Options for tax reform

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The Institute of Policy Studies at Victoria University of Wellington organised a seminar on tax reform as part of its Project on Taxation. The seminar was opened by the Minister of Finance with the following address which serves both to introduce and to provide a contextual background for the papers that follow.

I. INTRODUCTION

I want to begin my talk by discussing the broad objectives of tax reform and comparing these to the sorry state of our present taxation system. I then want to review the moves that have already been made and then discuss the place of the Institute's tax reform programme in the scheme of things. Finally I want to discuss options for corporate tax reform.

The starting point for any discussion about objectives for tax reform must surely be the fact that any tax system must raise sufficient revenue to fund government expenditure. The consistent and excessive shortfalls between expenditure and revenue over recent years have resulted in the unpalatable options of high interest rates and high inflation on the one hand, or the imposition of interest rate, wage, and price controls in order to suppress these problems on the other. A major objective of last year's Labour budget therefore was a reduction in the deficit to levels that are consistent with sound economic management. This required examination of both revenue and expenditure sides of the budget. Moves made in last year's budget went a substantial way towards a major reduction in the size of the fiscal deficit. Increased tax revenue made some contribution but I wish to make it clear that the bulk of the reduction in the deficit comes from reductions in expenditure — principally subsidies to industry and agriculture.

Tax reform requires examination of not only the amount of revenue required, but also of the best way to raise it. The important tests of a good tax system are that it should be fair, efficient, simple and certain.

Fairness has two aspects to it. Firstly, there is the concept of horizontal equity. That is, that people with the same ability to pay should face the same tax liability. The tax on fringe benefits is chiefly designed to ensure a greater degree of horizontal equity in the tax system. Those who are criticising the fringe benefit tax on the basis of so-called anomalies miss the point that the tax is designed to

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correct far greater anomalies that exist in the absence of the tax. It is highly anomalous, as well as inequitable, that people who receive remuneration in the form of cars and cheap loans should pay less tax than people who do not.

The second aspect of fairness is that of vertical equity. Those who have a greater ability to pay should pay more than those with less ability to pay. Our present tax system certainly does not meet this test. We have a system where many of the truly wealthy pay little or no tax whereas the average salary and wage earner pays too much. As I have said before, a wealthy person is not necessarily one who is currently facing a marginal tax rate of 55 or 66 cents in the dollar. The truly wealthy are people who own or inherit property, earn capital gains or those who can take advantage of extensive tax sheltering.

Our present tax system is riddled with distortions.

New Zealand's business tax system is one which taxes "winners" and lets the losers off scot-free. The present tax system changes the relativities between pre-tax rates of return and post-tax rates of return. Thus we get the situation where someone who buys a property, sits on it for two years and then sells it for a capital gain generally pays no tax. By comparison someone who builds a factory and employs people pays tax not only on the company profits, but again on any dividend they receive, and on top of that their employees pay too much tax. In New Zealand activities that contribute that little to total output tend to be taxed very lightly whereas productive activities contributing to the economic cake are overtaxed. That situation must be rectified. Large proportions of the community's savings, the funds which should be bankrolling productive activities and economic growth, are being diverted into avenues of marginal economic utility. The main culprit is high marginal tax rates which in New Zealand ensure that for a large number of investors the primary consideration in any investment decision is how it can be structured to minimise taxation payments, not how much will the investment mean.

Finally, we must have more simplicity and certainty in the tax system. Complexity and uncertainty further undermine the efficiency of the tax system. Complexity encourages wasteful effort and creates undue scope for the employment of highly qualified people in analysing the tax system itself rather than finding ways of increasing productivity and output. Complexity also undermines the equity of the system and hence its public acceptability. While salary and wage earners have limited scope for tax avoidance the self-employed and other types of income eearners have ample opportunity to use the complexity of the system to legally reduce their tax liability. Other important practical considerations which need to be taken into account in discussing tax reform are the international compatibility of the tax system and the ease of transition between the present system and any reformed system.

