Inland Revenue
Te Tari Taake

The New Zealand Tax System: where we have got to, where should we be going?

Presentation to

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INTRODUCTION

Depending upon one's point of view, New Zealand embarked on a period of major tax reform in 1982 (with the McCaw Report) or 1984 (with the election of the fourth Labour Government). Since that time significant tax legislation has been constantly before our Parliament. Few in our profession can now recall the times when tax change consisted of annual Budget announcements that tinkered with rates or incentives. Changes to fundamental tax rules now seem to be a constant.

Over the past year we have seen the introduction of legislation covering:

- The increase in the top personal marginal tax rate to 39%.
- The tax on superannuation fund withdrawals.
- Fringe benefit tax changes.
- The taxation of alienated personal services income.
- Changes to the tax treatment of income derived by minor beneficiaries.
- Tax measures arising from the Finance and Expenditure Committee Inquiry.
- The taxation of restraints of trade and inducement payments.
- A raft of measures flowing from the GST review.

Spanning over 15 years of activity, this level of tax reform amounts to a lot of expended energy. In this address I consider what has been achieved. I also reflect on what it means for the future. Will it ever stop? Right now seems an appropriate time for such reflection. The Government has announced the membership and terms of reference of the McLeod Tax Review. That review has been given the task of considering the architecture of a tax system appropriate for New Zealand into the future.

THE TAX SYSTEM SINCE 1984

The relative level of taxation has not altered significantly since 1984. Taxation rose from about 30% of GDP in 1984 to about 35% by the end of the decade. However, that increase largely reflected a more prudent fiscal position. In other words the government started meeting its expenditure from taxation rather than borrowing. Throughout the 1990s, the tax/GDP ratio remained at about 35%. As table 1 illustrates, New Zealand is a middle-level tax burden country in the OECD. Our tax/GDP ratio is lower than those of Denmark or Sweden but higher than those of Japan, USA and Australia. There has been little significant change here.

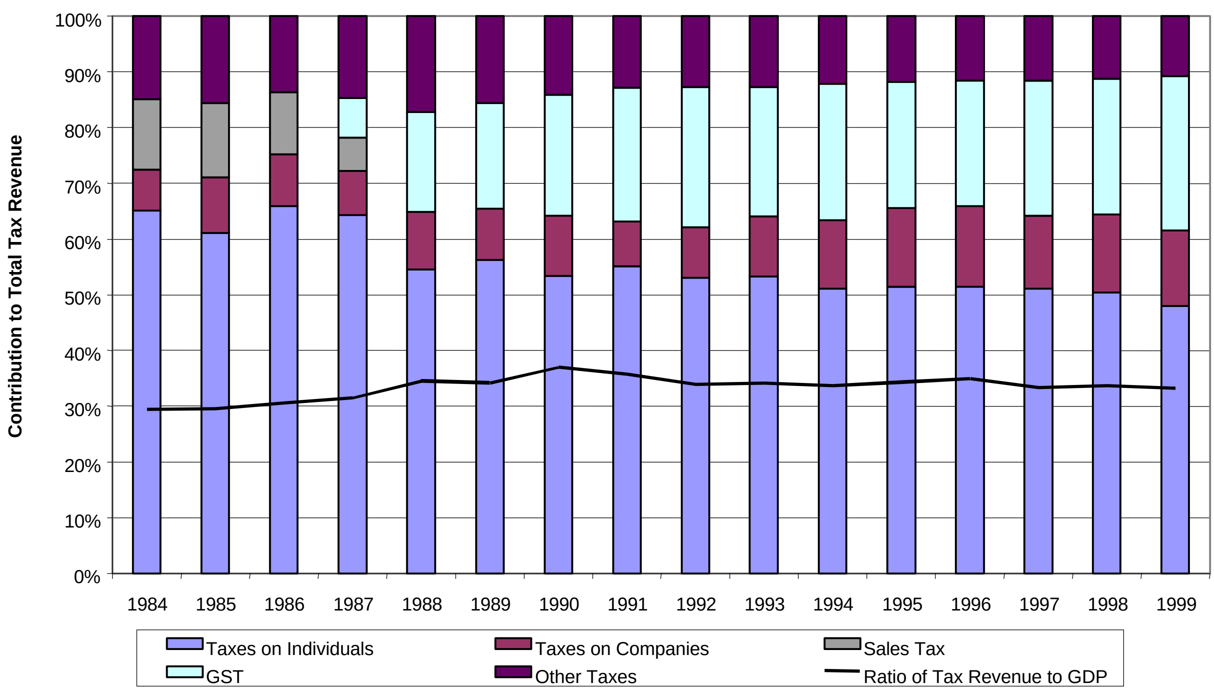
TABLE 1:
TAX/GDP RATIOS* (1996)

