Inland Revenue
Te Tari Taake

Briefing for the Incoming Minister of Revenue – 2008

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Inland Revenue Department

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Executive summary

A good tax system is not just about having good policy. Both tax policy and tax administration must be working well for us to have a good tax system, which will help business grow and to make New Zealand attractive to investors. Our key advice is that the tax system needs to be considered as a whole.

For example, individual tax policy changes cannot be considered in isolation. They need to be examined with a view to how they dovetail into building an overall coherent tax system. This involves coherence with both other policies and with our ability to operate the tax system in ways that are as low-cost and as helpful to taxpayers as possible.

The briefing is a stocktake on how we see the tax system is functioning. Overall, we see the tax system as operating well. We collect revenue to finance government spending using broad tax bases and mostly low rates. This is likely to minimise the economic costs of raising taxes. Despite recent downturns, our revenue collections from our three main tax bases – personal income, company income and expenditure on goods and services – have over time been robust. We collect significant amounts of revenue from these taxes. We believe that the tax system is mainly seen as fair. Compliance costs are relatively low by international standards. The money the government spends on Inland Revenue per $100 of revenue raised is moderate by international standards and is declining.

Nevertheless, there are some growing pressures. None of these should be viewed as a matter of alarm. The tax system is generally operating well. However, there are some growing problems which, if left untreated, have the potential to erode our ability to deliver a high quality tax system.

One concern is the overall coherence of the tax system. To an increasing extent, the tax paid by an individual depends on the way in which that income is earned. There is ample evidence that people are using different entities to structure their affairs in ways which reduce their tax liabilities. The scope that the current tax system provides for this to happen imposes costs that can lower the wellbeing of New Zealand as a whole. It can also create considerable business uncertainty around what is and what is not tax avoidance. It can create a mentality that rather than tax being something which is paid by all, tax is something for the smart, the able and the well-advised to avoid. Over time, this can erode confidence that the tax system is fair.

There are a number of possible ways of reforming the tax system to create greater coherence. We believe that an important priority for the government is to settle on a broad framework for reform and to take systematic steps over time to increase the coherence of the tax system.

A second concern is maintaining a robust company tax base as any substantial erosion of this base is likely to put upward pressure on other tax rates.

In charting a future path it is important for the government to be aware that governments around the world have been reducing their company tax rates. This creates pressure for New Zealand to do likewise. Despite New Zealand's recent reduction in its rate, the 30 percent company rate is still higher than average in the OECD. As other countries reduce their rate, this puts pressure on New Zealand to do likewise. But other things being equal, the lower the company tax rate is relative to higher rates of personal income tax, the greater will be the scope for taxpayers to structure their affairs in ways which shelter their income from higher rates of personal tax.

Another concern is the high effective marginal tax rates that many taxpayers face because of taxes and the abatement of social benefits that depend on income. High effective marginal rates can leave people with little real incentive to work harder or smarter or to undertake training to improve their productivity. It also creates scope for tax planning. This is not an easy problem to resolve. Reducing these effective marginal tax rates either requires providing less assistance, which could hurt many who are not well off, or involves abating social benefits more slowly, which can be costly. But these effective marginal rates need to be taken into account when considering future reform. It seems generally desirable to avoid adding to effective marginal rates and, where possible, to lower them.

These policy challenges are echoed on the delivery side. Problems with the coherence of policy settings flow through to the administration of the tax system. Our relatively high reliance on company tax, combined with the increasing integration of the world economy, makes it important that Inland Revenue has the skills necessary to protect our tax base. Those skills are also necessary to provide quick and accurate responses to give businesses and the public as much certainty as possible in applying the tax laws. New Zealand is unlikely to have the lowest tax rates in the world but we can contribute to the international competitiveness of the economy through high-quality tax administration.

New Zealand has the advantage of a history of strong tax administration, but we cannot afford to stand still. The world continues to change, with new technology being an obvious example. Moreover, over time, Inland Revenue has picked up a large number of additional tasks, including Working for Families tax credits, child support, student loans, paid parental leave and KiwiSaver. This has put pressure on key aspects of our system, in particular the payment and processing of employer tax obligations. Our systems need to work well and be able to handle inevitable government policy changes, including those in the National Party's *Post-election action plan*. As requests on the system have expanded, systems that were designed well for dealing with tax matters have been progressively modified and adapted to take on additional tasks. This has created a quite complicated administrative system that is becoming less agile and more costly in taking on urgent and important new tasks. A priority will be to consider both policy options and systems redesign options that will alleviate these concerns.

Inland Revenue is therefore undergoing a period of significant transformation. To manage the transformation, we are developing a programme of initiatives which will equip our infrastructure and our people to deliver better value for money, make it easier and less costly for individuals and businesses to comply with their obligations and receive their entitlements, and allow Inland Revenue to respond quickly and efficiently to changing government expectations.

1. Introduction

As Minister of Revenue you are accountable for the overall working of New Zealand's tax system and for the Inland Revenue Department. Tax policy decisions are made jointly by yourself and the Minister of Finance.

For the year ended 30 June 2007, Inland Revenue collected 75.4 percent of total government revenue and 83.1 percent of total tax revenue.[1] Total staff at 30 June 2008 numbered 5,976 (measured in full-time staff equivalents).

Constitutionally, tax can only be levied in accordance with laws enacted by Parliament. Inland Revenue has an obligation to levy tax in accordance with the law to the best of our ability. We also have an important obligation to maintain confidentiality of people's tax affairs. The Commissioner has statutory independence from Ministers to ensure we are able to levy tax and carry out our duties independently. We also administer KiwiSaver and a range of social policy initiatives which are not part of the tax system but are generally administered using the infrastructure put in place to collect tax. The Policy Advice Division of Inland Revenue, jointly with the Treasury, provides advice to Ministers on tax policy and assists with the management of tax legislation through Parliament.

Inland Revenue has an obligation to ensure that the tax system as a whole is well-functioning. This is important to the government, the economy and society.

We have identified six key factors that contribute to a good tax system.

First, there should be clear and well-understood tax policy and legislation. Complying with tax liabilities should not be like walking through a minefield where an inadvertent error produces dire consequences. Taxpayers should be able to get on with their affairs while spending as little time and as few resources as possible consulting the Income Tax Act, Goods and Services Tax Act (GST Act) or seeking tax advice. This is helped by having a clear and simple policy framework and clear legislation, which helps not only taxpayers and their advisors but also the courts in coming to clear and consistent decisions.

Second, even with the clearest of policy and legislation, taxpayers will need to contact Inland Revenue on occasion. There are clearly administrative costs that the department incurs when people make contact. However, taxpayers should receive high levels of service and timely responses from good, technically competent and receptive people.

Third, finding information and receiving assistance should not be a struggle for taxpayers. For this to be provided cost-effectively, it is desirable for as much as possible to be provided electronically in easy-to-access ways. Providing information electronically also provides scope for information to be tailored to taxpayer needs as efficiently as possible.

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[1] Source: The Treasury, Budget 2008.

Fourth, Inland Revenue should be able to anticipate and respond quickly to policy and administrative challenges. This is helped by having good, technically competent and receptive staff. It is also important, however, that agility of response does not lead to a culture of lobbying for favoured tax treatment or create uncertainty. To this end, the policy framework and legislation must be articulated as clearly as possible so that policy problems are evident.

Fifth, high tax rates and narrow tax bases are likely to increase the economic costs of taxation. High rates and narrow tax bases make it easy for taxpayers to alter their affairs in ways which reduce their tax burden. Where possible, it is attractive to ensure that tax is levied at low rates over broad tax bases.

Finally, a good tax system is characterised by high levels of voluntary compliance, which is helped by the tax system being perceived as broadly fair. That is more likely when the policy framework is clear. But it is also necessary to have good tax administration which makes it as easy as possible for those who wish to do so to get it right and as hard as possible for those who wish to do so to get it wrong.

We see our job as doing whatever we can to ensure that the government has a good, cost-effective tax system.

The key functions that Inland Revenue performs are:

- collecting tax to finance government spending;
- redistributing income in line with the government's equity objectives;
- delivering specific programmes that are not necessarily part of tax collection – including Working for Families tax credits, the student loan scheme, child support, KiwiSaver, paid parental leave, research and development (R&D) tax credits, and audits for government grants to firms;
- helping make the New Zealand economy competitive – not only by minimising the costs of collecting tax but also by providing high levels of service; and
- building trust and confidence in the public sector.

None of these functions stands alone. If the tax system is performing well in each area, they will be mutually reinforcing. Weaknesses in one area can undermine the others.

Our key advice is that the system we administer needs to be considered as a whole. An individual tax policy proposal needs to be considered not only on its individual merits but also on how it dovetails with other aspects of tax policy. The company tax rate, for example, needs to be considered in terms of how it fits with personal tax rates. When considering whether Inland Revenue should deliver a non-tax programme, consideration needs to be given to how this might impact on the management of the tax system. Similarly, a policy proposal may have merit but may have adverse operational implications for the department's overall activities. When a problem with the revenue base arises, the best response may be administrative action, such as educational and support initiatives, audits, a legislative change or a combination of these.

This briefing is our stocktake of how the tax system is functioning. Overall, we see the tax system as operating well. By international standards we have robust tax bases which generally collect taxes efficiently over broad bases at moderate rates. We believe that the tax system is seen as reasonably fair. Compliance costs are relatively low and the administration cost per $100 raised is modest. However, in all of our key functions there are pressures and risks that the government will need to manage over the next few years.

The current worldwide financial turmoil and New Zealand recession will affect revenue collections and debt levels. They also may, on occasion, create the need for rapid policy or administrative responses. We need to be well prepared and ready to provide considered responses as circumstances change.

The increasing integration of global commerce poses challenges to tax policy and administration. New government programmes and an increase in the public's expectation of the level of service that needs to be provided are stretching Inland Revenue's administrative capacity. The overall tax system is becoming less coherent as the same income is being taxed at increasingly different tax rates, depending upon the form in which it is earned. The delivery of social policy programmes on a platform designed to collect tax has created costs, complications and business pressures which will have to be addressed. Some core infrastructure will also need to be renewed.

The current tax system can be summarised as strong but not stable. While there are many good features of the tax system, certain aspects will need to change over the next few years, in some cases significantly, to meet the challenges we face. The government will need to make decisions in terms of both tax policy and how the tax system is delivered. Given the strains on the existing system, this needs to be a managed change process. Overall, we consider that the process would be one of evolutionary change rather than a radical departure from the current architecture.

Collecting tax to finance government expenditure

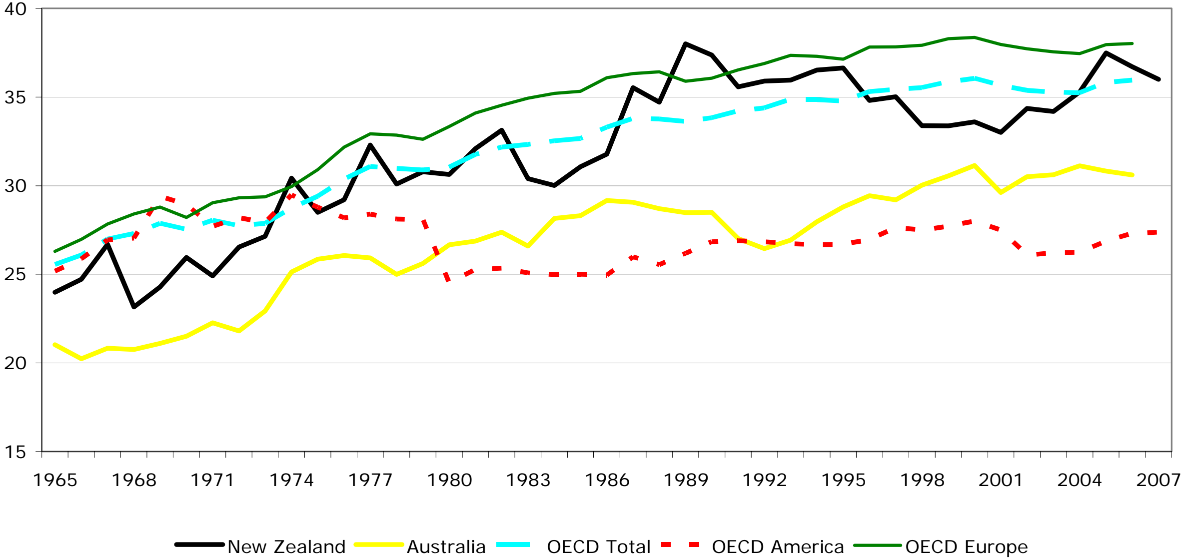
New Zealand's revenue is mainly derived from income tax (71.6 percent of total tax revenue for the year to 30 June 2008), GST (19.7 percent) and excises (2.8 percent). Other taxes (5.9 percent) are customs duty, road user charges, gaming duty, motor vehicle fees, energy resources levies, the approved issuer levy and gift and cheque duties.[2]

The primary purpose of taxation is to raise revenue to finance government spending. Our education and health systems, police and defence forces, for example, require a robust and sustainable tax system that raises sufficient revenue to make them affordable, in conjunction with a sound government fiscal position. A sound fiscal position provides the platform for the government's economic policies and can provide the government with the fiscal flexibility to pursue its overall policy objectives.

[2] Source: The Treasury, Financial Statements May 2008.

The current tax system has performed well in this regard in recent years. Given the size of current government expenditure, tax needs to be a substantial fraction of the economy. According to OECD figures, tax now amounts to 36.0 percent of GDP in New Zealand. Figure 1 shows tax as a percentage of GDP in New Zealand and a number of other countries.

Figure 1: Total tax revenues as percentage of gross domestic product



Source: OECD

Revenue growth has been very strong but there are signs of weaknesses in parts of the tax base. The main elements of the New Zealand tax system are described in chapter 3.

The main challenges we see are maintaining the very strong past performance of the corporate tax base in the light of international developments and, to a lesser extent, individual income tax given the reduced coherence of the tax system that is becoming evident. These issues are considered in chapter 4.

Redistributing income in line with the government's equity objectives

While the primary purpose of tax is to raise revenue, it is also universally used by societies to redistribute income towards lower income earners. A progressive income tax system such as ours that imposes higher average and marginal rates on higher incomes is often used to achieve this.

Even a proportional tax system (where marginal rates are constant) such as our GST has a redistributive function since more tax is still paid by those earning and spending the most over their life-times. Government spending on health, schools and social programmes will also have distributional effects. The Tax Review 2001, chaired by Robert McLeod, (the McLeod Review) argued that most redistribution occurs through government spending and that, if an increase in progressivity is desired, this would best

be achieved through an increase in targeted spending, not an increase in tax rates.[3] While a key decision for the government is how redistributive to make the tax system, it is important to bear in mind that it is not only taxation but also government spending that will determine the overall progressivity of the government's fiscal programme.

We believe that our total tax system is mostly seen as fair. Our tax bases are more comprehensive than most countries', leaving fewer loopholes that can undermine redistribution objectives and perceptions of fairness. From a tax administration point of view, this is especially important since these elements impact heavily on voluntary compliance. A tax system that is seen as fair will raise revenue at lower cost and help build trust and confidence in the public sector.

However, a reduction in the coherence of the tax system appears to be undermining this critically important element of our system. To a growing extent, different types of income are being taxed at different rates, and rates are becoming increasingly dependent on the form in which income is earned. Unless this is happening in accordance with explicit policy that is understood, this can undermine the integrity of the tax system. Taxpayers are increasingly entering into arrangements which exploit these inconsistencies in order to minimise tax. Over time this can undermine the revenue base. The challenges in this area are discussed in chapter 4.

Delivering non-tax programmes

Since the mid-1980s, Inland Revenue has taken on new tasks, including student loans, Working for Families tax credits, child support, paid parental leave and KiwiSaver. This year we have also taken on the new R&D tax incentive.

We must ensure that these programmes run smoothly and efficiently. Nevertheless, if Inland Revenue is to fulfil its core mandate of providing a good tax system that raises sufficient revenue to finance government spending, an important question is how broad the set of tasks assigned to it should be.

