How should business be taxed?

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This article, which is a revised and abbreviated version of a longer paper prepared for the Institute of Policy Studies, surveys the present New Zealand business tax system against standard criteria for evaluating tax systems, identifies the major defects in the current system, and offers comment on possible alternatives including amendments to the present income-based systems.

I. GENERAL CONTEXT FOR BUSINESS TAX REFORM

Business tax reform is a key tax policy issue to be addressed by the Labour Government. In his 1984 Budget the Minister of Finance stated that:

> A major review of business taxation will be carried out this year with the intention of reaching conclusions on reform options.

For that reason alone the business community and the investing public should make a point of getting acquainted with the issues and reform possibilities. There are other reasons.

Even a cursory review of business taxation in New Zealand reveals wide variations in the treatment of income generated from business capital. Examples include the double taxation of dividends; the non-taxation of most capital gains; the immediate write-off of capital expenditure in some industries; the availability of tax-free or tax-relieved savings instruments; and the divergence of real and historic cost profits.

In part variations result from the pervasive effects of inflation; in part from incremental adjustments to tax policy in response to perceived deficiencies; in part from successful interest group lobbying for tax privileges; in part from a view, rightly or wrongly held, that the costs of reducing tax distortions outweigh the benefits; and in part from the lack of a clear conception of how the tax system affects economic behaviour and of a central organizing principle around which coherent rules can be formed.

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The complexity and contradictions which have resulted are themselves a continuing source of pressure for change. Another source has been the lacklustre investment performance of the New Zealand economy since the early 1970s.

Although there is general agreement that reform is necessary, there is disagreement and considerable uncertainty about how it should be done.

In the context of an income tax the aim should be properly to measure business income. Then a decision can be made as to what tax rates should apply to such income. Obviously, precise measurement of income from capital is difficult; particularly during times of inflation.

Some tax policy experts[1] favour a move away from the income tax towards a tax based on consumption. In large part, this desire is a consequence of the problems of measuring income. It would involve immediate write-offs of 100 percent of investment expenditures but no deduction for interest on borrowing money.

The present Minister of Finance, Mr Roger Douglas, has in the past suggested another possibility — replacement of business income with a tax on business assets.

International experience does not provide a clear guide. At present polar opposite approaches to reform are being undertaken in different countries. The United States and Australia, for example, allow accelerated write-off of business fixed assets. In the absence of reduced deductibility of financing costs, this accelerated write-off can lead to negative taxes for business. The United Kingdom, on the other hand, after having gone as far as possible along that road with the result of massive accumulation of business tax losses, has reverted to standard measures of depreciation coupled with lower company tax rates. The U.S. Treasury[2] has recently proposed a similar reversion.

The Government's task is to bring about business tax reform in New Zealand in ways which are as efficient and even-handed as possible and which are conducive to improved economic performance. It has expressed a strong concern to improve productivity and growth by reducing impediments to competition and efficient resource allocation. This concern is exemplified by the accelerated programme to reduce the level and disparity of assistance to industry through gradual reductions in protection, export incentives, and agricultural assistance. Reductions in the uneven impact of taxation on business investment income would be consistent with this approach.

It is important to recognise that a sound business tax structure is only one ingredient in the policy mix conducive to efficient capital formation and growth. Government policy can influence savings and investment other than through taxes. Policies which have an important effect in this regard include, for example:

1 J. A. Kay and M. A. King *The British Tax System* (Oxford University Press, London, 1983).

2 U.S. Treasury *Tax Reform for Fairness, Simplicity and Economic Growth* (Office of the Treasury Department, Washington, D.C., 1984).

budgetary policy and the method of financing fiscal deficits; public capital formation; retirement and social security policy; regulation of the capital market; and the overall certainty and consistency of policy. Furthermore, the level and pattern of private business investment will be influenced by the tax treatment of residential housing and labour income as well as the taxation of business income itself.

At the same time the often arbitrary effects of the present tax system offend more or less well defined standards of fairness and justice. A central theme of Government policy has been to ensure a fair distribution of taxes and public expenditure.

