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How to fix a leaky tax system

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- Raising the top rate of tax to 39% for income over $60,000 has made New Zealand's tax system complicated and unfair. Because large numbers of people are able to avoid the increased top rate, the moral basis of the system is being undermined.
- Tax avoidance and evasion has greatly increased through the use of trusts, income splitting and companies.
- By and large, it is wealthier taxpayers who can employ these techniques. Most workers on a set wage or salary have no such luxury.
- This increasing complexity is costing the Inland Revenue Department, and society, more in terms of administration and compliance. The IRD's funding has increased by 50% in five years but it is struggling to keep up, while the use of accountants and tax lawyers has also increased greatly.
- The business tax review threatens to make the system even more complicated and open to evasion. Adopting tax concessions would end 20 years of consensus around a broad-based, low rate system.
- Trying to close the various loopholes would be expensive, difficult and unfair. The best solution is to have lower and flatter taxes that would make for a simpler system.
- Lower and flatter taxes would provide less opportunity for avoidance and less incentive to do so.
- As a first step, the government could start by scrapping the top rate of 39%. On a cost-benefit analysis, the top rate of tax is not worth it, given the distortions it has caused.
- In terms of money raised, the 39% rate has proven to be completely unnecessary. The government has received billions of dollars more tax revenue than it needed to implement its election promises. In fact, taxes could have been *cut* and revenue would still be higher than expected.

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Introduction

New Zealand's tax system has become complicated and distorted, with avoidance and evasion widespread. The main culprit is the 39% rate of tax for personal income over $60,000, introduced in 2000. The government was warned at the time of the practical problems it would cause and all the warnings have come to fruition. The moral basis of the system is being undermined.

Most experts agree that the point of tax is to raise enough money to cover spending in a fair way with the least distortion possible. The first paper in this series (*Are New Zealanders paying too much tax?* Issue Analysis 71) argued that the government has failed the first part of the equation by raising large amounts of extra revenue by stealth. This paper looks at the second part: the distortion costs that taxation is imposing on society through administration, compliance, avoidance and evasion.

Governments have the right to raise revenue as they see fit, but they also have a responsibility to do so in the most efficient manner. The level of avoidance means the government is not only failing to achieve its goals but that the failure is imposing a substantial cost on New Zealand.

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A background to New Zealand's tax system

For most of the twentieth century, governments used tax as a tool to tinker with the economy and direct outcomes. In the 1970s in particular, New Zealand employed a complicated range of subsidies, tax breaks and exemptions. There was a heavy reliance on income tax, with a top personal rate of 66% and the corporate rate reached a high of 48%. However many companies were able to find exemptions or lobby successfully to create them.[1]

Attitudes towards the role of tax began to change in the 1980s for the simple reason that the interventionist model didn't work. The complexity of the system made it expensive for both the government and taxpayers, and the unpredictability made it difficult for businesses to plan ahead. It also encouraged 'rent seeking' by businesses and other groups that devoted considerable resources to lobbying the government and it was unfair in that many taxes did not apply equally. Despite the high rates, the number of loopholes meant that the government was struggling to raise enough revenue.

From the 1980s the principle of a broad based, low rate (BB-LR) system became orthodoxy. A broad base means there are more sources of taxation (such as consumption) instead of relying too heavily on one source, such as income, and that those sources are taxed evenly with no exemptions. And a low rate is considered important in minimising deadweight costs, which distort people's behaviour and destroy potential wealth.

The success of the reforms was clearly demonstrated when the top personal rate was cut from 66% to 33%, yet revenues actually *increased*.[2] In the 1990s the OECD recognised New Zealand as having one of the least distortionary tax systems in the world.

A major review of the tax system, chaired by Rob McLeod, was undertaken by the government in 2001. The team of experts concluded that New Zealand's tax system was relatively robust and not in need of major reform. In particular, they strongly endorsed the BB-LR principle and rejected the interventionist approach:

> The New Zealand income tax base is one of the cleanest in the OECD. There are few major gaps in the tax base, which means that the income tax is generally both fair and efficient … As a result, New Zealand's tax system has been radically transformed for the better.[3]

The review also stressed the need for constant vigilance and continual improvement. In particular it warned of the dangers of raising the top personal rate to 39% for income over $60,000 and observed that pressures were already emerging just one year on. Five years after the review their predictions have been proved right.

