

Reflections on 'A Tax System for New Zealand's Future'

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Abstract

'A Tax System for New Zealand's Future', the Report of the Tax Working Group, is reviewed. The Report is judged a model of rational policy analysis, explaining the need for reform, the basic principles used to consider alternative policies, and the advantages and disadvantages of a range of reform proposals. A number of aspects concerning the evaluation of tax structures are considered, and some arguments which not stated explicitly in the Report are clarified.

Introduction

The Report of the Victoria University of Wellington Tax Working Group (TWG), 'A Tax System for New Zealand's Future' (2010) represents a unique collaboration among individuals from the New Zealand Treasury, the Inland Revenue Department and the Victoria University Centre for Accounting, Governance and Taxation Research (CAGTR), along with a range of other acknowledged tax experts. The Report has also been produced with remarkable speed and relatively cheaply. Favourable comparisons may be made with the review carried out by the Australian Treasury ('Australia's Future Tax System') and the Institute for Fiscal Studies ('Reforming the Tax System for the 21st Century') in the UK.

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Taxation is an area where strong disagreement and argument at cross purposes is notoriously present. The major strength of the Report is that it is an exercise in 'Rational Policy Analysis', in that it aims to examine the implications of a range of alternative policies, using a variety of measures. Such a procedure involves a clear statement of the criteria against which a tax structure may be compared. It thereby encourages an understanding of why different people may not agree about the best way to proceed, and so allows for rational discussion rather than heated argument. The Report is refreshingly free of the kind of rhetoric which is so often a part of taxation debates.

At times the TWG was unable to resist the pressure to make specific proposals for reform of the NZ tax structure, though in doing so it is careful to point out that its members are not always unanimous. The TWG was, it seems, responding to outside pressures to produce specific recommendations.² But rational policy analysis at its best provides the information which enables others, using their own value judgements and views about likely orders of magnitude, to make up their own minds.

After briefly describing the reforms suggested by the TWG, the paper goes on to consider the way in which tax structures are evaluated. Some criticisms regarding the precision of chosen concepts are aired, and suggestions for further analyses are made.

New Zealand Taxes and Reforms

Some distinctive features of the New Zealand tax structure may be briefly mentioned. The personal income tax has no tax-free threshold. There are few deductions, and the top marginal rate is 38 per cent. It has a very limited capital-gains tax, a substantial difference between the corporate tax rate (of 30 per cent) and the top personal rate, and a Goods and Services Tax with a very broad base and low rate relative to European countries. The Report explains why changes are needed, arising from domestic and international changes since the previous major reforms of the 1980s, such as the increasing extent of international capital mobility. Motivated by the extent to which the tax rate applied to corporations, trusts and the top personal tax rate have become 'misaligned', it then considers a range of alternative methods of taxing corporations. These reforms include: reductions in personal income-tax rates; methods to broaden

2 An early statement of aims was made in Buckle (2009: 2): 'The purposes of the Tax Working Group are to provide a forum for informed discussion of the priorities for medium-term tax policy that can feed into advice to Government Ministers and to promote and inform a wider public debate on tax policy. ... It was not designed primarily to lead to specific policy recommendations but rather to allow full identification of the issues that will need to be considered in reviewing medium-term tax policy.'

the tax base, including the introduction of a Land Tax and extensions to the Capital Gains Tax; and changes to rules regarding depreciation allowances for property investment. The report stresses the need for changes which place less reliance on those taxes (such as personal income taxes and corporation taxes) where there are efficiency problems and where labour and capital are mobile. The report argues for the need to bring corporation, trust and personal tax rates into closer alignment. In each case the advantages and disadvantages are carefully discussed.

In considering changes, an important feature is that the TWG restricted its attention to reforms which are revenue neutral, so that total tax revenue is estimated to remain unchanged. The restriction to revenue-neutral changes is necessary because any change in revenue involves another unspecified policy, so that alternatives cannot properly be compared. Thus, for example, the argument that concerns about the future adequacy of tax revenue would disappear if only government expenditure were cut would be irresponsible, unless at the same time a detailed set of proposals for cutting expenditure were produced and their implications examined. Expenditure considerations were outside the scope of the review.

Any revenue-neutral change in the tax structure must of course involve some winners and some losers. Hence unanimity cannot be expected and distributional value judgements cannot be avoided. It is therefore important to attempt to make such value judgements explicit, since they are the source of many disputes about tax policy. Given the inevitability of there being some losers from a tax-policy change, a strong desire on the part of policymakers to avoid creating losers clearly creates a bias towards the status quo.