	%
Denmark	52.2
Sweden	52.0
France	45.7
Germany	38.1
New Zealand	35.8
United Kingdom	36.0
Australia	31.1
United States of America	28.5
Japan	28.4

*includes local taxes

Where there has been significant change is in the composition of tax. This is illustrated in table 2.

TABLE 2:
THE CHANGING COMPOSITION OF THE NEW ZEALAND TAX BASE FROM 1984 TO 1999



In 1984 the New Zealand tax system was characterised by a high reliance on individual income taxes and a low reliance on consumption or sales taxes. In addition, a relatively small proportion of tax was collected from the corporate sector.

The main change since 1984 has been the increased reliance on consumption tax (from 13% to 25% of tax revenue) as a result of the introduction of GST. The income tax base has been broadened (FBT, accrual rules, international tax rules, and removal or reduction of corporate tax concessions).

This has allowed less reliance to be required to be placed on individual income tax. From this being about two-thirds of the tax base, it has reduced to less than half. These changes have also allowed a number of taxes to be removed (land tax, death duties and stamp duties).

Other features of tax reform since 1984 have been:

- The increased use of withholding taxes (company imputation and resident withholding tax on interest and dividends).
- The expansion of the use of the tax system to deliver social programmes:
  - Family Support
  - Family Plus
  - Student loans
  - Child Support
  - ACC.
- Ongoing efforts to simplify the tax system. Achievements here have been more apparent for individuals than for companies. The single most important measure was probably the removal of deductibility for employment-related expenses. This allowed the more recent measures to remove the requirement for most individuals to file tax returns.

INCOME TAX ON INDIVIDUALS

As previously noted, post-1984 reforms have significantly reduced the reliance the tax system placed on individual income taxes. That enabled a reduction in high individual marginal income tax rates. The top marginal rate was reduced from 66% to 33% until this year, when it was increased to 39%.

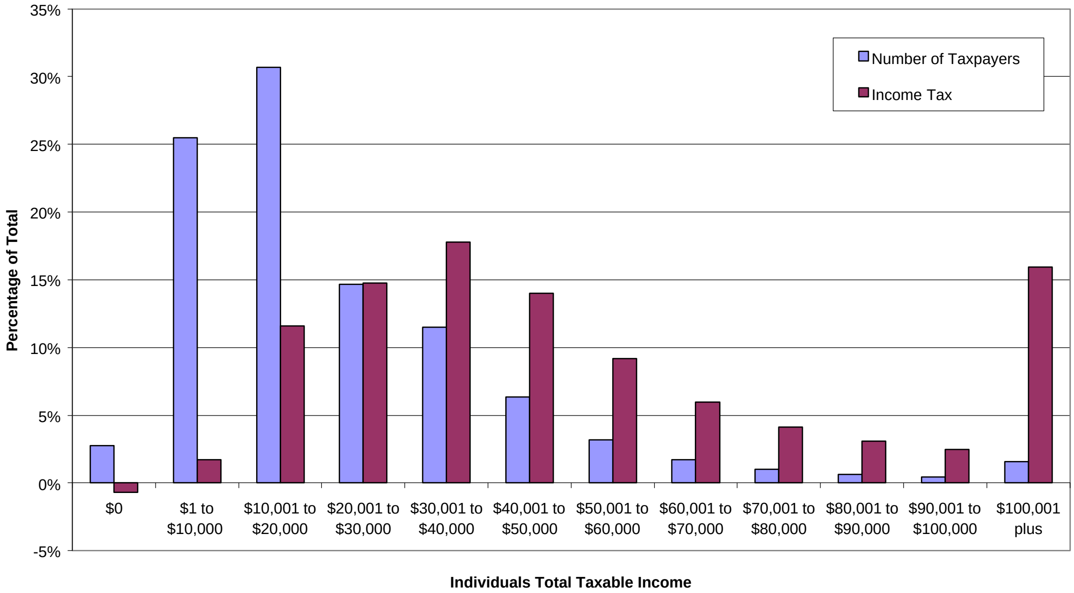
This is not very high by international standards (although the top rate does cut in at what is in international terms relatively modest income levels, $60,000). This is illustrated in table 3.