II. PERSONAL TAX REFORM

The major political issue for this year I believe will be whether people in New Zealand want a tax system that encourages people to earn extra income and which at the same time gives assistance to the low paid. The introduction of the goods and services tax and personal income tax reductions are inter-related. If we want to substantially reduce personal income tax there must be a switch from taxing income to taxing spending. What we are talking about is taxing what people take out of the system rather than taxing what they put into it. New Zealanders now look to government to provide health, education and welfare services that were never contemplated 20 or 30 years ago. The associated increase in the government's revenue requirement has placed enormous strain on the personal income tax system, and has forced successive governments to levy higher and higher rates of personal tax. The overall structure of taxation we now have is not appropriate for the 1980's. The shift in emphasis to indirect taxation is simply a recognition of the reality of funding the level of government expenditure the community now expects in a manner which is more equitable and less distortionary than the present system. If we are going to make it worthwhile for manufacturers and farmers to expand, improve their productivity performance and increase employment, then we must have lower marginal tax rates. If we are going to make it worthwhile for skilled people to work extra hours in the occupation for which they are trained (e.g. doctors), rather than say painting their own house as they at present do, then we must have lower marginal tax rates. A professional person on 66 cents rate of tax has a powerful incentive to, say, paint his or her own house rather than to pay someone to do it out of after tax income. What personal tax reform will mean, in short, is that if you want to make life a little better for yourself by working a bit longer or smarter then the tax system is not going to clobber you for doing it.

I would like to discuss the broad thrust of the reforms to personal income tax the government plans to introduce in concert with the goods and services tax which is to apply from 1 April 1986. Firstly, high marginal tax rates will be reduced. This does not mean that high income earners will necessarily be paying a lot less tax in total — average tax rates at the upper end of the income tax scale will probably not fall appreciably. However, high marginal tax rates must be reduced if we are to encourage investment to flow into productive areas of the economy, or encourage increased earnings by those already on high incomes. Secondly, we are looking to significantly lower the tax liability of low income earners. It should be possible to design a personal tax system which does not tax a person more in the dollar on Saturday or Sunday than it did on Wednesday or Thursday. Thirdly, we are examining ways to improve the interface between the personal income tax and social welfare benefit systems. As part of this exercise consideration is being given to rationalising the numerous instruments currently used to deliver family assistance. In essence, we are looking towards a much simplified system of personal income tax with significantly lower marginal tax rates for those on higher incomes with only slightly lower average tax rates whereas for low income earners the average tax rate should fall significantly, while marginal tax rates might not fall at all. This simplification will involve smoothing the interface between the personal tax and benefit systems.

As I said previously, few of those who are really well off in New Zealand pay as much tax as they theoretically ought because of the extensive use of tax sheltering. The Institute of Policy Studies, with the technical assistance of the Department of Statistics, is examining the incidence of the goods and services tax — in other words, who actually pays the tax — and the Institute intends to prepare a study of the administrative and compliance costs of the goods and services tax. An intensive programme of public discussion and education is essential for the successful implementation of this tax. The Institute's activities will be invaluable in stimulating an informed discussion on the tax.

While I am discussing lower marginal tax rates I would like to point out that companies now analysing the impact of the fringe benefit tax would be well advised to wait till later this year and consider the impact of lower marginal tax rates before making major decisions on how to deal with that tax.

III. BUSINESS TAX REFORM

The process of reforming personal income tax and the indirect tax base are already well under way. Business tax reform however stands alone to a certain extent and no decisions have been taken to pre-empt the directions of reform. Indeed the government last year made a conscious decision not to make ad hoc changes before determining what the long term direction of reform should be. The contribution of the Institute of Policy Studies research programme is therefore valuable in assisting the government in determining the options. Moreover, once a direction for reform has been determined the Institute's independent input will undoubtedly be beneficial in assisting the developing of that option. The Institute through this seminar and any later activity will be serving a useful function in providing a public forum for discussing the many complex issues involved in business tax reform. The Institute and government are endeavouring to ensure their respective research programmes are complementary.