Revenue-neutral changes examined by the TWG assume an absence of behavioural responses to tax changes, such as profit shifting by corporations and labour-supply adjustments by individuals. Such behavioural responses may be substantial.³ To the extent that a policy change improves incentives and increases taxable incomes (including profits), post-reform tax revenue is likely to be understated.

Evaluating Tax Structures

This section discusses the TWG Report's approach to the evaluation of tax structures.

³ For examples using a behavioural microsimulation model for Australia, see Buddelmeyer, Creedy and Kalb (2008).

It is suggested that an appreciation of these points should help readers to obtain a clearer understanding of the main arguments of the Report.

Basic Tax Principles

The TWG Report sets out six ‘principles of a good tax system’. These are: efficiency and growth; equity and fairness; revenue integrity; fiscal cost; compliance and administration cost; and coherence (as part of a multi-tax and benefit structure). Any statement of tax principles inevitably brings to mind Adam Smith’s famous ‘four maxims’, which are frequently discussed and extended.⁴ A fundamental problem is that, even if these principles were substantially elaborated, it would not be possible to treat them as axioms and from them derive an implied ‘ideal’ tax structure. The TWG appeared to recognise that even the production of a table, listing tax policies in the rows and the principles in columns, with ticks and crosses in appropriate boxes, would not in the present context provide sufficient information. The Report thus more usefully produced tables listing various advantages and disadvantages of each alternative. These features in fact include further criteria such as ‘certainty regarding future taxes’ (see pp.28 and 64).

However, there are some important principles which are implicit in the Report, but which really need to be made explicit. Thus, only on p.56 is mention made of the fact that ‘value judgements are necessary to determine the priorities and respective weighting of these objectives’. The fact that value judgements play such an important role in tax-policy decisions explains also why there is usually so much disagreement in tax-policy debates.⁵ It is seldom clear if opponents disagree because they hold different value judgements, or because they form different views about the way people respond to tax changes (given that complete information is never available). This is precisely how rational policy analysis can help — by indicating the implications of adopting different values, so that readers can make up their own minds.

4 Smith’s maxims, stated in *The Wealth of Nations*, were: payment according to benefit received (though there was some ambiguity as to whether this coincides with ability to pay); certainty; convenience; and economy in collection. A longer list was produced by G. W. Norman, whose list included: frugal; computable; simple; constant; divisible; popular; non-interferent; equal; uncorruptive; unvexatious; and unevasible. See O’Brien with Creedy (2009).

5 This point is discussed in detail in Creedy (2010).

The Tax Base

A fundamental judgement taken by the TWG — and not fully articulated in the Report — is that taxes should reflect 'ability to pay', rather than the 'benefits received' as a result of the subsequent public expenditure. Thus, it is stated that, 'a good tax system should [ensure that] taxes paid reflect ability to pay' (p.59). In considering ability to pay, a further important step is taken in suggesting that it 'should' be measured by 'comprehensive income'. Unfortunately the Report never states this explicitly, suggesting for example only that, 'taxing capital gain "on accrual" would bring the tax system closer to taxing comprehensive income' (p.48) and referring to a capital gains tax as 'a more comprehensive option for base broadening' (p.11).

The term 'comprehensive income' means simply that income is defined as the amount that can be consumed in a given period without reducing wealth. This 'maintaining capital intact' income concept is indeed widely used in economics, but its adoption as a tax base involves a value judgement. The important point here — not brought out sufficiently clearly in the Report — is that the use of this concept is the fundamental reason for attempting to tax capital gains. Such taxes obviously face problems in dealing with those gains which accrue but are not realised, and the Report recognises that a 'comprehensive capital gains tax' is impossible to impose. Nevertheless, there may be scope for extending CGT along the lines used in other countries.⁶

In popular debates regarding the introduction of, or extension to, a tax there is perhaps a tendency to judge a proposal against a 'perfect' tax, when of course no existing tax is perfect. And, there is always some resistance to a new tax. As the writer of the first English-language full-length treatise on public finance, John Ramsay McCulloch, declared: 'it is sometimes better "to bear those ills we have, than to fly to others that we know not of"'.⁷ It is therefore likely that the TWG's discussion of extending CGT in New Zealand will meet with some resistance, even among those who may not expect to lose by such a change, but it provides a useful starting point for debate.

⁶ The Report discusses the use of a risk-free rate of return method (RFRM) on property, but is generally not supportive.

⁷ See McCulloch (1863).

