New Zealand Chambers of Commerce and Industry

Submission on the Business Tax Review

September 2006

Executive Summary

New Zealand Chambers of Commerce and Industry stand for a low-rate, broad-based tax policy. They support a lower, flatter income tax structure including a reduction in the rate of company tax (and related rates of tax) and a narrower differential between personal and company tax rates. This would improve New Zealand's international competitiveness and boost investment, employment, productivity and economic growth.

The Chambers support a reduction in the company tax rate as floated in the discussion document. However a reduction in the company rate of 3 cents in the dollar is not enough if we are to fully transform New Zealand's economy or achieve the kind of productivity growth that both business and the Government seek.

It is likely that Australia and other countries will continue to lower their company and personal tax rates over the next few years and so the New Zealand company tax rate needs to be lower than 30% if we are to maintain international competitiveness.

It is not possible to review business tax without considering personal taxes and their relationship with the company tax rate. Around 40% of businesses are unincorporated – for example as sole traders or partnerships – and so would not benefit directly from reductions in the company tax rate.

Cutting the headline company tax rate from 33% to 30% would widen the differential between it and the top rate of personal tax. Closer alignment of company and personal tax rates is necessary to reduce tax planning.

In general tax incentives do more harm than good through the distortions they create, their eroding of the tax base and the resulting increase in compliance and administrative costs. The tax incentives in place in New Zealand prior to 1984 did not work well. In all likelihood, many of the pre-1984 problems would reoccur under the options outlined in the document and so these "tax base initiatives" should be avoided and the low-rate, broad-based tax principle should be retained.

There is little support amongst businesses for tax base initiatives. A recent survey of businesses in the Wellington region found that 72% of respondents would prefer that the Government reduce the company tax rate compared with 22% who would prefer targeted incentives for research and development or exporting.

In April 2006 the Chambers, together with Federated Farmers and the New Zealand Business Roundtable, proposed an alternative tax strategy. The package consisted of a reduction in the top and middle personal tax rates to 28% and the company rate to 25%. At the time, the fiscal cost of this strategy was estimated to be about $4.4 billion a year (2.7% of GDP).

This package would be funded by a combination of the existing provisions for additional spending, modest savings in base spending, a lower operating balance, and the revenue benefits of the impetus to the economy of a lower tax structure.

Introduction

New Zealand Chambers of Commerce and Industry is an umbrella organisation serving the interests of 34 Chambers of Commerce nationwide. These, in turn, represent over 24,000 businesses – most of the small to medium enterprises that are the backbone of business in New Zealand.

General Principles

The Chambers stand for a low-rate, broad-based tax policy. They support a lower, flatter income tax structure including a reduction in the rate of company tax (and related rates of tax) and a narrower differential between personal and company tax rates.

Such a tax structure would achieve a more efficient allocation of resources. It would make New Zealand a more attractive destination for internationally mobile capital and people. It would improve our international competitiveness and boost investment, employment, productivity and economic growth.

The government's fiscal strategy is to seek to maintain the tax to GDP ratio at around current levels. While recognising the importance of most government spending and the efficiency of taxes as a way of funding public goods, the Chambers' view is that the tax to GDP ratio is above optimal levels and that lower taxes should be funded by reductions in the growth of further government expenditure, savings from some spending cuts and reductions in the government surplus.

Company Tax Rate Reduction

The Chambers support a reduction in the company tax rate - as floated in the discussion document as one of the "options". A lower company tax rate would reduce incentives for firms to stream profits away from New Zealand and would encourage inbound investment by firms that have decided to locate in New Zealand. This would increase New Zealand's capital stock which would in turn boost labour productivity and wage rates.

However a reduction in the company rate of 3 cents in the dollar is not enough if we are to fully transform New Zealand's economy or achieve the kind of productivity growth that both business and the Government want.

The document makes the case for New Zealand to match Australia's company tax rate to maintain competitiveness with that country. However, this overlooks the likelihood that Australia will continue to lower its company and personal tax rates over the next few years and so a New Zealand company tax rate of 30% is not low enough if we are to maintain competitiveness with Australia.