II. CRITERIA FOR EVALUATING TAXES

There are three standard criteria for evaluating tax systems: efficiency, equity, and simplicity. *Efficiency* has to do with the effects of taxes on economic incentives and behaviour. Variations in tax treatment of different but economically identical or similar acts create pressures for scarce resources to be diverted into activities which yield competitive after-tax rates of return, but low pre-tax or social returns. This is wasteful as it implies that by reducing such tax discrimination total national income could be increased.

In considering efficiency from the viewpoint of business taxes, attention focuses on the impact of taxes on investment decisions. Three margins of choice or trade-off are relevant:[3]

(i) intertemporal efficiency — the choice between present and future consumption (i.e. consumption and savings);
(ii) production efficiency — the choice of asset or industry;
(iii) portfolio efficiency — the choice of financing for an investment and the form of business organisation.

In addition, consideration is given to the effects of multiple tax rates under a progressive tax structure on incentives for different taxpayers to exchange assets to maximise after-tax returns.

Equity is concerned with the distributional effects of taxes in relation to ability to pay. Opportunities for investors to choose among assets with differentially taxed returns results in unequal treatment of individuals with equal economic income and may reduce the progressivity of the tax structure, thus undermining apparent equity objectives. Equity cannot be viewed simply by comparing persons with equal pre-tax income (horizontal equity) or unequal pre-tax income (vertical equity). The tax system may also have dynamic equity effects if it limits opportunities for lower income individuals to raise their living standards while enabling higher income individuals to protect or enhance theirs. In this context it may be appropriate to compare persons with equal (or unequal) post-tax incomes after adjustments have been made through the operation of more or less competitive markets. Even more fundamentally, equity might be considered to require a comparison of individuals who start out with equal endowments.

3 D. F. Bradford "Issues in the Design of Savings and Investment Incentives" in C. R. Hulten (ed.) *Depreciation, Inflation and the Taxation of Income from Capital* (Urban Institute Press, Washington, D.C., 1981) pp. 251-278.

Incomes, after all, represent returns on endowments of human or physical capital and it may be appropriate to distinguish one who has a low income because he wasted his endowment from one who has a high income because he invested wisely. Equity is therefore a very imprecise concept for tax policy.

Simplicity relates to the ease of practical application of tax and its general understandability. In addition to the direct costs of administration and enforcement and the compliance costs of taxpayers, complex and arbitrary tax rules create strong pressures for resources to be squandered on avoidance arrangements and interest group lobbying to maintain special tax privileges.

The costs of voluntary compliance are also increased when taxpayer morale is lowered as a result of complexity and perceived unfairness.

Simplicity is a sub-set of efficiency in that the benefits of taxes which do not interfere with private economic decisions must be weighed against the costs of obtaining comprehensive and independently verifiable measurement of the desired tax base. For example, the various forms of relief for double taxation of dividends in force in many countries represent a compromise. The benefits, on one hand, of reduced interference in the decision to incorporate, or to finance investment from new equity issues as opposed to retained profits, must be weighed against the administrative and compliance costs, on the other hand, of fully integrating company and shareholder taxation.

There are three other aspects of tax evaluation which also need to be considered. First, taxes must be capable of raising *revenue*. All taxes are inefficient to a greater or lesser degree and this therefore involves a trade-off between the basic criteria outlined above and the revenue raising capability of the tax. Secondly, international considerations are particularly relevant in the area of business taxes since one of the main reasons for a separate company tax is to ensure that the community obtains a fair share of the returns from foreign investment without unduly discouraging such investment.

Finally, tax reform as opposed to de novo tax design frequently raises complex issues of transition from the present system to a preferred one. This also is an important element in the question of business tax reform.

III. BASIC APPROACH

The basic approach taken to business tax reform, therefore, is to ask the question 'what changes in tax structure would improve economic performance and overall living standards by reducing the costs of tax-induced interference in private investment decisions, including the costs of administering and complying with complex tax laws, and are these consistent with generally accepted notions of fairness?'

The remainder of this short paper summarises the main defects of the present taxation of business income in terms of the criteria outlined and briefly canvasses reform options. In the space available it has been necessary to focus on what are perceived to be the most fundamental shortcomings, some of which are inherent features of taxes based on income. It has not been possible to catalogue the multitude of particular defects of current income tax law and its interpretation but some of these are examples of more general deficiencies.

