SAVINGS WORKING GROUP
1 The Terrace, PO Box 3724, Wellington 6140
Tel: (04) 472-2733 Email: savingsworkinggroup@treasury.govt.nz

Document: **Nordic with Deep Capital Tax Cut**
Author: **[Inland Revenue]**
Date: **[26 Oct 2010]**
URL: **http://www.treasury.govt.nz/publications/reviews-consultation/savingsworkinggroup/pdfs/swg-b-ir-n-26oct10.pdf**

Nordic with deep capital tax cut

A Nordic tax system, also known as a dual tax system, applies separate tax scales to capital (including corporate) income and labour income. New Zealand generally applies the same progressive tax rates to all personal income and a flat tax rate to corporate income. Generally speaking, under a Nordic tax system labour income is taxed on a progressive scale with a high top tax rate while capital income is taxed at a lower, flat rate.

As implied by its name, Nordic tax systems are mostly used in the Scandinavian countries, with the leading example of them being Norway. One of the leading reasons these countries adopted a dual tax system is it allowed them to make deep cuts to their capital tax rates while maintaining internationally high labour tax rates on labour. For example, in Norway the current capital tax rate is 28 percent while the marginal tax rates on labour range from 28 to 48 percent. The 28 percent rate also applies to the capital income of companies. The taxation of their deemed labour income is more complex.

The main features of Norway's Nordic tax system are:

- Capital income is taxed at a flat tax rate of 28%;
- Labour income is taxed at a progressive tax rate schedule ranging from 28% to 48%; and
- There are mechanisms intended to distinguish capital income and labour income and tax them at the appropriate rate, in some cases when it is earned (income earned by an individual), and in some cases when it is distributed (income earned through a company).

Without a significant differential between the capital and the labour tax rates, there is little reason to adopt the mechanism for separating labour and capital income of a full Nordic tax system. The methods required to measure and tax labour and capital income separately are complex and would increase both compliance and administration costs – it is not worth bearing these costs unless there is a large rate difference. Accordingly, adopting a Nordic tax system would not make sense for New Zealand unless the capital tax rate were set at much lower level, such as 17.5 percent.

This would be a substantial reform of our existing tax system. Reducing the capital tax rate to 17.5 percent would involve cutting the company tax rate to that level. New Zealand currently generates around 14 percent of its total tax revenues from the corporate income tax ($8.3 billion). Adopting a Nordic tax system with a deep capital tax cut would not be fiscally feasible without large tax increases elsewhere (such as increasing taxes on labour) or significant expenditure cuts (and if there were such expenditure cuts, it does not necessarily follow that adopting a Nordic tax system would be the most efficient way of restructuring the tax system). Such a deep cut could cause a significant shift in the statutory burden of taxation to individuals and would sharply reduce taxes paid by non-residents.

For the Scandinavian countries that have adopted a Nordic system, one of the drivers of reform was the risk of capital flight. Capital investments have been shown to be quite sensitive to tax rates. Internationally high capital tax rates can drive domestic savings offshore and discourage foreign savers from investing in the host country. A dual tax system allowed these countries to respond to these pressures on the capital tax rate while still taxing labour reasonably heavily, which was shown to be much less mobile.

New Zealand differs from these Scandinavian countries in two important ways. First, our tax rates are already comparatively low – our corporate tax rate is 28 percent and our top personal tax rate is 33 percent. In addition, it is currently possible to face a final tax on investments of 28 percent by investing in certain entities (such as portfolio investment entities). These rates are broadly similar to the capital tax rates achieved in Scandinavia through adopting a Nordic system.

Second, New Zealand has one of the most mobile labour forces in the OECD. As such, the risk of capital flight cannot be the only consideration. A Nordic tax system would involve increasing the proportion of tax raised through labour taxation and a likely increase in the labour tax rates. This is very likely to increase permanent departures from New Zealand (i.e. "labour flight").

Design issues

Setting the Capital Income Tax Rate

A key question is what tax rate to set for capital income. Norway's capital tax rate is 28%, which is the same as New Zealand's company tax rate. In Norway, 28% is also the lowest tax rate on labour income, which is subject to a progressive scale of up to 48%.

Setting the capital tax rate involves judgements weighing the fiscal consequences and also elasticities and the impact on investment from capital tax rates. Depending on how the capital/labour tax split is done, there could also be mechanical issues. Norway applies a higher tax rate on labour/high returns to capital by double-taxing distributed company income at the capital tax rate to the extent it exceeds a certain return to capital. Double taxing income at 28% gives an effective tax rate of approximately 48%, which is the highest labour income tax rate.

