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The voice of business

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Hon Bill English
Minister of Finance
Parliament Buildings
WELLINGTON

Dear Minister

Re: Tax Working Group Report

I am writing to you in regard to the recommendations made by the Tax Working Group (TWG) in their final report to the Government.

First, on behalf of Business New Zealand I would like to congratulate both the Government and the TWG in researching, analysing and proposing changes to New Zealand's tax system in a relatively short period of time. Also, I would like to point out that we have found the process by which the TWG has conducted itself to be very open and transparent. This has meant representative organisations such as Business New Zealand have been able to closely follow the Group's progress and likely recommendations.

We appreciate the difficult task that was placed on the TWG, where the terms of reference meant there were often complex trade-offs to be made. As discussed in the final report, gaining a complete consensus on ways forward for New Zealand's tax system is almost impossible. There are also parts of the business community that will invariably agree or disagree with the recommendations put forward. However, it is important to identify those options that have the broadest support from the business community, which is the position Business New Zealand has taken together with its members, encompassing its regional associations, major companies group and affiliated industries group throughout the work of the TWG.

Business New Zealand has had numerous opportunities to provide thoughts on the possible proposals outlined, including attendance at selected TWG meetings, the tax conference, one-on-one discussions with TWG members, officials' briefings and meetings involving the major companies group. While we are aware of the views of the Government by way of the Prime Minister's Statement to Parliament on 9 February, we still believe it is important to provide our views on each of the recommendations to assist in making the final decisions that will need to be made in

the 2010 Budget. We have kept our responses below as succinct as possible, but would welcome any questions you may have.

1. The company, top personal and trust tax rates should be aligned to improve the system's integrity. If at any time this is no longer feasible due, for example, to global pressure causing the company rate to reduce, at the very least the trustee rate, top personal tax rate and top rate for portfolio investment entities (PIEs) and other widely-held savings vehicles need to be aligned, accompanied by the introduction of suitable fiscal integrity measures.

2. New Zealand's company tax rate needs to be competitive with other countries' company tax rates, particularly that in Australia. Balancing this factor against the integrity benefits of a fully aligned system will guide choices between an aligned and non-aligned system.

The first point Business New Zealand would like to make is that we support the pragmatic approach that the two recommendations above outline. While we are in favour of the general lowering of tax rates, given New Zealand is part of a competitive international market, any movements of company and personal tax rates will often need to respond to international pressures. Therefore, alignment of the company, top personal and trust tax rates may not be in the best interests of the New Zealand economy at all times.

In addition, Business New Zealand has consistently taken the view that New Zealand's company tax rate needs to be competitive with other countries', particularly with Australia's. Questions posed to our members regarding what level New Zealand's company tax rate should be in order to significantly increase our competitiveness have shown that businesses (both small and large) want a significant cut, typically to 25% or lower.

In terms of the details regarding alignment or near-alignment, there are two issues that need to be looked at. The first examines the issue of alignment regarding the main tax rates in New Zealand (i.e. the company, top personal and trust rates). We note that table 2 on page 44 of the report provides the fiscal costs of various scenarios in terms of alignment and non-alignment for the top personal, trust and company tax rates. We are pleased to see that any non-alignment relates to a lower company tax rate of either 27% or 25%, with fiscal costs that are generally within the bounds of the revenue raising and base-broadening options to compensate.

The second issue of alignment is in regards to what Australia may do regarding the company tax rate. We believe it is critical to at least match any change in Australia's company tax rate with our own. Again, views from our membership have consistently shown that it is very important for New Zealand's company tax rate to be aligned with Australia's. Therefore, any reduction to say 27% or 25% in Australia's rate also needs to occur. In fact, Business New Zealand would go a step further and look at the economic opportunities that would be created if we decided to have a company rate lower than Australia's (i.e. a 25% rate or lower if Australia moves to 27%).

3. The imputation system should be retained. However, this may need to be reviewed if Australia decides to move away from its imputation system.

Business New Zealand agrees. However, any movements in Australia, particularly in regards to action following the recommendations of the Henry review, will play a vital role in terms of the future validity of having an imputation system in New Zealand. Again, we believe this is a practical approach for the Government to take.

4. The top personal tax rates of 38% and 33% should be reduced as part of an alignment strategy and to better position the tax system for growth. Where possible, the Group would like to see a reduction in personal tax rates across-the-board to ensure lower rates of tax on labour more generally. This could be achieved as part of a package to compensate for any increase in GST.

Business New Zealand agrees with the strategy of lowering personal tax rates to boost growth and supports such moves (as discussed above).