Apart from reasons of space, the emphasis on a fairly fundamental review reflects the Government's apparent intentions and the inescapable fact that true reform requires a perception about whether the present system is merely in need of minor corrective surgery or warrants a major transplant.

This need to consider fundamental reforms should not be taken to imply that radical tax surgery, even if it is desirable, should be rapid. On the contrary, the more radical a desirable reform, the more time and effort should be devoted to framing transitional provisions and public education. It merely implies the obvious — that one has to know where one is headed before one knows whether any short step is in the right direction.

IV. DEFECTS OF PRESENT SYSTEM

A. Disincentive to Save

Income tax imposes a wedge between the gross return on investment and the net return after taxes to the savings used to finance that investment. Since this reduces the net of tax return to savings it could be expected to lower the rate of saving and, ultimately perhaps of investment. While this may be so, it is not possible to conclude that lower taxes on income from capital, or business income in particular, since they would have to be replaced by higher taxes on consumption or labour income only, would raise economic welfare as measured by, say, national income or gross domestic product. Such a switch would reduce one distortion — the disincentive to save — but raise another — the disincentive to work. It is possible that the gains may outweigh the losses but the case cannot be established by available empirical research.[4]

B. Aggregate Savings and Investment

There is a related though somewhat different question of whether taxation of capital income in general reduces total savings and investment and, therefore, expected economic growth. Provided the government's fiscal policy or borrowing capacity is unconstrained, any objective for aggregate investment can be achieved independently of the tax structure. A similar argument applies if the economy has ready access to foreign savings. If the latter are constrained, the effects on total capital formation and wealth accumulation will depend on the response of private saving to changes in government borrowing requirements and the relative efficiency of public and private investment. In other words, questions of tax structure can and should be considered separately from aggregate saving and investment objectives.[5]

4 M. A. King "Savings and Taxation" in G. Hughes & G. Head (eds.) *Public Policy and the Tax System* (Allen & Unwin, London, 1980); D. F. Bradford "The Economics of Tax Policy Towards Savings" in G. M. Von Furstenberg (ed.) *The Government and Capital Formation* (Ballinger, U.S.A., 1980) pp. 11-72.

5 Bradford, op.cit., supra n.4.

C. Pattern of Investment

More importantly, tax structure is likely to have a more significant impact on the composition of investment and the productivity of the capital stock than on total investment. It is conceivable, for example, that a lower effective tax rate on average for business investment, associated with a greater dispersion of tax rates among assets and industries, would reduce rather than increase welfare.[6] From a welfare viewpoint getting more from the existing capital stock is no less beneficial than boosting the stock — in fact it is better because no consumption is forgone.

One of the reasons it is not possible to say what is the average effective tax rate on business income from new investments is that its systematic measurement is a large task which has not been attempted in New Zealand. Yet it is readily apparent that there are in fact wide variations in the effective tax rate for different forms of savings and investment. Moreover, inflation acts to widen these tax differentials, increasing the tax wedge for some investments and reducing it for others, depending in part on how they are financed. These differences and the distortions in investment patterns which arise from them are due in part to various selective incentives (such as 100 percent capital allowances) provided to certain industries and assets. But to a large degree they arise from inherent defects of the income tax. These include the failure to adequately adjust depreciation and nominal inventory gains for inflation; the failure properly to measure economic depreciation and the general exclusion of capital appreciation from the tax base. The availability of unused tax losses can also significantly affect the effective tax rate on new investments.

D. Financing of Investment

These disparities are further complicated by tax discrimination among different sources of finance. The present tax system favours corporate debt and retained profits over new equity issues and retentions over new issues. Dividends are discouraged. The failure to index nominal interest payments and receipts for inflation has reduced the effective cost of debt and further distorted financial choice. The separate taxation of companies affects the incentive to incorporate and the choice between debts and retained profits depending on the relationship between corporate and individual tax rates.

