'd

June years	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**
Company Income Tax	2531	1762	1850	2394	3001	3967	4063	3233
Non-Residents' Income	268	277	258	264	344	285	491	824
Foreign Source Dividends	-1	18	10	10	3	9	59	72
Total	2798	2057	2118	2668	3348	4261	4613	4129
Company Tax Rate	0.33	0.33	0.33	0.33	0.33	0.33	0.33	0.33
Company Tax Base	8478.79	6233.33	6418.18	8084.85	10145.45	12912.12	13978.79	12512.12
GDP - Expenditure	**72,365**	**73,018**	**73,764**	**76,311**	**82,864**	**88,539**	**93,884**	**97,919**
Company Income Tax	12%	9%	9%	11%	12%	15%	15%	13%

NOTE: Shifted from March year to June year from 1989 and 1990

cont'd

June years	**1998**	**1999**	**2000**	**2001**
Company Income Tax	3721	3693	4158	4831
Non-Residents' Income	662	717	735	760
Foreign Source Dividends	205	8	58	71
Total	4588	4418	4951	5662
Company Tax Rate	0.33	0.33	0.33	0.33
Company Tax Base	13903.03	13387.88	15003.03	17157.58
GDP - Expenditure	**99,697**	**101,390**	**106,064**	**112,717**
Company Income Tax	14%	13%	14%	15%

NOTE: Shifted from March year to June year from 1989 and 1990

ANNEX H
TERMS OF REFERENCE FOR THE REVIEW OF THE TAX SYSTEM

Functions

The Tax Review has been appointed to carry out a public review into the tax system so that the government has an appropriate framework within which to build tax policy.

The functions of the Review will be:

(a) to examine and inquire into the structure and effects of the present tax system in New Zealand;

(b) to formulate proposals for improving that system, either by way of making changes to the present system, abolishing any existing form of tax, or introducing new forms of tax; and

(c) to report to Parliament through the Minister of Finance, the Minister of Revenue and the Minister of Economic Development.

The last fifteen years have seen an overhaul of the New Zealand tax system. The main changes have been to remove special allowances and exemptions and varied tax rates. The result has been to broaden the tax base, flatten tax scales and greater resource allocative neutrality.

Critics say that the present tax system allows individuals to arrange their legal affairs so as to escape full rates of personal income tax, treats some types of production unevenly, and favours some forms of long-term saving over others.

A second concern is that the tax system as a whole has become less progressive, while at the same time the interface between the tax and benefit systems is generating very high effective marginal tax rates for some low income people and families.

Thirdly, threats to the tax base are found in new forms of transacting (such as internet trading and internet banking) and the use of new tax havens. A related problem is whether increased globalisation requires re-examination of the very possibility of New Zealand setting its own tax rates and what will happen if it does.

Finally, there is a growing debate about how relevant the tax system is to the core features of the economic structure. (Rival) contenders to augment or replace elements of the current tax

structure are sector-specific taxes to be used as an instrument for sectoral assistance, cash flow taxation, financial transactions taxes, and eco-taxes.

There is both the need for and scope to review the tax system at the level of broad principle as well as in some detail. For this reason, it is proposed to divide this process into two stages. The Tax Review is the first stage of the process and will explore the broad principles of the tax system. Stage two will consider the detail of implementing any changes proposed in stage one.

Purpose

In the budget speech the Government announced:

> *We will set up a broad-based and wide ranging tax review to advise on the principles and structures best suited to sustaining a robust revenue base over the long term.*

The review will concentrate on how it is possible to ensure a sustainable and continuous flow of revenue to meet Government requirements in the face of changing economic, social and technological conditions. It will form the basis of advice to the Government in broad terms about whether the New Zealand tax system can be improved.

Ideally the tax system should raise revenue simply, efficiently, fairly and reliably in an environment of changing technology, growing globalisation and increasing complexity. It should do this in ways that do not materially undermine the environment, social cohesion or the effective use of resources.

Task of the Tax Review

The Tax Review will:

(a) assess the extent to which the tax system can contribute to broader social and economic objectives such as encouraging secure, high-quality employment, generating a fair distribution of income, maintaining a sustainable environment and promoting higher savings;

(b) Recommend structural changes for the tax system, if appropriate. In doing so the Review will focus on the following questions:

- Can the tax system be made fairer in its role of redistributing income? This includes considering whether the income tax base should be broadened and the extent to which marginal rates should increase with levels of income, wealth and expenditure. The Review should consider the best mix between different tax bases such as income, consumption, financial transactions and wealth.
- How can the tax system be designed to encourage desirable behaviour (eg, work and savings) and discourage undesirable behaviour (eg, the wasteful use of non-renewable resources)?
- How can the level of tax that is reasonably required by government for the provision of essential social services such as health, education, superannuation and social

welfare be achieved reliably in the medium and long-term bearing in mind the need for the tax system to be an effective instrument of fiscal policy in the management of the economy?

- Do the tax system and tax rates need to be modified in light of new technology and international competition?

(c) The Tax Review will report on progress to the Minister of Finance, the Minister of Revenue and the Minister of Economic Development at regular intervals during the course of the review.

The conclusions need to be sufficiently general so that they can serve as a guide to overall tax policy, but sufficiently particular so that they provide a clear idea of the actual tax policies that they would lead to. The Review will submit its final report to the Minister Finance, the Minister of Revenue and the Minister of Economic Development by the end of September 2001.

Process expectations

Process should be inclusive, with opportunity for the public and key stakeholders to provide input, perhaps by way of the Review commissioning studies, preparing and releasing issues papers and arranging various discussion fora.

Since tax policy is a well-developed field, the Review would gather and assess the views of stakeholders and previous studies, rather than devising principles and policies from scratch. The Review's reporting deadline (by the end of September 2001) reinforces this.

The Government would make available relevant tax-policy officials from Treasury and IRD to provide analytic and secretariat support, and would expect them to contribute significantly to the Review. The support will include a full-time secretary to the Review, reporting to the Chair of the Review, to co-ordinate the support services to be provided. The Review team will have the ability and the budget to engage external parties to provide advice and assistance on specific issues.

Officials and the Review team would keep Ministers informed of the progress of the Review.

The Government will consider the report of the Review, and indicate publicly its views on what principles should guide tax policy and what the general structure of the tax system should be.

Stage two of the process will develop the conclusions reached during the tax review and construct a set of workable proposals that can be put before the New Zealand public in the context of the 2002 general election.