One additional comment we would like to make is that the last sentence regarding lowering top personal tax rates as part of a package to compensate for any increase in GST tends to be thought of in relation to wage and salary earners. However, this type of compensation would also extend to both small and large business owners who pay the top personal tax rate. Also, a corresponding reduction in the company tax rate with an increase in the GST rate would help many businesses (both small and large) reduce the compliance and sunk costs described in recommendation 11 below.

5. Base-broadening is required to address some of the existing biases in the tax system and to improve its efficiency and sustainability. Base-broadening is also required if there are to be reductions in corporate and personal tax rates while maintaining tax revenue levels.

Business New Zealand agrees. We note that this is a point that seems to be missed by many who have made public comments about elements of the report. Given the terms of reference, if one is to lower company and personal taxes, then the forgone revenue needs to be obtained elsewhere. Therefore, examining each base broadening and revenue raising option by itself without looking at where it would sit in terms of the overall package can often lead to no changes being implemented.

Also, we would like to respond to the last point made in the recommendation regarding maintaining tax revenue levels. Although it was not within their scope, we believe the TWG has only looked at one half of the broader issue at hand. The balance of revenue neutrality has meant there has been no opportunity for the group to look at where Government expenditure could be reduced to free up revenue for further tax changes. In this regard, we note the relatively small pool of revenue outlined for changes (i.e. $1.6b for a 30-30-30 tax rate regime), compared with the estimated $54b that IRD collects that could be used more efficiently if spending

decisions were properly reviewed. Therefore, we would want the Government to make a more concentrated effort to find ways to lower unnecessary expenditure so that additional revenue could be passed back to taxpayers via lower tax rates, while revenue required for spending is done so in a productive way.

6. The most comprehensive option for base-broadening with respect to the taxation of capital is to introduce a comprehensive capital gains tax (CGT). While some view this as a viable option for base-broadening, most members of the TWG have significant concerns over the practical challenges arising from a comprehensive CGT and the potential distortions and other efficiency implications that may arise from a partial CGT.

While Business New Zealand does not have any formal position on a capital gains tax, we agree with the TWG in that the devil is in the detail of how this might be implemented. The report provides a good summary of both the advantages and disadvantages of a comprehensive capital gains tax, although we note the problems outlined may be too significant to overcome for the policy to be implemented successfully.

In this regard, we note that the Prime Minister has stated that the family home will not be subject to a CGT, and in addition has ruled out any form of comprehensive capital gains tax in his Statement to Parliament. Once the stance of a comprehensive capital gains tax is eroded by exclusions, then its effectiveness in terms of efficiency and revenue collection are called into question. Therefore, we agree with the TWG that given the exemptions most likely to occur, a CGT should not be introduced.

7. The other approach to base-broadening is to identify gaps in the current system where income, in the broadest sense, is being derived and systematically under-taxed (such as returns from residential rental properties) and apply a more targeted approach. The majority of the TWG support detailed consideration of taxing returns from capital invested in residential rental properties on the basis of a deemed notional return calculated using a risk-free rate.

Business New Zealand agrees that given the terms of reference, a variety of approaches needed to be presented by the TWG to ensure the income required for tax rate reductions was met.

The second sentence in this recommendation specifically looks at further consideration being put into a risk free return method (RFRM) on residential investment property. Like a CGT, Business New Zealand does not have any strong views on the idea of a risk free rate of return. However, we agree with the statement in the report that *'further work would be required to understand the full implications'*. One could argue that while a RFRM on the value of equity could be one way of circumventing issues relating to a capital gains tax, there would still be a number of issues to deal with, which the report touched upon on pages 53/54.

Again, we note the Prime Minister has ruled out a RFRM in his Statement to Parliament. Because of the various questions unanswered at this time, we agree with the Prime Minister's stance. The possible introduction of an RFRM requires further rigorous analysis, which should be open to public consultation.

8. Most members of the TWG support the introduction of a low-rate land tax as a means of funding other tax rate reductions.

Again, Business New Zealand believes there is an issue of balance at play here. First, we note that a land tax is nothing new. New Zealand had a land tax up until 1992, but the exemptions on this were considerable and therefore affected only a small group of taxpayers. We also currently have a form of land tax via the rates charged by Local Governments.

Despite a land tax being previously used in New Zealand, one of our main concerns with the re-introduction of it is that it could be used for other revenue raising purposes in the future, which would move it away from why it was introduced. The reason why taxes such as that relating to land are introduced is often easily forgotten, and subsequent administrations may use this tool for other purposes. For example, a future Government may need additional revenue for some elements of social spending, and therefore increase the land tax rate. Alternatively, changes to the land tax could come about by relating the rate paid to the income of the individual/family. While one could argue that existing taxes could also be changed in such circumstances, additional taxes mean there is a greater scope to do so, which is not the way forward for ensuring fiscal prudence within the Government. In addition, land is typically the principle form of equity held by banks to support lending for businesses to put in productive activities. Therefore, such action may undermine the banks' security and may also undermine their ability to lend to the business community. Lastly, like a CGT and previous land taxes in New Zealand, the opportunity for exemptions to take place over time are often politically hard to ignore, thereby undermining the original intent of the policy.

