REPORT OF THE

TASK FORCE ON TAX REFORM

APRIL 1982

7 April 1982

The Right Hon. R D Muldoon
Minister of Finance

The Hon. W F Birch
Minister of National Development

The Task Force on Tax Reform was appointed with terms of reference as set out in the Foreword to this Report. The terms of reference are wide and the matters for consideration have far reaching implications. It has not been possible for us to fully consider all aspects of Central Government taxation but we believe that we have concentrated our attention upon the most important and pressing issues requiring review and change.

We now have the honour to submit our Report.

P M McCaw (Chairman)

G J Schmitt (Deputy Chairman)

J A Kean

R T Phillips

E G Thompson

H M Titter

B H C Tyler

Kerrin M Vautier

Sir Allan Wright

FOREWORD

The Government announced the establishment and membership of the Task Force on July 27, 1981. The terms of reference were:

(a) To undertake a thorough and systematic review of all aspects of central government taxation;

(b) To draw on what is already known and established about taxation here and overseas and report on options for a reformed tax system for New Zealand;

(c) To consult in the course of its deliberations with the Private Sector Study Group, the New Zealand Planning Council and such other agencies, groups and individuals as it thinks necessary;

(d) To present an interim progress report to the Minister of Finance and the Minister of National Development before 7 December 1981 and a final report before 7 April 1982. The final report should include an evaluation of the costs and benefits of the various options.

The Steering Committee of the Task Force held its first meeting on August 11, 1981. Those appointed to the Steering Committee were:

P.M. McCaw (Chairman)
G.J. Schmitt (Deputy Chairman)
T.M. Hunt CBE
J.A. Kean CMG
E.G. Thompson
H.M. Titter
B.H.C. Tyler
Kerrin M. Vautier
Sir Allan Wright KBE

Mr Hunt died in December 1981, and members record their respect for his valuable contribution to our work. Mr R.T. Phillips was appointed to the Committee in December 1981.

At the first meeting it was decided that time constraints made it inappropriate to invite submissions from the general public, and that it would not be practicable to conduct formal public hearings. Instead we issued approximately 40 invitations to organisations in the commercial, labour, professional and academic fields with a particular interest in taxation reform. Almost all responded. Many other submissions were received throughout our work up to and including March of this year.

In addition to meeting the Private Sector Study Group and the New Zealand Planning Council we also arranged discussions with a number of organisations and maintained a close and continuing relationship with several Government Departments, particularly Treasury, Customs, Inland Revenue, Statistics and with the Reserve Bank. We are indebted to them all for the valuable information and opinions provided.

Throughout our work we have attempted to deal in broad principles and not to adopt a piecemeal approach. We have been fundamentally concerned with making recommendations which are suited to New Zealand conditions. Nevertheless, there is a wealth of valuable material available from overseas and we have drawn freely on the experience of other countries.

All members of the Steering Committee wish to place on record their respect and appreciation of the work of the members of the Secretariat, first in developing and supplying material for the consideration of the Task Force and then in playing the major role in the preparation of the report. The short time available bore heavily on the members of the Secretariat and their dedication to the task, often in circumstances of severe strain, and the particular skills they brought to their work, earned our unreserved admiration. We refer particularly to the Director of the Secretariat, Mr B.H.C. Tyler, who was also a member of the Steering Committee. Without his co-ordinating skills and tireless effort, our task would have been much more difficult. The Secretariat comprised:

Messrs B.M. Ashwell, A.A. Broad, L.W. Cook, K.M. Donovan, H.G. Holland, M.B. Hyndman, P.J. Ledingham, W.A. Poole, B.H.C. Tyler and Ms C.A. Cooper.

Finally our special thanks go to Professor Schmitt of the Steering Committee for undertaking the onerous task of editing the report.

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Chapter 1

INTRODUCTION AND GENERAL SUMMARY

1.1 Taxation and its impact continues to grow in complexity. Its effects are far reaching, partly as a result of Government policies but, perhaps even more, as a consequence of economic changes which are taking place quite independently of Government actions.

1.2 The need for constant and comprehensive review of all aspects of taxation can be easily demonstrated. Changes in the past decade have been swift and significant and are the prime reason for the setting up of the Task Force on Tax Reform in the middle of last year. Taxation reform is a major issue generating much public debate, and this Report is part of the search for a more acceptable and equitable taxation system which is being demanded by almost all sections of society.

1.3 High inflation brings many economic and social problems, through the distortionary and perhaps devastating effect it can have on savings and investment, productivity and living costs generally. It also forces many unintended changes on to the taxation system which can extend the distortions and alter the incidence of taxation in ways which, though they may be difficult to measure, are nevertheless serious.

1.4 The appointment of the Task Force on Tax Reform was the direct result of a report in June 1981 by the New Zealand Planning Council entitled "An Agenda for Tax Reform". In it the Planning Council expressed the view that reform of the tax system must be an important element of a strategy for economic and social development in the 1980's. It stressed the urgency of the problem and acknowledged the vast scope for investigation inherent in a comprehensive review of all issues involving taxation. However the Council believed that it would be essential to severely limit the time available to the Task Force so as to enable changes relating to the most important problems to be implemented quickly.

1.5 Early in our deliberations we noted the dramatic change in the proportion of taxation revenues received from the various sectors within the community. Chapter 2 reveals and discusses this in more detail. Of particular concern however is the very significant increase in the relative burden now being imposed upon the middle income earner, and in particular wage and salary earners with incomes up to $20,000 per year. On the other hand, the share of revenues now being paid by companies and the self employed has fallen substantially by comparison.

1.6 We regard it as serious that, despite energetic endeavours, we have not been able to obtain adequate explanations for these trends. We know that taxation incentives provide part of the explanation and, in the case of companies, it was possible to quantify some of the more important, such as export incentives. In addition we know that profitability has not kept pace with inflation and therefore the business tax base is not rising in monetary terms as quickly as wage and salary incomes. But in the absence of adequate factual information being available, all of which could be regularly compiled from information already provided by taxpayers and employers, many will suspect that those with more ability to indulge in various forms of avoidance and evasion are increasingly doing so.

1.7 Our comments concerning the lack of information should not be interpreted as a criticism of those Government Departments from whom we have sought information. In general they were most co-operative and did their best to assist us. The fact remains however that we were both surprised and frustrated by the lack of reasonably up to date statistical information which could be made available to us. In our view this is a serious weakness which must be rectified.

1.8 If one section of our community is to be asked to shoulder a greater share of the taxation burden, it is entitled to clear evidence of the cause and justification. If the reason is because of tax incentives to the business sector, the cost of those incentives, together with an indication of value received, should be clear. Unless this information is available, together with evidence that any unsatisfactory features thereby disclosed are being properly dealt with, the willingness of taxpayers to meet their share of taxes will be steadily undermined. The serious effects that such a trend would have upon our traditional social structure cannot be overestimated.

1.9 Because of the short time available and in recognition of the consequent need to concentrate attention on the more important issues, the Task Force divided its work into three distinct categories.

1.10 *First* was the group of topics which are of major importance and which were identified by the Task Force as being in the greatest need for reform. These topics, together with a summary of our conclusions, are as follows:

A **Personal Income Tax**

(i) There is a widespread public demand for a reduction in personal income tax rates. The marginal tax rate of the taxpayer earning around the average wage is now almost 50 cents in the dollar while his average tax rate has also considerably increased.

(ii) We believe that both average and marginal personal income tax rates should be reduced for the great majority of individuals and, as far as possible, the degree of progression in the scale as it affects most members of the labour force should be reduced. We provide a number of scales with varying levels and rates of progressivity which, in our view, provide the Government with a base from which they can make the final determination. The main features of each scale are examined while further comments are made about possible variations to each which might be considered. An estimate of the revenue cost in relation to each scale compared with the scale currently operating is also provided. (Chapter 6.V).

B **The Tax Unit**

(i) We are of the view that there is a serious lack of recognition of costs associated with the family unit in the present tax system. The Task Force sees the present differences in total tax payable by one and two income families and the ability of some taxpayers to split their income as being unfair.

(ii) Subject to one dissenting opinion, the Task Force therefore recommends that, *if both parties so wish*, the income of the primary income earner in a family can be combined with that of his or her spouse, and then divided by a predetermined factor. If, for example, the combined income of both parties amounted to \$17,000 for the year, and the divisor were fixed at 1.7, the total tax liability of both parties would be determined by the average tax rate applying to \$17,000/1.7 ie \$10,000. It is important to appreciate that provisions for dividing incomes in this way should be voluntary—both parties being taxed as individuals if either so wishes. (Chapter 6.III).

(iii) We believe that this option should extend in principle to include the children of the family. Because of administrative implications however we recommend that increased recognition of children should be provided by way of an increased Family Benefit. (Chapter 6.IV).

C **Family Support Measures**

(i) As a consequence of the scales we are recommending and to take account of increases in indirect taxation, special provision should be made for those families with low incomes, including solo parent families. An extension of the low income family rebate is therefore recommended. The benefits provided to the single income family by way of income splitting and the increased Family Benefit would replace the role of the Young Family Rebate and the Spouse Rebate, and the withdrawal of these rebates is therefore recommended. (Chapter 6.IV).

D **Tax Avoidance and Fringe Benefits**

(i) A constant theme in submissions received by the Task Force was the concern at the unfairness of a system which allowed a large element of discretion to be built into the personal income tax area—generally by taxpayers in upper-middle to high income levels. This is clearly resented by those taxpayers in the same income groups who do not have this discretion and by those in lower income brackets who see themselves as having to accept a tax burden which in their view properly belongs elsewhere.

(ii) Rapidly increasing tax rates are probably a major reason for the current surge in the use of fringe benefits and other forms of tax avoidance. Nevertheless such practices and their perceived inequities will not disappear merely because of a reduction in tax rates. In our view it is imperative that positive steps be taken to control and reduce the revenue losses and inequities inherent in their use.

(iii) It is also essential that the revenue authorities be provided with the resources necessary to combat undesirable avoidance practices and to seek out, identify and consequently minimise the most serious and costly areas of avoidance and evasion. There can be little doubt that the resources devoted to minimising taxes payable (much of which is perfectly legitimate) have grown rapidly in recent years. It is essential that the resources made available to those responsible for administering our income tax system be sufficient to provide an adequate response. (Chapter 3).

(iv) We believe that, in principle, all fringe benefits should be taxed, and we refer specifically to three types which warrant immediate attention. They are employer-provided vehicles available for private use, low interest loans to employees, and private accommodation provided at concessional rates. Because of the changing nature of fringe benefits it is an area demanding constant surveillance. We accept that, because of administrative complexities and low revenue potential, there will remain many minor benefits which present no significant problem in terms of equity and which will remain exempt from tax. (Chapter 6.VI).

E Consumption Taxes

(i) If the Government is to reduce significantly the rates of personal income tax while at the same time maintaining overall taxation revenues, the principal option available to it is an extension of indirect taxation on expenditure. We conclude that the most appropriate means available for immediate application would be through a rationalisation and extension of the present Wholesale Sales Tax system, together with a tax on certain services. This approach has limited revenue earning potential unless final goods and services purchased by business are subject to sales tax—a course which the Task Force, on balance, does not favour. If greater revenues were required, we conclude that serious consideration should be given to the introduction of a Value Added Tax (VAT). This would take approximately three years to implement fully. (Chapter 8).

F Business Income and Effects of Inflation

(i) Public understanding of the effects of inflation on business incomes has been considerably increased since the report of the Richardson Committee in 1976. The Task Force fully endorses the need for reflecting the impact of inflation on the determination of business income and this question was a major field of study by the Task Force.

(ii) Specifically, we recommend that the effects of inflation on inventories, depreciable assets and all monetary items both assets and liabilities, be measured for tax purposes by use of a suitable general price index. The effect would be to reduce taxable incomes for those businesses with substantial investments in inventories and depreciable assets and possibly increase the taxable incomes of those with significant borrowings invested in assets which are either not depreciated or are depreciated at a low rate.

(iii) The Task Force believes strongly that this recommendation would do a great deal to remove or at least mitigate many of the distortionary effects of inflation as they affect the business unit. It also recognises that its application would cause some difficult transition problems and furthermore have an effect upon areas of economic activity beyond the confines of taxation. For this reason it recommends that, as a matter of urgency, an investigation should be undertaken with a view to introducing a comprehensive system of inflation adjustments for business income tax purposes. (Chapter 7.I).

G **Company/Shareholder Taxation**

(i) The "double taxation" of company income and dividends received by shareholders was commented upon in many submissions and is seen by the Task Force as imposing an inequitable burden on income derived from this source. Furthermore, the ability of some but not all companies to pay tax-free dividends on a continuing basis is regarded as unsatisfactory and unfair. (Chapter 7.II).

(ii) Our main recommendations are:

(1) A personal rebate of 20 per cent be granted on all dividends received by individuals.

(2) The current exemption extended to tax-free dividends should be withdrawn in circumstances where revenue reserves are available for this purpose.

(3) Bonus issue tax should be abolished, subject to suitable anti-avoidance safeguards.

H **Capital Gains Tax**

(i) We do not recommend the introduction of a Capital Gains Tax at this time. While recognising the arguments in favour of a capital gains tax, we believe that any such tax should be imposed only on real gains—not on those gains simply arising from general inflation. We also believe that the majority of what are commonly regarded as capital gains are in fact better described as gains from the use of borrowed monies for the buying and selling of capital assets.

(ii) If our proposals in relation to borrowing gains in the business sector were implemented they would achieve most of the objectives of a capital gains tax. (Chapter 10.II).

I **Income Tax Concessions and Incentives**

(i) A consideration of the policy objectives giving rise to concessions and incentives was not part of our terms of reference. We did however, consider their effects on the taxation system and enquired into the monitoring procedures operating in relation to cost determination and effectiveness.

(ii) Based upon information made available to us, we estimate that the cost of business incentives in revenue forgone is in the vicinity of $470 million per annum. We strongly recommend that they be subject to a rigorous assessment of costs and effectiveness on a regular basis. We further recommend a more explicit accounting of all concessions and incentives to improve government management procedures in this area. (Chapter 4).

1.11 The above matters were identified by the Task Force as representing those most in need of reform, where the fairness of the system is most in question and to be the source of erosion of the acceptability of the system, in the absence of reform.

1.12 The *second* category identified by the Task Force relates to issues where there appears to be a clear need for reform of some kind. They are areas in which, in the absence of sufficient time for detailed study, we do not feel able to make specific recommendations. Instead, the nature of the concern has been identified and the issues have been highlighted as requiring further study and action on the part of Government. The principal areas in this category are:

wealth taxes
life insurance companies
superannuation funds
building societies
co-operatives
trusts
charities.

1.13 In the *third* category considered by the Task Force are a number of methods of taxation which have been promoted from time to time by individuals and groups of individuals in New Zealand. They are:

a direct personal expenditure tax
a turnover tax
a factor tax—principally for the agricultural sector.

1.14 Each of these possible forms of taxation was studied to some degree although most attention was paid to the first of those listed above (see Chapter 9). In each case the decision of the Task Force was that they do not represent forms of taxation which are appropriate in present circumstances.

1.15 There were many other issues which were brought to the attention of the Task Force in submissions forwarded to it but which it felt were subsidiary to its main concerns. We appreciate the importance of the issues to those most directly affected and regret that time constraints did not make it possible for us to pay more attention to them.

1.16 In the concluding chapter we bring together the estimated costs and revenues of the various recommendations and options we put forward. We also provide a series of possible income tax scales which indicate a range of options and costs including the amount required from indirect taxation if revenues are to be maintained. We recognise that revenue constraints may well impose limitations upon the ability of the Government to implement all our recommendations in the near future. In particular, and given the need to maintain total taxation revenues, the overall level of reduction in personal income taxes will have to be constrained by the amount which can be obtained quickly from other sources, particularly from indirect expenditure taxes. Even if the Government accepted all our recommendations and preferences it would still be necessary for it to make selections in the initial stages and gradually move over time to full implementation as sources of revenue are developed. In any event, it could be desirable to implement a switch from personal income tax to a consumption tax in stages to allow the effects to be absorbed without unnecessary disturbance to the economy. (Chapter 13).

1.17 From an early stage in our deliberations it became clear that the requirement in the terms of reference to "undertake a thorough and comprehensive review of all aspects of Central Government taxation" and to report to the Government by 7 April 1982 were not compatible. We therefore decided that the first priority was to report by the due date and, in so doing, to identify and report on those areas which we considered to be most in need of change. This we have done. We have also identified a number of special areas which, in our view, require further study as a prelude to reform. Finally, we have referred to a lack of information in some important areas of concern which, if available, might have enabled us to make further recommendations. We strongly urge detailed attention to these areas.

1.18 The Task Force submits this report to the Government confident that its recommendations provide the basis for a more equitable and acceptable taxation system.

Chapter 2

THE PRESENT TAX SYSTEM

I. THE STRUCTURE OF THE SYSTEM

Introduction

2.1 Before examining the options for reform of the New Zealand tax system, it is necessary to describe the level, composition, and incidence of the present system and to evaluate its main features.

The Level of Taxation in New Zealand

2.2 In the period 1960/61 to 1980/81, total Central Government tax revenue increased (in nominal terms) by over ten times from $670 million to $7051 million. The rate of increase over the period has not been constant, averaging 8 percent a year over the first decade, and rising sharply to an average annual rate of 17.2 percent for the period 1971 to 1981. Over the two decades, the ratio of total tax to Gross Domestic Product has increased from below 24 percent to over 29 percent. Again the increase is most pronounced in the period 1971 to 1981.

Table 2.1

INCREASE IN TOTAL TAX 1961 – 1981

Year	Total Taxation $m	Annual Increase (%)	Total Taxation as a Percentage of GDP
1961	670	-	23.8
1971	1445	-	24.8
1972	1707	18.1	24.9
1973	1927	12.9	24.4
1974	2395	24.3	26.2
1975	2865	19.6	28.6
1976	3185	11.2	27.7
1977	3845	20.7	27.9
1978	4626	20.3	30.4
1979	4989	7.9	28.5
1980	6020	20.7	28.8
1981	7051	17.1	29.3

Source: Annual Budgets.

The Composition of Tax Revenue

2.3 There is a wide variety of taxes, but most contribute only a very minor portion of total revenue.

Table 2.2

COMPOSITION OF TAX REVENUE—1980/81

	($m)	(%)
Direct Taxes		
Personal Income Tax	4710	66.8
Company Income Tax	589	8.4
Estate Duty	37	0.5
Gift Duty	2	0.0
Land Tax	12	0.2
	5350	75.9
Indirect Taxes		
Sales Tax	776	11.0
Customs Duty	349	4.9
Highways Tax	189	2.6
Motor Spirits Tax	140	2.0
Beer Duty	64	0.9
Motor Vehicle Fees	47	0.7
Racing Duty	46	0.7
Instrument Duty	40	0.6
Energy Resources Levy	20	0.3
International Departure Tax	12	0.2
Cheque Duty	8	0.1
Lottery Duty	6	0.1
Domestic Air Travel Tax	3	0.0
Film Hire Tax	1	0.0
	1701	24.1
TOTAL TAXES:	7051	100.0

Sources: Budget 1981, Inland Revenue Department Annual Report.

Table 2.3 shows the current mix of major taxes, that is the relative contributions of personal income tax, company income tax, and other taxes. That the tax mix has changed markedly in the twenty years since 1961 is equally as important as the rise in total taxation over that period. Personal income tax has increased from 43.2 percent to 66.8 percent of total tax while the proportion collected both from companies and by way of indirect taxes has fallen.

Table 2.3

TAX MIX: RELATIVE CONTRIBUTIONS OF MAJOR TAXES 1961 – 1981

Year	Personal Income Tax (%)	Company Income Tax (%)	Major Indirect Taxes[1] (%)	Other Taxes (%)	Total Taxes (%)
1961	43.2[2]	18.5	23.5	14.8	100
1971	46.6	19.6	21.0	12.8	100
1972	50.6	17.4	19.8	12.2	100
1973	52.7	15.5	19.8	12.0	100
1974	54.7	16.2	18.9	10.2	100
1975	59.1	15.4	17.8	7.7	100
1976	58.6	13.4	18.1	9.9	100
1977	59.7	13.8	17.0	9.5	100
1978	62.4	12.9	15.2	9.5	100
1979	64.1	9.2	15.9	10.8	100
1980	63.4	10.7	16.8	9.1	100
1981	66.8	8.3	16.9	8.0	100

(1) Customs duty, sales tax, and beer duty.
(2) Includes Social Security Income Tax.
Sources: Annual Budgets, Public Expenditure and its Financing (NZPC 12a).

International Comparisons of Revenue Composition

2.4 International comparisons of the burden of tax revenues can be misleading because of the absence of any measure of the nature and relative magnitude of government services provided, or of the extent of deficit financing. Nevertheless, the OECD has for many years been publishing data to facilitate such comparisons, and this forms the basis of those which follow.

2.5 The following table shows that New Zealand was (in 1978) well below the OECD average in a comparison of the ratio of total tax revenue to GDP, and also that there had been a relatively low change in this ratio over the period 1965 to 1978.

Table 2.4

TOTAL TAX REVENUE AS A PROPORTION OF GDP FOR SELECTED OECD COUNTRIES—1965 AND 1978[1]

Countries	1978	1965	Increase in Percentage 1965 – 1978
	(%)	(%)	
Sweden	53	36	17
Norway	47	33	14
Germany	38	32	6
United Kingdom	34	31	3
Canada	31	26	5
New Zealand	**31**[2]	**26**	**4**
United States	30	27	3
Australia	29	24	5
Japan	24	18	6
OECD Combined	36	27	9
North America	31	26	5
Europe	38	28	10
European Community	40	31	9

(1) Data for financial year nearest to calendar year.
(2) Later ratios for New Zealand are:
1978/79 30.8
1979/80 31.2
1980/81 32.1

Source: Revenue Statistics of OECD Member Countries 1965 – 1978 (OECD, 1980).

2.6 Table 2.5 shows that in 1978 the proportion of tax revenue obtained from personal income tax in New Zealand was one of the highest among OECD countries. Despite the below average proportion of GDP which total tax revenue represented in New Zealand (see Table 2.4), the ratio of personal income tax to GDP was among the highest ratios within the OECD, as shown in Table 2.6.

Table 2.5

PROPORTION OF TAX REVENUE OBTAINED FROM SPECIFIED SOURCES FOR SELECTED OECD COUNTRIES—1978[1]

Country	Personal Income Tax[2]	Company Income Tax	Goods and Services	All Other Taxes
		(percent)		
Sweden	69	3	24	4
New Zealand	**65**	**9**	**22**	**4**
Germany	64	6	26	4
United States	60	11	17	12
Norway	55	5	38	2
United Kingdom	52	7	27	14
Canada	45	11	32	12
Australia	44	11	31	14

(1) Data for financial year nearest to 1978 calendar year.
(2) Includes Employees' Social Security contributions.
Source: Revenue Statistics of OECD Member Countries 1965 – 1978 (OECD, 1980).

Table 2.6

PERSONAL INCOME TAX INCLUDING EMPLOYEES' SOCIAL SECURITY CONTRIBUTIONS AS A PROPORTION OF GDP

Country	1978	1965
	(percent)	
Sweden	23	20
New Zealand	**18**	**10**
Germany	17	13
Norway	17	13
United Kingdom	14	12
Australia	13	8
United States	13	10
Canada	10	6
Japan	8	5
OECD Combined	14	9

Source: Revenue Statistics of OECD Member Countries 1965 – 1978 (OECD, 1980).

Why the Composition Has Changed

2.7 Tax yields are dependent on the size of the associated tax base, and on the rate(s) at which tax is levied upon that base. The dramatic change in the relative importance of the various taxes can, to a large extent, be attributed to the effects of inflation upon these factors. Inflation has affected the yields of the various taxes differently.

The Tax Bases

2.8 In recent years the personal income tax base has grown faster than that of indirect taxes, and the latter has grown faster than the company income tax base. National accounts aggregates indicate the various changes. These are shown in Table 2.7. For instance, between 1972 and 1979, the personal income tax base rose by 169 percent while private consumption rose by 149 percent. The corresponding change in company income was 102 percent. Within the personal income tax base, the salary and wage component grew faster than other incomes over this period (the comparable increases being 174 percent and 153 percent).

Table 2.7

INDICATORS OF GROWTH IN TAX BASES

Year Ended March	Personal Income Tax Base Indicators			Company Tax Base Indicator[3]	Indirect Tax Base Indicator[4]
	Wages and Salaries[1]	Other Income[2]	Total		
		($ million)			
1961	1255	629	1884	317	-
1971	2945	864	3809	645	-
1972	3499	1130	4629	655	4210
1973	3926	1487	5413	857	4745
1974	4637	1641	6278	1091	5440
1975	5565	1431	6996	1048	6204
1976	6401	1746	8147	1175	7147
1977	7184	2210	9394	1353	8313
1978	8277	2251	10528	1249	9332
1979	9604	2855[5]	12459[5]	1326	10502
1980	11214[5]	-	-	1850[6]	12342[5]
1981	13412[5]	-	-	2230[6]	14624[5]

(1) Compensation of Employees.
(2) That part of Private Operating Surplus accruing to individuals.
(3) Companies' operating surplus.
(4) Consumption expenditure by or on behalf of households.
(5) Provisional.
(6) Estimated.

Source: NZ System of National Accounts (Department of Statistics and Reserve Bank).

Personal Income Tax Structure

2.9 The structure of personal income tax automatically increases the proportion of income taken as tax when nominal incomes rise. The basic features of the tax structure each interact with an increase in nominal incomes as follows:

(i) **Brackets**: A progressive tax schedule is designed to ensure that taxpayers earning higher real incomes experience higher average and marginal tax rates than lower income earners. However, the brackets contract in real terms as nominal incomes increase making taxpayers liable to higher rates of tax without the necessity of an increase in real income.

(ii) **Rebates**: The tax assessed on gross income is reduced by tax rebates to give the tax payable. Therefore if rebates are fixed in nominal terms while nominal gross incomes rise, the tax base expands while the rebates decline in real terms.

(iii) **Exemptions**: Tax exemptions are subtracted from gross income before tax is assessed. Within a tax bracket the net real worth of an exemption with fixed nominal value is eroded as for a rebate, but as an eligible taxpayer's gross income moves into a bracket with a higher marginal tax rate the net nominal worth increases in accord with the value of the marginal tax rate of the new bracket.

2.10 The interactions with increases in nominal incomes described above are the cause of the well known phenomenon called fiscal drag. On occasions the effect of fiscal drag has been reduced by discretionary changes to the rate structure and allowances, the most notable recent example being the major changes made in the 1978 Budget.

2.11 The simplified personal income tax scale introduced from October 1978 and amendments since are detailed in Table 2.8. Table 2.9 indicates how the tax bracket thresholds introduced in 1978 have contracted since by presenting for each stated date the tax bracket thresholds as a multiple of average weekly earnings. For instance, in October 1978, the 60 percent marginal tax rate was reached at an annual income of $22,000, which was three times surveyed average weekly earnings prevailing at that time. By November 1981, nominal earnings had increased so that $22,000 per annum was equivalent to just 1.8 times surveyed average weekly earnings. It is estimated that 100,000 taxpayers were in the highest tax bracket at March 1981, compared with fewer than 30,000 at October 1978.

Table 2.8

PERSONAL INCOME TAX BRACKETS 1978 – 1981

Period		Bracket 1	Bracket 2	Bracket 3	Bracket 4	Bracket 5
October 1978 to	Threshold[1]	0	4500	10000	16000	22000
September 1979	Tax Rate[2]	14.5%	38%	48%	55%	60%
October 1979 to	Threshold	0	4500	11000	16000	22000
March 1980	Tax Rate	14.5%	35%	48%	55%	60%
April 1980 to	Threshold	0	4900	11500	16000	22000
January 1981	Tax Rate	14.5%	35%	48%	55%	60%
February 1981	Threshold	0	5500	12600	17600	22000
onwards	Tax Rate	14.5%	35%	48%	55%	60%

(1) Lower income limit of each bracket.
(2) Tax rate on the portion of taxable income falling in each bracket.

Table 2.9

CONTRACTION OF TAX BRACKET THRESHOLDS 1978 – 1981

Date	Bracket 2	Bracket 3	Bracket 4	Bracket 5
	Threshold of Bracket as Percentage of Average Weekly Earnings[1]			
October 1978	61	137	219	301
April 1979	56	125	200	274
October 1979	52	127 (116)	185	255
May 1980	51 (47)	120 (115)	167	229
November 1980	47	111	154	212
February 1981	49 (44)	113 (103)	157 (143)	197
May 1981	47	108	150	188
August 1981	45	104	145	181
November 1981	44	101	141	177

(1) The figures in brackets represent the percentage at the corresponding date if the scale had not been adjusted in that month.

2.12 Quarterly estimates of the proportion of personal taxable income taken in taxation are shown in Table 2.10. These estimates also show the extent to which budgetary measures offset the continued rise in the proportion of income taken in tax through inflation. Budgetary measures have not been sufficient to prevent effective tax rates rising almost continuously in the three years since the major changes in October 1978.

Table 2.10

QUARTERLY ESTIMATES OF AVERAGE TAX RATE ON PERSONAL INCOMES

		Surveyed Average Weekly Earnings[1]	Average Tax Rate[2] Actual	Average Tax Rate[2] Unadjusted[3]	Change from Previous Quarter Due to: Nominal Income Change	Change from Previous Quarter Due to: Budgetary Change
		($ pwk)	(%)	(%)	(%)	(%)
1974	May	80.94	22.6			
	Aug	88.37	23.5		0.9	
	Nov	88.94	23.5		0.0	
1975	Feb	93.46	24.1		0.6	
	May	94.76	24.3		0.2	
	Aug	96.59	23.4	(24.7)	0.4	−1.3
	Nov	98.05	23.7		0.3	
1976	Feb	103.55	24.4		0.7	
	May	104.99	24.7		0.3	
	Aug	110.77	25.5		0.8	
	Nov	111.44	25.5	(25.8)	0.3	−0.3
1977	Feb	113.30	25.7		0.2	
	May	121.32	25.7	(26.6)	0.9	−0.9
	Aug	122.87	25.9		0.2	
	Nov	125.38	26.1		0.2	
1978	Feb	129.80	25.1	(26.7)	0.6	−1.6
	May	132.81	25.2	(25.5)	0.4	−0.3
	Aug	140.27	26.1		0.9	
	Nov	142.72	24.3	(26.5)	0.4	−2.2
1979	Feb	149.69	25.2		0.9	
	May	154.70	25.7	(25.7)	0.5	−0.0
	Aug	156.97	26.0		0.3	
	Nov	168.87	25.5	(27.1)	1.1	−1.6
1980	Feb	177.33	26.2		0.7	
	May	183.92	25.9	(26.8)	0.6	−0.9
	Aug	191.89	26.6		0.7	
	Nov	198.86	27.1		0.5	
1981	Feb	212.24	26.6	(28.1)	1.0	−1.5
	May	224.30	27.0	(27.5)	0.9	−0.5
	Aug	232.95	27.8		0.8	
	Nov	239.03	28.3		0.5	
1982	Feb	257.30[4]	29.5		1.2	

(1) Surveyed average weekly earnings is the value of average earnings for all persons surveyed by the Labour Department Employment Information Survey. Before February 1980 the survey dates differ from those specified, and these values are estimates only.
(2) Average tax rate is the tax accrued during the reference quarter as a proportion of total taxable income. Estimates based on Household Survey 1979/80.
(3) Indicates average tax rate which would have applied in the absence of the budget measure effective from that quarter.
(4) Estimated.
Source: Secretariat estimates.

International Comparisons of Personal Income Tax Scales

2.13 The OECD has recently completed a study of personal income tax rate structures in the latter half of the 1970s. Comparisons of rate structures without also considering the nature and level of tax allowances and transfer payments have limitations, since allowances cause the effective tax rates to differ from the scale rates, and transfer payments may be made in one country for the same purposes as tax relief in another. Nevertheless, the following general comparisons may be made[1]:

(i) The lowest scale rate was higher than that for New Zealand (14.5 percent) in only four countries, similar in two others, and lower in ten.

(ii) The maximum marginal tax rate applying among the lowest 10 percent of taxpayers (ranked by taxable income) was higher than that for New Zealand (14.5 percent) in eight countries, similar in three, but lower in only four.

(iii) The maximum marginal tax rate applying in the lower income half of taxpayers was higher than that for New Zealand (35 percent) in only one country, similar in three, and lower in eleven.

(iv) Considering the remainder of the income distribution, higher rates continue to be met at lower relative points in the distribution in New Zealand than they would have been in other countries.

(v) The New Zealand maximum scale rate (60 percent) matches that of seven countries; six countries have higher maxima and two lower. Remarkably, the highest rate was applicable to less than 1 percent of taxpayers in all countries except Denmark (where the proportion was 4 percent) and Ireland (5 percent), while in New Zealand just under 5 percent of taxpayers were in this category in 1980/81.

2.14 In general, the Central Government income tax scale rose less steeply in other countries than in New Zealand. Although some countries had very low initial rates, these applied to short brackets only. In most countries a large proportion of taxpayers are subject to the same scale rate of tax. The first rate, for example, applied to more than 90 percent of taxpayers in Australia, 60 percent in Denmark and 96 percent in the United Kingdom. In New Zealand only 35 percent of taxpayers had taxable income lying in the first

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(1) The distribution of taxpaying units (individuals, or couples for countries employing joint taxation) over the tax scale in Australia, Austria, Belgium, Canada, Denmark, France, Greece, Ireland, Italy, Netherlands, Norway, Portugal, Sweden, Turkey, United Kingdom, and United States of America, for tax years lying between 1975 and 1979, are compared with the New Zealand distribution in 1980/81.

Sources: OECD Committee on Fiscal Affairs (DAF/CFA/81.6), NZ Household Survey 1979/80.

bracket. Although the next 40 percent lay in the next bracket, these taxpayers have steeply rising average tax rates because of the difference between the first and second scale rates.

Company Income Tax Structure

2.15 Since 1978 companies have been taxed at a flat rate of 45 percent and thus that component of fiscal drag described in paragraph 2.9(i) above is not present in the company tax yield changes. Even before 1975 the company tax scale consisted of a similar flat rate for those companies with taxable income above a certain low level, minimising the effect of this type of fiscal drag in comparison with that seen in the personal income tax system. It is therefore to be expected that in the absence of discretionary changes, company income tax receipts would account for a decreasing percentage of total tax in times of inflation. However, the magnitude of the changes appears to be too large to be accounted for by this alone.

2.16 Whereas throughout the 1960s income tax was divided between personal and company income tax in the ratio of approximately 2:1, in the 1970s the ratio changed substantially so that by 1980/81 about 90 percent of all income tax was paid by individuals. This change can be explained, in part, by the availability to companies of business incentives and concessions. Also it appears that company profits have declined as a proportion of GDP although, as the calculation of this figure is largely based on tax figures of assessable company profits, it is considered to be unsatisfactory to regard this statistic as a complete explanation of the relative decline in company tax. The matter is discussed further in Chapter 7.II. The members of the committee and secretariat who sought to pursue the problem further by studying various sources of available information uncovered a few interesting points. For example, there was a dramatic increase in losses of companies, from 5 percent of the company surplus in 1960 to 10 percent in 1970 and 42 percent in 1978. This sort of information, however, merely raises further questions requiring explanation.

Indirect Taxes

2.17 Indirect taxes are generally of two types: ad valorem and specific. The yields from ad valorem taxes fluctuate in direct proportion to changes in the value of the tax base. However if the goods are subject to different rates the yield will also be sensitive to changes in expenditure patterns. Specific taxes such as the tax on motor spirits, are set on a per unit basis, and, as prices rise, become a decreasing proportion of the nominal value of the commodity unless the tax rates are increased. Since, for private households, goods and services are paid for out of after-tax income, an increase in income tax rates will cause the consumption tax base to contract relative to the income tax base.

Sectoral Comparisons

2.18 So far this chapter has dealt with changes in the revenues from different types of taxes. Recent changes in tax revenue composition by type of tax have arisen from:

(i) tax bases expanding at different rates, the personal income tax base growing fastest and the company tax base slowest; and

(ii) increasing tax rates on personal incomes but rates relatively static for other taxes.

So it appears that the main changes have occurred in the personal income tax area. The Task Force has studied changes in the distribution of personal income tax between wage earners and recipients of other incomes.

2.19 An approximate indication of the division between tax paid by wage and salary earners and by other individuals is given by statistics of PAYE tax and other tax receipts. This is the only basis on which statistics are available beyond 1978.

Table 2.11

PERSONAL INCOME TAX PAYMENTS BY METHOD OF RECEIPT

Year	PAYE	Other
	(% of total)	
1961	49	51
1966	56	44
1971	68	32
1976	71	29
1980	74	26
1981	76	24

Source: Inland Revenue Department Annual Reports and Internal Accounting Records.

2.20 Statistics of *assessable* incomes and associated tax assessed for those whose incomes are primarily from wages and salaries and for those whose incomes are primarily from self-employment are available up to 1978.

Table 2.12

ASSESSABLE INCOME AND TAX ASSESSED BY PRIMARY INCOME SOURCE

Year	SALARY AND WAGE EARNERS			SELF-EMPLOYED		
	Total Income	Tax Assessed	Effective Average Tax Rate	Total Income	Tax Assessed	Effective Average Tax Rate
	($m)	($m)	(%)	($m)	($m)	(%)
1960	1213	172	14.2	399	88	22.0
1965	1815	238	13.1	477	97	20.3
1970	2591	387	14.9	488	107	21.9
1976	6609	1496	22.6	941	283	30.0
1978	8295	2059	24.8	1086	334	30.7

Source: Department of Statistics.

Tax rates rose more steeply for salary and wage earners over the whole period shown in Table 2.12 than for self-employed persons—by 75 percent compared with 40 percent. In both cases, most of the change occurred between 1970 and 1978. Total assessable incomes of wage and salary earners rose by 600 percent over the whole period, and by 200 percent from 1970 to 1978. Total assessable incomes of the self-employed rose only 170 percent over the whole period, and by 120 percent from 1970 to 1978.

2.21 To some extent the slow growth of self-employed assessable incomes can be traced to the farming sector and may therefore be explained by economic and tax policy factors affecting that sector. But self-employed non-farm assessable incomes also rose at less than half the rate of wage and salary incomes.

2.22 The Task Force could not find a satisfactory explanation for this development. It is submitted that a full and detailed enquiry should be undertaken as a matter of urgency. If the apparent decline in the economic significance of the self-employed sector is confirmed to have occurred, no action in the tax field would necessarily be indicated, but presumably the finding would be relevant to other fields of policy. If, on the other hand, the enquiry shows that significant amounts of actual income are being excluded from the tax base, some tax changes would be indicated.

2.23 The statistics of tax received, tax rates, and assessable income raise some questions as to the extent of avoidance and evasion of personal income tax in the self-employed sector. Measures to deal with avoidance and evasion are discussed in Chapter 3.

2.24 Neither Table 2.11 nor Table 2.12 gives a precise basis for comparing the salary and wage earning and self-employed sectors. However they are two internally consistent bases on which to compare changes in the relative magnitude of the tax paid by the sectors. An analysis on each basis is provided in Table 2.13. The Task Force is convinced of the following trends. Personal income tax paid by taxpayers other than salary and wage earners declined as a proportion of total tax revenue between 1961 and 1971 from about 20 percent to about 15 percent, and has remained fairly stable since then. It has already been shown (Table 2.3) that all other types of taxes have also declined as a proportion of total tax revenue over this period. The complementary spectacular increase has been in the proportion of total tax revenue contributed in personal income tax by wage and salary earners. This has risen from a quarter in 1961 to a half in 1981, with most of the change occurring in the second decade. This represents a nearly threefold increase in the component as a proportion of GDP; while all other components of the total tax revenue have decreased. Thus the increase in personal income tax revenue from wage and salary earners more than accounts for the whole of the growth in total tax revenue as a proportion of GDP over the last twenty years.

Table 2.13

ANALYSIS OF CHANGES IN THE COMPOSITION OF TAX REVENUE 1961 – 1981

Year	Components of Personal Income Tax[1] (% of All Tax Revenue)				Components of Personal Income Tax[1] (% of GDP)				Other Taxes[2] (% of GDP)		
	Method of Receipt		Major Income Source		Method of Receipt		Major Income Source		Company Income	Major Indirect	Other
	PAYE	Other	Wages and Salaries	Other	PAYE	Other	Wages and Salaries	Other			
1961	21.2	22.0	27.4	15.8	5.0	5.2	6.5	3.8	4.4	5.6	3.5
1971	31.7	14.9	34.4	12.2	7.9	3.7	8.5	3.0	4.9	5.2	3.2
1978	-	-	49.7	12.7	-	-	15.1	3.9	3.9	4.6	2.9
1981	50.8	16.0	-	-	14.9	4.7	-	-	2.4	5.0	2.3

(1) The personal income tax revenue has been split into two parts by two different methods. The first method being by metod of receipt (similar to Table 2.11), the second by the taxpayer's major income source (similar to Table 2.12). The parts have been expressed as proportions of total tax revenue and GDP.
(2) For comparison, the other components of total tax (see Table 2.3) are also expressed as proportions of GDP.
Sources: Inland Revenue Department, Department of Statistics

2.25 The greatly increased share of total taxation paid as income tax by wage and salary earners points to this sector of the community as the one most likely to be deserving of relief. However, there are probably many inequalities within the self-employed sector itself and it is, in any case, impracticable and inappropriate to have different scales or other rules for application for wage earners on the one hand and self-employed on the other.

2.26 It is clear that over the period from 1960 to 1978 the proportions of taxation revenues received from companies, the self-employed and wages and salary earners have changed very markedly. The information base which would allow the reasons for these movements to be better identified is lacking. Changes of this magnitude could arise from a number of reasons, including the availability of tax incentives, reduced profitability, a change in the work force as between salary and wage earners and the self-employed, greater opportunities for family income sharing and, finally, from an increase in evasion and avoidance.

2.27 From the information available to the Task Force the relative importance of each of these factors could not be untangled. This is a matter of public and social concern.

2.28 The Task Force is of the view that the changes and trends indicated in the tables are so substantial that immediate steps should be taken to identify the reasons and to remedy any unsatisfactory features revealed. In addition an adequate data base providing for effective monitoring and evaluation on a continuing basis should be developed without delay.

II INCIDENCE OF TAXATION

Introduction

2.29 The first section of this chapter described the composition of the total tax revenue. This section addresses the question of how the burden of tax is distributed in the community. Under various assumptions, it examines the incidence among private households of personal income taxes and of some 70 percent of indirect taxes[2]. The proportion of household income devoted to these taxes is shown for various types of households and ranges of household income. Data sources, estimation methods, and limitations of this type of incidence analysis are outlined in Appendix A to this Chapter.

Who Bears the Tax

2.30 Tax legislation provides particular economic units (e.g. persons, companies, wholesalers) with a statutory obligation to pay certain taxes. A tax may be shifted to households in various ways, and each may result in a different incidence being estimated for the tax. For example, in the case of company income tax, the tax is formally paid out of company profits. Since the profit is clearly a part of the price asked for the goods sold, it could be argued that the buyers of the company's products bear the tax. These will, directly or indirectly, include households. However, considering an increase in the level of the tax introduces other points of view, since changing costs can lead to a variety of decisions on the part of the company. An increase in prices would pass on the tax to households via consumption, a reduced dividend payment would impinge on households via shareholders' current incomes, a reduced retained profit would erode the value of the savings of households insofar as they consisted of shares, while a drive to reduce other operating costs would pass the tax to the providers of labour and materials. We cannot know exactly the degrees to which these or other possibilities operate in practice.

2.31 In the case of consumption taxes, the final incidence of a new tax will be determined by how far competitive conditions allow the distributor to pass on the burden to the consumer and by the way that other costs must be adjusted to suit the new pattern of prices. Indeed the extent to which the statutory incidence is shifted will vary between commodities and distributors. Ascertaining the true final incidence is an intractable problem. However, to the

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(2) Includes those indirect taxes which could be reliably allocated to households. See Appendix A.

consumer it appears that the purchase price for commodities includes the full amount of sales tax. This is how indirect tax incidence is calculated for the purposes of this section.

2.32 It is natural to assume that the incidence of personal income tax is on the individual from whose income the tax is deducted, although in the case of the self-employed person, the range of possibilities for shifting the burden suggested above for companies will exist. The burden will be shared among the members of a household by way of reduced spending power to the extent that some members may be financially dependent on others. Also, it might be demonstrated that, for instance, employees bargain for higher wages because of fiscal drag[3]. Were this the case, then the burden of the tax would fall, at least in part, on the employer, leading to the range of possible shifts of incidence discussed above for company taxes.

2.33 In the tax system as a whole, the occurrence of avoidance and evasion of any of the taxes serves to redistribute the burden.

Household Types and Income Distribution

2.34 Individuals living in households are not usually independent economic units. As mentioned above, income tax may affect others apart from the recipient of the income. Taxes on consumption are even less readily allocated to specific individuals within the households which they make up. It may be argued that it is the welfare and ability to pay tax of families and/or households that is the ultimate concern in policy evaluation. These considerations lead to a choice of the household as the unit for incidence analysis.

2.35 For the purposes of showing the way in which tax incidence varies within the population, households have been classified in three main ways:

(i) Size of household.
(ii) Number of dependent children—being taken to be the number of children in the household eligible for the Family Benefit.
(iii) Range of household income.

In addition, households consisting of just one or two adults have been subdivided according to whether National Superannuation is received.

2.36 The distribution of households among sub-groups defined by the above classifications is shown in Table 2.14. About 20 percent of households fall into the residual household type, being those with three or more adults. About half of these also include children.

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(3) See R. Buckle, 'Wage Determination and the Role of Fiscal Drag in New Zealand', Victoria University of Wellington, 1981, for some work suggesting that this could be the case.

Table 2.14

NUMBER OF PRIVATE HOUSEHOLDS[1]
By Range of Household Income and Household Type, 1980/81

Household Income Range ($ p.a.)	Household Type: One Adult		Two Adults		Two Adults with Children			One Adult with Children	Other	All Households	(%)
	Nat.Sup.	Other	Nat.Sup.	Other	One	Two	Three+				
					(000)						
Under $8,000	72.0	30.1	37.4	12.4	7.9	6.4	5.0	28.0	4.8	204.0	(20)
$8,000-$12,000	9.8	23.4	24.2	16.2	12.7	17.2	12.4	6.1	9.1	131.1	(13)
$12,000-$16,000	4.7	15.4	17.8	20.3	15.7	24.1	18.4	2.9	15.3	134.5	(13)
$16,000-$20,000	2.2	7.1	11.2	21.6	11.1	20.9	15.1	1.3	19.9	110.4	(11)
$20,000-$30,000	1.5	4.5	13.0	53.3	13.8	25.9	19.2	0.9	55.5	187.5	(19)
Over $30,000	0.6	1.5	5.3	14.0	6.0	10.2	8.7	0.3	56.7	103.4	(10)
Not Specified	9.1	6.8	15.0	14.6	11.5	16.1	15.0	6.4	43.6	138.1	(14)
TOTAL	100.0	88.8	123.8	152.4	78.5	120.7	93.9	45.9	204.9	1008.9	(100)
(%)	(10)	(9)	(12)	(15)	(8)	(12)	(9)	(5)	(20)	(100)	
Average Income[2]	5,600	10,000	12,200	20,200	17,100	18,100	17,900	7,500	28,900	17,200	

Sources:
(1) 1981 Census of Population and Dwellings, 10% Sample File
(2) Household Survey 1979/80, estimates for 1980/81

2.37 The upper limit for the lowest income range was chosen to be near the minimum adult award wage. Of those households with specified incomes in the 1981 Census, 23 percent fell in this range. One- and two-adult National Superannuitant households made up about half of these. Apart from the two adult households with children the other households in this low income category receive a large proportion of their income as Social Welfare benefits.

2.38 Almost 80 percent of single National Superannuitant households are in the lowest income range (gross income under $8000 per annum in 1980/81). Other adults living alone have an average income almost twice that of the National Superannuitant group, and only 37 percent fall in the lowest range. Similar comparisons may be made for the two-adult group. Many two-adult National Superannuitant households receive substantial amounts of other income. Households of one adult with children also fall predominantly in the low income range.

1980/81 Personal Income Tax Liability

2.39 Table 2.15 shows the incidence of the personal income tax on households, measured by the proportion of gross household income paid in tax in each group. This proportion has three components:

(i) The basic tax liability, where no exemptions or rebates are allowed.

(ii) The reduction in tax provided by exempting some income from taxation, or allowing certain expenses to be deducted.

(iii) The reduction in tax provided by the subtraction of rebates.

Tables 2.B1 to 2.B3 in Appendix B show the separate impact of these components.

Table 2.15

INCOME TAX LIABILITY

by Range of Household Income and Household Type, 1980/81

Household Income Range ($ p.a.)	Household Type: One Adult		Two Adults		Two Adults With Children	One Adult With Children	Other	All Households
	Nat.Sup.	Other	Nat.Sup.	Other				
				(% of household income)				
Under $8,000	15	10	13	6	5	1	6	10
$8,000-$12,000	23	24	16	19	15	13	12	17
$12,000-$16,000	28	28	22	23	23	22	17	23
$16,000-$20,000	.	33	25	24	27	.	20	26
$20,000-$30,000	.	39	29	28	30	.	24	28
Over $30,000	.	.	40	38	40	.	30	34
TOTAL	20	26	23	28	28	10	27	26

Source: Secretariat estimates, based on Household Survey 1979/80.

2.40 The basic average tax rates (i.e. tax as a proportion of household income) increase with income for all household types. Multi-person households may have two or more earners each earning a portion of the total income. In these households the tax liability is lower compared with a situation where only one person earned all the income. This is because a higher proportion of the income is taxed at lower scale rates. Thus, for instance, single person households in the $12,000-$16,000 income range pay about 30 percent of gross income in income tax (before allowances), while two-adult households in the same range pay an average rate on their total income of 25 percent, and those households with three or more adults pay, on average, 19 percent (see Table 2.B1). The higher rates for two-adult households with children reflect the move out of the workforce, or a to reduced hours per week, of one spouse when there are children to be cared for in the household.

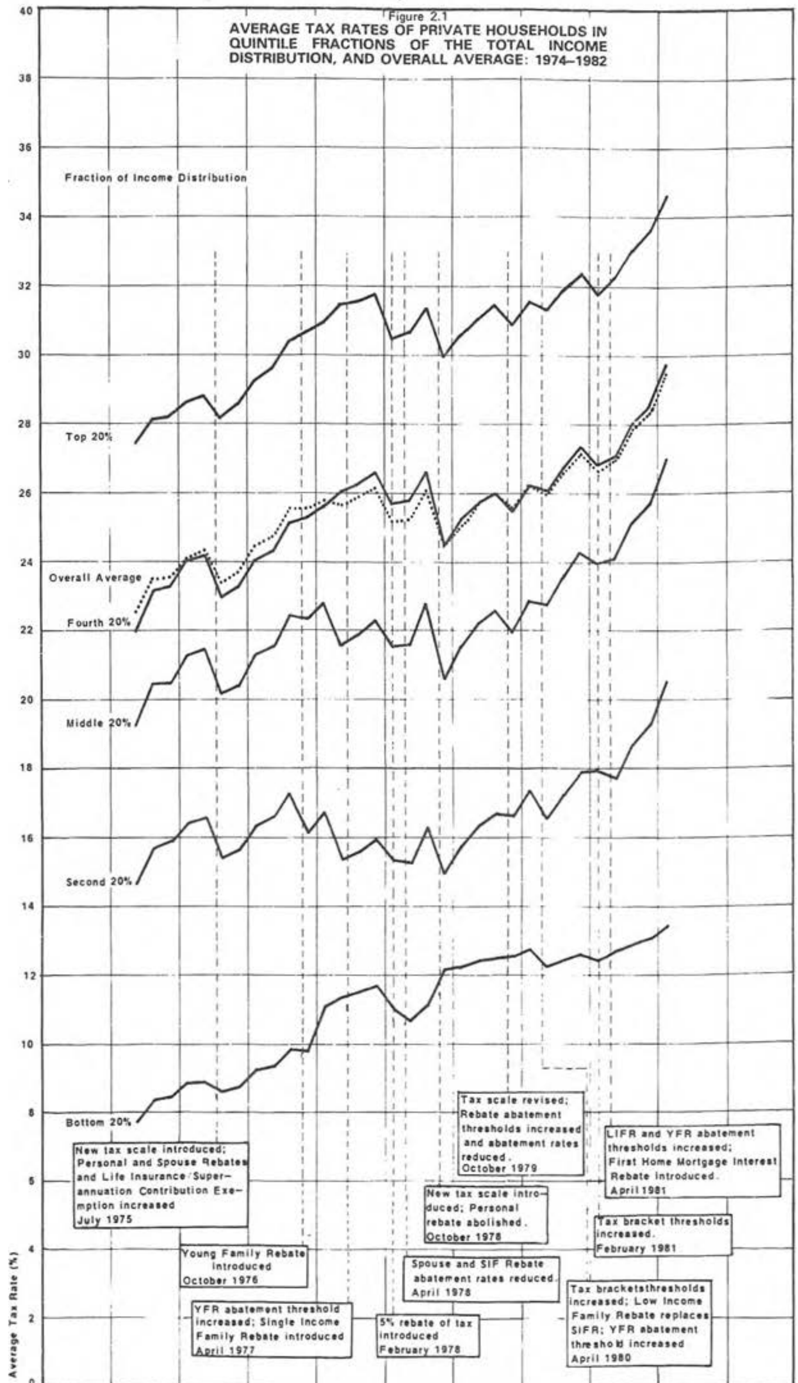
2.41 Table 2.B2 shows that, except for the lowest income range, the benefits of exemptions form a fairly uniform proportion (1 – 2 percent) of income over the income ranges, for each household type. The generally higher values for households with children reflect the ability of parents to claim as an exemption life insurance premiums paid on policies for their children.

2.42 Current rebates focus on assistance to families, and are targeted to supply the majority of aid to those with low incomes. Even when rebates are not so targeted (e.g. Rates Rebate) the value as a proportion of gross income reduces as income rises since the rebates are a fixed amount subtracted from tax (compared with exemptions which have a value increasing with the marginal tax rate). Table 2.B3 shows that the value of the main current rebates falls off dramatically over the specified income ranges.

2.43 The major effect of the last two components mentioned in paragraph 2.39 in modifying the basic liability is to reduce markedly tax rates for low income households with children but to produce a much more severe progression in rates through the low to middle income ranges. As described earlier in this chapter, such a structure interacts with increases in nominal incomes to cause fiscal drag problems unless it is regularly adjusted.

Changes in Personal Income Tax Incidence

2.44 Figure 2.1 shows the average tax rates for groups of households over the period 1974 to 1981. The groups chosen are the fifths of the income distribution i.e. the top 20 percent, the next 20 percent, and so on to the bottom 20 percent. The income levels of these groups are shown in Table 2.16 with reference to the average weekly earnings.



SOURCE Secretariat estimates based on Household Survey 1979/80

Table 2.16

QUINTILES OF THE HOUSEHOLD INCOME DISTRIBUTION, 1979/80

Fraction of Distribution	Income Range (Proportion of Average Weekly Earnings)
Top 20%	Over 2.4
Fourth 20%	1.7 to 2.4
Middle 20%	1.2 to 1.7
Second 20%	0.7 to 1.2
Bottom 20%	Under 0.7

Source: Household Survey 1979/80

2.45 The graphs show the net effect of inflationary and discretionary rate changes for the five groups. Between 1975 and 1978 budgetary measures concentrated upon middle-income households, while since then the only average tax rates remaining relatively stable have been those of the lower income households. This emphasises the existence of two types of incidence: static incidence and dynamic incidence. The structure of the system determines both, the former referring to the system as it stands, the latter to how it interacts with changes in nominal incomes. The targeting arrangements (e.g. progressive scale, abatement rates) establish explicitly the current differential treatment between types of taxpayers. On the other hand, the effect of fiscal drag is to affect most those taxpayers with high effective marginal tax rates relative to their average rates. In the present system such effects generally work in opposition to the explicit targeting. The manner in which budgetary changes compensate for fiscal drag embodies a separate set of redistributive decisions. That is, the initial relativities may not be restored, but a new set constructed. The extra revenue obtained from one group of taxpayers through fiscal drag may be used to finance special measures for another.

1980/81 Indirect Tax Incidence

2.46 Indirect taxes are paid, via the cost of goods and services, out of disposable income i.e. gross income less income taxes. Since the income tax is generally an increasing proportion of gross income as income rises, disposable income forms a reducing proportion of gross income. Thus if all goods and services were taxed at the same rate, and all disposable income was spent, the indirect tax component would fall as a proportion of gross income as income rose. Therefore it is not surprising to find in Table 2.17 that the total allocated[4] indirect taxes forms a reducing proportion of household income as households rise through the income

(4) Those taxes able to be allocated to households in the study for this section.

Table 2.17

TOTAL ALLOCATED INDIRECT TAXES[1]
by Range of Household Income and Household Type, 1980/81

Household Income Range ($ p.a.)	Household Type: One Adult		Two Adults		Two Adults With Children	One Adult With Children	Other	All Households
	Nat.Sup.	Other	Nat.Sup.	Other				
	(% of household income)							
Under $8000	6.2	9.7	9.9	12.4	15.4	9.1	11.6	9.4
$ 8,000-$12,000	3.5	7.5	8.4	9.2	9.9	8.1	10.8	9.0
$12,000-$16,000	2.8	6.7	8.3	8.0	7.6	6.7	10.5	7.8
$16,000-$20,000	-	7.2	6.2	7.0	6.4	-	8.8	6.8
$20,000-$30,000	.	4.3	4.5	5.7	5.8	..	7.9	6.2
Over $30,000	-	-	4.0	4.8	4.1	-	6.8	5.8
TOTAL	5.3	7.4	7.1	6.3	6.6	8.6	7.5	6.9

Note:
(1) Wholesale sales tax, excise duty on alcohol and tobacco, domestic air travel tax, energy resources levy, motor fees, and motor spirits duty.
Source: Secretariat estimates, based on Household Survey 1979/80.

distribution. There is another effect at work also; the ability to save some of a households disposable income increases as income rises. Moreover, low income households may be obliged (or have chosen) to spend savings. Table 2.B4 and 2.B5 break the total indirect taxes allocated into two parts, and express these as proportions both of gross income and of consumption expenditure; the latter presentation removes the regressive trend stemming from the income tax and savings effects.

2.47 No clear trends with income are shown in the lower sections of the tables except for the single person household. National Superannuitants living alone appear to pay a lower rate of tax on their consumption as their other income rises. Conversely, indirect taxes appear to be progressive for the other individuals; but the high income range is an exception. The selectivity towards "luxury" items in the sales tax does not serve to make it progressive.