As we take on a greater set of tasks, departmental resources and management time are drawn away from core tax matters. Where the tax system is used to deliver social policy or other objectives, it is important to consider whether systems that have been designed with one objective in mind are serving us adequately when used for another purpose. Using the tax system to provide incentives for certain activities may sometimes be a cost-effective way of delivering assistance but there are important effects on the coherence and clarity of the tax system that need to be taken into account.

[3] http://www.treasury.govt.nz/publications/reviews-consultation/taxreview2001

Delivery mechanism for social policy or other objectives

In our view, Inland Revenue has done a good job of expanding its set of activities. Indeed, a key reason why Inland Revenue has continued to be the delivery agency for new initiatives is that it has been successful in delivering in the past when it has taken on new functions.

However, there are undoubtedly some growing tensions. The continued addition of functions puts operational pressures on the department. A particular concern is that systems that operate successfully for dealing with tax issues have been extended to deal with non-tax matters. This has meant that systems designed to deal with tax have evolved to take on these different tasks. If one were designing a social policy delivery system from scratch it would be fundamentally different from a system based on tax collection.

One example is Working for Families tax credits. Despite being only 6.3 percent of tax registrations in the year to December 2007, Working for Families generates approximately 17.5 percent of phone calls to Inland Revenue at peak times. There are often much larger end-of-year adjustments that need to be made for Working for Families than for income tax. Many of the phone contacts are aimed at ensuring that these end-of-year adjustments are correct. This means that systems which work quite well in an income tax context may work less well in other areas.

A second example is KiwiSaver, which works off employer monthly schedules. There appear to be many minor errors that employers make when filing these schedules. It would not be sensible to require that all minor errors are corrected if tax were the only use of the schedules. However, because Inland Revenue is effectively providing a banking service for those saving in KiwiSaver accounts, it has a duty to ensure that exact amounts of money are recorded in each saver's account. Practical compromises that can be sensible in an income tax context may not be sensible when new functions are added to Inland Revenue's set of tasks.

Using the tax system as the delivery platform for other policies also affects the way those policies are designed. The student loan collection system, for instance, is complex and would most likely have been designed very differently if it had not been linked to the tax administration. The design is markedly different from how a bank would typically manage the risks associated with a debt-book based on unsecured loans to a highly transient population.

We continually review whether we have the best methods in place for administering our expanded set of tasks. This includes consideration of possible policy changes which would make it less costly for both Inland Revenue and taxpayers. Where substantial new functions are being contemplated for Inland Revenue, it is sensible to make these major changes carefully and to give full consideration to how best to adapt systems for these new functions.

Irrespective of views on whether it would be good, in principle, for Inland Revenue to be the delivery agency for further social policy or other objectives, we currently face an important practical short-term constraint. The range of tasks that Inland Revenue has taken on in recent years has seriously strained our systems.

Inland Revenue is addressing those strains and ensuring it is equipped to meet future expectations of government and taxpayers by developing a multi-year proposal to renew our infrastructure and capability. Essentially, through the overlay of new functions, our business has changed and we need to change the way we do business accordingly. We are planning initiatives which will equip our infrastructure and our people to deliver better value for money, make it easier and less costly for individuals and businesses to comply, and allow Inland Revenue to respond quickly and efficiently to changing government expectations.

Administrative issues are explored further in chapter 5.

Tax incentives

A second issue is the use of the tax system to provide incentives to achieve non-tax policy goals.

A government may, at times, wish to use the tax system to provide incentives for certain activities. However, there are also costs to be considered.

The more often the tax system is used for providing incentives, the more murky will become its guiding principles. This will create more need for taxpayers to seek tax advice when making normal commercial decisions. It will make it more difficult for Inland Revenue to apply anti-avoidance provisions in a consistent and predictable way. It will also make it more difficult to identify and correct any policy defects. This is because it will become more difficult to spot whether measures which appear to penalise some firms relative to other firms reflect flaws in policy or deliberate policy intentions.

There will always be pressure on black-letter borderlines in the law. Not all of the benefit of tax incentives will go to the firms undertaking the desired activities. Some is likely to be eaten up in accounting fees as accounting firms attempt to ensure that expenditure is described in ways which will meet the requirements of the incentive. Moreover, tax incentives and concessions narrow the tax base, requiring higher tax rates.

Another potential concern with using the tax system to provide incentives is that it may often be a poorly targeted way of delivering an incentive. This is because the benefit of tax concessions will often vary depending on the tax rate of the recipient and whether the recipient is in a profit or loss position.

Helping make the New Zealand economy competitive

Tax is a substantial cost on individuals (from whom resources are transferred to the government) and to the economy as a whole (since it creates disincentives to work, save and invest). Taxes create compliance costs for the public, and the cost of administering the system is expenditure that the government cannot devote to other priorities. Nevertheless, as Oliver Wendell Holmes said, "Tax is the price we pay for a civilised society".

It is therefore orthodox policy advice to seek to have the benefits of taxation with minimal costs. This means minimising compliance costs (keeping the tax system simple), administration costs (getting value for Inland Revenue funding) and the very substantial economic costs taxes impose (minimising distortions caused by taxes). As discussed in later chapters, the New Zealand tax system seems to rate highly in terms of its low economic costs (chapter 3), and its simplicity and value for Inland Revenue funding (chapter 5). We should nevertheless look at the tax system from a wider perspective, in terms of its impact on business and the economy. The tax system is one of the main interactions business has with government. If the government wants to create an environment in which business can grow and that attracts investment and entrepreneurship, the tax system must be responsive and easy to deal with. The certainty of the tax system and the speed with which that certainty can be obtained can be as important to business as the actual rate of tax being levied.

A good tax system is essential for a competitive economy. A good tax system is not just a matter of good tax policy. It also requires a good tax administration. Both need to be working well to help business grow and make New Zealand attractive to investors.

Good tax policy is not simply just what can be read in a textbook. Policies need to take into account administrative constraints and, if possible, policies should enhance administrative agility. Good tax policy needs to have good tax policy processes so that the concerns of the private sector are taken into account and so that legislative anomalies are corrected. These issues are discussed in chapter 2.

A good tax administration is not simply one that has the lowest cost. A professional, approachable, effective and efficient tax administration is an investment in a good environment in which to undertake business. What this means for Inland Revenue as it responds to the changing and increasing expectations of government and society is explored in chapter 5.

New Zealand is increasingly likely to be competing with low-tax jurisdictions for investment. So long as New Zealand continues to provide a high level of government services, it is likely to be unable to compete by undercutting the rates of tax levied in these countries. What we can do is ensure our tax policy and administration are as competitive as possible.

Building trust and confidence in the public sector

Building trust and confidence in the public sector is important to any government. Inland Revenue is one of the most frequent ways that all parts of society deal with the core public sector. In the year to June 2008 Inland Revenue handled 16.34 million contacts with the public, including letters, phone calls and visits to Inland Revenue offices. It is vital for our reputation and the reputation of the public sector generally that those contacts are handled well. If the public loses trust and confidence in Inland Revenue, it is likely to impact on all parts of the public sector.

Inland Revenue deals with substantial amounts of public funds and protects the confidential data of individuals, families and businesses. People rightly expect that Inland Revenue staff maintain the highest possible standards of behaviour. Two important vehicles for reinforcing the commitment to integrity are the staff *Code of Conduct* and Inland Revenue's *Charter*, which makes broad commitments about the standards and approach people can expect when they deal with Inland Revenue. Inland Revenue has important responsibilities to protect the confidentiality of the data it has on people and businesses under the secrecy provisions of the Tax Administration Act.

Just as building trust and confidence in Inland Revenue is dependent on maintaining a good tax system, so maintaining that trust and confidence is necessary to make the tax system work well. If the public does not trust Inland Revenue, the integrity of the tax system and the voluntary compliance necessary for a good tax system will be undermined.

2. The policy development process

Since 1994, tax policy has been developed in accordance with the Generic Tax Policy Process. The process was introduced to ensure better, more effective tax policy development through early consideration of key policy elements and trade-offs of proposals, such as their revenue impact, compliance and administrative costs, and economic and social objectives. Another key feature of the process is that it builds external consultation and feedback into the policy development process, providing opportunities for public comment at several stages.

The tax policy consultative process

In the years immediately preceding the introduction of the Generic Tax Policy Process, the public usually had its first look at proposed tax reforms when a bill introducing them was tabled in Parliament. Likewise, the opportunity to express views on proposed changes usually came only when the select committee considering the bill invited submissions, which was almost too late in the process if affected taxpayers did not agree with the general concept of a given reform.

Major tax initiatives are now subject to much greater public scrutiny at key stages in their development – from broad proposal through to post-implementation review. As a result, we now have more opportunity to develop workable options for reform by drawing upon information provided to us by the private sector early in the process.

Consultation throughout the policy process also contributes to greater transparency of policy-making, allowing the government to set out the policy objectives of proposals and the trade-offs it has made in developing them. Therefore it helps the public to understand the rationale behind government policy proposals. It also helps to ensure that when Ministers are making policy decisions they are fully informed of different views on their merits.

The consultative process cannot, of course, be used for changes that require immediate action to protect the revenue base. It would not be possible to move quickly and, at the same time, to engage in wide consultation on changes to close a recently identified loophole, for example, or to block a scheme that is losing the country hundreds of millions of dollars in revenue.

To judge from mainly anecdotal evidence, New Zealand's tax policy consultation process has an excellent reputation internationally. For example, the Australian Board of Taxation in its 2007 review of Australia's tax consultation system, which included a multi-country survey of how consultation is handled elsewhere, made extensive reference to New Zealand's consultative process. In the course of the review, representatives of the Board visited New Zealand to talk with officials and the private sector about our process, "as it was identified as a best practice model on several occasions" in its survey.

Within New Zealand, the Generic Tax Policy Process has been so accepted as the way to make tax policy that tax professionals and professional associations have come to expect it to be used, as a matter of course. Indeed, the Australian review cited as one of the main success factors in the operation of the New Zealand system, "a view shared by key officials and external stakeholders that they all need to contribute constructively in the best interests of the New Zealand tax system and economy. This leads to cooperation, assistance and frank dialogue both on parties' contribution to consultation and other processes."

Although consultation on tax policy can take several forms, the most common medium is the government discussion document. Its use has increased considerably over the last decade, with 13 consultation papers published in 2006 and 11 papers published in 2007, compared with four papers in 2000.[4]

The increasing opportunity for consulting on tax policy has resulted in growing numbers of individuals and organisations making submissions on proposed changes, whether they are set out in a discussion document or introduced in a taxation bill. The downside is that submissions are becoming increasingly technical and detailed, which in turn makes the process lengthier and requires greater policy, private sector and parliamentary resources.

Developing a new tax policy work programme

One of the first steps for the new government in relation to the Generic Tax Policy Process is to develop a three-year revenue strategy that is effectively linked with the government's economic strategy. The next stage is the development of a rolling tax policy work programme that gives effect to the revenue strategy. At present, the work programme covers an 18-month period.

Developing the work programme involves scoping broad policy proposals and prioritising and sequencing the development of initiatives. We also look at budgeted resource requirements, the time needed to develop, legislate for and implement initiatives, and modes of consultation and communication to be employed throughout the process.

This stage of the Generic Tax Policy Process culminates in a joint report by the Policy Advice Division of Inland Revenue and the Treasury to the Treasury Ministers and Minister of Revenue that suggests a policy work programme. Once approved, the work programme becomes a detailed tax policy agreement between the government and the two departments.

The work programme is generally made public, attracting strong interest from the tax and business communities, to whom it provides greater certainty and an understanding of the government's direction in tax policy.

[4] http://www.taxpolicy.ird.govt.nz/publications

As time passes and the work programme is updated and new policy initiatives are added to it, there is a risk that there will be more items on the programme than can be progressed during the 18-month period. It is therefore important that when items are added to the work programme, existing priorities are reviewed to ensure that the government's expectations across the work programme are met.

The work programme in recent years

The focus of the tax policy work programme over the last three years has been on tax reforms that reflected the government policy goals of increasing productivity and growth, making Zealand businesses more competitive internationally, and increasing personal savings and improving the way they are used. Work programme priorities over the last three years have included:

- Business Tax Review, which resulted in a reduction in the company tax rate from 33 percent to 30 percent, an associated reduction in the tax rate for certain savings vehicles, and introduction of the R&D tax credit.
- Review of New Zealand's international tax rules for outbound investment, to align them more closely with those of most other countries. The first stage of the review resulted in the proposed exemption from domestic tax of the active income of controlled foreign companies, which was the central feature of the taxation bill that was before Parliament when it rose for the general election.
- Measures to reduce tax-related compliance costs for businesses.
- Tax changes intended to make it easier for people to save for retirement and to remove any bias against saving through collective investment vehicles, which resulted in new tax rules on offshore portfolio share investments, the advent of PIEs – or portfolio investment entities, and the introduction of KiwiSaver.
- The personal tax cuts and complementary changes to Working for Families tax credits announced in Budget 2008.
- Tax changes to promote charitable donations, which included the removal of tax rebate limits on charitable donations by individuals and the deduction limit on donations by companies and Māori authorities.
- Modernising tax rules, which included completion of the 15-year rewrite of income tax law.
- Maintaining and negotiating double tax agreements with other tax jurisdictions.

The development of a new work programme will be a top priority for both Ministers and officials.

Setting priorities

The work programme must balance the resource requirements of the Minister of Revenue's main tax policy initiatives against those required for initiatives introduced by other Ministers – for example, in the areas of social policy or sector assistance – which can have substantial tax implications. It must also allow room to meet private sector concerns when tax legislation is identified as causing unintended practical problems. Finally, there is an increasing demand for tax policy resources to be allocated to international tax areas such as OECD work and trans-Tasman tax matters, a reflection of the increasing extent to which New Zealand must take into account international tax trends in setting its domestic rules.

Given the many areas of government policy that have tax implications, the complexity of tax issues and the finite resources available to deal with them, it is essential for Ministers to discuss and set out their tax policy priorities. Since many areas of government raise important tax policy issues, the allocation of tax policy resources is likely to affect the government's ability to use tax to pursue non-tax policy objectives, especially in economic development and social policy. It is therefore desirable for Ministers in those areas to be clear about the implications for the tax policy work programme of policy developments in their portfolios.

Budgetary fiscal rules

The tax policy work programme can also be affected in very important ways by any budgetary fiscal rules the government decides to adopt.

In setting fiscal rules, it is essential to ensure that fiscal discipline on expenditure applies in an equal way to initiatives that would reduce tax revenue – otherwise there is an incentive for expenditure initiatives to be packaged as tax initiatives.

That said, unless governments want to increase tax collections over time, it is important not to focus solely on the size of the government deficit or surplus. If reducing the size of the deficit or increasing the surplus is seen as "good", there is a danger of tax reductions being seen as inherently bad and tax increases being seen as inherently good. But of course there are two ways of closing a deficit or increasing a surplus: either by increasing taxes or by cutting back on government spending. As well as making judgements about the size of the government deficit, governments need to make decisions about whether they want to see taxes and government spending rise or fall over time, and these decisions should be incorporated into the budgetary fiscal rules.

The tax policy implications of any fiscal rule proposals, therefore, must be considered before such rules are adopted.

The legislative programme

The Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill, which was introduced in July 2008, lapsed with the dissolution of Parliament on 3 October, in anticipation of the general election. Reforms proposed in the omnibus bill included:

- reform of New Zealand's international tax rules;
- raising a number of tax thresholds to reduce compliance costs for smaller businesses;
- clarifying the law to ensure employer payments for relocation and overtime meal allowances are tax-free;
- reform of the taxation of the life insurance business;
- introduction of a voluntary payroll-giving system for charitable donations;
- updating the petroleum mining tax rules;
- strengthening the definitions of "associated persons" in income tax law; and
- most of the necessary taxation rules to support emissions trading.

Ministers will need to consider its reinstatement when the new Parliament convenes.

3. Taxes, distortions and the New Zealand tax system

Taxes are needed to finance government spending. At the same time, raising revenue creates administration and compliance costs. Moreover, taxes distort economic behaviour, which can inhibit economic performance in many different ways.

Although almost all taxes can distort economic behaviour, personal and company income taxes are likely to be particularly distorting. Taxes on labour income can influence decisions about whether people move into paid market work or not. They can also reduce entrepreneurship and discourage people from working as long or as hard as they otherwise would or from moving to a more challenging job. In extreme cases, they may even affect decisions on whether or not an individual chooses to continue to reside in New Zealand. High and increasing marginal rates may reduce incentives to take risks or upgrade qualifications. All of these distortions can affect productivity and growth.