The problems with the present business tax system were well covered in Treasury's Economic Management Book[1] — one of the books opened by the government — and in Paul Bevin's paper on business tax reform.[2] One of the major problems that has been raised concerns the double taxation of dividends. In principle, shareholders can pay 45 cents in the dollar in company tax and then up to 66 cents in the dollar personal tax on dividends received meaning a theoretical tax rate of up to 81 cents in the dollar. I say theoretical, however, because few people actually pay such rates of tax. Closely held private companies can avoid the problem by paying out company profits as salaries or directors' fees to employee/shareholders and by investing capital in the firm as debt rather than equity.

Double taxation of dividends is a serious problem because it makes the avoidance of paying taxable dividends a central consideration in any investment plan. It encourages business to be conducted through forms of organisation which minimise tax liabilities. As it penalises new equity issues over other methods of financing, it may also encourage companies to adopt excessively high debt/equity ratio. There are few options in dealing with this problem. One possibility is to levy different rates of tax on distributed profits and retained profits. Such a system would continue to tax retained profits at say 45 per cent but tax distributed profits at

1 Government Printer, Wellington, 1984.
2 Printed as a paper in this volume.

a lower rate. Such a regime is known as a split rate system and is used in a number of European countries. A similar result is achieved under an imputation system where shareholders receive some credit for tax previously paid by the company. Another option would be to allow companies to fully or partially deduct payments of taxable dividends. A fourth option would be full integration of the company tax system with the personal income tax system. The profits of a company would be attributed to its owners according to their shareholding. The major difficulty however with full integration relates to its administrative practicability and problems in negotiating double tax treaties in order to tax non-resident shareholders. There are obviously revenue implications in any move to reduce the double taxation of dividends. However, little revenue is gained from the taxation of dividends in practice.

When contemplating changes to the taxation of businesses, the government is not looking to increase the relative burden of taxation on other sections of the community. If we were to alleviate the double taxation of dividends, other compensating moves would have to be made for revenue purposes. I have mentioned a number of options for reforming the relationship between the personal tax structure and the corporate tax structure. A separate issue is what reforms, if any, should be considered for the corporate tax base itself. The Institute of Policy Studies has outlined a number of options for reform of the tax base. The first is some form of cash flow tax. This tax was proposed by the Meade Committee in the United Kingdom[3] and was formerly advocated by the United States Treasury. A flow of funds tax has the advantage of removing the need to make a distinction between capital and current income. A further advantage of the flow of funds tax is that it leaves pre- and post- tax rates of return unchanged. This would avoid the present problem whereby the tax system encourages certain activities and discourages others in unintended ways. However, this tax would need to be accompanied by a capital gains tax including the personal sector so that capital gains due to retained earnings in a company were taxed.

There are disadvantages with capital gains tax. A capital gains tax will tend to reduce the mobility of capital — which I believe is a bad thing. In the light of the number of tax experts and economists who have been advocates of cash flow taxes, it is worth considering why no country has adopted this tax. Perhaps this seminar and the Institute's work will throw light on this question.

A second option, which I have advocated in the past, would be to move to some form of taxation of assets combined with continued taxation of corporate income — with an extreme option of abolishing corporate income altogether and replacing it with a tax on assets. The taxation of wealth differs from an income tax by taking the market value of an asset rather than the stream of income it produces. In most cases the market value of an asset is closely related to its future earning potential, so that the effect of taxing an asset rather than the resulting income flow is therefore broadly similar.

In my view, the principal advantage of a partial shift in the taxation of assets is that it puts pressure on the owner of that asset to use that asset productively

3 *The Structure and Reform of Direct Taxation* (Allen and Unwin, London, 1978).

rather than to hold it in a less productive activity. If at the same time the disincentives to earning income are reduced — by the reduction of effective marginal tax rates and by reforming the double taxation of dividends, this would I believe give a tremendous boost to economic activity and employment growth. Paul Bevin says in his paper that it is difficult to see how an assets tax could sustain the revenue yield required. I am not fully convinced of this point and I would like to hear other points of view. Taxation of assets effectively taxes "losers" on a more even basis to the "winners", and would ensure the flow of capital into productive areas and out of unproductive areas. I believe insufficient attention has been paid to the potential incentives effects of a tax on assets. A business has only to cover the cost of the tax and all excess income would then be taxed at a low rate. In the extreme case of a full replacement of the tax on business with an asset tax all income over and above the assets tax would be tax free, a zero marginal rate. I think also insufficient attention is paid to the opportunity lost of not investing one's wealth productively. A Mercedes car for example becomes an even more expensive luxury when the opportunity forgone of earning tax free income in a productive activity is taken into account.