The economic effects of these differentials depend firstly on the degree of substitutability of investment among assets and industries; and secondly, on how firms and investors arbitrage among alternative assets and forms of business organisation in the capital market to equalise post-tax rates of return (adjusted for risk). Calculations of the losses in welfare or national income due to misallocation of investment require estimates or assumptions about the relevant substitution effects. Overseas studies do not capture all these effects but suggest that the losses can be considerable.[7] The most significant costs, however, relate to the misdirected

6 A. J. Auerbach "Corporate Taxation in the United States", Brookings Papers on Economic Activity (Brookings Institution, Washington, D.C., 1983), vol. 2, pp. 451-513.

7 J. G. Gravelle "The Social Cost of Non-neutral Taxation: Estimates for Non-residential Capital" in C. R. Hulten (ed.), supra n.3.

incentives for innovation and investment of effort and the consequent waste of growth potential.

Reduction of the distortions would materially improve the efficiency of the capital market and could provide significant gains in overall investment returns and national income.

E. Non-Business Investment

One general observation is that business income is probably taxed more heavily than income from private residential investment or investment in human capital. Whether or not this is a good thing depends upon the extent to which investment in these apparently favoured forms yields benefits to the community over and above those derived by the individuals who undertake them, and that these 'additional' benefits exceed those which arise from business investment.

F. Equity

With respect to the distributive effects of the present system, the same weaknesses which underlie the efficiency costs outlined above, due to the definition of the tax base, are also the main sources of inequity. On the face of it, the opportunities for high tax bracket taxpayers to obtain tax-favoured investments through various routes, including sheltering income within a company and investing in real as opposed to financial assets under conditions of inflation, significantly reduce the progressivity of the tax system apparently intended by reference to the structure of progressive tax rates. Horizontal equity appears to be violated for similar reasons. Indeed high and progressive personal tax rates are both a result and a cause of the erosion of the tax base.

It is important to recognise, however, that these inequities only persist insofar as the supply of tax-favoured investments is sufficiently restricted that only high bracket taxpayers can take advantage of them. Otherwise successively lower bracket taxpayers would also undertake such investments until the pre-tax return was driven down through the competitive process to the point that the after-tax (risk-adjusted) return was more or less equalised across all investments. In those circumstances it could be argued that horizontal inequities do not persist, especially if the tax preferences are longstanding, and that high bracket taxpayers will only be successful in achieving a broadly proportional tax structure. The most important outcome therefore would be the misallocation of resources into the tax-favoured investments.[8] Correspondingly, elimination of the tax preferences would simply inflict windfall losses on existing investors who have gained little from the preferences. This will be especially true if taxes have been capitalised into asset prices to a significant extent, such as in land or share prices.

G. Simplicity

Simplicity of the tax system is obtained to some degree at the cost of ignoring the most severe problems of the income tax which give rise to efficiency losses and inequity. There is little systematic basis for present tax depreciation rates

8 M. J. Bailey "Progressivity and Investment Yields under U.S. Income Taxation" (1974) 82 *Journal of Political Economy* 1157-1175.

and no real attempt to adjust for inflation. Major difficulties in practice arise in attempting to distinguish between income on capital and current account and the timing of income and deductible expenditure. These are inherent problems in a tax base which, if comprehensively defined, would include increases in net worth. Exclusion of capital gains, for example, while apparently simplifying tax administration and compliance, creates pressures for avoidance which are dealt with by even more arbitrary and discretionary anti-avoidance provisions.

Complexity is added to by tax preferences which are frequently of dubious economic merit and which are widely perceived as unfair. Because these preferences are built into the tax structure rather than the expenditure side of the Government budget they also undermine the credibility of the basic tax structure and taxpayer morale. Voluntary compliance is reduced and a climate of avoidance encouraged. These effects are compounded when such provisions as specified loss limits and interest recapture are introduced to counter the alleged avoidance which occurs when taxpayers accept the explicit invitation to invest in tax-favoured activities.

H. Summary of Defects

In brief, therefore, the main problems with the present system of business taxation arise from —

1. The failure to inflation-adjust taxable income.
2. Depreciation allowances which do not reflect true economic depreciation.
3. The general exclusion of capital gains from the tax base.
4. Discriminatory and apparently ad hoc tax preferences.
5. Discrimination between corporate and non-corporate equity income.
6. Biases arising from tax-favoured savings institutions and high and sharply progressive personal tax rates.