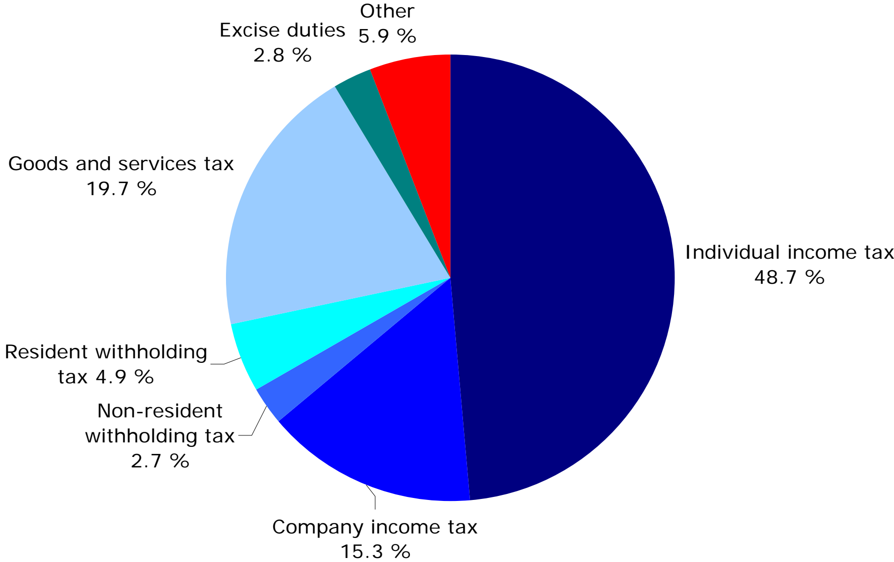
Income taxes can also affect the amounts that people save and, if different forms of savings are taxed differently, the types of savings being undertaken. This can lower economic welfare by causing people to save in intrinsically less valuable ways – in other words, in ways they would not have preferred had there been no tax biases.

In theory, taxing investment income need not be very distorting if income is taxed at modest rates over a very comprehensive economic income base. In practice, difficulties such as measuring how assets actually fall in value and reflecting these in tax depreciation allowances mean that it is simply not viable to tax all forms of investment income neutrally. Moreover, certain forms of investment income such as imputed rental income (the benefits that people get from owning and living in their own houses) are not taxed either in New Zealand or in most other OECD countries. This means that taxes on personal and corporate incomes can distort decisions on the types of investment the country undertakes and thus lower capital productivity. Even if all forms of investment income were taxed neutrally, taxes would tend to discourage investment, reducing New Zealand's stock of plant and equipment and buildings, reducing labour productivity and growth. These distortions will be higher the higher income tax rates are.

A recent OECD paper, "Tax and Economic Growth", published in July 2008, ranks different taxes and argues that corporate and personal income taxes are likely to be most distorting. The OECD measures distortions in terms of their effects in reducing long-run GDP per capita. This is a partial measure because taxes can be distorting without necessarily affecting GDP per capita. For example, in a small open economy such as New Zealand's, taxes on savings could, in theory, have little effect on GDP but still be quite distorting. However, even if we were to measure distortions more broadly, it is still likely that corporate and personal income taxes will be particularly distorting because of difficulties associated with defining and taxing income comprehensively. Not only are income taxes likely to be the most distorting taxes, it is income taxes where most pressures appear to be emerging. International tax competition is putting downward pressure on New Zealand's company tax rate. However, a company tax rate that is less than the higher rates of personal tax creates opportunities for people to use companies to shelter their incomes from higher rates of personal tax.

New Zealand's main sources of revenue are personal income tax (48.7 percent of tax revenue), GST (19.7 percent of tax revenue) and company income tax (15.3 percent of tax revenue), as illustrated in figure 2.

Figure 2: Composition of tax revenue (year ended June 2008)



Source: The Treasury

By international standards, New Zealand has broad bases for both its income taxes and GST. This allows lower tax rates and a more efficient tax system than would otherwise be possible.

In this chapter, we present some data on the New Zealand tax system and benchmark it against the tax systems of other countries. The data presented below suggest that:

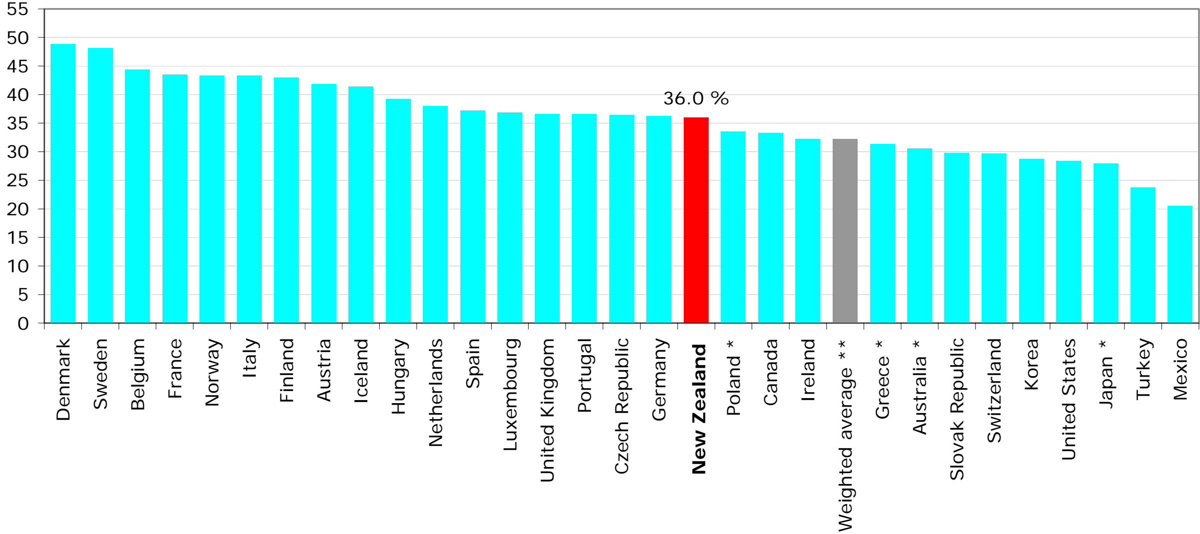
- New Zealand's tax to GDP ratio is towards the middle of the range for OECD countries.
- New Zealand collects a relatively high proportion of its revenue through taxes on income and profits.
- New Zealand has relatively broad bases for GST, company tax, and income tax. This allows substantial amounts of tax to be collected at rates which, with the exception of the company tax rate, are relatively low by OECD standards.
- New Zealand's taxes appear to have relatively low compliance costs.
- Despite New Zealand having a relatively low top personal marginal tax rate by OECD standards, many households face much higher effective marginal tax rates as a result of the abatement of Working for Families tax credits and other income-contingent measures.

Taxes in New Zealand and other OECD countries

Tax as a percentage of GDP

In 2007, New Zealand's tax collections amounted to 36.0 percent of GDP. This placed New Zealand towards the middle of OECD countries, as shown in figure 3.

Figure 3: Total tax revenue (including local taxes) as percentage of gross domestic product (2007)



* Data is for 2006.
** Weighted by 2006 gross domestic product (in US dollars, constant prices, purchasing power parity exchange rates)
Source: OECD

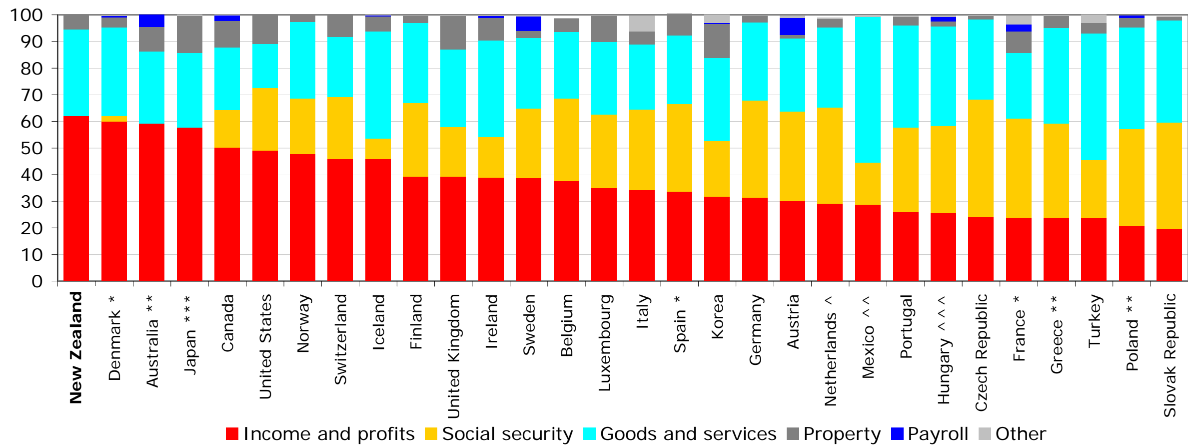
It should be noted that comparing New Zealand's ratio of tax to GDP with those of other OECD countries involves a comparison with relatively high-tax countries. Many non-OECD countries have lower ratios – for example, the 2007 tax to GDP ratios for Hong Kong and Singapore were 13.8 and 14.8 percent respectively.[5]

Tax mix

Compared with other OECD countries, New Zealand collects a relatively high proportion of its taxes on income and profits, as shown in figure 4. This is in large part because New Zealand has no social security tax. Australia, which has no social security tax, and Denmark, which has a negligible social security tax, are the other two countries collecting the highest proportion of taxes on income and profits. Often social security taxes will fall on employees and may have similar effects to an income tax in distorting labour supply decisions.[6] Since social security taxes, unlike income tax do not tax investment income, they do not distort savings decisions.

[5] Source: Hong Kong Census and Statistics Department and Statistics Singapore.
[6] If an individual benefits directly from his or her own social security contributions, these taxes may be less distorting than taxes on labour income.

Figure 4: Tax revenue of main headings as percentage of total tax revenue (2007)



Note: Countries are ranked from highest income and profits tax revenue as % of total tax revenue to lowest.
* The total tax revenues have been reduced by the amount of capital transfer. The capital transfer has been allocated between tax headings in proportion to the reported tax revenue.
** Data is for 2006.
*** Central government taxes only.
^ OECD estimates have been made for other taxes.
^^ Central government and social security funds only.
^^^ Cash basis.
Source: OECD

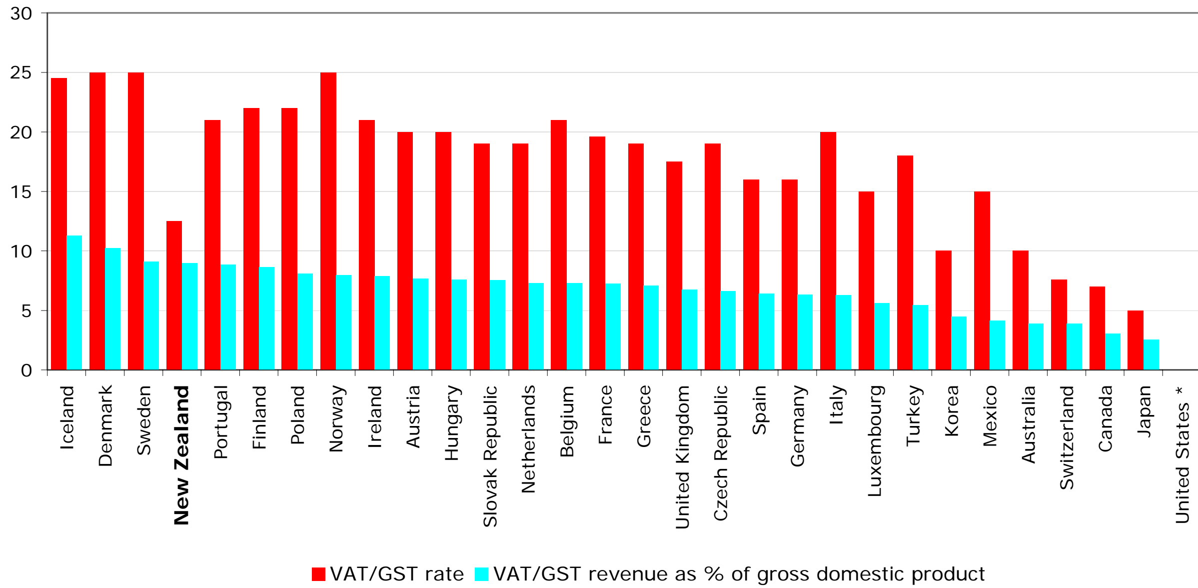
GST, company tax and income tax collections

Compared with most OECD countries, New Zealand has relatively broad bases for GST, company income and personal income. This means that it collects substantial revenue despite (at least in the cases of GST and personal income taxes) having relatively modest statutory rates of tax.

For example, New Zealand's GST rate is 12.5 percent. Setting aside the United States, which has no GST, this was the sixth lowest statutory rate of tax in the 29 other countries in the OECD. Nevertheless, in 2006[7] our GST collections amounted to 9 percent of GDP – the fourth highest level of tax collections (see figure 5).

[7] This is the latest year for which data is available across the OECD.

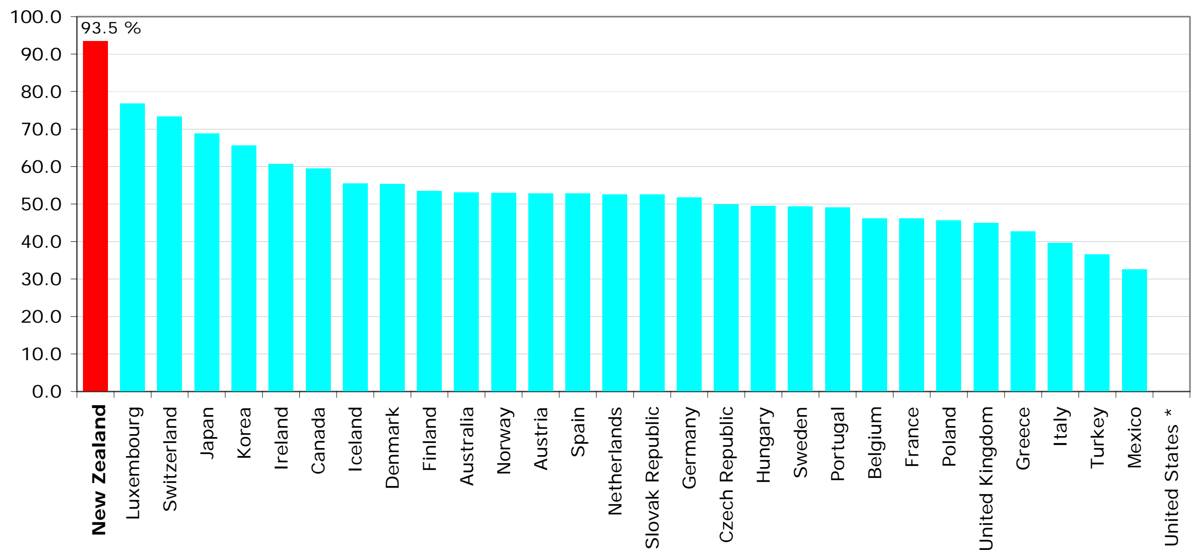
Figure 5: Value added/goods and services tax rates and revenues (2006, in percent)



Note: Countries are ranked from highest VAT/GST revenue as % of gross domestic product to lowest. The comparisons include all levels of government.
* No VAT/GST.
Source: OECD

The OECD measures the breadth of the VAT/GST base and the efficiency with which taxes are collected using the "C-efficiency" ratio. This is the revenue collected from GST as a proportion of the revenue that would be raised if the standard rate of GST were applied to all consumption. C-efficiency varies from a ratio of 32.6 percent in Mexico to 93.5 percent in New Zealand, as figure 6 shows. It is clear that the breadth of the New Zealand base allows substantial amounts of GST to be raised at a relatively low rate.