TABLE 3:
TOP INDIVIDUAL INCOME TAX RATES

	%
New Zealand	39
Australia (over 50K)	47
United Kingdom	40
United States of America	40
Japan	50*
Germany	53*
*plus local taxes	

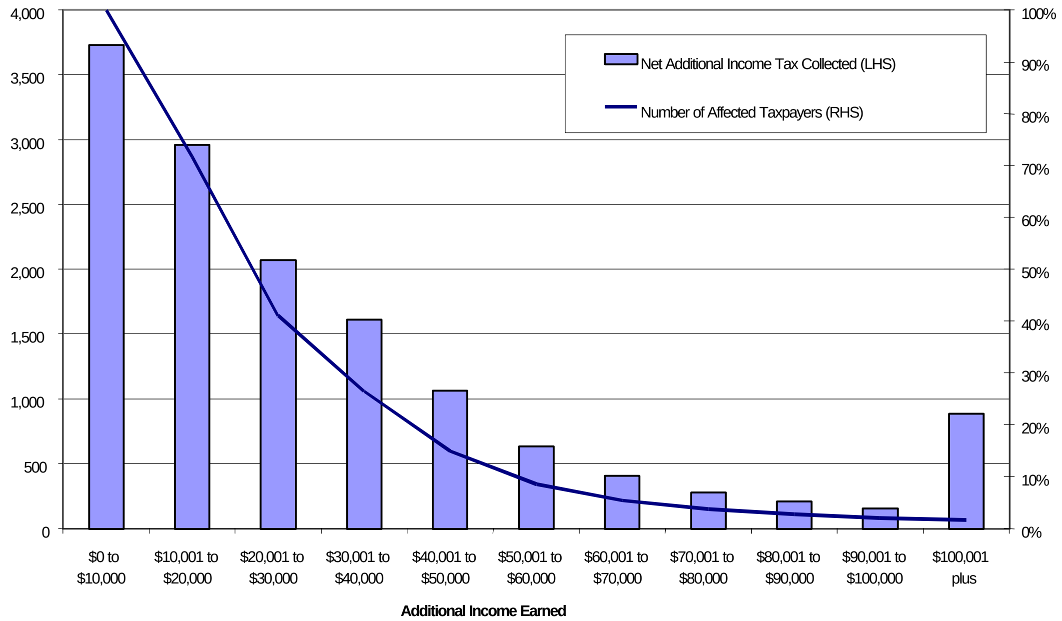
This still leaves New Zealand with an individual income tax scale that is distinctly progressive. As illustrated in table 4, most taxpayers earn under $20,000 a year, but less than 15% of tax is collected from this group. Conversely, a small proportion of taxpayers derive over $100,000 of annual income, but over 15% of income tax is collected from this group.