In the New Zealand context, the capital tax rate could be set at the middle personal tax rate (17.5%). Double-taxing income at this rate would impose an effective tax rate of approximately 32%, which is near the top personal income tax rate. If the double-taxing method of taxing labour/high returns to capital is not used, then there may be more freedom for setting a capital income tax rate.

If the capital tax rate is higher than the lowest personal tax rate (10.5%), then there may be equity issues as a low income taxpayer would face a higher tax rate on capital than they currently face. This could potentially be addressed by providing a lower capital tax rate when the equivalent labour tax rate is lower for the taxpayer, but this would increase complexity and also fiscal cost.

Separating capital and labour income

A Nordic system requires that income from a business, which earns its income from both returns to its assets and services provided by employees/owners, be separated into capital and labour components. This is important for maintaining its integrity and managing fiscal cost or else labour income would be widely recharacterised as capital income given the large rate differential. This would largely be required for sole-traders and also closely-held businesses with shareholders/employees.

There are two general approaches for performing this split – determining labour income and deeming the rest to be capital, or determining capital income and deeming the rest to be labour. A key difference in these methods is the taxation of economic rents. If labour income is determined then economic rents will be deemed return to capital and taxed at the low capital rate. On the other hand, if capital income is determined then rents will be deemed return to labour and taxed at the generally higher labour rate.

In practice, the second method, determining capital income, is used. The reason for this is labour income is very difficult to measure and value. Many self-employed people do not accurately track how much they work, and even if they do, it can be difficult to determine what a fair market wage for them would be. This is not to say that measuring capital income is simple – some types of capital, such as goodwill and intellectual property, can be very difficult to value.

The method generally involves calculating a deemed return on assets (this is generally based on the risk-free, ie, government bond rate) and deem that to be the capital income. Any excess is labour income. Norway does this for sole traders. In theory, it could also be done for closely-held companies and subject the company (or its shareholder-employees) to tax directly at the labour rate when the income is earned. Norway found difficulties in implementing this system partly due to defining what a closely-held company is, and also difficulties determining what the asset base is for a company.

To overcome these problems it has implemented a double-tax system for returns to company investment whether or not the company is closely held. This provides that dividends and capital gains derived from company investment is not taxed to the extent the return does not exceed the deemed return amount, but is subject to the capital tax rate to the extent the return exceeds this amount. The effective tax rate of the double-taxed amounts is approximately equal to the highest tax rate on labour income.

A critical feature of the Norwegian system is that the different tax rates are set in order to achieve these equivalence results. This means that government do not have the flexibility to vary rate to achieve other goals, such as the incidence of the tax burden.

Further detail on the mechanics of the Norwegian dual tax system is provided in the Annex.