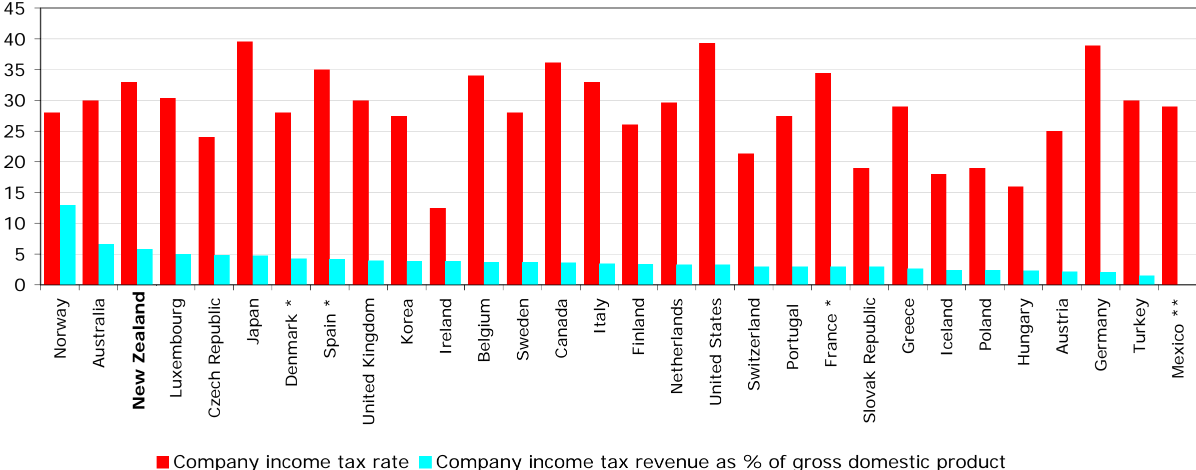
Figure 6: C-efficiency (2006, in percent)



* No VAT/GST.
Source: OECD and Inland Revenue calculations

Company tax is also an important part of New Zealand's tax base. In 2006, New Zealand collected 5.8 percent of GDP in tax, which was the third highest level of company tax as a proportion of GDP in the OECD, as shown in figure 7. In that year, New Zealand's company tax rate was 33 percent, which was eighth highest out of the OECD countries.

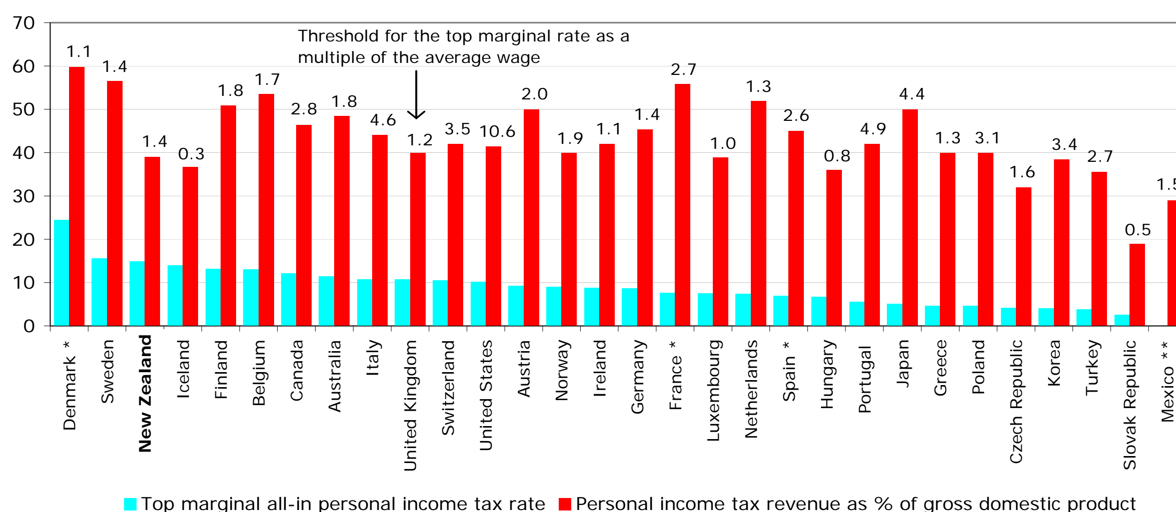
Figure 7: Company income tax rates and revenues (2006, in percent)



Note: Countries are ranked from highest company income tax revenue as % of gross domestic product to lowest. The comparisons include all levels of government.
* The total tax revenues have been reduced by the amount of capital transfer. The capital transfer has been allocated between tax headings in proportion to the reported tax revenue.
** Company income tax revenue not available.
Source: OECD

New Zealand has a relatively low top personal marginal tax rate of 39 percent. In 2006, this was the eighth lowest top marginal rate for the 30 OECD countries, as shown in figure 8. Despite this, New Zealand raises 14.9 percent of GDP in personal tax collections, which was the third highest amount of tax collected in the OECD. One reason for New Zealand's relatively high level of personal income tax collections may be that New Zealand's top personal marginal rate applies from a relatively low level of income (at a multiple of 1.4 of the average wage). Many countries have higher multiples than New Zealand.

Figure 8: Personal income tax rates and revenues (2006, in percent)



Note: Countries are ranked from highest personal income tax revenue as % of gross domestic product to lowest.
* The total tax revenues have been reduced by the amount of capital transfer. The capital transfer has been allocated between tax headings in proportion to the reported tax revenue.
** Personal income tax revenue not available.
Source: OECD

This suggests that New Zealand has a relatively broad base for these three main taxes. Levying taxes at a low rate across a broad base is generally likely to minimise distortions.

Compliance costs

New Zealand also has a tax system which is relatively easy for taxpayers to comply with. According to the World Bank, New Zealand has the second easiest system for companies to pay taxes amongst OECD countries, as shown in table 1.[8]

Table 1: Ease of paying taxes – ranking (2008)

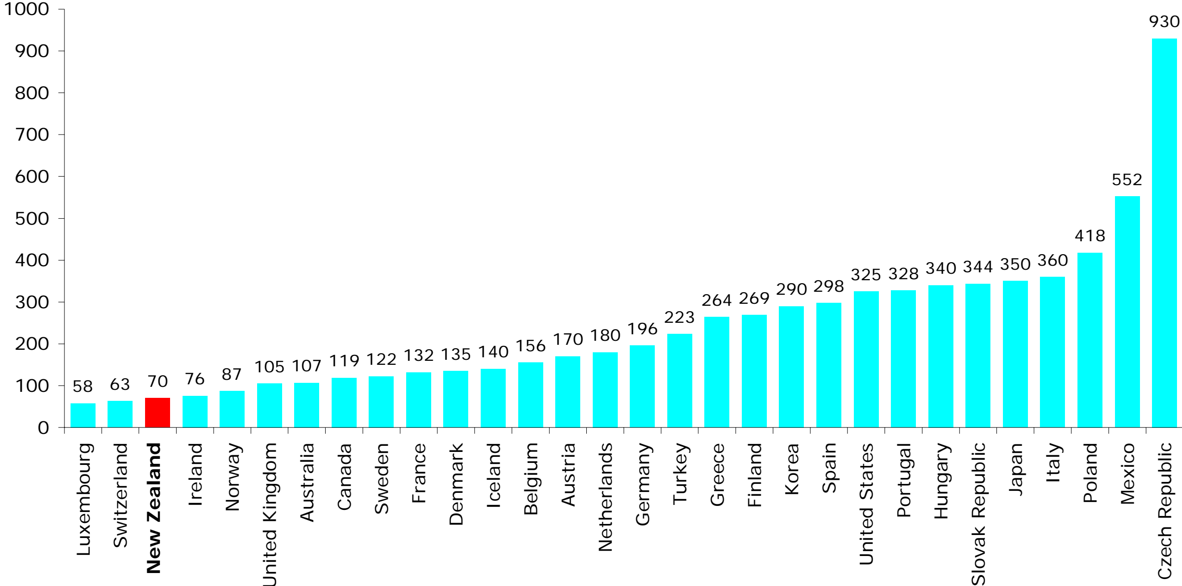
1	Ireland	16	Belgium
2	**New Zealand**	17	France
3	Denmark	18	Turkey
4	Luxembourg	19	Portugal
5	United Kingdom	20	Germany
6	Norway	21	Spain
7	Switzerland	22	Austria
8	Canada	23	Finland
9	Netherlands	24	Hungary
10	Iceland	25	Japan
11	Sweden	26	Czech Republic
12	Korea	27	Slovak Republic
13	United States	28	Italy
14	Australia	29	Poland
15	Greece	30	Mexico

Source: The World Bank

[8] This measure takes account of several factors: number of tax payments, time to prepare and file tax returns and to pay taxes, and total taxes as a share of profit before all taxes.

A recent World Bank and PricewaterhouseCoopers study found New Zealand had the seventh lowest time to comply with taxes out of the 177 countries surveyed. Within the set of the 30 OECD countries, New Zealand had the third lowest time to comply, as figure 9 illustrates.[9]

Figure 9: Total time to comply in hours per year (2008)



Source: The World Bank and PricewaterhouseCoopers

Effective marginal tax rates

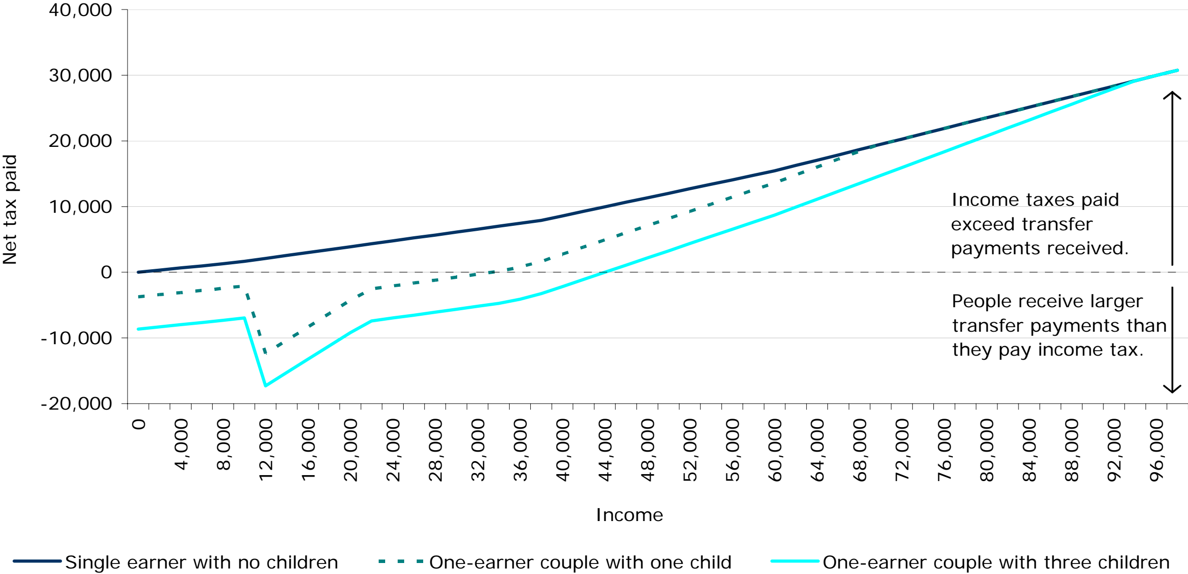
Despite having a comparatively low top statutory marginal tax rate, many families may face much higher effective marginal tax rates because of the interaction between taxation, abatement of various forms of social assistance, and payments or repayments which are income contingent. The effective marginal tax rate measures the proportion of an additional dollar of income that is lost either through taxation or in some other way such as abatement of social assistance or income-contingent payments or repayments. It is effective marginal rates rather than statutory marginal rates which will determine incentives to work and save. It is also gaps between these effective marginal rates and the tax rates in companies, trusts and other entities that will influence the tax integrity pressures that are discussed in chapter 4.

[9] The indicator measures the time to prepare, file and pay (or withhold) three major types of taxes: corporate income tax, value added or sales tax, and labour taxes, including payroll taxes and social security contributions.

One reason for effective marginal tax rates to exceed statutory marginal tax rates is the Working for Families tax credits scheme. This scheme provides support to families, reducing their net tax paid (as shown in figure 10) for the year ended March 2007. The dark solid line in the graph shows the net tax paid by an individual or a family with no children with a single income earner. Net tax is positive, which means that income taxes paid exceed transfer payments received. The light dotted and solid lines show the net tax paid by single income families with, respectively, one and three children. Net tax paid is negative for lower income families, which means they receive larger transfer payments than the amount they pay in income tax. Many people will be paying negative amounts of net tax. It is essential to ensure that those who end up bearing the tax burden are not discouraged from increasing their earnings by working longer or more productively.

Assistance rises with the number of children, which is why the light solid line is lower than the dotted lines which is lower than the dark solid line for incomes below the levels where assistance is fully abated. At incomes above about $12,000, net tax paid rises faster for families with children than for individuals or families with no children. This is because of higher effective marginal tax rates for families as a result of reduced transfer payments.

Figure 10: Net tax paid (year ended March 2007, non-beneficiaries, in dollars)

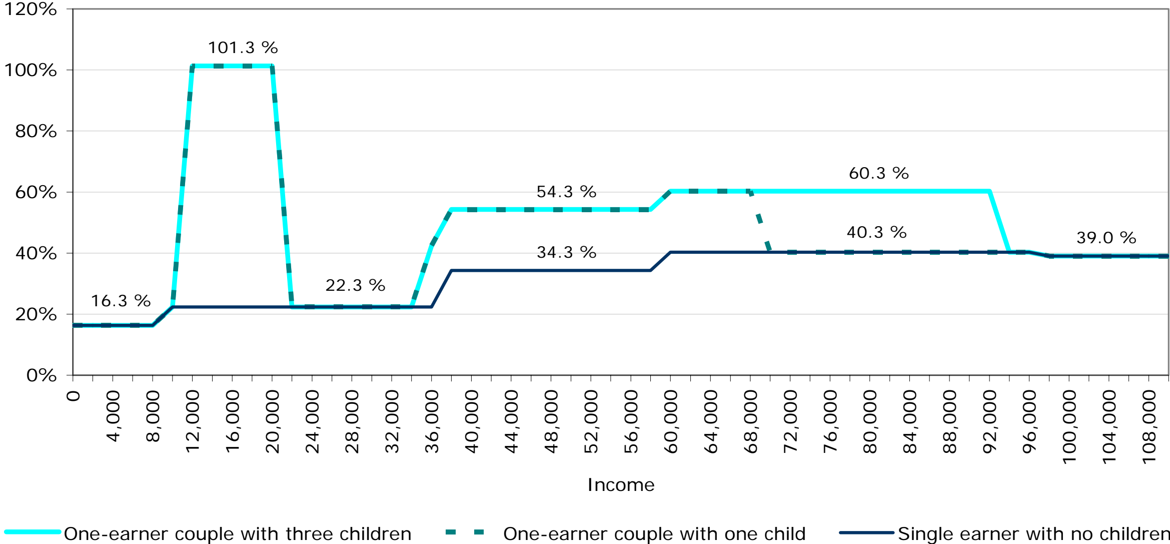


Source: Policy Advice Division, Inland Revenue

The effective marginal tax rates, taking account of statutory tax rates, ACC, and the abatement of Working for Families tax credits, are shown for the year ended March 2007 in figure 11. There is a short period where the minimum family tax credit, a component of the Working for Families tax credits package, is abated dollar for dollar in addition to ACC levy being collected. This leads to an effective marginal tax rate of 101.3 percent

between incomes of $10,660[10] and $21,658. For higher income families with either one or three children, Working for Families tax credits abate at 20 cents in the dollar for incomes over $35,000. This makes the effective marginal tax rate 20 percentage points higher than the statutory marginal rate and ACC levy. For both types of families, the effective marginal tax rate is 54.3 percent (a statutory rate of 33 percent together with a 1.3 percent ACC levy and 20 percent Working for Families tax credits abatement) until income reaches $60,000. After that, the effective marginal tax rate rises to 60.3 percent until Working for Families tax credits are fully abated.

