A TAX SYSTEM FOR NEW ZEALAND'S FUTURE

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Afternoon Session 2

Company tax

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Introduction

- In 1980s NZ adopted clear and simple tax paradigm.
- Broad base and low-rate income tax.
- Supported by full imputation company tax system with rate alignment.
- Goal: tax people on income earned at their marginal tax rates.
- Broad-based and low-rate GST.
- Since then external pressures (especially worldwide reductions in company tax rate) and policy decisions have created pressures on this paradigm.

Key Facts

- NZ is highly reliant on corporate tax base (5.1% of GDP cf average of 3.9%).
- NZ geographically isolated but open economy with mobile capital and labour.
- Highly integrated economy with Australia:
    - –approx 50% of inbound and outbound FDI;
    - –free labour market.

Where are we in 2009?

- Still relatively broad bases for income tax and GST.

- Tax rates:
  - company rate 30%;
  - top personal tax rate 38%;
  - higher EMTRs e.g., for those on Working for Families;
  - trust tax rate 33%;
  - PIE rate capped at company rate – a final tax.

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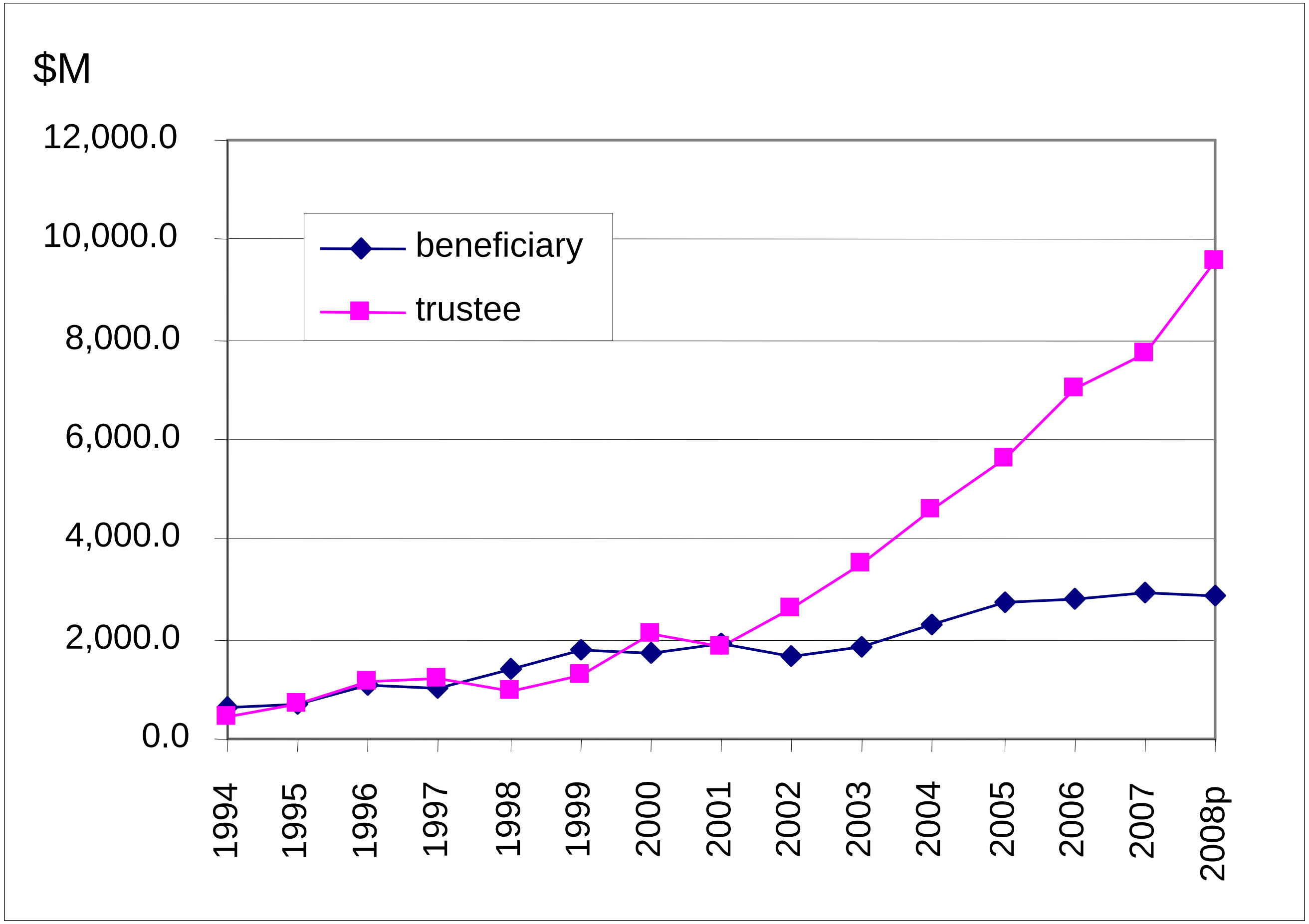
Effects of current rules