As well as Australia, we need to be mindful of other countries' tax rates. The discussion document shows that while New Zealand's corporate tax rate has been kept at 33% since 1990, the OECD's unweighted average has been steadily falling over that period. It was significantly higher than New Zealand's in 1990 but is now below 30%. We need to be below the OECD average if we are to remain internationally competitive.

The document points out that amongst selected countries, New Zealand has the largest proportion of tax revenue sourced from income tax. Many countries, including Australia, have a range of other taxes which New Zealand does not collect. The implication is that while other countries might have lower company rates they will typically have additional taxes and that New Zealand is not highly taxed once these additional taxes are accounted for. However this is not true.

International comparisons of tax rates are difficult because of the variety of different taxes different countries collect. The best measure of a country's tax burden is the ratio of Government spending to GDP. This measure suggests New Zealand ***is*** highly taxed relative to other OECD countries. The OECD forecasts a ratio of 42% for New Zealand for 2006. This compares with 34.8% for Australia and 40.6% for the OECD average[1].

Personal Tax Rates are Relevant to this Review

The discussion document says that personal taxes are outside the scope of this review. However, the Chambers have some serious concerns about reducing the company rate while leaving personal tax rates unchanged.

This is a review of business tax, and it is simply not possible to review business tax without considering personal taxes (rates and thresholds) and their relationship with the company tax rate. This is true for a variety of reasons.

Firstly, the company tax rate is not relevant to a large proportion of New Zealand businesses. Around 40% of businesses are unincorporated – for example as sole traders or partnerships – and so would not benefit directly from reductions in the company tax rate. These businesses represent a significant chunk of the Chambers' membership.

Secondly, cutting the headline company tax rate from 33% to 30% would widen the differential between it and the top rate of personal tax from six to nine percentage points. The incentive for personal tax-payers to set up companies or trusts to avoid the higher rates of personal tax is already high and the document acknowledges this incentive would increase further if the differential were to widen.

The Chambers submit that the existing six-point differential between the company rate and the top rate of personal tax is already too high. Closer alignment of company and personal tax rates, including taxation of trustee income and fringe benefit taxation, would greatly reduce tax planning. It would also reduce administration and compliance costs.

High personal tax rates provide a disincentive to invest. The relevant tax rates for new domestic equity-financed investment through companies are personal rates of tax not the company rate. As the personal rate of tax exceeds the company rate, the former is

[1] OECD Economic Outlook No. 79, May 2006

the effective rate of tax on new domestic equity-financed investment. Reducing the personal tax rate would increase the incentive to increase investment.

Furthermore, companies have an incentive to retain income and invest when their shareholders pay a higher rate of tax than they do. Widening the company-personal rate differential further would disadvantage investment by new businesses relative to existing companies.

Reductions in personal tax would assist in achieving the review's objective of providing better incentives for productivity gains and improved competitiveness with Australia. They would be more helpful to achieving these objectives than the "tax base initiatives" discussed below.

Savings Vehicles, Portfolio Investment Entities (PIEs) and the Trustee Rate

Just as the inter-relationship between company and personal tax points to the desirability of a flatter tax structure, there is a strong case for aligning these rates with those of other entities, including savings vehicles and PIEs, taxation of trustee income and fringe benefit taxation. This would greatly reduce administration and compliance costs and reduce tax planning.

If the company tax rate were to be reduced, then the rate for other entities should also be reduced to the same rate. Increasing the trustee rate to match the personal rate while reducing the company rate, as floated in the document, would simply increase the bias in favour of companies. A six-point differential between any combination of the top rate of personal tax, the company rate and other entities (including savings vehicles and PIEs) is too high. The only way to reduce tax planning is to reduce the differential. The more closely aligned the better.

Tax Base and Compliance Cost Measures

Tax Base Initiatives

A broad income tax base, which treats particular classes of business activities on an even-handed basis, enhances economic efficiency. Concessional tax treatment for selected businesses, categories of spending or income erodes the tax base, creates a misallocation of resources and is unlikely to achieve the government's growth objectives.

For this reason, the Chambers are in principle opposed to tax incentives. Notwithstanding the theoretical benefits some of the tax base initiatives discussed in the document might have, the Chambers submit that in general tax incentives do more harm than good through the distortions they create, their eroding of the tax base and the resulting increase in compliance and administrative costs.