An estimated 41 new taxes or levies have been introduced since 2000, although most have been minor changes to excise on goods such as petrol, alcohol and tobacco.[4] It is the 39% rate that has caused the most problems, and is the main focus of this paper. New Zealand now has four different tax brackets, and a corporate tax rate that is different from the top personal rate.

The IRD warned that our tax system is 'under increasing pressure and there is mounting evidence that our personal tax structure is fragile'.

How the top rate encourages avoidance and evasion

An injudicious tax offers a great temptation to smuggling.
Adam Smith, 'An Inquiry into the Nature and Causes of the Wealth of Nations', 1776.

In its briefing to the government last year the IRD was remarkably blunt. It warned that our tax system is '… under increasing pressure … [and] there is mounting evidence that our personal tax structure is fragile.'[5]

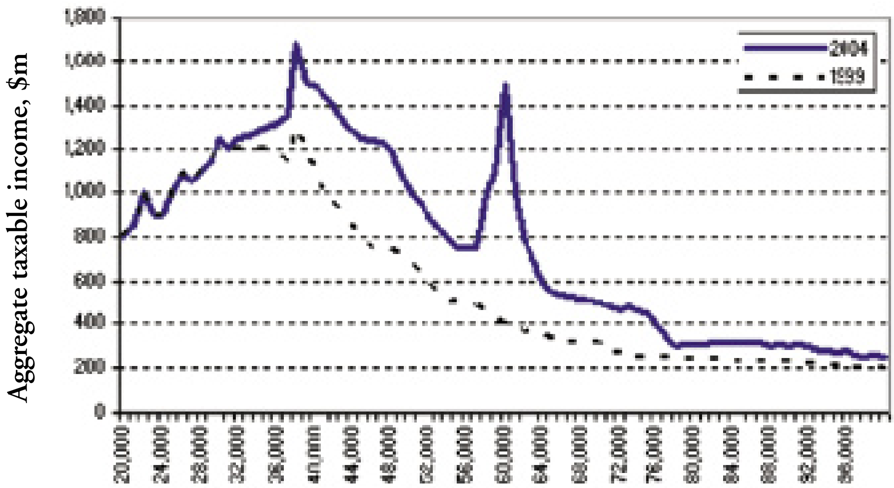
In particular it warned that avoidance of the two top personal rates (33% and 39%) is carried out through several means:

- Trusts: the income from trusts is taxed at 33% and so can be used to avoid the 39% rate. From 1998/99 to 2003/04 trustee income grew 256% and beneficiaries' income grew by 28%.[6]
- Income splitting: transferring income to a partner to avoid the top rate.
- Company sheltering: the gap between the top personal rate (39%) and the corporate rate (33%) creates the opportunity to defer paying the top rate. Since 1999, tax paid by companies (up 71%) has far outstripped the rise in tax paid by non-PAYE individuals (up 16%).[7]
- Salary sacrificing: for fringe benefits such as superannuation contributions which are taxed at a lower rate. Earlier this year the government introduced legislation to combat 'extreme salary sacrifice by employees who are trying to reduce the amount of tax they pay.'[8]

The evidence is clear from Gareth Morgan's graph (Figure 1), which shows the remarkable peaks in taxable incomes around the thresholds of $38,000 and $60,000 since 1999. According to Morgan, '… all the rational ones have capped their personal income at $60,000 and shifted other earnings into different vehicles.'[19]

The gap between the top personal rate and the corporate rate creates the opportunity to defer paying the top rate.

Figure 1: Personal Taxable Income (by $1,000 bands)



Source: Gareth Morgan, Infometrics and IRD Briefing for Minister of Revenue, 2005

Low and middle-income earners on a set wage or salary have the least opportunity to avoid tax.