2.48 The level of the sales tax as a proportion of consumption is also neutral as regards household types. On the same basis, the other indirect taxes fall more heavily on two adult households and single persons not receiving National Superannuation. Offsetting this is the fact that at any given income level, households with children tend to spend more than similar households without children. The net effect (seen in Table 2.17) is an indirect tax system fairly neutral towards different household compositions, except for very low incomes, where two-adult households with children pay a higher proportion of income to indirect taxation.

Family Benefit

2.49 The final component of the tax system (in a wide sense) to be considered here is the family benefit. A main aim of the benefit is to have the consumption costs of childraising shared throughout the community. From this view it is seen to be equivalent to a tax credit (i.e. a rebate which may be converted into a cash refund if the claimant has no tax to pay). Like a rebate, the value of the benefit reduces as a proportion of income as income increases (see Table 2.B6).

1980/81 Total Tax Incidence

2.50 The total of the personal income tax liability and the estimated incidence of the indirect taxes able to be allocated to households[5], less the family benefit, is shown in Table 2.18. The progressivity of the income tax system is moderated by the regressive nature of indirect taxes. However the subtraction of the family benefit restores the progressivity, the extent of the restoration depending on the number of children involved.

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(5) Wholesale sales tax, excise duty on tobacco and alcohol, domestic air travel tax, energy resources levy, motor fees, and motor spirits duty.

Table 2.18

TOTAL ALLOCATED, DIRECT[1] AND INDIRECT[2] TAXES LESS FAMILY BENEFIT

by range of Household Income and Household Type, 1980/81

Household Income Range ($ p.a.)	Household Type: One Adult		Two Adults		Two Adults with Children			One Adult with Children	Other	All Households
	Nat.Sup.	Other	Nat.Sup.	Other	One	Two	Three+			
	(% of household income)									
Under $8,000	21	20	23	19	15	10	−2[3]	0	8	17
$8,000-$12,000	26	31	25	28	23	18	15	14	19	22
$12,000-$16,000	31	35	30	31	28	26	23	24	25	27
$16,000-$20,000	..	40	32	32	31	29	27	..	27	30
$20,000-$30,000	..	44	33	34	35	34	32	..	30	33
Over $30,000	..	..	44	43	43	42	43	..	36	39
TOTAL	25	33	30	34	32	31	29	11	33	31

(1) Personal Income Tax
(2) Wholesale sales tax, excise duty on alcohol and tobacco, domestic air travel, energy resources levy, motor fees, and motor spirits duty
(3) Negative result occurs since Family Benefit recieved exceeds taxes paid

Source: Secretarial estimates, based on Household Survey 1979/80.

Chapter 2: Appendix A

SOURCES, METHODS, AND LIMITATIONS OF TAX INCIDENCE ANALYSIS

Sources

2.A1 The main source of data for the incidence analysis was the New Zealand Household Survey 1979/80. This provided detailed income and expenditure information for 4019 households interviewed throughout New Zealand in 1979/80. Income information was collected on an individual basis. Expenditures were recorded for households as units. The data were adjusted to give results in 1980/81 terms.

2.A2 Additional information was obtained from the 1981 Census of Population and Dwellings. A ten-percent sample file was used to establish the representation in the population of households of various types and in various income ranges.

Methods

2.A3 Some expenditures are not well measured by household surveys, e.g. alcohol, tobacco, "luxury" foods, domestic air travel. In the present study, under-recording of alcohol and tobacco expenditures was adjusted on the assumption that the true expenditure was proportional to the recorded amount.

2.A4 The personal income tax liability of each person responding to the sample survey was calculated according to the income and associated data (e.g. presence of children, payment of life insurance premiums) returned in the questionnaires. The household income[6] and tax liability were obtained by simply grouping together the individuals in each household. The implicit assumption made was that no shifting of the personal income tax burden occurs.

2.A5 Indirect taxes were estimated under the assumption that the burden of indirect tax was shifted to the consumer in full. The estimated retail mark-up (if any) was subtracted from the expenditure by each household on particular goods and services,

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(6) Gross income includes wages and salaries, self employment income, rent, profits from own business, interest, dividends, income-tested social welfare benefits and National Superannuation, other pensions and annuities, maintenance, etc. It excludes inheritances, lump sums and income in kind, and the family benefit.

and an appropriate proportion of the remainder was taken, according to the rate of sales tax, excise, or other tax applicable.

2.A6 Some indirect taxes are levied on items which are used in the production of other goods or in the provision of other services. It could be assumed that the tax burden is shifted to the consumers of those products which have the originally taxed commodity as an input to their production. Explicit allocation of the indirect tax component of goods used as intermediate consumption needs up-to-date information on the inter-industry structure of the economy. No such allocation was attempted.

2.A7 The aggregate personal income tax allocated represents 95% of the actual 1980/81 revenue from this source. Coverages of the various indirect taxes allocated are shown below:

Table 2.A1

AGGREGATE COVERAGE OF MAJOR INDIRECT TAXES IN INCIDENCE STUDY

Indirect Tax	Proportion of Actual 1980/81 Revenue Allocated
Wholesale Sales Tax	
— Tobacco and Alcohol	99%
— New Cars	63%
— Other	50%
Duty	
— Tobacco and Alcohol	99%
— Motor Spirits	50%

The amount of wholesale sales tax on goods other than tobacco, alcohol, and new cars not exactly allocated according to particular expenditures was allocated uniformly to households as a constant proportion of consumption. After this allocation, $1,210 million in indirect taxes had been allocated, being 71% of the total indirect tax revenue.

2.A8 In the tables presented in the chapter, figures are included only for those household type and income range cells into which ten or more sample households were classified. Sampling variability will nevertheless introduce perturbations in the results because of the occurrence of households with exceptional expenditure patterns, e.g. infrequently purchased expensive items. As a consequence, some other figures have occasionally been suppressed to prevent misconceptions.

Limitations

2.A9 The sampling frame of the Household Survey is all private households in New Zealand. Analysis of Census data reveal that 96% of the population, and 98% of income taxpayers, reside in private households. The incidence analysis will not be applicable to the remainder who live in institutions or group-living establishments such as boarding-houses, hotels, motels, and hostels.

2.A10 In interpreting the results, we assume that the expenditure patterns of households falling in a particular cell are representative of households of that particular type and income level. The validity of this assumption is affected by differential response in the survey. Even given representative results, the cell figures show only averages, with no measure of the variability about that average resulting from the discretion households have in directing their expenditure.

2.A11 Some fiscal incidence studies aim to estimate both those groups which benefit from government expenditures and those which are burdened by taxes. Taxes not only raise revenue, but influence the income distribution, as do the government expenditures financed by taxes. Thus a study of the re-distributive effects of taxes alone gives only a partial view of the re-distributive impact of government. It would be very difficult to allocate the benefits of many government expenditures objectively. Similarly the allocation to particular households of the tax burden depends on which assumptions are used to shift the statutory liability for taxes onto individuals.

2.A12 The database set up for this research into the current tax incidence has been used to evaluate options for reform of both the direct and indirect tax systems as they apply to private households. Some results are presented in later chapters. Because of the likelihood that substantial changes in income and indirect tax structures will themselves result in changes in consumption patterns, it is very difficult to draw any firm conclusions about incidence from studies carried out in advance. For obvious reasons the current study has had to use the present pattern of household consumption. This pattern has been influenced by the existing income and indirect tax structures. Thus, while the study may be seen as providing a useful indication of the immediate impact on incidence of major tax changes, it cannot safely be assumed that the pattern of incidence revealed is that which would emerge in practice if the proposed reforms were implemented and sufficient time had elapsed for spending patterns to alter.

Chapter 2: Appendix B

TABLES OF TAX INCIDENCE FOR HOUSEHOLDS, BY RANGE OF HOUSEHOLD INCOME AND HOUSEHOLD TYPE

Table	Description
2.B1	Basic Income Tax Allowing No Exemptions or Rebates
2.B2	Revenue Forgone by Personal Income Tax Exemptions
2.B3	Revenue Forgone by Personal Income Tax Rebates
2.B4	Current Wholesale Sales Tax
2.B5	Other Indirect Taxes
2.B6	Family Benefit

Table 2.B1

BASIC INCOME TAX ALLOWING NO EXEMPTIONS OR REBATES

by Range of Household Income and Household Type, 1980/81

Household Income Range ($ p.a.)	Household Type: One Adult		Two Adults		Two Adults With Children	One Adult With Children	Other	All Households
	Nat.Sup	Other	Nat.Sup.	Other				
	(% of household income)							
Under $8,000	16	11	14	8	15	3	9	13
$8,000-$12,000	24	25	18	21	24	18	14	22
$12,000-$16,000	29	30	23	25	27	24	19	26
$16,000-$20,000	.	35	27	26	29	.	22	28
$20,000-$30,000	.	41	30	29	32	.	25	30
Over $30,000	.	.	42	39	41	.	31	35
TOTAL	21	27	24	29	31	13	28	29

Source: Secretariat estimates, based on Household Survey 1979/80

Table 2.B2

REVENUE FORGONE BY PERSONAL INCOME TAX EXEMPTIONS[1]
by Range of Household Income and Household Type, 1980/81

Household Income Range ($ p.a.)	Household Type							
	One Adult		Two Adults		Two Adults With Children	One Adult With Children	Other	All House-holds
	Nat.Sup.	Other	Nat.Sup.	Other				
	(% of household income)							
Under $8,000	0.8	0.5	0.7	0.4	0.7	0.1	0.2	0.6
$8,000-$12,000	1.1	1.1	1.1	1.4	1.8	0.7	0.6	1.4
$12,000-$16,000	1.2	1.8	1.2	1.5	2.0	1.2	1.2	1.8
$16,000-$20,000	..	2.1	1.0	1.2	1.7	.	1.0	1.5
$20,000-$30,000	.	1.6	1.4	1.5	1.5	.	1.2	1.4
Over $30,000	..	..	1.2	1.2	1.4	.	1.3	1.3
TOTAL	0.9	1.4	1.1	1.4	1.6	0.6	1.2	1.4

(1) Interest and Dividends exemption, Life Insurance and Superannuation exemption, and Standard Employment Expenses deduction.
Source: Secretariat estimates, based on Household Survey 1979/80

Table 2.B3

REVENUE FORGONE BY PERSONAL INCOME TAX REBATES[1]

by Range of Household Income and Household Type, 1980/81

Household Income ($ p.a.)	Household Type							
	One Adult		Two Adults		Two Adults with Children	One Adult with Children	Other	All Households
	Nat.Sup.	Other	Nat.Sup.	Other				
	(% of household income)							
Under $8,000	0.3	0.2	0.5	1.1	9.0	1.7	3.0	1.6
$8,000-$12,000	0.2	0.1	0.4	1.0	6.6	4.4	2.1	3.5
$12,000-$16,000	0.1	0.1	0.3	0.5	2.2	1.1	1.5	1.5
$16,000-$20,000	..	0.1	0.2	0.2	0.8	..	0.8	0.6
$20,000-$30,000	..	0.0	0.1	0.1	0.4	..	0.4	0.3
Over $30,000	..	..	0.1	0.1	0.1	..	0.2	0.1
TOTAL	0.3	0.1	0.3	0.2	1.6	2.2	0.4	0.8

(1) Rates rebate, Spouse rebate, Low Income Family rebate, and Young Family rebate
Source: Secretariat estimates, based on Household Survey 1979/80.

Table 2.B4

CURRENT WHOLESALE SALES TAX[1]
by Range of Household Income and Household Type, 1980/81[1]

Household Income Range ($ p.a.)	Household Type: One Adult		Two Adults		Two Adults with Children	One Adult with Children	Other	All House-holds
	Nat.Sup.	Other	Nat.Sup.	Other				
(% of household income)								
Under $8,000	2.3	3.4	2.9	3.5	5.3	3.6	4.8	3.2
$8,000-$12,000	1.4	2.2	2.6	2.8	3.2	2.8	3.7	2.8
$12,000-$16,000	1.2	1.9	1.9	2.5	2.7	3.0	3.3	2.6
$16,000-$20,000	.	1.8	1.6	2.2	2.3	.	2.6	2.3
$20,000-$30,000	.	1.3	1.4	1.8	2.0	.	2.3	2.0
Over $30,000	.	.	0.7	1.3	1.3	.	1.8	1.6
TOTAL	2.0	2.2	2.0	2.0	2.3	3.0	2.1	2.2
(% of consumption)								
Under $8,000	2.6	2.7	2.8	2.7	2.9	2.8	2.8	2.7
$8,000-$12,000	2.6	2.7	2.6	2.8	2.8	2.8	3.4	2.8
$12,000-$16,000	2.0	3.0	2.3	3.2	3.0	2.7	3.4	3.0
$16,000-$20,000	.	3.0	2.6	3.1	2.9	.	2.7	2.9
$20,000-$30,000	.	2.9	2.5	2.8	2.8	.	3.1	2.9
Over $30,000	.	.	2.5	2.7	2.7	.	2.9	2.9
TOTAL	2.5	2.8	2.6	2.9	2.9	2.8	3.0	2.9

(1) Excluding sales tax on alcohol, tobacco, and motor vehicles
Source: Secretariat estimates, based on Household Survey 1979/80.

Table 2.B5

OTHER INDIRECT TAXES[1]

by Range of Household Income and Household Type, 1980/81

Household Income Range ($ p.a.)	Household Type							
	One Adult		Two Adults		Two Adults With Children	One Adult with Children	Other	All House-holds
	Nat.Sup.	Other	Nat.Sup.	Other				
				(% of household income)				
Under $8,000	3.9	6.3	7.0	8.9	10.2	5.6	6.8	6.2
$8,000-$12,000	2.2	5.3	5.8	6.4	6.7	5.3	7.1	6.1
$12,000-$16,000	1.6	4.8	6.4	5.5	4.8	3.7	7.2	5.2
$16,000-$20,000	..	5.3	4.5	4.8	4.0	..	6.2	4.6
$20,000-$30,000	..	3.0	3.1	3.8	3.8	..	5.5	4.2
Over $30,000	..	..	..	3.5	2.7	..	5.1	4.2
TOTAL	3.3	5.2	5.1	4.3	4.3	5.6	5.4	4.7
				(% of consumption)				
Under $8,000	4.4	5.0	6.6	6.9	5.7	4.4	4.0	5.3
$8,000-$12,000	4.0	6.5	5.8	6.4	6.1	5.5	6.5	6.1
$12,000-$16,000	2.8	7.5	7.9	6.9	5.3	3.3	7.4	6.0
$16,000-$20,000	..	8.8	7.3	6.6	5.0	..	6.6	5.8
$20,000-$30,000	..	6.7	5.4	5.9	5.3	..	7.3	6.0
Over $30,000	..	..	..	7.0	5.7	..	8.3	7.6
TOTAL	4.1	6.7	6.7	6.3	5.4	5.0	7.7	6.2

(1) Sales tax and excise duty on alcohol and tobacco, sales tax on motor vehicles, Domestic Air Travel, Tax, Energy Resources Levy, Motor fees, and motor spirit duty

Source: Secretariat estimates, based on Household Survey 1979/80

Table 2.B6

FAMILY BENEFIT
by Range of Household Income and Household Type, 1980/81

Household Income Range ($ p.a.)	Household Type: Two Adults with Children				
	One	Two	Three+	One Adult with Children	All House-Children
	(% of Household Income)				
Under $8,000	4.9	12.0	21.1	10.5	3.1
$8,000-$12,000	2.8	6.0	10.7	6.2	3.5
$12,000-$16,000	2.2	4.3	7.5	4.4	3.2
$16,000-$20,000	1.7	3.4	6.1	.	2.2
$20,000-$30,000	1.2	2.6	4.5	.	1.5
Over $30,000	0.8	1.6	2.4	.	0.8
TOTAL	1.7	3.4	6.0	7.8	1.9

Source: Secretariat estimates, based on Household Survey 1979/80

Chapter 3

THE TAX SYSTEM—SOME GENERAL CONSIDERATIONS

3.1 This chapter brings together a number of topics which reflect general concerns with the present tax system.

I. ECONOMIC MANAGEMENT

3.2 Taxation has long been regarded as one of the appropriate instruments for managing the economy as a whole—in particular, management of total demand, or expenditure (especially personal consumption expenditure) has often been approached through tax changes. The principal objective of demand management policy is to continually regulate the level of economic activity to its maximum sustainable level. In addition, economic management is also concerned with the *structure* of the economy, and some aspects of the use of the tax system to influence the economic structure are discussed in Chapter 4 on Tax Expenditures.

3.3 Use of the tax system for demand management relies on the effects which taxation has (either directly or indirectly) on the net incomes of individuals and companies, on prices, and on monetary conditions (both monetary aggregates and rates of interest). These factors, in turn, all influence spending decisions in the community. While there are both theoretical and practical difficulties in measuring the strength and the timing of these influences, there will continue to be a need for taxation to be available as a flexible instrument for demand management.

3.4 There are a number of difficulties in using the present tax system for demand management purposes. First, the use of company tax is not well suited to this role because there can be long time delays before a change in policy has its full effect, and because the effects on aggregate demand are not well determined in any case. Secondly, there are also problems with the use of indirect taxes. In principle, temporary variations in consumption based taxes could have potent effects on demand, but the present system is not sufficiently neutral or broadly based to achieve this effectively. To obtain a significant revenue increase from present indirect taxes, the tax rate changes would need to be large, and this would probably lead to significant switching of expenditure (into lower-taxed items) rather than overall expenditure reduction—the implications for *total* tax revenue and *total* consumption expenditure are not very clear. Use of a consumption type tax as a general demand regulator becomes increasingly practicable the more broadly based is the tax, and the more neutral it is with respect to expenditure alternatives. Of course, indirect taxes can be used relatively easily to dampen demand for specific commodities, and there are times when this can make a useful contribution to overall economic management objectives.

3.5 Demand management through personal income tax is also difficult at present, partly because this is an area where behavioural responses are very uncertain, and partly insofar as the generally held belief that the personal tax system in New Zealand has reached (or exceeded) its upper limits is accepted. Thus it may be feasible to reduce personal taxes to support demand, but it is doubtful if substantial tax increases to dampen it would be tolerated. It should also be noted that the delays in implementing a change to personal tax rates can be quite long at times, particularly at times when Parliament is not in session.

3.6 Overall, it would seem that the present tax system is not very well-suited to demand management purposes—no tax instrument is currently available which has both upward and downward flexibility over a range which is adequate for the purpose without causing significant distortions. The later recommendations in this report, that personal income tax should be reduced, and that indirect taxes should be more broadly-based, would help to alleviate these difficulties.

3.7 It would also be helpful to reduce the extent of the problems for economic management caused by some aspects of the operation of the present tax system, especially fiscal drag (as discussed in Chapter 6). Problems also arise from the long delays between income receipts and tax payments for provisional taxpayers and from the strong seasonality of tax flows—the extent of these would be reduced by changing the timing of tax payments, and this is discussed in more detail later in this chapter.

3.8 Finally, the Task Force is aware that a shift from direct to indirect taxation is bound to have effects on prices and incomes. These effects could be inflationary, in immediate impact, and perhaps induce continuing effects. Appropriate broad economic policies implemented in an atmosphere of community acceptance of the equity and benefits of the shift are therefore particular requirements for the success of the shift in tax policy recommended later in this report.

II. AVOIDANCE AND EVASION

3.9 There are indications that avoidance and evasion of income and other taxes are becoming increasingly widespread, and that taxpayers and their agents are adopting more sophisticated techniques. The reasons for this lie mainly in the high tax rates now faced by many taxpayers and the availability of a variety of ways to divert income from taxed to untaxed sources. Whatever the reasons, "conspicuous" avoidance and evasion undermine the acceptability of the tax system very rapidly, and once this has happened it is very difficult to redress—as countries such as France and Italy have found.

3.10 Evasion of tax—where taxable transactions are illegally concealed or incorrectly valued—must clearly be kept to a minimum. Its extent is very much a function of community attitudes, and there are regrettable signs that the "respectability" of evasion is on the increase. It is not possible to estimate the amount of tax evasion with any reliability; and even if it were possible, it would not be clear how much resulted purely from a desire to evade, and how much from illegal transactions (such as drug dealing) where evasion of tax is an incidental purpose.

3.11 The Task Force has given much consideration to the ways in which the revenue loss through evasion can be minimised. There is no simple answer, and it seems necessary to approach the problem on a number of fronts simultaneously. In particular, the incentive to evade must be minimised, the opportunities for evasion should be reduced, and detection rates should be increased.

3.12 The incentive to evade can be reduced in a number of ways. A general reduction in income tax rates will lower the return on evasion and could therefore be expected to reduce incentives across the board. Such benefits will be reduced to the extent that a shift to indirect tax, for example, increases the incentive to evade that tax. Increased rates of detection, the imposition of significant penalties and adequate publicity to such cases are also likely to deter would-be evaders. Lastly, there is some indication that taxpayers who are unable to take advantage of avoidance schemes tend to resort to evasion in an attempt to gain similar advantages. It is therefore reasonable to suggest that reducing avoidance opportunities will also reduce the incentive to evade.

3.13 There is scope for reducing the potential for evasion in the non-business sector. Surveys conducted by the Inland Revenue Department indicate that evasion through the failure to return investment income and small amounts of salary and wages is widespread. While the benefits of omitting such income from returns or failing to furnish returns may be small in individual cases, the total revenue loss is significant. Our recommendations on income splitting (dealt with in Chapter 6.III) would mean that spouses who receive small amounts of income, but who do not at present furnish returns, would be encouraged to do so in order to gain the advantages of the election to split income. It has also been suggested that the introduction of a withholding tax on interest and dividend payments would assist in controlling evasion related to investment income. The Task Force has not considered all the implications of this suggestion and therefore cannot recommend its adoption. However, the suggestion appears to have sufficient merit to warrant careful consideration.

3.14 The Department would be in a better position to control the evasion of income tax resulting from the non-returning of salary and wage income if greater use were made of the IRD numbering system. The verification of the accuracy of salary and wage earner returns of income is largely computerised, and relies for its effectiveness on the wide use of IRD numbers. However, the Department has no statutory power to insist that the number be shown on tax forms and the ability to detect this form of evasion is therefore substantially reduced. The Task Force recommends that the Department be given the power to require that IRD numbers be shown on returns of income and tax code declarations, and that appropriate penalties be introduced for non-compliance.

3.15 The rate of detection of evasion in the business sector depends on a number of factors including primarily the quality and number of staff engaged on investigation duties and the system adopted to identify evasion. The Inland Revenue Department has developed a sophisticated and successful system for the identification of possible evasion, and the Task Force is not aware of any major deficiencies at present. However, it is important that the Department monitor the techniques of evasion being used by taxpayers on a continuing basis and the Task Force considers that these aspects should be kept under continual review. The quality of staff engaged on investigation work is high, and a significant increase in evasion detection could probably be achieved only by increasing the number of inspectors. Currently, inspectors produce an average yield of over $8 in additional tax for each dollar of expenditure, and anything approaching this rate of return would make an increase in the inspectorate establishment well worthwhile.

3.16 Penalties for evasion of tax have also been considered. At present, the Commissioner of Inland Revenue has power to impose penal tax of up to three times the amount evaded, in addition to normal late payment penalties, and the Task Force considers that this power is adequate. However, it is rare for the full amount of penal tax to be imposed in practice and the criteria for the imposition of penal tax should be reviewed, with a view to increasing the deterrent element in appropriate cases.

3.17 Tax avoidance cannot be precisely defined but has been described as being "some act by which a person so arranges his affairs that he is liable to pay less tax than he would have paid but for the arrangement. Thus the situation which he brings about is one in which he is legally in the right, except so far as some special rule may be introduced that puts him in the wrong."

3.18 Avoidance therefore covers a wide range of devices. At one extreme is tax planning which is natural and acceptable—for example, taking tax implications (e.g. entitlement to concessions) into account in making normal business or financial decisions. At the other extreme is hard avoidance which is artificial and unacceptable. Examples of hard avoidance are schemes or arrangements which are entered into solely for tax savings, such as the direct transfer of income derived from personal services performed by the taxpayer to other family members. Between these extremes is, of course, a whole spectrum of degrees of acceptability.

3.19 The Task Force is in no doubt that tax avoidance in general is on the increase. Of particular concern is that, on the evidence available, a substantial section of the public appear to be adopting a less responsible attitude towards their income tax obligations, reflecting a significant change in perceptions of the morality of tax avoidance.

3.20 The development of tax avoidance schemes must be closely monitored by the administering departments. The Inland Revenue Department is currently seeking to increase its expertise in the monitoring of avoidance schemes, and the Task Force endorses this move. Prompt action should be taken to counter unacceptable schemes. The Task Force is concerned at the length of time which can sometimes elapse between the emergence of an avoidance scheme and the ultimate determination by the Courts of its acceptability or otherwise. This period should be reduced to a minimum, and the later recommendations on late payment penalties might assist in this. However, in legally doubtful cases where the scheme is clearly outside the intention of the law it may well be preferable to take legislative action promptly to remove any doubt, rather than waiting for a definitive Court ruling.

3.21 Many of the opportunities for avoidance will be addressed later in this report. The major areas are:

- **Fringe Benefits**

  The growing significance of this form of avoidance is discussed in Chapter 6.VI, and specific recommendations are made on ways in which such benefits could be taxed.

- **Income Splitting**

  There are many opportunities for the splitting of business and investment income among spouses and other family members. Our recommendations on the choice of tax unit (Chapter 6.III) recognise that not all taxpayers are in a position to take advantage of income splitting arrangements and propose that this inequity could be reduced by making the benefits which can be obtained available, at least partially, to all.

- **Dividend Taxation**

  The relatively recent practice of paying tax-free dividends from realised capital reserves has enabled a significant proportion of dividend tax to be avoided. In Chapter 7 we make recommendations which would eliminate this form of avoidance.

- **Superannuation Schemes**

  The avoidance opportunities available through the creation of lump sum superannuation schemes exclusively for the benefit of a single beneficiary are significant. This type of avoidance is discussed in Chapter 12.

- **Charitable Companies**

  The tax avoidance implications of charities are discussed in Chapter 12.

3.22 One area of avoidance which is not dealt with in detail elsewhere is that flowing from the creation of a family trust. As a result of changes made to the Income Tax Act in 1968 dealing specifically with the taxation of trusts and in 1974 dealing with tax avoidance in general, the attractiveness of family trusts solely for tax avoidance purposes has largely diminished.

3.23 There are, however, two aspects of the treatment of trusts that appear to the Task Force to warrant specific attention. The first relates to the circumstances in which income is deemed to be derived by an infant beneficiary, and the second concerns the rate of tax applicable to trustees income.

3.24 As a general rule, with a "specified" trust (essentially an inter vivos trust created since July 1968), income is deemed to have been received by an infant beneficiary only when it has been actually paid to that beneficiary, or applied on that beneficiary's behalf. There is some evidence to suggest that this rule is sometimes being interpreted far more liberally than originally intended. For example, cases have been cited in which trust income while purporting to have been applied on the beneficiary's behalf, is in reality simply being used to meet day to day family needs.

3.25 Income retained in the trust is taxed as trustees' income, at a minimum rate of 35 percent, whereas had the trust not been created that income could have borne tax in the settlor's hands at rates of up to 60 percent. The minimum rate has not been reviewed since 1968, and in the light of the significant changes in personal income tax average and marginal rates over the intervening period, it may no longer be appropriate.

3.26 The taxation of trusts is a highly complex area, and one which the Task Force could not hope to fully review in the time available. However, there appear to be grounds for concern that trusts still provide opportunities for unacceptable tax avoidance. It is recommended that the tax treatment of trusts, in particular the rate of tax applicable to trustees income and the treatment of the income of infant beneficiaries, should be reviewed.

III. TIMING OF TAX PAYMENTS

3.27 The Task Force has noted some significant contrasts in the timing of tax payments for different types of taxpayer. Salary and wage earners pay the bulk of their tax at the time when income is earned, whereas provisional taxpayers (persons and companies) pay tax significantly later on average. The extent of this difference is generally magnified by inflation, to the extent that this enables a higher proportion of the tax liability to be met by terminal tax rather than provisional tax; and inflation also increases the rate of return on the deferral of tax.

3.28 There are also inequities among provisional taxpayers, in that the payment dates vary in relation to balance dates—for example, taxpayers balancing in June are required to pay both their provisional tax instalments and their terminal tax three months earlier in relation to their balance dates than those balancing in March.

3.29 The bunching of tax payments (in September and March especially) also causes problems for the financial system—the large, and rapid, withdrawals of funds from the system can be disruptive, and although this has been ameliorated through the compensatory deposit scheme in recent years (whereby the Reserve Bank makes temporary deposits with the trading banks), this is a second-best solution.

3.30 The Task Force has reached the general conclusion that it would be desirable to shorten the delays in tax payment by provisional taxpayers and gather revenue more smoothly through the year, but it has not been possible to investigate administrative and compliance implications in sufficient depth to form specific recommendations. A firm conclusion has been reached that tax payment dates should be made uniform in relation to balance dates, and this change is recommended. As well as being more equitable, this would imply some smoothing of tax flows, although the large concentration of provisional and terminal payments in September and March would remain, since most provisional taxpayers balance in March.

3.31 A number of options to reduce terminal tax payments (and increase provisional payments) have also been considered:

(a) limiting the use of the previous year's income as a base for provisional tax—by, for example, requiring *all* provisional taxpayers to estimate their current year's income, with all such estimates being subject to the normal penalty arrangements for under-estimation.

(b) increasing the previous year's income by a specified percentage related to the current rate of inflation to provide the provisional tax base— but allowing the present arrangements for lower estimation to continue.

(c) charging interest on terminal liabilities at a market-related interest rate (from balance date or return date, for example). In equity, this might also require that interest should be paid by the Commissioner on refunds of tax overpaid.

(d) requiring terminal tax to be paid on the basis of self-assessment by, say, the date on which returns are due to be furnished, with this payment subject to later adjustment if necessary.

(e) reviewing withholding tax arrangements on lump sum arrears and similar payments, so that these are taxed at a rate closer to the current marginal tax rates of the individuals concerned.

3.32 Each of these options has both advantages and disadvantages but all would be relatively easy to implement, and would help in promoting more equity. Both (a) and (d) could cause problems for taxpayers, however, because of the difficulty in estimating income early in the financial year for (a), and because of the difficulty in meeting the required deadlines for both (a) and (d) (arising from the "bunching" of accountants' work at particular times of the year). The Task Force considers that options (b), (c) and (e) have sufficient merit to warrant serious consideration, and recommends accordingly.

IV. TAXPAYERS WITH VARIABLE INCOMES

3.33 Taxpayers with incomes that vary substantially from year to year face two main problems under the present tax system. First, the present provisional/terminal tax arrangements can often mean that they face high tax payments when their current income is low, and vice versa, which can be disruptive for their operations. Secondly, *personal* taxpayers in this category find that they pay more tax over time than people with the same income but spread more smoothly. This happens because of the progressive tax system, since high incomes in a particular year are taxed at a higher rate. The most obvious examples of taxpayers with variable incomes are farmers, but sharp fluctuations in incomes are not confined to this sector.

3.34 The first problem is a particular result of present arrangements for determining provisonal tax liabilities, and the changes to these arrangements suggested in the previous section could help to some extent.

3.35 The present income equalisation scheme can also be used to reduce the extent of these fluctuations. Under this scheme, farmers can deposit some of their income at the Reserve Bank (via the Inland Revenue Department), and any such amounts are assessed for income tax only on their withdrawal (and cannot then be assessed at a higher rate than would have applied if they had not been deposited). This is an easy scheme to administer, but some difficulties are apparent: first, the rate of interest paid on these accounts (3 percent p.a. taxable) does not in itself offer much of an incentive to use the scheme. Secondly, taking advantage of the scheme involves temporarily forgoing the whole amount of the income deposited, and not all farmers have the cash flow to enable this. The scheme has therefore been used by only a minority of farmers. Nevertheless, this sort of voluntary arrangement is attractive because it has the flexibility to meet the varying circumstances and needs of individual farmers. Since these deposits effectively take money out of circulation, this scheme can also help to insulate the economy as a whole from the monetary effects of the large fluctuations in export receipts which underly the variability in farm incomes. This last point raises some wider issues, and any changes to the income equalisation scheme would need to be reviewed in this broader context as well.

3.36 The income equalisation scheme can also be used to reduce the second problem—farmers can effectively smooth out their taxable incomes to the extent they regard as desirable. This could also be done through some sort of "averaging" scheme, whereby tax liability for a particular year is assessed not on that year's income alone, but rather on the average of several years' incomes. This would have the major advantage of achieving greater equity without the cash flow problems of the income equalisation scheme. It would, however, be complex to administer, especially if averaging were applied only to income derived from farming, for example, rather than total income— Australian practice is to limit the amount of non-farming income which can be included in the averaging calculation to a maximum of A$5,000.

3.37 Since the calculations would extend over a number of years, the inflation rate would also need to be brought into the calculation somewhere, on equity grounds. If this were not done, the upward *trend* in nominal farm incomes would mean that "averaged" income would usually be lower than current income. Averaging would be inflexible with respect to the circumstances of individual farmers, since the only element of choice available would be whether or not to participate in the scheme. It could also have the effect of magnifying fluctuations in after-tax incomes compared with present arrangements, since less tax would be paid in high income years and more in low income years.

3.38 On balance, the Task Force has concluded that there would be merit in the introduction of an income averaging scheme—this would improve equity for farmers, and perhaps other taxpayers, who are not in a position to take advantage of the income equalisation scheme. However, it should be noted that the need for averaging diminishes as the progression in the income tax scale is reduced, as recommended later in this report. It also diminishes to the extent that other stabilisation measures introduced by the Government (e.g. the supplementary minimum price scheme) have the effect of reducing fluctuations in agricultural sector incomes.

3.39 The Task Force recommends that provison for voluntary averaging of incomes be introduced for all taxpayers.

V. PENALTIES FOR LATE PAYMENT

3.40 Present penalties for late payment of taxes are as follows: for PAYE deductions, payment is required by the 20th of the following month, with a once-only 10 percent penalty for late payment. Income taxes generally are subject to a once-only 10 percent penalty if not paid within one month after the relevant due date. Sales tax is due by the 28th of the following month and attracts a 1 percent discount if paid by this date; a once-only 10 percent penalty is added a *further* month later (i.e. two months after the end of the month in which the liability was incurred).

3.41 Although precise information is not available, it appears that the majority of sales-taxpayers now do not take advantage of the discount arrangement, and make payment immediately prior to penalty date—roughly 70 percent of sales tax revenue falls into this category. In late 1981, sales tax arrears (which had attracted the 10 percent penalty) amounted to about $4 million.

3.42 Income tax arrears are more significant, amounting to approximately $172 million at the end of March 1981. Arrears as a proportion of collections have more than doubled in the last decade. However, remissions and write-offs of income tax in 1980/81 amounted to less than $4 million, implying that the great bulk of tax is collected eventually.

3.43 The main concern with current penalty arrangements is that they are not sufficiently penal in current circumstances. The 10 percent flat penalty was a significant deterrent when overdraft interest rates averaged 5 percent twenty years ago, but is much less of a deterrent at current rates of interest. Associated with this is the fact that the penalty is once-only, so that once a penalty has been incurred, the incentive is to further delay payment rather than promptly clear the liability. A less important concern is the difference between sales tax and PAYE collection arrangements—there would seem to be little case for the more generous treatment with respect to sales tax.

3.44 These problems could be solved by retaining the 10 percent immediate penalty, but providing also for an on-going monthly penalty, set at a level significantly in excess of marginal borrowing rates. There appears to be no reason why this arrangement could not be applied to all types of tax collection, subject to the completion of appropriate administrative arrangements. In the case of sales tax, this would involve abolishing the current discount provision, and bringing the penalty date forward by a month. The Task Force recommends these changes.

3.45 A somewhat different situation arises where tax assessments are disputed—in some cases, it is believed that objections to tax assessments have been primarily aimed at deferring the payment of tax (sometimes for lengthy periods), and because of this the rules have now been tightened to some extent. The new rules still imply a significant return to the deferral of tax by objection.

3.46 It is clear that rules in this area should be fair to the genuine objector, while not offering a significant inducement to the "non-genuine" objector. The Task Force recommends that tax in dispute should be treated in a similar manner to late payment, i.e. where the taxpayer retained the disputed amount and subsequently lost the case then he would pay the amount in dispute plus the 10 percent penalty plus the rolling monthly penalty. Where the taxpayer paid the tax in dispute and the Commissioner subsequently lost the case then the Commissioner should refund the amount paid plus an interest payment which corresponded to the monthly rolling penalty.

VI. SUMMARY OF RECOMMENDATIONS

3.47 The following specific recommendations have been made in this chapter:

Avoidance and evasion

- the Inland Revenue Department should be given the power to require that IRD numbers be shown on returns of income and tax code declarations, and appropriate penalties should be introduced for non-compliance.
- the tax treatment of trusts, in particular the rate of tax applicable to trustees' income and the treatment of the income of infant beneficiaries, should be reviewed.

Timing of tax payments

- tax payment dates should be made uniform in relation to balance dates.
- the following options to reduce terminal tax payments (and increase provisional payments) should be given serious consideration:
  - — increasing the previous year's income by a specified percentage related to the current rate of inflation to provide the provisional tax base—but allowing the present arrangements for lower estimation to continue.
  - — charging interest on terminal liabilities at a market-related interest rate (from balance date or return date, for example). In equity, this might also require that interest should be paid by the Commissioner on refunds of tax overpaid.
  - — reviewing withholding tax arrangements on lump sum arrears and similar payments so that these are taxed at a rate closer to the current marginal tax rates of the individuals concerned.

Taxpayers with variable incomes

- provision for voluntary averaging of incomes should be introduced for all taxpayers.

Penalties for late payment

- the 10 percent immediate penalty for late payment should be retained, but provision should also be made for an on-going monthly penalty, set at a level significantly in excess of marginal borrowing rates. This

arrangement should be applied to all types of tax collection, subject to the completion of appropriate administrative arrangements. In the case of sales tax, this would involve abolishing the current discount provision, and bringing the penalty date forward by a month.

- **tax in dispute should be treated in a similar manner to late payment, i.e. where the taxpayer retained the disputed amount and subsequently lost the case then he would pay the amount in dispute plus the 10 percent penalty plus the rolling monthly penalty. Where the taxpayer paid the tax in dispute and the Commissioner subsequently lost the case then the Commissioner should refund the amount paid plus an interest payment which corresponded to the monthly rolling penalty.**

Chapter 4

INCOME TAX CONCESSIONS AND INCENTIVES

TAX EXPENDITURES

Introduction

4.1 Modern governments of mixed economies have increasingly intervened through the tax system to influence the form of economic development and the pattern of income distribution. In New Zealand, as elsewhere, there now exists a complex patchwork of special assistance built up from a vast array of specific concessions available throughout the community.

4.2 These are attracting more attention because of the apparent size of but lack of information on the revenue forgone; the implications for macro-economic management, the tax base and shifts in tax incidence; and doubts as to the effectiveness of some concessions in meeting stated objectives. While an audit of individual "expenditures" through the tax system is well beyond its brief, the Task Force is compelled to highlight some issues of critical importance for a Government contemplating tax reform.

Present Position—Revenue Forgone

4.3 Task Force estimates, shown at the end of this section, suggest that current concessions amount to about $1200 million per annum. To put this in perspective, this is equivalent to about a quarter of personal income tax receipts in 1980/81. Business incentives/concessions alone were estimated to be equivalent to nearly two-thirds of the amount collected in net company tax in 1980/81.

Need for Review

4.4 This information is not meant to suggest that all present tax expenditures are immediate candidates for reduction or reform. Review will be forced on some (e.g. accelerated depreciation provisions) if recommendations of the Task Force are adopted, and on others (e.g. export incentives) through external pressures. But, over and above these categories, there is considerable scope for review and rationalisation of the plethora of concessions that currently exists. Businesses are often unaware of the details of concessions which may be of assistance to them, and inconsistencies are also noted; for example, sales tax is imposed on plant and machinery as a selective measure, while at the same time accelerated depreciation is allowed for income tax purposes.

4.5 Particularly in the absence of terminating or even review dates for individual tax incentives there is no expectation amongst target groups that there will be a formal review. The more ingrained they become, the more obscure is their impact on the particular decisions that they were initially designed to influence. The longer the period of application the more likely it is that a tax incentive is shifted around, through capitalisation for example, and the more it becomes taken for granted. In view of these dampening influences, the Task Force considers there is an especially strong case for reviewing those tax incentives that have been in place for a long time. Unless there is strong evidence to suggest that they are still having their intended effect, their withdrawal should be considered. Some could be reduced or eliminated on a trial basis (subject to the honouring of Government commitments).

4.6 There may well be unintended side-effects associated with incentives designed to influence individual or business behaviour. Examples include capitalisation of the allowable deductions for agricultural or forestry development in the price of undeveloped land with potential for such development; some transfer of the benefit of export incentives to overseas purchasers or domestic consumers through lower prices; and the availability of an additional tax escape route. This last effect is attracting considerable attention, but the Task Force considers that the primary consideration is whether or not the incentive itself is well-designed in terms of its ability to achieve its purpose of, say, farm or forestry development, at reasonable cost. What has to be assessed is whether or not, on balance, the beneficial changes induced outweigh the adverse side-effects; and whether or not the national benefit represents value for money to the general body of taxpayers financing it. Paragraph 4.11 raises an important question in this context of evaluation.

Tax Expenditure Budgeting

4.7 Governments should be as accountable for their "tax expenditures" as for their direct expenditures. At present, the true costs of Government policies are not known to the managers within Government or the public, and political control is impaired. To meet the fundamental objectives of Government accountability and efficient and effective management, requires, as a first step, more explicit accounting of the cost of tax expenditures and their allocation (where possible) to the Government's economic and social programmes.

4.8 Tax expenditure budgeting is appealing in broad concept although there are conceptual, measurement and administrative difficulties to be resolved. But this course will not necessarily restore management *control* over resources disbursed through the tax system. By their very nature open-ended incentives escape the detailed administrative control that accompanies official review of applications and eligibility for assistance within some overall spending guideline. Because they escape effective government control, tax expenditures seem to be more difficult to terminate.

Need for Monitoring

4.9 Having ascertained base-level costs, tax expenditures should be monitored as to their costs and effectiveness and be subject to at least the same level of scrutiny by the Government as direct expenditures. From replies to a Task Force inquiry it is evident that, beyond checks by the Inland Revenue Department for legal compliance, business/agriculture income tax concessions are being inadequately monitored by departments (although they may undergo rigorous assessment before introduction). In the view of the Task Force this is unacceptable. Individual departments should be required to be as accountable for the less visible part of their funding as for their formally appropriated annual vote.

4.10 All this is consistent with the broader aim of improving budget procedures, of reviewing policies in an integrated way, of determining priorities in the context of competing demands for Government funds, and of evaluating alternative means for pursuing objectives. Such monitoring and review should be a continuing feature of Government management.

Efficiency and Effectiveness

4.11 Most concessions are provided as exemptions or deductions from assessable income, and therefore the benefit obtained by taxpayers depends on their having otherwise taxable income and, in the case of individuals, on their marginal tax rate. This has obvious implications for equity but, equally important, is the effect on the evaluation of the cost-effectiveness of those concessions intended to act as incentives: for example, it must be difficult to defend an argument that a young farmer is sufficiently encouraged to incur development expenditure by a saving of say, 14.5 cents in the dollar, while a high income earner needs the encouragement of a 60 percent saving to act in a similar way. It seems likely therefore, that the cost to the revenue is too high for those on high incomes, or the incentive too low for those on low incomes, to generate the activity that the Government desires. This feature of incentives provided through the tax system is inefficient.

4.12 The measurement of efficiency and effectiveness is clearly difficult, but present attitudes suggest that taxpayers in general will become even less tolerant of significant claims for special treatment, especially if the benefits are obscure, the measures poorly targetted or their efficiency and effectiveness not reviewed.

Cost to the Revenue

4.13 The following tables are included to demonstrate the sheer number of concessions available through the tax system (although the list is not exhaustive because of the exclusion of a number of relatively small items); the length of time they have been in place and, most important, an indication of the revenue forgone by the Government each year. It is emphasized that these figures are approximations only as there are no accurate accounting records of the costs.

4.14 Tax expenditures can take several forms—special tax rates, deductions or exemptions from assessable income, credits against tax liability and tax deferral; and, recently, some incentives have been extended to provide an actual payment to the taxpayer of any amount that could not be absorbed within tax otherwise payable (actual disbursements of this type amounted to $69.5 million in 1980/81). The commom element in any particular year of application is that tax liabilities are reduced for selected groups and government revenue is thus forgone.

4.15 For business, the major incentives are export incentives, first year depreciation allowances and investment allowances. Further incentives are also provided to agriculture, forestry and fishing. In the aggregate the total revenue cost in 1980/81 was about $370 million. A recent report on the results of a survey on business investment, conducted by the New Zealand Institute of Economic Research, noted that respondents were evenly divided as to whether government incentives influenced their investment decisions. It reported "a surprisingly low acknowledgement of incentives given the extent of Government's intervention in the market . . .". However, export-related incentives were the most frequently mentioned and they were considered to "have had a significant impact on firms' policies and investment" (which was likely to continue) compared with the small impact attributed to other incentives.

Encouraging Exporting

4.16 International pressures, at least, require a serious review of alternatives for export incentives—for implementation perhaps from 1985. It is important to distinguish here between the case for encouraging exporting, i.e. the resource allocation question, and the *methods* by which exchange earning/saving activities might be encouraged. More often than not, alternatives to present methods are seen to lie within the fiscal system. But in the light of international and fiscal concerns it may be that greater reliance on general policies, including the exchange rate, would offer an acceptable alternative—*provided* that any policy package avoided a piecemeal approach to industrial protection, and *provided* that appropriate wage bargaining machinery was put in place. No one would seriously suggest a simple devaluation/export incentive trade-off, especially since present assistance is aimed at compensating, inter alia, for the higher costs associated with protected import-substituting industries.

4.17 Added inflation and the erosion of intended benefits are invariably associated with devaluation—but these are the same issues that must be addressed in contemplating a major shift from direct to indirect taxation. A reasonable approach to increases in money incomes is vital to both strategies. In the case of a tax switch, the Task Force is concerned that wage claims do not lose sight of any direct/indirect tax trade-off particularly since the Consumer's Price Index does not accommodate changes in direct tax costs to the average earner. Similarly, if exchange rate policy were part of a more general package to replace export incentives (as well as some other forms of assistance), the Task Force would be concerned to see that consequential wage claims recognised any direct tax reductions (or lesser switch to indirect taxes) made possible by the policy change, as well as any benefits associated with reductions in relatively high levels of industrial protection.

Recommendations

4.18 The Task Force recommends:

- **that there be more explicit accounting of tax expenditures for management purposes and preferably also for public information;**
- **that these be allocated to the Government's various social and economic programmes to give a better indication of the costs of Government policies;**
- **that tax expenditures be subject to continual monitoring and review to determine their effectiveness both in meeting objectives, and relative to alternative methods of providing assistance—these methods may lie within the tax and direct expenditure system as well as outside;**
- **that the Government should undertake without delay a rigorous assessment of major tax incentives to ascertain whether or not their continued (and uncertain) cost can be justified relative to the benefits.**

Fig. 4.1

TAX EXPENDITURES—REVENUE FORGONE
(Secretariat Estimates)

	First year of application	Estimates 1980/81 $m
PERSONAL CONCESSIONS*		
Insurance and superannuation exemption	1892	200
First home mortgage interest rebate	1982	95+
Young family rebate	1977	52
Spouse rebate	1933	43
Employment related expenditure deduction	1967	40
Low income family rebate	1981	30
Rates rebate	1979	15
Overtime rebate	1974	13
Donations and school fees rebate	1963	25
Dividend and interest exemption	1970/1958	35
Shiftwork rebate	1974	9
Dependent relative rebate	1921	7
Special farm/home/fishing vessel ownership rebates	(various)	5
Housekeeper rebate	1933	4
Back pay and extra pay rebates	1969/1965	5
Child rebate	1979	2
Farm vendor finance bond/mortage interest exemption	1979	1
Rebate for visiting experts	1970	1
Sub-total		582

* excluding income exempt from tax e.g. social welfare benefits
+ 1981/82

BUSINESS INCENTIVES/CONCESSIONS

Export Incentives		
Increased exports	1963	108
Increased exports to new markets	1976	11
Export performance for qualifying **goods**	1980	60
Export performance for qualifying **services** Export performance for qualifying **overseas projects**	1980	1
Export performance for qualifying **tourist services**	1980	2
Export market development and tourist promotion	1980	36
Sub-total		218
Investment Allowances		
Export—new manufacturing plant and machinery	1977	8
Regional	1977	6
Industrial development plan High priority activity	1977 1978	5
Farming and agriculture	1977	28
Fishing vessel	1977	2
Sub-total		49
"Other" Business Concessions		
First year depreciation allowances	1976	40
Additional depreciation on 2 and 3 shift, plant and machinery	1979	2
Deduction for contributions to employees' superannuation funds	pre 1923	76
Deduction by companies of specified preference share dividends	1976	8
Miscellaneous (6 items)	(various)	6
Current year deduction for forestry costs—Companies Current year deduction for forestry costs—Individuals	1965	9
Deduction for forestry holding companies	1966	1
Sub-total		142

AGRICULTURAL, FORESTRY, AND FISHING CONCESSIONS

(See also under Investment Allowances)

Farming		
Deduction for farm development expenditure	1952	30
First year depreciation—plant, machinery buildings, meatworks	1976	12
Deduction for increase in stock units	1977	5
Income equalisation averaging provisions	1965	2
Spreading of income on substantial sale of livestock	1950	2
Miscellaneous (9 items)	(various)	3
Sub-total		54
Fishing		
Deduction for development expenditure on fishing	1969	5
First year depreciation allowances for the fishing industry	1975	2
Deduction for capital expenditure on fishing vessels	1969	
Sub-total		7

OTHER REVENUE FORGONE

(excluding Savings Incentives)

Exemption from tax of trustees' income of superannuation funds	pre 1923	110
Tax treatment of life insurance offices	1931	50
Exemption from tax of charities	pre 1923	*
Tax treatment of building societies	1892	6
Exemption from tax of Friendly Societies	pre 1923	10
Exemption from tax of Racing Associations and Clubs	1973	5
Tax treatment of Maori authorities	1953	3
Exemption from tax of scientific research bodies	1958	2
Exemption from tax of first $1000 of non-profit organisations	1973	1
Sub-total		187
TOTAL		1239

* Unknown

Chapter 5

SOME CENTRAL ISSUES

Introduction

5.1 The principal objectives of the tax system are to raise the revenue required by the Government, and to assist directly with the attainment of economic and social objectives. The Task Force was not required to review economic and social objectives as such—in particular, the overall tax revenue requirement is dependent on the desired level of government expenditure and the extent to which this is financed by borrowing. These matters were outside its brief.

5.2 The Task Force has also had close regard for the traditional principles of taxation. In essence, these principles are that the tax system should be fair, simple, certain and neutral in its application. Some of these (such as simplicity) apply mainly to individual taxes, but "fairness" can only be assessed in relation to the tax system as a whole. If a paramount consideration has been adopted, it is for fairness, or equity—on the ground that no system which is unfair and is perceived to be unfair will have the acceptability and relative permanence which are required of a good tax system. The purpose of this chapter is to examine the implications of this judgement (and some other criteria) for the desirable shape of the tax system as a whole. The aim is to establish a frame of reference against which the role of the individual taxes discussed in succeeding chapters can be assessed.

5.3 The essential expression of the equity criterion is that taxation should be related to ability-to-pay, which raises two questions: first, how ability-to-pay should itself be measured, and secondly what the relationship should be between measured ability-to-pay and the ensuing tax liability. The first question is primarily a *horizontal equity* consideration—we are looking for a measure that implies that people with the same capacity to pay tax are located at the same point on the scale. The second question is essentially one of *vertical equity*: it is clear that a higher ability-to-pay should imply a higher tax liability, but the relationship could be proportional, progressive or regressive, or some mixture of these, and objective considerations have to be blended with important value judgements about the redistributional goals of the community before a conclusion on the shape of this relationship can be reached. Discussion of this second question is deferred until Chapter 6.

5.4 In practice, three main elements are used as indicators of ability-to-pay: income, expenditure and wealth. Each of these is used in our present tax system, and, indeed, in the tax systems of all other OECD countries. The fact that all three are used in the one tax system implies either that no country has found that a single measure of ability-to-pay is satisfactory, or that other considerations have forced the adoption of multiple bases. In practice, both reasons have probably been important. We therefore turn to a consideration of each of these bases, and then to the choice of a balance among them.

Alternative Tax Bases

Income as a Tax Base

5.5 There is no exhaustive definition of "income" for tax purposes in New Zealand law—rather, the concept of income has been established from a combination of legislative provisions, accounting conventions, and administrative and judicial decisions. Although this is a continuing process, the essential characteristics of income are reasonably clear. According to one text, these are:

"(a) it must be a gain;

(b) it must actually come in, severed from capital, in cash or its equivalent;

(c) it must be either the produce of property, or the reward of labour or effort;

(d) it must not be a mere change in the form of, or accretion to the value of, articles in which it is not the business of the taxpayer to deal;

(e) it must not be a sum returned as a reduction of private expense.

It must, of course, be borne in mind that the above general principles may be, and in certain cases have been, modified by express statutory provision."[1]

5.6 An appropriate benchmark against which to assess this concept of income is the notion of "comprehensive income", developed most thoroughly by the Canadian Royal Commission on Taxation (the *"Carter Commission"*) which reported in 1966. The Carter Commission felt that taxation should be related to the "total economic power" of a tax unit (defined as the power to command goods and services for personal use, whether the power is exercised or not), and considered that this "total economic power" could best be represented for a given period by a comprehensive income base. This "comprehensive income" is much wider than our present income concept however—with some exceptions and qualifications, the Commission recommended that net gains of all kinds should be included. For example, benefits in kind, net capital gains, windfall gains, gifts received, and social welfare benefits would all, in principle, be brought in. Looking at the definition in another way, it amounts to consumption plus (or minus) the change in wealth during the period—in other words, actual claims on resources together with the change in potential future claims. The Commission felt that when measuring taxable capacity, in an "income" sense, the *source* of gain is irrelevant. This is a clear principle, and one which would command wide acceptance; but neither the Carter Commission itself, nor the Task Force felt able to adopt it as an operational basis for income taxation without some modification, for reasons which are discussed in various parts of this report.

5.7 However, it is clear that many of the problems of the present tax system can be traced to the fact that our income definition is not comprehensive, or has been eroded in various ways. The failure to tax such gains as fringe benefits and capital profits, the partial or total exemption of the incomes of some types of business, and the wide range of tax concessions of various types, provide substantial incentives and opportunities for taxpayers to convert income from taxed to untaxed (or less-taxed) sources. This diversion may reduce the *overall* welfare of the community since activities with the highest economic rate of return may not have the highest after tax rate of return; it means that the redistribution carried out through the tax system diverges from what is intended and, of course, it requires tax rates on "taxed" income to be higher than they would need to be with a wider income definition. In fact, these effects can all work in combination, and aggravate one another. This has happened in New Zealand, and the overall result has been, in the opinion of the Task Force, a significant diminution of the general acceptability of the tax system.

5.8 The lack of a comprehensive definition of income will be a recurrent theme of this report, although it has been possible to consider fully only some of the major divergences. Fringe benefits are discussed in Chapter 6.IV, capital gains in Chapter 10, tax concessions in Chapter 4, and some forms of income that are either exempt or taxed at concessional rates in Chapter 12. The Task Force has given little attention to borderline problems of income definition—not because these are regarded as unimportant, but rather because the shortage of time available has meant that the field of enquiry has had to be limited to central issues.

Expenditure as a Tax Base

5.9 Various types of expenditure taxation are possible. In 1978, the "Meade" Committee in the United Kingdom thoroughly argued the case for a *direct* tax on personal *consumption*. By *direct* is meant that each individual, or tax unit, is assessed on its actual consumption during the tax period, with this *consumption* being measured essentially by deducting saving (including the purchase of capital assets) from cash receipts (whether income or capital in nature). This base aims to tax what people take out of the community rather than what they put in; in Carter terms, it taxes the power to command goods and services which is *actually* exercised rather than that which *could have been* exercised without reducing wealth. Taxing expenditure *directly* provides the only means of introducing a significant progressive (or redistributive) element into expenditure taxation. Although arguments for direct expenditure taxation have a long history, this type of tax has not yet been used as a major ingredient of the tax system in any country. Direct personal expenditure tax is discussed more fully in Chapter 9.

5.10 Expenditure can also be taxed *indirectly* by taxing the sellers of goods and services at some point in the distribution chain rather than the person who ultimately purchases them. There are various forms of indirect tax, which are discussed in Chapter 8. For present purposes, we simply note that there is no direct relationship between the tax attached to a particular commodity and the ability-to-pay of the person purchasing that commodity; and that the base defined by the taxed commodities need not closely resemble personal consumption. A significant aspect of indirect taxes is that they provide a ready means for treating commodities *differentially*, although this may not in itself be desirable for a number of reasons discussed in Chapter 8. It can be noted, however, that this differential treatment of commodities is not really possible under a direct expenditure tax.

Wealth as a Tax Base

5.11 The net wealth of a person—the value of assets, less liabilities— has long been regarded as an appropriate base for taxation. It is argued that wealth provides a direct indication of ability to pay tax, although this is not an unqualified conclusion: it has to be recognised that different assets may need to be treated differently, according to whether or not they are income-earning and whether or not they are divisible, for example. In practice, arguments for wealth taxation nowadays generally put it as an adjunct to income or expenditure taxation, although this was not the case historically. Other arguments for wealth taxation are that the distribution of wealth in the community is a legitimate objective in its own right (it need bear no precise relationship to the distribution of income), and that wealth taxes may have lower disincentive effects overall than income taxes—although opinions differ on this latter point.

Relationships among the Bases

5.12 These three bases are not as distinct overall as they first appear. Over a lifetime, comprehensive income (including inheritances and gifts received) is equal to expenditure plus tax paid plus gifts and bequests made. However, there can be significant variations in the relationship between "comprehensive" income and "comprehensive" expenditure *during* a lifetime; and the difference between income and expenditure taxation is predominantly a question of timing. However, this difference is not a trivial one. It has two main elements: first, a direct tax on expenditure involves using a cash flow, or net receipts, concept rather than an income concept. In other words, the starting point for measuring a person's expenditure is net receipts, whether income or capital. Secondly, net savings are deducted from net receipts in order to obtain consumption expenditure. Similarly, an indirect tax applying to all consumption expenditure items is effectively a tax on net receipts less net savings.