TABLE 4:
INCOME TAX COLLECTED FROM INDIVIDUALS FOR YEAR ENDED MARCH 1998



One should not conclude from this that most tax is collected off the top of high incomes. Quite the reverse is, in fact, true. A key feature of the New Zealand income tax scale is that there is no income threshold before tax is payable. A few rebates aside, income is collected on the first dollar derived. As illustrated in table 5, a high proportion of the tax revenue is collected from the first $10,000 of income derived by everyone (rich and poor), whereas relatively little is collected from marginal income over $100,000 a year. This simply reflects the fact that most adults earn $10,000 a year, but few people earn over $100,000 a year.

TABLE 5:
ADDITIONAL INCOME TAX COLLECTED FROM INDIVIDUALS BY TAXING THEIR NEXT $10,000 OF INCOME FOR THE YEAR ENDED MARCH 1998



Our lack of income threshold explains why New Zealand can collect reasonably high levels of tax at rates that are relatively low internationally. For a single person on average employment income, New Zealand's marginal rate of income tax plus social security contributions was in 1998 the second lowest in the OECD. Only Korea was lower. By contrast, New Zealand had relatively high marginal rates (similar to those of Germany and USA) for a married single income earner with two children. That reflects Family Support abatement.

COMPANY TAX

The New Zealand company tax rate of 33% is well below previous rates of 45-48%. The 33% rate is within quite a narrow band of international corporate tax rates, as illustrated in table 6.

TABLE 6:
COMPANY TAX RATES

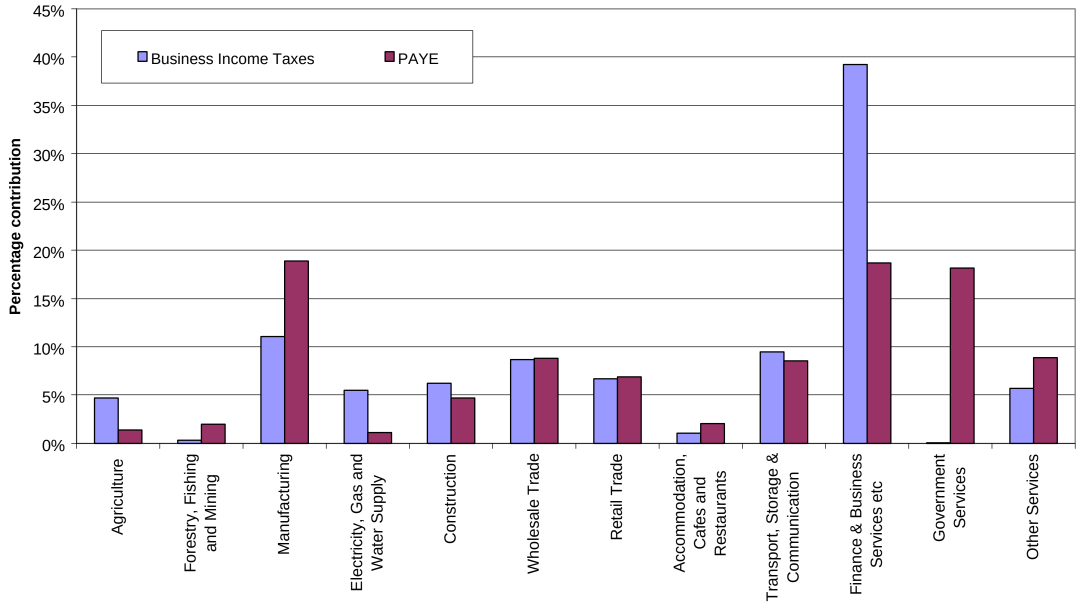
	%
Sweden	28
France	41
Germany	30*
United Kingdom	31
New Zealand	33
Canada	38
Australia	30+
United States of America	35
Japan	38*

*plus local taxes
+ reducing to

We have been able to reduce our company tax rate to within this international norm while still increasing the level of tax collected from the corporate sector. As a percentage of tax revenue, company tax has increased from about 8% of revenue in 1984 to 12-15% now. That reflects a programme of tax concession removal and base maintenance.

Nevertheless, our corporate tax base remains susceptible to erosion. That is because it relies heavily on the finance and business services sector as illustrated in table 7.