V. POSSIBLE REFORMS

It is readily apparent that the taxation of business income is an integral part of personal direct taxation. In that context proposals to shift the direct tax base from income toward consumption expenditure or assets must be considered first.

A. Assets Tax

Assets tax is usually advocated on the basis that it would prevent undue wealth accumulation and encourage more efficient use of resources. While a moderate wealth tax may be a desirable redistributive device, it is difficult to see how it could sustain the revenue yield required to be an effective replacement for taxes on income from capital.

An assets tax would raise in a more acute form the annual asset valuation problem which already beset income taxes. The practical difficulties and avoidance incentives created would be more severe with the result that erosion of the tax base would substantially weaken any theoretical attraction it might have.[9] Its

9 Kay and King, supra n.1.

efficiency-encouraging properties are, in any event, confined to existing assets since in a competitive environment assets taxes, like income taxes, impose a tax wedge between the return to saving and the gross return on new investments.

Consideration of an assets tax, however, does highlight the corresponding deficiencies in income taxes as far as measuring annual increases in net worth are concerned — the approximation of asset depreciation rates and exclusion of capital appreciation.

B. Consumption or Expenditure Taxes

A personal tax on consumption would be levied by exempting all savings from tax, allowing a deduction for repayment of debt and taxing all withdrawals from savings — effectively a cash flow tax.[10]

Because it avoids the problems of measuring accrued income and increases in capital assets, a personal consumption tax is simpler in many respects than an income tax. All costs of investment are deducted immediately rather than amortised; all inventory costs are similarly expensed rather than being recognised as goods are sold; capital gains are not taxed as such. The corporate tax would be necessary as a withholding tax only.

Because consumption is always measured in current dollars, such a tax avoids all the problems of inflation which distort the income base for tax purposes.

There are also strong arguments that consumption tax avoids the savings disincentive and that it is more equitable than income tax from a lifetime perspective.

Despite these advantages it is difficult to envisage a move to personal direct consumption taxes within the relevant planning horizon. There are major transition problems and neither the taxpaying public nor the tax administration could understand and absorb such a radical change in the near future. Important implications for taxation of wealth and accessions also arise. In addition, New Zealand would stand alone as an expenditure tax country in a world of income tax trading partners which would greatly complicate international tax obligations.

Nevertheless, the time for consumption taxes may yet come and the properties of such a tax are a useful benchmark for tax policy evaluation. Moreover, it may be worthwhile to explore the feasibility of a separate cash flow tax being applied to companies only in the context of a personal income tax. As discussed below, it may be an efficient means of overcoming some of the worst features of the present income tax as it affects corporate-sourced income.

C. Income Tax

If income is to remain the underlying basis for taxing business, and thet fact that it is the current basis is a persuasive argument in its favour, the most

10 J. E. Meade et al. *The Structure and Reform of Direct Taxation* (Institute for Fiscal Studies, London, 1978); U.S. Treasury *Blueprints for Basic Tax Reform* (U.S. Government Printing Office, Washington, D.C., 1977).

important reforms required relate to inflation adjustment; capital gains; company/shoreholder taxation; and the marginal rate structure.

1. *Inflation adjustment*

Failure to adjust for inflation is arguably the most serious flaw in the business income tax. An inflation-proof income tax would be complicated but the alternative is to allow inflation to wildly distort effective tax rates creating socially less productive investment and inequity.

The closest that an indexed system could come to a proper measure of real economic income for tax purposes would be a constant purchasing power (CPP) system. This would adjust inventories, depreciable assets, capital gains and net monetary liabilities by a general price index. It could however, include a current cost accounting (CCA) adjustment of depreciation to replacement costs (i.e. one based on a specific price index). This broadly corresponds to the McCaw Committee[11] proposals.

A tax system based on 'real' profits would retain all the distortions of a nominal income tax although their magnitude would be much reduced. The tax wedge between pre- and post-tax returns would be related to the real rather than the nominal rate of return.