Figure 11: Effective marginal tax rates
(year ended March 2007, non-beneficiaries, in percent)



Source: Policy Advice Division, Inland Revenue

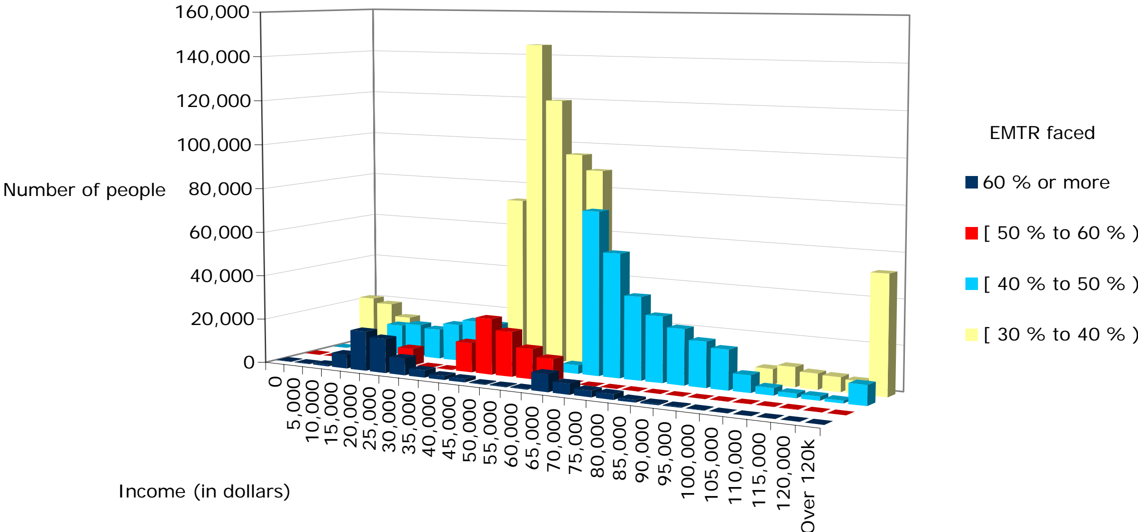
There are a number of other income-contingent measures. For example, additional income can lead to the requirement to make higher student loan repayments or child support payments. Whether these should be considered as part of effective marginal tax rates is an open question. For example, as student loans are repaid, borrowers have the benefit of a reduced student loan, reducing the amount which must be repaid in the future. However, there is some tax element because making student loan payments now rather than in the future will increase the present value of these payments. Similarly, some parents paying child support may do so willingly because of the benefits their children receive. In this case, child support should not be seen as a tax. On the other hand, for those who do not choose to pay child support voluntarily these obligations are very much a tax.

There are also other measures which abate with income, including childcare assistance and accommodation supplement. These are not taken into account in figures 11 and 12. Thus, these graphs provide a lower bound on possible effective marginal tax rates. Benefit abatement has not been taken into account in figure 11 but has been taken into account in figure 12, which shows the numbers of taxpayers on various effective marginal tax rates above 30 percent.

[10] This assumes only one adult. Incomes below $10,660 are unlikely to qualify for the "full-time work" requirements of the minimum family tax credit.

Above $60,000, there are significant numbers in the 40 to 50 percent range, although many are only just in this range because of a statutory marginal tax rate of 39 percent plus an ACC levy of 1.3 percent.

Figure 12: Effective marginal tax rate (EMTR) distribution for people with EMTRs over 30 percent (year ended March 2007, excludes student loans, child support, child care assistance and accomodation supplement)

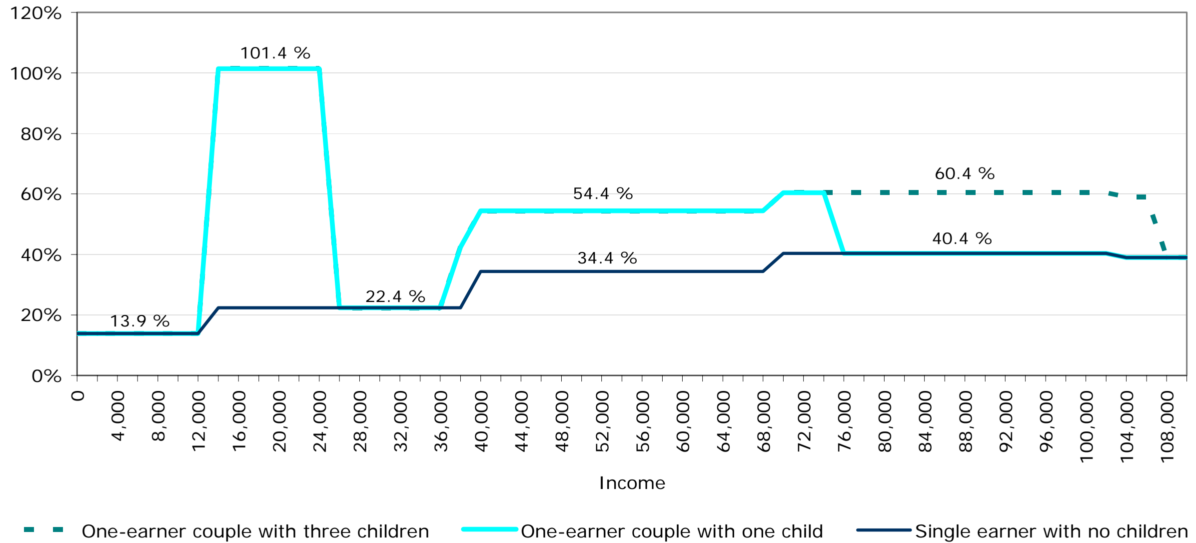


Source: Policy Advice Division, Inland Revenue

In total there are around 3.3 million individual taxpayers. Of these about 668,450 people are on tax rates of 30 to 40 percent, 383,250 on tax rates of 40 to 50 percent and 167,250 on tax rates above 50 percent. Including other income-contingent measures such as student loans, child support, the accommodation supplement and childcare allowance would increase the numbers facing higher effective marginal tax rates.

It is clear that for some people there will be limited incentives to earn additional income, which may discourage productivity and growth. As discussed further in chapter 4, New Zealand's high effective marginal tax rates also create scope for tax planning. But this is not an easy problem to resolve. Reducing these high effective marginal tax rates either requires providing less assistance, which could hurt many who are not well off, or involves abating social benefits more slowly, which could be costly. Nevertheless, the high effective marginal tax rates need to be taken into account when considering future reforms. It seems generally desirable to avoid adding to effective marginal tax rates and, where possible, to lower them.

Figure 13: Effective marginal tax rates
(year ending March 2010, non-beneficiaries, in percent)



Source: Policy Advice Division, Inland Revenue

Figures 11 and 12 reflect numbers on effective marginal tax rates in the past (year ended March 2007). Changes to personal tax rates announced since then will affect effective marginal tax rates. Figure 13 shows effective marginal tax rates for the income year ending 2010 under the legislated tax rate changes. It shows that the tax rate changes will extend higher effective marginal tax rates to higher incomes.

4. Policy challenges

Compared with other OECD countries, New Zealand has broad bases for personal and company income and for goods and services tax. With the exception of the company tax rate, which is still relatively high by OECD standards, New Zealand has relatively low marginal tax rates. This helps the New Zealand tax system to be relatively robust and operationally efficient.

Nevertheless, pressures identified in our 2005 *Briefing to the Incoming Minister* remain. First, globalisation is continuing to put downward pressure on the company tax rate. Despite New Zealand's reduction in its company tax rate from 33 percent to 30 percent, it remains higher than most OECD countries. The incentives this creates for multinational companies to stream profits away from New Zealand means that New Zealand may be forced to cut its current company tax rate in the future. Second, domestically, there continues to be evidence of individuals using companies and trusts to shelter personal income from higher rates of personal tax. The greater the gap between the company tax rate and higher marginal income tax rates, the greater the benefits of doing so. There are a number of possible ways of achieving greater consistency in personal taxation, and this chapter concludes by considering some of these options.

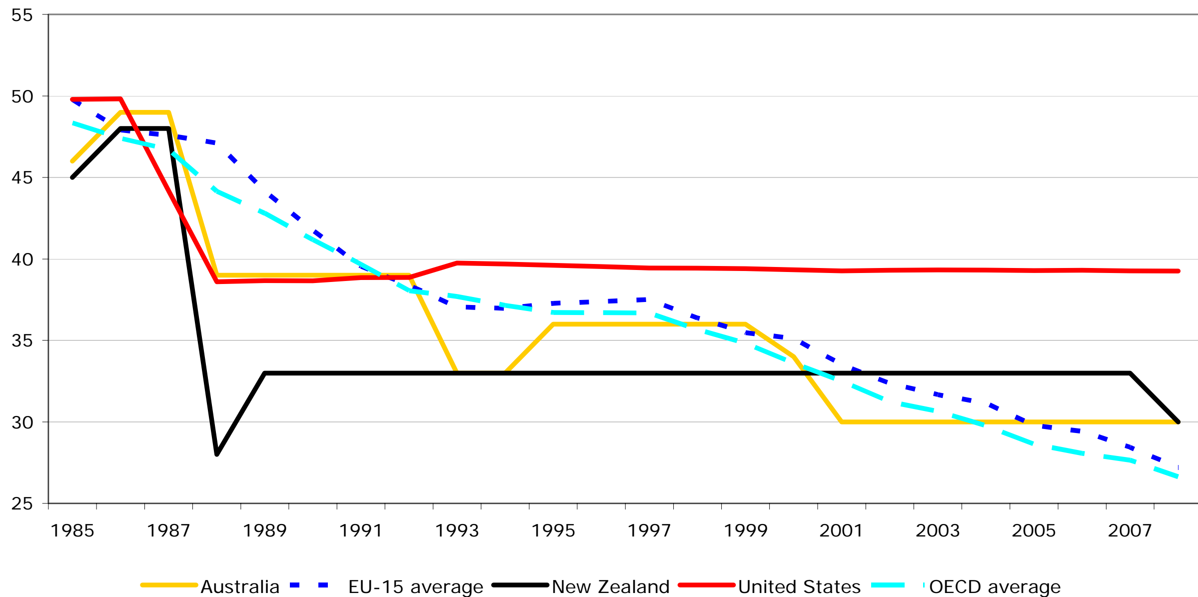
Globalisation and downward pressure on the company tax rate

In the years beginning 1 April 1986 and 1987, New Zealand's company tax rate was 48 percent, which was around OECD norms. This is shown in figure 14.[11] In the year beginning 1 April 1988, the company tax rate fell to 28 percent and was raised back to 33 percent a year later, where it remained until the year beginning 1 April 2007, with a reduction to 30 percent from 1 April 2008. The company tax rate was relatively low compared with rates in other OECD countries from the late 1980s until about 2000. However, since the mid-1980s there has been a downward trend in company tax rates around the world and, even given New Zealand's recent cut in its company tax rate, New Zealand's rate is now above the average for OECD countries.

There are concerns with having a company tax rate that is too high. In particular, despite New Zealand's relatively broad company tax base, there will always be considerable difficulties in measuring income accurately. There will also be biases between business income taxed at the company rate and forms of income which are untaxed, such as the imputed income that people earn through owning and living in their own houses. Reducing the company tax rate will tend to minimise these biases.

[11] The data reported for New Zealand is the tax rate applying at 1 April of a given year. For example, the tax rate in 2006 is the tax rate applying for the year beginning 1 April 2006.

Figure 14: Historical trends in statutory company tax rates (in percent)



Source: OECD

A high company tax rate may also discourage innovation, constrain inbound investment and make New Zealand an unattractive place to base a business, all of which have the potential to reduce productivity and growth. There is, however, an offsetting economic consideration. Taxing company income is a way of taxing foreign residents on the profits they make through investing in New Zealand. If foreign-owned firms are making economic profits from their investments in New Zealand, reducing the company tax rate could potentially lead to higher economic profits for their shareholders with little effect on investment. In this case, much of the benefit of a company tax cut could go to foreign residents. Levying replacement taxes on New Zealanders may make New Zealand as a whole worse off.

There is another important consideration. A relatively high company tax rate can make it attractive for multinational firms to stream profits away from New Zealand and into lower tax countries. This might be achieved by firms "thinly capitalising" the New Zealand operations (by financing as much of their New Zealand activities as possible by using debt rather than equity) or by transfer pricing arrangements where New Zealand entities pay as high as possible prices and charge as low as possible prices on transactions with associated companies overseas. There are measures to prevent transfer pricing and thin capitalisation but these are not completely effective. Incentives to stream profits from New Zealand overseas will tend to arise when the New Zealand company tax rate is higher than in other countries, or when the other country has an imputation system.

As countries around the world have responded to these sorts of "tax-competition" pressures, company tax rates have fallen. However, as company tax rates have fallen across the world, company tax revenues have not declined as a proportion of GDP. Between 1985 and 2006 the average company tax rate fell from 48.3 to 28.1 percent but company tax collections increased from 2.6 to 3.9 percent of GDP (columns (1) and (4) in table 2). This is in large part because many countries have broadened their corporate income base while reducing their company tax rates to protect company taxation as a

source of revenue. We believe that maintaining a broad and neutral income base is an important element in future New Zealand tax reforms.

The OECD experience is compared with that of New Zealand and Australia in columns (2)-(3) and (5)-(6) in table 2. In New Zealand and Australia, the increase in company tax as a percentage of GDP has been much larger than the OECD as a whole. In recent years a major reason has been the strong growth in corporate profitability in both countries. Part of the reason may also be the base protecting effects of our imputation schemes. No doubt part of the reason is also that our company rates are less than our top personal rate, which has created incentives for incorporation to shelter income from higher rates of personal taxation.

Table 2: Company income tax rates and revenues (in percent)

	Company income tax rate			Company income tax revenue as % of gross domestic product		
	(1) OECD average	(2) New Zealand	(3) Australia	(4) OECD average	(5) New Zealand	(6) Australia
1985	48.3	45.0	46.0	2.6	2.6	2.6
1990	41.2	33.0	39.0	2.6	2.4	4.0
1995	36.7	33.0	36.0	2.7	4.4	4.2
1996	36.7	33.0	36.0	3.0	3.5	4.5
1997	36.7	33.0	36.0	3.2	3.9	4.4
1998	35.7	33.0	36.0	3.3	3.8	4.9
1999	34.8	33.0	36.0	3.2	3.8	4.9
2000	33.6	33.0	34.0	3.6	4.2	6.3
2001	32.5	33.0	30.0	3.5	3.8	4.6
2002	31.2	33.0	30.0	3.4	4.4	5.2
2003	30.7	33.0	30.0	3.3	4.7	5.1
2004	29.8	33.0	30.0	3.4	5.5	5.7
2005	28.6	33.0	30.0	3.7	6.3	6.0
2006	28.1	33.0	30.0	3.9	5.8	6.6

Source: OECD

The downward trend in company tax rates around the world shows no signs of abating.

A particular area of concern for New Zealand is Australia's imputation scheme and the fact that 54.5 percent of foreign direct investment into New Zealand at 31 March 2008 was from Australia.[12] At present, the Australian and New Zealand company tax rates are aligned at a rate of 30 percent. However, Australian parent companies with Australian shareholders have an incentive to stream profits from any New Zealand subsidiaries back to the parent companies. This is because the shareholders will receive imputation credits (called franking credits in Australia) for Australian but not for New Zealand company taxes.

One way to overcome these pressures would be mutual recognition of New Zealand imputation credits and Australian franking credits. If this were to proceed, it would involve a major step towards the creation of a single economic market in Australia and New Zealand. It would involve Australia and New Zealand cooperating to do what is in Australasia as a whole's best interest rather than competing on tax. New Zealand has responded to an invitation by Australia to make a submission on mutual recognition to the *Australian Future Tax System Review*.[13] Decisions from the review not only on

[12] Source: Statistics New Zealand.
[13] http://www.taxpolicy.ird.govt.nz/publications/files/other/2008-10-nz-submission-mutual-recognition-afts.pdf

mutual recognition but also on tax reform more broadly are of strong interest to New Zealand because of our highly integrated economies.

Globalisation and international capital mobility can constrain choices in other ways. It is now increasingly less realistic for New Zealand to adopt tax policies without examining tax settings in other countries. For many years New Zealand stood out in the OECD as the only country to attempt to tax the foreign-sourced income of its overseas subsidiaries as this income accrued while allowing credits for foreign taxes. Other countries had rules which exempted foreign active income or taxed it with foreign tax credits but only when profits were remitted. The upshot was that firms wanting to expand internationally had incentives to relocate to other countries such as Australia with more generous offshore tax rules than New Zealand. It is no longer viable for New Zealand to impose rules which encourage dynamic firms which are expanding internationally to relocate to other countries. As a consequence, the International Tax Review[14] has recommended that New Zealand introduce an exemption for active offshore income.