Having said this, the recommendations of the TWG are certainly about balance and trade-offs, so all recommendations need to be looked at to ascertain the best way forward. For example, if the introduction of a land tax and an increased GST rate meant a 30-30-30 tax structure then we would most probably not support a land tax as part of the mix. If, however, the same policies meant a 25-25-25 tax structure, then we would be more open to the idea of a land tax given the significant drop in the company and top personal rates.

The Prime Minister has effectively ruled out a land tax being introduced. From Business New Zealand's point of view, unless the introduction of a land tax means <u>significant</u> reductions in the company tax rate and/or a much lower/flatter tax structure, then we do not support its introduction.

9. The following targeted options for base-broadening should be considered for introduction relatively quickly:

- **Removing the 20% depreciation loading on new plant and equipment.**
- **Removing tax depreciation on buildings (or certain categories of buildings) if empirical evidence shows that they do not depreciate in value.**
- **Changing the thin capitalisation rules by lowering the safe harbour threshold to 60% or by reviewing the base for calculating this measure.**

We note that the possible income streams provided by these three options have been estimated at up to $0.3b, $1.3b and $0.2b respectively.

Regarding the first option of removing the 20% depreciation loading on new plant and equipment, as we understand it this would mean that new assets (excluding buildings), including assets used for the first time in New Zealand, would not qualify for an additional 20% loading on the relevant economic depreciation rate. We also note that the main body of the text also outlines the option of reducing the loading figure, as well as removing it. We are not convinced this is the best step forward if we wish to raise our productivity levels, as the 20% addition to depreciation claims was introduced to encourage investment in income-producing assets. Therefore, we would place the option of removing/reducing loading as one of the least supported options.

Regarding tax depreciation on buildings, any decisions made in this area will most likely have significant effects, not only in terms of the taxpayer funds saved, but also on associated residential property investment. Given our view of what will this mean for the broad business community, we note the caveat of removing depreciation on buildings perhaps only applying it to certain categories of buildings, namely residential properties. In effect, the removal of depreciation would be ring-fenced. Business New Zealand does not have a strong view on removing depreciation on residential buildings, but we would obviously <u>strongly reject</u> any moves towards extending the removal of tax depreciation on commercial/industrial buildings. Such buildings typically depreciate over time as the specific requirements of the building can rapidly change due to new technology or a shift in focus involving the operations of the business. We also believe care needs to be taken in differentiating between residential and commercial buildings in terms of any ring fencing taking place.

Regarding the last option of changing the thin capitalisation rules by lowering the safe harbour threshold from 75% to 60%, we believe this option for revenue raising may lead to more questions than answers, and we would urge caution. The IRD paper associated with this option during session 4 of the TWG did not provide a clear steer in terms of the net benefit from reducing the threshold. As the paper stated, the existing 75% safe harbour is essentially arbitrary, as it is based on judgement and compromise. Also, direct comparisons with other countries are difficult as approaches vary. While the U.S.A has a 60% threshold, Australia is still at 75%. In addition, a lower safe harbour would increase compliance costs for foreign direct investors, while the estimated $177m fiscal gain from reducing the threshold to 60%

is most likely at the upper end of the saving, calling into question the positive fiscal impact it would produce. From our perspective, this seems to raise more questions than answers, and therefore, like depreciation loading, would place it as one of the least supported options.

10. GST should continue to apply broadly. There should be no exemptions.

Business New Zealand thoroughly endorses this recommendation. We have long held the view that GST should remain a broad based tax with few if any exemptions. Overseas evidence has consistently shown that exemptions often lead to gaming and the diverting of resources that would be better used in more productive means.

11. Most members of the Group consider that increasing the GST rate to 15% would have merit on efficiency grounds because it would result in reducing the taxation bias against saving and investment. However, any increase in the GST rate would need to be accompanied by compensation to those on lower incomes. This would significantly reduce the net revenue raised from a higher GST.

On balance, Business New Zealand believes that of the various options outlined to collect revenue and ensure cost neutrality, increasing the rate of GST should be viewed as a primary mechanism by which to raise revenue. Not only does it reduce the taxation bias against savings and investment, but also means changes are made that are part of the existing tax structure, without having to create another level of complexity in the system.

The introduction of GST occurred when there were significant trade-offs in a tax policy sense, as a 10% GST rate came about with other significant changes to imputation, personal tax rates and benefits in 1986. While the increase from 10% to 12.5% in 1989 was primarily a revenue raising option without other major tax reforms, the Government now has the opportunity to again associate a revised GST rate with a broad based, low rate tax system.