5.13 The first timing difference would more often than not operate to delay payment of tax under an expenditure regime compared with an income regime, so long as unrealised accruals of income are positive overall. The second difference is more complex—typically in New Zealand net flows of saving are positive in early income years, negative during the household formation period, positive again in middle age, and negative in retirement; but while typical, this pattern is not universal. All we can be sure of is that a person's net saving over his lifetime (after allowing for capital transfers) will be equal to his estate at the end of it.

5.14 The relationship between wealth and income or expenditure is more straightforward: the change in wealth in any period is equal to "comprehensive" income less expenditure. Thus, to tax comprehensive income (including gifts and inheritances received) is to tax not only expenditure but also wealth as it is accumulated; to tax expenditure (including gifts and bequests made) is to tax wealth as it is disbursed. The real effect, over a lifetime, is essentially the same in both cases.

Choice of a Base

5.15 It follows that there is no strong basis in equity for choosing between *comprehensive* income and expenditure taxation. Over a lifetime they are essentially equivalent, and even in particular years there will usually be a high degree of correlation between income and expenditure. On conceptual grounds, income is likely to provide a better *general* indicator of ability-to-pay than expenditure (expenditure, if it is mainly non-discretionary, provides a prima facie *negative* indication of ability-to-pay), but in practice modification of either an income or a direct expenditure base could be achieved to allow for non-discretionary commitments (such as those resulting from the presence of dependants) which cannot be taken to be reasonably uniform over all taxpayers.

5.16 The other main conceptual issue here is the treatment of savings, or changes to wealth. Assuming for the moment that there is no inflation, expenditure taxation taxes consumption expenditure when it happens, while income taxation, by taxing savings, constitutes a tax on *deferred* consumption, but it also taxes any income return on such saving. It is arguable that this operates as a disincentive to save, and that this might deter investment if it has the effect of restricting the domestic saving which can be utilised for investment purposes. However, it is not clear that saving behaviour is in fact substantially influenced by after-tax rates of return—while evidence on the point is incomplete, it suggests that rates of return have a greater effect on the *form* of saving than on the total *level*.

5.17 Ideally, the after-tax return to saving should reflect the economic rate of return on the investment financed, but in practice it is difficult to determine where this balance lies at present. First, the after-tax investment return is itself distorted by the range of tax concessions made available. Secondly, inflation in conjunction with present methods of income determination does impose a heavy burden on some forms of saving, through taxing as income the capital maintenance element of interest received. The holder of a fixed-interest security which yields a rate of interest equal to the rate of inflation is made no better or worse off over time—but if this interest is taxed his real wealth is eroded, and the incentive to hold this type of asset is significantly reduced. There is little doubt that this can often reduce the after-tax return on interest-earning assets to a level markedly below the return on the capital expenditure financed. More generally, inflation blurs the distinction between income and capital transactions, and distorts calculations involving significant time periods to such an extent that it makes the traditional basis for income determination unacceptable—for reasons which are discussed in more detail in Chapter 7.

5.18 The effects of inflation on income determination have been used (by Meade for example) as a major plank of the argument for expenditure taxation— the view has been taken that full adjustment of a comprehensive income tax regime for inflation would be so complex and costly that it is unlikely to be achievable. This argument must be taken very seriously, but it is not clear that a move to direct expenditure tax would be a *fundamental* remedy so long as expenditure is measured via income—many of the problems are common, and it is the move from an accrued concept of income to a "cash" concept which would make the system more neutral to inflation, rather than the choice of base itself. This comment also applies to some other difficulties—the valuation of accrued capital gains or pension rights is difficult enough even without inflation, and there are strong arguments even under an income tax regime for taxing such income only on realisation, partly to avoid these valuation problems, but partly also because ability-to-pay in a *cash* sense may arise only on realisation.

5.19 In practice, whether the approach is from the income or expenditure side, the assets which could constitute saving for tax purposes could be defined in a variety of ways. Such assets are generally referred to as "registered assets", but no one has suggested that *all* savings should be treated as registered assets. Meade suggested, for example, that houses, shares, and business assets should be registered but that other durables (such as cars, furniture) and some financial assets should not be. The possibility of selective treatment is also illustrated by current New Zealand arrangements —where deposits in farm income equalisation accounts, and contributions to life insurance/superannuation, are essentially treated as registered assets (subject to conditions and limits in both cases). This point implies that there is in practice no clear line between income and expenditure taxation— rather, a spectrum is available. The more assets that are treated as registered, the closer the regime is to an expenditure basis, and vice versa. While there is a strong case for treating similar types of saving in a similar way for tax purposes to avoid capital market and asset market distortions, there appears to be no compelling case for going to either overall extreme— that *all* assets should be either registered or unregistered. In other words, shifts of tax liability *within* a lifetime are not of fundamental concern (subject to appropriate treatment for migrants).

5.20 Overall, the income and direct expenditure bases provide somewhat different means to an end which is the same over a full life-cycle, so long as capital transfers are treated in an integrated manner. However, the less "comprehensive" are the income definition and the treatment of capital transfers in practice, the stronger the case becomes for significant *indirect* taxation of expenditure, and taxation of wealth, as devices for taxing gains which are not captured by the direct tax system.

The Role of Indirect Taxes

5.21 Two basic distinctions between the direct and indirect taxation of personal expenditure have already been noted. The first is that only the *direct* form can be closely related to ability-to-pay, and can therefore be used for redistributive purposes. In contrast, the purchasers of a commodity subject to a sales tax have to pay the tax irrespective of their total income or expenditure, or of their wealth position. While the *immediate* impact of indirect taxes on households can be gauged, the diversity of income/expenditure relationships and uncertainty about the size and location of any secondary effects mean that indirect taxes are a very blunt distributional tool, and they therefore score poorly in equity terms. This is based on the view that there is no precise relationship between indirect taxes and ability-to-pay. It may be possible to say that an indirect tax is broadly regressive, for example, but it has to be accepted that there may be significant variations in individual cases.

5.22 The second distinction is that *indirect* taxes provide in many cases the best means to recognise market imperfections or social costs and benefits —for example, higher tax rates on tobacco and alcohol, or lower rates on pharmaceuticals, could not readily be achieved through a direct expenditure tax alone, just as they cannot readily be achieved through an income tax. There is room for debate on the extent to which the Government *should* intervene to change market prices, but when it is appropriate to do so, an indirect tax system often provides the most convenient means.

5.23 Another argument which is frequently used in favour of indirect taxes is that, insofar as they enable a reduction in rates of *direct* taxation, they can contribute to greater efficiency by encouraging greater work effort. However, this conclusion is by no means clear. Even with a reduction in income tax *alone*, we cannot be sure whether work effort will increase or not—theory says that as people are made better-off by the tax cut they may be encouraged to work less (the "income" effect), but as they also stand to benefit more from extra effort they may be encouraged to work more (the "substitution" effect). We do not know enough about the relative strength of these effects, either for individuals or overall, to say where the balance will lie.

5.24 When an income tax reduction is financed from indirect taxes, the situation is even more complicated. If this "shift" is done in a way which does not change the distribution of the tax burden at all, then in principle there should be no effect on work incentives: in "real" terms, the income and substitution effects are both zero—after tax income can buy precisely the same goods as before. However, there would be a wealth effect operating even in this "neutral" case—since the shift towards indirect taxes would raise prices, there would be a once-and-for-all loss in the real value of money savings, and this loss would not be spread evenly. In practice, such a neutral switch is unlikely to be exactly achieved. Any shift would involve a change in the distribution of taxes (ie there would be winners and losers), but nothing can really be said about the likely effects on incentives. Putting all this another way, incentives would be changed only if the *overall* distribution of the tax burden is changed—they are different sides of the same coin—but we do not know the size, or even the direction, of the behavioural response to such a change. The case to shift either away from income tax and towards indirect taxes, or vice versa, cannot therefore be convincingly argued on efficiency grounds with our present stage of knowledge.

5.25 Beyond this point, the arguments for and against indirect taxes become more pragmatic. One argument already mentioned is that if the *direct* tax base is not comprehensive (ie some types of income or capital transfers escape the direct tax net partially or altogether) or if avoidance and evasion of direct tax are significant, then indirect taxes provide a means of placing some imposition on these receipts when they are spent. While this is true, it is clear that no distinction can be drawn in the indirect tax system between spending financed out of taxed and untaxed gains, so that it does not provide a very efficient way of capturing untaxed gains. Nevertheless, if it is not possible to tax some receipts directly (which is the best solution), greater reliance on indirect taxes may lead to some improvement in equity to the extent that these receipts are then taxed when spent.

5.26 It is also arguable that the operation of a tax system with a greater number of individual taxes has the advantage of minimising strain on each individual part of the system. The lower are individual tax rates, the less incentive there is to evade tax or to develop elaborate schemes to avoid tax. However, balanced against this is the obvious inefficiency (for both administration and compliance) of duplicating collection systems to gather essentially the same amount of revenue from essentially the same people. Nevertheless, it seems reasonably clear in present circumstances that a move from personal taxes to indirect taxes would assist in reducing the *total* "strain" on the system.

5.27 Another argument arises from current international conventions, which are based on a wish to tax traded goods only in their country of final *destination* and not in their country of *origin.* However, this principle is applied only partially in practice: under GATT it has been agreed that income taxes should be paid by exporters in the country of origin, but that sales type taxes (including VAT) should be paid in countries which import their products. This implies that sales type taxes should be refunded on exported goods, thus avoiding double taxation of internationally traded goods. The assumption underlying this arrangement is that the allocation of taxes between income type taxes and sales type taxes in the signatory countries to GATT is similar. However, as was noted in Chapter 2, New Zealand is particularly heavily reliant on income taxes compared with most other countries. Our exporters have therefore to carry a large part of the burden of taxation within the country and in addition the sales taxes imposed in their overseas markets, thus leading to the kind of double taxation the GATT arrangements were supposed to avoid. A shift from income taxes to sales taxes would enable us to redress this imbalance, while keeping within the rules of GATT, to which we are now full signatories.

5.28 Finally, there is clearly a significant body of feeling in the community that people's perceptions of incentives, and the acceptability of the tax system, *would* be changed by a shift towards indirect taxation even if the overall tax burden were not altered. There may be some substance to this view in practice, particularly since income tax rates are highly visible, while the rates of tax on commodities purchased are usually unknown at present. However, if a shift were implemented, this effect might be only temporary, as people would eventually see their after-tax income gains eroded by higher prices, and awareness of indirect tax rates would be heightened. Another perception is that some people feel that they have some discretion over their expenditure and therefore over the degree to which they pay an indirect tax, but this is something of an illusion—in the case of most taxpayers, it is doubtful if they have a great deal more discretion over the amount of their expenditure than they do over the amount of their income.

5.29 The submissions and other correspondence which have been made available to the Task Force have covered the desirability of a "shift" only to a limited extent. Perceptions that personal income tax is too high and/or too progressive are clearly widespread, and many correspondents have pointed to the incentive effects of reducing personal tax. Relatively few, however, have focused on the means that would enable Government revenues to be maintained if a substantial reduction in personal income tax were in fact effected. The few who did comment on the greater use of indirect taxes were mainly concerned at the regressive effects.

5.30 Overall, neither theoretical nor practical considerations lead to a clear conclusion on the appropriate balance between direct and indirect taxation. However, it is clear that the present tax system is not capable of delivering the revenue required at present, while remaining acceptable to the broad range of taxpayers. This situation has arisen because of the undue reliance on one tax—personal income tax—and the narrowness of the tax base as a whole. The solution is to broaden the base. Although there may be useful gains in broadening the income base, there seems to be no prospect of obtaining sufficient revenue to finance the significant reduction in personal tax which is clearly necessary without significant recourse to indirect taxes. However, this conclusion has not been reached without some reservations. The uncertain distributional effects and the difficulties of transition (particularly the possible inflationary effects, as discussed in Chapter 3) imply a need for some caution in determining the desirable size of such a "shift" and the nature of the actual "package" adopted for that purpose.

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(1) Cunningham and Thompson's "*Taxation Laws of New Zealand*", Volume 3, Wellington, Butterworths, 1967.

Chapter 6

PERSONAL INCOME TAXATION

I. INTRODUCTION

6.1 The present system of personal income taxation is the subject of widespread dissatisfaction throughout New Zealand. This is abundantly clear from the many submissions to the Task Force and from its consultations with various groups around the country.

6.2 Amongst the wide range of concerns expressed to the Task Force, four have been predominant:

(a) that marginal income tax rates are too high relative to average tax rates for the bulk of taxpayers—notably full-time wage and salary earners in the middle income range,[1] thereby tending to discourage productive effort and to encourage tax avoidance and evasion;

(b) that inflation is causing average tax rates to rise too rapidly for these middle-income taxpayers, thereby also tending to affect the incentive to work;

(c) that individuals and households with similar abilities to pay tax often pay markedly different amounts of income tax, and that this is unfair; and

(d) that evasion and avoidance of personal income tax is unfairly increasing the burden on those people who actually pay the tax.

6.3 These concerns appear generally to be well founded. They accord by and large with the Task Force's assessment of the major problems inherent in the present system of personal income tax, which stem from two of its basic features.

(a) a highly progressive tax rate scale; and

(b) a narrow tax base.

The corollary is that reducing the progressivity of the rate scale and broadening the tax base would go a long way towards alleviating, if not overcoming, many of these concerns.

6.4 The Task Force believes that the scope for such reforms is constrained by other consideration such as the revenue cost and degree of redistribution of the tax burden that would be acceptable

(1) "Middle income range" refers to gross incomes of 1–2 times the level of average weekly earnings (AWE). In 1981/82, 1AWE is estimated to have been $256 per week or about $13,300 per year.

to the community at large. Additional reforms, therefore, would need to be implemented to remedy the present situation. Such reforms centre on the choice of tax unit. One possibility would be to change from the present individual-based system of tax assessment to one based on a family tax unit. But, if this were compulsory it would entail major shortcomings on social and equity grounds. Accordingly, the Task Force is inclined instead towards the introduction of some form of *optional* income-splitting for families (including children), or at least for married couples.

6.5 In the remaining sections of this chapter, the Task Force examines each of the main components of the personal income tax system to determine what, if any, reforms may be warranted, especially in view of the above concerns.

Section II deals with the tax base, including the distribution of individuals by total income ranges.

Section III focusses on the tax unit and related issues such as income splitting.

Section IV concentrates on how family circumstances affect ability to pay tax—e.g. the presence of dependants.

Section V examines the structure of the tax rate scale and its implications.

Section VI discusses the taxation of fringe benefits.

II. PERSONAL INCOME TAX BASE

Introduction

6.6 Personal taxes can be used to achieve a fairer distribution of the tax base than indirect taxes. In a personal system individual and collective circumstances can be more readily reflected. This is true whether income or expenditure is the base (the relative merits of each are discussed in Chapter 5). Given income as the base, however, if the measurement of personal income for tax purposes omits certain kinds of income, then its effectiveness as a social instrument will be impaired and people will search for ways to avoid the tax. There are practical limits as to how comprehensively income can be defined and for this reason it is customary to supplement personal income taxes with taxes on company income, with taxes on the accumulation, holding and dispersion of wealth and with indirect taxes of various kinds. While some of these taxes, in themselves, may not contribute much to the overall revenue yield, on equity grounds their existence complements a tax on personal income.

The Treatment of Interest for Income Tax Purposes

6.7 The tax treatment of interest and the current levels to which interest rates have risen has caused a great deal of public debate and concern recently. Under conventional financial contracts and the present tax treatment of interest the saver is required to pay tax on total "interest income". This is so even though the "interest income" in times of inflation represents compensation (in some instances, partial compensation only) for the erosion of the purchasing power of the capital investment together with an element of real return on the investment. The Task Force has noted in Chapter 7 that inflation in combination with the present tax system, results in a dramatic and inequitable redistribution of net income away from savers to borrowers and, in particular, to business borrowers.

> "The result of using the interest rate to adjust for inflation, paradoxical as it may seem, is that interest rates tend to end up being too low and too high at the same time. From the point of view of savers, they are too low (given that after-tax, and often before-tax, real rates of return are negative) . . . But from the point of view of borrowers they are too high (given the cash flow requirements to service the debt) . . . A response to this situation would be for financial contracts to be indexed i.e. the inflation adjustment would be made to the principal of the debt and not by way of the addition of an "inflation premium" to the interest rate. So far as tax policy is

concerned, the essential step required before indexation of financial contracts could be implemented would be to make the "inflation premium" component of the return on financial assets neither assessable (for the saver) nor deductible (for the borrower) for tax purposes."[2]

6.8 As far as the business taxpayer is concerned this result would be effectively achieved through the inflation adjustments recommended by the Task Force for business assets and liabilities (Chapter 7.I refers).

6.9 A comparable adjustment is required for the non-business interest recipient. However, the multitude of types of fixed interest investment held by personal taxpayers would make it very difficult to segregate the inflation and the "interest" components of the interest receipts.

6.10 Bearing in mind the demand (identified in Chapter 7.I) for indexed securities that is likely to develop if the Task Force's recommendations concerning inflation accounting are accepted and the desirability of providing a means for personal taxpayers to save in a form which does not require them to be taxed on the inflation component of interest, the Task Force recommends that in association with its recommendations for determining business income where a personal taxpayer lends by way of an indexed financial contract the inflation premium payable in accordance with that contract should, subject to appropriate safeguards, be exempt from tax.

The revenue cost of introducing this recommendation, in the unlikely event that *all* lending by individual taxpayers was by way of indexed lending, is estimated to be approximately $200 million a year in 1980/81 terms.

The Distribution of Income

6.11 Figure 6.1 below shows an estimate of the distribution of individuals by total income ranges and types of household member in 1981/82, based on the Household Survey for 1979/80. This distribution shows three distinct areas of concentration: people reporting no income; people reporting $3000 to $5000 p.a. of income, mostly National Superannuitants; and people with incomes between $8000 and $15,000 p.a. The bulk of people reporting incomes are in the lower half of the range with very few in the upper income brackets. By comparison the average weekly earnings in 1981/82 is estimated to have been $256 or about $13,300 annually. Thus people with incomes under one and a half

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(2) Mr R W R White, Governor of the Reserve Bank of New Zealand. Letter to the Task Force on Tax Reform—August 1981.

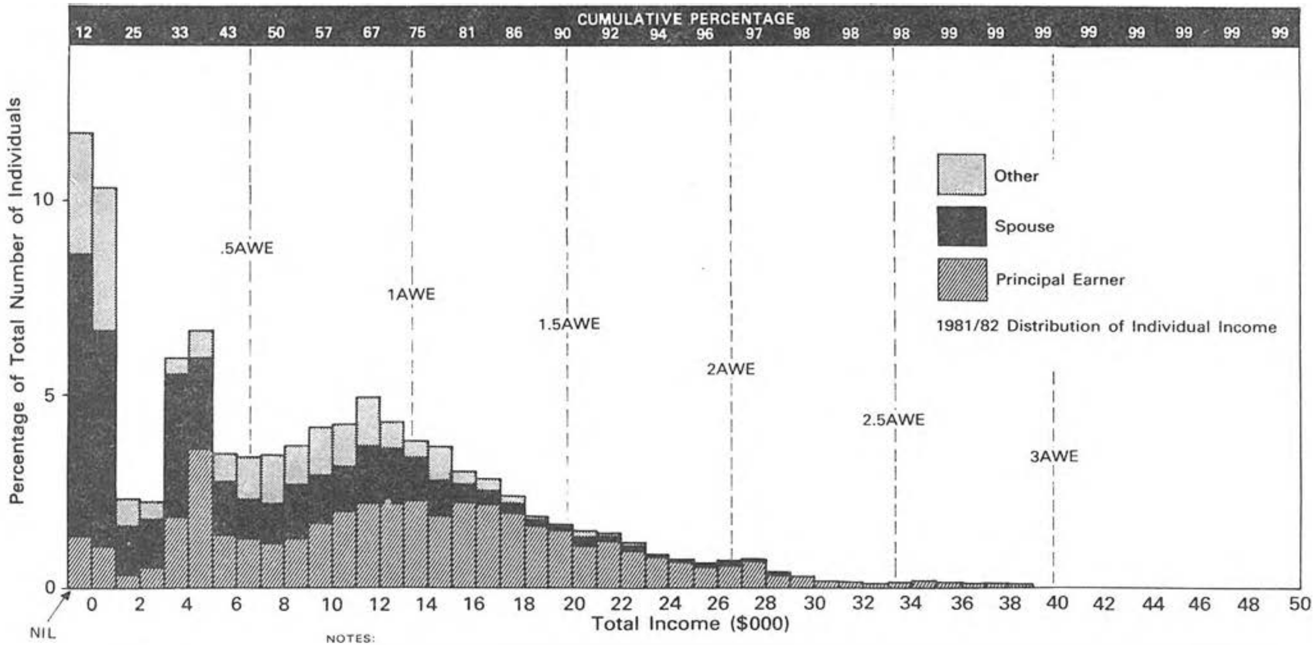
times the average wage accounted for almost 90 percent of the adult population in that year, with people with incomes between $1000 and $8000 p.a. accounting for 28 percent of the total.

An important point to note is the rapid rate at which the distribution thins out as incomes rise above the level of average earnings. Many people believe that it is possible to tax high incomes more heavily in order to give relief to those on low to middle incomes but the extra tax which may be collected has only a very slight effect on the tax paid by people lower down the scale.

6.12 Figure 6.1 also shows a breakdown of the adults in the distribution into principal income earners, spouses, and other persons (e.g. boarders etc.) it may be seen that the principal income earners are concentrated in the income range ($11,000 to $18,000) a level somewhat in excess of the adult population as a whole. When the distribution is looked at in terms of household income (see Figure 6.2), especially in the middle to upper ranges it may be seen that a significant proportion of household income is derived by spouses and other persons. In particular many of the higher income households (i.e. with incomes above $32,000 or 1.5 times the average household income of $21,000 in 1981/82) have more than one source of income. One implication of this for tax policy is that a relatively high proportion of the benefit of tax concessions to *individuals* with low incomes could in fact be received by *households* in the upper income bracket.

Figure 6.1

ESTIMATED DISTRIBUTION OF INDIVIDUALS AGED 15 YEARS AND OVER BY TOTAL INCOME RANGE AND TYPE OF HOUSEHOLD MEMBER—1981/82



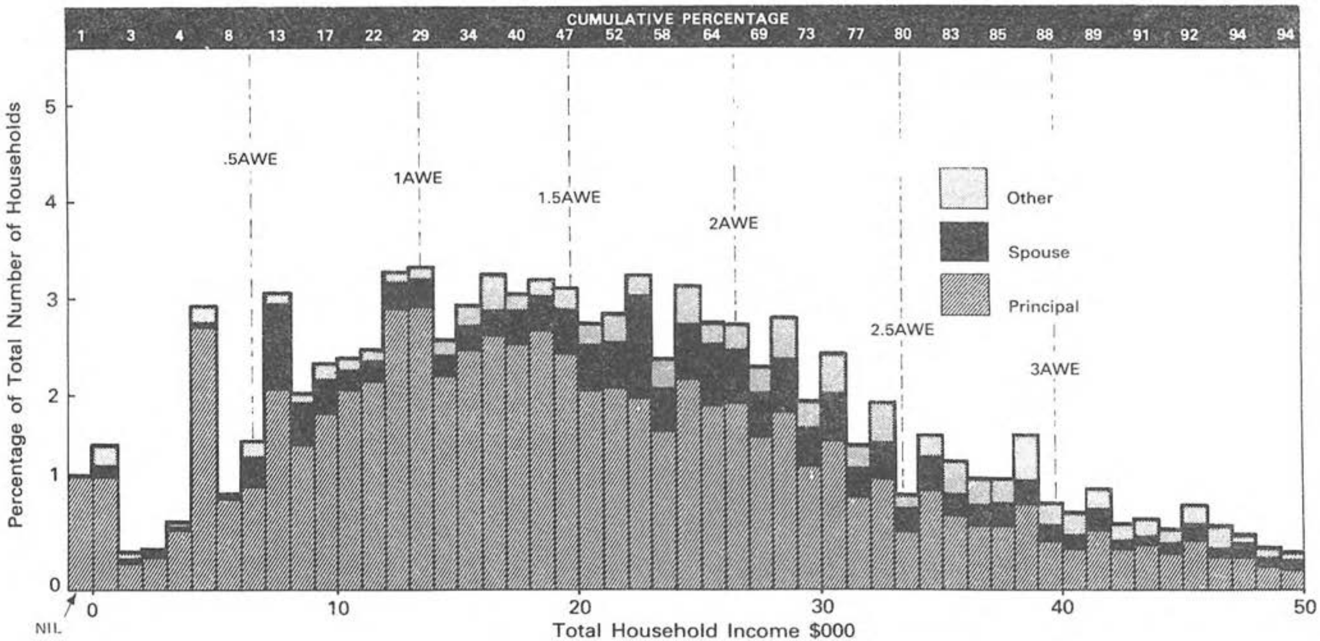
Source:
Household Survey, 1979/80

NOTES:
"Total income" is total current income. It excludes only those sources of current income which are completely exempt from taxation (e.g., social welfare benefits, war pensions alimony and maintenance, lump sums from superannuation and accident compensation).

1AWE = Estimated average weekly earnings of $256 in 1981/82, or about $13,300 per annum

Figure 6.2

ESTIMATED DISTRIBUTION OF HOUSEHOLDS BY TOTAL INCOME RANGE, AND RELATIVE CONTRIBUTIONS TO TOTAL HOUSEHOLD INCOME BY TYPE OF HOUSEHOLD MEMBER. 1981/82



Source:
Household Survey,
1979/80,

NOTES:

"Total Income" is total current income. It excludes only those sources of current income which are completely exempt from taxation (e.g., social welfare benefits, war pensions, alimony and maintenance, lump sums from superannuation and accident compensation).

Each bar is divided in proportion to the average contributions to total household income by types of household member (i.e., principal income recipient, spouse, and other members).

1AWE = Estimated average weekly earnings of $256 in 1981/82, or about $13,300 per annum

6.13 The following table shows a distribution of adult individuals with incomes below $7000 in 1980/81. These accounted for 51 percent of adult individuals in that year.

Table 6.1

DISTRIBUTION OF LOW-INCOME ADULT INDIVIDUALS BY TOTAL INCOME RANGES AND TYPES OF HOUSEHOLD MEMBERS (AS % OF ADULTS)—1980/81

Total Income Range	Principal Income Earner	Spouses	Other Persons in Households[1]	National Super-annuitants	Total[2]
($)	(%)	(%)	(%)	(%)	(%)
NIL	1.5	7.1	3.3	0.0	11.9
1—1,000	1.2	5.9	4.0	0.0	11.0
1,000—2,000	0.4	1.3	0.7	0.1	2.5
2,001—3,000	0.6	1.3	0.6	1.9	4.3
3,001—4,000	0.5	1.5	0.3	6.5	8.9
4,001—5,000	0.5	1.3	0.9	1.9	4.5
5,001—6,000	0.6	1.0	1.4	1.1	4.0
6,001—7,000	0.9	1.3	1.3	0.6	8.1
TOTAL	6.1	20.6	12.4	12.1	51.2
(% of Row Total)	(12)	(40)	(24)	(24)	100)

(1) "Other persons in households" include: son/daughter (including step or adopted); parent (including in-law); other relative; boarders; flatmate/friend; other non-relative.
(2) Columns and rows may not add up to totals due to rounding.
Source: Secretarial estimates, based on Household Survey 1979/80.

III. PERSONAL TAX UNIT

Introduction

6.14 The "tax unit" is the primary mechanism for specifying the extent to which, if at all, individuals' incomes are to be aggregated for the purpose of assessing their respective tax liability. It can be the individual, the married couple, the family (including dependent children) or the household (broadly defined to include any group of individuals living together and sharing their resources and household responsibilities).

6.15 In a system of personal income taxation with a progressive tax rate scale, such as exists in New Zealand, the choice of tax unit—or combination of units—can have a major impact on both the distribution of the tax burden and the resultant social and economic consequences.

What the impact of any particular choice of unit(s) is, however, depends largely on its interaction with other key elements in that system, notably: the scale(s) applied to the unit(s), the definition of assessable income, the extent to which costs of earning that income are deductible, and the recognition of dependants. Indeed, similar impacts can be achieved by a variety of different combinations of these elements.

6.16 New Zealand's personal income tax system is based entirely upon the "individual" unit. This has been the case since the system's inception, apart from the period 1939-1962 when there also was compulsory aggregation of married couples' incomes if these exceeded a certain, moderately high minimum level in aggregate. Family circumstances are taken into account in assessing tax liability, although only to a limited extent, via the provision of several rebates of tax (e.g. the spouse rebate, the young family rebate and the low-income family rebate).

6.17 Most submissions to the Task Force have not focused directly on the appropriateness of the individual tax unit basis of the present system. But concern has been expressed about disparities between the tax payable by one-income vis-a-vis two-income families whose total gross incomes are identical. These perceived "horizontal" inequities arise because of the conjunction of a progressive tax rate scale with an individual tax unit. They could be overcome, or at least alleviated, in a number of ways of which introducing a family tax unit (or married couple tax unit) is one possibility. Reducing the progressivity of the tax rate scale is another. Income splitting on a notional basis—either with the present scale or a less progressive one—is also a possibility.

6.18 The case for choosing any particular tax unit, or combination or units, is by no means clear cut. Each of the main options can be justified on certain criteria. But none is entirely satisfactory because each conflicts with at least one of the criteria that people typically consider should be met by the tax system. As a result, the choice of tax unit(s) inevitably depends on value judgements as to the appropriate trade-offs between conflicting criteria.

International Perspective

6.19 That there is no single "best" tax unit option is evident from the diversity of approaches taken by overseas countries. Nevertheless, in recent years, there has been a marked change from joint to individual assessment.

6.20 Only ten or so years ago the bulk of western countries provided for some form of aggregation of individuals' incomes, in assessing tax liability. At that time New Zealand was conspicuous as being one of the very few countries—along with Australia and Canada—which maintained only an individual basis of personal income taxation.

6.21 More recently there has been "a trend away from compulsory joint or family taxation towards the choice of the individual as the tax unit for earned income or, at least, the provision of an option for individual taxation."[3] This trend reflects in large measure the growing importance attached to the status and role of women in society, including a widespread desire to ensure that the tax system does not discourage married women from taking up employment. At present individual taxation is allowable in twenty OECD countries, of which fifteen have made it compulsory at least for certain income groups.[4] The remaining eleven OECD countries however, are continuing to use joint spouse or family taxation for the majority of their taxpayers.

6.22 The changing social attitudes underlying this trend are also evident in the contrasting views on the tax unit, of two major reviews of taxation policy: the Carter Commission in Canada in 1966, and the Asprey Committee in Australia in 1975.

The *Carter Commission* said:

> "We believe firmly that the family is today, as it has been for many centuries, the basic economic unit in society. Although few marriages are entered into for purely financial reasons, as soon as a marriage is contracted, it is the continued

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(3) OECD Committee on Fiscal Affairs report, *The Treatment of Family Units in OECD Member Countries Under Tax and Transfer Systems*, 1977.

(4) The twenty countries are: Australia, Austria, Belgium*, Canada, Denmark, Finland, Germany*, Greece, Iceland, Ireland, Italy, Japan, Netherlands, New Zealand, Norway*, Spain, Sweden, Turkey, United Kingdom*, and United States of America*; Individual taxation is optional in those countries marked with an asterisk.

income and financial position of the family which is ordinarily of primary concern, not the income and financial position of the individual members. Thus, the married couple itself adopts the economic concept of the family as the income unit from the outset. In Western society, the wife's direct financial contributions to the family income through employment is frequently substantial. It is probably even more true that the newly formed family acts as a financial unit in making its expenditures."[5]

The *Asprey Committee* took the contrary view:

"that the adoption of a compulsory family unit basis must be rejected on grounds of general social principle. The right to be taxed as an individual has always been accorded in Australia. At a time when women are playing an ever greater role in the economic and other affairs of society, the withdrawal of this right would certainly be regarded as a retrograde step. And objections would come not only from women: men too might take exception to a universal and compulsory conmingling of their tax affairs with those of their wives. This would, in the Committee's view, make a change in this direction politically unacceptable irrespective of whether married women (or married men) paid more or less tax after the change than they do now: social attitudes to the separate status of the sexes, rather than purely economic considerations, are involved here."[6]

Conflicts in Choosing a Tax Unit

6.23 The primary aims underlying the choice of taxpayer unit are to ensure that personal income tax liability is assessed "fairly" and in a manner which is generally neutral with respect to social and economic decisions. More specifically, for a majority of New Zealanders, these twin aims probably can be elaborated into the following propositions:

(a) personal income tax should be progressive—i.e. the average tax rate should increase as income increases;

(b) families with equal incomes should, other things being equal, pay equal amounts of income tax;

(c) decisions to marry or not, or divorce or not, should not be affected by personal income tax considerations;

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(5) *Report of the Royal Commission on Taxation*, Canada, 1966, Vol. 3.
(6) *Taxation Review Committee, Full Report*, Australia, 31 January 1975.

(d) two persons living together and sharing household expenditures can generally live more cheaply and therefore have a greater taxable capacity than two single persons living separately;

(e) the incentive for any member of a family to earn income should not be "blunted by tax considerations which depend upon the economic position of other members of the family"[7]; and

(f) economic and financial arrangements within a family—e.g. as regards the ownership of property or equity shares—should not be dominated by income tax considerations.

6.24 The problem is that although each of these aims may be quite acceptable in its own right, they cannot all be achieved together. For example, few would disagree that the tax system should not influence decisions to marry or not (proposition (c)). On this criterion the individual tax unit would be preferred as being the more neutral with respect to marriage decisions, as it does not recognise marital status. But if it is accepted that married couples benefit from economies of living together (proposition (d)), then it would be more appropriate for the tax unit to be either the "married couple" or the "family". This would violate the previous criterion. It would also conflict with proposition (e), insofar as the income position of an individual member of a family would generally affect the tax position of the others. Nevertheless, it would avoid the present situation whereby—contrary to proposition (b)—families with equal incomes may pay widely different amounts of income tax due to differences in the proportion of income derived by members within a family. This situation, which arises because of the present combination of a progressive rate scale (proposition (a)), and an individual tax unit, could be alleviated by reducing the progressivity of the rate scale. The introduction of a uniform proportional rate scale would overcome it entirely.

6.25 Apart from these conflicting considerations there is a more general conflict between two basic concerns:

(a) the desire of individuals to be treated as individuals for income tax assessment purposes; and

(b) the desire to relate tax liability to the totality of a taxpayer's economic circumstances, to satisfy the ability-to-pay criterion.

The first of these concerns points to an individual tax unit and the second to some social grouping of individuals such as a married couple, family or household.

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(7) Report of the Meade Committee, *The Structure and Reform of Direct Taxation*, 1977.

Examination of Main Issues

6.26 In evaluating the present individual tax unit basis of personal income taxation, the Task Force's first concern was whether or not it contributes to a "fair" distribution of the income tax burden. There are, of course, no absolute standards of "fairness". It can be judged only on the basis of normative criteria which preferably should correspond to the value judgements of as large a portion of the community as possible. The Task Force believes that in this context, most people probably would regard "fairness" as requiring that the income tax burden should be distributed between personal tax units in proportion to some notion of their respective "abilities to pay" or "economic capacities". Although there is scope for much debate on what is a satisfactory measure of a unit's economic capacity, a broadly defined concept of income is the best in principle in the Task Force's view—for the reasons stated in Chapter 5.

6.27 Despite changing patterns of social behaviour in recent years the family remains a predominant socio-economic unit in New Zealand. For example, about 70 percent of households surveyed by the 1979/80 Household Survey included married couples (with or without children). The significant feature about families is that the economic capacity and living standards of individual members of a family generally depend on the income (and wealth) of the family as a whole, net of any costs incurred in earning that income. As noted in an Australian Treasury submission to the Asprey Committee on taxation:

> ". . . . this is not to imply that the incomes of all members of a family are necessarily pooled, but the separate incomes of persons commonly referred to as dependants, namely spouses and children, do increase the command of a household over present and future consumption by, if nothing else, relieving the main breadwinners of some or of all of the responsibility for contributing to the standard of living of these dependants."[8]

Given the interdependence of family members, the question is whether the individual or the family tax unit offers the most appropriate means of recognising the impact on an individual's taxable capacity of family circumstances—including total family income.

6.28 The existence of a mandatory individual tax unit basis of assessing personal income tax, as in New Zealand, certainly does not rule out the possibility of taking account of a family's total income. For example, the present low-income family rebate provides the principal income earner in a family with a rebate of tax, the amount of which abates as the family's aggregate income

(8) *Personal Income Tax: The Tax Unit*, Australian Treasury Taxation Paper No. 6, October 1974.

exceeds a specified level until it is eventually extinguished. The fact remains, however, that the individual tax unit basis of assessment is deficient in several important respects.

6.29 A major deficiency of the individual tax unit, is that when it is coupled with a progressive rate scale, the total tax liability of families with the same total income will vary substantially according to the way in which receipts of income are distributed amongst the members of each family. This result is generally unacceptable in the Task Force's view; the more so when the magnitude of differences is realised. An illustration of their size is provided in Table 6.2 which shows the variation in the total tax liability of couples with different income shares under the present

Table 6.2

VARIATIONS IN INCOME TAX PAYABLE BY MARRIED COUPLES WHOSE TOTAL INCOME IS THE SAME BUT SPLIT DIFFERENTLY BETWEEN SPOUSES[1]

Total Family Income	Principal Income	Spouse Income	Total Tax Payable	Difference in Tax vis-a-vis Single-Income Family	Average Tax Rate of Family
($)	($)	($)	($)	($)	(%)
10,000	10,000	0	2,198[2]	0	22.0
	8,000	2,000	1,939	−260	19.4
	6,000	4,000	1,527	−671	15.3
	5,000	5,000	1,435	−763	14.4
15,000	15,000	0	4,254[2]	0	28.4
	12,000	3,000	3,482	−772	23.2
	9,000	6,000	2,959	−1,295	19.7
	7,500	7,500	2,959	−1,295	19.7
20,000	20,000	0	6,818[2]	0	34.1
	16,000	4,000	5,462	−1,356	27.3
	12,000	8,000	4,709	−2,109	23.5
	10,000	10,000	4,709	−2,109	23.5
25,000	25,000	0	9,715[2]	0	38.9
	20,000	5,000	7,691	−2,024	30.8
	15,000	10,000	6,764	−2,951	27.1
	12,500	12,500	6,459	−3,256	25.8
30,000	30,000	0	12,715[2]	0	42.4
	24,000	6,000	10,226	−2,489	34.1
	18,000	12,000	8,928	−3,787	29.8
	15,000	15,000	8,819	−3,896	29.4

(1) Tax liability is calculated on the basis of the present personal income tax rate scale (effective since 1 February 1981).

(2) After deduction of the spouse rebate ($156 p.a.), which abates to zero at the rate of 20 cents per $1 of spouse income over the range $520-$1,300 p.a.

tax rate scale. It is evident that single-income couples incur the maximum tax liability whereas two-income couples, in which each spouse receives half the total income, incur the minimum tax liability.

6.30 This inequity is compounded by the fact that some families are legally able to redistribute income between members of the family (e.g. by the transfer of asset ownership or the formation of family partnerships or trusts) so as to minimise their tax liability, while others do not have the scope to do so. Wage and salary earners cannot split their ("earned") incomes in this way, but taxpayers with large amounts of business or property ("unearned") income can do so relatively easily.

6.31 But the inequity may not be as extensive as it appears at first sight. This is true insofar as some of the income tax advantage obtained by two-income families in which both spouses work, can be thought of as providing compensation for the present inadequate recognition of some employment-related costs (e.g. childcare costs) on the one hand, and the non-taxation of the imputed value of household services provided by non-working spouses (in the case of one-income families) on the other.

6.32 The overall result, nevertheless, is that the personal income tax burden is distributed unfairly between:

(a) families with the same total income distributed in different ways;

(b) families with different types of income; and

(c) families with different income levels (as those who are able to indulge in artificial income splitting are often at the upper end of the income distribution).

6.33 There are essentially three options for remedying, or alleviating, this anomalous situation:

(a) to retain the "individual tax unit" as the sole (i.e. compulsory) basis for assessing personal income tax, while introducing a proportional—or at least much less progressive—tax rate scale; or

(b) to introduce a compulsory "family tax unit" basis for assessing families, or at least a "married couple tax unit" basis, while continuing to assess unattached single persons on an "individual tax unit" basis; or

(c) to retain the "individual tax unit" basis while providing families with the option of instead being assessed as a "family tax unit".

6.34 The effects of flattening the present tax rate scale are discussed in Section V of this chapter. Suffice it to say here that the foregoing horizontal inequities would be completely avoided under a proportional rate scale. The other two options are discussed in this section.

Family Tax Unit

6.35 There are two main—albeit related—arguments in favour of the family tax unit. First, it would enable families' tax liabilities to be assessed in a way which more closely and directly reflected their respective abilities to pay tax, insofar as each family's total income is taken into account in determining its tax. Second, it would provide a means of overcoming the present unfair variations in tax liability between families with the same total taxable income. The extent to which these potential advantages were actually achieved would depend on three factors:

(a) the precise definition of the family unit;
(b) the effective tax rate scale applied to the family unit—e.g. different tax rate scales may be applied to individuals and families; and
(c) whether the unit was compulsory or voluntary for families.

Definition of Family Unit

6.36 To satisfy the ability-to-pay criterion it is important that the "family tax unit" should be defined as comprehensively as possible. In the Task Force's view it should at least include the following types of households: childless married couples, married couples with dependent children (usually minors), and solo parents with dependent children. More permanent "de facto marriages" should also be included in this context. Ideally the family unit should be more broadly defined to encompass other groups of persons who live together and share their household resources and responsibilities, regardless of the nature of the relationship.

> "For instance, it is legitimate to ask whether the same principle should extend to a child who supports an aged parent, two sisters who share an apartment, or a divorced parent who lives with an adolescent child. Should a relationship established by blood or marriage be demanded, to the exclusion, for example, of unmarried parents who live together, homosexual companions, and communes?"[9]

Such a broad definition is probably impracticable to administer.

6.37 The narrower the definition of the family tax unit the greater is the likelihood that ability to pay would not be adequately reflected by a household's tax liability. In other words, the narrower this definition, the greater would be the frequency of cases in which families of similar composition and the same aggregate income would continue to pay widely different amounts of income tax. On equity grounds all income of a family—

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(9) Boris I. Bittker, "Federal Income Taxation and the Family", *Stanford Law Review*, Vol. 27, p. 1398.

including that of dependent children—should be aggregated in assessing tax liability, although this is commonly not the case overseas. Most countries operating joint taxation include the income of a husband and wife only, although France, Belgium and Italy include also the incomes of dependent children. The exclusion of "earned income" (i.e. wages and salaries) of dependent children from the taxable income of families may be justified as an incentive for dependants to take up part-time employment. But the exclusion of dependants' "unearned income" (e.g. interest, dividend receipts, and rent) would provide considerable scope for tax avoidance when dependants are taxed separately and therefore, almost inevitably would cause inequities between recipients of "earned" income and of "unearned income".

6.38 The remainder of this section focuses on the "married couple tax unit", with the family unit (including children) examined in Section IV of this chapter. The desirability of joint income tax assessment of couples, however, is not dependent on any decision that may be made on the extension of the tax unit to include dependants.

6.39 A moot point is whether introducing a narrowly defined family tax unit, such as the "married couple", would result in a fairer situation than the status quo. In the Task Force's judgement the answer is "yes", insofar as this would greatly reduce the extent of anomalies between the tax liabilities of one—and two-income families.

6.40 A snag in the family unit approach to measuring ability to pay tax is that it presupposes that families do effectively share their respective total income and wealth. Although this may be true for a majority of families, no doubt there are many for whom it is not. In these latter cases, the Task Force agrees that it would be unfair to determine the tax liability of individual family members on the basis of their family's aggregate income. This is one of several reasons why the Task Force rejects the idea of *compulsory* assessment of families on a family-tax-unit basis.

6.41 The primary complaint of most critics of family or joint (i.e. married couple) assessment, concerns its impact on:

(a) attitudes towards marriage and divorce; and

(b) the incentive for spouses—chiefly wives—to obtain market employment.

This impact, however, depends principally on the nature of the tax rate scale which is applied to the individual tax unit.

6.42 Several possible rate scale approaches—in relation to the "married couple tax unit"—were considered by the Task Force:

(a) "simple aggregation"—i.e. applying the basic individual rate scale to the aggregate income of a married couple;

(b) "simple averaging"—i.e. permitting a couple *notionally* to divide its aggregate income by 2 and taxing the couple's total income at the average tax rate applicable to an individual whose income equals that quotient;

(c) "partial splitting"—i.e. permitting a couple notionally to divide its aggregate income by a divisor of less than 2, and taxing the total income of the couple at the average rate applicable to an individual whose income equals that quotient.

Compulsory Simple Aggregation

6.43 Compulsory simple aggregation would result in all couples being assessed as if the total income of each couple were received by only one spouse. It would remove the tax advantage now obtained by those couples whose aggregate income is split (whether artifically or because both spouses work) between husband and wife. Almost all two-income couples would pay more tax, with the greatest increase in tax falling on couples whose aggregate income is split about equally between the spouses. Single-income couples' tax liability would be unchanged. Essentially this was the approach which applied to higher-income couples in New Zealand from 1938 to 1962.

6.44 There are three major disadvantages inherent in simple aggregation. First, is the requirement that it be compulsory, to be effective, as otherwise virtually no two-income couple would voluntarily choose to be jointly assessed. But compulsory joint assessment would be unfair in many cases as explained earlier (paragraph 6.40 refers). Second, it would provide a significant disincentive to marriage. To avoid the higher tax rates on married couples' income, some would-be married couples may choose instead to live together unmarried, and likewise some married couples may even become divorced. Third, there seems no justification in terms of the ability-to-pay criterion for imposing such a punitive, effective tax rate scale on two-income couples many of whom incur considerable costs in order to earn their respective incomes (e.g. the cost of child care and the value of other household services forgone as a result of both spouses working). For all these reasons, the Task Force does not favour the simple aggregation approach to assessing married couples' income tax liability.

Simple Averaging

6.45 Simple averaging would enable married couples with the same aggregate income to have the same tax liability. In this sense it would be fair between couples. It could be provided on a voluntary basis, because it offers the prospect of reduced tax liability for all couples except those with equally split incomes in fact; this latter group would be no worse off. The criterion of neutrality with regard to marriage decisions seems unlikely to be met, however, since taxpayers would have a financial inducement to marry or present themselves as being "married" in order to reduce their tax bills. Under a simple averaging scheme couples would pay twice the tax of a single individual with half their total income. But this would not correspond to a fair distribution of the tax burden between married couples and single persons, as it fails to take any account of the general perception that couples (with the same per capita income as an unattached individual) do enjoy certain economies of living together and thus have a higher ability to pay tax. A further disadvantage of simple averaging is its high revenue cost, at least in the context of a steeply progressive income tax rate scale such as the present one. This could require an increase in the income tax paid by single individuals, if personal income tax revenue were to be preserved. In view of all the above shortcomings of simple averaging of couples incomes, the Task Force does not favour such an approach.

6.46 Clearly neither simple aggregation nor simple averaging of a couple's incomes provides a satisfactory basis for joint assessment of its income tax liability. The Task Force shares the Asprey Committee's view[10] that the first approach is undoubtedly too harsh on electing pairs, too kind to single persons and those who accept individual treatment", and the second is "too kind to electing pairs, too unkind to single persons and couples who require individual treatment". Mindful of the horizontal equity arguments for joint assessment, some intermediate approach between these two extremes would appear to offer the only feasible prospect of implementing it.

Partial Income Splitting

6.47 One such possible approach would be to allow married couples the option of being assessed on the basis of a sort of partial splitting, as follows. For example, a couple's aggregate income would be divided by some number less than 2 (say 1.7), in recognition of perceived economies of living together.[11] The average tax rate corresponding to this quotient under the individual rate scale is then applied to the couple's aggregate income. In essence, the couple would be taxed at the rate

(10) *Taxation Review Committee, Full Report*, Australia, 31 January 1975.

(11) The divisor could, however, be anywhere in the range 1-2. The lower is the divisor, the lower is the revenue cost of partial income splitting but also the less will be reductions in the variance of tax paid by couples with the same aggregate income.

applicable to their "adult equivalent" income (as opposed to income per head under simple averaging).

6.48 The main advantage of such an optional system of partial income splitting for couples, is that—depending on the divisor selected—it could:

(a) significantly alleviate the unfair variations in the tax liabilities of couples with the same aggregate incomes and household composition; and

(b) maintain a reasonably equitable distribution of the income tax burden between married couples and single persons.

It can also be viewed as a fairer means of assessing couples' income tax liabilities, insofar as their ability to pay tax is considered to be better measured as income per adult equivalent. An extension of this concept to the whole family unit (e.g. the French family quotient system) is examined in Section IV of this chapter.

6.49 There are a number of problems with such partial income splitting. First, it would not fully satisfy the criterion of equal income tax liability for couples with equal aggregate incomes, other things being the same. This is because some couples would still be better off by not notionally splitting their income and so would not voluntarily do so. With any divisor less than 2, if a couple's total income is *in fact* divided between them fairly equally then they would pay less tax by not using the notional income splitting formula. Nevertheless, it would greatly reduce the present degree of inequity in the distribution of the income tax between couples—this reduction would be greater the closer the divisor is to 2.

6.50 Second, there remains a major worry about the influence that even partial income splitting for couples might have on social and economic decisions. As regards its possible impact on attitudes towards marriage, it would provide less financial incentive (than simple averaging) for taxpayers to marry or pretend to be "married" for tax purposes. Of perhaps greater concern, however, is the question mark over its likely impact on the attitudes of wives towards market employment. Some people are worried that any form of income splitting would discourage wives (or husbands who are not the principal earner) from working. This may occur for two reasons:

(a) a wife may choose not to work in the market place, or to work there for less hours, because with the couple's increased after-tax income (due to partial income splitting) there is less financial need for her to work;

(b) a wife may choose to work less or not at all, because her income is subject to a higher marginal tax rate—namely that of her husband—if the couple opts to be jointly assessed.

The other side of the work-incentive impact of income aggregation for tax purposes, is that whereas one spouse in a marriage with disparate incomes will face higher marginal and average tax rates, the other will face lower rates. The net effect of the two on work/leisure choices is debatable, and would depend on work motives as well as the tax rate changes.

6.51 To minimise the possible impact which a partial income splitting scheme for couples might have on wives' participation in the labour market, the Task Force considers that such a scheme could be introduced in a way whereby the average tax rate of the lower earning spouse is not altered, with instead the entire adjustment being limited to the principal earning spouse.

6.52 A third problem with partial income splitting is that—under a progressive tax rate scale system—it would provide the greatest benefit to couples who have higher incomes and particularly those with single incomes; whereas it would be of little benefit to low-income couples and particularly those in which both spouses found it necessary to work.[12] In the Task Force's view, however, such an outcome could be justified on the grounds that it is a couple's income per adult equivalent that properly reflects their capacity to pay at *any* income level and that the gains would simply reflect the removal of a previously unfair distribution of the income tax burden. As regards couples with low aggregate incomes, their financial situation should properly be assisted—if desired—via separate measures specifically designed for the purpose of income maintenance. (This is discussed in some detail in Section IV of this chapter.)

6.53 Finally, there would also be a possible problem with such a partial income splitting scheme insofar as it would make it possible for losses of family businesses to be split between spouses, without the need for both spouses to be partners or shareholders in the business.

Administrative Implications of Partial Income Splitting

6.54 Adopting partial income splitting, or any form of family concept as the tax unit would introduce a further administrative complexity. The Inland Revenue Department has advised the Task Force that, if the basis of income splitting was kept simple with minimum alternatives to existing taxpayers requirements and procedures, it could adequately administer such an alternative for individual taxpayers without requiring a substantial increase in resources of personnel and finance. The principal difficulty relates

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(12) The impact of partial income splitting (with a 1.7 divisor) under different personal income tax scales is shown in Section V of this chapter (Tables 6.5—6.7 refer).

to policing and monitoring requirements which would have to be rigorously pursued, as the benefits of partial income splitting could be substantial.

6.55 Partial income splitting would be very difficult, if not impracticable, to incorporate on a PAYE basis. The essence of the New Zealand PAYE system is that an employer is able to calculate the tax to be deducted from two sources of information:

(a) a tax code declaration (generally made annually) by the employee; and

(b) information available to the employer from his/her own records—e.g. gross wages, superannuation contributions.

If partial income splitting were adopted, it could only be taken into account for PAYE purposes if a spouse's income were either known to the employer or somehow reflected in the employee's tax code. Clearly the former is not possible.

6.56 Reflecting a spouse's income in the employee's tax code would present immense difficulties. Incomes often vary from week to week, and spouses may enter and leave the workforce a number of times each year. It would therefore be impossible in many cases for the code selected at the beginning of the year to reflect adequately the likely annual mix of family incomes. The alternative would be to require a new tax code to be selected every time a spouse's income changed, but this would seem unworkable.

6.57 Although there would be a number of practical problems involved in implementing partial income splitting for couples on a voluntary basis, the Task Force believes that it is nevertheless capable of implementation without undue difficulty.

Recommendation

6.58 The Task Force recommends (one member dissenting) that the Government should introduce a voluntary scheme of "partial income splitting" for married couples, whereby couples would have the option of notionally dividing their aggregate income by some divisor of between 1.3 and 1.8 with their total income being taxed at the average tax rate applicable to a single individual whose income equals that quotient.

The dissenting opinion appears at the end of Chapter 6.

IV RECOGNITION OF DEPENDANTS

Introduction

6.59 A wider definition of "income" is a pre-requisite to a fairer and economically more efficient distribution of personal income tax. This is true whether the tax is assessed on an individual, joint or family tax unit basis.

6.60 But gross income, no matter how comprehensively defined, is not itself an adequate measure of a tax unit's ability to pay tax (particularly when the tax unit is the individual). Other factors also affect that ability, notably the existence of any dependants who must be supported from that unit's income. For example, it appears to be generally accepted in New Zealand that a tax unit with one or more dependants to support from *any* given level of gross income has less ability to pay tax than another with no such dependants but the same income. Accordingly, a major reason for recognising household (or family) circumstances in determining personal income tax liability is to ensure that it is distributed fairly, in terms of the ability-to-pay criterion.

6.61 Another reason for recognising household circumstances is to provide some degree of "income maintenance". The aim of income maintenance is to go at least part way towards ensuring that all households have sufficient income to enjoy a socially acceptable minimum standard of living (albeit an unspecified one).

6.62 Although both of these general aims may be widely accepted, there is nevertheless a problem with them as they can lead to conflicting conclusions. For example:

(a) in the case of two individuals who have the same assessable income level (whatever that may be) and who differ only insofar as one has a dependant to support, the generally accepted notion of ability to pay requires that the one supporting a dependant should pay less tax than the other. How much less, however, is a moot point; but

(b) in terms of financial need for "income support/maintenance", it is less necessary (if at all) to recognise the presence of someone dependent on a high-income individual than on a low-income one.

Another manifestation of this conflict is that:

(a) the ability-to-pay aim suggests that the existence of such dependence upon any individual should be *universally* recognised—i.e. irrespective of his/her income level; whereas

(b) the income maintenance aim suggests *selectivity* in targetting recognition for dependency circumstances—as this would ensure that the maximum benefit from the available Central Government budget could be directed to individuals in most need of financial assistance.

6.63 The remainder of this section chiefly considers various ways of meeting these two aims and how the inherent conflict between them may be reconciled. The main focus is on the impact which dependants have on a tax unit's ability to pay tax. So that these issues can be considered in perspective, however, the main measures in the present tax system for recognising family circumstances are briefly reviewed first. Because the family benefit is closely associated with these measures, although not in the tax system, it has been included in the review.

Present Family Assistance Measures

6.64 Family circumstances are presently recognised in the personal income tax system by various rebates of tax and in the social welfare system notably by the family benefit. The total cost of such "family assistance" measures in 1980/81 is estimated to have amounted to nearly $460 million, comprising:

Measure	Cost in 1980/81
	($ million)
Family Benefit	330
Young Family Rebate	52
Spouse Rebate	43
Low Income Family Rebate	30
Housekeeper Rebate	4
	459

Family Benefit

6.65 The family benefit is a *universal* cash allowance of $6 per week ($312 per annum) payable in respect of every child resident in New Zealand under the age of sixteen. Children between sixteen and eighteen can qualify for the benefit if they attend a school or university full time and are not in receipt of a tertiary study grant or other bursary assistance. The benefit is paid to the caring parent (normally the mother) at fortnightly intervals.

6.66 Two main aims appear to underlie the provision of the family benefit:

(a) to share the consumption costs of child rearing throughout the community; and

(b) to alleviate poverty in large families.

The level of the benefit does not seem to be closely related to any estimate of the actual cost of child rearing.

6.67 The strength and weaknesses of the family benefit as a means of channelling assistance to families are:

(a) *strengths*
- it reaches low income families with insufficient tax liability to take full advantage of tax rebates;
- it is related directly to the number of children and therefore to the consumption cost of children;
- it is paid to the caring parent; and

(b) *weaknesses*
- over one third of the total benefit is paid to high income families(i.e. those with total incomes exceeding about twice the level of average earnings in 1980/81).

Young Family Rebate

6.68 A tax rebate of up to $9 per week ($468 per annum) is allowable to the principal-income-earning taxpayer in a family with at least one dependent child who is under 5 years of age. This rebate abates by 12 cents for each dollar of the taxpayer's income in excess of $13,700 per annum until it is exhausted at $17,600 per annum.[13]

6.69 The aim of the rebate is to meet the high set-up costs of a family at a time when household income may not be very high. This was stated in the 1976 Budget:

> "The Government is keenly aware of the difficulties faced by young families on low incomes. In many cases these families are facing high mortgage costs or are trying to save for their first home. When the family has pre-school children, there is usually the added difficulty of only one income, although the mother may decide or be forced by circumstances to take employment."

6.70 The young family rebate generally appears to be quite well targetted in terms of fulfilling its aims, although it does have several shortcomings:

(a) the rebate is estimated to have missed about 2.5 percent of the target group of households in 1980/81, namely, those households which are at the lower end of the income spectrum and have insufficient income tax liability to obtain the full value of this rebate;

(b) the rebate is estimated to have given about 12 percent of the target group more assistance than would have been warranted by their aggregate household income (if the rebate abated against aggregate household income, instead of only the principal income earner's income); and

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(13) The upper bound of the abatement interval was chosen to avoid the "effective marginal tax rate" under the present personal income tax scale—i.e. the actual marginal rate (48% up to $17,600) *plus* the abatement rate (12%)—exceeding 60 percent.