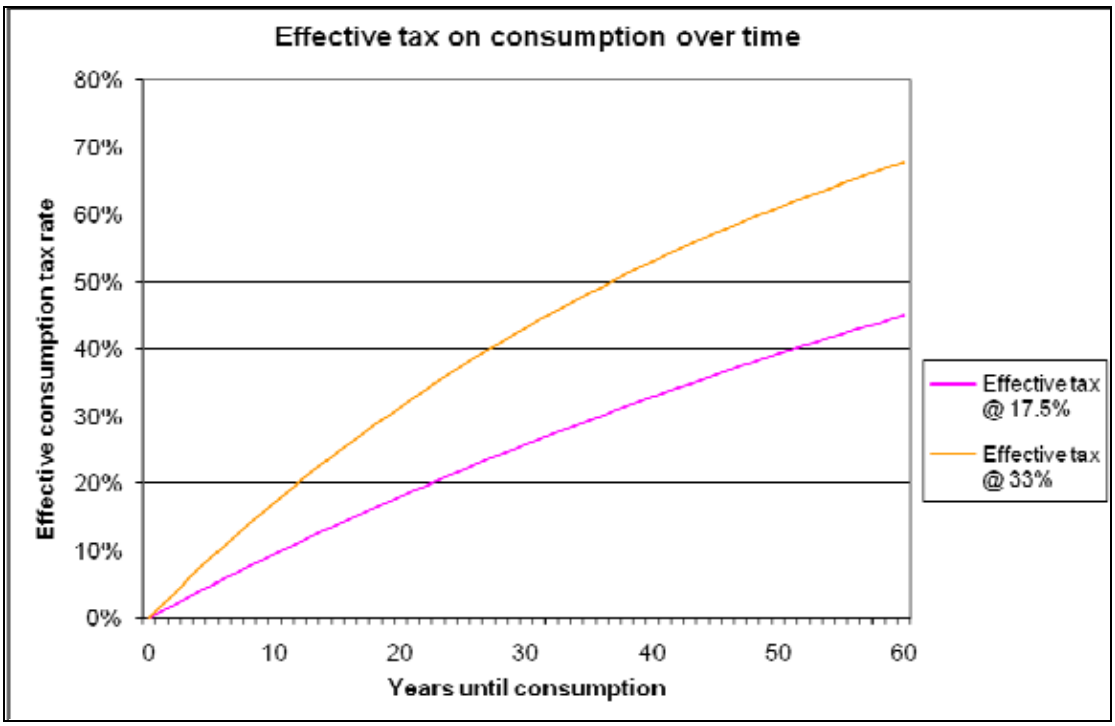
Standard tax policy criteria

Efficiency and growth

Moving to a Nordic tax system (and a resulting deep cut in the capital tax rate) would increase the incentives for both residents and non-residents to invest in New Zealand.

The lower tax rate on capital will reduce the microeconomic distortions in investor behaviour. The difference in effective tax rates between fully taxed and only partially taxed (or completely untaxed) assets will be reduced. Additionally, as income is taxed at the same rates regardless of the vehicle it is derived in, there will be no incentives to channel income through entities (such as trusts) for tax reasons.

The reduced capital tax rate also reduces distortions in inter-temporal consumption/savings decisions as shown below. These distortions occur because, due to the taxation of interest income, the effective tax on savings increases the longer the savings period. The higher the tax rate, the larger this distortion is. For example, say an individual facing a 33% tax rate invests $100 for 60 years. At the end of this period their investment will be worth $1064 and they will have paid $2235 in tax. This is effectively a tax on consumption of 68%. If instead they were taxed at 17.5%, the tax on consumption would only be 45%.



The lower tax on capital would tend to reduce the taxation of economic rents. The impact on rents is important as they can be taxed without affecting decisions to invest (provided the investment still returns at least its cost of capital after tax). To the extent that these rents are being earned by non-residents, this is unlikely to be in New Zealand's best interests. This would have to be weighed against the benefits of reducing the cost of capital, and increasing total investment from offshore.

Nordic systems generally have capital gains taxes, and they are important for maintaining integrity if the double-taxing method for determining labour income of companies is used. In the absence of a capital gains tax, a high return to capital realised from selling shares may not be subject to the double-tax. It may be possible to have a Nordic system without a capital gains tax if the double-tax method were not relied on as a way of taxing recharacterised labour income. The benefits and costs of a capital gains tax were discussed with the Tax Working Group last year.[1]

Equity and fairness

As described above, a Nordic system involves taxing all capital income at a low flat rate. This will tend to decrease vertical equity – those on the highest incomes currently have the highest marginal tax rates and also generally have the highest level of capital income. A cut to the capital tax rate will therefore benefit these individuals much more than those with lower incomes, who tend to have fewer investments and face lower tax rates. Moreover, if the chosen capital tax rate is higher than the current lowest personal tax rate, then taxes for those with the lowest incomes would actually increase.

While vertical equity would be decreased, horizontal equity with respect to income from capital would be improved. The lower capital tax rate make the taxation of capital assets more neutral; the difference between partially taxed and fully taxed assets would be less significant. Additionally, it would not be possible to change one's tax liability by channelling capital income through different entities. Both these factors mean that people in similar situations will be more likely to have the

[1] See http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-taxation-of-capital-gains-ird_treasury.pdf.

same tax liabilities. However, horizontal equity will be reduced when comparing individuals earning labour income and an equivalent amount of capital income.

Revenue integrity

Integrity of capital income taxation would be improved compared to New Zealand's existing tax system as all capital income is taxed at a uniform rate. In addition, channelling income through vehicles such as trusts or companies would not affect the tax rate applied to the income. Nevertheless, there will be strong incentives for taxpayers to reclassify labour income as capital income. Strong anti-avoidance rules will be required and they will need to be actively applied. For example, unincorporated businesses will have incentives to reclassify low-yielding private assets as business assets.

An additional complication is that, assuming the capital tax rate is 17.5% and the bottom labour income rate is 10.5%, low-income taxpayers will actually have incentives to classify capital income as labour incomes. This may further erode revenue integrity, as it is more difficult to design anti-avoidance rules where there is no clear tension between the correct policy result and the tax efficient result.

Fiscal cost

Due to the complexity of the proposal and the number of specific design considerations we have not costed a switch to a full Nordic tax system. However, based on background work done in relation to the Victoria University Tax Working Group, and assuming a capital income tax rate of 17.5% and a mechanism similar to Norway's it is reasonable to assume the proposal would cost in excess of $3 billion per year.