TABLE 7:
INDUSTRY DISTRIBUTION OF NEW ZEALAND'S INCOME TAX REVENUE
YEAR ENDED MARCH 1998



The finance sector, in particular, has the available cash-flow to take advantage of holes in legislation. Hence the ongoing need for active base maintenance.

A STOCKTAKE

The New Zealand tax reform programme has been orthodox. The New Zealand tax system does not stand out internationally as being abnormal. Reforms have been extensive but within international norms, driven by the objective of raising substantial tax revenue efficiently and fairly. That can be illustrated by comparing the Australian Ralph proposals with reforms that New Zealand has implemented. This comparison is made in tables 8 and 9.

TABLE 8:
BUSINESS TAX REFORM

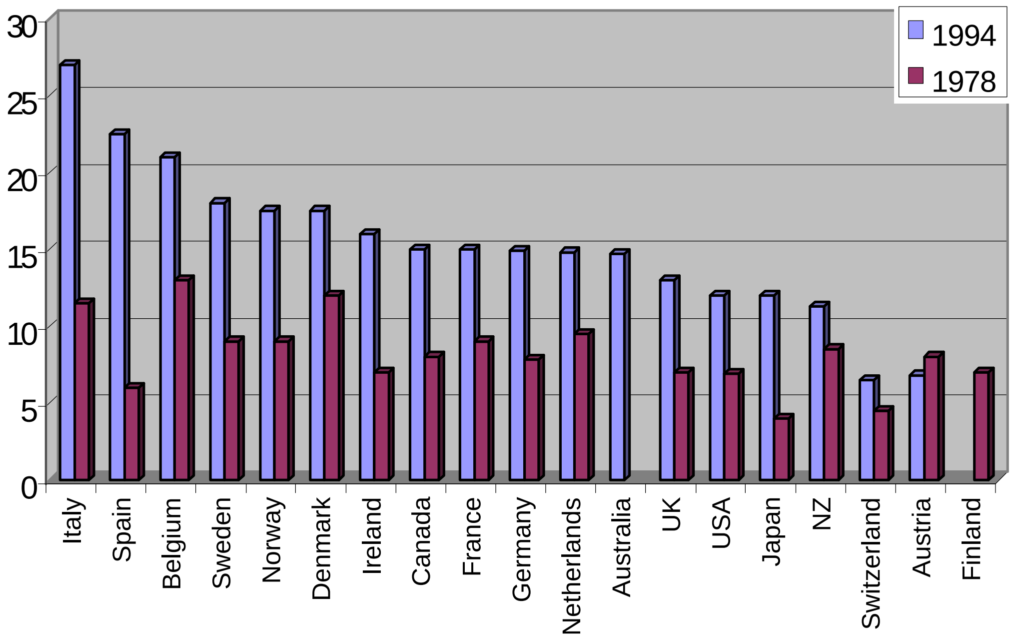
	Australia	**NZ**	**Date**
Depreciation	Ch 1	Yes	1992
Trading stock	Ch 2	Yes	1997
Goodwill	Ch 3	No	
Financial assets & liabilities	Ch 4-7	Yes	1986
Leases & rights	Ch 8-10	Yes	1982 & 1999
Capital gains	CH 11-14, 28,29	N/A	
Entity distributions	Ch 15-23	Yes	19988 & 1992
Anti-avoidance	Ch 24	Yes	Ongoing
Consolidation	Ch 24	Yes	1992
Non-resident investments	Ch 30	Yes	1992 – 1995
Conduit investment	Ch 31	Yes	1998
Foreign income of residents	Ch 32	Yes	1988 + 1992
Source/Transfer Pricing/Thin Cap	Ch 33	Yes	1994
Life Insurance & Super	Ch 34 – 37	Yes	1988
Fringe benefits	Ch 38	Yes	1984

The Ralph proposals mirror New Zealand reforms but within a more compressed timeframe.

Overall, we seem to have been reasonably successful at building an orthodox tax system. OECD studies suggest that our tax system is less economically costly than most other systems, although its measured compliance costs may be relatively high.