The requirement that the adjustment of monetary liabilities be accompanied by the exclusion of inflationary losses from nominal interest receipts of individual lenders leads inevitably to the need to have comprehensive indexing of financial contracts. A properly indexed tax system would therefore be complex to administer and involve fundamental reforms in the capital market. Major redistributive and transitional issues would accompany implementation.

The issue for further study is whether the costs of introducing this complexity outweigh the benefits and whether simpler proxy measures are worthwhile. The inflation issue must be confronted if income tax is to remain a serious contender among reform options.

2. *Capital gains*

The problem of capital gains is inherent in any attempt to measure true income. On equity grounds there is a case for taxing all capital gains and allowing a deduction for capital losses. On efficiency grounds the case for taxing windfall gains and losses is weaker because unanticipated gains do not affect investment decisions. It may be overwhelmed by the practical considerations involved and the limited revenue potential. For assets such as wine and trees, however, which systematically increase in value with age, there seems no practical argument to counter the efficiency and equity arguments for inclusion of annual accrued gains in the income tax base. Essentially, the same considerations apply as to the practical problems of imputing the capital loss arising on other assets in the form of economic depreciation. These problems are a general feature of an income tax.

11 P. M. McCaw et al. *Report of the Task Force on Tax Reform* (Government Printing Office, Wellington, 1982).

The arguments for capital gains taxes would be weakened by measures to inflation-adjust income, which would effectively tax anticipated gains on borrowing, and eliminate capital gains due solely to inflation.

Company/shareholder tax integration, which would effectively tax retained company profits at personal rates, would also reduce the need for capital gains taxes.

Inclusion of all realised capital gains may simplify tax administration and compliance by eliminating the need to distinguish capital and income. Provided losses are deductible there is no reason to believe taxing real capital gains would discourage investment in wealth-creating ventures, particularly in view of the residual advantage of tax deferral if the tax is levied on realisation.

3. *Company/shareholder tax integration*

There are various possibilities for reducing the financial distortions and penalty on incorporation arising under the present separate or classical system of company tax. These include imputing part of company tax as a credit to shareholders; a higher tax rate on undistributed profits; dividend deductibility; dividend relief; and full integration.

The principal gains from such systems are that they reduce the penalty on incorporation and the degree of discrimination between different methods of financing investments. Although debt and (in the absence of a capital gains tax) retentions are still normally more attractive than new equity issues, the extent of this difference is reduced. Debt will always be a favoured form of finance so long as separately taxed companies can deduct interest.

Relief from double taxation of dividends would probably improve the access to the capital market of low income investors. With the exception of full integration, however, none of the systems would reduce the advantages of tax shelter or deferral for high rate taxpayers.

Only two regimes are capable of completely eliminating these financial distortions; a classical system with no interest deductibility and a full integration system. The former would increase the tax penalty on incorporation.

Full integration would effectively do away with the separate taxation of companies and attribute all profits to individual shareholders as at a certain annual date. Company tax would operate merely as a withholding tax.

Administrative difficulties have been long regarded as an obstacle of full integration. Recent analysis, particularly by the Campbell Committee's inquiry into the Australian financial system,[12] suggests these difficulties are not overwhelming. Nonetheless, it may be that full integration should be restricted to closely held companies as is provided in the United States tax law. Of course, a distinction along these lines would create a new distortion between certain classes of corporation and the costs of this would need to be examined.

12 Committee of Inquiry into the Australian Financial System (1982).

Probably a more persuasive obstacle to full integration (and to a lesser extent other forms of dividend relief) relates to the treatment of foreign shareholders and the revenue implications. If relief were granted in respect of domestic shareholders, our main trading partners would press for similar relief for their shareholders. These arguments proved decisive in West Germany which rejected full integration in favour of a split rate/imputation system under United States pressure to extend relief to U.S. investors.

The redistribution of shareholder wealth consequent upon major dividend relief options would require consideration and possibly some transitional provisions.

One final observation is that a flatter tax scale with less disparity between the company tax rate and top personal rates would itself reduce some of the costs of the present system.