- Changes to tax rates have made it very easy for people to shelter income from higher personal marginal tax rates:
  - accumulation of profits in companies;
  - growth of income in trusts;
  - PIEs: heavily marketed to reduce tax rates on interest.

- This undermines basic paradigm.

Income of trusts



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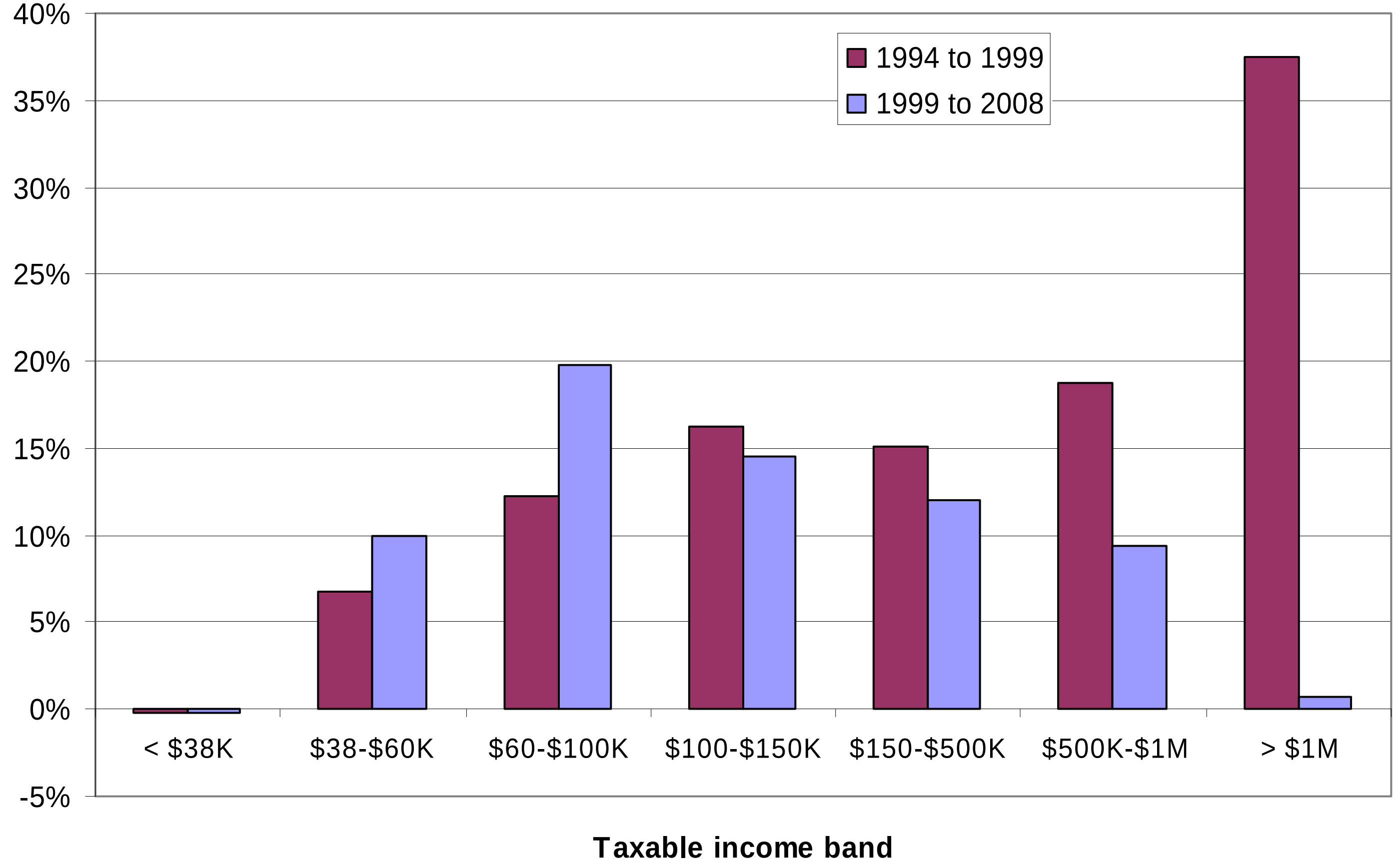
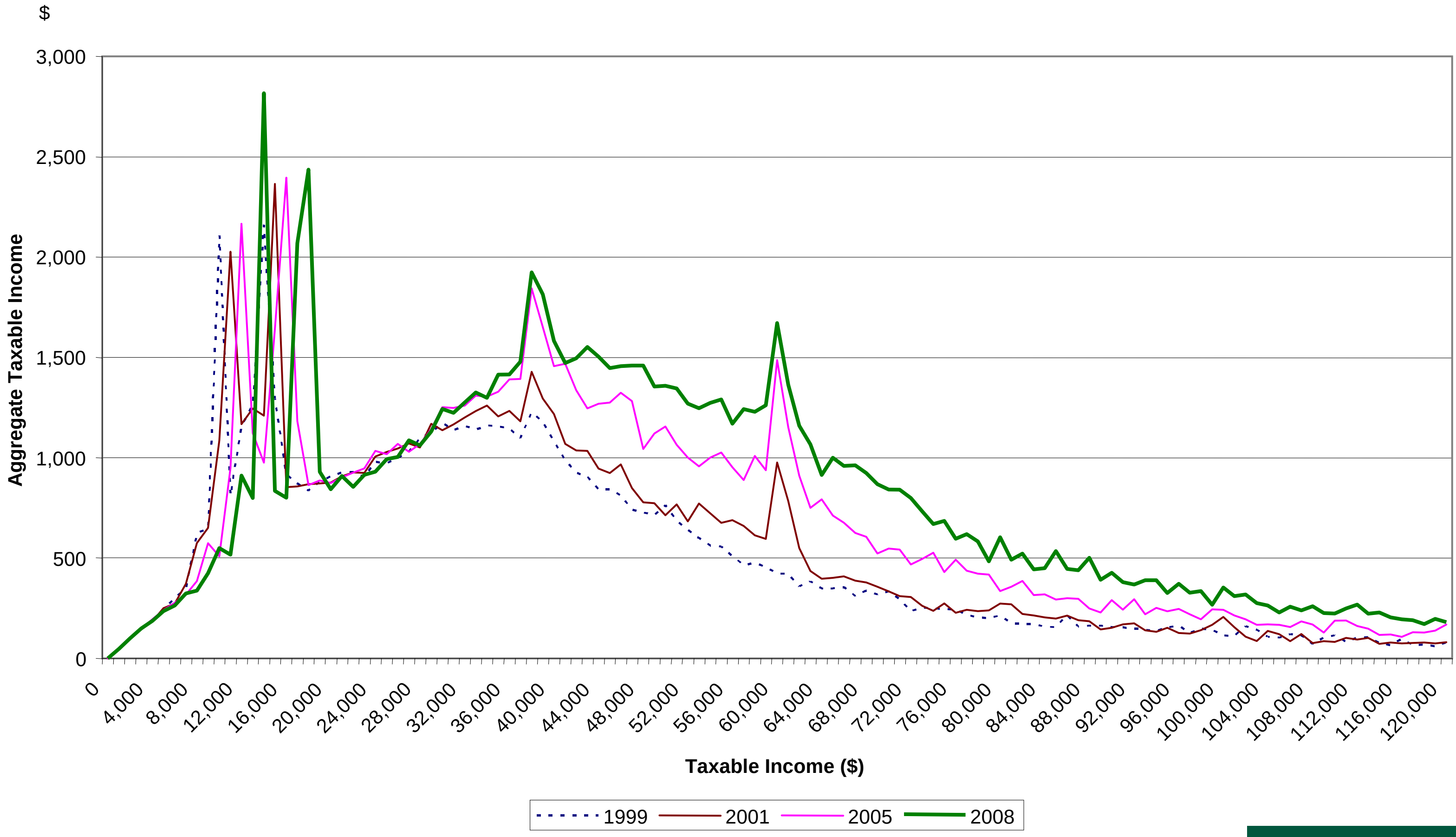
Average annual growth in number of taxpayers