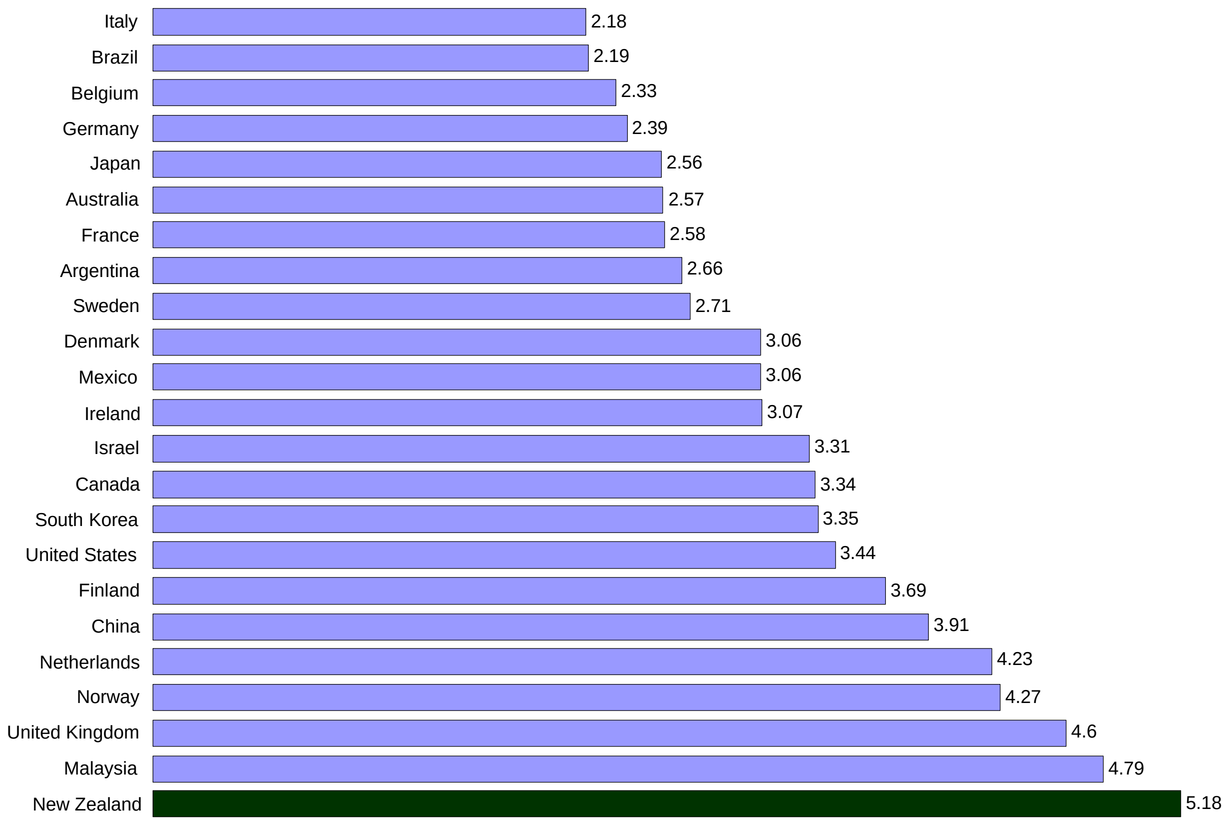
From what we know (which is very little) about the size of the hidden economy, that seems relatively low, as illustrated in table 9.

TABLE 9:
SIZE OF HIDDEN ECONOMY AS % OF GDP



The Global Economic Forum posed the question "Does the tax system in your country enhance business competitiveness?" and ranks the responses from 10 (positive) to 0 (negative). New Zealand scored a surprising level of satisfaction, as shown in table 10.