Robustness of personal tax system

Policy pressures also arise because individuals are able to shelter personal income from higher effective marginal rates using companies, trusts, portfolio investment entities (PIEs) and other savings vehicles. This can erode confidence in the fairness of the tax system and undermine voluntary compliance.

In terms of statutory tax rates, New Zealand has a progressive tax system, with increasing marginal and average tax rates. It also has a targeted social assistance programme under which assistance is abated as income rises, leading to high effective marginal tax rates at middle income levels for programme recipients. Information derived from tax collection data since 1999 indicates that there has been considerable rearrangement by taxpayers to minimise tax and avoid the full application of the apparent progressivity of the tax system.

From 1 April 2000, the top personal marginal rate was increased from 33 percent to 39 percent. At the same time, the company tax rate, trustee tax rate and tax rate applying to many other savings entities were kept at 33 percent. This provided scope for those on the top marginal rate to shelter income in these entities. From 1 October 2007, the new PIE rules were introduced, with a top rate of 33 percent on income earned in these entities.

From the year beginning 1 April 2008, the company tax rate, the top tax rate on PIEs and the tax rate on other widely held savings vehicles were all reduced from 33 percent to 30 percent. These tax rate changes have increased incentives and opportunities for individuals to structure their affairs in ways which reduce their exposure to higher personal marginal tax rates. However, this change is too recent to be picked up in the data.

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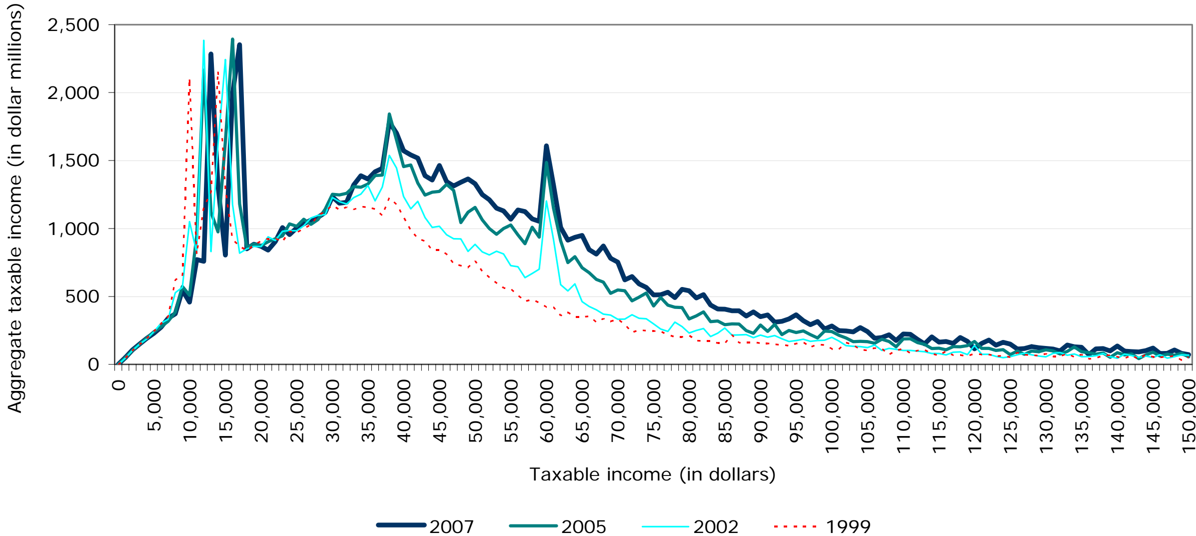
[14] http://www.taxpolicy.ird.govt.nz/news/archive.php?year=2007&view=563

The aggregate income of individuals in different income bands for the years ended March 1999, 2002, 2005, and 2007 is shown in figure 15. The year 1999 was before the introduction of the 39 percent top marginal rate for incomes above $60,000 and at that stage there was no spike of taxpayers clustered at $60,000. Since then there has been an obvious spike. For example, in 2007 there is much more income attributable to people earning between $59,000 and $60,000 than for other $1,000 bands of income on either side. This is evidence that those who would otherwise be facing the top marginal rate are using companies, trusts and other savings vehicles to shelter income from higher rates of personal tax.

Figure 15: Aggregate taxable income of individuals by $1,000 bands of taxable income (year ended March)



Note: The data for the year ended March 2007 is at June 2008 and incomplete.
Source: Policy Advice Division, Inland Revenue

There are a number of ways of escaping higher marginal and effective marginal tax rates by diverting income to lower-taxed companies or trusts. For example, by earning income through a company, an individual can ensure that income is taxed at a 30 percent rate so long as profits are retained within the company. While income may eventually be taxed at the shareholder's marginal rate when dividends are paid, there can be substantial benefits from tax deferral if income is retained for a number of years in a company before it is distributed as dividends. The saving can be permanent if the dividends are trapped in a trust and trustee tax of 33 percent is paid. A sharp increase in the amount of imputation credits held by closely held companies (see figure 16) suggests there is significant deferral of dividend payouts for such companies in order to avoid the higher personal marginal tax rates.

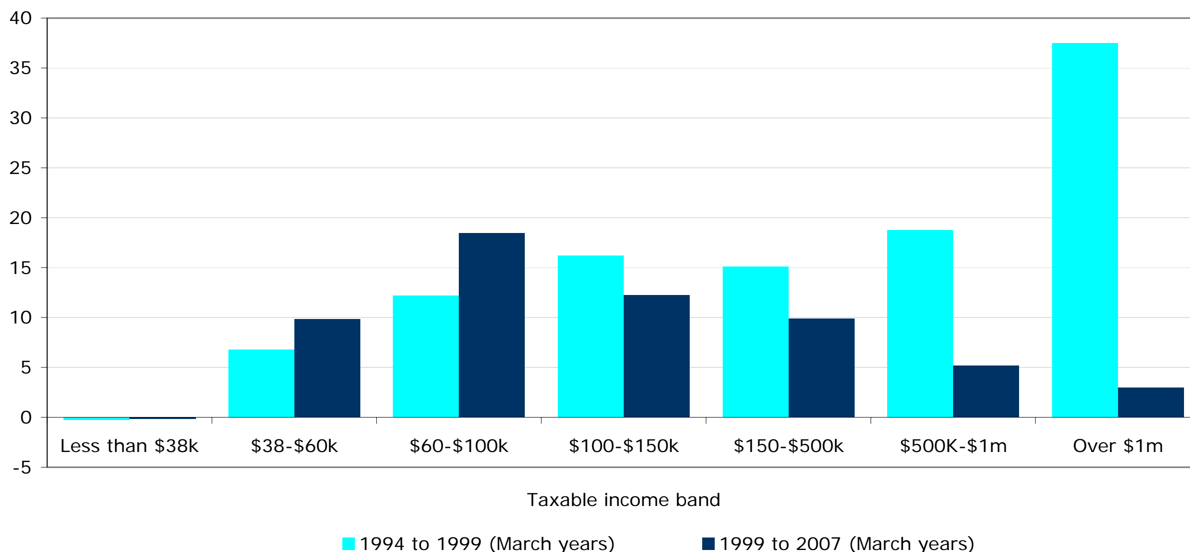
Figure 16: Excess imputation credits (year ended March)

* The data for the year ended March 2007 is at August 2008 and incomplete.
Source: Policy Advice Division, Inland Revenue

It is clear that there has been rapid growth in excess imputation credits of closely held companies following the increase in the top personal marginal tax rate to 39 percent in 2000. These pressures are likely to increase with the recent reduction in the company tax rate to 30 percent.

Annual growth rates in numbers of individuals in different income bands are shown in figure 17. Over the period from 1999 to 2007 there has been very slow growth in the numbers of taxpayers on higher incomes relative to growth rates in earlier years. Again, this seems likely to be evidence of greater income sheltering.

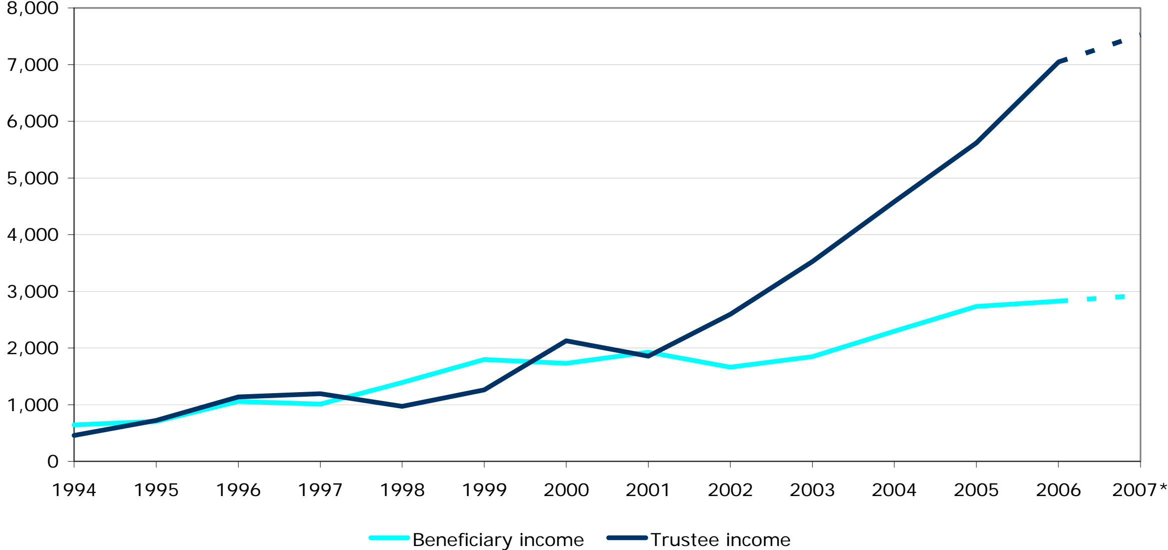
Figure 17: Average annual growth in numbers of individual taxpayers (in percent)



* The data for the year ended March 2007 is at July 2008 and incomplete.
Source: Policy Advice Division, Inland Revenue

Trusts can be used to shelter income by having it taxed as trustee income (at a rate of 33 percent) rather than having it distributed to beneficiaries and taxed as their income. There is continuing evidence of trustee income growing much more quickly than beneficiaries' income, as shown in figure 18.

Figure 18: Income of trusts (year ended March, in dollar millions)



* The data for the year ended March 2007 is at October 2008 and incomplete.
Source: Policy Advice Division, Inland Revenue

In summary, current tax rules provide considerable scope for taxpayers to use companies, trusts and other entities to shelter their income from higher rates of personal taxation. There is continued evidence that they are doing so, and recent reductions in the company tax rate and the capping of tax rates for PIEs have increased both the pressure and the opportunity for tax sheltering.

This raises concerns about whether it is fair for some taxpayers to be able to escape higher personal rates while others, such as salary and wage earners, face the top statutory tax rate. It also raises efficiency concerns. It is not without cost for people to set up tax-efficient entities. From the nation as a whole's perspective, the resources spent doing so is a source of economic waste.

There is also uncertainty among taxpayers and in Inland Revenue about when escaping higher marginal tax rates becomes unacceptable tax avoidance. This is costly for businesses and puts pressure on voluntary compliance. It also makes it difficult for Inland Revenue to fulfil its mandate of reducing compliance risk. Currently, significant Inland Revenue and taxpayer resources are being applied to disputes in this area, and it is a current priority area for Inland Revenue's compliance programme. This issue would appear to be best resolved by possible legislative options, discussed later, which could enhance the integrity of the tax system.

The current tax provisions raise questions about the achievement of the objectives underlying the current statutory personal tax rates and thresholds, and other measures which also affect effective marginal tax rates (such as abatement of Working for Families tax credits, student loans, and child support). These all apply if individual income is received and taxed as personal income, but not if earned in other ways such as through companies, trusts or PIEs.

Moreover, there are considerable differences between the tax treatments of sheltered forms of income. For example, an individual can set up a company which derives business income. If the individual earns income through the company, this will be taxed at the company rate of 30 percent so long as it is retained in the company. It will be subject to a wash-up tax on distribution and taxed at the individual's marginal rate so long as shares are held directly. If the individual is on a 39 percent rate and all income is distributed, income would end up being fully taxed at the 39 percent rate. For this person there may be little tax sheltering benefit from using the company if most of the profits are distributed soon after they are earned by the company to finance personal consumption.

However, there are more tax-efficient options. If, instead, a trust is interposed between the individual and the company so the shares in the company are held by the trust in which the individual is a beneficiary, the company's profits will once more be taxed at 30 percent so long as they are retained in the company and not distributed. On distribution to the trust, however, these can be taxed as trustee income at a final tax rate of 33 percent. In this case, if all income were distributed to the trust, the company's income would end up being taxed at a 33 percent tax rate. Trusts are increasingly being used in this way not only to avoid the top marginal tax rate but also to avoid the higher effective marginal tax rates brought about by other social policy measures.

If passive forms of capital income are being earned, it may be more attractive for these to be earned through PIEs or other forms of widely held savings vehicles where 30 percent will be a final rate of tax. Thus, the current tax rules often treat passive forms of capital income more favourably than active forms of income which, at least on distribution, may face a higher tax rate. It is hard to see a good reason for passive income being taxed at lower rates than active business income.

Table 3 shows the rates at which income would be taxed on accumulation and on distribution if those on different marginal tax rates are earning income in different ways. The table allows for the possibility of individuals on a range of effective marginal tax rates of 59 percent (a 39 percent statutory marginal tax rate plus abatement of Working for Families tax credits at 20 cents in the dollar), 39 percent, 33 percent and 21 percent. We assume that the distribution policy is tax efficient. For example, if income is earned through a trust it may either be taxed in the trust as trustee income (at a rate of 33 percent) and then distributed to beneficiaries or else be distributed to beneficiaries and taxed in their hands at their marginal rates. Thus, tax-efficient distribution means the tax rate will be 33 percent for a beneficiary on a 39 percent marginal rate and 21 percent for a beneficiary on a 21 percent marginal rate.

There is considerable variety in the way that income is taxed, depending on exactly how the income is earned.

Table 3: Tax rate on savings (in percent, as of November 2008)

	Accumulated at entity level	Distribution/attribution of income Shareholder marginal personal tax rate				
Type of entity		59%	39%	33%	21%	12.5%
Direct investment	not applicable	59	39	33	21	12.5
Trust	33	33	33	33	21	12.5
Company/unit trust	30	59	39	33	21	12.5
Company owned by trust	30	33	33	33	21	12.5
Portfolio investment entity	not applicable	30	30	30	21	12.5
Widely held superannuation fund	30	30	30	30	30	30
Life insurance policyholder *	30	30	30	30	30	30

* Under the lapsed Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill, life insurance would receive PIE treatment from 1 April 2009.

Case study – PIEs

The practical implication of taxing income differently can be illustrated by considering the new PIE rules. Individuals saving through PIEs are taxed at a maximum rate of 30 percent on their PIE income. These rules have been designed to support government goals of promoting saving. But this means that those on the top (39 percent) marginal rate and those on higher effective marginal tax rates as a result of social taxes are much better off earning passive capital income through PIEs than they would be if they earned the same income directly.

This has meant that it is now common practice for banks and other financial institutions to offer so-called cash PIEs. This involves a bank setting up a PIE for those who would otherwise be earning interest income, so a final top marginal rate of 30 percent can be offered. Even if PIEs are a more costly and less efficient vehicle, the tax benefits they offer can result in them being used ahead of standard savings accounts.

The current tax treatment may also create arbitrage opportunities. Suppose an individual who has $100,000 of income taxed at a rate of 39 percent wishes to shelter this income from the 39 percent rate. By borrowing $1 million at a 10 percent interest rate and lending this through a PIE at a 10 percent rate, the individual might claim a deduction for $100,000, which would reduce the personal tax liability by $39,000. The PIE income would only bear $30,000 of tax. Thus, a scheme like this might be used to generate a net tax benefit of $9,000. At this time it is doubtful that any of these schemes could be struck down as tax avoidance without much greater clarification of that term by the courts. Exact borderlines are uncertain.