(c) because the rebate ceases when the youngest child in a family is 5 years or older, it can lead to an abrupt significant drop in after-tax income for some families.

Spouse Rebate

6.71 A tax rebate of up to $3 per week ($156 per annum) is allowable to principal-income-earning taxpayers who have a dependent spouse. This rebate abates by 20 cents for each dollar of a spouse's income in excess of $520 per annum until it is extinguished at $1,300 per annum.

6.72 The aim of this rebate is to supplement the income of a taxpayer with a dependent spouse. Unlike the other family assistance measures (referred to in paragraph 6.64 above) it does not depend on the presence of children. It is therefore essentially the only measure of such assistance available for childless couples.

6.73 The spouse rebate appears to reach effectively its target group. But, it is not related to financial need for assistance. Indeed, where such need exists—for example, because of a large number of children in a family or a low principal income—frequently little or no benefit can be gained from the rebate. Also, high income and childless households do receive a good deal of this assistance. For instance, in 1980/81 only about 31 percent of households which included a couple where the principal income is less than the average weekly earning level were eligible for the rebate. By contrast 41 percent of such households where the principal income exceeded twice the level of average weekly earnings claimed the rebate.

Low Income Family Rebate

6.74 A tax rebate of up to $9 per week ($468 per annum) is allowable to the principal-income-earning taxpayer in a family which has at least one dependent child for whom family benefit may be claimed and whose gross income (i.e. principal income and spouse income combined) does not exceed a specified amount. This rebate presently abates by 12 cents for each dollar of gross family income in excess of $9,800 per annum until it is exhausted at $13,700 per annum.[14]

6.75 This rebate is targetted to families with low aggregate incomes. The group includes a significant number (about 25 percent) with a large number of dependent children and two incomes.

(14) The upper bound of this abatement interval was selected to avoid any overlap with the abatement interval of the young family rebate, which would substantially increase the effective marginal tax rate (i.e. the actual marginal rate plus the two abatement rates of 12 percent each) for taxpayers otherwise eligible for both the low income family rebate and the young family rebate.

6.76 Because the low income family rebate abates against family income, instead of just that of the principal income earner or the spouse in a family, it can cost-effectively channel assistance to those families deemed to have a financial need for it.

Housekeeper Rebate

6.77 A tax rebate of up to $3 per week ($156 per annum) is allowable in certain circumstances to a taxpayer who employs a "house-keeper"[5] to tend the home of the taxpayer or to care for a dependent child. Where the housekeeper is employed to tend the house, eligibility for the rebate is effectively limited to those cases in which a taxpayer (or his/her spouse) is disabled. Where the housekeeper is employed to care for a dependent child, eligibility is essentially limited to either:

(a) a solo parent; or

(b) a married couple, insofar as the housekeeper is engaged either:

  (i) to enable both spouses to undertake paid employment or business activities; or

  (ii) one of the spouses is disabled.

6.78 The housekeeper rebate is effectively targetted, but provides only token recognition of the costs of employing a housekeeper in the circumstances for which the rebate is intended to provide some assistance.

Impact of Dependants on a Tax Unit's Ability to Pay Tax

6.79 A fundamental assumption underlying arguments for recognising any tax unit's household circumstances is that its ability to pay tax is affected by the number and type of persons who are required to be supported from its total income. More specifically, the more people (or adult equivalents) to be supported from a given income, the less a unit's ability to pay. In this context three main types of dependants are typically distinguished:

(a) spouses;

(b) children (minor);

(c) other dependants.

The Task Force, in the time available to it, has considered only the cases for recognising spouses and minor children.

Recognition of Spouses

6.80 The inter-dependence of both partners in a marriage was an important reason for the Task Force (in Section III) favouring joint assessment of a married couple's income—albeit on a

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(15) For the purposes of this rebate the term "housekeeper" includes an institution such as a creche, day nursery, playcentre, kindergarten or similar body, but does not include any institution concerned with the education of children over 5 years of age.

voluntary income splitting basis. This approach to recognising a spouse's effect on ability to pay tax applies equally whether both spouses derive (and share) market income or one is fully dependent on the other's income. By contrast, under an individual-based system the foregoing distinction has an important bearing on what (if any) recognition should be given for a spouse.

6.81 In the context of an individual tax unit and a progressive tax rate scale, it seems appropriate to reduce a married person's income tax liability (compared to that of a single person) *only if* he/she has a spouse who is fully, or largely, dependent on his/her taxable income. This is because generally a couple in which both spouses have significant taxable incomes already obtains a tax advantage, insofar as it pays less tax than either a single person or single-income couple with the same total (taxable) income. If a spouse is dependent then it is arguable that some reduction of the principal income earner's income tax liability is necessary in recognition that two people require more income to achieve a standard of living equivalent to that of a single (adult) person. How much more income a couple requires is debatable—various overseas empirical studies suggest that couples require between 1.3 and 1.8 times the income of a single person. In practice, this issue can only be resolved on an *arbitrary* basis and the same applies to how much a principal income earner's tax should be reduced because he/she has a dependent spouse to support.

6.82 On the ability to pay criterion, the case for recognising the presence of a dependent spouse holds irrespective of the reason for that dependence. But the general acceptability of doing so, and what is the most appropriate way, may be significantly influenced by whether a spouse's dependence is voluntary or involuntary. If a spouse chooses to remain at home instead of undertaking market employment, some people may well question the desirability of "subsidising" that decision (i.e. by according the principal income earning spouse a tax reduction for that dependence). If a spouse chooses to stay at home to look after dependent children, however, there seems likely to be much less opposition to recognising the spouse's dependence. Indeed, in the latter circumstance, it may be argued that as the spouse's dependence is due to the presence of young dependent children, it should be recognised in the context of whatever allowance is made for childcare costs.

6.83 Where a spouse is dependent involuntarily because of his/her inability to obtain market employment, it could be argued that on social grounds the appropriate recognition for this circumstance would be to provide that spouse with an unemployment benefit. The question then would arise whether the size of the benefit should be influenced by the income/wealth positions of that spouse's household. For instance, if unemployment benefit were to be paid to a spouse whose husband/wife has full-time market income, then it may be desirable—in terms of the need for assistance—to either abate the amount of unemployment benefit against the other spouse's income over a given range, or to tax the benefit on the basis of the household's joint income.

6.84 Whether the presence of a dependent spouse should be recognised in cases where it is voluntary, in addition to those where it is involuntary, is a question of value judgement. The answer hinges on the trade-off between the ability-to-pay criterion and social attitudes about the appropriateness of compensating people for consequences which may be essentially of their own choosing. The Task Force considers that *actual*, rather than *potential* ability to pay (which is implied by not recognising a voluntarily dependent spouse), should be the over-riding concern.

6.85 It is also noted that the determination of income tax liability is in all other cases based on a tax unit's actual ability to pay. For example, a salary or wage earner's tax liability is not increased because he/she could, but does not, work overtime. Nor is a manufacturer's tax liability increased because he could, but does not, increase his output or operate more efficiently; and so on.

6.86 It is also true that a non-working spouse in very many cases releases a working spouse from household responsibilities, so allowing that spouse to increase his/her income earning capacity.

6.87 What mechanism is the most appropriate for recognising a dependent spouse's effect on an individual tax unit's ability to pay income tax is also basically a question of value judgement. Specifically, it depends on whether this effect is regarded as *constant* or *varying with income.*

6.88 The *former* assumption is consistent with the notion that a tax unit's ability to pay is only affected by those expenses necessary to provide for a spouse's physical subsistence and that such necessary (or non-discretionary) expenses generally do not vary with income. A *fixed rebate* would correspond to this approach. In cases where a tax unit has insufficient tax liability to utilise the rebate fully, however, this would need to be convertible into a cash refund or credit to provide the same dollar value of tax reduction in all cases.

6.89 This approach may be tempered by a belief that the financial need for such recognition of a dependent spouse diminishes as the tax unit's income increases beyond some level until eventually it is no longer necessary. An *abating rebate*—in this case one which abated to zero over a specified range of the tax unit's income—would correspond to this belief. The existing spouse rebate, which is claimable by the principal income earner, abates against spouse income thereby providing a method of defining how much income a spouse may earn before ceasing to be recognised as dependent.

6.90 The *latter* assumption in paragraph 6.87 (i.e. that ability to pay varies with income) is consistent with the belief that the presence of a spouse reduces a tax unit's ability to pay by comparison with someone else deriving the *same income* but not having a spouse to support, and that considerations of horizontal equity require the tax liabilities of the two units to bear some appropriate relationship having regard to the relative standards of living which that level of income allows each to enjoy. Essentially this conforms with the view of the Canadian Carter Commission.[16]

6.91 The Task Force shares this view. Accordingly, it considers that a tax unit's personal income tax liability should be reduced by an amount which increases with its income—at least up to a point. As already stated (paragraph 6.80 refers), the Task Force's preferred means of achieving this end is *voluntary income splitting* for married couples. Another means which corresponds to some extent to this approach (in the absence of income splitting) is a *fixed exemption or deduction* in respect of a dependent spouse. These two last devices (which are equivalent) have the following characteristics:

(a) they provide a mechanism for recognising the assumption that certain expenses to support a dependent spouse are essential—irrespective of the supporting tax unit's income level—and so should be excluded from the tax base;

(b) they yield tax relief in proportion to the tax unit's marginal tax rate —i.e. under a progressive tax rate scale, the value of relief increases progressively as income increases. This is consistent with (a) and simply amounts to relieving whatever tax otherwise would be payable on that part of the tax unit's income deemed to be spent on the "essential" costs of supporting a dependent spouse.

6.92 In summary, the following is the descending order of preference in which the Task Force ranks the various mechanisms for recognising the impact of a dependent spouse on his/her marriage partner's ability to pay tax:

(a) voluntary income splitting for married couples;
(b) a fixed exemption or deduction;
(c) a fixed rebate; and finally
(d) an abating rebate.

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(16) Reference cited.

The last three are essentially in order of increasing divergence away from the impact of income splitting. The Task Force considers that if any were in fact adopted, its value should approximate the value under (a).

Recognition of Dependent Children

6.93 On ability-to-pay grounds it is arguable that some allowance should be made for a tax unit's obligation to support dependent children, insofar as this involves extra, essential costs and so reduces its ability to pay compared with a childless unit with the same income. These extra costs comprise:

(a) **consumption costs**—such as the food, clothing, and shelter requirements of dependent children; and

(b) **child care costs**—either the direct costs of child care or the indirect cost of income forgone by a parent while caring for children.

Both types of costs are recognised to some extent by existing policy measures (as discussed earlier in this section).

6.94 Not everyone shares the view that the presence of dependent children should be recognised as reducing ability to pay tax. Its opponents argue that because children are generally the result of a choice by a tax unit, it should be the responsibility of that unit alone to meet the extra costs involved in supporting its children. Whether childless tax units should contribute towards the costs of supporting dependent children can only be answered on the basis of a value judgement. In the Task Force's perception, an overwhelming majority of New Zealanders appear to regard such a contribution as fair. The Task Force certainly considers it to be fair.

6.95 How much recognition should be accorded for dependent children is also a matter of judgement. Inevitably, it can only be determined on an arbitrary basis—subject no doubt to a Central Government revenue cost constraint.

6.96 Whether such recognition should be *universal* or *selective* is another fundamental issue. On the ability-to-pay criterion, fairness as between tax units with and without children at any given income level requires a universal recognition of the impact of dependent children—as is the case with the family benefit. But if the primary aim of recognising them is to provide financial assistance to those families or tax units which are most in need of it, then a selective approach is more appropriate.

6.97 Which mechanism is preferred for recognising the dependence of children upon a tax unit, depends—as with the case of a dependent spouse—on how this is assumed to affect the unit's ability to pay tax. For instance, if it is believed that the presence of dependent children reduces the ability to pay of a tax unit by comparison with another unit having the same income and fewer children to support, and that the tax liabilities of the two units should bear some appropriate relationship having regard to the relative standards of living which that level of income allows each to enjoy, then a *family quotient system* of income splitting would be consistent with this view. Such a system assumes that a family unit can be converted into a number of adult equivalents which does not vary with the family's income level.[17] The average tax rate applicable to a family's total income would be determined from the individual-based tax rate scale as being that applicable to an individual whose income equals the family's income per adult equivalent. This extension of income splitting to cover married couples and their dependent children, has essentially the same features and rationale as its more limited version. It would give families with higher income levels greater absolute relief for dependents than those with lower incomes, because of the greater advantages to higher income groups of splitting incomes under a progressive tax rate scale. In the Task Force's view this is simply a reflection that in the absence of full recognition of dependants, the high-income tax unit with children currently "overpays" its tax by a greater absolute amount than does a low-income no-children unit.

6.98 A *fixed exemption or deduction* for each dependent child also would provide tax relief which increased with a tax unit's income insofar as the quantum of such relief would be proportional to the unit's marginal tax rate. Alternatively, either of these mechanisms could be used simply to recognise the presence of dependent children irrespective of the number. In this case it would not be acknowledging the consumption and childcare costs of each child, but would represent some recognition of the impact of dependent children on a tax unit's ability to pay tax.

6.99 *Rebates* of tax offer a mechanism for providing tax relief which does not vary with a tax unit's income, except at the lower end of the income spectrum up to the point where income is sufficient to allow full utilisation of a rebate for dependent children.[18] This limitation could be remedied by allowing such rebates to be convertible into a cash refund or credit. Rebates could be provided on either:

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(17) In France, for example, a family's adult equivalence for tax assessment purposes is calculated as the sum of 1 for each adult plus 0.5 for each dependent child. Accordingly, a family comprising a husband, wife and two dependent children would be deemed to be equivalent to three adults.

(18) A low-income tax unit cannot utilise the full value of any rebate unless its tax liability at least equals that value.

(a) a per child basis—which would exacerbate the utilisation problem for those with low incomes, unless the rebates were convertible into a refund or credit; or
(b) a fixed rebate for the presence of dependent children, irrespective of the number.

The resultant tax relief could be limited to tax units or families with incomes in some specified target range, by *abating* (to zero) the value of a rebate over a given range of either the principal income earner's, couple's or family's income. For example, the present young family rebate is abated against the principal earner's gross income and the low income family rebate against the couple's gross income.

6.100 An alternative widely used method for recognising the presence of dependent children is *cash transfer payments* via the social welfare system. Cash transfer payments (e.g. family benefit) are analogous to rebates of tax which are convertible into cash refunds. Their principal advantage is that their value is not constrained by the amount of a person's tax liability. Another major advantage is that they can be given to any specified member of a household (e.g. the parent actually caring for a child, as in the case of family benefit) and not only to those who are taxpayers, as is the case with rebates, deductions, and refunds. Because cash transfers are independent of tax liability, they can easily be provided on a frequent periodic basis (akin to pay period). Also, fixed cash transfers provide the same amount of relief to persons irrespective of their income level, so that families with lower incomes obtain proportionately more benefit than those with higher incomes. A final argument for cash transfer payments is that the social welfare system is better geared than the income tax system to target recognition of family circumstances.

6.101 The Task Force considers that recognition of dependent children's impact on the ability to pay of any tax unit—irrespective of its income level—should be given in the form of a *universal fixed rebate per child* or a *universal fixed cash transfer payment per child* (e.g. the family benefit) despite the attraction of a family quotient system of income splitting (on horizontal equity grounds) as an alternative basis for recognising dependent children. This conclusion stems from the Task Force's view that:
(a) the family quotient system would be complex both to administer and to understand; and
(b) the introduction of income splitting for married couples would already provide substantial tax relief for families.

6.102 In the view of the Task Force an appropriate recognition of children would be to increase the family benefit by (say) $3 per week, or alternatively to provide an equivalent income tax rebate, with the former being preferred.

Recognition of Childcare Costs

6.103 At present little recognition is given to the impact which childcare costs have on a tax unit's ability to pay tax. It is recognised explicitly via the housekeeper rebate (up to $3 per week) and the charitable donations and school fees rebate (up to $3.36 per week); and implicitly via the family benefit ($6 per week per child). Yet in the case of a family with pre-school age children, for example, if both parents are engaged in market employment then a sizeable portion of the secondary-income earner's after-tax income may be spent on purchasing childcare. Such costs are not tax deductible as they are treated under law as a *prerequisite* to earning taxable income, rather than as being *incurred directly in producing* that income.

6.104 It seems clear from submissions to the Task Force that many people consider the present level of recognition of childcare costs to be completely inadequate. Whether greater recognition should be accorded for such costs and, if so, what form this should best take, involve a number of issues. First, some people argue that at present (under an individual-based system of personal income tax and a progressive tax rate scale) two-income families already derive a compensating tax advantage insofar as they pay substantially less income tax than a one-income family with the same number of children and the same total income. They argue that unless this advantage is removed (or reduced) by the introduction of:

(a) income splitting for married couples; and/or

(b) a flatter income tax rate scale;

it would be inappropriate to increase the present level of recognition of direct childcare costs. But this ignores the situation of solo parent families which seem likely to have comparatively high childcare costs yet derive no such tax advantages (i.e. because each family has only one income).

6.105 Second, in many cases the costs of childcare are implicit and difficult to measure. For example, in the case of a family in which one spouse remains at home to care for dependent children, the childcare costs correspond to the market income forgone by the spouse. It can be argued that there is an offsetting tax advantage in these cases too. This arises insofar as such families have the benefit of a wide range of other domestic services performed by the spouse at home, whereas two-income households forgo many such services because both spouses are out working in the market place.

6.106 Ideally the costs of childcare could be treated fairly in the personal income tax system by *either*:

(a) broadening the tax base to include the imputed value of domestic services (including childcare) performed in the home; or
(b) allowing the direct employment-related costs of childcare purchased in the market to be deductible from that base.

In practice, the first step would not be feasible—chiefly in view of the difficulty of imputing an acceptable market value to such domestic services. Also the integration of this specific form of imputed value into the tax system could hardly be justified if other items (e.g. rental value of owner-occupied housing) remain untaxed. The second step would also pose many practical problems as well as constituting a significant, explicit exception to the longstanding tax policy criterion that only those costs directly incurred in producing assessable income should be deductible.

6.107 In the light of the foregoing arguments, the Task Force considers that:

(a) the present level of explicit recognition of direct employment-related childcare costs' impact on ability to pay tax should be increased for two-parent families if:
  (i) income splitting is introduced (on a voluntary basis) for married couples, in which event the level of recognition should be higher the nearer the income-splitting divisor is to 2; and/or
  (ii) the personal income tax rate scale is significantly flattened;

  either of which events would significantly reduce the tax advantage currently enjoyed by two-income families, vis-a-vis single-income families;
(b) greater recognition of direct childcare costs should be given to solo parent households, irrespective of whether (a)(i) and/or (ii) occur(s);
(c) the most practical means of providing relief in respect of direct childcare costs for solo parent families and those with both spouses working is to substantially increase the present housekeeper rebate; and
(d) if "partial income splitting" (i.e. with a divisor of less than 2) is introduced for married couples, on a voluntary basis, then a couple with dependent children should not be permitted to claim the increased housekeeper rebate unless it notionally splits its income in accordance with this divisor. In this way any advantage there may be from not notionally splitting would effectively be netted out from the rebate. Otherwise a two-income family in which both spouses have say equal incomes would benefit from not splitting and also from the greater recognition of childcare costs.

Income Maintenance and Assistance

6.108 The aim of designing a tax system which is fair in terms of recognising the relative effect of dependants on a tax unit's ability to pay should not be confused with the aim of ensuring that all households have a generally acceptable minimum income level which will depend on the number and type of dependants involved. Certainly there is no guarantee that meeting the former aim will also result in the latter being met. For the sake of simplicity, the Task Force considers that it would be desirable to separate income-maintenance instruments from any other recognition of dependants, for horizontal equity reasons, in the tax (or social welfare) system.

6.109 In the view of the Task Force, the conflict between the horizontal equity aim and the income support/maintenance aim, should be resolved by:

(a) *universal* recognition of the presence of a spouse and dependent children to ensure that income tax is fairly distributed in terms of horizontal equity; and

(b) *selective* recognition of the same factors, to provide income maintenance/support to tax units whose total income is unacceptably low in the light of their family circumstances.

To achieve the latter end, the Task Force considers that the present low income family rebate—if it is increased substantially—offers a practical means of targetting income support to those families which are most in need. The abatement of this rebate against the couple's aggregate income, over a particular income range, is an effective method of targetting assistance.

Recommendations

6.110 The Task Force recommends that:

(a) a spouse's impact on a tax unit's ability to pay tax should be recognised by introducing "partial" income splitting for married couples on a voluntary basis (see recommendation in Section III);

(b) if recommendation (a) is introduced, then the present spouse rebate and the young family rebate should be abolished as they would no longer be necessary on horizontal equity grounds;

(c) if recommendation (a) is not acceptable, recognition for a dependent spouse should be given—in the following descending order of preference —namely:

(i) a fixed exemption or deduction;

(ii) a fixed rebate; or

(iii) an abating rebate;

These three are essentially in order of increasing divergence away from the impact of income splitting. If any were in fact adopted they should approximate the value under income splitting.

(d) dependent children's impact on a tax unit's ability to pay tax—irrespective of its income level—should be recognised by either:
   (i) a universal, fixed rebate for each dependent child (i.e. one in respect of whom family benefit may be claimed); or
   (ii) a universal, fixed cash transfer payment per child (e.g. the family benefit);

   with an increase (of say $3 per week) in the family benefit being regarded as the most practicable means of giving effect to this recommendation;

(e) the present level of explicit recognition of direct, employment-related childcare costs' impact on two-parent families' ability to pay tax should be increased in the form of an increased housekeeper rebate, provided that:
   (i) income splitting is introduced for married couples, in which event the level of recognition should be higher the nearer the notional income-splitting divisor is to 2; or
   (ii) the personal income tax rate scale is significantly flattened;

   in either case sizeably reducing the tax advantage currently enjoyed by two-income families, vis-a-vis single-income families;

(f) if voluntary, partial income splitting is introduced for married couples, then a couple with dependent children should not be permitted to claim the increased housekeeper rebate unless it notionally splits its income in accordance with the specified divisor (of less than 2);

(g) greater recognition of direct, employment-related child-care costs should be given to solo parent households, via the housekeeper rebate, irrespective of whether (e)(i) and/or (ii) occurs; and

(h) the low income family rebate should be retained, and increased substantially, in order to provide a generally acceptable level of income support/maintenance to eligible low income families. An increase to $25 per week would seem appropriate.

V. TAX RATE STRUCTURE

Introduction

6.111 The present scale of personal income tax rates has been widely criticised as both discouraging productive effort on the part of those persons who cannot avoid most of their income being subject to it, and encouraging tax avoidance and evasion. Mindful of such serious criticisms, the Task Force in this section first analyses the implications of the present type of scale in terms of fairness, economic efficiency and revenue collection. The remainder of the section is devoted to an examination of what reforms of the present rate structure are desirable and feasible in the Task Force's view.

Present Rate Scale Structure

6.112 With effect from 1 February 1981, the following scale (shown in Table 6.3) has been the basis for taxing the personal income of individuals.

Table 6.3

PRESENT SCALE OF PERSONAL INCOME TAX RATES: EFFECTIVE FROM 1 FEBRUARY 1981

Taxable Income Range	Marginal Tax Rate[1]	Average Tax Rate At Top of Range
($)	(%)	(%)
0—5,500	14.5	14.5
5,500—12,600	35	26.1
12,600—17,600	48	32.3
17,600—22,000	55	36.8
Over 22,000	60	—

(1) The marginal tax rate applies to that portion of an individual's taxable income in the corresponding income range—e.g. an individual whose taxable income is $12,600 would pay tax at the rate of 14.5 per cent on the first $5500 of taxable income, and 35 per cent on the balance.

6.113 The origin of this scale dates back to 1 October 1978. Prior to this, personal income tax was levied on the basis of a complex scale—comprising 19 marginal tax rates and a corresponding series of small brackets of taxable income. Thenceforth it was replaced by a 5-rate scale with each rate applying to a much larger income bracket. This new rate structure has since been modified three times, mainly to provide some compensation for the effect of inflation on taxable incomes and thereby average tax rates. Thus the present scale is a fourth generation development of the October 1978 scale, although its shape has changed significantly as explained later in this section (in paragraph 6.123).

6.114 In the Task Force's view, there are three main (inter-related) problems with the rate structure which the present tax rate scale typifies, namely:

(a) marginal tax rates are too high relative to average tax rates for the vast majority of taxpayers;

(b) marginal tax rates rise very rapidly for the bulk of taxpayers— notably those in the middle range of the income spectrum;

(c) taxpayers with low- and middle-range incomes are subject to a high, but variable, degree of fiscal drag.[19]

These three features have important implications for the alleged distortionary impact of the present system of personal income taxation, the fairness of the distribution of the tax burden resulting from it and its revenue-collection ability.

Marginal Relative to Average Tax Rates

6.115 The first consideration about the design of any personal income tax rate scale is what amount of revenue it must yield. Given the distribution of adult individuals by total income ranges (see Figure 6.1 of Section II of this chapter), this revenue goal determines the overall average tax rate. A wide variety of marginal rate scales may fulfill any particular revenue goal. For example, in fiscal year 1980/81 the average rate of personal income tax assessed under the present rate structure was about 26 percent. This same average rate could have been produced instead by a much less progressive rate structure than the current type, with the extreme being a uniform proportional rate scale of 26 percent. The scope for variations, however, is limited economically by the actual distribution of taxable income and politically by the maximum marginal rates that may be applied—without losing general acceptance—to the lower and upper ends of the income spectrum.

6.116 The significance of these observations stems from the impact which marginal and average rates of personal income tax can have on economic and social decisions. High marginal rates of personal income tax are widely perceived to be both unfair and a disincentive to productive effort. The extent to which high marginal rates do actually distort choices between work and leisure is difficult to gauge, as people respond in different ways to rising

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(19) Fiscal drag refers to the impact of inflation on average tax rates under a progressive personal income tax rate scale (see paragraph 6.127 ff)

marginal tax rates. But the higher are marginal tax rates on employment income, the less will be the net benefit from:

(a) entering the workforce (in the case of a housewife);
(b) increasing the number of hours worked (in the case of part-time workers or overtime); and
(c) accepting promotions and thereby greater responsibility.

This may persuade some people that the return on the extra work involved in such options is not worth the extra effort. Others, however, may be induced by high average rates of personal income tax to work harder or longer in order to obtain a given level of after-tax income—e.g. to meet fixed commitments or to achieve a particular living standard.

6.117 There is no absolute criterion for judging if marginal or average rates of personal income tax are "high" or "too high" for any given level of taxable income. This is a matter of individual, subjective perception. It may be influenced by marginal and average rates perceived to be applying overseas to comparable income levels, or by those applying in New Zealand to income levels above and below that of a particular individual.

6.118 For whatever reason, however, it seems clear from submissions to the Task Force that a large number of taxpayers regard their present marginal tax rates as "high", if not "too high". It is also clear that for the vast majority of taxpayers marginal tax rates need not be as high as they presently are relative to average tax rates. In other words, the same overall average rate of personal income tax—and thereby the same personal income tax yield—could be achieved with a flatter marginal rate structure.

6.119 Nor is there any conclusive empirical evidence to confirm the alleged disincentive impact of the present type of personal income tax rate scale. But the Task Force has been left in no doubt that the present scale is unacceptable to a large number of taxpayers. This may be due simply to concern that marginal rates are "too high" or may be reinforced by a belief that many people receive income which is outside the present tax net and so escapes these (perceived) "high" marginal rates. Regardless of the reasons for such unacceptability, it can be expected to lead to increased avoidance and evasion of personal income taxation because the New Zealand tax system relies heavily on voluntary taxpayer compliance which, in turn, requires the system generally to be seen as fair.

6.120 The higher are marginal tax rates, the greater is the incentive to avoid or evade tax. The more widespread is tax avoidance and evasion, then the greater will be the erosion of the personal income tax base and the higher must be marginal tax rates on those incomes still subject to tax in order to yield any given revenue target, let alone a rising one.

6.121 In summary, it appears that the present rate structure is unsatisfactory insofar as:

(a) its marginal rates are widely regarded as being "too high", whereas the present revenue yield could be met without their being nearly so high for the vast majority of taxpayers;

(b) its "high" marginal tax rates tend to distort economic choices, in particular, by encouraging tax avoidance and evasion and probably also by discouraging many taxpayers from achieving their productive potential; and

(c) by encouraging tax avoidance and evasion, it also tends to result in a cycle of still higher marginal rates being required on the incomes of those people who are not avoiding or evading tax.

All these features of the present rate structure lead the Task Force to conclude that it is most desirable that personal income tax should be levied on the basis of a much less progressive marginal rate structure.

6.122 The Task Force recognises that introducing a less progressive scale would have the disadvantage of achieving a less egalitarian distribution of after-tax income than at present. But its distributional impact would be relatively small because of the already very compressed distribution of before-tax incomes (as indicated by Figure 6.1 of Section II).

Progressivity of the Scale

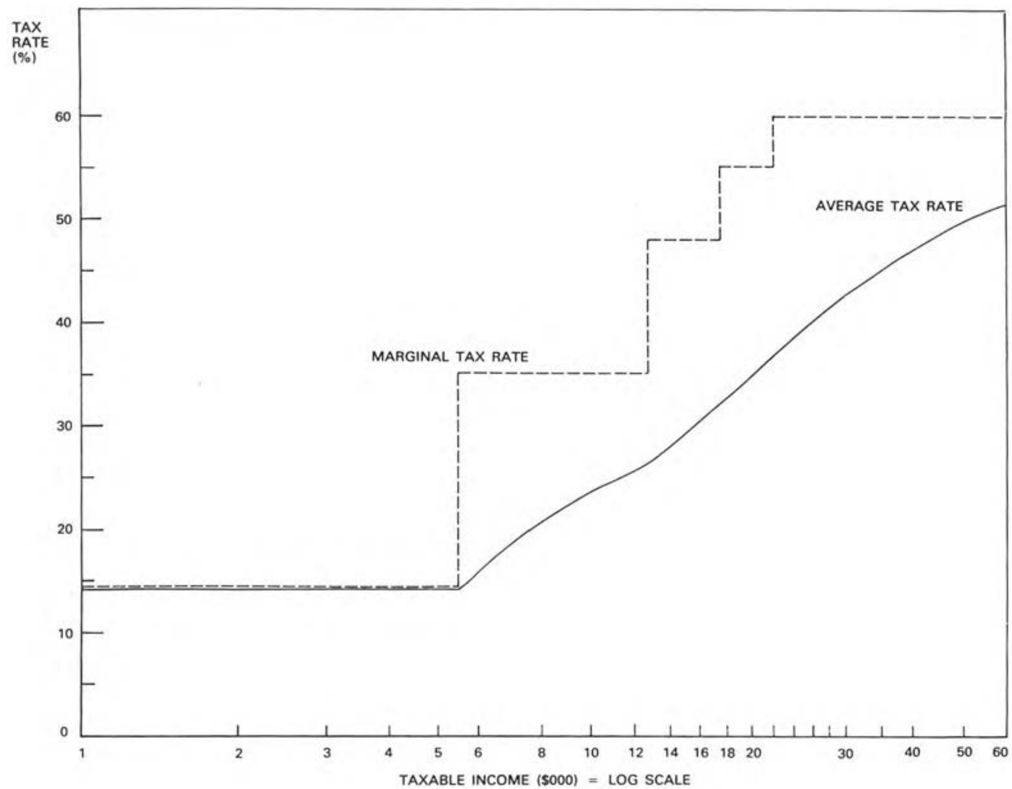
6.123 Marginal tax rates are not only higher than they need to be for a vast majority of taxpayers, but also rise very rapidly as their taxable incomes increase—as depicted in Figure 6.3 below. Specifically, the marginal rate rises from 35 percent to 60 percent (a 71 percent increase) as taxable income rises from $12,600 to $22,000 (an increase of about 75 percent).

This rapid progressivity over the middle-income range is due to a combination of three factors:

(a) *narrow income brackets*—these have arisen largely because the present form of scale has been only partially indexed since it first took effect in October 1978 (as shown in Table 2.9 in Chapter 2), and the threshold for the maximum marginal rate has not been increased since 1975);

(b) *big jumps in rates*—between the first (14.5%) and second (35%) steps in the present scale. The marginal tax rate jumps by about 140 percent, and by nearly 40 percent between the second and third (48%). This latter rise is of more concern, however, since it comes at around the average earnings level in 1981/82 (about $256 per week or some $13,300 per year) and therefore affects a large number of income earners; and

Figure 6.3
PRESENT SCALE (EFFECTIVE FROM 1 FEBRUARY 1981)



(c) *high inflation*—the rapid increase in nominal incomes, notably wages and salaries, over the past three years has pushed more taxpayers into the high tax rate brackets—particularly as the thresholds have been only partly indexed. (This is shown clearly in Chapter 2, Table 2.9).

6.124 Such rapidly rising marginal rates tend to compound any disincentive effects of marginal rates simply being regarded as "high" at a given income level. For example, if an employee with an ordinary-time taxable income of $17,000 per year is already unenthusiastic about working overtime because the resulting extra pay would be taxed at the rate of 48 cents per dollar, he would certainly be much more unwilling to earn more than an extra $600 (gross) in overtime pay because the surplus above that amount would be taxed at 55 cents per dollar. In other words, the employee would only need to work 1 hour overtime per week to cause his marginal tax rate for PAYE purposes[20] to rise from 48 to 55 percent. This feature of the present rate structure is all the more significant because the bulk of *full-time principal earners*—who are predominantly wage and salary earners—fall within the $12,600—$22,000 range of taxable incomes.

6.125 A highly progressive rate structure such as the present one has several other undesirable consequences which have been a focus for criticism in submissions to the Task Force. Most notable of these is the fact that under an individual-based system of personal income tax, the more progressive is the rate scale then the greater are the horizontal inequities between households with equal aggregate incomes and similar family composition. (This aspect is discussed in detail in Section III of this chapter). Another consequence is that the degree of so-called "period inequity" increases with the progressivity of the scale. Period inequity arises in two main ways. First, under a progressive rate scale people with fluctuating incomes pay more income tax than people whose incomes are essentially constant from year to year, or fluctuate less. Second, under a progressive scale expenditures may be incurred in a given income year in producing taxable income and are deductible in that year at one marginal tax rate; whereas the resultant income may be produced in another income year and subject to a quite different marginal tax rate. Such inequity is common in the tax treatment of farming and superannuation income and expenditure.

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(20) On a PAYE basis, 1 hour's overtime at "time and a half" is treated as an annual increase in income of $637—i.e. $37 in excess of the 55 percent marginal tax rate threshold.

Fiscal Drag

6.126 Directly associated with the foregoing features of the present type of rate structure is a high and variable degree of "fiscal drag" for the bulk of taxpayers—i.e. those with low- and middle-range incomes. Fiscal drag refers to the effect of inflation on average tax rates under a progressive rate structure. Given a progressive scale applying to *nominal* incomes, then average tax rates will rise under inflationary conditions without there necessarily being any *real* increase in a taxpayer's incomes—as is the case when the cost of living increases at the same rate as nominal incomes generally.

6.127 Fiscal drag can be measured in a variety of ways, depending on whether it is thought of in terms of increasing the Central Government's tax revenue or decreasing taxpayers' real after-tax incomes. From an individual taxpayer's viewpoint it is pertinent to measure fiscal drag as:

- the proportionate amount of extra income required to maintain a taxpayer's real disposable income level, relative to a given increase in price and wage inflation.

This ratio is commonly referred to as the "real disposable income ratio" (RDIM).[21] Corresponding to each level of taxable income—under a given rate scale—is a particular value of this ratio which shows how taxpayers at that income level may be affected by inflation. For example, if prices generally rose by 1 percent, then a taxpayer whose income corresponds to a ratio of 1.6 would require a 1.6 percent increase in income to maintain the purchasing power of his/her after-tax income. Figure 6.4 below shows how the ratio varies with different income levels under the present scale of personal income tax.

6.128 It is readily apparent from Figure 6.4 that fiscal drag (measured in this way) is indeed high and variable. The relatively high degree of fiscal drag is directly attributable to the sizeable gap between average and marginal tax rates at most taxable income levels beyond the first bracket. This gap is due chiefly to the extremely large jump from the first to the second step in the scale and is exacerbated by the subsequent sizeable, although reducing steps. In other words, a root cause of the present level of fiscal drag is the 14.5 percent initial marginal tax rate which is very low relative to most taxpayer's average tax rates.

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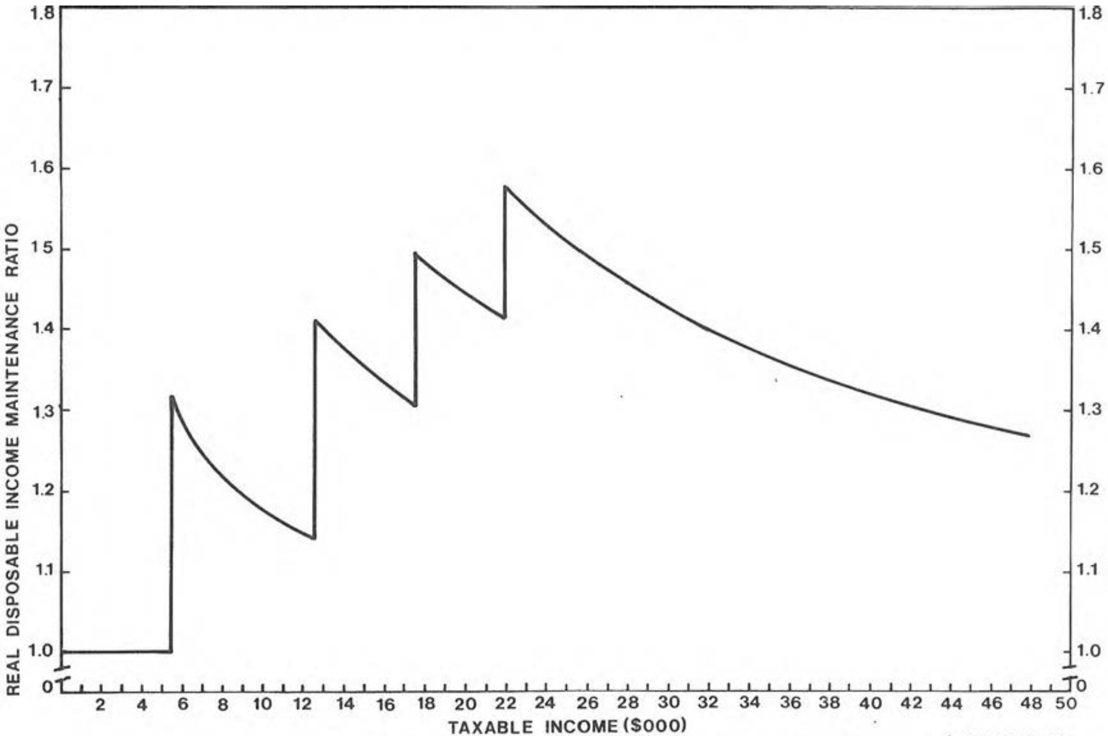
(21) Algebraically the real disposable income maintenance ratio (RDIM) may be expressed as follows:

$$\text{RDIM} = \frac{1\text{—average tax rate}}{1\text{—marginal tax rate}}$$

Under a uniform, proportional rate scale this ratio would be 1.

Figure 6.4
FISCAL DRAG DUE TO THE PRESENT PERSONAL INCOME TAX SCALE: BY TAXABLE INCOME LEVELS



Note: Fiscal drag is measured as the real disposable income maintenance ratio (RDIM), where RDIM = $\frac{1\text{—average tax rate}}{1\text{—marginal tax rate}}$

6.129 Both the fiscal drag and its variability are undesirable in the Task Force's view. A high level of fiscal drag may further tend to discourage productive effort, whereas the variability of fiscal drag results in unwarranted differences in the extent to which inflation affects the tax liability of taxpayers with different income levels. A flatter tax rate structure than at present, including a higher initial marginal rate, would also go a long way towards alleviating this problem.

Factors Affecting Rate Structure Reform Possibilities

6.130 Having focussed on the major deficiencies inherent in the present rate structure, the question to be answered is how these can be remedied, or at least alleviated. As already indicated, there appears to be a strong prima facie case for reducing the progressivity of the rate structure. How much it should be reduced is a moot point. Before considering any specific avenues for reform, however, it may be helpful first to review general factors which set the bounds for such reform. These factors include those general features of the present type of progressive rate structure and their inter-relationship with the underlying distribution of individuals' personal taxable incomes (see Figures 6.1 and 6.2 and Table 6.1 in Section II of this chapter).

6.131 How progressive or otherwise the personal income tax rate scale should be is largely a value judgement. Any such decision would need to have regard to the degree of progressivity inherent in the tax system as a whole, and indeed the wider fiscal system (including the distribution of social welfare transfer payments and the benefits from government-provided services). For example, to the extent that switching to greater reliance on indirect taxation may be regressive initially, this may make a reduction in the progressivity of the personal income tax rate scale less desirable on distributional grounds. This is because under a flatter scale incorporating a higher initial marginal rate, people with lower-incomes would pay a higher percentage of their income in tax, in addition to paying a higher proportion of their after-tax income in indirect taxes. This poses a dilemma if it is considered necessary to compenste *all* people with lower incomes for an increase in their total tax liability due to flattening the scale in conjunction with a switch to a greater degree of indirect taxation. The two goals would be conflicting and must therefore be traded off.

6.132 Another important consideration in the design of any personal income tax rate structure, is how inflation will affect the distribution of average tax rates. The greater the gap between average and marginal rates, the shorter-lived will be the desired distribution of average tax rates. For example, if each marginal rate in the present scale were cut by 20 percent, without any change in the income brackets, the benefit to someone with a taxable income of $12,600 (the top of the first bracket) would be fully offset by an increase in his/her taxable income of only about 13 percent. In other words, the benefit would be very short-lived unless the scale was indexed frequently, which has not been the general experience.

Initial marginal tax rate and low-income taxpayers

6.133 In a stepped marginal rate structure such as the present New Zealand personal income tax rate scale, the initial rate level has a crucial effect on the entire scale. As the initial marginal rate applies to all taxpayers—not just those whose total taxable income lies within the initial tax bracket— increasing it even slightly would have the advantage of producing a disproportionately higher amount of extra tax revenue, and conversely. To the extent that the initial rate was increased, therefore, it would provide scope for reducing marginal tax rates for those persons with taxable incomes in the middle to upper-range.

6.134 The main problem with raising the initial marginal rate is that— other things being equal—it would raise income tax liability of taxpayers with very low taxable incomes, which may be regarded as unfair. Indeed, at first thought one might consider a near-zero rate to be more appropriate, despite its undesirable implications for fiscal drag and the revenue yield. Whether this is so, however, would depend largely on what kinds of people have low taxable incomes. This is discussed in paragraph 6.150 below.

6.135 A perspective on some of the implications of adjusting the initial marginal tax rate can be gained from considering two opposite adjustments to the 1 April 1980 scale. Namely:

(a) raising the initial rate from 14.5 percent to 25 percent; and
(b) lowering it to zero.

Based on the estimated distribution of personal taxable incomes in fiscal year 1980/81 (which was derived from adjusted 1979/80 Household Survey data), approximately 50 percent of the nearly $800 million in extra tax from raising the initial rate to 25 percent would have fallen on households receiving total income per annum in excess of 2 times the average weekly earnings level (about $20,500 per annum for the whole of 1980/81). About 34 percent of the extra burden would have fallen on those households earnings 1 − 2 times the average weekly wage; and 17 percent on those earning less than the average weekly wage, including only about 3 percent with total incomes within the then $4,900 initial rate bracket. However, the extra tax liability as a percentage of total household income would have been greater for hose with lower incomes than with higher incomes.

6.136 About 45 percent of the almost $1,000 million revenue that would have been forgone in 1980/81 from lowering the initial rate to zero, would have benefited households with total incomes in excess of 2 times the average weekly earnings. About 35 percent of it would have benefited those in the 1 – 2 imes average weekly earnings range, and only 20 percent would have benefited those with weekly earnings less than the average. But the benefit as a percentage of total household income would have been greater for those with higher incomes than with lower incomes.

6.137 The lesson from both of these examples is that any adjustment of the initial marginal rate affects taxpayers at *all* levels of taxable income. Reducing this rate, therefore, is not a cost effective means of assisting those persons with low-incomes, since almost 80 percent of the benefit would go to households with income in the middle- and high-income ranges. By contrast, increasing the initial rate even moderately would provide considerable scope for reducing the marginal rates (and as a result, fiscal drag) in the middle-income range.

Maximum marginal tax rate and high-income taxpayers

6.138 It is sometimes argued that there is scope for redistributing the income tax burden from the lower to the higher income groups. In fact, because of the nature of the distribution of individuals' taxable income (as indicated in Figure 6.1, of Section II, Chapter 6) there is little scope for financing tax reductions for those on lower incomes by tax increases for those on higher incomes—there are too few taxpayers in the higher-income range. Conversely, the revenue cost of lowering marginal tax rates for these taxpayers would be comparatively small.

6.139 The choice of what the maximum marginal rate should be, therefore, depends on non-revenue considerations such as its effect on economic decisions, and the desired level of progressivity in the tax system as a whole.

Middle-income taxpayers

6.140 Most full-time earners have taxable incomes in the "middle-range" which may be defined as extending roughly from 1 to 2 times the level of average weekly earnings. It is this category of taxpayers who have been experiencing most of the worst features of the present scale. Any reduction of marginal tax rates for them, however, would be costly because of the total amount of taxable income involved. Also, a cut in marginal rates for the middle-range of incomes would inevitably reduce the tax payable by all those with incomes above this range.

Avenues for Reforming the Rate Structure

6.141 A recurring theme which has emerged from the Task Force's examination of the present type of personal income tax rate structure, is the desirability (on many grounds) of flattening this rate structure. At the extreme, a uniform proportional rate scale would be consistent with this view. Although it would fully overcome a number of major problems inherent in the present rate structure, it would also entail some serious disadvantages. An acceptable solution, therefore, is more likely to be a scale which is significantly less progressive than the present one but not proportional.

6.142 Nevertheless, it is instructive to consider the pros and cons of a proportional scale as it highlights the issues involved in flattening the present rate structure and so provides a useful reference point. Accordingly, the following paragraphs consider the general characteristics of first a uniform proportional rate scale and, second, several less extreme types of flatter scales.

Proportional Tax Rate Scale

6.143 The impact of a proportional scale depends largely on the level of rate set. For example, the following table shows the variations in the break-even level of taxable income for a shift from the present personal income tax rate scale to several flat rates of tax.

Proportional Tax Rate	Break-even Taxable Income Level[1]
(%)	($ p.a.)
20	7,650
25	11,500
30	15,500
35	20,150

(1) Below the break-even taxable income levels tax liability is increased, and above them it is reduced.

6.144 The choice of break-even level is constrained by the amount of tax revenue that can be forgone altogether or otherwise be obtained—e.g. from the introduction of a broad-based tax on consumption expenditure and/or adoption of a more comprehensive definition of taxable income.

6.145 Irrespective of the rate, any proportional scale has certain general features. These are categorised below into advantages and disadvantages.

Advantages

6.146 Adoption of a proportional scale for assessing personal income tax would:

(a) reduce the fiscal drag effect of the scale to zero;

(b) remove the argument for income splitting—i.e. to overcome inequities due to the individual tax unit in the context of a progressive tax rate scale—and with it the risk of inequities and social problems associated with any version of income splitting which does not embrace all types of households (e.g. is limited to married couples);

(c) make tax liability much simpler to calculate and its collection via PAYE much easier;

(d) facilitate the integration of company and personal income taxation, by permitting the deduction of tax *at source* for dividends paid; and

(e) eliminate "period inequities" of the kind described in paragraph 6.125 above, and the associated need for income averaging to overcome such inequities experienced by people with markedly fluctuating incomes.

6.147 In the Task Force's view the most important advantage of a proportional scale—provided the rate is not set too high (e.g. say does not exceed 25 percent)—is that it would:

minimise the *perceived* disincentive impact of high marginal tax rates on tax evasion and avoidance, and on work, saving and investment decisions—for any given personal income tax revenue goal—because the level of marginal tax rates for all but relatively low income recipients would likewise be minimised, other things being equal.

Disadvantages

6.148 The main features of adopting a proportional scale which are likely to be perceived by many as disadvantageous are that it would:

(a) clearly not distribute tax liability progressively amongst taxpayers, which may be considered unfair in terms of ability to pay criteria;

(b) increase the tax liability of those persons with relatively low taxable incomes—i.e. those with incomes below the break-even level—which may be considered unfair;

(c) benefit higher income earners proportionately more than low income earners, which may be regarded as unacceptable—particularly because of:

(i) the limited scope for personal income tax reductions, given the Government's budget constraint; and

(ii) the more so, if personal income tax scale changes were financed by a switch to greater reliance on a broader-based consumption tax (e.g. VAT or an extented wholesale sales tax) the immediate burden of which may be regressive.

6.149 The first disadvantage, however, may be much less of a real problem than it appears at first sight insofar as:

(a) the distribution of taxable income is very compressed in New Zealand and the bulk of taxpayers therefore have average tax rates (under the present progressive scale) which lie in a fairly narrow range. As a result the redistributive impact of shifting to a proportional scale would be less than generally appreciated; and

(b) the narrowness of the present income tax base—despite the present progressive scale—means that the income tax burden is distributed much less progressively than it would be in terms of a more comprehensive definition of income (i.e. one that more accurately reflects ability to pay tax). Indeed, in these terms it may be regressive for the upper taxable income range.

6.150 The second disadvantage—i.e. a higher tax liability for persons with low taxable incomes—also may be a less extensive problem in economic reality insofar as the taxable income of certain types of *individuals* tends to understate their ability to pay tax:

(a) spouses' (e.g. in households with middle to high aggregate incomes) and other dependants' (e.g. a child, young adult apprentice or student) ability to pay tax arguably is a function of both their own income and that of others in their resource-sharing household—notably the principal income earner whose income they supplement.

Given this view it is arguable that such individuals with low *taxable* incomes for years may have paid less income tax than was appropriate in terms of ability to pay, so that an increase in their tax liability is justified. An increase may be further justified to the extent that each such individual's household benefits overall from the scale reducing (often substantially) the tax liability of the household's principal income earner;

(b) social welfare beneficiaries (other than national superannuitants) whose benefits generally are not taxed, but who may earn additional taxable income of up to a maximum of $40 per week ($2,080 p.a.) before ceasing to be eligible for the benefit; and

(c) some principal income earners—e.g. some self-employed individuals— who currently:

(i) can effectively split their income amongst family members; and/or

(ii) have substantial non-taxable benefits (tantamount to income) such as the use of their own production and the provision of a phone, car and other items as deductible business expenses.

6.151 Inevitably, however, there would be some low-taxable-income individuals whose economic circumstances would justify provision of at least partial compensation for the increased tax liability resulting from adoption of a proportional scale. The number of such persons would depend largely on:

(a) the level of proportional rate adopted; and

(b) the level of disposable income (and corresponding taxable market income) deemed to be a generally acceptable and adequate minimum for a single adult supporting himself/herself—on the assumption that different family circumstances (e.g. the presence of dependants) or other special circumstances (e.g. disability) are, or should be, otherwise taken into account (e.g. via tax rebates or social welfare payments).

Summary

6.152 The case for a proportional scale rests essentially on the expectation that it would improve economic efficiency—by generally reducing both the incentive to avoid or evade tax and any disincentive to work—and so lead to a general improvement in economic welfare. The associated demise of fiscal drag due to the underlying scale itself, easier administration, and defusing of tax unit problems may be regarded as secondary benefits.

6.153 The main argument against a proportional scale is likely to be that it would clearly not distribute the burden of personal income tax progressively, whereas many people may wish to see at least some degree of progressivity— even if it effectively is less than the scale suggests. The fact that individuals with low taxable incomes would pay more if a proportional scale were introduced may be of lesser concern, insofar as it arguably is justifiable in some cases and in others can justifiably be compensated for.

Largely Proportional Scale

6.154 If a proportional scale is not acceptable, then it could be modified in one of the following three ways, while still retaining a sizeable degree of proportionality:

(a) by introducing progressivity at the upper end of the scale;

(b) by introducing progressivity at the lower end of the scale; or

(c) by a combination of both—i.e. a so-called "double-ended progressive" scale.

6.155 The impact on the average tax payable by the majority of taxpayers, of choosing one of the foregoing approaches instead of a given proportional tax rate, is shown graphically below in Figure 6.5(i)-(iv).

Largely Proportional Scale with Progressivity in Higher Income Range

6.156 A scale which is proportional for low—to middle-income level taxpayers and thereafter progressive, would have the following advantages:
(a) it would enable a slightly lower rate to apply to all individuals with taxable incomes on the flat step, than under an equi-yield proportional scale (see Figure 6.5 (i) and (ii);
(b) it would reduce the need for changing from the present individual tax unit;
(c) for the majority of taxpayers it would have the other benefits of a proportional scale (see paragraphs 6.146—6.147).

6.157 Its main disadvantages would be:
(a) an increase in the tax liability of people on lower taxable incomes; and
(b) people with higher taxable incomes would be taxed at higher average and marginal tax rates than otherwise necessary.

Largely Proportional Scale with Progressivity over Lower Income Ranges

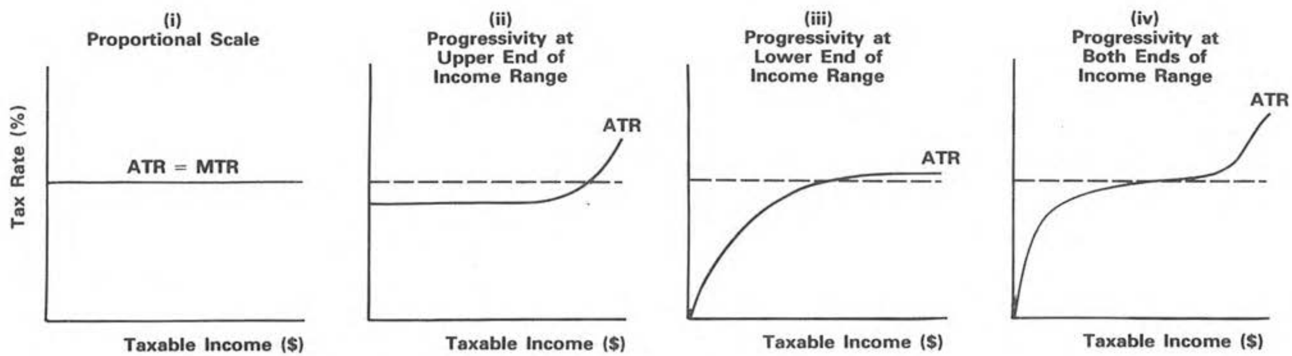
6.158 A scale which is markedly progressive over the lower range of taxable income and thereafter essentially proportional would have:
(a) the advantages of proportionality for taxpayers with higher incomes while permitting low average rates of tax for those on lower taxable incomes; and
(b) the disadvantage that low marginal rates on the initial income bracket(s) would benefit all taxpayers, not just those in the lower taxable income range; and
(c) the further disadvantage that the flat rate component of the scale would need to be higher than necessary under an equi-yield, proportional scale (see Figure 6.5 (iii)).

Double-Ended Progressive Scale

6.159 This type of scale is a combination of a scale with progressivity at the top end of the income spectrum only and one with substantial progressivity at the bottom due to either a zero or

Figure 6.5

VARIATIONS ON A PROPORTIONAL SCALE



Note: ATR = average tax rate
MTR = marginal tax rate

very low marginal rate on the initial bracket of taxable income. It represents a compromise between a desire to reduce the tax burden of low-income taxpayers and a desire to tax those on high incomes at higher average rates. As a result, introducing such a scale would have:

(a) the effect of distributing the tax burden more progressively than under the present type of scale, the extent depending how low is the initial marginal rate; and
(b) the disadvantage of highly progressive marginal rates for taxpayers with low and high taxable incomes, and therefore
(c) the bulk of taxpayers would face a higher than otherwise degree of fiscal drag; and
(d) higher marginal rates for most taxpayers.

6.160 The marginal rate for the middle-income bracket of this type of scale would be lower:

(a) the higher is the initial marginal tax rate;
(b) the smaller is the income range to which the lower marginal rates apply; and
(c) the lower is the income level at which higher-income progressivity begins.

Summary

6.161 If a proportional scale is unacceptable, then a scale with a modest degree of progressivity over either the lower—or higher-income range, or both, and with a long flat bracket for the majority of individuals, may offer a reasonable compromise between economic efficiency and equity goals. *This is the Task Force's preferred approach.*

Illustrative Scale Options

6.162 The following four types of personal income tax rate scales *illustrate* the rate structure shapes which the Task Force consider could feasibly replace the present scale, provided that the threshholds of the illustrative scales were increased to take account of the estimated general increase in income levels between 1981/82 and 1982/83.

6.163 The *first two types of scale* represent the shapes of rate structures which the Task Force believes would be the most desirable. Both are much less progressive than the present scale for most taxpayers. Their impacts would depend on the level at which their respective marginal rate profiles are set, and this would depend primarily on what level of income tax cuts may be considered feasible by the Government—in view of its budgetary constraints. For example, the $1,000 million revenue cost options in 1980/81 terms—which are depicted in figures 6.6 and 6.7—may require a corresponding switch to greater reliance on indirect taxation. This may take several years to implement. A range of scales having one or other of these two basic shapes, but corresponding to different revenue costs in 1980/81 terms (ie relative to the present 1 February 1981 scale) is shown in Table 6.4. These demonstrate the trade-off between revenue cost constraints (in 1980/81 terms) and break even levels of taxable income—in this context the break even income refers to that level at which a taxpayer will be no better or worse off if one of the illustrative scales were introduced in place of the present scale.

6.164 The *third type of scale* represents a shape which, in the Task Force's view, would be only a modest improvement on that of the present scale and could be introduced as an *interim* measure at a much lower revenue cost, preparatory to introducing either Scale Type 1 or 2 once circumstances permitted. The *fourth type of scale* illustrates the implications of incorporating a zero rate bracket (i.e. a zero marginal tax rate on the first so-many dollars of every taxpayer's taxable income) in a scale with lower marginal and average tax rates than at present for the majority of taxpayers, in order to minimise the extent of increased tax liability that lower-income taxpayers otherwise would incur.