TABLE 10:
COMPARISON OF TAXPAYER RESPONSE TO STATEMENT
"THE TAX SYSTEM IN YOUR COUNTRY ENHANCES BUSINESS COMPETITIVENESS"



THE FUTURE

The government expects that the McLeod Review will consider whether New Zealand's basic tax architecture, as outlined above, should be altered. Regardless of the outcome of that review, I do not see a major slackening of the pace of tax changes. That is because of the ongoing requirement for active base maintenance, as well as the two major challenges facing the tax system: simplification and changes in the world economy.

TAX SIMPLIFICATION

As previously mentioned, some data suggest that New Zealand tax compliance costs are high, although such international comparisons need to be treated with caution. However, the point remains that businesses continue to emphasise their concern with tax compliance costs and this concern needs, as far as possible, to be met with a constructive response.

Early next year the Government will release a discussion document covering business simplification. Simplification is not simple, nor is it easy. A constructive simplification programme that achieves something needs to:

- Combine policy changes with operational changes within IRD.
- Recognise that as well as taxpayers and the IRD, other intermediaries (such as tax agents and banks) are part of the tax system.
- Capitalise on the opportunities technology provides to change the way tax questions can be posed and answered.

Above all, we need to identify and deal with the main problems businesses face in operating within the tax system. That seems to be much more a matter of minimising risk than minimising the number of forms and payment dates. More forms create more risk of mistakes tying up a business in an expensive dispute process. It is this concern that needs to be addressed.

A second aspect of tax simplification is the rewrite of the Income Tax Act. Early next year the Government will be releasing an exposure draft on the rewrite of Parts C, D, and E. This will be followed by legislation towards the end of the year.

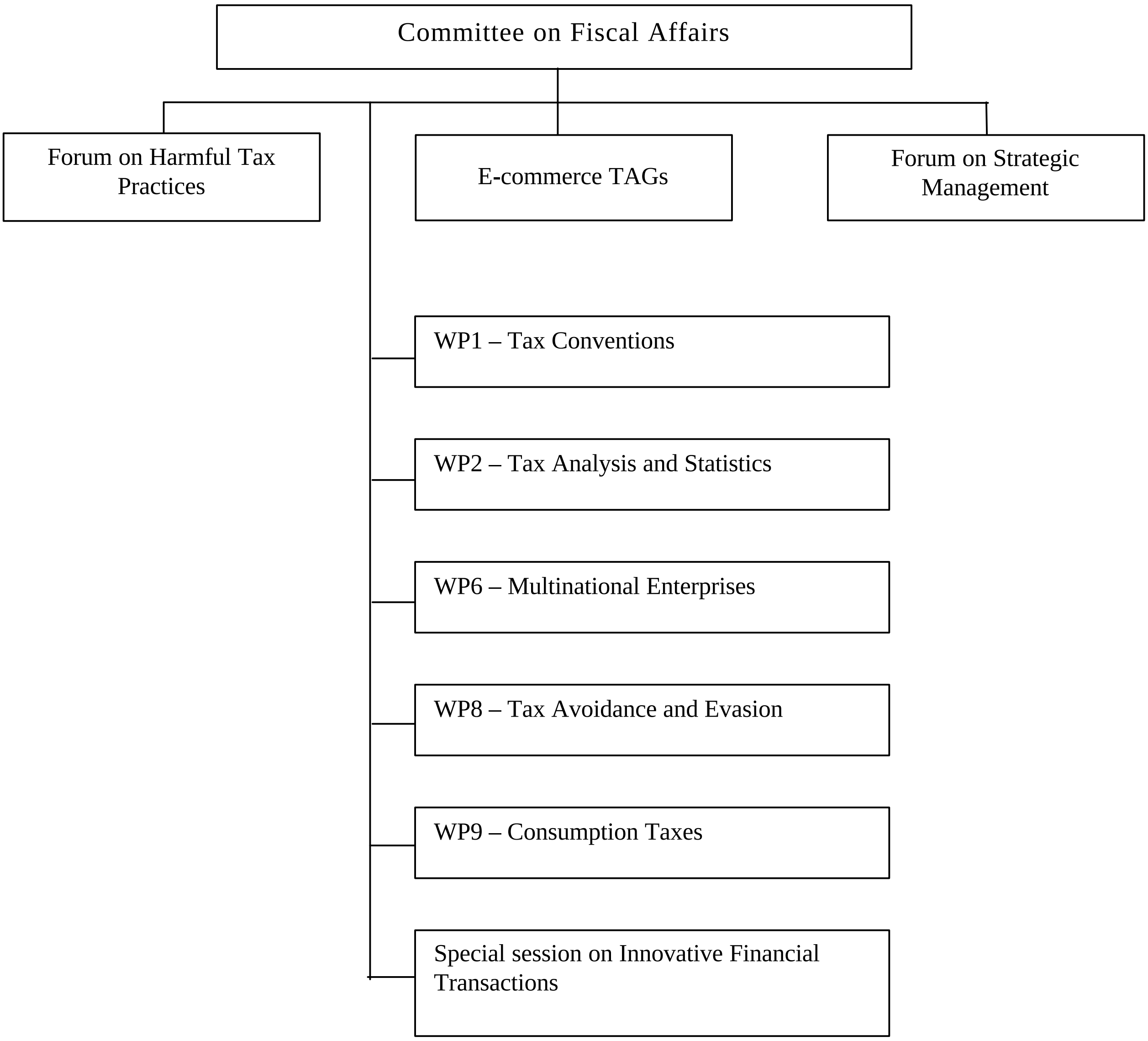
Reaching this stage of the rewrite has taken considerable time and resources. We have in the process considered various approaches to the rewrite, ranging from the quite radical to simply reordering. The proposed approach will lie between these. It will veer towards the conceptually familiar at the cost of retaining some structural tensions. On the other hand, it will be unfamiliar enough to be unsettling for some. For example, the rewrite will not have the wording of section CD 1(2)(a) bringing to gross income an amount: "derived from the sale or other disposition of any land if the land was acquired for the purpose or intention, or for purposes or intentions including the purpose or intention, of selling or otherwise disposing of it". Finally, the rewrite will not make complex underlying rules simple. However drafted, complex rules remain complex.