4. *Progressive rate structure*

Many of the difficulties alluded to earlier are aggravated by the wide disparity in personal tax rates. In particular, the incentives are exacerbated for tax sheltering, and income splitting and the use of alternative forms of business organisation without regard to their underlying costs.

Attempts to achieve vertical equity through steeply rising marginal rates are vitiated by numerous tax preferences and an incomplete definition of taxable income .In an inter-active way the high rates strengthen the pressures to erode the tax base.

The introduction of a less progressive or even a flat rate of tax coupled with a more comprehensive definition of income and appropriate company/shareholder tax integration would substantially reduce these distortions and inequities without necessarily shifting the tax burden from high income groups to lower income groups. This possibility arises from the obvious fact that high income earners in the top tax bracket are the main group which avoids tax through the many (legitimate or otherwise) arrangements for tax minimisation. An issue for research is the degree to which a more moderate progression in personal tax rates, or a single rate, would shift the tax burden on to low and middle income groups and the extent to which broadening the tax base might offset this. Unfortunately, it is impossible to estimate the distribution and extent of under-reported and sheltered income. If overseas experience provides any guide it suggests that enormous sums of income from capital escape the tax net and they are heavily concentrated in upper income brackets.[13]

The introduction of a broad-based goods and services tax will provide scope for achieving such a direct tax restructuring in the context of lowering direct marginal tax rates across the board. The overall immediate incidence of these large distributive changes must be publicly analysed.

D. Cash Flow Tax on Companies

An interesting possibility for reducing the problem of inflation adjustment,

13 U.S. Treasury, supra n.2.

capital gains, and company/shareholder integration is a cash flow tax applied to companies only.

A cash flow tax can be imposed on several bases.[14] No distinction is made between capital and revenue items, and tax is levied on the net cash flow derived from the trading activities of the business.

Examination of such a proposal leads to the conclusion that it has significant advantages from the viewpoints of efficiency and simplicity and could be no less equitable in operation. The efficiency properties derive from the neutrality of consumption taxes with respect to the investment decision and among different assets (that is, they do not impose a tax wedge between the gross return on investment and the return to savings). Simplicity derives from the fact that the tax base is entirely measurable by reference to observable cash flows and there is no requirement to deal with inflation or changes in asset values.

A cash flow tax can be operated for corporations with either a personal income or expenditure tax base. The latter, though more logical, is not essential.[15] Operation in conjunction with an income tax would involve separate 'classical' taxation of companies and would retain a discrimination between corporate and non-corporate sources of income. It would not add to the present distortions in the personal income tax system, however, and would reduce them because new investment through a company would not affect the rate of return by comparison with direct personal investment.

As under the present system, scope would remain to accumulate assets in the company. This incentive to accumulate would be accentuated, however, because the company would have no tax liability unless profits were distributed, i.e. generated a cash flow. It would be essential therefore to have an accrual-based tax on capital gains on company shares as part of the personal income tax.

Major difficulties would arise in transition to the new base, including the taxation of cash flows from past investments, and the question of double tax relief for foreign shareholders. The complexity of taxing capital gains on shares could be weighed against the prospect of companies having a much simpler tax return. It is a matter for study whether these difficulties are likely to be more severe than alternative reforms of the income tax.

E. Tax Expenditures

The exhaustive list of tax expenditures — subsidies and concessions delivered to selected activities through the tax system — presented in the last Budget has surprised many. Clearly a proper accounting and review of these is desirable.

However, since they are usually the result of deliberate policy to foster other economic objectives, the general criteria of tax evaluation are inappropriate. Instead they are properly considered in the context of industry assistance policy.

14 Meade, supra n.10.
15 J. S. S. Edwards *On the Case for a Flow-of-Funds Corporation Tax* Working Paper No. 35 (Institute for Fiscal Studies, London, 1982).

Unfortunately, many of these hitherto hidden subsidies are ingrained in the basic tax structure and widely perceived as part of it. Export incentives, for example, are frequently raised in business discussions of tax policy. The unfortunate aspect is that such tax reliefs undermine the credibility of the basic tax structure. To that extent an exercise is required to distinguish so-called tax expenditures which are in fact defects in tax design from those which are explicit preferences aimed at other policy objectives. Whether the latter should remain in the tax system as opposed to the expenditure budget depends on which is the most efficient method of delivering assistance.