6.165 The possible impact of partial income splitting for married couples under each of these scales is also shown. A divisor of 1.7 has been used purely for the purposes of illustration. Use of a lower divisor, however, would reduce the benefit of partial income splitting and cost less, and conversely.

Scale Type 1

6.166 Scale Type 1 is depicted graphically in Figure 6.6. Its general characteristics are:

(a) a long second marginal tax rate bracket encompassing people with incomes ranging from $6,000 (ie less than half the level of average earnings in 1981/82[22]) to $24,000 (ie 1.8 times the level of average earnings in 1981/82);

(b) a higher initial marginal tax rate than at present, for those persons whose incomes are less than about half the level of average earnings in 1981/82—ie essentially people earning income on a part-time or part-year basis, or some people with unearned income; and

(c) a moderately progressive series of marginal rate steps above 1.8 times the level of average earnings in 1981/82—for equity reasons—with these last steps estimated to yield only about 5 percent of the total revenue from the $1,000 million cost variant of Scale Type 1.

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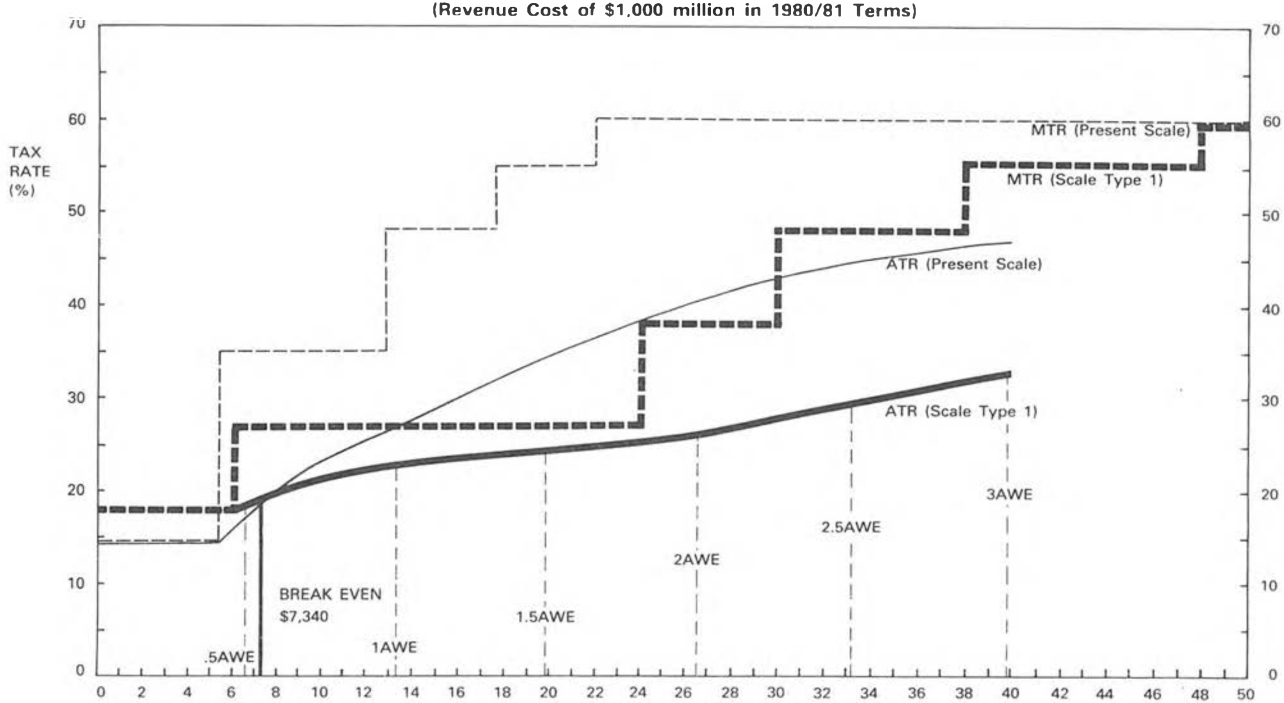
(22) The estimated level of average weekly earnings in 1981/82 is $256, or about $13,300 per annum.

Table 6.4

TRADE-OFF BETWEEN REVENUE COST & BREAK-EVEN INCOME LEVELS FOR VARIOUS TYPES OF PERSONAL INCOME TAX SCALES

SCALE	REVENUE COST IN 1980/81 TERMS	BREAK-EVEN INCOME	MARGINAL TAX RATES FOR THE FOLLOWING TAXABLE INCOME BRACKETS (values in $1000)							
			0 – 6	6 – 9	9 – 16	16 – 24	24 – 30	30 – 38	38 – 48	48 +
	($M)	($ p.a.)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Scale 1 variants	350	15,580	21	32	32	32	44	55	60	60
	500	11,690	20	31	31	31	43	54	60	60
	750	8,790	19	29	29	29	40	51	60	60
	1,000	7,340	18	27	27	27	38	48	55	60
	1,250	6,480	17	25	25	25	36	45	53	60
Scale 2 variants	350	8,670	22	22	34	40	45	50	55	60
	500	8,050	21	21	33	39	44	50	55	60
	750	7,520	20	20	31	36	41	46	50	55
	1,000	7,050	19	19	29	34	39	44	50	55
	1,200	6,630	18	18	27	32	37	42	48	55
Scale 3 variants	350	5,640	15	35	35	48	55	55	60	60
	500	5,640	15	33	33	46	54	54	60	60
	750	5,640	15	31	31	41	49	49	55	55
	1,000	5,640	15	28	28	38	47	47	55	55

Figure 6.6
SCALE TYPE 1
(Revenue Cost of $1,000 million in 1980/81 Terms)



Note: MTR = marginal tax rate.
ATR = average tax rate.
AWE = average weekly earnings level in 1981/82.
1AWE = $256, or about $13,300 per annum in 1981/82.

Table 6.5

EFFECT OF INTRODUCING $1000m VARIANT OF SCALE TYPE 1, AND VOLUNTARY INCOME SPLITTING, ON DIFFERENT TYPES OF HOUSEHOLDS

ITEM	TOTAL HOUSEHOLD INCOME	HOUSEHOLD TYPE							
		SINGLE PERSON		MARRIED COUPLE					
				Ratio of Principal Earner's Income to Spouse's Income					
				100:0		70:30		50:50	
	($)	($)	(%)	($)	(%)	($)	(%)	($)	(%)
Tax under present scale	5000	725	14.5						
Change due to new scale		175	3.5						
New Tax Total 1		900	18.0						
Change due to income splitting		0	0.0						
New Tax Total 2		900	18.0						
TOTAL CHANGE		**175**	3.5						
Tax under present scale	10000	2372	23.7	2372	23.7	1757	17.5	1450	14.5
Change due to new scale		−213	−2.1	−213	−2.1	133	1.3	350	3.5
New Tax Total 1		2160	21.6	2160	21.6	1890	18.9	1800	18.0
Change due to income splitting				−360	−3.6	−90	−0.9	0	0
New Tax Total 2				1800	18.0	1800	18.0	1800	18.0
TOTAL CHANGE		**−213**	−2.1	**−573**	−5.7	**43**	0.4	**350**	3.5
Tax under present scale	15000	4434	29.5	4434	29.5	3200	21.3	2995	19.9
Change due to new scale		−924	−6.1	−924	−6.1	−95	−0.6	−25	−0.1
New Tax Total 1		3510	23.4	3510	23.4	3105	20.7	2970	19.8
Change due to income splitting				−378	−2.5	*27*	*0.1*	*162*	*1.0*

New Tax Total 2				3132	20.8	*3132*	*20.8*	*3132*	*20.8*
TOTAL CHANGE		**−924**	−6.1	**−1302**	−8.6	***−68***	*−0.4*	***137***	*0.9*
Tax under present scale	20000	7002	35.0	7002	35.0	4927	24.6	4745	23.7
Change due to new scale		−2142	−10.7	−2142	−10.7	−607	−3.0	−425	−2.1
New Tax Total 1		4860	24.3	4860	24.3	4320	21.6	4320	21.6
Change due to income splitting				−378	−1.8	*162*	*0.8*	*162*	*0.8*
New Tax Total 2				4482	22.4	*4482*	*22.4*	*4482*	*22.4*
TOTAL CHANGE		**−2142**	−10.7	**−2520**	−12.6	***−445***	*−2.2*	***−263***	*−1.3*
Tax under present scale	25000	9902	39.6	9902	39.6	7132	28.5	6495	25.9
Change due to new scale		−3583	−14.3	−3583	−14.3	−1462	−5.8	−825	−3.3
New Tax Total 1		6320	25.2	6320	25.2	5670	22.6	5670	22.6
Change due to income splitting				−488	−1.9	*162*	*0.6*	*162*	*0.6*
New Tax Total 2				5832	23.3	*5832*	*23.3*	*5832*	*23.3*
TOTAL CHANGE		**−3583**	−14.3	**−4070**	−16.2	***−1300***	*−5.2*	***−663***	*−2.6*
Tax under present scale	30000	12902	43.0	12902	43.0	9575	31.9	8869	29.5
Change due to new scale		−4683	−15.6	−4683	−15.6	−2555	−8.5	−1849	−6.1
New Tax Total 1		8220	27.4	8220	27.4	7020	23.4	7020	23.4
Change due to income splitting				−1038	−3.4	*162*	*0.5*	*162*	*0.5*
New Tax Total 2				7182	23.9	*7182*	*23.9*	*7182*	*23.9*
TOTAL CHANGE		**−4683**	−15.6	**−5720**	−19.0	***−2393***	*−7.9*	***−1687***	*−5.6*

Notes:
(1) Scale type 1 replaces the current (1.2.81) scale; the income splitting applies to married couples with a divisor of 1.7 for illustrative purposes.
(2) The percentages are the tax totals and changes as a percentage of total household income.
(3) The italicised figures represent changes which would only apply if income splitting were compulsory.

6.167 Essentially all full-time workers would obtain a reduction in personal income tax for any variant of Scale Type 1 which has a revenue cost in 1980/81 terms of $750 million or more (Table 6.4 refers). Conversely, the losers under this type of scale would be mainly taxpayers with part-time or part-year incomes. At present the vast majority of minimum adult award wage rates correspond to an income in excess of $8,800 per annum.

6.168 Both the level and variability of fiscal drag would be greatly reduced under any of the Scale Type 1 variants, as indicated in Figure 6.10 which shows the real disposal income maintenance ratio for the $1,000 million variant of Scale Type 1.

6.169 The impact of the $1,000 million revenue cost variant of Scale Type 1 on single individuals and married couples whose total income is derived in different ratios, is shown in Table 6.5. This Table also illustrates the impact of introducing partial income splitting (with a 1.7 divisor) for married couples, which is discussed in general terms in Section III of this chapter.

Scale Type 2

6.170 The main features of Scale Type 2, which is shown graphically in Figure 6.7, are:

(a) a higher initial marginal rate than Scale Type 1 (for any given revenue cost variant) and the present scale, but a substantially longer initial income bracket (up to two-thirds of the average earnings level in 1981/82); and thereafter

(b) a series of relatively low rising rate steps with relatively longer income brackets than the present scale.

6.171 There are two main reasons for this shape. First, it is intended to ensure that the break even income level—for even a comparatively low revenue cost variant (e.g. $350 million in 1980/81 terms)—would be less than the minimum adult wage rate. Extending the initial marginal rate bracket (compared with the present scale) would necessitate a more progressive scale thereafter. Because of this an extra step has been added in the income range covering most full-time workers, to ensure that fiscal drag is kept to a minimum.

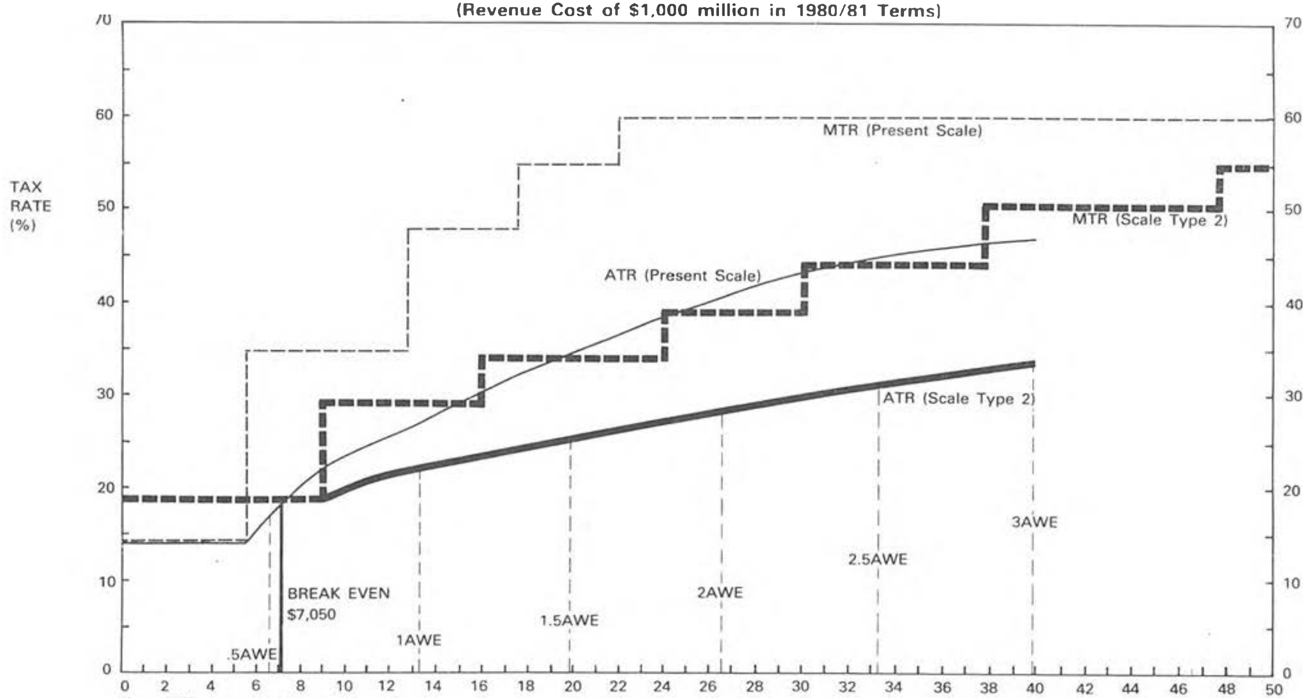
6.172 As a result of introducing this type of scale, fiscal drag would be much lower and less variable than under the present scale (Figure 6.10 refers).

6.173 The impact of the $1,000 million revenue cost variant of Scale Type 2 on single individuals and married couples whose total income is derived in different ratios, is shown in Table 6.6. This table also illustrates the impact of introducing partial income splitting for married couples.

Figure 6.7

SCALE TYPE 2

(Revenue Cost of $1,000 million in 1980/81 Terms)



Note: MTR = marginal tax rate.
ATR = average tax rate.
AWE = average weekly earnings level in 1981/82.
1AWE = $256, or about $13,300 per annum in 1981/82.

Table 6.6

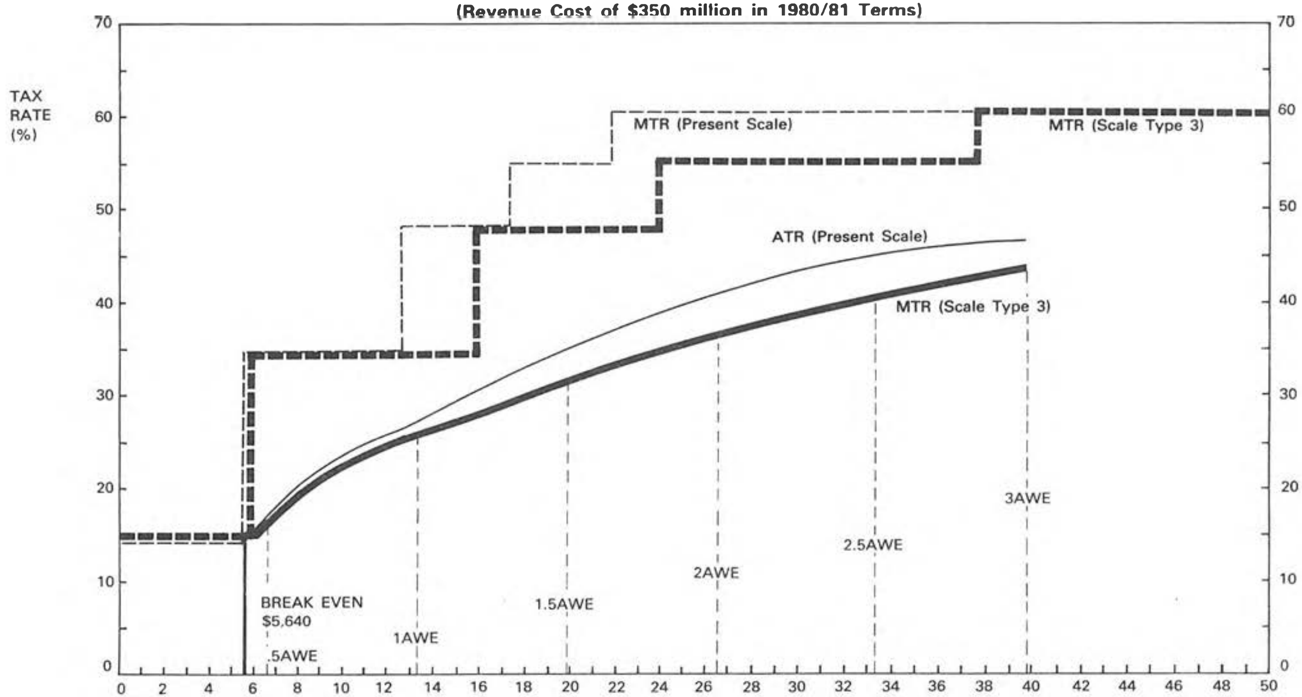
EFFECT OF INTRODUCING $1000m VARIANT OF SCALE TYPE 2, AND VOLUNTARY INCOME SPLITTING, ON DIFFERENT TYPES OF HOUSEHOLDS

ITEM	TOTAL HOUSEHOLD INCOME	HOUSEHOLD TYPE: SINGLE PERSON		MARRIED COUPLE: Ratio of Principal Earner's Income to Spouse's Income 100:0		70:30		50:50	
	(S)	(S)	(%)	(S)	(%)	($)	(%)	($)	(%)
Tax under present scale	5000	725	14.5						
Change due to new scale		225	4.5						
New Tax Total 1		950	19.0						
Change due to income splitting		0	0.0						
New Tax Total 2		950	19.0						
TOTAL CHANGE		**225**	4.5						
Tax under present scale	10000	2372	23.7	2372	23.7	1757	17.5	1450	14.5
Change due to new scale		−373	−3.7	−373	−3.7	143	1.4	450	4.5
New Tax Total 1		2000	20.0	2000	20.0	1900	19.0	1900	19.0
Change due to income splitting				−100	−1.0	0	0	0	0
New Tax Total 2				1900	19.0	1900	19.0	1900	19.0
TOTAL CHANGE		**−373**	−3.7	**−473**	−4.7	**143**	1.4	**450**	4.5
Tax under present scale	15000	4434	29.5	4434	29.5	3200	21.3	2995	19.9
Change due to new scale		−984	−6.5	−984	−6.5	−200	−1.3	−145	−0.9

New Tax Total 1		3450	23.0	3450	23.0	3000	20.0	2850	19.0
Change due to income splitting				−600	−4.0	−150	−1.0	0	0
New Tax Total 2				2850	19.0	2850	19.0	2850	19.0
TOTAL CHANGE		**−984**	−6.5	**−1584**	−10.5	**−350**	−2.3	**−145**	−0.9
Tax under present scale	20000	7002	35.0	7002	35.0	4927	24.6	4745	23.7
Change due to new scale		−1902	−9.5	−1902	−9.5	−627	−3.1	−745	−3.7
New Tax Total 1		5100	25.5	5100	25.5	4300	21.5	4000	20.0
Change due to income splitting				−830	−4.1	−30	−0.1	*270*	*1.3*
New Tax Total 2				4270	21.3	4270	21.3	*4270*	*21.3*
TOTAL CHANGE		**−1902**	−9.5	**−2732**	−13.6	**−657**	−3.2	*−475*	*−2.3*
Tax under present scale	25000	9902	39.6	9902	39.6	7132	28.5	6495	25.9
Change due to new scale		−3052	−12.2	−3052	−12.2	−1457	−5.8	−1045	−4.1
New Tax Total 1		6850	27.4	6850	27.4	5675	22.7	5450	21.8
Change due to income splitting				−1130	−4.5	*45*	*0.1*	*270*	*1.0*
New Tax Total 2				5720	22.8	*5720*	*22.8*	*5720*	*22.8*
TOTAL CHANGE		**−3052**	−12.2	**−4182**	−16.7	***−1412***	*−5.6*	***−775***	*−3.1*
Tax under present scale	30000	12902	43.0	12902	43.0	9575	31.9	8869	29.5
Change due to new scale		−4102	−13.6	−4102	−13.6	−2425	−8.0	−1969	−6.5
New Tax Total 1		8800	29.3	8800	29.3	7150	23.8	6900	23.0
Change due to income splitting				−1490	−4.9	*160*	*0.5*	*410*	*1.3*
New Tax Total 2				7310	24.3	*7310*	*24.3*	*7310*	*24.3*
TOTAL CHANGE		**−4102**	−13.6	**−5592**	−18.6	***−2265***	*−7.5*	***−1559***	*−5.1*

Notes:
(1) Scale type 2 replaces the current (1.2.81) scale; the income splitting applies to married couples with a divisor of 1.7 for illustrative purposes.
(2) The percentages are the tax totals and changes as a percentage of total household income.
(3) The italicised figures represent changes which would only apply if income splitting were compulsory.

Figure 6.8
SCALE TYPE 3
(Revenue Cost of $350 million in 1980/81 Terms)



Note: MTR = marginal tax rate.
ATR = average tax rate.
AWE = average weekly earnings level in 1981/82.
1AWE = $256, or about $13,300 per annum in 1981/82.

Scale Type 3

6.174 A $350 million revenue cost variant of Scale Type 3 is shown graphically in Figure 6.8. Other revenue-cost variants of this type of scale are shown in Table 6.4.

6.175 Scale Type 3 essentially comprises a retention of the present scale type, which would only make sense in the context of a low revenue cost constraint (eg $350 million in 1980/81 terms). This type of scale would still be subject to a high and variable degree of fiscal drag (Figure 6.10 refers). Any of these variants, however, would have a break even income level (vis-a-vis the present scale) which is less than the present level of adult minimum award wage rates, and this would minimise the degree of redistribution at low income levels, which would be inherent in a new but different rate scale type.

6.176 The impact of $350 million revenue cost variant of Scale Type 3 on single individuals and married couples whose total income is derived in different ratios, is shown in Table 6.7. This table also illustrates the impact of introducing partial income splitting for married couples.

Scale Type 4

6.177 Scale Type 4 is essentially Scale Type 1 modified in order to incorporate a zero rate bracket of $1,000. As with the previous scale types a range of revenue cost variants is provided (Table 6.8 refers). Figure 6.9 depicts graphically the implications for marginal and average tax rates of modifying the $1,000 million cost variant of Scale Type 1 in the above way. This variant has the great advantage that it can avoid any taxpayer incurring an increase in income tax liability. The same advantage applies to incorporating a $1000 zero rate bracket in Scale Types 2 and 3 at all revenue costs.

6.178 Nevertheless the Task Force does not favour the adoption of this type of scale for the following reasons:

(a) The benefit to the low income taxpayer is purchased at the cost of significantly higher rates in the middle and upper income levels.

Bearing in mind the fact that very few full year/full time workers earn less than $7800 per annum; that most part time workers would be contributing to households deriving a much higher income; and, finally, the capacity of the transfer payment system to compensate those in need, all suggest that the measure would not be cost effective.

Table 6.7

EFFECT OF INTRODUCING $350m VARIANT OF SCALE TYPE 3, AND VOLUNTARY INCOME SPLITTING, ON DIFFERENT TYPES OF HOUSEHOLDS

ITEM	TOTAL HOUSEHOLD INCOME	HOUSEHOLD TYPE							
		SINGLE PERSON		MARRIED COUPLE					
				Ratio of Principal Earner's Income to Spouse's Income					
				100:0		70:30		50:50	
	($)	($)	(%)	($)	(%)	($)	(%)	($)	(%)
Tax under present scale	5000	725	14.5						
Change due to new scale		25	0.5						
New Tax Total 1		750	15.0						
Change due to income splitting		0	0.0						
New Tax Total 2		750	15.0						
TOTAL CHANGE		**25**	0.5						
Tax under present scale	10000	2372	23.7	2372	23.7	1757	17.5	1450	14.5
Change due to new scale		−73	−0.7	−73	−0.7	−58	−0.5	50	0.5
New Tax Total 1		2300	23.0	2300	23.0	1700	17.0	1500	15.0
Change due to income splitting				−800	−8.0	−200	−2.0	0	0
New Tax Total 2				1500	15.0	1500	15.0	1500	15.0
TOTAL CHANGE		**−73**	−0.7	**−873**	−8.7	**−257**	−2.5	**50**	0.5
Tax under present scale	15000	4434	29.5	4434	29.5	3200	21.3	2995	19.9
Change due to new scale		−384	−2.5	−384	−2.5	−50	−0.3	−145	−0.9

New Tax Total 1		4050	27.0	4050	27.0	3150	21.0	2850	19.0
Change due to income splitting				−840	−5.6	*60*	*0.4*	*360*	*2.4*
New Tax Total 2				3210	21.4	*3210*	*21.4*	*3210*	*21.4*
TOTAL CHANGE		**−384**	−2.5	**−1224**	−8.1	***10***	*0.0*	***215***	*1.4*
Tax under present scale	20000	7002	35.0	7002	35.0	4927	24.6	4745	23.7
Change due to new scale		−683	−3.4	−683	−3.4	−327	−1.6	−145	−0.7
New Tax Total 1		6320	31.6	6320	31.6	4600	23.0	4600	23.0
Change due to income splitting				−1360	−6.8	*360*	*1.8*	*360*	*1.8*
New Tax Total 2				4960	24.8	*4960*	*24.8*	*4960*	*24.8*
TOTAL CHANGE		**−683**	−3.4	**−2042**	−10.2	***33***	*0.1*	***215***	*1.0*
Tax under present scale	25000	9902	39.6	9902	39.6	7132	28.5	6495	25.9
Change due to new scale		−1113	−4.4	−1113	−4.4	−587	−2.3	−145	−0.5
New Tax Total 1		8790	35.1	8790	35.1	6545	26.1	6350	25.4
Change due to income splitting				−2080	−8.3	*165*	*0.6*	*360*	*1.4*
New Tax Total 2				6710	26.8	*6710*	*26.8*	*6710*	*26.8*
TOTAL CHANGE		**−1113**	−4.4	**−3192**	−12.7	***−422***	*−1.6*	***215***	*0.8*
Tax under present scale	30000	12902	43.0	12902	43.0	9575	31.9	8869	29.5
Change due to new scale		−1363	−4.5	−1363	−4.5	−825	−2.7	−769	−2.5
New Tax Total 1		11540	38.4	11540	38.4	8750	29.1	8100	27.0
Change due to income splitting				−2716	−9.0	*74*	*0.2*	*724*	*2.4*
New Tax Total 2				8824	29.4	*8824*	*29.4*	*8824*	*29.4*
TOTAL CHANGE		**−1363**	−4.5	**−4079**	−13.5	***−751***	*−2.5*	***−45***	*−0.1*

Notes:
(1) Scale type 3 replaces the current (1.2.81) scale; the income splitting applies to married couples with a divisor of 1.7 for illustrative purposes.
(2) The percentages are the tax totals and changes as a percentage of total household income.
(3) The italicised figures represent changes which would only apply if income splitting were compulsory.

Table 6.8

REVENUE COST & MARGINAL TAX RATES FOR SCALE TYPE 4

REVENUE COST IN 1980/81 TERMS	BREAK-EVEN INCOME	MARGINAL TAX RATES FOR FOLLOWING TAXABLE INCOME BRACKETS (values in $1000)						
		0 – 1	1 – 6	6 – 24	24 – 30	30 – 38	38 – 48	48 +
($M)	($ p.a.)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
500	0	0	17.5	36	49	60	60	60
750	0	0	17.5	33	45	55	60	60
1,000	0	0	17.5	30.5	41	48	55	60
1,250	0	0	17.5	27.5	39	47	55	60

Figure 6.9

SCALE TYPE 4 COMPARED WITH SCALE TYPE 1 IN 1981/82 TERMS

(Revenue Costs of $1,000 million in 1980/81 Terms)

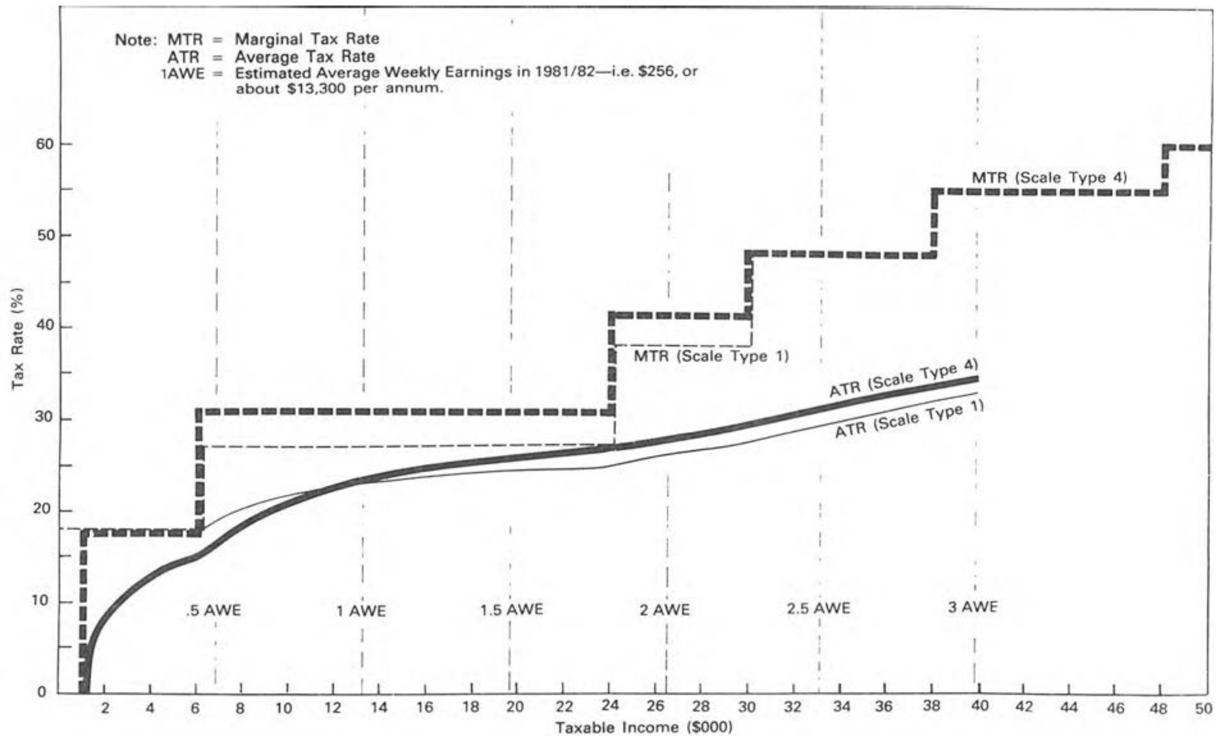
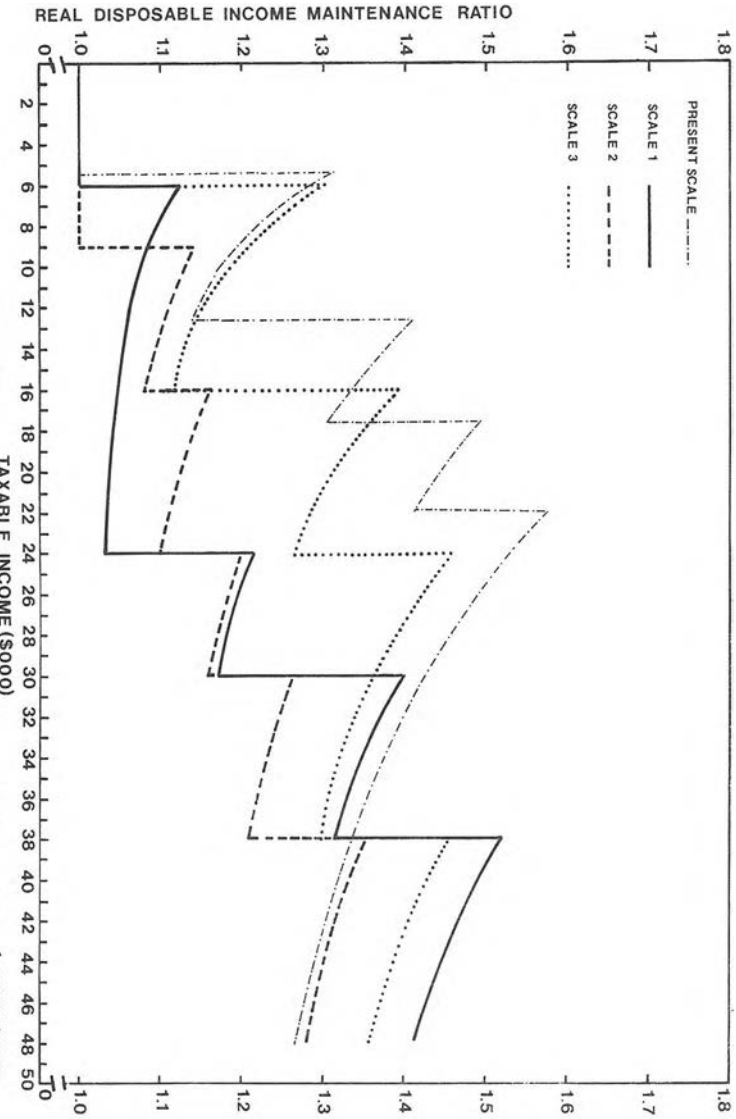


Figure 6.10
FISCAL DRAG RESULTING FROM VARIOUS PERSONAL INCOME TAX SCALES



Note: Fiscal drag is measured as the real disposable income maintenance ratio (RDIM), where RDIM = $\frac{1\text{—average tax rate}}{1\text{—marginal tax rate}}$

(b) Contrary to what might be expected, it would not reduce the number of taxpayers who would be required to submit annual tax returns. Already all salary and wage earners deriving less than $11500 per annum are exempt from this requirement, while all self employed persons are required to furnish a return irrespective of the level of income.

In fact, a zero rate bracket may well increase the number of taxpayers furnishing returns for the purpose of obtaining a refund. This effect would apply to part year workers in particular.

(c) The presence of a zero rate band would increase the incentive for taxpayers to transfer income earning assets to members of the family in order to take advantage of this scale. It must be acknowledged that this incentive is present under any progressive scale.

Recommendation

6.179 The Task Force recommends that the present type of personal income tax scale should be replaced by a scale having a modest degree of progressivity over both the lower- and higher-income ranges and a long flat bracket for the majority of individuals. Scale Types 1 and 2 illustrate these features.

VI FRINGE BENEFITS

Introduction

6.180 Fringe benefits have become widespread in recent years. They are to be found in most industries and are provided to employees at all levels of remuneration.

6.181 Fringe benefits do not, under existing legislation, generally represent assessable income of the recipient. Some benefits provided in kind, such as accommodation and food, are assessable in terms of the existing tax law. The courts have held that other benefits provided in kind are not assessable unless they can be converted into cash by the recipient. Cash payments are assessable except to the extent that they can be demonstrated to be reimbursement of expenses incurred in gaining or producing assessable income. The Task Force does not consider that such reimbursement allowances constitute a fringe benefit and therefore does not propose any change to the current tax exempt status.

The Case for Taxing Fringe Benefits

6.182 Fringe benefits that reduce an employee's need to meet private outgoings from income clearly increase a taxpayer's capacity to pay in just the same way as does the payment of additional salary or wages in cash. Those who receive part of their remuneration in this form do not bear their fair share of the tax burden. Furthermore employers who provide non-taxable benefits in lieu of salary or wages are in a favoured position as their total labour cost is reduced.

6.183 The Task Force considers that the inequity which results from the non-taxation of fringe benefits has reached serious proportions. It is clear that it is a major example of perceived unfairness in the tax system. In the view of the Task Force, which is supported by comments in a number of submissions received, it has been a significant factor in the development of a climate in which taxpayers are increasingly resorting to a variety of other avoidance practices and to outright evasion.

6.184 The scope for avoidance through fringe benefits is wider than might generally be appreciated. They range from relatively low value items such as payment by the employer of private telephone accounts up to high value items such as motor vehicles available for private use. Many taxpayers can and do receive more than one such benefit. For example, it would be quite possible for an employee to be provided with a company car (perhaps two) and a low interest housing loan, and in addition have school fees, clothing costs, annual holidays, and child care costs all paid for by his employer. Under present tax legislation, none of these disbursements by an employer on behalf of his employee can be taxed as extra income to the employee or be treated as non-deductible expenses to the employer.

6.185 If such benefits remain untaxed the Task Force believes that the practice of including such tax-free benefits in a remuneration package will continue to grow rapidly. This could lead not only to an additional degree of inequity but also to a severe narrowing of the tax base. In addition, the level of taxable remuneration would increasingly become a matter of discretion between employer and employee at the expense of Government revenues.

6.186 The ability to receive benefits in kind is not limited solely to salary and wage earners. Shareholder employees of private companies and self employed taxpayers have many opportunities to receive such benefits. Any move to tax salary and wage earners' fringe benefits should be accompanied by the application of similar rules to those classes of taxpayer.

6.187 The Task Force is firmly of the view that immediate action should be taken to make fringe benefits taxable, subject to appropriate transitional arrangements as discussed later.

6.188 The action required is to amend the Income Tax Act to provide that all benefits supplied to employees, whether in cash or kind, shall be assessable income. A general provision of this type is to be preferred to the alternative of specifying particular classes of benefit currently in use, as such a course would leave open avenues for avoidance through the development of new benefits or modification of those currently provided.

Identification and Quantification

6.189 There are two approaches to the identification and quantification of fringe benefits, within a general tax provision which relies for its force on a declaration of principle to the effect that any payment of income in kind is taxable. First, benefits may be valued individually, case by case. Secondly the general rule may be supplemented by providing that certain classes of cases (e.g. provision of a company car) shall constitute the provision of a taxable benefit, and that the value of such a benefit shall be calculated in accordance with a specified formula.

6.190 Fringe benefits which are easily quantified, and which could be assessed by individual valuation (i.e. the case by case approach) include the payment of excessive expense allowances and items such as school fees, clothing and annual holidays. With such benefits, the value to be assessed as income of the employee should be the cost to the employer.

6.191 The case by case approach is inappropriate for some types of fringe benefits. The valuation of the benefit attributable to a car provided to an employee and available for private use is an obvious example. For each case, it would be necessary to consider factors such as the cost and age of the vehicle, the ratio of private to business running, the expenditure by the employer on running expenses, cleaning and garaging costs met by the employee, and so on. Each factor would vary from taxpayer to taxpayer.

6.192 Benefits of this class are best dealt with by the adoption of specified rules, provided such rules are applied in a reasonably conservative way. Company cars, low interest loans and accommodation at concessional rates are examples of classes of cases which can be dealt with in this way. The appendices to this section outline an appropriate basis of assessment for each of these benefits.

6.193 The merit in adopting specific rules is that it permits the quantification of the more complex benefits in a manner which is both administratively feasible and certain. Specified rules, however, involve subjective judgements on the degree to which it is acceptable to have some overtaxed, while allowing others to be undertaxed. In other words, there is a sacrifice of some equity for practicability and certainty. But those who may be overtaxed may be able to correct their position by exchanging the benefit in kind for increased cash remuneration.

6.194 There remains a third category of benefit which neither of the above approaches can deal with satisfactorily. This includes benefits such as staff cafeterias providing meals at subsidised prices, recreational facilities, creches, free car parking, and social or sporting activities. Such benefits cannot be quantified satisfactorily, are generally of low value, and are not seen by the Task Force as representing a significant problem either in principle or in equity. The Task Force does not recommend that they be treated as constituting additional income of the employee.

6.195 Proposals in this chapter do not apply to the benefit arising through employers' contributions to employee superannuation funds. Some of the factors relating to this particular issue are discussed in Chapter 12.

The Transition

6.196 Fringe benefits are an integral part of many remuneration packages, and it can be expected that their inclusion in assessable income would be accompanied by demands for increased salaries or wages by those affected. A sudden transition could have significant implications for relativities, salary and wage rates in general, for prices, and for industrial relations generally. The Task Force therefore proposes two measures which will ease the transition and thereby give employers and employees time to adjust to the new regime.

6.197 First, the Task Force proposes that, in respect of certain high value fringe benefits, the proportion of the value assessed as income should be gradually increased so that full assessability is achieved over a period of years. Company cars, low interest housing loans and concessional rentals might be so treated. The transition period may need to differ between benefits. For example, a period, say 5 years, may be required in respect of low interest housing loans because of the long term nature of the contract while a shorter period may be justified for other benefits. Suggested approaches are included in the examples in the Appendices.

6.198 The second interim measure proposed is the introduction of a provision under which the employer can elect to undertake responsibility for payment of the tax resulting from the assessability of fringe benefits. This interim measure could be allowed to run for say 5 years. During that period, employers and employees would be able to come to terms with the new regime and progressively adjust remuneration packages so that the eventual mandatory assessment to the employee would not need to be accompanied by a major realignment of benefits and cash income.

6.199 It may be necessary for administrative reasons to place some limits on the right of an employer to use this option selectively as between individual employees or individual classes of benefit. Any such limits should be avoided as far as possible, so as to provide the maximum flexibility for employers to make a phased transition to full assessability in the hands of employees.

6.200 The option would be available to all employers, including those not currently subject to income tax such as Central and Local Government, charitable organisations and building societies and those taxed on special bases, such as insurance companies and co-operatives.

6.201 Where the employer accepts responsibility for the tax it would be imposed as a separate tax equal to the current rate of company tax—45%. If this tax is non-deductible, the employer's incentive to provide fringe benefits will be substantially reduced, thus easing the transition.

6.202 Consider, for example, an employer who wishes to give an employee a fringe benefit of $550. An employee whose marginal tax rate is 45 percent would either be indifferent to receiving a tax free fringe benefit of $550 or cash remuneration of $1000, or else would positively favour the cash remuneration which would not be tied to a particular line of expenditure. The employer would also be indifferent as the following shows.

Tax Paid Cost to Employer

(a) Cash remuneration of $1000	$500.00
(b) Fringe benefit of $550 (deductible)	$302.50
Special tax (not deductible)	$247.50
	$550.00

6.203 On the above assumption, both employer and employee would be indifferent between the cash remuneration and the fringe benefit. If the employee's marginal tax rate were greater than 45 percent there would still be some incentive to take the fringe benefit, but much less than at present.

Revenue Yield

6.204 Substantial revenue would be gained by taxing fringe benefits, reflecting the extent of the present inequity. Best available estimates are that the additional revenue to be generated by taxing identified and significant fringe benefits currently offered amounts to about $210 million per annum in 1980/81 terms of which $150 million would flow from the provision of cars. In view of the increasing reliance being placed on fringe benefits in determining remuneration packages the revenue cost in future years of *not* assessing fringe benefits could significantly increase this figure. The transitional measures recommended will reduce this potential yield in the early years.

Conclusion

6.205 The failure to tax fringe benefits contributes significantly to unfairness in the tax system. The Task Force is of the view that, unless action is taken to tax these benefits, it may be generally concluded that Government is implicitly accepting the propriety of this form of tax avoidance. The result will be an acceleration of existing widespread moves towards the provision of remuneration in a non taxable form, with increasingly serious implications for equity and for the ability of the remaining tax base to yield sufficient revenue at acceptable rates of tax.

6.206 The Task Force strongly recommends that fringe benefits should be brought within the definition of taxable income immediately.

6.207 Specifically, the following measures are proposed:

(a) Benefits which cannot be readily valued should be quanitified by reference to relatively conservative formulae.

(b) Other benefits should be valued at an amount equal to the cost incurred by the employer in providing those benefits.

(c) In general benefits should be assessed to the employee. However as a short term transitional measure the employer should have the option of paying a special tax on the benefit at a flat rate of 45 cents in the dollar. The special tax would be non deductible to the employer.

(d) To further ease the transition, full assessability of certain 'high value' benefits should be phased in over a period of, say, 5 years.

Chapter 6: Appendix A

CARS PROVIDED BY EMPLOYERS

Introduction

6.A1 The Task Force considers that the provision of a car to an employee should give rise to a taxable benefit where that car is substantially available for private use at the employee's discretion. A benefit should be assessed for each month or part of a month during which the vehicle is so available.

Valuation of the Benefit

6.A2 The value to an employee of a company car will vary depending on a number of factors, including the cost of the car, the extent of private running and the amount of operating costs met by the employer. It would be impracticable for all such variables to be identified and quantified for each case. Adoption of a specified formula is therefore proposed.

6.A3 The Task Force has concluded that as a general rule the value to an employee of a fringe benefit is equal to the amount by which the employee's need to meet private outgoings is reduced. Thus the value of a benefit to the employee may differ from the employer's costs of providing that benefit.

6.A4 Therefore, in arriving at an appropriate formula we have had regard to the typical costs of operating a vehicle. We have adopted as a benchmark the total operating costs where the annual

Table 6.A1

OPERATING COSTS AT 16,000 KMS P.A.

Vehicle Size	Annual Operating Costs	Approximate Vehicle Cost	Percentage of Cost of Vehicle per Month
Small	4093	9,400	3.6
Medium	5068	12,400	3.4
Large	7303	20,500	2.9

(1) Size of Car—"Small" —Mini/Mitsubishi Lancer
"Medium" — Cortina/Mitsubishi Galant
"Large" — Holden/Valiant

(2) Operating Costs include an allowance for depreciation, interest on capital as well as running costs such as tyres, fuel, repairs etc.

(3) Estimates of average annual distances travelled are not published. We are advised that distances vary widely, but that 16,000 km per annum would be a reasonable estimate.

distance travelled is 16,000 kms and have used as a base details published by the Automobile Association Inc. New Zealand.[23] The following table shows the benchmark costs in terms of total annual expenditure and as a percentage of the cost of the vehicle for each month.

Formula Options

6.A5 The first option is to provide that the taxable value be calculated by applying a fixed percentage rate to the *cost of the vehicle.* Table 6.A1 indicates that if all operating costs are met by the employer the value of the benefit would range between 2.9 and 3.6% of the vehicle cost for each month for which it is available for private use.

6.A6 If this option were adopted, the Task Force is of the opinion that the rate should be set at a conservative level, say 2% per month, in recognition of the following factors:

- Many taxpayers would travel less than the benchmark distance of 16,000 kms in a year on private running.
- Some operating costs may be met by the employee (e.g. fuel).
- The vehicle may be superior to that which the employee would have purchased for his own use.
- Some restrictions may be placed on the use of a vehicle for private purposes—that is, it may be substantially, but not wholly, available for private running.

6.A7 The second option would be to adopt the specified rate approach of the first option, but to apply the selected rate to the *book value of the vehicle* rather than to the cost price (book value being that arrived at after the deduction of depreciation at Departmental rates). The rate adopted should be something in excess of that which would have been adopted under the first option. This option has the added advantage that the value to be assessed will reduce as the vehicle ages.

6.A8 A third option would be to fix a specific value which varies with the size of vehicle. To be consistent with the benchmark position outlined above, and in keeping with the conservative approach recommended, the values could be fixed for 1982/83 as follows:

Size of Car	Approximate value to be assessed for each month of availability $
Small Car (up to 1350 cc)	188
Medium Car (1350 to 2000cc)	248
Large Car (over 2000cc)	410

(23) "New Zealand Motorworld" October 1981.

General

6.A9 There are however circumstances in which it would be inappropriate to tax a benefit. For example, we would not envisage that a benefit would be assessed where a van is made available for commuting only, and it is a requirement that the driver transport employees or equipment or make deliveries or collections during that commuting. Another example would be where an employee is required to maintain two residences and is provided with a car at each. In such circumstances, we would envisage that only one car would give rise to an assessable benefit.

Transitional Provisions

6.A10 Because the amount of income to be assessed as a company car benefit would in many cases be substantial, it may be considered that transitional arrangements are desirable. A phasing in could be achieved in the following ways:

(a) The specified rate (options 1 and 2) or fixed value (option 3) could be introduced at a low level and progressively lifted to the full amount.

(b) A moratorium period could be specified, at the completion of which all company car benefits would be taxable in full.

6.A11 The Task Force doubts, however, whether any special transitional arrangements are needed. The general transitional provision allowing for payment of tax by the employer would be adequate, especially if the proposal were implemented by a budget announcement with effect from April 1 of the following year. If a shorter delay from announcement to implementation were desired, a year at half the full rate might be appropriate.

Revenue Yield

6.A12 The revenue yield from taxing employer provided vehicles will depend on the approach adopted and the nature and duration of any transitional provisions. It is estimated, however, that when fully operative, the yield would approximate $150 million per annum.

Chapter 6: Appendix B

LOW INTEREST LOANS

Introduction

6.B1 A 'case by case' approach to the valuation of the benefit arising through the provision of a loan at a concessional interest rate would pose considerable difficulties. Ideally, the value of the benefit would be arrived at by comparing the servicing costs incurred by the employee with those which would have been incurred had the loan been raised in the open market. Quantification on this basis would require the consideration of many factors, including the rate of interest, the term and form of the loan, and possibly also recognition of any restrictions imposed by the employer regarding the use of funds or access to additional mortgages, etc. A specified formula is therefore proposed.

Specified Formula

6.B2 The amount to be included as income would be calculated as the difference between:

- The interest paid during the year; and
- The interest that would have been payable in that year, had the loan carried interest at a "prescribed rate".

The prescribed rate would be specified in the Income Tax Act and would apply to all such loans regardless of the purpose for which granted (e.g. housing, car purchase, etc.).

6.B3 Employers lend funds to employees for a variety of purposes, including housing, car purchase and to assist with major expenditure such as financing an overseas holiday. The selection of an appropriate prescribed rate to apply to all such loans therefore poses problems.

6.B4 Private sector housing mortgage interest rates give some indication, but these vary widely, ranging between 11% and 18% with a weighted average of over 15% for those registered in July 1981[24]. (Housing Corporation lending rates are excluded because its rates reflect an element of low income support and would therefore be an inappropriate measure). Rates on hire purchase finance are higher, with true rates currently reaching about 28%. A further indication of appropriate rates may be given by the long-term Government borrowing rates which (for both Central and Local Government stock) run at around 13%.

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(24) Reserve Bank Bulletin—December 1981

6.B5 The Task Force considers however that, as the majority of loans currently offered are for housing assistance, the prescribed rate should reflect private sector housing mortgage interest rates. It is considered that the rate should be struck at a relatively conservative level, and that it should lie in the range of 11% to 13%.

Transitional Arrangements

6.B6 Because of the long-term nature of most loans and because they are a firmly established feature of certain industry remuneration packages assessability should be introduced progressively so as to minimise any unduly harsh impact. The recommended way of achieving this is to set the prescribed rate at a low level initially, say 6%, and to progressively increase the rate to near market rates over a period of say five years. The prescribed rate should be reviewed regularly in the light of prevailing market rates.

Revenue Yield

6.B7 It is estimated that when fully operative, the revenue yield would approximate $35 million per annum.

Chapter 6: Appendix C

ACCOMMODATION AT CONCESSIONAL RATES

Introduction

6.C1 The benefit arising on the provision of housing or other accommodation at a concessional rate is taxable under current legislation (Section 72 of the Income Tax Act 1976). No valuation procedure is specified, nor does the section provide any guidance to the Commissioner as to how his discretion should be exercised.

Current Practice

6.C2 The Department has adopted a variety of systems, both arbitrary and factual, to enable it to arrive at the value of a benefit. This approach is necessary because of the wide range of circumstances in which accommodation is provided by an employer and no change to this general approach is proposed.

6.C3 However, while the validity of the general approach is accepted the value being attributed to accommodation benefits has become unrealistic in many cases. Certain fixed values have been in force for many years and should be brought up to date.

6.C4 The Task Force proposes the following approach:

(a) Fixed value benefits

Fixed amounts have been established as the value of the benefit of board and lodging supplied to groups such as farm workers and hotel employees. The values have not been changed for many years. For example, in a number of cases full board and lodging is currently valued at $2 per week per adult. These, and all other unduly low fixed rates, should be moved over a short period of years to near market rates, and thereafter kept under regular review.

(b) Shareholder/employee accommodation

In general, a specified formula is used to arrive at the value of the benefit. The value is calculated as being the total of:

— 3% of the cost price of the property
— Depreciation at the rates allowed by the Commissioner of Inland Revenue for tax purposes
— Repairs and maintenance
— Rates and insurance

Because the formula adopts the cost price of the property, the rental value arrived at quickly becomes out of date in times of rising property values. The calculation should therefore be based on the current market value of the property. Consideration could also be given to the adoption of a simplified formula under which the value assessed is related *solely* to the property value—e.g. 5% of the market value with no addition for the other factors currently included.

(c) Other concessional rental accommodation

In these cases the rental value is arrived at having regard to normal rentals for comparable accommodation. However, Departmental policy is not to review the value once it has been established. These values should be appropriately indexed.

Transition

6.C5 In many cases, benefits are grossly undervalued and significant flow on effects could be expected on a sudden revaluation. Such effects will be reduced if the proposal to permit employers to undertake the tax liability is adopted.

6.C6 Special problems may arise in relation to accommodation provided in remote areas. The first is that in the absence of an established rental market there is little guide as to the true value of the benefit. It is suggested that in these cases the benefit should be valued by having regard to prevailing rents in nearby communities where a rental market in fact exists. The second problem is that the likelihood of industrial action in response to a move to fully tax such benefits is greatest where accommodation is provided in remote areas. To facilitate a phasing in of full assessment, the Task Force considers that consideration could be given to discounting market rents by, say, 50 – 70% prior to calculating the benefit value. The discount rate could be progressively reduced over a period of about 5 years.

Revenue Yield

6.C7 It is estimated that when fully operative, the proper taxation of such benefits would yield an additional $25 – 30 million per annum.

DISSENTING OPINION

by Kerrin M. Vautier

1 In my judgement the case for horizontal equity between one and two income families, and for voluntary income splitting as a policy tool, has been overstated. I have concluded that the appeal of aggregating and splitting the income of eligible couples is superficial because of the implications of applying such a scheme in practice. Following are the principal reasons for my dissent from the majority's recommendation, at the end of Section III, for "a voluntary scheme of 'partial income splitting' for married couples".

2 Income splitting is a blunt policy instrument. It does not discriminate among differing household compositions. It fails to target assistance specifically to the middle income range—which was identified by the Task Force as a particular area of concern. It also seems a questionable device for rectifying any unfairness arising from the relative ability of some groups to split income through the application of capital.

3 As a basis for Government action it would be an oversimplification to frame "the problem" in terms of unequal tax treatment between one and two income families. There are both relatively poor two income families and relatively wealthy one income families. There may also be other real differences between so-called similar households containing, respectively, a single earner on, say, $20,000 and two earners on $10,000 each.

4 Horizontal and vertical equity are inseparable and both are related to ability to pay. I believe the majority's case for income splitting gives disproportionate weighting to horizontal equity, with ready acceptance that the benefits of income splitting would rise as the principal income rises, irrespective of the presence (or number) of dependent children. To purchase horizontal equity for some at the expense of vertical equity is to disregard an essential element if overall equity is to be achieved.

5 On the basis of the Task Force's illustrative personal tax scales, Secretariat estimates (1980/81) suggest that over half of the (gross) benefits of income splitting (using a divisor of 1.7) would go to the minority of households which have combined incomes above $20,000.

6 A flattening of the tax scale would of itself give the greatest benefit to relatively high income earners. I accept that the size of *present* horizontal inequities is widely perceived as a cause for concern but, to the extent that progressivity of the present scale can be reduced for all taxpayers, so too can the horizontal inequities between different family groups. In my view, therefore, income splitting is not a practicable addition to this more fundamental tax reform in a period of budgetary pressure.

7 With resource constraints the more broadly applied is Government assistance the thinner is the spread. Beyond the State assistance that is clearly required for low income groups, I suggest that any additional tax advantage could be effectively targeted (via rebates) to middle income groups, particularly those households with children. (Abating rebates operate more fairly under a less progressive scale.) This strategy would enable an acceptable balance to be achieved between the objectives of horizontal and vertical equity, at a cost of forgone revenue which other taxpayers could fairly be called on to finance.

8 Finally, estimates of the gross benefits from income splitting can be misleading. For example, if income splitting were to supersede the Spouse and Young Family Rebates (both of which have an abating provision), then the *net* change of benefits, by income groups (particularly middle income) should also be an important consideration in evaluating policy. This is because of the different size and distribution of benefits that would result.

CHAPTER 7

BUSINESS AND COMPANY TAXATION

I. INFLATION AND BUSINESS TAXATION

Introduction

7.1 Under the present system of business taxation, income tax is levied on companies and unincorporated business enterprises very largely on the basis of a conventional measure of business income described as historic cost accounting. Continuing and high rates of inflation have however reduced the relevance of the historic cost convention both as a medium for reporting financial results and as a basis for the imposition of income tax.

7.2 The debate on the appropriate alternative system for financial reporting and tax purposes has been advanced significantly in recent years with contributions from various Committees of Inquiry both overseas and in New Zealand. Recently, emphasis has been directed to the development of a system of Current Cost Accounting.

7.3 The Committee of Inquiry into Inflation Accounting (the Richardson Committee), in its report to the Minister of Finance in September 1976, gave its views on the basis on which business income tax should be levied. That Committee supported the adoption of Current Cost Accounting (CCA) based on specific price change adjustments for financial reporting purposes and also for determining taxable business income.

7.4 The New Zealand Society of Accountants has indicated its intention of promoting CCA. Initially, however, the Society proposes that only companies listed on the Stock Exchange will be required to include CCA reports as supplementary statements to historic cost accounts. The application of the CCA accounting standard will be extended later to cover other business units.

7.5 The CCA system is directed at measuring income in relation to maintenance of the operating capacity of the business. The profit of a business is therefore determined only after full allowance has been made in that year for the business to replace its assets at then current costs, where current costs are taken as being those specific to the particular type of business. Under this approach, the measurement of income has due regard to movements in specific prices as they affect that business. The change in the price of a specific asset may, of course, differ considerably from the change in the general level of prices.