However, there are a few points Business New Zealand wishes to raise regarding increasing GST, in particular issues that may have a significant impact on New Zealand's small-medium sized enterprises. First, increasing the rate of GST from 12.5% to 15% means businesses may no longer have a simple calculation to work out in terms of what the GST would be. Previously, a 10% GST rate meant a calculation of dividing by 11, while a 12.5% rate meant division by 9. A new rate of 15% would mean division by 7.66, which is not easy to calculate for businesses with a basic calculator.

The second issue is that there may not be the opportunity to pass on the costs of an increase in GST to consumers for certain sellers/products. For instance, a good that sells for $49.99 may be price sensitive by having to remain under $50. This means a business cannot increase the price of the good to take into account the rise in GST.

Instead, they will have to wear the increased costs. Other costs, particularly related to compliance such as price tag changing will also occur.

We note that the Prime Minister in his Statement to Parliament has indicated a 'modest' rise in the rate of GST to no more than 15%. The TWG also outlines a more ambitious option, increasing GST to 17.5%. Rather than raising $1.9b with a 15% GST rate, a 17.5% GST rate would raise up to $3.7b. By itself - without any other revenue raising or base broadening options - this could mean four of the five revised tax rate structures illustrated on page 44 are feasible. However, we would like to point out that any effort increasing GST has on raising additional revenue is tempered by the second part of the TWG's recommendation. Namely, any increase in GST would have to be accompanied by compensation to those on lower incomes, which the TWG rightly points out would significantly reduce the net revenue raised. We would be disappointed if the net fiscal gain was at such a low level that it meant only minimal change to the main tax rates and/or the least workable of the base-broadening/revenue raising options had to be considered.

Although we raise some issues associated with raising the GST rate, we believe of all the methods outlined for revenue raising, increasing GST should be considered the <u>primary</u> mechanism used by the Government.

12. There should be a comprehensive review of welfare policy and how it interacts with the tax system, with an objective being to reduce high effective marginal tax rates.

Business New Zealand agrees, as a comprehensive review into this area is long overdue. In particular, the distortionary effects of Working for Families (WFF) need to be investigated, which is discussed in the report. We took the opportunity to provide the TWG with a paper that we compiled around two years ago outlying the significant problems WFF was creating in terms of workers accepting promotions and pay increases, simply because it was not often financially viable to accept a new role because of the drop in the WFF benefit.

We note that the Prime Minister has stated that there would be no major changes to the WFF scheme. We believe this is step in the wrong direction, as we believe a comprehensive review with alternatives outlined is in the best interests of New Zealand's competitiveness and growth.

13. Government should introduce institutional arrangements to ensure there is a stronger focus on achieving and sustaining efficiency, fairness, coherence and integrity of the tax system when tax changes are proposed.

Business New Zealand agrees. A forward looking and coordinated approach to tax policy has been lacking in New Zealand for some time, as most decisions have been piecemeal at best. We have long advocated the establishment of a New Zealand Productivity Commission as the type of independent agency that in addition to other

duties could carry out such reviews and monitor compliance with the six principles of tax mentioned above.

Other Points to Note

In addition to the 13 recommendations made by the TWG, Business New Zealand believes there are three further issues that are worth consideration by the Government:

- *Next steps for tax policy change:* Large scale ideas such as that presented by Gareth Morgan regarding a comprehensive capital gains tax should be investigated by officials. While we do not have a view as to whether such schemes would be best for New Zealand, a wide-ranging approach like the one Morgan has suggested deserves further work if we are to make a significant step change in New Zealand's tax system.

- *Tax policy add-ons on the horizon:* In relation to the bullet point above, New Zealand seems to go through a pattern of a one time significant tax policy change, followed by various add-ons and tinkering that undoes much of the drive towards simplification and increased competitiveness of the tax structure. An example is the fact that income splitting will be supported in its first reading by the Government, with possible implementation by 2012. Such a scheme was rejected out of hand by the TWG because of the additional complexity it creates. The Government needs to be mindful of where such policies exist when looking at the main principles of a good tax system.

- *TWG has only examined one side of the coin:* As mentioned in our comments to recommendation 5 above, the tight terms of reference that the TWG worked with meant that there was essentially a balancing act between revenue raised and revenue spent. Like a business, this is only looking at one side of the equation. The issue of expenses also needs to be examined, and while the Government has announced various cost saving measures, there does not appear to be a sizeable drive towards making the most efficient use of the estimated $59b that IRD collects annually.

Again, we thank you for the opportunity to comment, and are happy to meet regarding any questions you might have.

Kind regards,

Phil O'Reilly
Chief Executive
Business New Zealand

Cc: John Key, Prime Minister