Compliance and administration costs

A Nordic tax system would be a fundamental change in how tax is levied in New Zealand. There are numerous details that would be needed to work through in addition the systems and complexities described earlier. This makes it difficult to determine the extent of the impact on compliance and administration costs. However, due to the special rules required to separate labour and capital income from unincorporated enterprises and companies, as well as the various anti-avoidance measures that accompanies these, it is very likely that both compliance and administration costs would increase.

Coherence

A fully adopted Nordic system would be coherent. As such, it would be an improvement over the status quo, which is not entirely coherent due to the capped tax rate that applies to investment income in portfolio investment entities. Whether or not a Nordic system adopted for New Zealand would be an improvement over our current system depends very much on the specific design.

Possible effect on savings

A move to a Nordic tax system with a low tax rate on capital is more than likely to increase private savings. However, assuming no change in the current labour tax rates, the change would come at a significant cost to the Government. The resulting decrease in Government savings would more than offset the increase in private savings, resulting in lower overall national savings.

It would be possible to change labour tax rates so that a move to a Nordic tax system is revenue neutral. It is difficult to know what effect on national savings this would have; if there were no other changes then it would increase. But, assuming no other changes is not particularly realistic – New Zealand has a very mobile labour force, so increasing taxes on labour would increase emigration.

Appendix

Further Detail of Norway's Method for Separating Capital and Labour Income

The Norwegian method for taxing unincorporated enterprises is to calculate the return to capital by multiplying the amount of capital by the risk free rate of return. It was this area that was the "Achilles heel" of the pre-2006 system. There are incentives for individuals to challenge the labour/capital boundary due to the tax rate differential. For example, some may attempt to transfer low-yielding personal assets, such as a car, into their business. This would increase their imputed capital income without increasing their total income, reducing their tax liability.

Another complication is how to treat debt. There are two possibilities – the first is to use only the net assets of a business when calculating its imputed capital return, while the second is to use the gross assets of a business. There are advantages and disadvantages of both options. The net assets method is more complex as it requires business owners to calculate their net asset position. However, while the gross asset method is simpler in theory, it requires rules to limit interest deductions to the capital tax rate (as otherwise, if the debt interest rate is higher than the risk free rate of return, purchasing debt-financed capital will tend to reduce a business's tax liability).

The treatment of capital losses also requires consideration. In theory, any capital loss should be able to be fully offset against any labour income. If this is the case, then these rules will generally not discourage risky investments. The reason for this is that the government essentially acts as a silent partner in every investment, sharing equally in any gains or losses. However, due to avoidance concerns, the Scandinavian countries tend to limit capital loss offsetting. This will tend to discourage risky investment.

As a consequence of these issues, Norway radically modified the system applied to companies in 2006. (The previous system was maintained for unincorporated businesses as the new system relied upon a balance among tax rate applied to company income, dividends and capital gains.)

For incorporated companies, there are again two general methods for apportioning income between labour and capital. The first is to attempt to define a closely held company and tax those companies in a similar way to unincorporated enterprises. The second is to make no distinction between companies and implement a shareholder taxation system.

Attempting to define what constitutes a closely held company can be very difficult. Closely held companies would be taxed in the same way as unincorporated enterprises while widely held companies would be only be taxed at the capital rate on their profits. Norway attempted this with an "active shareholder" test, but this was widely circumvented by introducing many inactive shareholders, such as the wives and children of the business owners. Other methods would be possible, but there will be significant pressure on the boundary.

The second method for taxing company income is to avoid drawing a distinction between closely and widely held companies and to avoid the need to explicitly identify labour and capital income. This is the system that Norway adopted in 2006, as recommend by the Skuage Report. It should be noted that a critical feature of this system is a capital gains tax on shares – without it, the shareholder taxation system does not work.

First, all income derived by a company is taxed once at the capital rate. Shareholder income, defined as dividends plus any realised capital gain, below a rate of return allowance (RRA), which is again set at the risk free interest rate, is untaxed at the shareholder level – the only tax levied is the initial company tax. However, shareholder income in excess of the RRA is taxed a second time

at a rate set so that the total tax imposed is roughly equal to the top labour income tax rate. If the realised income is below the RRA, then this is carried forwarded to future years. The carried forward RRA is then added to the tax value of the shares for the purposes of calculating future years' RRAs.

The effect of this is that shareholders are indifferent between receiving wages, dividends or capital gains. In fact, even though capital gains are not taxed until realisation, taxpayers are not induced to postpone the sale of their shares past what is optimal. The intuition behind this result is that if investors realise an accrued capital gain in order to re-invest the after tax return, they will not be taxed on the normal returns of the reinvested gain. This contrasts to the treatment under a standard income tax, where the realisation of gains is discouraged because the normal returns of any reinvested gains are taxed.