7.6 The Task Force accepts the widely held view that with the continuing and high rate of inflation in New Zealand the retention of historic cost income as the basis for determining business income taxation will have serious effects within sectors of the business economy. The selection of an appropriate alternative system of income measurement for tax purposes does however involve consideration of factors which extend far beyond the tax system.

Objectives of Inflation Adjustments for Tax Purposes

7.7 The definition of the objectives of a business income tax system, which is to take into account the effects of inflation for tax purposes, will in itself determine the system to be selected. The issue addressed in this chapter is how taxable income should be defined under conditions of inflation, and in particular whether the inflation adjustments should be related to changes in the general level of prices, or whether account should instead be taken of the specific price changes experienced by particular business firms.

7.8 A number of submissions received by the Task Force suggested that the objective of the business tax system should be to tax profits only after full provision for maintenance of the operating capacity of a business. This would involve the adoption of the CCA system of specific prices or price indices for business income tax purposes. While the above objective is considered appropriate for the determination of accounting profits for financial reporting purposes, the Task Force considers it inappropriate in principle for tax purposes. Also, if adopted for tax purposes, it would give rise to a number of practical problems.

7.9 Taking the practical problems first, it is considered that the use of a wide range of specific indices would introduce an unacceptable degree of subjectivity into the determination of taxable business profits. This would raise problems for the Inland Revenue Department in verifying adjustments made in respect of individual assets or groups of assets. The tax liability of a business could therefore become subject to debate and complex negotiations. This would impair the certainty required of an efficient tax system.

7.10 As indicated earlier, the CCA system proposed by the Society of Accountants would not be mandatory for all businesses. It will only apply initially for listed public companies, and on this practical ground alone could not be readily adopted as a base for income tax purposes.

7.11 On the other hand, inflation adjustments which adopted a general index for all businesses would be relatively simple and implementation would not require a massive re-education programme.

7.12 Regardless of these practical issues, however, there is a compelling case in principle for adopting a general index, rather than specific indices, for tax purposes.

7.13 The Task Force is of the view that the objective of the tax system should be to recognise only the effects of the general level of inflation as it affects the business unit. Under this approach, if the replacement costs of the assets of a business rise at a rate faster than that of the general price level, the general inflation element of increases in asset values would be excluded from profits leaving only the real element of profits subject to tax. In other words, the tax system would recognise that the owners' equity in a business should be maintained in terms of general purchasing power before a profit is recognised, but would not protect owners in the event that prices of the particular assets in which they have elected to invest increase at a rate faster than the general rate of inflation. The converse would apply in the case where the specific values of the assets of the business rise more slowly than the general rate of inflation.

7.14 Application of a general index would therefore leave with the owners of a business the gain or loss generated by their own decision to undertake a particular line of business, but would allow for changes in the value of money. It might thus be considered a parallel to the relative position of firms in an economy in which prices change, but there is no overall inflation.

7.15 The Task Force accordingly concludes that a general price index rather than a range of specific price indices should be utilised in adjusting income for tax purposes.

7.16 The CCA system of accounting being promoted for financial reporting purposes by the New Zealand Society of Accountants follows in principle the Richardson Committee's recommendations, including the application of specific price change adjustments, whereas the Task Force is of the view that, for tax purposes, general price level adjustments should be made. The difference in approach here may seem to represent a divergence between financial accounting and tax accounting which may be undesirable. The Task Force considers that this divergence of approach is not inappropriate. As already indicated the perspective relevant to the definition of income for tax purposes is different from that relevant to an individual firm, and it is therefore entirely appropriate that accounting methods for taxation and financial reporting purposes should differ in some respects, as indeed they have in the past. The objective of the business tax system is primarily to ensure an equitable sharing of the tax burden within the business sector. The objective of the financial reporting system, on the other hand, is to measure net profits of the business that can be distributed to shareholders without reducing the operating capacity of the business.

Comprehensive System

7.17 The Task Force proposes a comprehensive system which by applying a general index adjusts the business income tax base to allow for the effects of the general level of inflation on trading stocks, monetary assets and depreciable assets, and also recognises the gains which arise from the decline in the burden of business liabilities. The system proposed by the Task Force would be comparatively simple and inexpensive to apply as it involves no more than adjustments to historic cost data. The adjustments would also be objective, and verifiable. An outline of the proposed adjustments is set out in Appendix A of this Chapter.

7.18 The present tax system provides some concessions and arrangements for businesses generally which may be seen as surrogates for explicit recognition of inflation. First year depreciation is a notable example. These concessions and arrangements should be identified, reviewed and, in principle, withdrawn concurrently with the introduction of a comprehensive system of inflation adjustments.

Borrowing Gains

7.19 Submissions received by the Task Force which dealt with business taxation all stressed that the present method of determining taxable business income is deficient in not allowing for the effects of inflation on trading stock and monetary assets. In addition, because depreciation is allowed only on the historic cost of fixed assets, it does not adequately reflect the value of that proportion of assets consumed during the income tax year.

7.20 However, the submissions received did not all recognise the fact that a business gains in times of inflation from the erosion of the real burden of its debt. Especially because interest is allowed as a deduction for tax purposes, the cost of borrowing is negative in virtually all cases, and businesses make a real gain from this tax treatment of interest payments.

7.21 While a business is permitted to deduct nominal, and not just real, interest payments, lenders are obliged to pay taxes on nominal interest receipts. Inflation in combination with the present tax system therefore results in a dramatic and inequitable redistribution of net income away from lenders to borrowers and, in particular, to business borrowers. The Task Force's recommendation concerning taxation of personal lenders is included in Chapter 6.II.

7.22 The problem identified with the present tax treatment of interest payments at first caused the Task Force to consider the possibility of disallowing a tax deduction for the capital element currently included in nominal interest payments. It concluded however that this would be an unsatisfactory way of dealing with the matter. For example, there are problems in dealing with borrowing arrangements at varying interest rates, appropriately identifying the interest component in leasing or rental arrangements and the exclusion from any such adjustment of the losses incurred in respect of monetary assets financed by such borrowing. It was therefore concluded that the best treatment was by way of adjustment within a comprehensive system.

7.23 Allowing inflation adjustments in relation to only the assets of a business would reduce tax payable. The estimated revenue cost of business inflation adjustments in relation to trading stocks and fixed assets only would have been in excess of $400 million in the 1979 income tax year, the latest year for which sufficiently reliable aggregate data were available. The effect of including the adjustment for net monetary liabilities proposed below would in aggregate have reduced the estimated 1979 revenue cost to approximately $135 million.

7.24 A full adjustment for borrowing gains on all monetary liabilities would however in certain circumstances exceed the adjustment for assets and thus increase the overall tax payable by some taxpayers. Yet it would not be sensible or equitable to allow inflation tax adjustments for assets alone, and not recognise inflation gains from borrowing. If borrowing gains were not brought into account, a taxpayer would be able to deduct for tax purposes both the full inflation adjusted cost of revenue or capital expenditure where this is financed by borrowing and also the capital element included in present nominal interest payments. The taxpayer would thereby receive a double allowance for inflation in respect of the same expenditure.

7.25 It is recognised that there are practical matters to be considered in detail before implementation of a comprehensive system of inflation adjustments for tax purposes, but these should be capable of early resolution. The implications of the possible liquidity problems discussed below require comprehensive investigation.

Liquidity Problems

7.26 The Richardson Committee recognised the problem which may be caused in relation to a taxpayer's liquidity where tax payable is increased above present levels through the addition to income of borrowing gains. Its recommendation was to limit taxable income to the lower of CCA adjusted income and the historical cost profit. The Task Force noted that this might ease problems of transition, albeit at the expense of the revenue. The estimated revenue cost of adopting this limitation for the 1979 income year would have been in excess of $100 million, in addition to the $135 million indicated in paragraph 7.23.

7.27 The Task Force, however, believes that a more satisfactory approach is to seek a solution to the liquidity problem caused by increased tax payable rather than to support a similar proposal, which it considers imperfect in concept and inequitable in application.

7.28 Conventional borrowing arrangements at current high rates of interest create a heavy burden of debt servicing in early years of the borrowing term, often leading to liquidity problems for borrowers even though the venture being financed is profitable. The relief of the real burden in later years, resulting from inflation and maturity of the venture, does not, of course, alleviate the short-term immediate problem. Liquidity problems often exist even when, as at present, the whole interest charge—both the real and inflation component—is deductible for tax. Taxation of borrowing gains could substantially increase the liquidity problem for some taxpayers.

7.29 The Task Force notes that the liquidity problem associated with taxation of borrowing gains would be especially evident in the farming sector and bear heavily during years of establishment or major development. This is so partly because of high prices of agricultural land but also because existing tax law, through such concessions as standard and nil livestock values and immediate deductibility of development expenditure, already provides benefits on the asset side which are similar in effect to the inflation adjustments proposed as a general provision under the system put forward in this chapter.

7.30 A general change in the conventional system of borrowing could alleviate these liquidity problems. The adoption of more flexible forms of financial contracts, supported by changes in the taxation of the interest incomes of lenders, should be considered. The high debt servicing costs inherent in conventional financial contracts would be reduced if financial contracts allowed for capitalisation of interest, variable loan repayment terms, or the formal indexation of the financial contract.

7.31 It is recognised that the broader implications for monetary and economic policy of the indexation of financial contracts would require a thorough review. The Task Force has considered a paper prepared by the secretariat which outlines some of the possible transitional problems of the inflation adjustment proposal. The paper also indicates various aspects of indexation of financial contracts which may need to be resolved in the event that it is considered necessary to introduce such contracts. In the time within which the Task Force was required to report, it was not possible to comprehensively research all aspects of these and other possible transitional problems. The secretariat paper does not document exhaustively all the transitional problems that will require consideration as part of the investigation recommended by the Task Force. It is possible, however, that several matters raised in the paper could form a useful starting point for the investigation, and the paper is therefore reproduced as a separate appendix attached to this report. (Refer Appendix B) The comments in the paper are those of the secretariat and should not be taken as necessarily representing the views of the Task Force Steering Committee or any of its members.

Conclusion

7.32 It has been argued that the acceptance of indexation would reflect a willingness to accept inflation and consequently reduce the determination to fight it. The Task Force does not accept this argument. In an inflationary economy the borrower and, particularly the business borrower, has a vested interest in continuing and indeed increasing inflation. It is probable that the influence of business taxpayers in policy-making is greater than that of the individual lenders. It is likely, therefore, that the acceptance of indexed debt would strengthen rather than reduce the resolve of the community as a whole to fight inflation.

7.33 The Task Force considers that recognition of the effects of inflation in determining taxable business income should be implemented as soon as possible. The availability of indexed financial contracts could be a highly desirable adjunct to such a move. The investigation referred to in para. 7.36 should determine whether it is necessary to delay introduction of a new tax system until indexation of debt is also put in place.

7.34 It is the view of the Task Force that all taxable business incomes should be determined in the same way. If the impact of liquidity problems which may be created for particular sectors such as farming cannot be solved short of indexation of debt, and if such indexation cannot be introduced quickly, there could nevertheless be a case for continuing, as an interim measure, to determine taxable incomes for those particular sectors by the rules that at present apply. Though it is undesirable in principle to continue differences of treatment, this might be preferable to withholding the benefits for the economy generally of applying a comprehensive system of inflation adjustments for all other business sectors.

Special measures would need to be developed for any transitional period to overcome possibilities of avoidance that would arise if different rules applied for different business sectors.

7.35 It is highly desirable that the business income tax base be redefined to allow for the effects of inflation as soon as practicable. The longer changes are delayed the greater will be the distortions to investment patterns caused by inflation and an inadequate taxation system. Furthermore, given that businesses and individuals are constantly adapting their behaviour to take advantage of inflation or to mitigate its effects on their existing tax burden, the implementation of the essential changes will become increasingly difficult. In other words, the longer tax changes in this area are delayed the more difficult will be the transition.

7.36 The Task Force recommends that, as a matter of urgency, an investigation should be undertaken with a view to introducing a comprehensive system of inflation adjustments for business income tax purposes, as described in this Chapter. The terms of reference of such an investigation should include the following:

- **The development of detailed rules for calculation of the adjustments;**
- **Selection of the appropriate general index;**
- **Transitional and administrative matters, relevant to farming and other business sectors;**
- **Review of concessions which are identified as surrogates for inflation adjustments;**
- **Interim measures required for taxpayers who would face liquidity problems because of increased tax liabilities;**
- **Implications of providing for a change in the tax treatment of indexed financial contracts, including economic considerations;**
- **A requirement that account be taken of governmment policy for continued support for various sectors within the business economy;**
- **A requirement for direct consultation with sectoral interest groups.**

II COMPANY/SHAREHOLDER TAXATION

Present Position

7.37 Company income tax was first introduced in New Zealand in 1891. Since that date the rates of company tax have varied from 5 to 50 percent, and at various times these rates have been subject to additional levies of up to one third. Currently company tax at a flat rate of 45 percent is levied on incomes of resident companies with a 50 percent tax rate for non-resident companies.

7.38 Dividends are subject to personal income tax in the hands of resident individual shareholders, after allowance of an exemption of $200 of income from dividends and interest combined. Resident companies are not liable for further company tax on dividends received. Dividends paid to non-resident shareholders, both companies and individuals, are subject to a withholding tax, the rate being 15 percent in most cases, pursuant to double tax treaties with some countries, and 30 percent in other cases.

7.39 The latest available statistics indicate an increasing trend for company dividends to be paid to other companies and financial institutions, with a reduction in the proportion of dividends paid to individuals.

Table 7.1

RECIPIENTS OF DIVIDENDS PAID BY COMPANIES

	1976–77 $ million	per-cent	1977–78 $ million	per-cent	1978–79 $ million	per-cent
Recorded as received by:						
Companies[1]	132.1	43.0	227.4	56.0	277.4	64.3
Individuals[13]	92.0	29.9	93.0	22.9	92.0	21.3
Non Residents	20.5	6.7	23.7	5.8	41.2	9.6
Recipient Not Identified[2]	62.7	20.4	62.0	15.3	20.8	4.8
TOTAL DIVIDENDS PAID	307.3	100.0	406.1	100.0	431.4	100.0

(1) Includes Dividend income received from overseas companies. The estimated amount of overseas dividend income included in these aggregate figures, based on the results of the Household Survey, is of the order of 3 percent of total dividends received by individuals. No estimate is available in relation to overseas dividends received by companies.
(2) It is assumed that this may represent some measure of both tax free dividends currently not required to be reported in income tax returns and taxable dividends not reported in the case of either evasion or exemption (e.g. exemption for superannuation funds). The amount is subject to adjustment for note 1 above.
(3) National Income statistics show dividends received by households for the above years as S97, $115, S143 million respectively (Source: "Consolidated National Accounts for New Zealand on an SNA Basis", Reserve Bank of New Zealand, Research Paper No. 32, May 1981, Table 7). The differences for each of the above years of $5, S22, and $51 million give some indication of the trend in tax-free dividends paid to individuals.
Source: Department of Statistics

7.40 Revenue derived from tax on companies is shown below:

Table 7.2

TOTAL INCOME TAX COLLECTIONS AND COMPANY INCOME TAX COLLECTIONS

Year Ended March	1960	1965	1970	1975	1980
			$ Million		
Total Income Taxes	351.8	547.7	779.2	2136.0	4465.6
Company Income Taxes	106.9	193.9	233.2	426.4	646.7
Company Tax as a percentage of Total Income Tax	30.4	35.4	29.9	20.0	14.5

NOTES:
(1) Company income tax collections are net of refunds paid out during the income year.
(2) Further analysis of total income tax collections is included in Chapter 2.
Source: Inland Revenue Department; Department of Statistics

Table 7.3

ANALYSIS OF COMPANY OPERATING SURPLUS—REVENUE EFFECTS OF INCENTIVES AND COMPANY TAX LOSSES

Year Ended March	1965	1970	1976	1978	1979
			($ Million)		
Company Operating Surplus[1]	444.0	620.0	1175.0	1249.0	1442.0[2]
Company Tax Assessed	205.6	278.4	418.6	452.2	575.9
Tax Assessed as Percentage of Company Operating Surplus	46.3	44.9	35.6	36.2	39.9
REVENUE COST OF MAJOR COMPANY TAX INCENTIVES					
First Year Depreciation Allowance	–	–	60.7	45.0	59.0
Investment Allowances	–	–	9.5	14.0	20.0
Export Incentives	–	10.0	43.0	96.0	119.0
REVENUE EFFECT OF COMPANY TAX LOSSES					
Losses Offset in Current Year[3]	4.5	11.0	39.0	108.0	135.0
Company Losses Incurred in Current Year and Not Offset[4]	(11)	(24)	(182)	(245)	(303)

(1) Company operating surplus is taken from "Consolidated National Accounts for New Zealand on an SNA Basis", Reserve Bank of New Zealand, Research Paper No 32, May 1981, Table 13.
(2) Revised figure for 1979 based on revised information from the Department of Statistics.
(3) Revenue costs of losses offset in current year relate to prior year losses carried forward and applied in offset in the year. No estimate is available for current losses offset in the same year against assessable income of other companies within the same group of companies.
(4) Revenue effect of tax losses arising in the current year, but not applied in reducing tax assessed in that year. The tax losses are available to be carried forward and offset in future years.

Sources: Department of Statistics; Secretariat Estimates

7.41 These figures do not, of themselves, point to a need to reform the taxation of companies and shareholders so as to provide relief. As discussed below, however, the Task Force found that the present system, as a system, displays faults and inequities which should be corrected or at least alleviated.

7.42 The Task Force endeavoured to catalogue and quantify the reasons for the decline in the proportion of income tax revenue paid by companies. It found that a large part of this decline was directly related to the availability of tax incentives. To the extent that such incentives actually achieve the policy objectives of the Government they should be set aside in any consideration of the equity of the company tax system. On the other hand, to the extent that measures made available as incentives to certain actions are enjoyed by companies for doing what they would have done in any case, they may be seen as a form of tax relief. Information available to the Task Force was neither complete nor current enough to allow any definitive judgement on this matter.

7.43 The Task Force also found a dramatic increase in the amount of company tax losses carried forward, and in the offsetting of past losses in reduction of current tax. Table 7.3 above shows the revenue effect of tax losses on tax assessed in the current year. No detailed information was available as to the extent of tax losses not utilised in the current year and available for carry forward to reduce taxes payable in future income years. The secretariat analysed the trend in company tax losses and has estimated that, at the end of the 1981 income year, company tax losses available to be carried forward and applied in reducing taxes payable in future years were approximately $2,500 million. The potential revenue effect of these losses will be to reduce tax payable for the corporate sector in future years by approximately $1,125 million. The above estimates include government trading entities and related government corporations, and at the end of the 1981 income year, tax losses carried forward by these bodies are estimated to be in excess of $800 million. Again, however, evidence of appropriate monitoring of this, and the factual information necessary to analyse and evaluate this phenomenon, were lacking.

7.44 National Accounts figures indicate that the percentage of Gross Domestic Product represented by company operating surplus has declined in recent years. Such analysis as the Task Force could perform confirmed that such a decline has occurred but did not confirm that its true magnitude would fully explain the decline in company tax, even after allowing for incentives.

7.45 The Task Force strongly recommends that a comprehensive information system be established to provide analysis of all significant facets of company incomes and company income tax.

This information should be monitored on an on-going basis so that decisions of policy and administration, and judgements about equity, may be soundly based. It is understood that the Inland Revenue Department is currently in the process of establishing such an information system.

7.46 The Task Force considers however that a review of the principles of the present system of company shareholder taxation does not need to await the establishment of the information system. A reformed tax system which is more sound, in itself, will be a better base on which to apply the results of an improved information system.

Evaluation of the Present System

7.47 The New Zealand system which, basically, taxes both company profits in full and distributions to shareholders in full, is an example of what is called "The Classical System".

7.48 Arguments generally advanced to support a separate company tax include:

- Those who own a business conducted under limited liability should pay extra tax for that statutory privilege;
- Unless a capital gains tax is levied on increases in share values, company profits retained would not be taxed in the absence of a company tax. Thus tax avoidance opportunities would arise for those accumulating savings within the company structure;
- A separate company tax widens the income tax base and is a convenient way of raising additional tax revenue;
- Elimination of tax at either the company or the personal level would lead to substantial unexpected windfall gains for existing shareholders, most of whom have acquired their shares in the expectation that the current regime would continue;
- A separate company tax provides a means to levy tax on income derived by non-resident shareholders. Double tax agreements preclude any significant tax on non-resident shareholders in the absence of a separate company tax.

7.49 The most common argument against the classical system of full taxation of both company profits and shareholders' dividends is that it amounts to double taxation and, thus, to excessive taxation. Businesses conducted by companies are thus seen to be disadvantaged as against businesses conducted by, say, partnerships. This may be said to operate against an efficient and desirable form of business organisation, and also to be inequitable.

7.50 It is possible for tax to be paid at a rate of 78 cents in the dollar on company profits, when both company tax and shareholder tax are taken into account. This, however, occurs only where all the profits of a company are distributed and the shareholder is paying the maximum marginal tax rate of 60 percent. The following table shows the position at various personal tax rates and various percentages of profit distribution.

Table 7.4
COMBINED COMPANY AND SHAREHOLDER TAX RATES ON COMPANY PROFITS

Shareholder's Taxable Income	Shareholder's Marginal Rate of Personal Tax Percent	Combined company/shareholder tax, expressed as a percentage of company pre-tax profits, assuming the following level of dividend distribution				
		0	33	50	67	100
Up to $5,500	14.5	45	47.6	49.0	50.3	53.0
$5,501 to $12,600	35.0	45	51.4	54.6	57.9	64.3
$12,601 to $17,600	48.0	45	53.7	58.2	62.7	71.4
$17,601 to $22,000	55.0	45	55.0	60.1	65.3	75.3
Over $22,000	60.0	45	55.9	61.5	67.1	78.0

7.51 At a typical level of dividend distribution (between one-third and one-half of tax-paid profit) all shareholders except those in the higher marginal tax brackets are subject to combined tax on company profits at rates significantly higher than their marginal personal tax rate.

7.52 To the extent that shares have been transferred from a taxpayer either to a spouse or children, many "low marginal rate" shareholders may well be the beneficiaries of a form of income splitting. As this device for tax avoidance is available only to those who derive income from the application of capital and is not available to other taxpayers, (for example salary and wage earners), the double taxation of company profits may not be as inequitable as it seems at first sight, and 'rough justice' may be achieved. The present classical system of taxing company profits is however considered a crude mechanism for overcoming the inequity of this situation. The proposals of the Task Force relating to the taxable unit set out in Chapter 6.III are considered to deal more appropriately with this inequity.

7.53 Table 7.4 ignores the fact that, because of various tax incentives and concessions, the actual rate of tax applicable to reported income is, for many companies, well below the nominal company tax rate. For example, it is estimated that in aggregate the average rate of tax paid on company profits was only 32.6 percent in 1980/81. Tax incentives are separately discussed in Chapter 4 of this report and, are therefore set aside in this discussion of the principles of the company tax system.

7.54 Shareholders of closely-held private companies are in a different position to that of shareholders of widely-held companies, such as listed public companies. They are able to reduce, or even escape completely, so-called double taxation. For example, such companies can eliminate company tax by paying out all "profits" as salaries to full-time shareholder employees. The profits are then taxed at personal tax rates, as if the shareholders were partners in a partnership. In practice this treatment of private companies and their shareholders is closely analogous to the "full integration" method outlined below. This approach to company taxation is often argued to be the most appropriate method of taxing company income. The Task Force proposes no change in the existing taxation treatment of remuneration payable to full-time shareholder employees.

7.55 So far as other individual shareholders are concerned, the Task Force is of the opinion that the present system, of full taxation of dividends with no offset to recognise that company tax has also been paid on the profits from which the dividends arise, is inequitable. Various methods in use overseas are discussed later in this chapter, and a proposal is made for a form of relief.

7.56 Further criticism of the present system concerns the differing treatment of dividends and interest. While interest payments are deductible to the company, dividends are not (with the exception of those paid on specified preference shares). A result of this unequal treatment is a strong preference for debt capital over equity capital, a preference determined by tax law rather than commercial considerations.

7.57 The Task Force has concluded that the appropriate treatment of interest payments is to continue to allow these as deductions for income tax purposes. Inflation gains on debt should however be included in taxable business income, as one of the inflation adjustments in a comprehensive business tax system proposed earlier in this chapter.

Alternative Systems of Company/Shareholder Taxation

7.58 Several alternatives to the classical system have been considered, principally on the basis that it is desirable to achieve greater neutrality and equity than is implicit under the present regime. The alternatives include:

- full integration;
- imputation or tax credit system;
- split-rate system;
- a combination of the split-rate and imputation system.

Full Integration

7.59 Under this system there is no company tax as such and each individual shareholder is taxed, at the relevant personal tax rate, on his share of company income, whether received as dividends or retained by the company. In essence shareholders are treated in the same way as partners in a partnership.

Imputation System

7.60 Under an imputation system, some or all of the tax paid by the company on distributed profits is treated as a prepayment of the shareholder's personal income tax payable on the dividend received. The individual shareholder's assessable income includes the dividend received plus the amount of the company tax deemed to be prepaid on the dividend. In determining the shareholder's personal income tax payable, credit is given for the deemed prepayment with any excess credit being refundable to the shareholder. This method is currently in use in the United Kingdom.

Split-Rate System

7.61 A split-rate system levies company tax at full rate on profits that are retained and at a lower rate on profits distributed. The shareholder continues to be taxed separately on dividends as under a "classical" system, with no account being taken of tax paid at the company level.

Combined Split-Rate/Imputation System

7.62 The combined system provides for some relief from the "double taxation" of the classical system at both the company and the shareholder level. Where company profits are distributed and personal income tax is payable, the company's tax liability on the profit is reduced. The shareholder's personal tax liability also takes into account some or all of the underlying company tax paid on the distributed profit.

Revenue Implications of Alternative Systems

7.63 The Task Force has recognised the restriction that the need for maintaining government revenue (particularly from non-resident shareholders) places on the reforms it may practically suggest in the area of company shareholder taxation. Without this restriction the Task Force might have been favourably disposed to proposing an imputation system.

7.64 It was noted in particular that these systems would all result in a significant reduction in revenue derived from overseas investors and could not be readily implemented in respect of institutional shareholders, such as life insurance companies and superannuation funds, the former being taxed on a special formula and the latter not taxed at all. Reference to the desirability of reform in the taxation treatment of these institutions is discussed in Chapter 12 of this report.

A Rebate on Dividend Income

7.65 The Task Force considers that a simple dividend rebate system directed at reducing tax payable by individual resident shareholders would be the most appropriate option for reform of company/shareholder taxation.

7.66 A dividend rebate would be relatively simple to determine, being based on a fixed percentage of dividends received by the individual. It is compatible with the general system of rebates currently given for various reasons to individual taxpayers. The value of the rebate is independent of the marginal tax rate of the individual and is therefore of equal benefit to taxpayers with low or high taxable incomes.

7.67 Inevitably, the selection of a figure for such a percentage rebate must be somewhat arbitrary, but having considered the matter carefully the Task Force considers that a figure in the range of 15 percent to 20 percent of dividends received would be appropriate. The Task Force's preference is for a rebate of 20 percent, although it would be administratively convenient to set the rebate at the same rate as the first step in the personal income tax scale.

7.68 The present exemption of $200 applied to the combined amount of interest and dividends would need to be limited to interest only. The general question of interest received by personal taxpayers is discussed in Chapter 6.II.

7.69 The rebate would be applied to reduce, or eliminate, income tax payable by an individual. The rebate would be limited to tax assessed and any excess rebate not so applied would not give rise to payment of a tax credit by the Government to any shareholder.

Tax Free Dividends

7.70 Various methods of avoiding personal tax on dividends have been devised in recent years and are now widespread, with significant cost to the revenue. In particular, companies have resorted to distributions from Share Premium Account and from realised capital profits.

7.71 In general the share premium distributions have not in real substance amounted to a return of capital to shareholders, as in most cases a condition of the High Court's approval for these distributions has been the transfer of an equivalent dollar amount from retained revenue earnings to a "Capital Replacement Fund". This procedure has merely resulted in a "washing" of retained revenue earnings so that otherwise taxable dividends have taken on the tax-free nature of share premium distributions. Sources for payment of tax free dividends have also been created by arrangements with related companies for the generation of capital profits, including cases of formation of wholly owned subsidiary companies to buy properties and other capital assets from the parent company at market valuations where these exceed the original cost price of the asset to the parent.

7.72 Until recently, the payment of tax-free dividends out of reserves created from tax-free capital profits or from the Share Premium Account was an insignificant portion of total dividends paid by companies. Two factors have given rise to their rapid increase in recent years.

- High rates of inflation have led to increases in the monetary values of capital assets at a much more rapid rate than was the case prior to the early 1970's. Sales of such assets are therefore much more likely to generate capital profits.
- The search for tax-free sources from which to pay dividends has led to the increased use of Share Premium Account distributions. In this case the payment amounts to a reduction of fixed capital only in terms of the Companies Act although the distribution has also been treated as a return of capital for tax purposes.

7.73 Some companies, larger ones in particular, are regularly buying and selling capital assets as part of the changing pattern of business. Where mergers and take-overs take place, it is quite normal that surplus assets will be acquired which can be disposed of at a nominal capital profit. Such profits are not revenue profits, in the sense that the company is not engaged in the business of buying and selling of such assets, but arise from time to time as business activities change or as more modern assets are acquired to replace others. When there is no inflation, capital profits from this source are relatively insignificant but if there is a continuation of current rates of inflation, it is inevitable that the potential for realising nominal gains will continue. To the extent that these gains reflect the rate of inflation over the period between purchase and sale of a capital asset, they are "capital profits" only in a nominal, but not in any real, sense. In fact, the full proceeds are often required to be reinvested to replace the assets sold.

7.74 Both realised capital reserve accounts and share premium reserve accounts can be constantly replenished by some, but not all, companies. For example, a successful company whose shares are worth significantly more than their nominal value, can continue to increase its share capital by cash issues of its own shares at a premium, thereby replenishing its share premium reserve account.

7.75 In the view of the Task Force there are two unsatisfactory features of the present position.

- Access to a continuing source of tax-free capital gains for use as tax-free dividends is not available to all companies.
- The pressure to obtain access to tax-free dividend reserves has led to many artificial arrangements. This clearly gives an unfair advantage to those companies able or willing to adopt such practices.

7.76 It is the Task Force's opinion that the current distinction between capital (tax-free) and revenue dividend distributions should not be continued and for tax purposes restrictions should be placed on a company's ability to nominate the source of its dividend distributions. While the current tax-free distribution procedures outlined above might be excused as "ad hoc" adjustments to the tax system to alleviate the effect of taxing company profits at both the company and the shareholder level, the ability to make use of such mechanisms is not available to all companies and shareholders in an equitable manner. In the context of tax reform it is considered that the continuation of these "ad hoc" measures is inappropriate and a system which more adequately meets the essential criteria for reform should be adopted.

7.77 The Task Force accordingly recommends that the existing treatment of dividends should be amended so that all company distributions are treated as taxable revenue distributions in all cases where there are retained revenue earnings available for distribution. Legislation should be introduced to provide that while a company , or any company within a group of companies, has retained revenue earnings, from past or current years, dividends would be deemed to be paid first from this source.

7.78 Distributions would therefore be recognised as tax-free only after all retained revenue earnings had been paid out. Distributions then made from realised capital profits or Share Premium Account would be treated as exempt from tax in the hands of the shareholder. Where capital was sought to be returned to shareholders pursuant to a formal reduction of capital or on the liquidation of the company, the capital reduction would, for tax purposes, first be deemed to be paid from any retained revenue earnings. After all retained revenue earnings had been paid out the capital then returned to the shareholder tax-free would be paid up share capital plus share premium reserves and realised capital profits. Appropriate anti-avoidance provisions would need to be introduced.

7.79 The overnight introduction of a change in the tax treatment of company distributions may cause problems for the share-market. It also appears that some companies may have already anticipated a change in the tax rules in this area and have brought forward their dividend payment dates or made special distributions from currently tax-free sources in an endeavour to avoid the effect of the possible legislative change if this were applied in the current income tax year.

7.80 To overcome problems of avoidance during any extension of the current tax-free treatment of dividends, a limitation could be introduced as to the amount of tax-free distributions allowed following any government announcement of the change. For example tax-free payments might be restricted to the annual average of the last two years, any balance of additional dividend distribution then being taxable to the shareholder regardless of the nominal source of the distribution.

7.81 The Task Force considers that the rebate proposed in paragraphs 7.65 to 7.69 should not be introduced until the expiry of any period of extension allowed for tax free distributions.

Revenue Cost and Gain

7.82 The revenue loss from the tax-free distribution of "capital" dividends is estimated at approximately $35 million in 1980/81 terms. This is therefore the order of magnitude of the revenue gain from withdrawing this avenue of avoidance. With all dividends subject to tax, the offsetting revenue cost of the proposed rebate, at current personal tax rates, has been estimated at $26 million for a 20 percent rebate. In the event that a change in the personal income tax scale was introduced these estimates would not alter significantly.

Bonus Issue Tax

7.83 Bonus issues of shares made by capitalising retained revenue earnings of a company are subject to a bonus issue tax, payable by the company, at the rate of 17.5 cents for each dollar of retained earnings capitalised.

7.84 Bonus issues exempt from bonus issue tax may also be made by capitalising a share premium reserve or realised capital profits or from the revaluation reserve created on writing up the book value of capital assets in excess of the original cost of the assets.

7.85 Bonus issues are not, in the Task Force's opinion, a distribution to shareholders in any sense analogous to a dividend. In fact, they merely constitute notice to shareholders that some accumulated revenue profits or other gains or reserves which were available for distribution to shareholders are to be locked in and therefore not distributable except in the event of a reduction in capital.

7.86 The bonus share issue gives nothing to shareholders that they did not already have. The shareholders' proportionate interests in the company following the bonus issue are unchanged.

7.87 It is sometimes argued that the making of a bonus issue is of benefit to shareholders, it being observed that the combined market value of the head shares and bonus shares is in some cases greater than that of the head shares alone, prior to the announcement of the issue. The principal reason for this is that the issue of bonus shares is a formalised way in which directors signal their confidence in the company's ability to sustain an increased total dividend payout in the long term. Thus it is possible that a bonus issue is seen by the market as a firmer assertion of such an expectation than mere announcement of an increase in the dividend rate for existing nominal share capital.

7.88 There is thus no logical reason for taxing a company or its shareholders merely because it makes a bonus issue.

7.89 The only reason for such a tax is an administrative one—namely that, in the event of a winding up or reduction of capital of a company, some revenue earnings, capitalised as bonus shares, may be distributed to shareholders disguised as a return of capital, and therefore tax-free in nature.

7.90 The Task Force proposes that the tax payable on making a bonus issue should be abolished, because it is unsound in principle and operates to inhibit the free and proper operation of the capital market.

7.91 It is proposed that provision should instead be made to levy tax on distributions made to shareholders upon a winding up or reduction of capital by any company which has, within the last ten year period, made a bonus issue by capitalising revenue reserves. In accordance with the Task Force's recommendation in paragraph 7.78, any such distribution of the capital reduction should be deemed to be made first in relation to retained revenue earnings and then second in relation to such bonus shares. Such a distribution from bonus share capital, within the ten year period after the bonus issue, would be taxable in the hands of the shareholder as though it were a dividend.

7.92 Measures would need to be considered to overcome any foreseen avoidance problems. In general the Task Force is of the opinion that a company can not hold out that it is making a reduction of its capital if at the same time it also has retained revenue reserves. Anti-avoidance measures should also provide for cases where a company sought to capitalise all its retained revenue reserves and then applied for the Commissioner's approval to pay out tax free distributions from realised capital profits or Share Premium Account.

7.93 The current revenue cost of this proposal is estimated at less than $4 million per year.

Conclusion

7.94 The Task Force submits the following recommendations concerning company/shareholder taxation.

- **The establishment of an information system relating to the facts of company incomes and company income tax, as sufficient data for full consideration of taxation policy issues are not currently available.**
- **Except where all retained revenue reserves have been paid out all dividends and distributions made by a company should be subject to tax in the hands of shareholders.**
- **A rebate of 20 percent of dividends received should be allowed to resident individual shareholders.**
- **Bonus issue tax should be abolished and replaced with a provision for tax to be levied upon any reduction in capital made within the ten years after a bonus issue.**

Chapter 7: Appendix A

TAX ADJUSTMENTS FOR INFLATION

7.A1 The proposed tax adjustments to allow for the effects of general inflation which the Task Force has studied and which it suggests could form the basis of a comprehensive business income tax system are outlined as follows:

- **Trading stocks and monetary assets**

  A reduction in tax liability by permitting a deduction against business income for the effects that inflation and the consequent change in money values have on the trading stock and monetary assets of the business. The inflation adjustment is made by applying the movement in a general index of inflation for the tax year to the average value of those assets for the year.

  The adjustment would be made to the tax book values for all items of trading stocks and monetary assets such as trade debtors and advances. All financial advances and deposits providing for capital repayment on maturity in non-inflation adjusted terms would be subject to the inflation adjustment. Investments in shares would be excluded.

- **Liabilities**

  An increase in tax liability so that the extent by which a business gains from inflation as its debt diminishes in real terms would be recognised in determining taxable business income. The same general index would be used.

  The liabilities subject to the adjustment would include all borrowings, such as debentures, trade creditors, etc. The principal items excluded from the adjustment would be the provision for tax itself, any deferred tax credit and liabilities subject to full inflation adjustment on repayment.

  Where no liabilities are disclosed in the financial statements of the business, but interest expense is included as a deduction in that income tax year, the Commissioner should have the right to review the circumstances of the interest expense and where appropriate amend the inflation adjustment.

- **Depreciable assets**

  A reduction in tax liability by granting an increase in the tax depreciation allowance for the year proportionate to the percentage increase in the inflation adjusted value of depreciable assets since purchase or the date of introduction of this adjustment, whichever is the later. For the purpose of this adjustment it is not proposed that the general index increase should be applied retrospectively to the date of purchase of the depreciable asset where this is prior to the date of introduction, and only the increase in the index from the date of introduction of the adjustment should be allowed. To allow the depreciation increase to be calculated from the date of acquisition without adjusting borrowing gains of past years would not be justifiable.

On the sale of a fixed asset, tax depreciation subject to recovery would be the inflation adjusted tax claims made in respect of that asset. A tax-free capital gain to the business would be realised on sale only where the sale price exceeded the inflation adjusted original purchase cost of the fixed asset.

- **Changes to the present tax base**

  Concessions that are proxies for an inflation adjustment to the business tax base should be identified and if appropriate withdrawn. This would provide a substantial offset to the revenue cost of the proposals.

7.A2 The following example sets out the procedures required to calculate the adjustments proposed by the Task Force.

The example is based on the following information and assumptions.

Historic Cost Balance Sheet of XYZ Ltd.

	This year	Prior year
Current Assets	$	$
Trading Stock	50,000	48,000
Trade Debtors	38,000	30,000
Other Current Assets	9,500	7,000
Investments		
Mortgage Advances	8,000	9,000
Shares in Other Companies	5,200	5,000
Fixed Assets	70,000	65,000
TOTAL ASSETS	$180,700	$164,000
Financed by		
Trade Creditors	42,000	35,500
Provision for Tax	1,000	500
Bank Overdraft	14,000	20,000
Other Current Liabilities	18,000	14,000
Term Liabilities	18,000	12,000
Deferred Taxation	16,500	14,800
Shareholders' Funds		
Paid Up Capital	42,000	40,000
Retained Earnings and Reserves	29,200	27,200
	$180,700	$164,000

7.A3 The historic cost taxable profit for the income year is assumed to be \$10,000 (after providing for tax depreciation of \$6,000, and deducting interest expenses of \$6,400). The company tax rate is 45 percent.

7.A4 Inflation during the income year is assumed to be 15 percent, as measured by the appropriate "general index" adopted for the inflation tax adjustments. The movement in the "general index" was:

Beginning of Income year	1700
End of Income year	1955

The percentage change in the "general index" for the year is therefore:

$$\frac{1955 - 1700}{1700} \times 100 = 15\%$$

To calculate the general index adjusted opening value of assets and liabilities, the averages of opening and closing account balances are divided by the calculated index midpoint for the period and then multiplied by the general index at the beginning of the income year. The midpoint of the index for the year is calculated by determining the arithmetic mean of the beginning and end index numbers above:

$$\text{Midpoint of index} = \frac{1700 + 1955}{2} = 1827.5$$

7.A5 The objective of the adjustments is to apply the rate of inflation to the average balances during the period. This requires first the calculation of average balances, translating this to the opening index price level and then applying the percentage change in index values for the year.

7.A6 The calculation of the individual components of the inflation adjustments would be:

(a) Trading Stock and Monetary Assets

Opening Tax Values	
Trading Stock	48,000
Trade Debtors	30,000
Other Current Assets	7,000
Monetary Investments	9,000
	\$94,000
Closing Tax Values	
Trading Stock	50,000
Trade Debtors	38,000
Other Current Assets	9,500
Monetary Investments	8,000
	\$105,500

1 The average qualifying assets for the period at average historic cost prices for the period are:

$$\frac{94{,}000 + 105{,}500}{2} = \$99{,}750$$

2 The average assets at opening index values are therefore:

$$99{,}750 \times \frac{1700}{1827.5} = \$92{,}791$$

3 The inflation adjustment required is therefore:

$$15\% \text{ of } \$92{,}791 = \$13{,}919$$

(b) A similar calculation is made in respect of the liabilities of the business

Opening Tax Values	
Trade Creditors	35,500
Bank Overdraft	20,000
Other Current Liabilities	14,000
Term Liabilities	12,000
	$81,500
Closing Tax Values	
Trading Creditors	42,000
Bank Creditors	14,000
Other Current liabilities	18,000
Term Liabilities	18,000
	$92,000

1 The average qualifying liabilities for the period at average cost prices for the period are:

$$\frac{81{,}500 + 92{,}000}{2} = \$86{,}750$$

2 Average liabilities at opening prices of the period are therefore:

$$\$86{,}750 \times \frac{1700}{1827.5} = \$80{,}698$$

3 The inflation adjustment to determine the borrowing gain is therefore:

$$15\% \text{ of } \$80{,}698 = \$12{,}105$$

Note: The example adjusts the gross values of qualifying assets and liabilities. In practice the qualifying assets and liabilities could be netted together and the inflation adjustment then determined in one calculation.

(c) Depreciation

The tax depreciation claimable based on historic cost tax book values was assumed to be $6,000.

To make the inflation adjustment it is necessary to index each year the opening tax book values of the depreciable assets and calculate depreciation on this adjusted opening tax book value. In this example, the opening tax book values are $50,000 and additions in the first half of the year were $5,000. The balance of fixed assets is assumed to be non-depreciable land.

The non-inflation adjusted tax depreciation was assumed to be calculated as follows:

$55,000 + $5,000 = $60,000 at 10% = $6,000

The inflation adjusted tax depreciation would be calculated as follows (where inflation is 15%)

$55,000 × 1.15	=	63,250	at 10% =	6325.0
$5,000 × 1.075[1]	=	5,375	at 10% =	537.5
		$68,625		$6,862.5

In the following year and again assuming an index change of 15%, and that depreciation on all assets is calculated on a diminishing value basis, the inflation-adjusted depreciation would be the previous year's inflation adjusted closing net tax book value of $68,625 less the adjusted depreciation of $6,862.5 i.e. $61,762.5. This is adjusted as above and depreciation for the second year would be calculated as follows:

$61,762.5 × 1.15 = $71,027 at 10% = $7,102.7

(1) It is assumed that additions in the first half of the year would be adjusted for half the inflation rate of the year and that no inflation-adjustment would be made for fixed asset additions in the second half of the year.

7.A7 The total inflation adjustments to taxable income in the first year for XYZ Limited would therefore be:

Historic cost taxable income		$10,000
Less adjustments for		
Trading Stock and Monetary Assets		(13,919.0)
Additional Depreciation		(862.5)
(Inflation adjusted tax depreciation	6862.5	
Historic cost tax depreciation	6000	
Additional depreciation	862.5)	
Plus adjustment for		
Borrowing Gain Liabilities		12,105
Inflation adjusted taxable income		$7,323.5
Tax payable at 45 cents in $ on $7,323.5 =		$3,295.57

Chapter 8

INDIRECT CONSUMPTION BASED TAXES

Introduction

8.1 One factor which has contributed to the emergence of high personal income tax rates in the New Zealand system has been the comparative narrowness of the indirect tax base overall. This is illustrated by the fact that the current wholesale sales tax brings within its scope only a little over one quarter of private expenditure on consumption, or about 9 percent of expenditure on gross domestic product.

8.2 In 1980/81, the most recent year for which official figures are available, private final consumption was estimated to be $14,624 million. Of this, approximately $10,400 million could be included in an indirect tax base. Such an expansion of the current base would enable a general reduction of the current tax rates to be made and would relieve pressure on the income tax system.

The Present Position

8.3 Wholesale Sales Tax (WST) is the predominant source of indirect tax revenue in New Zealand. It was introduced in 1933 at a flat rate of 5 percent on nearly all consumer goods except food. From time to time many classes of goods have been excluded, some end uses (e.g. education and charities) have been granted concessions, and multiple rates, both ad valorem and specific, have been struck. The reasons for these changes have included policy judgements seeking to distinguish goods which are regarded as necessities from luxuries, as well as broad social and economic judgements.

8.4 At present, about 40 percent of the value of the maximum possible base is subject to wholesale sales tax.

8.5 $775 million was collected in 1980/81, equal to 11 percent of total tax revenue. The sources of WST are shown in Table 8.1.

8.6 The tax is imposed on either the last wholesale transaction—that is, to a retailer—or on importation if the goods are imported directly by a retailer or consumer. All manufacturers or wholesalers of taxable goods must be licensed. Tax returns are made monthly. Transactions between licence holders are not taxed provided the goods are for resale or are to be physically incorporated in goods for resale. Taxable goods which are purchased by businesses and are not incorporated in goods for

Table 8.1
Estimates of the Base and Revenue From Wholesale Sales Tax 1980/81

	Base $m	Percentage of Present Taxable Base	Estimated Revenue Yield $m	Percentage of Total Wholesale Tax Collected	Average Rate Percentage
Motor Vehicles	623	18	231	30	37
Alcoholic Beverages	380	11	122	16	32
Tobacco Products	140	4	35	4	25
All Other Goods	2358	67	387	50	16
	3501	100	775	100	22

Note: Motor spirit is subject to tax in terms of the Motor Spirits Duty Act. It is not subject to wholesale sales tax (which is imposed by the Sales Tax Act.)
Source: Customs Department

resale are taxed whether the buyer is licensed or not, though there are some specific exemptions to this rule based on use—for example, farm motorcycles.

8.7 The tax is administered by the Customs Department. It is collected from 8175 taxpayers at a cost of 24 cents per $100. There are 120 staff engaged on WST duties.

Motor Vehicles, Motor Spirits, Alcohol and Tobacco

8.8 Throughout this chapter it is assumed that present rates of indirect tax would continue to apply to motor vehicles, motor spirits, alcohol and tobacco. Thus the options presented are dealt with in the context of supplementing the $387 million presently collected on other goods, by expansion of WST, or by incorporating such other goods in the base of some new tax to be introduced.

Main Features of Indirect Tax Systems

8.9 There are three basic mechanisms which distinguish consumption-based indirect tax systems from one another.

(a) *Staging*

(i) Multi-stage, that is, levied on goods and services at all or several points as they pass through the distribution system. Examples are a turnover tax and a value added tax (VAT).

(ii) Single-stage, that is, levied once only, such as the present wholesale sales tax or a retail sales tax.

(b) *Offsets*

Tax on goods and services used in production of final goods and services may be relieved. Where relief—offset—is given it may be provided by one of two methods.

(i) A ring system, under which transactions between licensed taxpayers are free of tax, as under the present wholesale sales tax or a retail sales tax.

(ii) A credit system, under which tax is paid on all purchases and charged on all sales, with taxpayers returning the difference to the revenue authority. This is the procedure under a value added tax.

Under other systems, such as a turnover tax, no relief is given.

(c) *Level*

Tax may be finally charged on sales by manufacturers, wholesalers or retailers.

8.10 The features of each of the alternative mechanisms include the following:

(a) staging: the advantage to the Government of multi-stage taxes is that a clear audit trail of invoices follows goods from a manufacturer or importer to the point of final sale. This, together with the smaller sums collected at each stage, lessens opportunities for evasion. The disadvantage to the Government is that the number of taxpayers is increased (especially if the tax encompasses the retail level) with correspondingly higher administrative costs.

(b) offsets: the advantage to the Government of a credit offset mechanism is that evidence of an invoice showing tax must be available to support a claim for credit of tax paid. This facilitates detection of evasion especially if the revenue authorities are able to compare income tax and sales tax returns. The disadvantage to the Government is that although it collects more sales tax than is the case under a ring mechanism the additional collection must be repaid to taxpayers. The advantage to businesses of a credit offset is that tax on final goods and services used by businesses can be more completely relieved than under the ring system and the taxpayer is not required to determine the final tax liability of the purchaser. A disadvantage is that traders, particularly at the retail level, are required to account for purchases and sales.

(c) level: intermediate taxes finally levied on manufacturers and wholesalers involve fewer traders from whom tax must be collected than is the case with retail taxes, but the total value of sales is lower. The administrative costs to the Government of intermediate taxes are lower than for retail taxes but a higher tax rate is required to return the same revenue as a tax imposed at the retail level. Traders who must purchase goods tax-paid may have the disadvantage of having to finance tax on stocks but the advantage of no legal obligations in respect of sales tax.

Criteria for Evaluating Sales Tax Options

8.11 A simple tax based on known and established values with minimum deviations from standard commercial and accounting practices minimises both administrative and compliance costs and opportunities for evasion and avoidance. Complex tax systems make it generally difficult for taxpayers to work out their liability. In summary, the ideal sales tax system is one:

(a) from which a high and sustainable yield of revenue is available at moderate administrative and compliance costs on a base which grows with real growth in the economy;

(b) which does not distort relative prices or discriminate between production techniques or paths through the distribution system i.e. which, insofar as possible, attaches a tax content to final prices which is a uniform percentage of those prices;

(c) which is complementary to other taxes in its incidence, both initially and over a period of time, and which does not unfairly burden taxpayers.

8.12 The Task Force identified a number of criteria which, in its view, would facilitate a decision on the adoption of any proposed sales tax option. Some of the criteria are inter-related and the relative importance to be attached to them is a matter of judgement and policy.

- The amount of revenue the tax will yield—whether it is sufficient for purposes of short-term reform; whether, at a given rate, it will vary with domestic consumption in real and money terms; and whether the base will support expansion to increase the proportion of total revenue provided by the tax. A broad base is considered essential.
- The speed with which the tax could be applied.
- Costs of administration to the Government and to taxpayers, and other costs to taxpayers, such as financing the tax pending recovery from customers.
- Simplicity—having particular regard to the number and types of persons involved in applying and returning the tax.

- Neutrality—uniformity or otherwise of effect on final prices, regardless of method of production or method of distribution; avoidance of double or multiple taxation; cascade effects i.e. tax on tax or margin on tax.
- Ability to reflect social costs or benefits.
- Variability—ability to accommodate different rates on various classes of goods and services, and to change the rates from time to time should Governments so decide.
- Susceptibility to avoidance and evasion.
- Horizontal and vertical equity, both as regards the tax itself and as part of the whole tax system. Regressivity.
- Effects on inflation.
- Ability to exempt export goods, and tax imports on a comparable basis to locally produced goods.

8.13 In considering the amount of yield the Task Force has formed the view that it should seek options which would yield between $500 million and $1000 million more than the present WST in 1980/81 terms. Such options might be suitable as a permanent feature, or might be a transitional arrangement for use while some other tax, which displayed preferred characteristics and had a higher long-term potential, is put in place.

8.14 The amount sought, in the short run, will depend on judgements as to the intrinsic benefit of a shift to indirect tax and on the availability of sources of revenue, other than indirect tax, to offset such changes in personal income tax scales and methods as may be decided upon.

Regressivity/Progressivity

8.15 The options which, in the view of the Task Force, merit full consideration for adoption, whether in the short term or in the longer term, have no ascertainable differences in inherent regressivity or progressivity.

8.16 Indirect taxes are widely held to be regressive, on the ground that the lower the income, the greater the proportion of it that will be spent and hence taxed. This view is, in part, the reason why the flat WST originally applied in New Zealand has been drastically adjusted and modified over the fifty years since it was introduced.

8.17 To the extent that these adjustments have in fact reduced regressivity, the expansion of the base to cover all goods and the application of a flat rate would provide an increment which, of itself, would be regressive.

8.18 In its consideration of the incidence of sales taxes of various sorts and yields, the Task Force received great assistance from analyses made on the basis of income and expenditure data drawn from the 1979/80 Household Survey. This pattern has been influenced by the existing income and indirect tax structures. Thus, while the study may be seen as providing a useful indication of the immediate impact on incidence of major tax changes, it cannot safely be assumed that the pattern of incidence revealed is that which would emerge in practice if the proposed reforms were implemented and sufficient time had elapsed for spending patterns to alter. Our analyses were inevitably predicated on the assumption that patterns of expenditure would not be greatly changed by alterations in direct or indirect taxation. This seems a reasonable assumption provided the tax is imposed across the board at a flat rate, the incidence of taxes is not significantly altered as a result of reforms, and savings ratios are not significantly increased as a result of increased emphasis on indirect taxes. But it must be recorded that this assumption is implicitly contested by adherents of the view that a move from reliance on direct tax to more reliance on indirect tax will change expenditure and savings habits to an important extent.

8.19 Analysis of the effect on households with various income levels of a flat tax on all consumption expenditure to yield additional revenues of $500 million and $1000 million respectively indicated the following approximate levels of incidence. These were measured as percentages of pre-tax household income i.e. the total income of all individuals in the household.

8.20 While there are differences in incidence within income groups depending on the composition of the households these are relatively small for the $500 million option but become more significant with the $1000 million option. The greatest variance among household types occurs in the under $8000 household income bracket.

Effect of Exempting Food and Clothing

8.21 In order to test the possibility of achieving a significant reduction in regressivity by manipulating exemptions and rates, the Task Force studied the effects of exempting food, and exempting both food and clothing. The following table shows the effect of excluding food from the base, taking into account the increase in the rate necessarily applied to the residue of the base to maintain the revenue yield.

Table 8.2

The estimated immediate effect of replacing the present WST with a flat rate sales tax at the retail level, yielding $1000 million additional revenue, as a percentage of household gross income in 1980/81 terms[1].

Household Income 1980/81	One Adult (19%)[3]	Two Adults (27%)	Two Adults with Children (29%)	One Adult with Children (5%)	Other (20%)	Total $1000 Million (100%)	Total $500 Million[4]
$0 – 8000 (20%)							
Present WST	2.6	3.0	5.3	3.6	4.8	3.2	3.2
Change	8.1	9.4	14.8	10.2	12.2	9.6	4.8
New RST or VAT	10.7	12.4	20.1	13.8	17.0	12.8	8.0
$8000 – 12000 (13%)							
Present WST	2.0	2.7	3.2	2.8	3.7	2.8	2.8
Change	4.4	7.3	7.8	6.9	8.2	7.0	3.5
New RST or VAT	6.4	10.0	11.0	9.7	11.9	9.8	6.3
$12000 – 16000 (13%)							
Present WST	1.7	2.2	2.7	3.0	3.3	2.6	2.6
Change	3.9	5.5	6.8	6.0	7.6	6.3	3.1
New RST or VAT	5.6	7.7	9.5	9.0	10.9	8.9	5.7
$16000 – 20000 (11%)							
Present WST	2.0	2.1	2.3	-	2.6	2.3	2.3
Change	3.2	4.9	5.8	-	6.8	5.5	2.7
New RST or VAT	5.2	7.0	8.1	-	9.4	7.8	5.0
$20000 – 30000 (19%)							
Present WST	1.2	1.8	2.0	-	2.3	2.0	2.0
Change	3.6	4.0	5.0	-	5.1	4.7	2.3
New RST or VAT	4.8	5.8	7.0	-	7.4	6.7	4.3
Exceeds $30000 (10%)							
Present WST	-	1.2	1.4	-	1.8	1.6	1.6
Change	-	3.3	3.6	-	4.1	3.8	1.9
New RST or VAT	-	4.5	5.0	-	5.9	5.4	3.5
Total [3]							
Present WST	2.1	2.0	2.3	3.0	2.1	2.2	2.2
Change	5.5	4.9	5.8	8.3	4.8	5.3	2.6
New RST or VAT	7.6	6.9	8.1	11.3	6.9	7.5	4.8

(1) Excludes motor vehicles, motor spirits, alcohol and tobacco. The replacement retail tax is assumed to have identical rates to those currently imposed under WST.

(2) Where no figure has been inserted there were insufficient numbers of households to make an estimate.

(3) Figures in brackets at the top and side of the table show the proportion of households of each type and income range respectively in the population, according to the 1981 Census of Population and Dwellings. The side total does not add to 100 percent because 14 percent of total respondents did not specify an income.

(4) This column shows the total effect for a tax yielding $500 million in additional revenue. Corresponding figures in the body of the table may be derived by adding "present WST" and half the "change" figure, e.g. $12,000 to $16,000 One Adult.

	$1000 Million		***$500 Million***
Present WST	1.7		1.7
Change	3.8 ÷ 2	=	1.9
New RST or VAT	5.5		3.6

Source: Secretariat Estimates

Table 8.3

The estimated immediate effect of excluding food from a flat rate sales tax at the retail level, yielding $1000 million additional revenue, as a percentage of household gross income in 1980/81 terms[1].