Rules of Thumb

An important position taken by the Report is that, ‘the TWG considers that the broad-base low-rate [BB-LR] option is generally a sound principle to adopt’ (pp.16 and 64). However, the adoption of BB-LR is not in fact a ‘principle’, but a rule of thumb.⁸ It is nevertheless a useful rule. It arises from recognition that the efficiency cost (in terms of the excess burden) of a tax is approximately proportional to the square of the tax rate.⁹ Hence it is useful, other things being equal, to keep the rate low, and this is achieved by keeping the tax base as broad as possible. But, of course, in evaluating a tax structure there are other considerations (as indeed are indicated in the TWG’s own list of criteria), involving distributional value judgements, along with ‘merit good’ and externality arguments.

The BB-LR rule of thumb leads, in the Report, directly to the suggestion that the top marginal income-tax rate should be reduced. But it is important to recognise that economic ‘efficiency’ criteria alone are not sufficient to determine policy — value judgements play an important role and more detailed information is required. For example, there is considerable heterogeneity in excess burdens, and many individuals below the top marginal rate face high burdens, depending on demographic and other characteristics. The preferred policy depends on the judge’s precise value judgements, including the degree of aversion to inequality.¹⁰

Some ambivalence is also present in the TWG’s discussion of the ‘alignment’ of the corporation tax rate, the rate applied to trusts and the top personal income-tax rate. It sometimes appears that the Report treats alignment as a basic principle, while recognising that it would involve a loss of degrees of freedom in policy choices. Yet again it is more appropriate to consider it as a rule of thumb based on an assumed ease of shifting between income sources, rather than a principle. Starting from some specified objectives, and given other features (such as regulations regarding allowances and deductions, the costs of income shifting and the precise extent of behavioural responses to tax changes), it would be extremely difficult (as mentioned above) to produce an optimal structure: there is little reason *a priori* to expect identical rates to emerge from such a problem. And of course the relevant rates on trusts and corporations are proportional, while the average personal income-tax rate is below the top

8 For further discussion of this rule of thumb, see Creedy (2009). Similarly, references to ‘folk theorems’ were made by Slemrod (2004).

9 For an introduction to the excess-burden concept and explanation of the approximation, see Creedy (2004).

10 On the use of Utilitarian value judgements in tax reform, see Creedy and Hérault (2009).

marginal rate. However, there can be little doubt, as the Report argues, that the rates have now become seriously out of line and some movement towards alignment, if not necessarily to equality, is a high priority.

Precision Regarding Concepts

Perhaps surprisingly, one major concept is not defined by the TWG, leading to some potential misunderstanding. A tax structure is progressive if, over the relevant income range (where income is the tax base), the average tax rate increases with income. However, progressivity does not require 'marginal rate progression', which refers to an increasing marginal tax rate as income increases. Indeed, a considerable degree of progressivity can be achieved with a proportional tax, combined with a basic income (that is, a fixed and unconditional transfer payment).

This is relevant when considering a change in the tax mix — a shift from personal income taxes towards indirect taxation in the form of the GST. This can of course be achieved in a variety of ways, including reductions in all marginal income-tax rates, or as part of a rate-flattening exercise with reduction in the top personal rate of taxation. A revenue-neutral tax shift must, as suggested earlier, involve losers as well as winners. However, the approach adopted clearly depends on the value judgements regarding income distribution. Where concern is largely with low-income groups, a cut in higher income-tax rates can be combined with an increase in the GST rate, along with a suitable adjustment to benefit levels to maintain their real values. After all, this was done when GST was first introduced.¹¹

Taxes and Elasticities

The TWG Report suggests that, 'taxing those bases that are least likely to be subject to significant behavioural change ... (inelastic bases) is also a sound principle to adopt when ... broadening the tax base' (p.10). This is an allusion to the efficiency effects of taxes, concerning the distorting effect of non-uniform taxes on behaviour. Reference is made to a result obtained by Ramsey (1927). If the aim is to minimise a measure of the sacrifice arising from taxation, the appropriate tax structure turns out to be one that reduces the consumption of

¹¹ On indirect taxes in New Zealand, see Creedy and Sleeman (2006). The Report (p.47) shows that GST as a proportion of total expenditure is similar across income decile groups.

all goods by the same proportion. This implies a higher tax on inelastic goods and a lower tax on elastic goods. However, this result is severely limited because it refers to a single-person economy, and thus excludes any equity concerns.