Aggregate taxable income declared by taxpayers in each $1000 income band



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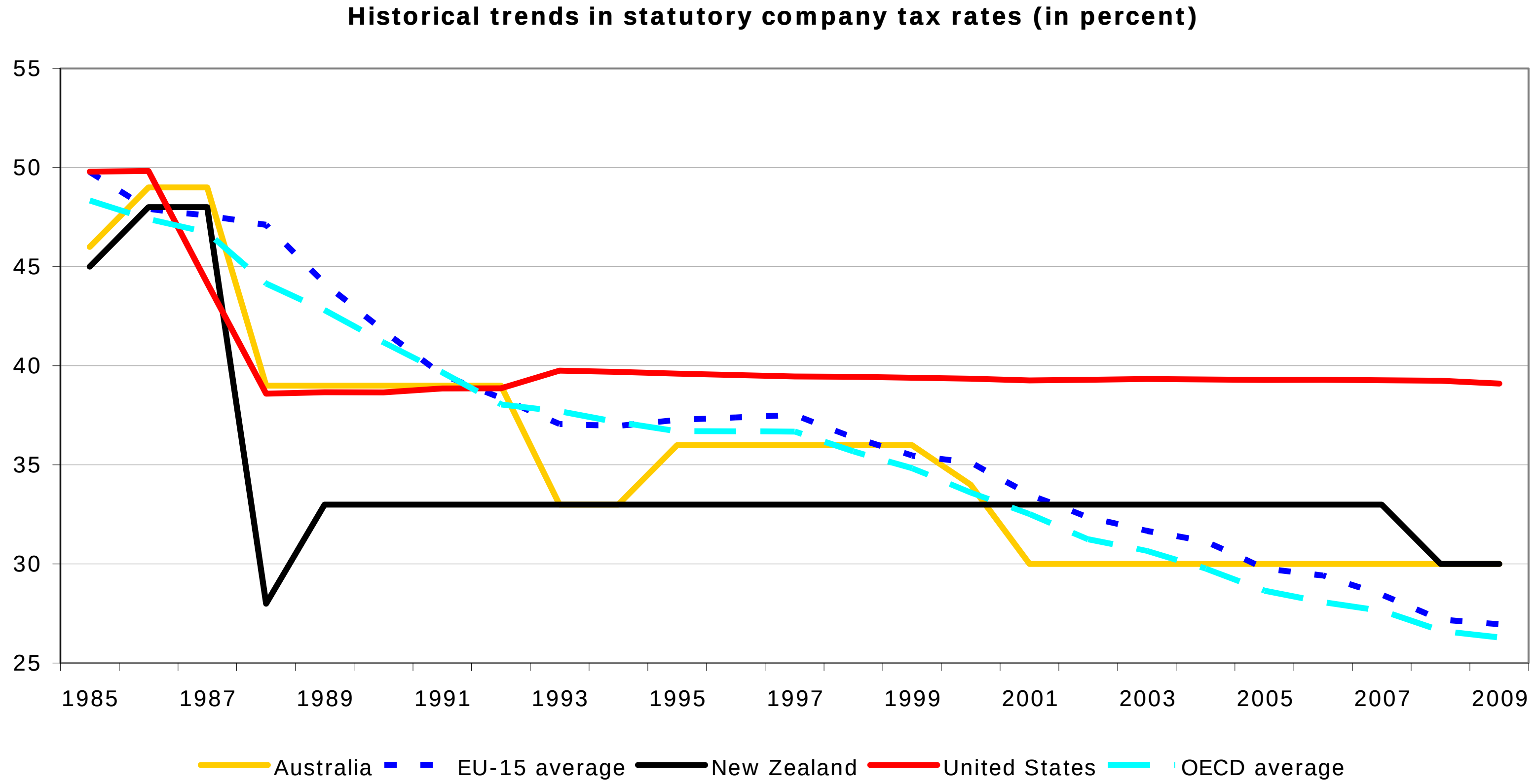
Determining policy choices