Household Income 1980/81	One Adult (19%)[3]	Two Adults (27%)	Two Adults with Children (29%)	One Adult with Children (5%)	Other (20%)	Total $1000 Million (100%)	Total $500 Million[4]
$0−8000 (20%)[3]							
New RST or VAT	10.7	12.4	20.1	13.8	17.0	12.8	8.0
Exclude Food	−0.1	−0.3	−1.7	−1.4	−2.1	−0.5	−0.3
Net Incidence	10.6	12.1	18.4	12.4	14.9	12.3	7.7
$8000−12000 (13%)							
New RST or VAT	6.4	10.0	11.0	9.7	11.9	9.8	6.3
Exclude Food	0.0	0.2	−0.8	−0.4	−1.0	−0.4	−0.2
Net Incidence	6.4	10.2	10.2	9.3	10.9	9.4	6.1
$12000−16000 (13%)							
New RST or VAT	5.6	7.7	9.5	9.0	10.9	8.9	5.7
Exclude Food	0.2	0.4	−0.2	−0.4	−0.3	−0.1	0.0
Net Incidence	5.8	8.1	9.3	8.6	10.6	8.8	5.7
$16000−20000 (11%)							
New RST or VAT	5.2	7.0	8.1	-	9.4	7.8	5.0
Exclude Food	0.4	0.3	−0.2	-	−0.2	0.0	0.0
Net Incidence	5.6	7.3	7.9	-	9.2	7.8	5.0
$20000−30000 (19%)							
New RST or VAT	4.8	5.8	7.0	-	7.4	6.7	4.3
Exclude Food	0.8	0.2	0.0	-	0.0	0.1	0.1
Net Incidence	5.6	6.0	7.0	-	7.4	6.8	4.4
Exceeds $30000 (10%)							
New RST or VAT	-	4.5	5.0	-	5.9	5.4	3.5
Exclude Food	-	0.4	0.2	-	0.1	0.2	0.1
Net Incidence	-	4.9	5.2	-	6.0	5.6	3.6
Total[3]							
New RST or VAT	7.6	6.9	8.1	11.3	6.9	7.5	4.8
Exclude Food	0.1	0.3	−0.2	−0.8	0.0	0.0	0.0
Net Incidence	7.7	7.2	7.9	10.5	6.9	7.5	4.8

(1) Excludes motor vehicles, motor spirits, alcohol and tobacco. The replacement retail tax is assumed to have identical rates to those currently imposed under WST.

(2) Where no figure has been inserted there were insufficient numbers of households to make an estimate.

(3) Figures in brackets at the top and side of the table show the proportion of households of each type and income range respectively in the population, according to the 1981 Census of Population and Dwellings. The side total does not add to 100 percent because 14 percent of total respondents did not specify an income.

(4) Shows the estimated effect of a tax yielding $500 million additional revenue.

Source: Secretariat Estimate.

8.22 Inclusion or exemption of food has only marginal effects on incidence except at household income levels below $8000. Similarly, inclusion or exemption of clothing was found to have little effect on incidence as the household survey showed clothing expenditure to be approximately proportional to income. Having regard to the benefits in administration and prevention of avoidance which are to be gained by having a comprehensive base, the Task Force considers that alternative methods of income maintenance for low income households, applied through the income tax and social welfare systems, should be fully considered in lieu of excluding food from a revised indirect tax base.

8.23 It is also generally argued that neutrality would be achieved by applying any indirect tax as a uniform percentage of the final prices of most goods, regardless of their classification and also regardless of their method of production, origin or path through the distribution system. This ensures that, as far as possible, the allocation of resources and the distribution of domestic product accords with what the operation of market forces would have determined in the absence of a tax.

Need for Rates to Reflect Social Costs

8.24 It is however also accepted that the market does not reflect the costs to society of consumption of certain goods and services. Obvious examples are tobacco and alcohol. These have effects on both health and behaviour which are costly to the community in money and in social terms.

8.25 Subject to dealing with social costs, neutrality calls for flat rates of tax and comprehensive coverage. Flat rates and comprehensive coverage also limit opportunities and incentives for avoidance and evasion. Administration is simplified and rates can be minimised. Some exemptions from comprehensive coverage may however be justified to avoid the costs of pursuing small amounts of revenue from a large number of potential taxpayers.

8.26 While flat rates and comprehensiveness are, for these reasons, highly desirable, it is nevertheless a fact that, in virtually all countries, deviations from these criteria occur. Therefore the Task Force concludes that it should report on the ability of each type of tax to support a regime which includes exemptions and a variety of rates, whether introduced to relieve perceived regressivity or for other economic or social reasons.

Visibility of Tax

8.27 Implications for inflation of increases in indirect tax of any sort depend on fiscal, monetary and economic policies and, in the case of a shift from income to indirect taxation, on the extent to which changes in income tax are accepted as offsetting indirect tax increases. These are not matters upon which the Task Force has any special competence to offer opinions. It is however noted that the visibility of the type of indirect tax selected and the ability to be reasonably precise about its incidence may affect the acceptance or otherwise of any switch from direct to indirect taxes, especially at average income levels.

8.28 The tax content of prices under both a retail sales tax (RST) and a value added tax (VAT) may be readily ascertained since it is a constant proportion of the final selling price. It is not necessarily the case, however, that the effect on prices will exactly equal the tax imposed. Nevertheless it is to be expected that the analysis of the incidence effects would have to assume a full, but no more than full, transmission into prices of taxes imposed. A WST, on the other hand, would be less visible (and certain) since varying retail mark-ups may give rise to varying tax contents in the final price of goods. This might increase the problems of securing agreement as to what is the incidence of the indirect tax and, thus, the extent to which any switch is "fair".

Rejected Options

8.29 The Task Force gave full consideration to a turnover tax and also to a comprehensive retail sales tax operated in conjunction with WST, but decided not to put forward either of these for consideration. The reasons are now summarised.

Turnover Tax

8.30 Under a turnover tax a product is repeatedly taxed on its gross value as it moves through the production and distribution chain without any credit being given for tax paid at preceding stages. The result is that the taxable base becomes several multiples of total cost. Not all goods pass through the same number of stages nor do they have an identical value added at each stage. Thus, under this system, identical goods may incorporate differing amounts of tax in the final price.

8.31 The resulting cascade effects, both tax on tax, and margin on tax, would disadvantage smaller businesses who would generally purchase through a tiered distribution chain and others which are not vertically integrated.

8.32 Firms could reduce tax by merging with their suppliers. Vertical integration and reduced competition would be encouraged not on the ground of comparative efficiency, but solely for tax considerations. Since the total tax content of locally produced goods could not be calculated precisely the rebates allowed on exports would necessarily be based on estimates and so subject to greater international scrutiny. Imports would be favoured relative to domestically produced goods.

8.33 The relatively recent abandonment of turnover taxes by European and South American countries no doubt reflects unsatisfactory features such as those instanced.

Retail Sales Tax in Conjunction With Wholesale Sales Tax

8.34 A flat retail sales tax in conjunction with the existing wholesale sales tax, suitably rationalised, would parallel the system in Canada where federal tax is raised by the imposition of a wholesale sales tax and the provinces raise revenue from a retail sales tax. The Task Force considered that such a taxation system would cause confusion amongst taxpayers and make it impossible to establish the tax content of many goods. Further, the administrative detail, staffing numbers and introduction period would parallel those for a VAT or stand-alone RST. It was concluded that this proposal should not be pursued.

Selected Options

8.35 After studying a number of proposals and possibilities, the Task Force decided that the following options merit serious consideration:

- A rationalised and extended WST. (Para 8.36–8.51)
- A rationalised and extended WST in conjunction with a selective services tax. (Paras 8.52–8.58)
- A Retail Sales Tax (RST) on goods and services. (Paras 8.59–8.83)
- A Value Added Tax (VAT) on goods and services. (Paras 8.59–8.83)

A Rationalised and Extended WST

8.36 This option and the next contemplate the rationalisation of the existing WST. Such action seems highly desirable under any tax regime which includes an element of WST. Rationalisation should aim at the following changes:

- Reduction in the number of different rates.
- Reduction and clarification of exemptions based on user and/or use.
- A revision of the rates to ensure that similar goods attract the same rate.
- Clearly defined criteria for valuation of goods when the wholesale stage of distribution is not used.

8.37 The value of exempt wholesale sales is estimated at $5900 million (excluding motor spirits) in 1980/81 terms (see Appendix A). The major items include food, clothing, furnishings, printed matter, gas, electricity for industrial use (that for domestic use is included in a service base), and some electrical goods (see Appendix B). The total potential base (excluding motor vehicles, motor spirits, alcohol and tobacco) is thus $8200 million ($5900 million + $2300 million as shown in Table 8.1).

8.38 The rates of tax on the currently exempt base of $5900 million needed to raise given amounts of revenue are as shown below. The calculations assume maintenance of the total take from presently taxed items and show the effects of exempting food from the base and also taxing it at a lower rate.

Table 8.4
Estimates of Tax Rates to Yield Both $500 Million or $1,000 Million Additional Revenue From Presently Exempt Wholesales Sales 1980/81

Wholesale Sales Base	Estimated Value 1980/81 ($ m)	Tax Rate to Yield S500m Additional Revenue Percent	Tax Rate to Yield $1000m Additional Revenue Percent
Maximum	5,900[1]	8.5	17.0
Maximum excluding food	4,240	11.8	23.6
Maximum, food at 5 percent	5,900	9.9	21.7

(1) Appendix A
Source: Secretariat Estimates.

8.39 If all goods (other than motor vehicles, motor spirits, alcohol and tobacco)—whether presently taxed or not—were included in a revised rate structure the average rates required would be as follows:

Table 8.5
Estimates of Tax Rates to Yield Either $500 Million or $1,000 Million Additional Revenue From a WST on All Goods[1] 1980/81

Wholesale Sales Base	Estimated Value 1980/81 ($ m)[2]	Tax Rate to Yield S500m Additional Revenue percent[3]	Tax Rate to Yield S1000m Additional Revenue percent[3]
Maximum	8,200[2]	10.8	16.9
Maximum excluding food	6,560	13.5	21.1
Maximum, food at 5 percent	8,200[2]	12.3	19.9

(1) Excluding motor vehicles, motor spirits, alcohol and tobacco. See paragraph 8.8 above.
(2) Includes both S2300 million of goods presently subject to WST and S5900 million of goods presently exempt.
(3) Revenue to be found includes both S387 million estimated revenue from goods presently subject to WST and the additional $500 million or $1000 million.
Source: Secretariat Estimates.

Final Goods used by Business

8.40 Among the goods at present untaxed are final goods used by business estimated at a value of $1500 million. In addition, approximately $1000 million of goods included in the present base are so used and contributed approximately $122 million of sales tax in 1980/81 terms. These are amounts for final goods used by business, eg industrial and office machinery (including computers), stationery, and fuels other than petrol. They do not include materials and supplies physically incorporated in output.

8.41 A fair proportion of final goods used by business will be used by enterprises which do not pay WST, eg service establishments. In respect of the balance, however, if it is assumed that sales tax is shifted forward into prices, tax on these final goods used by business is reflected in the wholesale price of a product, which is itself subject to tax. While some part of the tax might be absorbed it is considered that in most cases it would be passed on. This involves a measure of double taxation for those businesses paying WST, which would fall unevenly not only among different goods but also among goods of the same type produced or distributed in different ways.

8.42 Final goods used by business are currently taxed under a WST for the following reasons:

(a) to supplement the size of the wholesale base;
(b) it is frequently difficult for taxpayers and the authorities to decide, either by the nature of the goods or by the identity of the purchaser, the use to which the goods will be put;
(c) their inclusion reduces the problem of evasion.

8.43 The Task Force was also aware that certain kinds of goods, such as liquor, motor vehicles, and petrol are usually regarded as "near consumption" and proposes that they be taxed regardless of the purchaser or the intended user.

8.44 The Task Force considered at some length the question of the appropriateness of taxing final goods used by business. Although there are strong arguments for and against including such goods in the base the Task Force, on balance, considered that the majority of these items do not form a suitable base for an indirect tax which is to be operated into the indefinite future. In arriving at its conclusion the Task Force was conscious that exclusion of final goods used by business would seriously impair the revenue producing capacity of the existing WST and reduce the revenue that could be generated from any expansion of it. It was also realised that the principle of not taxing such goods must inevitably be applied to services used by business. This is further discussed in Paragraphs 8.55 and 8.56.

8.45 Required rates, on a base of presently untaxed goods, excluding final goods used by business and deducting also those at present taxed are dramatically higher than those on the maximum base.

Table 8.6

Estimates of Tax Rates to Yield Either $500 Million or $1,000 Million Additional Revenue From Presently Exempt Wholesale Sales and Excluding All Final Goods used by Business 1980/81

Wholesale Sales Base	Estimated Value 1980/81[1] ($ m)	Tax Rates to Yield $500m Additional Revenue Percent[2]	Tax Rates to Yield $1000m Additional Revenue percent[2]
Maximum	4,400[1]	14.1	25.5
Maximum excluding food	2,760	22.5	40.7
Maximum, food at 5 percent	4,400	19.6	37.7

(1) Presently exempt wholesale sales of $5900 million less estimated value of final goods used by business ($1,500 million).
(2) Revenue to be found includes both $122 million estimated current revenue from WST on final goods used by business and the additional $500 million or $1000 million.
Source: Secretariat Estimates.

8.46 If all goods whether presently taxed or not (other than motor vehicles, motor spirits, alcohol and tobacco) and excluding final goods used by business were subject to the same rate, the following would be the position:

Table 8.7

Estimates of Tax Rates to Yield Either $500 Million or $1,000 Million Additional Revenue From a WST on All Goods[1] Excluding Final Goods used by Business 1980/81

Wholesale Sales Base	Estimated Value 1980/81[2] ($ m)	Tax Rate to Yield $500m Additional Revenue percent[3]	Tax Rate to Yield $1000m Additional Revenue percent[3]
Maximum	5,760[2]	10.8	19.5
Maximum excluding food	4,120	15.1	27.2
Maximum, food at 5 percent	5,760[2]	13.1	25.2

(1) Excluding motor vehicles, motor spirits, alcohol and tobacco. See paragraph 8.8 above.
(2) Includes both $4400 million of goods presently exempt from WST and $1360 million of goods presently taxable.
(3) Revenue to be found includes both $122 million estimated revenue from final goods used by business presently subject to WST and the additional $500 million or $1000 million.
Source: Secretariat Estimates.

8.47 The rates computed above could be modified by rationalisation of existing rates. Thus, for example, it would be possible to raise additional revenue by increasing the current "low" tax rate of 10 percent (the base for which is over $1000 million), and by altering the sale value provisions of the Act to provide an adjustment in the taxable value of goods where the wholesaler is omitted from the distribution chain.

8.48 Because a great proportion of wholesalers and manufacturers operating in New Zealand are already licensed for sales tax, there would be little immediate administrative difficulty in extending the scope of the wholesale sales tax, provided that extension did not differentiate between consumption goods and goods for use by businesses on the basis of determining end use. Administrative difficulty and the extent of delay in implementation would depend on the degree of precision required should a decision be made in principle to exempt final goods used by business.

8.49 Under WST, as under any intermediate tax, retailers purchase goods for resale on a tax-paid basis. Thus the tax levied forms part of the costs to which the retailer adds a gross margin. If the margin is calculated as a fixed amount, the full amount of intermediate tax will be reflected in retail prices. If, on the other hand, the margin is calculated as a percentage the retail prices of taxed goods will rise by more than the amount of tax levied. The methods of setting prices vary from good to good and from industry to industry and are affected by conditions prevailing in the marketplace. While some price cascades occur, the extent and size of the effect on prices cannot be precisely determined. It is the view of the Task Force that dollar rather than percentage margins would be maintained and, at least after an adjustment period, the effect of cascades on prices under any reformed and extended system would be relatively minor.

8.50 The Task Force has identified the following features as being the principal advantages and disadvantages of a rationalised and extended wholesale sales tax:

Advantages

- The system has been in operation for 48 years and is generally understood by manufacturers and wholesalers.
- The system is capable of sustaining varying rates. It is also capable of yielding significant revenue, at low collection costs, from a flat rate or a small range of rates.
- Adjustments to it can be made quickly without major disruption to the business community.
- Administrative and compliance costs are low for the Government and the business community.
- There is little evidence of evasion.
- It is capable of a rapid extension. A full extension is estimated to increase the number of taxpayers to something less than double the current number (8175 as at 31st March 1981).

Disadvantages

- In order to raise significant amounts of revenue at low or moderate tax rates it would be necessary to tax final goods used by businesses.

- The amount of tax paid is seldom ascertainable by the consumer.
- Price cascades make it difficult to determine the precise effect of the tax on final prices and may, in some circumstances, raise prices by something more than the amount of the tax.
- Retailers carry stocks of taxable goods at a cost which includes tax, with effects on their cash position.
- There is an incentive for businesses to integrate and shift the point at which tax is applied back up the distribution chain.

Summary

8.51 The present wholesale tax could be rapidly extended to raise either $500 million or $1000 million additional revenue with rates in the latter case ranging between 16 percent and 21 percent depending on the treatment of food— see Table 8.5. Such rates would require goods purchased by business which are not physically incorporated in final goods to be included in the base. The Task Force sees objections to the taxation of such goods. If these are exempted, then the remaining base has a limited revenue earning capacity. While it could support an increase of $500 million a year an increase of $1000 million a year would require rates which would be beyond those that might be considered acceptable.

A Rationalised and Extended Wholesale Sales Tax in Conjunction with a Selective Service Tax

8.52 A wholesale sales tax is primarily a tax on goods and does not readily lend itself to the taxation of services. The implementation of a "stand-alone" service tax to complement the wholesale sales tax is an option which has been considered by the Task Force. New Zealand has moved towards this concept with the taxation of domestic air travel and the international departure tax.

8.53 The Task Force has concluded that the introduction of a *general* service tax in conjunction with a WST has serious disadvantages. It would be necessary to license all service establishments, a minimum of 22,000 new taxpayers, for modest additional revenue. In the case of services such as repairs it would be necessary to separate the services element from the goods element, as double taxation would otherwise occur. In many cases this would pose great administrative problems.

8.54 In analysing the value of services which readily lend themselves to a "stand-alone" service tax, the Task Force noted that $1575 million related to services mainly used by households. These services include services provided by Government, accommodation and restaurant meals, dry cleaning and admission charges.

8.55 The Task Force has therefore concluded that a service tax would be a feasible and attractive option provided the services chosen have a low goods content, relatively few taxpayers, are primarily directed to the household sector, and yield substantial revenue. The Task Force notes that the Ross Committee also proposed a selective service tax.

8.56 A "stand-alone" service tax could be applied to easily taxed services used by business e.g. advertising, cleaning services, telex, etc. The Task Force does not favour the taxing of any services used by businesses but notes that substantial amounts of revenue could be raised from this source.

8.57 The size of the tax base for the services discussed in paragraphs 8.54 and 8.56 above is shown in Appendix C and amounts to $1575 million. A moderate rate of tax would therefore yield significant revenue–say, $160 million at 10 percent. An estimated 7000 taxpayers would need to be licensed, and an initial staff of 40 would be required, for an estimated collection cost of 50 cents per $100 at a 10 percent rate. The Task Force considered that a tax on services provided by Government could be quickly introduced and taxation on the balance could be phased in over, say, 18 months.

8.58 Selectivity would impair the neutrality of such a tax but this is not considered to be a major defect, having regard to the types of service suggested for inclusion. It is also noted that taxation of some services would be consistent with a movement towards a general Retail Sales Tax, or VAT, should this be decided upon as a long-term objective.

Retail Sales Tax (RST) and Value Added Tax (VAT)

8.59 These taxes have many similar characteristics, notably in the size of the base, the number of taxpayers, the point of ultimate collection, incidence, and neutrality.

8.60 Following a brief description of each, their common features will be described and discussed. Differences will then be described and the two options evaluated.

8.61 A retail sales tax is a single-stage tax which is levied at the point of final sale to consumers. Although most such sales are made by retailers, many are also made by wholesalers, through open warehouses, and by manufacturers, farmers and importers.

8.62 A value added tax is a multi-stage tax which is levied as goods proceed through the chain of production and distribution up to and including the final purchaser. Each taxable firm in the chain charges tax at a specified rate on all sales and claims a credit of tax paid on its purchases of materials and other inputs. The tax also applies to services.

8.63 A simplified example of the operation of a VAT is given.

Table 8.8
An Example of a VAT Transaction

		Charged Out	Less Tax Already Paid	Net Payment To Tax Authorities
(a) Saw miller (cuts and dresses timber)	$	$	$	$
Value added and selling price	25.00			
Plus 10 percent tax	2.50	2.50	-	2.50
Total invoice price	27.50			
To				
(b) Furniture manufacturer				
Purchase price (without VAT)	25.00			
Value added	50.00			
Selling price	75.00			
Plus 10 percent tax	7.50	7.50	2.50	5.00
Total invoice price	82.50			
To				
(c) Wholesaler				
Purchase price (without VAT)	75.00			
Value added	10.00			
Selling price	85.00			
Plus 10 percent tax	8.50	8.50	7.50	1.00
Total invoice price	93.50			
To				
(d) Retailer				
Purchase price (without VAT)	85.00			
Value added	15.00			
Selling price	100.00			
Plus 10 percent tax	10.00	10.00	8.50	1.50
Total invoice price	110.00			10.00

Price of cabinet to customer = $110 (includes $10.00 VAT)

(1) If the goods were exported by the retailer he would be eligible for a refund of $8.50 which is the VAT element in the price charged to him by the wholesaler.
(2) For simplicity, the example assumes that the sawmiller has no taxable inputs and that timber is the only taxable input of the furniture manufacturer.

8.64 RST and VAT employ similar initial administrative procedures. Both require the licensing of businesses. For RST a licensed taxpayer would be able to purchase taxable goods, both for resale and for business use, free of tax, and would be required to make a return of sales made to non-licensed purchasers (generally private individuals), collect the tax from them and pay it to the Government. For VAT, a licensed taxpayer would remit to the Government the tax on all sales, whether to a licence holder or not, but would be entitled to claim a credit for tax paid to suppliers on all inputs. Very small businesses with sales under, say, $10,000 annually would not be licensed, but would be treated as final consumers.

8.65 Appendix D shows estimates prepared by the Secretariat of the number and classes of business which would be required to be licensed under either RST or VAT. It is estimated that approximately 100,000 businesses would need to be licensed under either system.

8.66 For RST a number of taxpayers, mainly manufacturers and wholesalers, would collect and return only small amounts of tax in respect of final sales to consumers, including staff purchases. Under both these taxes it is customary to make special arrangements for agriculture and for the building and construction industry.

8.67 For all practical purposes, the base for the two taxes is the same. Appendix E shows an estimate of the base, which includes both goods and services. The base in 1980/81 terms is approximately $10,400 million. Of this $1570 million is estimated to be services. The Task Force noted that $730 million of such services relate to gas and electricity, admission charges and accommodation—all of which can be satisfactorily taxed under a "stand-alone" service tax. The argument advanced to adopt an RST or VAT on the ground that either can tax services seems, to the Task Force, to be exaggerated.

8.68 The following table shows the average rates required, for either RST or VAT, to yield specified annual amounts of additional revenue and, in addition, to recover the yield (other than from motor vehicles, motor spirits, alcohol, and tobacco) of the present WST.

8.69 The compliance costs associated with the introduction of RST would approximate those of VAT. Continuing costs to business would however be lower under RST than under VAT, as the latter requires collection and returns at all points in production and distribution. Many cash registers operating in New Zealand do not have a tax key and they would therefore have to be adapted or replaced where retailers elected to show the tax separately rather

Table 8.9
Estimated Tax Rates on Goods[1] and Services at the Retail Level to Raise Either $500 Million or $1000 Million and to Replace the Revenue from the Present WST (1980/81)

Retail Sales Base	Estimated Value ($ m)	Tax Rate to Yield $500 Million[2] Additional Revenue percent	Tax Rate to Yield $1000 Million[2] Additional Revenue percent
Maximum	10,400[3]	8.5	13.3
Maximum excluding food	7,550	11.7	18.4
Maximum food at 5 percent	10,400	9.9	16.5

(1) Excluding motor vehicles, motor spirits, alcohol and tobacco. See paragraph 8.8 above.
(2) Revenue to be found includes both $387 million estimated revenue from goods presently subject to WST and the additional $500 million or $1000 million.
(3) Appendix E.
Source: Secretariat Estimates.

than sell at tax-inclusive prices. The last occasion a total replacement took place was in 1967 when decimalisation was introduced. At that time 69,000 cash registers were replaced.

8.70 The staffing requirements and administrative costs for both RST and VAT vary considerably among countries according to the style of administration adopted. For example, the frequency of tax payments, number of different tax rates, number and extent of exemptions, and enforcement procedures all affect staffing and administrative costs.

Table 8.10
Examples of Staff to Taxpayer Ratios in Selected Countries (VAT) and States of the USA (RST)

Ratio of Administrative Staff to Taxpayers Under VAT		Ratio of Administrative Staff to Taxpayers Under RST	
Ireland	1:457	Arizona	1:1293
Netherlands	1:399	Utah	1: 767
Sweden	1:250	Nevada	1: 640
France	1:173	Indiana	1: 476
United Kingdom	1:106	Rhode Island	1: 406

8.71 The wide variance in the figures shown above demonstrates the difficulty of making precise estimates of the administrative requirements of VAT or RST if either were proposed in this country. Nevertheless, the Task Force has estimated that such systems would require between 250 and 500 staff and cost between $6 million and $15 million per year in

1980/81 terms to administer. Both staff numbers and costs would be expected to exceed these limits if a complex system involving multiple rates and exemptions were chosen.

8.72 Both systems would require an extended period for detailed design, legislation, staff recruitment and training and education of taxpayers. Based on overseas experience it is estimated that a period of three years would be needed.

8.73 The main differences between RST and VAT concern problems of avoidance or evasion and ability to handle a multiple-rate structure. There is also some difference in the method of providing exemption for final goods used by business, VAT being superior in concept. However, when necessary administrative adjustments are made to remove unnecessary complexity, the difference on this score may not be material.

8.74 A VAT is shown by experience overseas, especially in Europe, to be capable of supporting rates of the order of 20 percent or more. In contrast, no case was found of a satisfactory RST at a rate above 10 percent. Given such ceilings, VAT could supply an additional $1000 million or more, while an RST would probably be strained to supply even $500 million.

8.75 The difference is said to exist because the method of administering VAT provides both an audit trail to detect evasion and a mechanism that makes the tax self-enforcing. All transactions short of sale to the final purchaser must be invoiced, as these invoices must be available to support the purchaser's claim for a credit of tax already paid. The purchaser has a powerful incentive, therefore, to ensure such invoices exist. The authorities can check claims for credits against the accounts of the invoicing supplier.

8.76 This mechanism does not apply completely at the retail level as invoices for such sales are often not used and their possession is of no benefit to the buyer, who has no right to a credit. A retailer could evade tax by suppressing some sales, but beyond some point the relationship with claimed credits on purchases would alert the department. Suppression of purchase invoices involves the risk of detection through audit of the supplier's accounts.

8.77 Overseas experience shows that evasion is a problem at the retail level, that small contractors in building trades are a source of difficulty and that falsification of invoices is also a problem. Collection costs and the numbers of staff employed in the United Kingdom, for example, give some support to the view that policing cannot be left to the system itself.

8.78 In an RST system there is no audit trail of invoices showing tax and no element of self-policing. Although the Task

Force is of the opinion that claims for the benefits of self-policing under a VAT are often exaggerated, they do exist. On these grounds, the Task Force concluded that it could not present for favourable consideration a retail sales tax at rates not previously applied successfully elsewhere. This means a limit to 10 percent for RST. The revenue yield at such a level would not justify introduction of a wide and costly new system.

8.79 Experience shows that a VAT can be successfully applied at a range of varying rates. Problems of definition, evasion by misclassification, and administrative complexity and cost occur, the extent depending on the nature and diversity of such variations. Shortcomings in terms of neutrality and perhaps of equity also occur. However, within reason, the system itself can cope.

8.80 In this respect, VAT is superior to RST. Producers and wholesalers can handle differing rates, as shown by experience with WST. Under VAT the identification of the appropriate rate is given by the supplier and shown on the invoice provided to the retailer. Thus the retailer is informed of the rate to attach to sales to final consumers.

8.81 Under RST, a retailer is supplied with goods tax free. The question of liability and rate on final sale, therefore, rests with the retailer. Having regard to the number of small retailers, and their relatively unsophisticated accounting systems, it is concluded that an RST would be able to handle only a very restricted range of rates.

Summary

8.82 The Task Force is of the opinion that in a choice between RST and VAT the decision would favour VAT.

8.83 As a method of indirect taxation to be implemented in New Zealand, VAT is seen to have the following characteristics:

Advantages

- It is capable of sustaining high rates and yielding significant revenue.
- It is capable of taxing a broad base of goods and services.
- It can be as neutral as desired with a flat rate or a range of rates, and does not, in the normal course, tax final goods used by business.
- It can handle differing rates and exemptions.
- The tax is ascertainable in that it is a constant proportion of the final selling price.

Disadvantages

- It would take up to three years to implement.
- It would mean licensing approximately 100,000 taxpayers, all of whom would be active and most of whom would be unfamiliar

with indirect tax. The education and familiarisation of all concerned would be a sizeable task.

- Both the Government and the business community would face substantial administrative and compliance costs.
- Many businesses dealing in services are small and they may well find it difficult to adjust to the accounting necessary for VAT.

Conclusion

(1) Any early increase in revenue from indirect taxes can be obtained only from the extension of WST.

(2) The Task Force, on balance, favours the exemption from WST of final goods used by business but notes that such exemption would reduce the base drastically so as to seriously impair the ability of the tax to generate satisfactory revenue.

(3) If WST is retained or extended, rates should be rationalised and the sale value provisions redefined.

(4) A selective service tax to supplement WST could be introduced progressively over a period of 18 months.

(5) A VAT would take up to three years to put in place.

(6) VAT has the maximum potential for revenue yield of all the options considered.

(7) An extension of WST and a Selective Service Tax could be undertaken so as to be compatible with the introduction of VAT in due course.

Submissions

8.84 The bulk of submissions from trade groups received by the Task Force on the subject of indirect tax favoured a tax at the wholesale level. These submissions were unanimous in calling for an extensive rationalisation of the structure of wholesale sales tax rates and a reduction in the number of exemptions. A small number of submissions called for the adoption of a tax at the retail level but no trade group favoured the introduction of value-added tax.

Chapter 8—Appendix A

Table 8.A1

Estimate of the Potential for Extension of the Wholesale Tax Base 1980/81 (Goods Only)

			($ million)
Total Wholesale Tax Base			10,788
LESS	Raw materials and intermediate goods for use in agriculture and manufacture	507	
	Motor spirits which are taxed separately	900	
	Maintain motor vehicles, tobacco and alcohol at current rates	1,143	
		2,550	
Value of Residual Wholesale Tax Base			8,238
LESS	Maintain all remaining wholesale goods currently taxable at current rates	2,358	
		2,358	
Value of Residual Wholesale Tax Base			5,880

Note: The above table is based on the 1971 – 1972 Inter-Industry Transaction Table which has been updated to 1980/81.

The wholesale values quoted are *exclusive* of intermediate goods, a term which under sales tax legislation is restricted in meaning and in fact covers only those goods which are actually "wrought into" other goods during production. They *include* other inputs which are utilised in a business but not actually "wrought into" other goods, (e.g. stationery)—and, in the case of agriculture, fertiliser, fencing wire, etc.

Source: Secretariat Estimates

Table 8.B1
Wholesale Value of Exempt Items1980/81

Goods	Total Value ($ million)
Live animals	5
Foodstuffs	1,641
Electricity and gas for industrial use	730
Medicinal and pharmaceutical products	155
Industrial cleaning materials	55
Plastic materials	50
Chemicals etc.	41
Leathergoods	19
Articles of rubber	60
Cork and wood manufactures	130
Paper, building, wallpaper, etc.	36
Textile yarn, fabrics and articles	374
Non-metallic manufactures	330
Iron and steel, also non-ferrous metals	128
Metal manufactures	262
Agricultural machinery	160
Industrial machinery	108
Electrical machinery, apparatus and appliances	224
Road vehicles	18
Other transport equipment (includes boats)	80
Sanitary/plumbing, heat/light	37
Furniture and parts	230
Articles of apparel	500
Footwear	126
Professional, scientific and controlling equipment	29
Printed matter	200
Toys and games	14
Sporting goods	19
Office and stationery supplies	15
Works of art	6
Musical instruments	12
Miscellaneous manufactured articles	86
	$5,880

Note: The notes to Table 8.A1 also apply to this table.
Source: Secretariat Estimates

Table 8.C1
Base for a "Stand Alone" Service Tax

Description of Service	Estimated Number of Licensed Taxpayers	Estimated Value of Sales[3] 1980/81 ($million)
(A) Services used mainly by households.		
Services Provided by Government		
Telephone (including tolls)		180[1]
Radio and television licence fees		30
Electricity and gas domestic sales		330
Sub-Total		540
Other Services		
Accommodation and restaurant meals	7,000	800[2]
Laundries, drycleaning	100	65
Admission charges	50	170
Sub-Total	7,150	1,035
(B) Services Used Primarily by Business		
Advertising		
Broadcasting stations	10	30
Television studios	2	69
Newspaper	100	153
Cleaning	200	50
Telegraph and telex		25
Sub-Total	312	327

(1) Supplied to households only. Business use amounts to $300 million.
(2) Excludes alcohol purchases but includes sales to businesses.
(3) Figures are estimates of total sales to both households and industrial users. In the case of electricity only, household sales are shown. Industrial sales of electricity have been treated as a good (i.e. as part of the WST base).

Source: Secretariat Estimates.
fig. 8.15 (Table 8.D1)

Table 8.D1
Estimates of Taxpayers Under VAT or RST

	Estimated Number of Establishments September 1981	Estimated Number of Taxpayers
Agriculture[1], Fishing[2], Forestry[3], Hunting[4], Mining and Quarrying[5]	74,000	8,000
Retailers[6]	28,000	25,000
Restaurants and Hotels[6]	7,000	7,000
Wholesalers[6]	7,000	6,000
Manufacturers[7]	11,000	8,000
Banks, Insurances, Real Estate Agents[8], etc.	20,000	10,000
Building and Construction[9]	11,000	5,000
Transport and Communication[10]	8,000	6,000
Services[11]	26,000	25,000
TOTAL:	92,000	100,000[11]

Source:
(1) Agricultural Census, June 1980.
(2) Secretariat Estimate.
(3) Census of Forestry and Logging 1979/80.
(4) Secretariat Estimate.
(5) Census of Mining and Quarrying 1978/79.
(6) Census of Distribution 1977/78.
(7) Census of Manufacturing 1978/79.
(8) Secretariat Estimate.
(9) Census of Building and Construction 1978/79.
(10) Census of Transport Storage and Communication 1979/80.
(11) Secretariat Estimate.

fig. 8.16 (Table 8.E1)

Table 8.E1
Estimated Retail Tax Base for Value Added Tax (VAT) and Retail Sales Tax (RST) 1980/81

			($million)
Total Private Household Consumption on Goods and Services			14,416[1]
LESS:	Wholesale sales tax	807[2]	
	Public transport	238	
	NZ resident expenditure overseas	246	
	Nett gambling	129	
	Consumption not incurring expenditure	543[3]	
	Insurance service charge	148	
	Medical, education, welfare services	372	
	Housing	1,583[4]	
	Motor spirit	600	
		4,666	9,750
ADD:	Wholesales sales tax on motorcars, tobacco and alcohol	404[5]	
	Tourist expenditure in New Zealand	246	
		650	
Retail Tax Base: Maximum on Goods & Services[6]			10,400

(1) The VAT and RST bases would differ were some final goods used by business to be taxed in the RST to protect revenue (e.g. building materials).
(2) Wholesale tax revenue ($775 million) increased by 4 percent to allow for a cascade effect of retail margin mark-up.
(3) Government provided services, salary and wages in kind, and home agriculture.
(4) Rental value of owner-occupied housing, and rent.
(5) Sales tax on motorcars, motorcycles, tobacco and alcohol increased by 4 percent to allow for cascade effect as in note (2).
(6) The value of household consumption expenditure on services amounts to $1570 million.
Source: Secretariat Estimates.

Chapter 9

PERSONAL DIRECT EXPENDITURE TAX

Introduction

9.1 The Task Force received various papers and submissions in support of the introduction of a Personal Direct Expenditure Tax in New Zealand, wholly or partially replacing personal income tax, and also studied overseas reports, in particular the Meade Committee report from the United Kingdom.[1] The quality of much of the literature is impressive, as is the detail of discussion of procedures for implementation. Inevitably, the various reports reflect the tax systems, societies and economies of the authors' countries. Main common elements have however been distilled. This report summarises and comments upon them. Inevitably, this report cannot cover all issues.

9.2 Although the concept of a direct expenditure tax has been discussed on many occasions since the middle of the nineteenth century, no developed western democracy has adopted it. This is not a sufficient reason for rejecting such a tax. It does however mean that there can be no appeal to experience of administration or of economic or social effects either to support or to oppose its introduction. Thus its selection as an option for reform would require a compelling line of argument.

9.3 Expenditure is one of the bases of taxation in virtually every country. However, the tax is usually levied as an indirect tax; that is, the person who pays the tax to Government is not the same as the person who bears the burden of the tax. Examples in New Zealand are wholesale sales tax, excise duties and tariffs. A direct personal expenditure tax, however, would be paid to Government directly by each person, on the base of that person's expenditure.

9.4 Advantages of a direct expenditure tax are mostly argued in the context of a total or partial replacement of income tax. In this context a main advantage claimed may be summarised thus: expenditure tax taxes what the taxpayer "takes from society" instead of what the taxpayer "contributes to society" by way of production and earnings. Hence expenditure tax is said to be more equitable than income tax. Further, it would remove or reduce the disincentive effects of a progressive income tax, as the choice between spending or saving earnings—and thus of paying or escaping tax—is made by the individual.

9.5 It is also argued that both incentives and opportunities for evasion and avoidance are lower under a direct expenditure tax than under a progressive income tax.

9.6 A direct expenditure tax is said to be superior to an indirect expenditure tax. It is proposed that it be applied equally to expenditure on all sorts of goods and services, and thus be neutral, whereas an indirect tax may levy different rates on different goods or services. It avoids the cascade effect of wholesale sales taxes and is said to be cheaper to adminster and to be less subject to evasion than are most indirect taxes.

Method of Assessment

9.7 Proposals range from complete replacement of all personal income tax to the application of a flat or mildly progressive income tax, supplemented by a direct expenditure tax levied on expenditure above a certain annual amount. These variants make no basic difference to the method of determining the taxable amount

9.8 Annual expenditure would not be determined by adding up an individual's purchases of goods and services. This would be clearly impracticable for most taxpayers and impossible for the authorities to check.

9.9 A person's expenditure during a year is broadly equal to income minus what is saved (or paid off past debts) or plus what is withdrawn from past savings (or borrowed) and spent. Accumulated savings are held as assets of various sorts. In other words:

Taxable Amount (expenditure) equals
Income plus or minus Change in Net Assets.

9.10 Income would be reported as at present under the income tax system, though some changes of definition could be made if desired.

9.11 In principle, the total amount of all assets would be declared annually and taken into account if it were really desired to tax consumption expenditure of each year. Proposals indicate, however, that only a limited range of assets would be taken into account. In part, the limitation is based on recognising only some assets as a repository of true savings—for example, bank accounts, stocks and shares, and real estate. Such assets are distinguished from cars, furniture and so on which may be considered consumption goods whose life merely happens to exceed one year. The limitation also recognises the need of the authorities to verify the amount of assets taken into account.

9.12 Classes of assets included in the calculation are called "Registered Assets" and all others are "Unregistered Assets".

Comment on Theory and Policy

9.13 The basic case for direct expenditure tax outlined in paragraph 9.4 is the same as that for any expenditure tax, even if indirect. Its conceptual merits, in equity and in relationship to effort and risk taking, have thus been fully dealt with in earlier chapters.

9.14 Whether direct expenditure tax would have the advantages over an indirect tax outlined in paragraph 9.6 depends on comparison of the facts of a particular case. An indirect tax can be imposed at a flat rate and thus be neutral. On the other hand, the distinction between registered and unregistered assets for direct expenditure tax would result in a lack of neutrality in the market for assets and in the capital market and monetary system.

9.15 An indirect tax can be applied as a VAT or RST and thus have no cascade effect. Finally, opportunities and incentives for evasion and avoidance vary from one indirect tax regime to another and may be relatively small. As the following paragraphs indicate, a direct expenditure tax is seen to have many avenues for avoidance and evasion.

9.16 The Task Force finds the theoretical and policy case for direct expenditure tax to be insufficiently strong for it to be preferred to other options on these grounds.

Comment on Administration

9.17 Many problems affecting equity, avoidance, sectoral impact and public acceptability have been identified. While not an exhaustive treatment, the following paragraphs indicate the nature and significance of these issues. Reference to the literature and to some of those who have supported the introduction of a direct expenditure tax has not supplied remedies for these problems.

9.18 To apply such a tax, it would be necessary first to select those classes of assets which should be "registered", that is, deemed to be savings and not expenditure. This is a difficult matter involving questions not only of verification but also of effects on revenue, on classes of taxpayer, and on the market. For example, as a simple case, it is generally accepted that houses should be registered assets. The land registry system in New Zealand would make this practical. It is however not generally proposed that other major personal assets, such as cars, should count as registered assets. Thus a second home, such as a beach cottage, may be a registered asset but a caravan an unregistered one.

9.19 Transition problems would be considerable. Schedules of registered assets would have to be collected from all individuals, and then it would be necessary to verify that these were accurate and, particularly, not understated.

9.20 By switching assets between the registered and unregistered classes taxpayers may minimise, avoid or evade expenditure taxation. This is most obviously possible at the transition from income taxation to expenditure taxation.

9.21 It would pay a taxpayer to have switched from registered assets, e.g. a savings bank account into unregistered classes before transition so as to be able to switch back after transition and claim a tax reduction—or just for untaxed consumption. Any storable assets would do depending on the taxpayer's objective—groceries with a reasonable shelf-life, liquor, household durables, items such as precious metals in various forms, antiques, art perhaps bought from overseas. Transition has implications for major avoidance and perhaps for the balance of payments.

9.22 Similar problems would arise with persons arriving to live in New Zealand and emigrating from it. For example, immigrants would seek to bring their savings as unregistered assets, while emigrants would aim to build up registered assets to realise abroad—in effect, taking untaxed income to spend elsewhere under an income tax regime.

9.23 Those who have built up savings in the past, presumably from income after income tax, would regard it as inequitable that such savings should be taxed again when they are spent. Avoidance at transition might well be socially acceptable to many.

9.24 A progressive expenditure tax or one imposed only at high expenditure levels would probably be subject to widespread avoidance. However, progression could still yield gains to the revenue at the expense of individuals with fluctuating taxable amounts.

9.25 The complexity of the system would lead to inequalities among taxpayers depending on their skill in managing their affairs. In addition, lumpy tax payments may be incurred by unusually high expenditure, which may occur from circumstances beyond a taxpayer's control. However, those with significant accumulations of unregistered assets could minimise the effects of such a circumstance, so that wealth and not only expenditure would affect tax liability.

9.26 Final assessments of the tax would necessarily be made annually. Thus a taxpayer, in making purchases would accumulate a tax liability which may be difficult to keep in sight. At present, for many, PAYE income tax is virtually final tax liability. It is sometimes argued that the problem could therefore be reduced by having taxpayers make PAYE or provisional payments. Such a similarity to income tax might reduce the incentive benefits claimed for a switch to expenditure tax.

9.27 Expenditure tax may be high at times when ability to pay, as indicated by income and wealth, is relatively low, and vice versa. This may happen for many reasons, but also the relationship between income and saving or dis-saving typically varies with the stage of the life cycle. While this may even out with everyone living their whole lives under an expenditure tax, for many years after transition this would not be the case, with consequent inequities.

9.28 Because of the proposed method of assessing expenditure—income plus or minus change in net assets—an expenditure tax is open to the avoidance and evasion devices already available under an income tax system, even though use of such devices may be reduced by using the escape route of savings. Then, it is also open to devices relating to registered assets.

Conclusion

9.29 The Task Force recognises the force of basic conceptual arguments, but is of the opinion that the advantages claimed for a direct expenditure tax, considered in relation to the present progressive income tax and compared with various possible indirect expenditure taxes, are not proven. Verification from actual experience is impossible. Similarly, the administrative difficulties cannot be verified from life, but are supported by overseas studies.

9.30 Accordingly, the Task Force concludes that a direct personal expenditure tax should not be introduced as part of current reforms.

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(1) "*The Structure and Reform of Direct Taxation*", Report of a Committee chaired by Professor J.E. Meade. (London, Geo Allen & Unwin, Institute for Fiscal Studies, 1978).

Chapter 10

CAPITAL TAXES

I. THE TAXATION OF WEALTH

10.1 The only wealth taxes imposed in New Zealand are Land Tax and Estate and Gift Duties. While at one time, these taxes accounted for the majority of direct tax revenue, their importance has declined to such an extent that they are now insignificant revenue earners.

Table 10.1
Wealth Taxation Revenue

Year (Ended 31 March)	Land Tax Collections	Estate and Gift Duty Collections	Total Collections	Percentage of total direct tax	Percentage of gross domestic product
	$ million	$ million	$ million	%	%
1960	3.0	21.1	24.1	6.4	0.9
1965	2.6	20.9	23.5	4.1	0.6
1970	2.8	26.3	29.1	3.6	0.6
1975	3.4	41.1	44.5	2.0	0.4
1980	10.7	49.7	60.4	1.3	0.3
1981	11.6	39.0	50.6	0.9	0.2
1982 *	34.0	27.0	61.0	1.0	0.2

(*Estimate)
Sources: Inland Revenue Department Annual Reports; Department of Statistics.

10.2 The relative insignificance in terms of revenue yield is not peculiar to New Zealand, but is a feature of the tax structures of all developed countries. A study of such taxes imposed by OECD countries indicates that the proportion of annual wealth taxes and death duties to GDP ranged (in 1976) from 1.63% in the case of Switzerland to .07% in Italy and Canada.

The Case for Wealth Taxes

10.3 Taxation of wealth is justified on grounds of ability to pay and on its use to redistribute wealth in ways deemed desirable by society.

10.4 Ability to pay is recognised as being a function of income which is taxed. However it also increases with wealth, which reduces the need to save from income and can augment income in supporting discretionary spending.

10.5 Redistribution can be achieved by the tax system in two ways. First, a transfer of some wealth to the Government by taxation is a redistribution from the wealthy generally to society at large. Second, the taxation system can encourage the wider dispersion through a mechanism which reduces liability where wealth is distributed amongst a greater number of recipients.

The Taxation of Wealth in New Zealand

10.6 In evaluating both the need for wealth taxes, and the form they should take, it is essential to be aware of both the present distribution of wealth and of the direction in which the pattern of distribution is moving. The Task Force found that little work had been done either on the present distribution, or in the trends of that distribution. In the time available to it the Task Force was unable to undertake the necessary research itself. Little that is useful can be said about the desirability of taxing wealth until the basic data are available.

10.7 The Task Force therefore proposes that a study be commissioned to determine the pattern of wealth distribution in New Zealand and changes in the pattern of that distribution.

Death Duties

10.8 Limits for imposition of Estate Duties are frequently reviewed by Government. Currently duty is payable only on estates with a value in excess of $300,000. This provides part of the reason for the failure of revenue from the tax to rise with·inflation.

10.9 Another important reason is the widespread practice of what is called "estate planning". A consequence is that the tax falls unevenly on estates of those who die relatively young or who are unwilling to progressively transfer title to their assets to their heirs.

10.10 A number of submissions received by the Task Force suggested that the threshold of $300,000 be increased. Estate values, particularly in the rural sector, are rising rapidly and hence the real value of the threshold is diminishing. The Task Force recommends that the level of exemption continue to be regularly reviewed so as to maintain its value in real terms until such time as the study of the wealth distribution is complete.

10.11 Some submissions suggested that estate duty should be abolished altogether. The Task Force is unable to make any recommendation in this connection until the basic information concerning wealth distribution is available.

10.12 Given however that the principal purpose of death duties is the social one of inhibiting the undue aggregation of wealth, and assuming that death duties in some form or other will be retained, it may be worth examining the merits of an inheritance tax as against those of the present estate duty.

10.13 The essential difference between an estate duty and an inheritance tax is that with the former, the tax liability is governed by the amount *transferred by the deceased*, while with an inheritance tax the liability is governed by the amount *received by the beneficiary*. The implication for wealth redistribution is that given a progressive rate structure, total duty can be minimised under an inheritance tax by distributing the property of an estate widely whereas the duty payable under an estate duty regime is unaffected by the breadth of the distribution. Proponents of inheritance tax argue that this feature encourages testators to distribute their property widely and in any case that it is more equitable than estate duty in that liability to some degree reflects the ability to pay of the recipient.

Gift Duties

10.14 Gift Duties are mainly an adjunct of Estate Duties. Rates of gift duty are frequently reviewed by Government. This also provides part of the reason for the failure of revenue from this source to rise with inflation.

Land Tax

10.15 The Task Force is of the opinion that Land Tax has no perceptible redistributive effect.

10.16 It is a minor source of revenue, but simple and cheap to collect. Only 5% of total land value is taxed, agricultural land being explicitly exempted and residential land effectively exempted by the exemption of $175,000 for all landowners. There is some degree of limitation on the use that can properly be made of land as a tax base by Central Government, as rates are the principal source of Local Government revenue.

10.17 Because the base is limited to land alone, of all the forms of wealth, it is not an adequate indicator of the taxable capacity provided by wealth. A comprehensive base for an annual wealth tax would, however, involve massive problems of administration.

Conclusion

10.18 The Task Force doubts whether wealth taxes as presently constituted in New Zealand perform any useful function other than provision of a small revenue. However, such taxes have traditionally been regarded as an important element in the overall taxation system of many countries, including New Zealand. The Task Force considers that they require careful study and research against an adequate background knowledge of the current distribution of wealth in New Zealand.

10.19 It therefore *recommends* that such a study be undertaken at which stage a policy decision as to their acceptability and retention and/or modification can be made.

Recommendations

10.20 It is recommended that:

- **a study be undertaken to determine the pattern of wealth distribution in New Zealand;**
- **the level of the estate duty exemption continue to be regularly reviewed so as to maintain its value in real terms until such time as the study of the wealth distribution is complete.**

II. THE TREATMENT OF CAPITAL GAINS

Introduction

10.21 The Committee received a number of submissions advocating the introduction of a capital gains tax on equity grounds. Many countries, including most OECD members, impose a tax on realised capital gains which arise on the sale of assets other than those sold in the ordinary course of business which are subject to income tax.

10.22 In principle, there is no reason why capital gains (whether made by a business or a private individual) should not be taxed. Such gains increase taxable capacity in just the same way as does a gain on income account. The Task Force considers that failure to tax real capital gains is inequitable in principle, and is seen by many to be so. It has also been represented to the Task Force that failure to tax capital gains provides an incentive for funds to be diverted from productive activities to unproductive investments offering prospects of capital appreciation. While this argument has merit, and is very credible, the Task Force received no evidence that the diversion of funds in this way is of major proportions.

10.23 Despite the comments and observations above, the Task Force does not recommend the introduction of a capital gains tax at this time.

The Measurement of Capital Gains

10.24 Real gains should be distinguished from nominal gains, especially when the times of purchase and sale of an asset are separated by a period of substantial inflation. A real gain will be made if the rise in price of the asset exceeds the rise in the general price level. To the extent that the transaction is financed by borrowing, a real gain may also be made even where there is no such excess in the rise in price of the asset itself.

10.25 Based on its study of real price trends, and on overseas experience, the Task Force is of the opinion that a capital gains tax would not produce significant revenue. It is recognised that there remains a question of equity but the Task Force is of the view that introducing substantial complexity for little revenue gain is not justified.

10.26 The Task Force considers that taxation of nominal gains in current New Zealand conditions would be wrong in principle. The introduction of a capital gains tax in a period of high inflation would probably bring with it more inequities than it would cure, unless the effects of inflation were also taken into account.

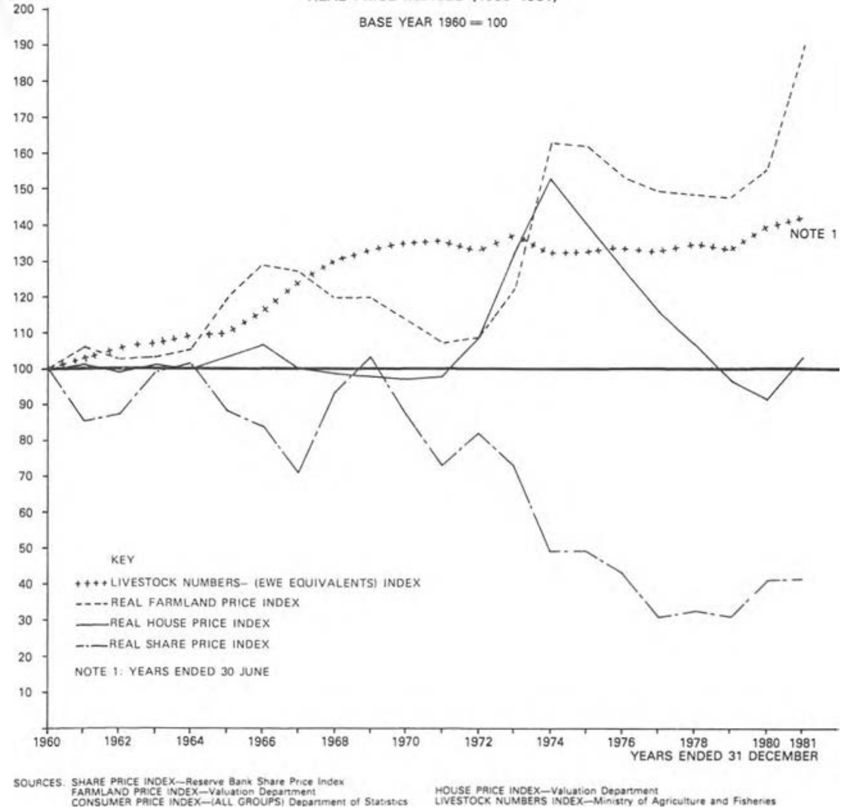
10.27 Nevertheless, many countries do tax nominal capital gains. Such taxes were introduced in times of relatively low inflation however when nominal gains would have approximated real gains. Even so, revenue from capital gains taxes is generally low in such countries despite the fact that their rates of inflation have since increased to high levels. For example, the yield from capital gains taxes in Canada was 0.8% of total tax revenue in 1978 and 0.9% in the United Kingdom in the same year. Yields in the United States are higher, being in excess of 1.9% of total Federal tax.

10.28 Real gains can be made on a wide range of assets including real estate, equity investments, and personal property such as antiques and art. In Figure 10.1, aggregate changes in the real value of listed public company shares and real property over the period 1960 to 1981 are shown, after deflation of the index by applying movements in the Consumer Price Index over the same period.

Gains on Company Shares

10.29 The graph of real share prices indicates that aggregate capital gains on equity investments have been negative over the twenty year period. However, this does not mean that no capital gains have been made. Even in a period of generally falling prices, real capital gains will have been derived by some, either through the careful timing of purchases and sales or through investment in shares which have increased in value against the trend. Even so, under a capital gains tax, taxpayers would be able to defer the realisation of the gain, and, to neutralise it by realising capital losses on other investments. It is presumably this sort of arrangement that makes the revenue from the tax so small in countries which have adopted it.

Figure 10.1
REAL PRICE INDICES (1960–1981)



Gains on Land

10.30 Different considerations apply in respect of rural land. The potential has existed for the realisation of significant capital gains on the sale of farms as the real price of rural property has increased significantly (although not steadily) over the period. The last twenty years have seen three periods of sharp upward movement, two of which have been followed by a period of decline. That the third such period is still in the upward phase of the swing is apparent from the Rural Price Index to December 1981 (released in March 1982). This latest short term movement should not be viewed in isolation from the long term secular trend.

10.31 Many of the increases in real land values are probably related directly to certain incentives currently available to the business and agricultural sectors. For example, there is some relationship between the increase in farm prices and the increase in livestock units carried. The increased carrying capacity may flow from a specific policy decision to meet part of the capital cost (e.g. deduction for development expenditure). To the extent that such incentives are being applied in accordance with deliberate Government policy and are achieving clearly defined Government objectives, it would be inappropriate to tax benefits accruing as to do so would undermine the value of the incentive originally offered. If unintended benefits are accruing, the remedy lies in changing or modifying the incentive to bring it more in line with the intention of the incentive and, in particular, to ensure that costs to the taxpayer are not unreasonable in relation to the national interest and benefits accruing to the individuals concerned. This question, including the need for more effective controls and reporting procedures, is discussed in Chapter 4.

10.32 Substantial individual gains have no doubt been made on residential properties at some points during the period we have studied. On the other hand, the principal residence of a taxpayer is usually exempted from the impost of the tax, with the result that the capital gains tax revenue that would have been derived from this source is probably small. Even what might seem a real gain on the sale of a principal private residence is to some extent illusory, because, generally, the vendor requires the proceeds to replace the property with one of a comparable standard.

10.33 Section 67 of the Income Tax Act provides a wide code for the assessment of profits made on the sale of land. In general, the transactions covered by the section are essentially of a revenue nature, such as profits made by those who deal in land, and those made where land is improved by the erection of a building or by subdivision. However, the section also includes a power to treat as income, certain profits made as a result of land price increases following a change of zoning or the like. Such profits may be considered to be more akin to capital gains than revenue gains. The Task Force is of the opinion that the breadth of this provision further reduces the need for a specific capital gains tax. The areas in which profits are being made on the sale of land should be continually monitored and where necessary, the section amended so as to maintain its effectiveness.

Borrowing Gains

10.34 It is the view of the Task Force that most real gains arising from the sale of capital assets are made through financing the original cost in whole or part with borrowed funds. The taxation of borrowing gains in the business sector is fully discussed in Chapter 7 and, if implemented, would remove the most important taxation inequity associated with the gain on sale of capital assets.

10.35 Careful consideration has been given to the possibility of identifying and taxing borrowing gains in the non business sector. Significant problems were recognised, and no solution found. Both for personal taxpayers and in the business sector it would often be impossible to associate specific assets which have been sold with particular borrowings. To overcome this by assuming that the asset was purchased with funds that could have been used to reduce debt would almost certainly be regarded as unfair and would introduce serious calculation and administration problems. As non business interest is not deductible for tax purposes, the equity problem caused by the non taxation of private borrowing gains is considerably mitigated.

Conclusion

10.36 The Task Force is not convinced of the need for a separate capital gains tax, and does not propose its introduction, even though capital gains are being made by some which should in principle be taxed. The adoption of the suggestions concerning determination of business income would substantially meet equity requirements.

Chapter 11

OTHER TAXES

11.1 The Task Force examined a number of other revenue sources to assess their effectiveness, and capacity to collect extra revenue, and their impact on the efficiency with which the economy uses productive resources.

Revenues from Imports

11.2 The import licensing system and the Customs Tariff are used primarily to provide protection to domestic industry. However, duties levied on some items have an explicit revenue purpose and the tariff also reflects a number of trade policy objectives.

11.3 In the year ended 31 March 1981, revenue derived from customs duties amounted to $231 million or some 3.3 percent of total government revenue. Receipts from the pilot import licence tendering scheme introduced in 1981 have been relatively small, amounting to some $3 million in its first year of operation.