In summary, the current tax system suffers from a lack of consistency. Economically equivalent income streams are taxed at different rates, depending upon the arrangements under which the income is earned. The effect of the inconsistency calls into question a government's progressivity goals. If these are expressed by the statutory marginal tax rate schedule, people's ability to shelter income will undermine these goals and frustrate the desired targeting of other programmes (such as the Working for Families tax credits, student loans or child support) administered through the tax system. If, on the other hand, the government's progressivity goals are adequately achieved by having a top marginal rate of 30 percent, it is difficult to see why this opportunity is not available more broadly.

Of course, governments must juggle a wide variety of conflicting considerations when considering how best to tax different forms of savings entities. Moreover, New Zealand is clearly not alone in having different forms of savings taxed in different ways. But our inconsistency in tax treatment leads to unfairness as taxpayers in similar economic circumstances are treated differently. It undermines the integrity of the tax system and could reduce confidence in the fairness of the system. Over time this may reduce voluntary compliance. Finally, it adds to the costs of administering the tax system and to taxpayer compliance.

Enhancing the integrity of the tax system

Greater consistency in the tax system can be accomplished by reducing the variation in tax rates facing taxpayers in different situations. There are a number different ways in which tax rate variation could be reduced. Decisions by government are required in a number of areas:

- A fundamental decision, which frames other decisions on the rate structure, is the level of the company tax rate relative to the tax rates (particularly the top rate) on personal income.
- The second decision concerns the marginal tax rates to be applied at different personal income levels and, as discussed below, possibly on different types of income.
- The third addresses the degree to which social programmes are to be targeted using abatements, which add to effective marginal tax rates over their abatement ranges.
- Finally, decisions are required on the more detailed tax policy changes necessary to give effect to the government's general decisions on the three issues above.

Choices by government on tax rates applied to the income of individuals will reflect views on the level of revenues required to fund government spending programmes, the appropriate progressivity of the tax system, and efficiency considerations related to the effect of taxation on economic behaviour. Choosing the appropriate company tax rate reflects a balance of revenue objectives, international considerations and the structure of taxation of domestic income. Finally, the tax system must be administratively feasible and should strive to minimise compliance costs to the extent possible.

It is important to decide on a future direction for the tax system, so that tax changes are compatible with the government's longer-term goals. Ideally, the tax system should be flexible so that it can evolve as New Zealand's needs change. For example, fiscal demands may change as there are economic or demographic changes, or particular tax parameters may need to be calibrated as a result of external factors – for example, a lowering of the company tax rate in response to continued reductions in company tax rates internationally.

Fiscal considerations and administrative constraints may mean that consistency needs to be attained progressively over a number of years rather than in "one hit". In particular, the administrative constraints discussed in chapter 1 mean that it would simply not be viable to implement a major structural change to the tax system in the near future.

There is no one best way of balancing these considerations, and different countries have chosen different routes to achieving their objectives. These are summarised below as a guide for possible approaches to lessening the current inconsistency in marginal tax rates.

Conceptually, tax rates could be made more consistent in three different ways:

- By means of overall rate alignment – which is essentially a return in structure to New Zealand's pre-1999 alignment of the company, trusts and top personal tax rates.
- Through adoption of integrity measures – which would introduce provisions to prevent current tax deferral and diversion possibilities, while retaining a company tax rate lower than the top personal tax rate; with deep company tax rate cuts this could be considered similar to the Irish approach.
- Through use of a split rate system – which would introduce a lower tax rate applied to income from capital that aligns personal tax rates on investment income with the company tax rate, but continues to tax labour income at full personal tax rates; variations of this approach have been adopted by the Nordic countries.

These approaches are offered to illustrate the potential ways in which the integrity concerns facing the New Zealand tax system can be addressed. If the government wishes to increase the consistency of the tax system, an important question is whether one, or perhaps a combination, of these approaches is the best direction for future reforms.

Overall rate alignment

This approach would reduce the higher marginal tax rates on personal income to restore alignment of the top personal marginal rate with the current company tax rate. The trustee tax rate would also be reduced and aligned with the company tax rate and top personal marginal rate. This would remove incentives for many individuals to use companies or other entities to shelter income from higher personal tax rates.

Changing personal tax rates does not remove incentives for individuals with abating Working for Families tax credits to use companies or other entities to shelter income from higher effective marginal tax rates. In the context of a rate alignment approach, incentives could be eliminated by removing the 20 percent abatement of the credits by making them universal. But there are other reasons for high effective marginal tax rates (such as abatement of the accommodation supplement, childcare subsidies, student loan repayments or child support). These may make it difficult to prevent all forms of tax sheltering in companies or other entities.

Aligning rates is the most direct way to increase the coherence of the tax system. The major questions raised by the approach relate to cost, targeting and future flexibility.

In the absence of other changes, this approach would have a significant revenue cost. For example, reducing higher marginal tax rates to 30 percent would cost in the order of two billion dollars a year. One option would be to align rates at a higher tax rate than the current company tax rate of 30 percent. Given the international tax pressures noted above, this does not appear to be a feasible option. Alternatively, the change could be part of a shift in the tax mix away from direct taxes and toward indirect taxes by increasing the rate of GST to make these cuts in personal tax rates more affordable.

Cutting the top personal tax rates and/or introducing universality of the Working for Families tax credits reduce the progressivity of the tax system. Locking tax rates together also reduces the flexibility of the tax system. There will be continued international pressures for company tax rate cuts. In this event, either tax rate inconsistency would be reintroduced into the rate structure or the government would need to make difficult compromises between responding to international pressures and achieving its domestic objectives for the level of revenue required, the tax mix and the distribution of the tax burden. In the longer run, this direction of reform may require the government to consider either reductions in the rate of growth of government spending or an increase in the rate of GST. Increasing the rate of GST could allow personal tax rates to be lowered in a way which has little effect on progressivity while increasing the coherence of the tax system.

Rate alignment is by far the simplest approach for resolving current integrity concerns, as it does not require the introduction of new mechanisms or distinguishing between different types of income. It would eliminate the incentive for taxpayers to enter into complex and wasteful arrangements to avoid the higher marginal tax rates. The revenue cost of this approach could be mitigated by spreading rate alignment over a number of years.

Reductions in marginal tax rates and taxing income the same regardless of the form in which it is earned would increase the efficiency of the tax system and reduce disincentives to work and save.

Integrity measures

The second approach would introduce measures to make higher marginal tax rates stick. There are a number of possible mechanisms to achieve this result, the choice of which would depend upon concerns about complexity and the difference in the company and top personal tax rates. A mix of mechanisms would also be possible.

At the simplest, this would involve increasing the trustee tax rate and top PIE rate to align these with the top personal marginal tax rate. Assuming that international pressures prevent an increase in the company tax rate, companies could still be used to defer tax on personal income, but the imputation system would be relied upon to levy the personal tax rate when the funds are eventually distributed. If further company tax rate cuts occur in the future, this option becomes less viable, especially in the absence of a capital gains tax on the sale of shares.

A more comprehensive, but more complex approach, one adopted by a number of countries, would introduce anti-deferral mechanisms to be applied to investment income earned in closely held companies and private trusts. These mechanisms can take various forms, but essentially apply the top personal tax rate to investment income earned by closely held companies. Accordingly, such income would need to be distinguished from ordinary business income. Special rules might also need to apply to widely held New Zealand or Australian companies, which generate substantial amounts of interest or other forms of investment income.

The latter approach is more complex than simply adjusting the PIE and trust rates, but eliminates the potential for deferral by using companies, as illustrated in table 3. It allows more flexibility to accommodate future company tax rate cuts or for changes in the progressivity of the personal tax system.

In the absence of other measures, it would raise tax revenues and realise the progressivity implicit in the personal marginal rate schedule. It would also raise marginal tax rates for activities that have been structured to minimise tax, increasing tax rates on savings and work. These impacts could be reduced and efficiency improved if the funds raised were used to provide more general tax rate reductions for all taxpayers.

The choice between these two approaches depends critically on the difference between the company tax rate (current and future) and the top personal tax rate. With a small difference between the rates, the simpler rate adjustment approach would be viable. With a somewhat larger difference, explicit anti-deferral mechanisms for companies may be needed. In Ireland, which has a substantial difference between its 12.5 percent company tax rate and its top personal tax rate of 41 percent, dividends are double-taxed under a classical tax system, there is a capital gains tax and anti-deferral mechanisms are in place.

Changes to income tax rates would not stop companies or other entities being used to shelter income from the abatement of transfer payments. Making these abatement rates effective would require some form of look-through rules to include income earned indirectly through trusts and companies in the calculation of family income for abatement purposes. Such rules would be complex. Their form and the timing of any changes would need to be considered in light of the considerable resource pressures that exist in administering the current system.

Split rate system

A third approach would be to tax capital income at a lower rate than labour income. This approach has been implemented more or less comprehensively by the various Nordic countries.

The simplest option could provide that income from investments earned by individuals and trusts would be taxed at the company tax rate. On the other hand, labour income would continue to be taxed at full marginal rates. To preserve the integrity of labour income taxation, certain personal service income earned through companies and trusts could be taxed at the top personal tax rate, perhaps through extensions of the attribution rules. However, no attempt would be made to distinguish the labour income component implicit in the business income of a closely held company or unincorporated business, in contrast to what happens in Nordic countries.

A more comprehensive, and thus complex, option would be to make a formal distinction between labour and capital income for these businesses. This would involve a very substantial redesign of the tax system as it would require some method for identifying what part of the income of a closely held business is labour income and what part is capital income.

Either of these approaches involves a major shift away from the proposition that all types of income should be taxed equally. A key motivating argument for the Nordic countries adopting a dual income tax approach has been the belief that higher marginal tax rates on savings have more deleterious effects on economic activity than taxes on labour. However, it is clear that New Zealand has a highly mobile labour force and high taxes on labour incomes are also likely to be inefficient.

These approaches achieve their integrity objectives relating to the taxation of investment income by accepting the company tax rate as the appropriate personal tax rate for such income. Public acceptability of this direction of reform would require agreement that it is fair for those with high levels of capital income to sometimes pay lower amounts of tax than individuals with lower levels of labour income.

Problems with the diversion of labour income potentially remain and would need to be addressed as noted above. Concerns with avoidance of the abatement of transfer payments also remain. Moreover, the logic of the split rate system for income taxation, that investment income should be taxed at a reduced rate wherever it is earned, would suggest that investment income would not be included as income for abatement purposes, contrary to the objective of targeting such assistance to those most in need.

This result underlines the different analytic frameworks applicable to a progressive tax system and a targeted social programme.

Either system would increase complexity of the tax system as a result of the line-drawing required between different types of income. In the experience of the Nordic countries, making a formal division of business income into income from labour and capital has been complex and problematic.

The system would also link the taxation of personal investment income to the company tax rate, which might be under pressure internationally for cuts that would be at odds with the distributional and revenue objectives of the domestic personal income tax system.

The way forward

Current inconsistencies in the tax treatments of different forms of income can create horizontal inequity, meaning that people with the same income end up paying different amounts of tax depending on how they earn the income. There is strong evidence that companies, trusts, PIEs and other savings entities are being used to shelter income from higher rates of personal income tax. We are concerned that, over time, this may reduce voluntary compliance and corrode confidence in the integrity of the tax system. At the same time, it pushes people to save in complex and costly ways and creates considerable uncertainty. There are a number of possible directions for reducing inconsistencies. A key decision for the incoming government is the best longer-term direction for reform in this area.

5. Administrative issues

The earlier chapters of this briefing have concentrated on tax policy issues that will be a focus of Ministerial attention. However, an overall well-functioning tax system requires this policy be delivered through Inland Revenue in a cost-effective way that:

- meets the government's revenue requirements by achieving high levels of public compliance with tax law;
- meets the government's requirements relating to non-tax programmes;
- helps make the New Zealand economy internationally competitive; and
- builds trust and confidence in the public sector.

Inland Revenue interacts with New Zealand families, individuals and businesses in a host of ways. Our ability to manage this well influences overall trust in the public sector and helps determine whether New Zealand has a tax environment of low compliance cost and certainty that makes it easy to do business.

We therefore place much store on building and maintaining public confidence and trust. We also believe that public confidence in Inland Revenue underpins voluntary compliance; people are more likely to pay the right tax and access the correct entitlements if they have confidence that Inland Revenue acts effectively and with integrity.

As noted earlier, Inland Revenue has seen a significant increase in its operations. The department has a strong track record of delivering a growing range of initiatives, including Working for Families tax credits, the R&D tax credit, and KiwiSaver, which has grown at a rate surpassing any projections since its introduction in 2007.

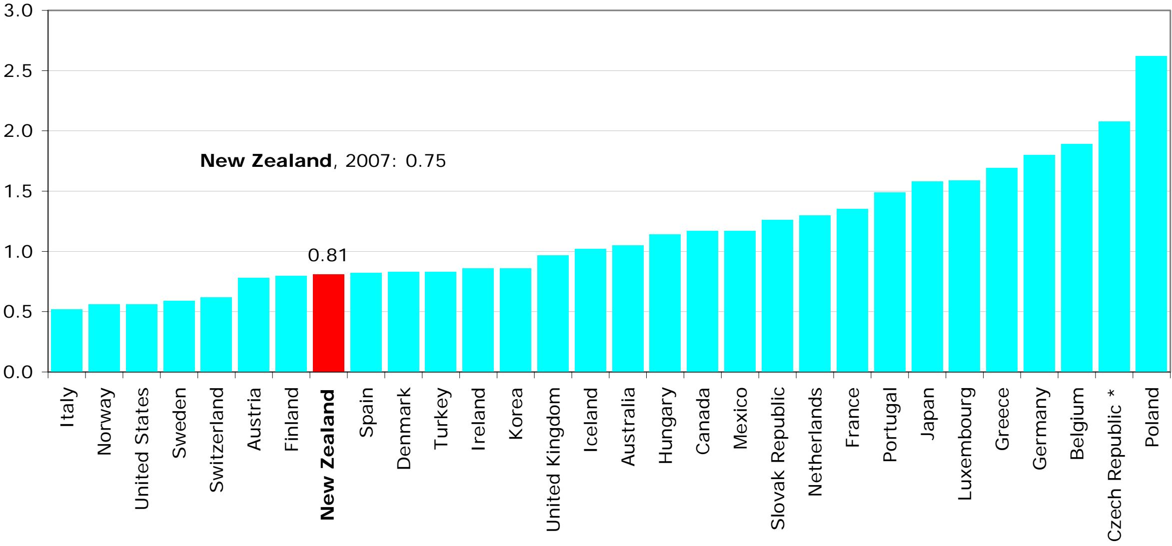
These initiatives have significantly increased the number of people with whom Inland Revenue interacts, and added to the variety and complexity of those interactions. This chapter focuses on Inland Revenue's priorities and the challenges it faces if it is to continue to deliver good service to New Zealanders and provide value for money in implementing the range of policies that governments ask it to do.

Delivering an efficient tax administration

Government and the public generally expect public agencies to deliver services and manage customer contacts efficiently and effectively – providing services that represent value for their money.

Internationally, New Zealand is recognised as having an efficient tax system and tax administration. In 2007, the OECD commented that New Zealand's tax system was regarded as one of the simplest and most efficient in the OECD. Figure 19 compares the administrative costs of collecting 100 units of revenue in OECD countries.[15] In 2004 it cost $0.81 to raise $100 of revenue in New Zealand. That was the eighth lowest cost in the OECD. By 2007 the cost had fallen to $0.75.

Figure 19: Aggregate administrative costs for tax functions to net revenue collections (2004, costs per 100 units of revenue)



* Data is for 2002.
Source: Forum on Tax Administration, Organisation for Economic Co-operation and Development

Changing service profile

Inland Revenue has experienced significant changes in the nature of its services and "customer base" as it has acquired wider responsibilities.

The growth in social policy functions has been a key driver of the overall growth in staff numbers in recent years. Between 1999 and 2008, total staff numbers (measured in full-time staff equivalents) grew by 1,819, from 4,157 to 5,976. Table 4 charts staff numbers and annual growth increases and indicates the key factors behind the growth.