- For current paradigm need broad alignment between company, trust and top personal tax rate.
- Does the policy of alignment still make sense?
- Is alignment achievable and will it continue to be so?
- In late 1980s NZ had a relatively low company tax rate.
- Company rates have been declining worldwide.
- What will happen in the future?

Historical trends in statutory company tax rates (in percent)



Source: OECD

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Should we cut the company tax rate?

- In a small open economy, taxes on capital invested into the economy can be particularly inefficient. Backdoor inefficient tax on domestic labour.

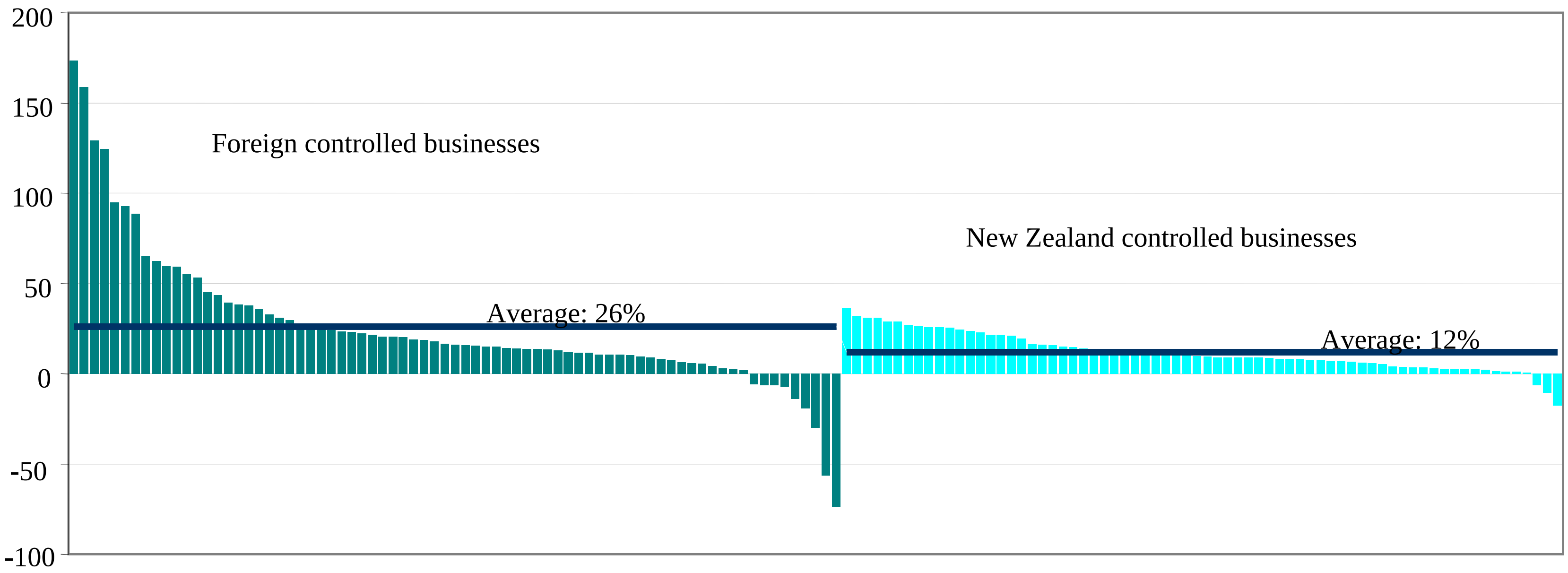
- Factors pushing for lower company rate:
  - economic efficiency:
    - reduce inefficient tax on inbound investment;
    - reduce investment distortions;
    - international evidence that high company tax rates can reduce productivity and growth.
  - Base maintenance:
    - thin capitalisation and transfer pricing pressures.