While the Chambers are prepared to keep an open mind on the use of some tax base initiatives, as an exception rather than the rule, a satisfactory case has not been made in the discussion document, or anywhere else, for the introduction of any tax incentives at all.

The tax incentives in place in New Zealand prior to 1984 did not work well as they encouraged investment to flow into activities ahead of levels dictated by market demand.

Furthermore the tax regime prior to 1984 became increasingly complex as businesses successfully lobbied for new concessions. Not only did this further erode the tax base and complicate the tax system, most importantly it diverted businesses energy away from productive activities towards reliance on government assistance.

In all likelihood, many of these problems would reoccur under the options outlined in the document (targeted tax credits for export market development, research and development and skills improvement; deferral of losses; deductions for "blackhole" expenditure; adjusting depreciation loadings etc) and so these tax base initiatives should be avoided and the low-rate, broad-based tax principle should be retained.

It should be noted that there is little support amongst businesses for tax base initiatives. A recent survey of businesses in the Wellington region found that 72% of respondents would prefer that the Government reduce the company tax rate to 30 cents in the dollar compared with 22% who would prefer that the Government provide targeted incentives for research and development or exporting. The survey also found that if targeted incentives were offered for research and development or exporting, only 20% of businesses would change business planning to put more emphasis on these activities.

When ranking initiatives (which the document asks submitters to do) the Chambers have a clear preference for a cut in the company rate ahead of tax base initiatives. This would have a much greater impact on productivity and competitiveness when measured against the fiscal cost. For example, the document shows that the combined fiscal cost of deductions for "black hole" expenditure and increased depreciation loading on new assets to 40% is comparable with the fiscal cost of a 3-cent cut in the company tax rate. We doubt that the former measures together could have as positive an impact on the economy as a 3-cent tax cut would.

The goal should be higher productivity in all industries. Concessional tax treatment for certain activities would not achieve this. As well as the fiscal cost and doubtful impact on productivity and competitiveness, many of the tax base initiatives would have a negative impact on the economy through the distortions created and compliance and administrative costs imposed.

Compliance Cost Burdens

The measures outlined in the document to reduce compliance costs are positive and are supported. However, rather than tinkering with thresholds, the Chambers maintain that the best way to significantly reduce the cost of complying with the tax system is to simplify the tax system. This can be achieved by aligning company and other entity tax rates with personal tax rates, and by implementing a flatter tax structure.

Many of the tax base initiatives discussed in the previous section would increase compliance costs.

Alternative Tax Strategy

In April 2006 the Chambers, together with Federated Farmers and the New Zealand Business Roundtable, proposed an alternative tax strategy. The package consisted of a reduction in the top and middle personal tax rates to 28% and the company rate to 25% in two steps by 2009/10.

At the time, the fiscal cost of this strategy was estimated to be about $4.4 billion a year (2.7% of GDP).

The strategy would be funded by a combination of:

- existing provisions for additional spending or revenue reductions ($2 billion or 35% of the provision made in the 2006 Budget Policy Statement for 2008-2010) ;
- achieving savings from relatively small spending cuts ($0.5 billion);
- a lower operating surplus ($1.9 billion or 1% of GDP), thereby funding more capital spending from debt; and
- the revenue benefits of the impetus to the economy of a lower tax structure[2].

The amounts in brackets above are the April 2006 estimates.

We see this proposal as consistent with the government's commitment to a 'bold' review. It would benefit investment, employment, productivity and economic growth in New Zealand; improve the international attractiveness of New Zealand's tax structure; and be fiscally responsible.

Conclusion

Tax cuts are not a panacea. The benefits have been overstated by many commentators, many of whom overlook the desirability of catch-up public infrastructure expenditure, the importance of fiscal responsibility, and the potential impact of tax cuts on inflation and the monetary policy response. However, as argued in this submission, the benefits to the economy from tax cuts are real and affordable and should be implemented as soon as possible.

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[2] A reduction in tax rates will boost economic growth thereby increasing tax revenue to a certain extent. For example, some research undertaken in the United States suggests that a 10% reduction in income tax rates may claw back taxable income by 4%.