[15] OECD, Centre for Tax Policy and Administration, *Tax Administration in OECD and Selected Non-OECD Countries, Comparative Information Series (2006)*, February 2007, pp. 110-111. Note: these figures will be updated in an OECD report planned for release in December 2008.

Table 4: Inland Revenue staff numbers (at 30 June, in full-time staff equivalents)

	2004	2005	2006	2007	2008
Total staff	4,682	4,653	5,018	5,728	5,976
Change on previous year	54	(29)	365	710	248
Key initiative	Working for families	Working for families; increased auditing	KiwiSaver; increased auditing	KiwiSaver; business tax reform	KiwiSaver; business tax reform

Source: Corporate Services, Inland Revenue

Renewing the way we do business

While Inland Revenue has successfully managed a period of significant growth in the size of its business and implemented a range of new initiatives, it is now timely to consolidate our business platforms and plan for future demands. To manage risks and meet future expectations of the government and the public, a transformation of Inland Revenue's business platform is required. As noted earlier, the nature of our business has changed and we need to change our business practice accordingly. Increasingly, it is not cost-effective to keep delivering a range of social policy functions using a system that was designed for a pure tax function. There is an opportunity in coming years to improve the coherence and sustainability of our business platform. In doing so we need to provide better value for money, make it easier for individuals and businesses to deal with us and equip ourselves to respond quickly and efficiently to new government needs.

Inland Revenue's wide portfolio of functions has increased the diversity and complexity of interactions with the public and resulted in increasingly complex technology systems. The department's core tax processing system (FIRST) was designed for processing and administering tax requirements; it was not intended to fit social policies which have subsequently been overlaid. In simple language, successive "work-arounds" and "bolt-ons" have been added to FIRST. That is an expensive way to do business and it limits our ability to make changes quickly and simply.

To increase voluntary compliance and meet people's expectations of managing their own tax affairs – in the same way they can access and manage their bank accounts online – Inland Revenue must be able to deliver greater access to more sophisticated e-services.

The department has identified what will be required to deliver effectively and efficiently on our outcomes and to be positioned to meet future challenges. This initial work indicated that fundamental change is required over the next five to seven years to manage the risks that the department faces[16] and to achieve increased agility, effectiveness, efficiency and customer service performance.

[16] These risks include unsustainable increases in operating costs, a reduced ability to respond appropriately to government initiatives or to environmental changes, a potential for decreased service performance and levels of voluntary compliance, and the failure to collect or disburse revenue.

Over the coming two years, the main focus will be on standardising and simplifying our business processes, delivering value for money and making it easier for the public to deal with us. A large part of this will be making it easier for taxpayers to access their own Inland Revenue "accounts" and self-manage their interactions with Inland Revenue. From the government's point of view, it will improve our ability to collect maximum revenue, address the risks our business faces and respond more swiftly to policy changes.

The changes made in these areas will help us to develop new capabilities that include:

- simplified end-to-end customer processes;
- developing more automated processes that remove to an extent the need for manual processing; and
- building a comprehensive channel approach that provides for the greater application of e-services. Increasingly, people will be able to access and manage their accounts, requiring less manual intervention from Inland Revenue.

During 2008–09, Inland Revenue will be undertaking more detailed financial modelling of the cost-benefits associated with the transformation as we develop individual business cases and proposals.

The department will be analysing current and future capabilities to identify what needs to be done to close any gaps between the two. This will also involve agreeing relative priorities and looking for opportunities for policy alignment.

Making it easier to contact Inland Revenue

Inland Revenue receives a large number of contacts every year and has been facing year-on-year growth in these contacts. A good tax system and public confidence in Inland Revenue makes it essential that people are able to contact us and receive timely and accurate responses.

Table 5 indicates the volume of contacts and the growth between 2006–07 and 2007–08 across various contact methods.

Table 5: Summary of operations (year ended June)

	2006-07	2007-08
Correspondence	1.81 million	3.22 million
Counter enquiries	218,726	233,080
Telephone calls and referrals	4.90 million	4.67 million
Self-help service enquiries	5.99 million	8.22 million

Source: Inland Revenue Annual Report 2007 and 2008

While there has been a positive growth in the uptake of the department's self-help services, the high volume of contacts received through call centres is a concern. The large volume of telephone contacts continues to put considerable pressure on the department's ability to respond to them in a timely fashion. Telephone contacts are increasingly more complex in nature, and it is taking longer to deal with them. Despite these factors, the public continues to express high levels of satisfaction with our call centre performance (83 percent in the September quarter 2008).

Like any large call centre operator, Inland Revenue must deal with peaks in calling volumes. In Inland Revenue's case there are yearly, monthly and weekly patterns of call volumes. To fund call centres to meet maximum levels would be an inefficient use of taxpayers' money. However, at the same time, people expect their calls to be answered within a reasonable time.

Our contact with other tax administrations shows that most are dealing with similar challenges. Like other call centre operators, we continue to explore technology and workforce planning initiatives to improve our ability to meet demand. Inland Revenue is now using a technology called Virtual Hold in its call centres. This allows callers to choose to receive a phone call, rather than wait on line. These initiatives are improving our performance, but we expect the issue to be difficult for some time.

Inland Revenue's response to mitigating this pressure has partly been through supplementing traditional service channels with more self-help services (e-business) options —providing more options for people to obtain information and do transactions with us electronically. At present, they can obtain comprehensive information about many of our products, get information about their KiwiSaver accounts, file various returns electronically, and access a growing range of other services.

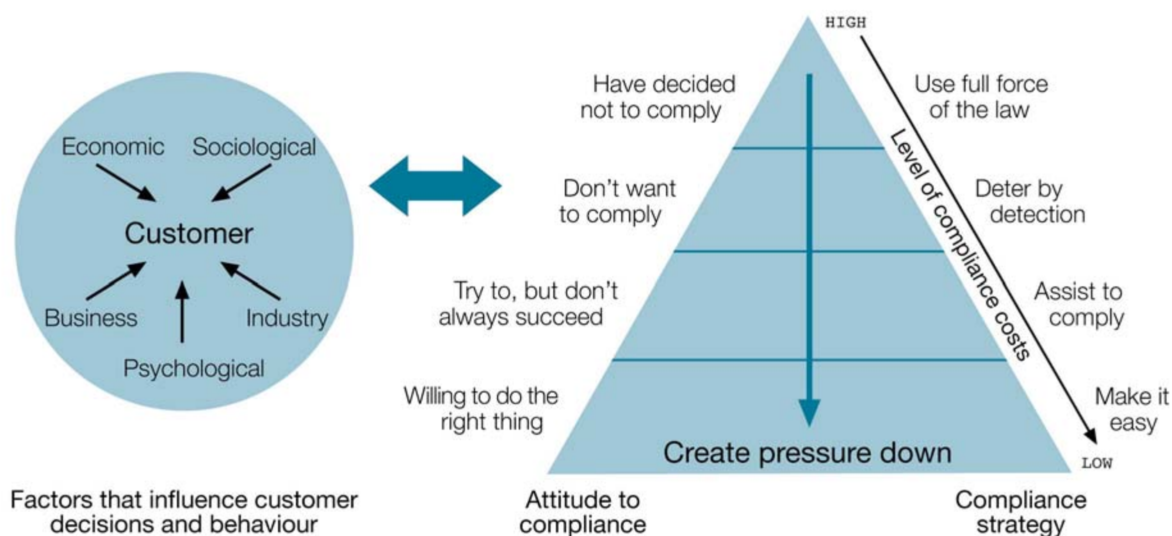
Even so, the delivery of more information on-line has not led to the anticipated transference away from telephone calls or reduced the public's reliance on the telephone as a way of obtaining information from us. On the contrary, many people now want to confirm information they have obtained from our website; they may have partially resolved a question through the website but want to call to take the matter to a conclusion.

Although the department will continue to make contacts as effective as possible, it is also essential to ensure that effective and realistic contact options are built into tax policy. Simply increasing resources to meet increasing public demand is unlikely to be cost-effective. Policy options to reduce the need for contacts by simplifying and automating online services will need to be considered as part of the transformation of Inland Revenue's business over the next few years.

Increasing voluntary compliance

The New Zealand tax system relies on voluntary compliance, and the vast majority of people comply with their obligations within required timeframes. Inland Revenue's intent is to create an environment which promotes compliance.

Figure 20: Tailoring responses to degree of non-compliance



Through the use of the voluntary compliance model shown in figure 20, Inland Revenue tries to identify people's attitudes to compliance and tailor its responses to their behaviour according to the degree of non-compliance – from assistance and education through to enforcement.

The legislative framework and our public interaction and enforcement activities are directed at encouraging people to meet their obligations voluntarily. We do publicise the consequences of non-compliance, and will continue to use the full force of the law for those who do not meet their obligations.

The traditional approach to compliance has been to focus on auditing for non-compliance. We have been moving to a more comprehensive approach incorporating customer education, providing assistance and helping people claim entitlements, as well as the more traditional use of audit enforcement. Inland Revenue operates a Compliance Management Programme through which compliance risks have been prioritised on the basis of evidence, research and analysis. We respond to these risks through integrated, co-ordinated, cross-department activities that are tailored to the needs and behaviour of the groups concerned. The current areas on which we are focussing are:

- identifying common errors people make so that these can be reduced by education and assistance programmes;
- e-commerce – ensuring people understand that e-commerce trade can give rise to tax liabilities and that a reasonable level of compliance is established with respect to these activities;
- assisting employers to meet their tax obligations in areas such as PAYE, student loans and KiwiSaver;
- increasing the degree to which taxpayers file on time;
- following GST refund claims to ensure that they are appropriate;

- auditing the extent to which personal income is diverted to companies and trusts to reduce overall tax liabilities; and
- auditing property transactions to ensure that tax rules are complied with.

By prioritising our compliance activities in this way we can provide more value for our funding and minimise our involvement with low-risk areas, allowing business people to get on with the job of running their businesses.

We are also moving to a more transparent approach to compliance. From 2009–10 we plan to publish annually a document outlining the Compliance Management Programme, detailing the compliance risk priorities we plan to focus on. It will set out the patterns of compliance risks that have attracted our attention and how we plan to respond to them, along with activities we will undertake to make it easy for people to comply voluntarily.

Working in an international arena

The increasing globalisation of international commerce poses particular risks to the tax system. This is particularly true of our company tax base, which forms a significant proportion of our overall revenue.

Although Inland Revenue is a small tax administration by international standards, it faces the same risks and challenges that larger administrations do. The pace of globalisation (including opportunities presented by rapid advances in technology) continues to open up new directions for business development here and overseas. But these also increase our tax risks. These include businesses being able to shift tax liability from New Zealand, increased use of technology to shift functions off-shore and the transfer of intangibles to overseas entities. Many of these factors also add more complexity to determining tax liabilities.

It is vital that Inland Revenue is equipped to meet the full range of challenges while at the same time making New Zealand an attractive destination for investment and business. The international nature of compliance risks means we need to work closely with other tax administrations and organisations to respond to those risks. Many international businesses operate in New Zealand. We need them to comply with their tax obligations without imposing higher compliance or administrative burdens on them than they experience in other countries.

Dealing with these matters often requires a legislative approach coupled with operational approaches to maintain the integrity of our tax system. Just as tax policy is dependent on good delivery of that policy, so good administration is dependent on good tax policy. To the extent to which some of the tensions in the coherence of policy mentioned in earlier chapters can be resolved, this will assist our compliance work.

Building relationships with large businesses and tax intermediaries

Large businesses are especially internationally mobile. To attract foreign investment and be internationally competitive we need to make it as easy and cost-effective as possible for large businesses to comply with their tax obligations. Our experience is that large businesses value certainty from the tax administration. They expect timely and reliable information about their obligations, particularly in areas such as binding rulings. Following discussions with the Australian Taxation Office, its priority rulings approach may present lessons for improving the timeliness of our rulings.

In common with other OECD countries, the department is focusing on how to work with tax professionals and tax intermediaries to improve compliance. Part of this focus involves working with the OECD and its tax intermediaries project, which arose from the 2006 Seoul Declaration.

In early 2008, the OECD's "Study into the Role of Tax Intermediaries" report discussed the role of tax intermediaries within tax systems, particularly in relation to unacceptable tax minimisation arrangements. The report also recognised the need to strengthen relationships between large business, tax intermediaries and revenue authorities.

It is long recognised that tax intermediaries play a vital role in all tax systems – helping taxpayers understand and comply with their tax obligations in an increasingly complex world. However, some of them also design and promote aggressive tax planning – a role that has a negative impact on tax systems. This is one of the risks revenue bodies have to manage in order to collect the tax due under their tax systems.

Aggressive tax planning typically requires the involvement of tax professionals and intermediaries. They represent the supply side of aggressive tax planning, but large corporate taxpayers, tax intermediaries' clients, set their own strategies for tax-risk management and determine their own appetites for tax risk. They are the ones who decide whether to adopt particular planning opportunities. Taxpayers, therefore, represent the demand side of aggressive tax planning.

To maintain the integrity of New Zealand's tax system and identify and deal with risks to our revenue base, Inland Revenue needs to be as sophisticated as those tax intermediaries. Over the coming year, it will be important to harness lessons from countries (for example, the United Kingdom and the United States) that have large intermediaries actively promoting aggressive tax planning activities.

Inevitably, there will be disputes between Inland Revenue and businesses or their agents despite the fact that most business transactions are not tax-driven. As far as possible, businesses want certainty on the tax consequences of their actions and speed in getting that certainty. We recognise the need to work alongside businesses, understand their problems and respond quickly. To that end, we have recently instituted a system to provide businesses with Inland Revenue's indicative views of how tax law affects transactions, where this is possible.

Developing our people

The department operates in a tight labour market, competing with other government departments, the private sector and the international labour market to recruit and keep the best people. It is vital to develop our staff to meet existing and emerging needs and to help drive greater levels of agility and flexibility.

Planning for future workforce requirements is a strategic priority, particularly in those areas where we are experiencing shortages of specialists (such as tax technical, legal, information technology and human resources). Shortages in these areas and high turnover within the first two years of employment continue to threaten the department's ability to develop skills and experience in the workforce and to sustain capability.

While we compete with the private sector for people, we also actively recruit from private firms. Many of our people at all levels through the organisation have come from private sector roles; they bring highly valued perspectives to the organisation, helping us to understand our business taxpayers better.

Inland Revenue must have the best possible recruitment procedures. Recently, the department established a centralised recruitment function for National Office recruitment and appointed a number of preferred supplier agreements among recruitment agencies. We are about to begin a national review of all the department's recruitment procedures, with the intention of implementing an effective future recruitment model across the organisation.

The department also needs to provide strong leadership to maximise the potential and performance of our people, particularly in times of transition and change, and to achieve the behavioural change required to support our evolving operating environment.

Maintaining public confidence in the tax administration

Maintaining public confidence in Inland Revenue is critical. One of the more important underlying principles of the tax system is voluntary compliance. People more willingly comply with their tax obligations and ensure they are receiving the correct entitlements if we make it easy for them to do so and they know there will be consequences if they break the law. At the core of that model is public trust in Inland Revenue as an organisation that is efficient, effective and committed to acting always with integrity.

Inland Revenue has two core documents that seek to uphold trust and integrity. The Inland Revenue *Charter* – refreshed in 2008 – gives people strong commitments about how we will deal with them, and what they can do if they do not believe they are getting excellent service. Internally, the *Code of Conduct*, which all staff members must read and sign up to, commits all Inland Revenue people to clear and readily understood standards of integrity. There are strong disciplinary procedures in place, including dismissal, for breaches of the *Code of Conduct*.

In the most recent community perception research, conducted in May 2008, the department found that a majority of people were either confident or very confident that Inland Revenue does a good job (63 percent of the general public, 68 percent of small business taxpayers and 61 percent of large business taxpayers). In another indication of confidence in the tax system, more than 90 percent agree with the statements "paying tax is the right thing to do" and "by paying tax you are contributing to New Zealand society".

The department also measures satisfaction levels among people who have had recent contacts with us. In the September quarter 2008, the overall satisfaction rating achieved was 81 percent. This was up from 78 percent a year earlier. For coming years, we are developing our survey approach to give us more detailed information about New Zealanders' perceptions, in line with the State Services Commission's recently launched Kiwis Count survey, which measures people's overall satisfaction levels across many government services.