Should we cut the company rate?

- Factors pushing against cutting company rate:
  - – economic rents;
  - – foreign tax credits available abroad;
  - – coherence of personal tax system.

- Economic rents:
  - – two types: firm specific and location specific;
  - – small open economy cannot get away with taxing firm specific rents;
  - – can tax location specific rents;
  - – location specific rents likely to be important for island economy like NZ.

Average return on total equity



Economic rents?

- High returns on equity may be because of high debt levels.

- For estimates of after-tax return on capital: foreign 16%, domestic 10%.

- Rents may be firm specific and not location specific:
    - if so, likely to be associated with significant levels of exports;
    - no evidence of this from the data.

Options for the future

- Full imputation with alignment.
- Misaligned systems:
  - Nordic tax system;
  - classical company tax system;
  - keep imputation but abandon alignment;
  - other options (discussed in TWG papers but not here).

Full imputation with alignment

- Neutrality properties:
  - little bias in choice of business organisation;
  - little bias in whether raise debt or equity from residents (but international biases);
  - little bias to portfolio choice.

- Imputation system:
  - allows NZ to tax NZ sourced income of non-residents;
  - ensures residents are tax on domestic and foreign-sourced income earned through companies;
  - buttress to company tax;
  - keeps mutual recognition as an option.

- But:
  - costs $1.6 billion.
  - will alignment continue to be sustainable?

Nordic (or dual) tax system

- The system:
  - low? flat tax rate on capital income;
  - higher progressive tax rates on labour income;
  - key pressure determining capital and labour income;
  - all the devil is in the detail.

- Norway's system:
  - split income of self employed into capital and labour income;
  - if $1 million of capital and 5% risk-free rate, $50k capital income and rest labour income.

Nordic (or dual) tax system

- . . . Norway’s tax system:
  - for companies, income taxed at 28% company (and capital) tax rate;
  - dividends plus capital gains below risk free rate are exempt;
  - dividends plus capital gains above risk free rate are double taxed (at 28% rate);
  - ingenious relationship between tax rates: double taxation at company rate is equivalent to top tax rate on labour income.

Nordic tax system

- Potential attractions:
  - lower tax rate on savings;
  - lower company rate;
  - (if reducing tax rates on labour income not desired) would allow reduction in company tax rate without necessarily reducing tax rates on labour income.
- Potential concerns:
  - reduced taxes on economic rents;
  - complex;
  - penalty on risk;
  - cutting tax rates on capital may predominantly benefit the better off.
- Question:
  - if want modest move in this direction, would cutting all marginal rates of income tax and boosting GST be preferable?

Classical company tax system

- Double taxation of dividends.
- Revenue neutral switch does not provide deep company rate cut because of likely changes in dividend behaviour.
- For a cost of $1.6 billion could have deeper cut.

Classical company tax

- Potential attractions:
  - lower company tax rate;
  - (if reducing tax rates on personal income is not desired) allows company rate to be cut without reducing personal tax rates.

- Potential concerns:
  - reduced taxes on economic rents;
  - double taxation;
  - reduced incentives for domestic residents to save;
  - if deep company rate cut, complex anti-tax-sheltering measures likely to be necessary.

Imputation without alignment

- Changes to current rules are *essential*! Current system is not working well!!
- If minor misalignment:
  - alignment of trustee tax rate with top personal marginal rate;
  - remove cap and allow income of PIEs to be taxed at top marginal rate;
  - tax on manager buy backs from unit trusts?
- If more major misalignment:
  - more substantial measures to deal with accumulation of personal income in companies;
  - capital gains tax??

Conclusions

- Considerable attractions in imputation with alignment.
- Key question is whether or not this will be feasible if other countries continue to cut company rates.
- Ultimately best reform cannot be determined independently of what other countries do.
- If unaligned, what measures would be needed to bolster the effectiveness of the personal tax system?