11.4 In recent Budget statements, the Government has indicated its intention to continue a gradual reform of protection policies. This reform has three main features—changing the form of protection from import licence control to tariffs, introducing more uniformity in the protective structure primarily by reducing the highest levels of assistance, and lowering the average level of protection. These gradual changes in the protective structure are aimed primarily at promoting an improved pattern of industrial development.

11.5 Studies have shown a wide divergence on average between world prices and domestic prices in New Zealand. This reflects the level of protection provided by way of import restrictions and tariffs, a level which is high by international standards. Nevertheless, as protection is mainly afforded by import licensing, tariff revenues are quite low. The low revenues reflect the fact that the level and method of protection switches imports away from final goods towards raw materials and intermediate products. The wide divergence in prices not only indicates the extent of protection afforded to local producers but also implies that restriction of imports by licences granted to selected importers enables them to reap abnormal profits. Under a tariff system of protection, the divergence in prices accrues to Government.

11.6 It is considered that there is scope for diverting to the Government some of the profits accruing to importers from the existing licensing system by an extension of the import licence tendering scheme and/or a movement from licence to tariff protection, particularly if tariffs are adjusted upwards or import volumes increase.

11.7 The introduction of more uniformity into the protection structure by reducing highest levels of assistance will also have revenue implications. There may be cases where high protection under licensing is replaced by modest tariff assistance.

11.8 The Task Force noted that the Government's intention to move towards lower levels of protection implies a continuation, in the long run, of the relative decline in tariff revenue. Nevertheless, noting the current low yield of tariffs in relation to existing protection levels, it suggests that in the medium term there is potential for increased revenue by expanding tendering for import licences and by the shift to tariff-based protection, consistent with Government's broader industrial policy objectives.

Foreign Exchange Surcharge

11.9 A foreign exchange surcharge is, in essence, a one-sided devaluation which raises the price to New Zealand residents of foreign payments, but not of receipts. It can also be seen as a proportional tariff on all imported goods combined with a similar tax on other current payments and, conceivably, on capital payments. The imposition of such a surcharge would have domestic economic effects, as well as implications for New Zealand's international trade and payments undertakings.

11.10 The likely first round effects of a surcharge would be a reduction in both imports and exports and an increase in domestic prices. As with any general increase in protection, imports would initially fall, because they would be made more expensive, and because there would be some opportunities for domestic products to replace imports at the higher price level. Unlike a devaluation, however, a foreign exchange surcharge would not increase prices received by exporters. A surcharge, like import tariffs or quotas, would raise exporters' costs both directly (through pushing up the price of imported inputs) and indirectly (through enhancing the ability of protected industries to increase prices) thus tending to lower the supply of exports.

11.11 The operation of a foreign exchange surcharge may, moreover, conflict with international agreements entered into by New Zealand. A surcharge of more than 2 percent is forbidden by the IMF's Articles of Agreement except where special approval is given. Such approval could be given provided certain conditions are met, but only for a temporary measure. A surcharge could also be challenged under several articles of the GATT, which prohibit New Zealand from raising duties or charges of any kind on a wide range of goods. A further agreement to which New Zealand is a party, the OECD Trade Pledge, discourages measures which impede the free flow of funds for current or capital transactions.

11.12 Despite the difficulties recorded above the Task Force does not reject the idea of a foreign exchange surcharge completely. The Task Force did not consider that the surcharge could play a significant role in long -term tax reform but might be a useful "stop-gap" measure while a new indirect tax was being introduced.

Excise Duties on Tobacco Products and Alcoholic Beverages

11.13 The excise duty (including beer duty) on alcohol and tobacco products is a major source of revenue, amounting to $182 million for the 1980/81 year.

11.14 All excise duties presently collected are calculated at specific rates (eg, on alcoholic content) and therefore do not return additional revenue when prices rise. The rates are regularly reviewed in the Budget context. Social considerations have also been a factor in such reviews.

11.15 It is noted that upward adjustment of rates could provide significant revenue. For example, a 10 percent increase in excise duty and flow on to import duty would return an additional $36 million (including sales tax).

11.16 The Task Force considers that the impost of at least the current rates is acceptable and that they should be regularly reviewed to reflect price rises and social costs. It is submitted that such reviews should not be dependent on Budget action but rather that the specific rates should be indexed so that virtually automatic adjustments are made at least annually.

Motor Spirit Duty

11.17 The duty on motor spirit was last raised in 1978 when it was increased from 9.7 cents to 12.7 cents per litre. Revenue amounted to $284 million for the 1980/81 year. Of this total, $132 million accrued to the National Roads Board Fund as the light motor vehicle sector's contribution to roading costs. The remaining $152 million formed part of Government's general tax revenue. The amount of the tax collected does not change with the price and regular reviews are necessary to reflect general price increases.

11.18 Based on the revenue collected for the period ended 31 March 1981, each 1 cent per litre increase in motor spirit duty would realise an extra $23 million. The Task Force considers that, because of the need to maintain the revenue in real terms, there is a case for increasing motor spirit duty. This is, however, more appropriately reviewed as part of the current Government energy pricing exercise than solely in the context of tax reform.

Stamp Duties

11.19 The Stamp and Cheque Duties Act 1971 imposes six types of duty: conveyance duty, lease duty, deed duty, denoting duty, cheque duty, and credit card duty. Together they contributed $48 million for the year ended 31 March 1981. All stamp duty rates were reviewed in 1981 and many were increased, giving a revenue estimate for the year ended 31 March 1982 of $66 million.

11.20 Stamp duty is one of the oldest forms of taxation both in New Zealand and overseas. It is cheap and easy to collect. Dutiable transactions are largely those involving significant financial and real property and thus the duties are probably progressive in their impact. As long as the rates are low there are few economic distortions involved and little encouragement for evasion.

11.21 It was represented to the Task Force that it is inequitable that securities issued by diffferent sorts of institutions should be subject to different treatment. It was also argued that stamp duty has impeded development of an active secondary market for commercial debt securities. It is said that, in consequence, lenders prefer short maturities which in turn can impair financial stability. The Task Force did not have evidence that stamp duty, rather than other changes such as inflation and uncertainty of borrowers about long term interest trends, has been the cause of expansion of short term securities. However, it suggests that investigation of the matter is warranted.

11.22 The Task Force considers that while a case could be advanced for the abolition of stamp duty, it does not generally have material adverse effects. It provides a useful amount of revenue, and abolition would require an increase in other taxes. Therefore no changes to the existing system are proposed.

Totalisator Duty

11.23 Totalisator duty is charged on all monies invested on the totalisator including the TAB. Although payment is made by the racing clubs and the TAB the tax is borne by bettors through a reduction in the pool available for distribution.

11.24 The current rates of duty are 8.5 percent on on course investments and 9 percent on other investments. Total nett revenue yield for the year ended 31 March 1981 was $46 million.

11.25 The Task Force concluded that totalisator duty is a useful form of taxation and makes no proposal to change it.

Film Hire Tax

11.26 Film hire tax has been levied in New Zealand since 1930. It is payable by film renters (not exhibitors) at a flat rate on the gross rentals received. It is additional to any income tax liability of the film renters. For the year ended 31 March 1981 the tax generated $850,000. The tax, which supplemented a customs duty on imported film, was introduced with the aim of recognising the varying profitability of films. The customs duty has since been abolished but the rate of film hire tax has remained unchanged since its introduction, contrary to the accepted international practice of not taxing films. The Task Force was advised that the present tax operates inequitably, is proving to be uncertain in its effect and also contravenes international practice on the taxation of films.

11.27 The Task Force submits that it should be abolished and replaced with a service tax on entertainment as part of the indirect tax changes put forward for consideration in Chapter 8.

Lottery Duty

11.28 Lottery duty was first imposed in 1931. In its current form it is a duty imposed at a flat rate of 10 percent of the nominal value of all live tickets in lotteries promoted by the Minister of Internal Affairs, e.g. Golden Kiwi, Mammoth Kiwi, and those held in conjunction with horse races.

11.29 The revenue yield for the year ended 31 March 1981 was $6 million. The Task Force received no submissions regarding the tax; neither has it any proposal to change it.

Domestic Air Travel Tax

11.30 Domestic air travel tax is levied on all domestic air travel operators. Tax is levied at a rate of 5 percent on the amount paid or payable in respect of passengers on all fare paying or chartered flights beginning and ending in New Zealand. Revenue yield for the first year ended 31 March 1981 was $3 million. Under any of the indirect tax alternatives domestic air travel would be classed as a service and taxed. The Task Force considers that the tax should be retained subject to incorporation of the base in any expanded indirect tax regime that may be introduced.

International Departure Tax

11.31 International departure tax applies to all tickets supplied for international travel. Tax rates are $7 for children under the age of 12 years and $35 for other persons. Specific rates were applied to ensure that all persons departing for overseas paid a flat standard rate rather than applying an ad valorem rate on the price of the ticket.

11.32 Revenue yield for the year ended 31 March 1981 was $12 million. Under any of the indirect tax alternatives international travel would be classed as a service and taxed. The Task Force considers that the tax should be retained subject to the specific tax rates being incorporated in any expanded indirect tax regime that may be introduced.

Chapter 12

SPECIAL CASES

I. LIFE INSURANCE AND SUPERANNUATION

12.1 Life insurance policies and superannuation schemes may be looked upon as systems of long-term saving, but there is a clear insurance element of provision against adverse contingencies (usually death) in both life policies and in many superannuation schemes. Separation of the two is beginning to feature in some of the more modern life insurance policies.

12.2 The tax status of the various elements of life insurance and superannuation activity is as tabulated.

Table 12.1

LIFE INSURANCE, SUPERANNUATION TAX STATUS

Institution	**Premiums and (Personal)**	**Contributions (Employer)**	**Earnings of Institution**	**Terminal Benefit**
Life Insurance	Deductible up to the limit of $800 if in employer subsidised scheme, or $1000 if self-employed (i.e. no subsidy)	Not applicable	Taxed as proxy for individual on special basis	Not taxed
Lump sum Super-annuation		Deductible up to a % of wage/salary (Ceiling $700 each employee)	Not taxed	Not taxed
Pension Super-annuation		Not taxed up to a limit of 10% or more (if individual approval given by Commissioner of Inland Revenue) of the employee's wage/salary	Not taxed	Taxed as part of personal income[1]
Purchased Annuities (Life Offices)	Non-deductible	Not applicable	Not taxed	Taxed as part of personal income including the capital component

(1) In practice, the great majority of pensioners commute part (usually 25%) of their entitlement to a lump-sum on retirement.

12.3 The assessable income of life offices is deemed to be the present value (at date of declaration) of reversionary bonuses declared in any year out of the life office's actuarially determined "surplus". The amount so determined is taxed at a rate equal to two-thirds of that paid by companies generally, i.e. at the present time 30%. This rate, for a number of reasons, is very concessional by comparison with that payable both by other savings institutions subject to normal company income tax rates or the average marginal rate payable by individuals in receipt of investment income in their own right.

12.4 The tax base of life offices—the actuarially determined surplus—has been eroded in recent years. Policies now often include a contractual obligation to add some interest to policy benefits, thereby absorbing some part of the surplus which would otherwise be subject to tax and which, under previous practice, would have been distributed after tax as bonuses. To this extent, both life office and policy-holder avoid tax on the income earned on premiums paid. Revision of the method of computing the base for taxation of life offices is strongly indicated.

12.5 Superannuation funds are wholly exempt from income tax liability.

12.6 In addition to the favourable treatment extended to the institution, the exemption allowed to policy-holders (limited by the $800/$1,000 limit though it may be) and the deduction allowed in respect of an employer's contribution to a superannuation fund, means that investments in insurance policies/superannuation funds are made substantially out of untaxed incomes and, once made, accumulate on either a concessional or tax-free basis.

12.7 This has led to two divergent pressures by other savings media—*either* that the advantages enjoyed by life offices/superannuation funds should be made available to all savings institutions *or* the special advantages enjoyed by the life offices/superannuation funds should be withdrawn.

12.8 The Task Force sees considerable merit in the argument that the treatment of savings should be neutral and should not discriminate strongly in favour of one avenue of savings as against another.

12.9 The basic issues identified by the Task Force as requiring consideration are:

(a) How the tax liability of life offices/superannuation funds should be calculated.
(b) What recognition, if any, should be given for taxpayers in respect of premiums paid on policies or contributions made to superannuation funds.

(c) How receipts on the maturity of policies, or on retirement (in the case of superannuations funds) should be treated.
(d) Avoidance schemes.

Taxation of Institutions

12.10 There is at present a marked disparity in the treatment of ordinary life insurance business and superannuation business. The Task Force sees a strong case for a uniformity of treatment between the two.

12.11 In the view of the Task Force there is a strong prima facie case for treating the life office/superannuation fund as an agent of the policy-holders and liable for income tax on investment income at the average marginal income tax rate that would be payable by the policy-holders if they derived the investment income in their own right.

12.12 The Task Force recognises, however, that a large proportion of life office/superannuation fund investment portfolios are represented by fixed interest securities. It draws attention to its recommendations concerning the desirability of taking account of inflation in the determination of business income and the treatment of interest income[1].

Premium Payments: Receipts on Retirement/Maturity

12.13 If neutrality is to be maintained among various forms of saving, and if savings generally are to be made from tax-paid income (i.e. a deduction for savings is not to be provided generally) a decision needs to be made regarding the treatment of:

- Life policy premiums and contributions to superannuation funds.
- Receipts on maturity of the policy or on retirement.

12.14 If the Government decided to move towards a more 'neutral' treatment of life offices/superannuation funds it would be appropriate to *either*:

(a) withdraw the current exemption (or let it erode over time as a result of inflation) and consequently to treat all receipts on maturity/retirement as non-taxable whether received in a lump sum or as a pension;

or

(b) allow an exemption or rebate in respect of all contributions *and* to treat *all* receipts on maturity/retirement as taxable.

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(1) Chapters 6 and 7

12.15 Consistency with other forms of saving would suggest that the first of the above options should be favoured. A concern to encourage long-term contractual savings could suggest the second option. The second option would however involve a considerable revenue loss in the short to medium term. The benefit to the taxpayer of this deferral would be partially offset by the assessment, on maturity/retirement, of all receipts—both the original contribution allowed as an exemption or rebate and the accumulation thereto arising from its investment by the institution.

12.16 In the event that the *second* option were introduced, some recognition should probably be given to that part of the eventual entitlement which accrued before the changeover date. One simple approach, and one which would be favourable to the taxpayer, would be to exempt, certainly in respect of lump sum entitlements (which are currently exempt from tax), that part of the actual receipt which was equal to the proportion of the total policy term which had expired at the point of changeover.

12.17 If the second option were adopted it would be consistent with recent moves to change from an exemption system to a rebate. Since the exemption is in itself a regressive element in taxation, switching to rebates would assist in some way in minimising the problem of regression consequent on a change in emphasis from personal income tax to indirect taxes. With a rebate system, as with an exemption system, it would be possible to maintain an outright concession (if so desired), recognising individual provision of long-term contractual savings and for cover against adverse contingencies.

Employers' Contributions to Superannuation Schemes

12.18 If the first option above (para.12.14 (a)) were adopted and the current treatment of an employer's contributions remained unchanged, a major gap in the tax treatment of superannuation schemes would become apparent. This is because the employer's contributions would not be taxed at any stage, either on payment to the superannuation fund, or on its eventual payment to the employee.

12.19 The Campbell Committee addressed this issue and decided that receipts by superannuation funds of employer and other contributions in respect of which a tax deduction had been allowed should be treated as 'income received' (assessable income of the institution). Such an approach would result in a consistent treatment of savings in their various forms and would largely remove the present favourable treatment of that part of wage and salary packages represented by superannuation payments by an employer especially toward lump-sum schemes.

12.20 The Task Force is nevertheless fully aware of the social desirability of independent provision being made for retirement needs and the national requirement for an adequate level of savings within the community. It recognises that these considerations may outweigh the desirability of an even-handed approach to savings generally, but considers that determining their merits lies outside its terms of reference.

Avoidance

12.21 There is evidence that lump-sum superannuation schemes are being created with the principal purpose of avoidance of tax on investment income. It is possible for a person to set up a lump-sum superannuation scheme, exclusively for his own benefit, obtaining exemption of the income from the assets placed in it. There is a clear tax advantage in setting up such a scheme. Such schemes are currently advertised as "retirement planning".

12.22 A solution to this tax avoidance problem might be provided by restoring to the Commissioner of Inland Revenue the right to express an opinion on whether or not a scheme of superannuation was designed or adjusted solely for tax avoidance, and through the Government Actuary, prohibit such schemes or amendments being counted as approved for tax purposes.

Conclusion

12.23 The treatment of life offices and superannuation funds raises difficult issues and the transitional problems that would arise as a result of any change in basis are clearly complex.

12.24 The Task Force is of the view, however, that the present treatment of life offices and superannuation funds is anomalous not only as between themselves but also when compared with other savings institutions. It therefore recommends that the whole treatment of life offices/superannuation funds for taxation purposes should be the subject of separate and urgent review by the Government. The benefits which would flow from a more even-handed approach across all savings institutions are substantial. The Task Force is fully cognisant of the transitional problems that would arise from any substantial change in basis and of the need to recognise the contractual nature of the obligations already undertaken in respect of future liabilities by both life offices and superannuation funds. Accordingly, the Task Force recognises that lengthy transitional arrangements would inevitably have to be considered.

II BUILDING SOCIETIES

12.25 Building societies have been totally exempt from both land and income tax for the entire period of their operations in New Zealand. The exempt status began in 1892, at least partly in recognition of the social value of their operations in facilitating the housing of working people. A move to tax them in 1932 when trustee savings banks lost their tax-exempt status failed because of their then weak financial situation which would not allow them to withstand the burden of taxation. In 1967 the Ross Committee analysed the tax exempt status of the building societies in some depth,[2] reaching the conclusion that the tax exempt status should be abolished but disagreeing as to the precise method of taxing the societies.

12.26 The Ross Committee's reasoning may be summarised as:

(a) rapid growth over two decades reflected both efficient management and the favourable tax position;

(b) general affluence outweighed the importance of the societies in marshalling small savings for housing purposes;

(c) direct operation of the state, notably the State Advances Corporation (now the Housing Corporation) which was not exempt from income tax in financing housing for people in lower income brackets;

(d) accumulation of substantial reserves out of tax-exempt income, which had been channelled into freehold properties, enabling the societies to compete with other property owners whose profits were taxable in the normal way;

(e) permanent societies being comparable with finance companies in the nature of their activities—the existence of proprietary shareholdings and nominal nature of some of the membership weakening whatever approach to mutuality there may once have been;

(f) in terminating societies some 70 percent of ballot winners sold their rights to interest-free loans, indicating that the main purpose was investment in the hope of a tax-free capital gain.

12.27 Its conclusion was that there existed the following gaps in the tax base,[3] which base it wished to make as wide as possible:

(a) large accumulations of untaxed retained profits;

(b) profits of terminating societies' members selling ballot rights, which, as they represented the capitalisation of imputed interest, were treated as capital gains.

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(2) Taxation in New Zealand—Report of the Taxation Review Committee 1967, Chapter 57
(3) op. cit. para 799

12.28 The Task Force accepts the Ross Committee's reasoning as valid in its day, and believes that it applies with yet stronger force today.

12.29 Currently, there exist six terminating societies and 31 permanent societies.

12.30 Terminating societies traditionally attracted funds by sale of contractual shares to the public, requiring the purchasers to make regular subscriptions of capital on which no interest was payable. The shares would be in terminating groups, about half the subscribed capital being made available from time to time, as accumulated, for interest-free loans allocated amongst the members by ballot—and the rest of the subscribed capital being made available to members by tendering. Earnings would be returned to members at the termination of the group, usually after about a quarter of a century from its commencement. The passing of the Building Societies Amendment Act 1980 means that the significance of this type of operation will gradually diminish. No more terminating groups may commence, but those in being may continue until natural termination. There is now an option for these societies to operate special bonus balloting share accounts, bearing interest, but with part of the earnings of the society available for taxable cash prizes, allotted by ballot. It is expected that the distinction between terminating and permanent societies will gradually disappear—already there have been mergers between terminating and permanent societies.

12.31 Permanent societies offer competitive rates of interest to the public, and lend as do other lenders for housing to persons with satisfactory savings histories. Marketing has become aggressive, weakening the application of a concept of tight "mutual" groups operating on internal lines only.

12.32 Proprietary shareholding of building societies is more important now than in 1967—and where the societies are more clearly behaving like competitive financial institutions, the dividends paid to the proprietors come from surpluses that are tax free. Some societies derive important fractions of their revenue from investments that cannot be classed as investments with members.

12.33 Building societies are part of the controlled capital market, with compulsory investments in public sector securities, and limits on the investment avenues for funds which may be surplus for the time being. It is self-evident that the freedom from taxation can be exploited as a weapon in competition in the capital market.

12.34 Building societies have lately enjoyed even greater freedom from the application of taxation than have co-operative societies which have traditionally relied on protection through theories of mutuality. In the case of building societies, the income tax forgone through this freedom is estimated at $6 million p.a. currently.

12.35 The Task Force recommends that building societies be taxed on a basis consistent with other savings institutions.

12.36 Special consideration should nevertheless be given to existing terminating groups of terminating building societies, as these will wind up gradually under the 1980 legislation.

III. CO-OPERATIVES

Present Position

12.37 Co-operatives are an important form of economic organisation especially but not exclusively in the primary sector. A consideration of tax practice and policy must have special regard to those in the primary sector.

12.38 While there are important common law considerations deriving from the doctrine of mutuality, the tax status of co-operatives in New Zealand is largely determined by statute law. Because of the broad and important economic considerations involved in the whole question, it is desirable to continue to deal with both status and procedure by statute.

12.39 Broadly, under present law a co-operative pays income tax on its annual surplus only to the extent that:

(a) the surplus arises from trading with parties who are non-members of the co-operative; and

(b) the surplus is not distributed to members by way of rebates on transactions with the co-operative.

12.40 Thus any retained surplus is subject to tax in the hands of the co-operative. However, there are further legislative provisions relating to primary producer co-operatives exempting retained surplus from tax to the extent that it is applied, or shortly to be applied, to expenditures for the true purpose of the particular co-operative.

12.41 Rebates are taxable as personal income in the hands of members except where these relate to private expenditure.

12.42 There is concern at some of the recent activities of some primary sector co-operatives, which have been acquiring assets, or taking positions in ordinary companies by relying on untaxed surpluses—whereas those companies being challenged do pay tax. In terms of tax reform, any continuation or extension of such activities would gradually erode the corporate tax base. Although the rebates emerging from co-operatives which supplant ordinary companies would be assessable income in the hands of members, the tax structure may also be relatively favourable insofar as this does not equate with company/shareholder taxation. This concern about take-overs of, and large share-holdings in, ordinary companies is a facet of a broader concern about co-operatives which include in their operations some which compete with other businesses (incorporated as companies or not) subject to full normal taxation on their profits, whether retained or distributed. Some co-operatives have operations solely of this type.

12.44 There appears to be a particularly strong case for reviewing the taxation relief enjoyed by both co-operatives and their members in such cases. The matter is, however, not a simple one.

Conclusion

12.45 The treatment of co-operatives, having regard to the application of appropriate taxation principles, quite clearly suggests that they should be assessed on a basis comparable with any other business activity. In the case of a co-operative's retained surplus there seems to be no difficulty—it should be assessed regardless of the purpose for which it is retained. In respect of rebates, there is a problem insofar as some would already be counted as assessable income, and it is desirable to avoid double-taxation in such cases. In other cases, relating to what would be looked upon as consumer co-operative activity, the rebates are not assessable—and this should be reviewed.

12.46 The Task Force recognises, however, that considerations extending well beyond the area of tax policy, as such, have determined and will continue to determine, the treatment of co-operatives. It therefore recommends that the treatment of co-operatives for tax purposes be independently studied, such study having regard not only to the factors mentioned above but also the social considerations underlying their existence and a concern for their continuing viability in the event of a change in the taxation regime.

IV CHARITABLE ORGANISATIONS

Background

12.47 Sections 61(25) and 61(27) of the Income Tax Act exempt from income tax both the income derived by a charitable organisation, and any income derived directly or indirectly from any business carried on by it or on its behalf.

12.48 This exemption which is of long standing arose from traditional reasoning that charitable and religious organisations should be encouraged and assisted in the attainment of their objectives. Originally this exemption was intended to exempt the income from church bazaars and second-hand stalls, etc., but over the years many other organisations as well as the churches have set up businesses in a wide range of activities.

12.49 Generally such businesses are not in competition with the private sector as the activities are carried on as a primary object of the charity itself. These ventures include religious book shops, second-hand clothing shops, hospitals or homes for the aged, farming operations as an adjunct to a school in animal husbandry, and many more.

12.50 A relatively recent development has been the creation of an increasing number of charitable organisations operating businesses for profit and in direct competition with taxpaying enterprises. The tax exempt status enables them to enjoy a favourable pricing policy, and in addition as they do not have to service proprietor's capital, they are free to accumulate profits as they wish. The effect of this is to distort the allocation of resources within the economy with a consequent general lowering of welfare, ie resources are attracted into a particular activity not because this accords with consumer preferences, but as a result of an indirect subsidy from the general body of taxpayers.

12.51 These advantages have enabled rapid growth in the business activities of some charities to the extent that in certain areas of production they have gained a virtual monopoly due to the inability of the commercial taxpaying sector to compete on equal terms.

12.52 While some of the larger operations are being conducted by major charitable organisations themselves, eg established churches, a disturbing trend in recent years has been the tendency for individual business taxpayers to conduct their business activities through a charitable company, apparently for tax avoidance purposes. For example, a businessman may create a charitable trust, and sell the shares in his private company to that trust. The taxpayer continues to operate the business, but charges the company a management fee or takes out a salary (taxable to the individual) though profits retained in the company or applied though the trust for charitable purposes are not taxed.

12.53 The full extent of the commercial activities carried on by charities and the amount of revenue forgone as a result of the concession is not known. Once charitable status is granted, tax returns are no longer required and no check is kept on the activities of the charity other than to consider whether the charitable objects are still being complied with.

Comment

12.54 It appears that while most countries allow some form of tax concession for the income from the business activities of charities, only Italy is as generous as New Zealand. In the United Kingdom profits made by a charity in carrying on a trade are exempted if they are paid over to the charity annually in accordance with its trust. The United States, Germany and Canada limit the percentage of profits which may be paid over tax-free and France reduces the rate of tax (to 24%). In the US "trading activities" are taxed but income from rental property and investments (including dividends) is not considered to be trading income and is exempt in the hands of the charity. Singapore provides for an exemption if the business is exercised in carrying out the primary purpose of the charity; the work is mainly carried on by persons for whose benefit the charity was established; and not less than 80% of the net income of the previous year was applied to charitable ends.

12.55 The Ross Committee recommended that the trading profits derived by charitable organisations and dividends from any company substantially owned by such organisations should be assessable at normal rates, although all other income including normal investment income and rents from property would remain exempt. The Carter Commission in Canada came to the conclusion that charitable organisations should not be given a competitive advantage in business activity. It recommended that business income and income from non-portfolio investment should be assessed at the full rate of corporation tax, defining business income for this purpose as income flowing from any interest of 10% or more in a business and including the ownership of real property as a business. These recommendations were not adopted by the Canadian Government but measures have been taken (see above) to tax certain parts of the income of charities.

Conclusion

12.56 The Task Force is of the opinion that the unrestricted exemption of business income derived by charities is inconsistent with the objectives of equity, neutrality and economic efficiency espoused in this report. It appears that a system broadly consistent with that adopted in Singapore most closely meets these objectives. In the time available it was however not possible to frame proposals in full detail.

Recommendation

12.57 The Task Force recommends that urgent action be taken to introduce appropriate measures along the lines suggested (i.e. permit charitable organisations to undertake their traditional fund raising activities but at the same time minimise the scope for avoidance and reduce the advantages accruing to charities which operate in competition with taxable businesses).

Chapter 13

SUMMARY OF FINANCIAL IMPLICATIONS OF PROPOSALS

Introduction

13.1 The Task Force has identified a number of major areas in the tax system which it believes are in urgent need of reform. In the case of personal income taxation, these centre on the marginal tax rate scale and, in particular, the desirability of reducing its progressivity. Other personal income tax reforms, however, are also envisaged, notably: broadening the income tax base by taxing fringe benefits, introducing voluntary income splitting for married couples, and changing some of the ways in which dependants are recognised in the tax system.

13.2 The Task Force has also identified desirable reforms in respect of the taxation of business income, dividends and interest.

13.3 Implementing all the foregoing reforms would involve substantial revenue cost. The Task Force has recognised that there is a strong demand for a significant reduction in personal income tax rates. For working purposes it assumed that a "significant reduction" indicated a public expectation of a reduction of the order of 20 percent—or $1,000 million per year in 1980/81 terms. The other reforms that the Task Force sees as pressing would also require substantial additional revenue to be generated if overall Government revenues were to be maintained.

13.4 The Task Force has searched for possible compensating sources of tax revenue. We have recommended the taxation of certain fringe benefits. In the direct tax field, we have also recommended certain action for more effectively monitoring business concessions and for minimising losses through evasion and avoidance practices. However, we have not been able to quantify possible savings from these latter sources.

13.5 In the indirect tax field, a VAT would have the necessary revenue generating capability but requires a three year lead time for its introduction. The other possibility would be an extended and rationalised wholesale sales tax in association with a selective tax on services. This would generate additional revenue in the short term, but its capacity is limited unless final goods and services purchased by businesses are subject to sales tax—a course which, as stated in Chapter 8, the Task Force on balance does not favour.

It is estimated that if these goods and services used by businesses are not taxed the yield from the wholesale sales tax could make available about $500 million in 1980/81 terms for personal income tax reductions.

13.6 As a result, two things become clear given the need to maintain Government revenues overall:

> *first*, if the Government decided to accept none of the Task Force's recommendations concerning income tax other than a reduction in the personal income tax scale, a reduction of the order of 20 percent could not be effected in the short term;
>
> *second*, insofar as other reforms were introduced, *either* the indirect tax revenue requirement would be increased *or* the scope for reducing the personal income tax scale would be reduced. In the latter case, some taxpayers would certainly receive a reduction in their income tax liability but some of this would be other than by way of a change in the scale as such (eg from the benefits arising from income splitting, etc.)

Proposed Avenues for Reform

13.7 To illustrate the revenue implications of the types of reforms favoured by the Task Force (some of which are largely interdependent) it is worth briefly reviewing the main elements of the recommended reforms. All costs are expressed in 1980/81 terms and are approximate estimates only.

Personal Income Tax

13.8 Reforming the marginal tax rate scale is the central element in the Task Force's proposals for personal income tax reform. Several alternative types of scale have been presented as possible replacements for the present one (see Chapter 6.V, paragraph 6.162 ff). In each case, variations corresponding to a range of estimated revenue costs in 1980/81 terms have been shown—Table 6.4 refers. This table is reproduced below as Table 13.1.

Table 13.1
TRADE-OFF BETWEEN REVENUE COST & BREAK-EVEN INCOME LEVELS FOR VARIOUS TYPES OF PERSONAL INCOME TAX SCALES

SCALE	REVENUE COST IN 1980/81 TERMS	BREAK-EVEN INCOME	MARGINAL TAX RATES FOR THE FOLLOWING TAXABLE INCOME BRACKETS (values in $1000)							
			0–6	6–9	9–16	16–24	24–30	30–38	38–48	48+
	($M)	($ p.a.)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Scale 1 variants	350	15,580	21	32	32	32	44	55	60	60
	500	11,690	20	31	31	31	43	54	60	60
	750	8,790	19	29	29	29	40	51	60	60
	1,000	7,340	18	27	27	27	38	48	55	60
	1,250	6,480	17	25	25	25	36	45	53	60
Scale 2 variants	350	8,670	22	22	34	40	45	50	55	60
	500	8,050	21	21	33	39	44	50	55	60
	750	7,520	20	20	31	36	41	46	50	55
	1,000	7,050	19	19	29	34	39	44	50	55
	1,200	6,630	18	18	27	32	37	42	48	55
Scale 3 variants	350	5,640	15	35	35	48	55	55	60	60
	500	5,640	15	33	33	46	54	54	60	60
	750	5,640	15	31	31	41	49	49	55	55
	1,000	5,640	15	28	28	38	47	47	55	55

13.9 This table demonstrates the problem that, to reduce *substantially* the degree of progressivity of the scale for the vast majority of taxpayers, which the Task Force regards as desirable, some increase in the marginal tax rates at the lower end of the income spectrum seems inevitable if the overall cost is to be kept within reasonable bounds. Unless marginal rates at the lower end of the income spectrum are increased quite significantly, it would not be possible to make good the revenue shortfall arising from the reduction in marginal and average rates for the bulk of taxpayers in the middle-income range. If this shortfall were to be financed by a switch to greater reliance on indirect taxation, it appears likely from the Task Force's analysis of indirect tax incidence (based on recent Household Survey data) that lower-income households may be subject to an increase in both personal income tax and indirect tax in order to achieve this end, unless special recognition is provided in respect of them by way, for example, of the low income family rebate or a personal rebate, the latter of which the Task Force does not recommend.

13.10 Table 13.1 also illustrates the levels of marginal tax rates that might be possible given different revenue cost constraints in 1980/81 terms. For instance, in the case of Scale Type 1, introducing a $1,000 million cost variant would allow marginal rates to be reduced to the extent that no persons with incomes exceeding about $7,300 per annum in 1981/82 (ie about half the estimated level of average earnings) would pay more income tax due to the scale change. But if the introduction of this type of less progressive scale were subject to a $500 million revenue cost constraint, the initial marginal rate would need to be higher and, as a result, the break-even income level would be about $11,700 (ie about .9 times the estimated level of average earnings in 1981/82).

13.11 The three types of scale illustrated in the table also reflect a differing degree of compromise between reducing the progressivity of the scale on the one hand and minimising the redistribution of tax liability on the other. The first two are substantially less progressive than the present scale and therefore would given rise to some redistribution of the income tax burden in favour of middle and higher income taxpayers. The third type of scale, although less progressive than the present scale, would still be much more progressive than the first two for low- and middle-income taxpayers, and the break-even income levels would be lower as a result. But this reduced redistributive impact—which would be aimed at protecting low-income earners (comprising about one third of all taxpayers but only about one tenth of principal income earners), and which would benefit comparatively few taxpayers (only about 10 percent of taxpayers have incomes of less than about one-half the average earnings level)—would be achieved at the expense of significantly higher marginal tax rates for most other taxpayers.

13.12 Other reforms of the personal income tax system recommended include the following measures shown in Table 13.2.

Table 13.2

PERSONAL INCOME TAX REFORMS REVENUE COSTS[1]

	Item	Estimated Revenue Cost (−) or Yield (+) in 1980/81 terms
		($ million)
1	Voluntary income splitting for married couples—in recognition of the impact which a spouse has on a tax unit's ability to pay tax (using a 1.7 divisor for the purpose of illustration);	—150 to—400 [2]
2	Abolition of both the spouse rebate and the young family rebate, provided that income splitting is implemented;	90
3	An increase in family benefit—by (say) $3 per child per week—in recognition of the impact which dependent children have on a tax unit's ability to pay tax;	− 160
4	A substantial increase in the housekeeper rebate from $3 per week to a maximum of (say) $15 per week, provided that income splitting is implemented and/or the personal income tax scale is significantly flattened;	− 40
5	An increase in the low income family rebate from $9 per week to a maximum of (say) $25 per week—to provide income support for low-income households with dependent children;	− 100
6	Taxation of fringe benefits.	210

(1) Consequent upon the introduction of further indirect taxation, some adjustments to National Superannuation and other social welfare benefits may be necessary. The costs of any such adjustments are not included.

(2) The actual revenue cost of the Task Force's voluntary income splitting proposal would depend on what new personal income tax rate scale it was associated with and would range between about $150 million (for the least progressive scale) to about $400 million for the most progressive.

Business Income Taxation

13.13 The estimated revenue implications of the Task Force's recommended reforms in the area of business income taxation are shown in Table 13.3.

Table 13.3

BUSINESS TAX REFORMS
REVENUE COSTS

	Item	Estimated Revenue Cost (−) or Yield (+) in 1980/81 terms
		($ million)
A.	For immediate implementation	
1	All dividend distributions to be treated as taxable to the shareholder;	35
2	Dividend rebate to be allowed to resident individual shareholders;	− 26
3	Abolition of bonus issue tax at time of bonus issue;	− 4
		+ 5
B.	For investigation with a view to early implementation	
1	Inflation adjustments for business income (1979 income year estimate $135 million)	− 150[1]
2	Withdrawal of existing tax concessions identified as surrogates for inflation adjustments	50
		− 100

(1) The Task Force has recommended, in association with its recommendations concerning business taxation, that where a personal taxpayer lends by way of an indexed financial contract, the inflation premium payable in accordance with that contract should, subject to appropriate safeguards, be exempt from tax. In the unlikely event that all lending by individual taxpayers was by way of indexed lending, the revenue cost is estimated to be approximately $200 million a year. This potential cost has not been included above as it is not possible to anticipate the rate at which a change to indexed lending would take place.

Appendix A

LIST OF DEPARTMENTS, ORGANISATIONS AND INDIVIDUALS WHO MADE SUBMISSIONS TO THE TASK FORCE

The following is a list of those who sent in submissions.
A number of submissions were also received by the Prime Minister's Department.

Adams, B.J., Cambridge
Alston, A.P., Christchurch
Armstrong, K.H., Nelson
Arthur, C.M., Hamilton
Association of Accredited Advertising Agencies of NZ Inc
Association of Anglican Women—Social Concerns Committee
Association of Representatives of the AMP Society
Ashburton Borough Council
Associated Products Ltd
Associated Trustee Banks

Bishop C.O., Auckland
Booksellers Association of New Zealand Inc

Combined State Unions
Cooney, G., Invercargill
Cowan, T.K., Dunedin
Crafts Council of New Zealand Inc
Consumers Institute
Customs Department

de Joux, E.H., Upper Hutt
Department of Trade and Industry
Department of Social Welfare
Devenport, F., Christchurch
Diocese of Dunedin—Public & Social Affairs Committee

Ellis, P.N., Masterton
Export Institute of New Zealand

Federated Farmers of New Zealand Inc
Feminists for Life
Forsyth, D.E., Wellington

Harrison, Hon. Sir Richard, Wellington
Huckstep, M., Balclutha
Hutchinson, J.D., Hamilton

Inland Revenue Department
Interdenominational Committee of Independent Schools
International Fiscal Association
IYDP, Legislation & Income Focus—NZ National Committee

Jefferies, P., Auckland
Jewellers Association of New Zealand Inc

Kelman, E.H.H., Wellington

Lewis, G.W., Auckland
Lewis, J.A.B., Auckland
Life Offices Association
Lowry, R., Whangaparaoa

McDonald, C.J., Christchurch
McFarlane, J., Christchurch
Managh, J.F., Lower Hutt
Manufacturing Development Council
Ministry of Agriculture and Fisheries
Minogue, M.J., M.P., Wellington
Monks, M.D., Nelson
Mutch, J., Wellington

National Art Gallery—Friends of
National Organisation for Women

National Research Advisory Council
Nelson, G., Takapau
New Zealand Bankers Association
New Zealand Bureau of Importers and Exporters
New Zealand Business Roundtable
New Zealand Chambers of Commerce
New Zealand Commercial Stationers Guild
New Zealand Computer & Office Products
New Zealand Council of Social Service
New Zealand Employers Federation
New Zealand Engineers Union
New Zealand Federation of Labour
New Zealand Federation of Master Cleaners
New Zealand Federation of Voluntary Welfare Organisations Inc
New Zealand Finance Houses Association Inc
New Zealand Forest Service
New Zealand Freezing Companies Association
New Zealand Institute of Economic Research
New Zealand Manufacturers' Federation Inc
New Zealand Newspapers Provident Association
New Zealand Planning Council
New Zealand Police Association
New Zealand Retailers Federation Inc
New Zealand Society of Accountants
New Zealand Soft Drink Manufacturers Association
New Zealand Stock & Station Agents Association
New Zealand Teachers Colleges Association Inc
Niculescu, B.M., Wellington

Paine, A.C., Raglan
Plastics Institute of New Zealand
Presbytery of Manawatu
Private Sector Tax Reform Working Party

Queen Elizabeth II Arts Council

Radford, H.J., Wellington
Rankin, K., Wellington
Recording Industry Association of New Zealand
Reserve Bank of New Zealand
Roxburgh Women's Section of the National Party

Securities Commission
Schnauer, D., Auckland
Speedy, S.L., Auckland
State Services Commission
Stewart, D.B., Lake Tarawera

Tiller, Mrs M.A., Wellington
Tolich, J., Auckland
Treasury

Webber, N., Auckland
Webster, B.D., Auckland

APPENDIX B

INFLATION AND BUSINESS TAXATION

REVIEW OF TRANSITIONAL PROBLEMS

B.1 The comments made in this appendix are those of individual members of the Secretariat of the Task Force on Tax Reform and should not be taken as necessarily representing the views of the Task Force or of any of the members of the Steering Committee of the Task Force.

B.2 The Secretariat is grateful to Mr R W R White, Governor of the Reserve Bank of New Zealand, for the time and assistance provided in the review of certain aspects of the transitional problems and in particular the implications of the introduction of indexed financial contracts.

Background

B.3 The Task Force has recognised that the business income tax base should as a matter of urgency be redefined to eliminate the distortionary effects of inflation. The longer changes are delayed the greater will be the distortions to investment patterns caused by inflation and an inadequate taxation system. Businesses and individuals are constantly adapting their behaviour to take advantage of or to mitigate both the effects of inflation and the impact this has within the present tax system. The longer tax reform in this area is delayed the more difficult will be the necessary transition.

B.4 The Task Force has indicated its general support for the development of a comprehensive system of inflation adjustments for tax purposes. It has however suggested that before such a system is introduced the various transitional and administrative problems should be reviewed by an appropriate body or government department.

B.5 The transitional problems identified and listed below are not exhaustive, and it should be noted that the development of answers for some problems will have an impact on areas other than tax reform. In particular the question of the indexation of financial contracts is not an issue that can be clearly or easily disposed of. It has wide ramifications not just for tax policy but for the operation of the monetary system as a whole. Indexation may offer a solution to the very real transitional problems associated with the introduction of inflation accounting complete with the taxation of borrowing gains. It is recognised, however, that it is clearly not the only possible solution to those problems even though it may, on the face of it, appear to be the most appropriate from a taxation point of view.

B.6 The implications of a move to indexation of financial contracts could easily be the subject of a full report in itself. The following comments where they relate to indexation of financial contracts must therefore be accepted as an initial appraisal only of some of the transitional matters which the recommended review will need to comprehensively investigate. The following comments are not presented as part of the formal report of the Task Force, but are included here as they may be of assistance in carrying out the review recommended in paragraph 7.36 of the Task Force's report. The order in which the points are listed should not be taken as any indication of their priority for the review.

Implications for Existing Borrowing Arrangements

B.7 Perhaps the major transitional problem arises from the fact that most business borrowers will have entered into existing borrowing arrangements with the expectation that interest will continue to be a tax deductible expense. While the Task Force has concluded that a business should continue to be allowed a full tax deduction for interest, it has recommended that a comprehensive system of inflation adjustments should include as taxable income the borrowing gain of the business in respect of the decline in the real burden of all the businesses monetary liabilities.

B.8 Where the tax liability was increased significantly this could give rise to liquidity problems for some taxpayers. A potential solution to the liquidity problem appears to lie in the ability of those taxpayers to switch to more flexible debt repayment terms, or to borrowing contracts which provide for capitalisation of interest, or perhaps to indexed borrowing contracts. If borrowing contracts were fully indexed the cash flow required to service the debt could be reduced for a number of years below that currently required, notwithstanding that "interest" is presently tax deductible (paragraph 7.30). The real cost of servicing the indexed loan would, throughout its term, be less than the real cost of servicing a non-indexed loan in its initial period.

Tax Treatment of Interest

B.9 The present tax treatment of interest income is a possible barrier to the adoption of more flexible repayment terms for debt where the lender may otherwise be prepared to "capitalise" interest flows either implicitly, or explicitly through indexed financial contracts. Both capitalised interest and any inflation premium on indexed securities are currently taxable. As a result, lenders have not been attracted to this form of lending, perhaps requiring cash flows to be maintained in order to meet the payment of tax levied on the full nominal interest income.

B.10 This treatment of interest and the current levels to which interest rates have been pushed has caused a great deal of public debate and concern recently. These concerns were outlined for the Task Force in the following comments of the Governor of the Reserve Bank:

> "The use of the interest rate mechanism as the means by which financial contracts are adjusted for inflation severely distorts the pattern of cash flows associated with debt servicing. Lenders are compensated (if only partially, and before tax) for the erosion of the purchasing power of their capital in the form of a higher rate of interest. On the other hand, interest payments for the borrower have, in effect, become almost totally capital repayments. The overall debt servicing burden is thereby pushed towards the early years of the borrowing term, often causing liquidity problems for borrowers, even when the venture being financed is profitable. In combination with existing tax arrangements which allow interest payments to be deducted from taxable income, this tends to bias investment expenditures away from longer term developments, which, on balance, is likely to have an adverse effect on economic growth. Compressed debt repayment schedules are also likely to put further pressure on the rate of inflation, given that businesses facing cash flow problems are likely to raise their prices in order to cover their debt servicing commitments.
>
> "The overall result, paradoxical as it may seem, is that interest rates tend to end up being too low and too high at the same time.
>
> "From the point of view of savers, they are too low (given that after tax, and often before tax, real rates of return are negative), this having adverse implications for resource allocation and inflation. But from the point of view of borrowers they are too high (given the cash flow requirements imposed by "high" nominal interest rates), this again having adverse implications for resource allocations and inflation.
>
> "A response to this situation would be for all financial contracts to be indexed, i.e. the inflation adjustment would be made to the principal of the debt and not by way of the addition of an "inflation premium" to the interest rate. This

would enable debt servicing burdens to be more evenly spread over the term of the loan, and at the same time, real rates of return to savers could be raised. So far as tax policy is concerned, the essential step required before financial indexation could be implemented would be to make the "inflation premium" component of the return on financial assets neither assessable (for the lender) nor deductible (for the borrower) for tax purposes."[1]

B.11 As far as the business taxpayer is concerned this result would be effectively achieved through the inflation adjustments recommended by the Task Force for monetary assets and liabilities. To effect the same result for personal lenders by way of an inflation accounting type adjustment to interest received would give rise to a number of administrative difficulties, and it is therefore suggested in Chapter 6.II of the report that only where funds have actually been lent by a personal taxpayer by way of an indexed financial contract should the inflation component be exempt from tax. (The tax treatment would be similar to that which applies currently for inflation savings bonds.) This requirement would have the additional advantage of providing a strong incentive for the development of a general market of indexed financial contracts.

B.12 Consideration would need to be given to what is, and what is not interest, with particular reference to the treatment of leasing and hire purchase arrangements. Are leases effectively financial liabilities and lease payments effectively interest? If not, and interest was adjusted for tax purposes through the borrowing gain, borrowers may have an incentive to switch from loan to leasing arrangements and vice versa for lenders. Where the balance would lie is not clear, but then so long as some balance were struck, this may not be considered to be a problem. The consequences of the changes that do occur would need to be carefully monitored and if any imbalance did arise legisation may be required to correct this.

B.13 A problem would arise however where the "lender" was a superannuation fund, a building society or a life office. The former two types of institution do not at present pay income tax (subject to some qualifications) and life offices pay tax on reversionary bonuses, not income. (The taxation treatment of these institutions is discussed in Chapter 12 of the Task Force's report.) Therefore, even if real interest only was assessable through the inflation adjustment on monetary assets while other forms of returns on "lending" (e.g. lease rentals, loan administration fees, etc.) remained assessable in full for income tax purposes, these three

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(1) Mr R W R White Governor of the Reserve Bank of New Zealand, letter to the Task Force on Tax Reform—August 1981.

categories of institution would probably remain indifferent as to what form the return on their "lending" took. In some circumstances, it could be expected that these institutions may be willing to create "off-balance sheet" "lending" arrangements so as to enable their clients to avoid the borrowing gain adjustment for tax purposes.

Borrowing Gains

B.14 The taxation of borrowing gains where the inflation adjustments give rise to an increased tax liability is a matter of some concern. Many taxpayers are already protected to some degree from the effects of inflation, through immediate or accelerated tax write off of capital expenditures. These taxpayers would not enjoy significant benefits from the inflation adjustments for assets. Likewise, taxpayers who have borrowed to invest in non-depreciable assets (e.g. land) or assets that are depreciated for tax purposes at a low annual rate are likely to face an increased tax liability as a result of the inflation adjustment. The rationale for including borrowing gains as part of the inflation adjustments is, in the view of the Task Force, well established. To have regard to those gains only where the adjustments would reduce total taxes payable and to disregard them when taxes payable were increased would in the opinion of the Task Force be neither sensible nor equitable (refer paragraph 7.27).

B.15 Transitional arrangements could be made to overcome these liquidity problems, and allow time for taxpayers to rearrange their financing. These include:

(a) The borrowing gain could be added to assessable income only to the extent that deductions for the trading stock, monetary assets, and depreciation inflation adjustments are allowed.

This would effectively result in the taxable income of a business being the lower of the conventional historic cost base or the inflation adjusted base. (The Richardson Committee made a similar proposal for limiting the taxation of the borrowing gain.) The Task Force, however, does not consider this approach to be an appropriate option (paragraph 7.27).

(b) The borrowing gain adjustment (to the extent that this exceeds the inflation adjustment deductions) could be introduced over (say) a three year period. This would give the business the opportunity to alter its financial structure or move to a system of borrowing by way of indexed debt on which no borrowing gain arises. This option could be difficult to administer as businesses could rearrange their financing in the interim so as to obtain the full deductions from the inflation adjustments and by borrowing through separate entities isolate borrowing gains which were then not brought into account for tax purposes during the transition period.

(c) All aspects of the inflation adjustments could be gradually phased in over (say) a three year period. By comparison with the previous option, this would have the advantage that the momentum for change to the full adjustments proposed in the comprehensive system would be maintained, as the majority of taxpayers would have further benefits to realise from the subsequent stages.

(d) The payment of any increased taxes could be deferred, with the deferred debt for taxes itself being inflation adjusted.

Redistribution Effects of Inflation Accounting

B.16 The full implementation of inflation accounting for tax purposes would not result in the business sector being adversely affected in terms of its *aggregate* after tax income position. The 1979 revenue cost of the proposal recommended by the Task Force is estimated at approximately $135 million, that is, a reduction in tax in the aggregate of about 15 percent. There would nevertheless be some redistribution of the tax burden within the business sector. For instance it is likely that the farming sector in particular would face an increased tax burden. The appropriate treatment of this sector may therefore need particular consideration.

B.17 It is not entirely clear whether the problems facing the agricultural sector stem from an inadequate overall rate of return or from an inadequate cash flow. If the latter, it could well be that the measures proposed above, if coupled with the acceptance of indexed mortgages by farmers, could be beneficial in terms of agricultural production.

B.18 Another "sector" which may be affected could be the private rental housing market, although here indexed depreciation would provide a greater offset (in relative terms) than would be the case for the agricultural sector. The overall after tax rate of return on investments in rental housing, particularly where heavily financed by borrowing, could be reduced. The likely impact on the supply of rental housing would therefore need to be considered.

Impact of Inflation Adjustments on Accounting Procedures

B.19 There would be some administrative and transitional problems for accountants and the Inland Revenue Department in correctly calculating the inflation adjustment for tax purposes particularly in relation to monetary items. In general, calculations would be based upon the simple average of opening and closing historic cost balances in the balance sheet. There would however be many cases in practice where such a calculation would not provide an accurate reflection of the average for the year as it applies to specific classes of assets and liabilities. This problem is not as important as it might appear at first sight. If for example the annual balance date of a business takes place when for seasonable reasons the value of stocks on hand is much lower than the true average for the year, it would be offset by the fact that average liabilities would also be lower by a similar amount. In other words the changes in average working capital throughout the financial year would, in the great majority of cases, vary by relatively insignificant amounts throughout the year. A simple averaging of opening and closing balances would therefore produce a reasonably accurate result.

B.20 On the other hand, there would be circumstances in which the result of the simple average of opening and closing balances would require to be adjusted. The purchase (or sale) of substantial fixed assets in the final weeks of the year may lead to a substantial overstatement (or understatement) of average borrowings for the period. Some adjustment in this case would clearly be appropriate.

B.21 There would also be some definitional problems in relation to the determination of "equity" and "borrowings", particularly in the cases of relatively small family businesses. In the case of unincorporated businesses the difference between capital of the owners and loan accounts of the owner and his family is frequently ill-defined and this can also be the case with family owned limited liability companies. There could also be further complications because of the temptation to avoid the taxation of borrowing gains through temporarily paying off liabilities at year-end through private borrowings which are then "paid" into the business as "capital". Such practices could lead to complexities and uncertainties in the determination of borrowing gains for taxation purposes unless clear rules were laid down and the Commissioner of Inland Revenue was given the necessary authority to determine a fair but realistic borrowing gain where the circumstances justified it.

B.22 There might also be a tendency for businesses to leave surplus cash funds in the business rather than withdrawing them so as to obtain the inflation adjustment on monetary assets. Provided indexed securities for lending purposes were also available to private investors, however, there would be no advantage to be gained and no overall effect on taxation revenues (unless marginal rates of tax were significantly different) as the gain obtained by leaving such surpluses in the business sector would be substantially the same as could be obtained by personal lending on indexed terms.

B.23 Based upon the limited research carried out there would appear to be little reason for concluding that problems in implementation could not be satisfactorily overcome.

B.24 While any change in the tax laws to make only the real rate of interest assessable and deductible for tax purposes would give an incentive to both borrowers and lenders to enter into indexed contracts, it is not entirely clear that indexed instruments would become available as quickly as borrowers (who faced an increased drain on their cash resources more or less immediately) might require. The banking industry could be expected to move cautiously, because financial indexation would involve a fundamental review of lending criteria. The legal profession would also have to become conversant with the potential legal complexities, in addition to the more practical issues such as the drawing up of new forms of financial documents.

B.25 These points do not represent problems in any fundamental sense, but could pose difficulties in the short term. The best way to lessen these kinds of problems may be to announce the tax changes in advance of their taking effect, so that all involved would have time to prepare for the changes.

Some Implications of Indexed Financial Contracts

B.26 Financial indexation raises questions relating to financial institutions' portfolio management, i.e. could it be expected that financial institutions would be able to match indexed assets with indexed liabilities and would financial institutions need to have access to indexed reserves, i.e. indexed government securities? If an indexed debt escalates faster than the market value of the asset over which the debt is secured, would there be a need for, say, more extensive mortgage guarantee facilities?

B.27 The position of companies with substantial overseas borrowing would require special consideration. There are implications here for exchange control and private Overseas Exchange Transaction capital flows. The treatment of exchange losses on overseas borrowing would also need to be reviewed.

B.28 The impact on real rates of return on financial instruments and the implications of this for monetary policy would also need to be considered. Presumably the change would give rise to positive after tax real returns to lenders and therefore an increased willingness to hold financial assets. If a contraction in aggregate demand, because of an increase in the level of savings, was to be avoided, careful management of fiscal and monetary policies would be required for a period subsequent to the tax changes.

B.29 Acceptance of indexed financial contracts would reduce debt servicing costs, at least in the short term. It is likely that lending institutions would also revert to a more conservative policy in respect of securities accepted as collateral for loans. The borrower in these circumstances may therefore be required to increase his initial equity in the investment. It is unlikely that this would cancel out the cash flow advantage above, and it should be noted that in saving up the initial equity capital the borrower would himself have access to indexed savings securities.

B.30 As discussed above, the tax treatment of superannuation funds and life offices will have an effect on establishing indexed financial contracts. In general these institutions are net lenders. The implications of extending the inflation adjustments to include the investment funds of these institutions would be to exempt from tax that part of the "return on the fund" that merely represented the inflation rate. As these institutions would be expected to provide indexed financial contracts, any review of their tax treatment as discussed in Chapter 12 of the Task Force report would need to recognise these implications.

Selection of an Appropriate General Index

B.31 An appropriate index against which the inflation premium of the indexed financial contract and thereby the gains and losses on borrowing could be measured would need to be adopted. The general indices (CPI and GPI recently renamed the Producers Price Index (PPI)) are currently published on a quarterly basis. While estimates can be constructed for intervening periods it may be more apropriate to arrange for an index series to be published on a monthly basis. A single general price index, measuring the general rate of inflation, would be the most appropriate, to apply in indexing financial contracts. The CPI might be the most approriate index as far a personal savers were concerned, however the PPI may be the most appropriate general index for business inflation adjustments. Whether the two index adjustments would be compatible if they operated in conjunction with each other, or whether an "overall general" index of inflation should be adopted for all adjustments, would need to be resolved.

Summary and Conclusions

B.32 In summarising the above points it should be noted that:

- a change in the tax system through the inclusion of borrowing gains in taxable income coupled with other inflation accounting adjustments for tax purposes, would probably create a need to provide for and encourage financial indexation (noting of course that the proposed change in the tax status of interest set out in Chapter 6.II would in itself remove what is presently probably the major impediment to financial indexation procedures);
- if the offsetting inflation accounting and financial indexation procedures were adopted, there would be a change in the

distribution of after tax income within the business sector. The effects that this may have on certain sectors, especially those that may be disadvantaged, e.g. farming and the rental housing market, require examination. *It should be noted however that these effects are similar to or the same as would result if inflation were eliminated*;

- from an administrative point of view, the changes proposed would be major ones, for both the Inland Revenue Department and taxpayers;
- a continuation of differences of tax treatment for different categories of financial institutions could result in obvious tax avoidance opportunities (as indicated at B.13 above);
- the implications of a substantial increase in the real rates of return available on financial assets and the effect on aggregate demand need to be assessed, with a view to monetary and fiscal policy stances during the transition period.

B.33 While an attempt has been made to provide solutions to, or ways around, the problems identified, several aspects obviously require further review before the proposal can be efficiently implemented. In many respects, the major outstanding problems are the practical and administrative ones. It is clear that any solutions to these problems will involve some trade-offs between theoretical appropriateness and what is feasible in a practical sense.

B.34 In view of the very real and harsh effects that inflation is having on the business and financial community it was *not* a feasible option for the Task Force to recommend *no changes* in the determination of business income for tax purposes. In this regard an essential point is that the longer changes are delayed, the more difficult it is going to become to make them, given that people all the time are undoubtedly adapting their behaviour to take account of inflation and the effects it has on the tax system. As indicated in the introduction to this appendix, the longer the tax changes layed, the more difficult will be their introduction.

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