A Changing World

The world economy is changing. The tax system needs to be monitored and modified where necessary to reflect this.

As countries become more interdependent, more of this work will be considered at a multi-national level. In tax, the main international body is the OECD's Committee on Fiscal Affairs. That Committee is structured as per table 11.

Table 11:



The Forum on Harmful Tax Practices has been consuming considerable New Zealand resources. It is establishing international standards on acceptable national tax rules and also considering a co-ordinated approach by OECD countries to counter harmful practices. A report on harmful tax competition was released in May 1998 and an update report in mid-2000. OECD countries have agreed that within the OECD, the harmful features of preferential regimes need to be eliminated by April 2003. New Zealand is one of the few countries with no potentially harmful practices. Outside the OECD, 47 potentially unco-operative tax havens have been identified, and commitments are being sought by July 2001 for those countries to commit to remove their harmful practices.

Other policy focal points of OECD work are:

- Working Party 9 (VAT, reverse charging and e-Commerce).
- Working Party 1 (DTAs).
- Working Party 6 (Thin capitalisation rules).

The work of the OECD is likely to become increasingly important to us. The private sector can provide input through the OECD's Business and Industry Advisory Committee (BIAC).

CONCLUSION

Since 1984 we have had continuous tax reform that seems to have been reasonably successful in building an internationally orthodox and efficient tax system. However, the pace of reform is not likely to reduce. The McLeod Review will consider the architecture of our tax system, and we face many challenges such as simplification and changes in the world economy.

At the end of the day, the tax system is too important and too pervasive not to keep it under constant review. Table 12 illustrates its central place in our society. A good tax system raises revenue without unduly damaging the economy. The tax revenue funds a strong public sector that assists the economy. A strong economy leads to strong revenue flows. In other words, a good tax system helps build a strong economy and a strong public sector that reinforces the good tax system.

TABLE 12:
THE IMPORTANCE OF THE TAX SYSTEM