F. Investment Incentives

Among other reform options, investment incentives are frequently suggested as a way of counteracting the worst effects of inflation or to stimulate investment either in general or in selected industries. The earlier discussion of savings and investment argued that tax structure should not be considered primarily in the context of stimulating *aggregate* investment. Nor is it considered that the issue of relative levels of assistance to different sectors or industries can properly be addressed in the context of tax reform.

Several arguments have been presented from time to time for general investment incentives applicable across the board to as wide a range of assets as possible. Most of these arguments are inconsistent with the basic criterion for an efficient tax structure. It is doubtful, for example, that such a broadly based investment incentive would provide other than transitory improvements in the international competitiveness of New Zealand producers as a whole.

A stronger argument may exist for using a 'consumption-type' incentive, such as the present first year allowance, to reduce some of the worst distortions resulting from an unindexed income tax with imperfect measures of tax depreciation. This would be consistent with moves to a consumption tax base for business. Other types of incentive such as direct grants or tax credits, accelerated depreciation, or a lower company tax rate are distinctly inferior.[16] Desirably, an increased first year allowance should be accompanied by a corresponding reduction in the deductibility of interest to avoid bias between investment in real and financial assets. Rapid write-off of debt-financed asset purchases can result in the Government subsidising investments with low and negative pre-tax returns.

G. Conclusion

Fundamental reform of business taxation is desirable. The broad choices for long term reform are to repair the income tax or shift to a consumption based tax. An assets tax is so radical its advantages as a substitute for income tax would have to be overwhelming. They are not. A limited revenue yield assets tax may, however, be an efficient means of preventing excessive wealth accumulations.

Whether business or investment income in general is taxed under an income or expenditure regime, the rate structure should be lower and far less progressive.

16 Bradford, supra n.3.

In the short and medium term a switch to a personal expenditure tax regime is not feasible. The only viable solution is to repair the income tax. This does not rule out a separate company tax based on cash flow in the context of a personal income tax.

The main requirements for repair of the income tax are:
(a) inflation adjustment of business and investment income.
(b) integration of personal and company tax.
(c) a flatter tax scale.

If these steps were taken capital gains exclusion would be a less serious problem, but it may be simpler not to exempt realised capital gains than to do so.

A cash flow tax for companies only would reduce the need for (a) and avoid (b) but require capital gains on shares to be taxed on accrual. Dividends would be taxable.

The first option is more widely understood. Whether it is better depends on the practical problems of devising detailed rules which are simple yet overcome the worst aspects of the present distortions. For example, can simple rules be devised which approximate correct inflation adjustment and company shareholder integration without creating a whole series of new distortions?

The fact that these reforms have been advocated for many years suggests that there are significant practical difficulties even in repairing the income tax. The cash flow tax which appears more radical may be simpler in practice and preferable to continuing an unrepaired income tax.

H. Constraints on Reform

Even the process of repairing the income tax in the manner suggested involves radical surgery and significant revenue implications. In the normal course of events such changes would require thorough analysis and public airing and discussion if general acceptance were to be won.

In the present circumstances the Government is contemplating almost a complete rewrite of the tax statutes — indirect taxes, personal income tax and social security as well as business tax. It is true that these issues cannot be considered in isolation but there is a limit to what the public can absorb and understand in a short time.

Perhaps more importantly, the work required to bring detailed reforms to the point of legislation throws another burden on a tax bureaucracy grappling with the other new tax proposals being promoted by the Government. Mistakes now could set back the reform process substantially if political attachment to simplistic proposals became entrenched.

For these reasons the possibilities for legislating business tax reform in the immediate future may be much more modest. Certainly, they are confined to repairs and maintenance of the income tax. They may be limited to rate restructuring and attention to some specific anomalies which have not been traversed in this brief paper. Nevertheless, analysis and debate of the more fundamental reforms must continue with haste because of the continuing costs of present tax distortions and inequities, and the present momentum for budgetary reform in general. The Government's open-minded attitude to business tax reform should be welcomed and the opportunity taken for constructive contributions.

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