Importantly, the most widely accepted modern measures of the efficiency effects (excess burdens) arising from taxation are based on ‘compensating variations’ and ‘equivalent variations’. These measures depend not on market price or income elasticities, but on ‘compensated’ elasticities, where the ‘income effects’ of the price changes are excluded.¹² This is not merely a pedantic point about definitions. In the context of labour supply and taxation, where income effects of tax changes can be significant, it is possible to observe high marginal welfare costs (excess burdens per dollar of extra revenue), even for those whose labour supply changes very little.¹³

Here is the appropriate point to consider how the TWG’s discussion of a Land Tax fits in with their list of tax principles. It is not in fact motivated by the use of a comprehensive income measure of ability to pay. Indeed, the comprehensive-income concept gives no support to any kind of wealth (or net worth) tax — only tax on the income arising from assets (both human and non-human capital). The proposal for a Land Tax relies exclusively on the desire to find an additional tax base and, on the argument that the stock of land is fixed, uses the criterion relating to elasticity. Hence it is concerned only with efficiency, while transition, tax shifting and equity effects are important considerations which need further analysis.¹⁴

Some Next Steps

The TWG Report recognises that further analyses need to be carried out. Given the remarkably short time scale within which the Report was produced, and the low level of resources made available to the TWG, this is of course inevitable. One area mentioned concerns the transfer system and its integration with the personal income-tax structure. In particular, the complex system of in-work benefits in New Zealand gives rise to substantial marginal tax rates applying to middle-income groups, and high levels of government expenditure. It also appears that there are unintended consequences whereby some individuals who are not in the ‘target group’ considered by the designers of the system are in

12 The compensated elasticity therefore measures only the pure substitution effect of the price change. For an introduction to these concepts, see Creedy (2004).

13 Examples of this kind of result for Australian individuals are reported by Creedy, Hérault and Kalb (2009).

14 Furthermore, the supply of land for sale is not fixed.

receipt of transfer payments. It is suggested here that a comprehensive review of the benefit system, to complement that of the tax side, needs to be given very high priority.

Additional areas where further work is needed, not mentioned explicitly by the Report but undoubtedly supported by it, include behavioural responses. Despite the potential importance of foreign direct investment, and profit-shifting by corporations (both real and that achieved by the exploitation of transfer pricing), very little solid empirical evidence is available regarding companies operating (or previously operating) in NZ. Similarly, there no longer exists a behavioural model in NZ that is capable of producing estimates of labour-supply responses to tax changes and their associated efficiency (welfare) costs.¹⁵

One suggestion made several times in the Report is that there should be some kind of review body, or organisation, charged with, and sufficiently equipped to carry out, the task of conducting regular independent evaluations of the tax structure in NZ. This, it seems, is not intended to propose yet another quasi non-governmental organisation, but presumably the TWG has in mind something like the role played (among other things) by the Institute for Fiscal Studies in London. The aim is to inform public 'rational debate', by investigating the detailed implications of tax-policy changes. It is suggested that this could impose some constraints on politicians, with a propensity to tinker with a tax structure in ways that have insufficient regard for the integrity of the complete system. It could also help to make the system less vulnerable to the inevitable special pleading by interest groups. The question of the funding and location of such a body was not discussed in the Report.

Conclusions

In any discussion of taxation, it is important to recognise the inevitability of disagreement and a lack of consensus.¹⁶ There are simply too many value judgements involved and too many areas where only informed guesses must be made in the absence of direct information. It is certainly no weakness of the TWG Report that it does not report unanimous support for various policy reform proposals. However, the TWG members managed to agree on a broad framework for discussing reforms, and the need for some action. A Report which simply set out a dogmatic agenda for reform, using the kind of rhetoric that is familiar from the commentaries of special-interest groups, would have little value and would be read only by like-minded people.

¹⁵ For a description of the only large-scale New Zealand microsimulation model, and examples of policy simulations, see Buddelmeyer, Creedy and Kalb (2008), Chapter 12.

¹⁶ For further elaboration of the reasons for this comment, see Creedy (2010).

The influence of the TWG on the tax debate, indeed in making taxation itself more prominent in public debate, is clear from even the most casual examination of the media in New Zealand. The suggestion that there are substantial revenue risks and that the distorting effects of some forms of taxation have growth effects as well as the less visible — but nonetheless substantial — excess burdens, has clearly influenced the government in its thinking about changes to the tax structure.

As mentioned earlier, the strength of the report is in its attempt to contribute to rational policy debate by rehearsing the various arguments in a clear and dispassionate manner, so that those on different sides of the debate can come to understand just why they differ. That a disparate group of individuals from a range of backgrounds have established some common ground in a way of thinking about taxes is itself sufficient cause for praise. The Report can be read with interest and profit by all those interested in tax policy.

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