However, there are clear practical difficulties with the taxation of assets. The first is valuation where there is little or no market for the assets. Another is dealing with firms who have insufficient immediate cash flow to pay the tax. A third is the appropriate tax treatment of private companies whose major assets may be the worth of their owners.

A worthwhile longer term task for the Institute would be to attempt to devise other tax systems that may also meet the goals of encouraging the productive use of assets. In the short run it may be necessary to retain a nominal income base but to make it more comprehensive. This would require the removal of a number of loopholes and anomalies which have become evident. A more complex option would be to look at whether there are simple and practicable steps that we could make to move towards a real income tax base. This would require inflation adjustments for depreciation, inventories and interest so that businesses were taxed on the real — rather than the inflationary component — of their income.

It is not my wish to consider the options here at any length. All I have done is simply raise them. Discussions of these options is the task of those attending this seminar. I would caution those trying to read between the lines of this speech. The government has an open mind on the question of business taxation. Clearly, the present system has many problems and I have signalled some that I would rate as high priority. But beyond that, I would like to see a vigorous and open-minded discussion on reforms which go beyond the sectional lobbying for investment allowances and such like — which has characterised proposals for business tax reform in the past. Indeed sectional lobbying has been a prime cause of the messy tax system we have at present. In particular I would say that any proposal for a tax on assets could only be introduced after the fullest examination and public consideration. It is unlikely that an assets tax could be introduced in this parliamentary term. I should also point out that business tax reform does not mean lowering the overall burden of taxation on the corporate sector. We are talking about improving the system so that the revenue need to fund government expenditure can be collected more fairly, simply, with more certainty and with less interference with efficient resource allocation.

Finally, I hope that the discussion in this seminar and in the wider, public arena can focus on the ends as much as the means. As with the government's economic strategy as a whole, we should concentrate our attention less on whether or not a particular option is consistent with old dogma, and more with looking at whether the option is more likely to achieve our objectives than the alternative options.

IV. CONCLUSION

For as long as I can remember, New Zealanders have been talking about tax reform. We had the Ross Committee[4] in 1967 and the McCaw Committee[5] in 1982 followed by so-called or partial tax reform in the guise of a billion dollar addition to the deficit. The 1985 programme of reviewing our direct and indirect tax system is well under way with a task force studying options for reform of the personal income tax and social security benefit system. A discussion document on this subject will be released within a month.[6] Work has commenced on a comprehensive review of the taxation of life insurance and superannuation. Planning for the goods and services tax is well advanced: a white paper will be issued early in March[7] as a basis for public consultation. Now it remains to determine the major components of corporate tax reform.

I am mindful that in considering options for tax reform, we would do well to take account of an old adage quoted by Professor Sandford in a recent paper:

> Whoever hopes the perfect tax to see
> Hopes that ne'er was, nor is, nor e'er shall be.

If the ideal tax system is not obtainable, we must then seek the best imperfect system or combination of systems available, recognising the need to compromise between differing objectives and to give due weight to facilitating transition from the old to the new.

4 *Taxation in New Zealand* (Government Printer, Wellington, 1967).
5 *Report of the Task Force on Tax Reform* (Government Printer, Wellington, 1982).
6 *Benefits, Taxes, and the 1985 Budget* (Government Printer, Wellington, 1985).
7 *White Paper on Goods and Services Tax*. N.Z. Parliament. Appendix to the Journals. B.27 (Government Printer, Wellington, 1985).