The IRD has even more compelling evidence. From 1998/99 to 2003/04 the number of taxpayers with reported earnings over $1 million fell by 6.3%, which is bizarre given the strong economic growth over that period. The IRD says it is '…likely evidence that significant numbers of those with substantial amounts to gain through income splitting and tax sheltering are availing themselves of these opportunities.'[10]

New Zealand has a high number of small businesses and farmers who suffer considerable income variability. A bad season might mean low returns, but a good season, offering a chance to recoup from previous losses, is often hit by the top rate of 39%. This provides a strong motive to dodge the higher rate of tax through the means described above, or simply by under-reporting income.

Largely it is the wealthy who can employ these methods to avoid tax. By contrast, low and middle-income earners on a set wage or salary have the least opportunity to avoid tax. This prompted the IRD to warn that 'our tax system may be much less progressive than the statutory tax rates would suggest, which raises concerns about the possible corrosion of the tax system.'[11]

Illegal tax evasion, which is different from avoidance, is also likely to be significant. Some studies estimate that New Zealand's black market is equivalent to 10% of the economy.[12] To a large extent tax evasion happens when people feel that a tax, or the level of tax, is unfair, which leads to a gradual loss of the system's moral foundations. The IRD notes that '… in a self-assessment system such as New Zealand's, it is critical for taxpayers to accept that the tax rules are broadly fair and even-handed.'[13]

These kinds of behaviours are distortionary and harmful to the economy. They create deadweight losses as people change their behaviour and use resources in different, less productive ways to minimise their tax burden. Instead of using all their time and skills to create wealth, dodging the taxman becomes an important priority for many people.

All these concerns were raised by the government's tax review in 2001 but were ignored by the government. They were also ignored by the National Party's tax policy at the last election that merely raised the top threshold to $100,000. This would do nothing to solve the problems outlined here, only shift them further up the scale.

Administration and enforcement costs

As well as the cost in terms of lost revenue, a more complicated tax system is difficult and expensive to administer.

The IRD is now one of the largest government departments.

Public servants must be employed to collect tax and enforce the law, while individuals and companies expend time and resources meeting their obligations (or avoiding them, as the case may be). The New Zealand Institute of Chartered Accountants says the rise in the top personal rate has forced the IRD to work harder to enforce tax law, at considerable expense:

> Since that time we have seen a raft of complex avoidance-type legislation and Inland Revenue audit activity designed to mitigate such behaviour. Along with that comes increasing complexity, compliance costs and business uncertainty, which lowering and flattening of tax rates will remove.[14]

As a result the IRD is now one of the largest government departments with over 4,700 staff and a budget of $531 million, an increase of nearly 50% from five years ago.[15] In their briefing paper to the Minister of Revenue last year, the IRD warned that they were at full capacity and that one of their key challenges was keeping up with 'demonstrable shifts in customer behaviour in response to current policy setting.'[16]

Business tax: the trend away from a neutral tax system

While the problems with personal income tax are apparent, the major risk now is that corporate tax will also head away from the BB-LR principle.

In July this year the government released its Business Tax Review that presented a range of options for lowering tax in order to boost productivity and growth. The review is vague on exact costings, but perhaps the most important question it asks regards the *type* of tax cut. What is best for growth—targeted incentives for activities like exporting, research and development and capital expenditure, or a general reduction in headline rates?

The New Zealand Institute is promoting tax concessions and the idea is receiving support from Finance Minister Michael Cullen and even the National's Finance spokesperson John Key.[17]

Dr Cullen argues that across the board tax cuts are likely to be spent on dividends and higher wages, which are inflationary and will have a limited impact on growth. He suggests that targeted measures for certain activities and industries will have more 'productivity bang for the buck' than a general cut.[18]

Moving back to a 'hands-on' tax system would be a major change in philosophy and policy. If the government is serious about such a change it needs to be clear about what is wrong with the current system and whether the proposed cure is worse than the disease.

The potential problems are many. For a start, there are enormous practical difficulties in implementing incentive-based tax schemes. The Business Tax Review is deliberately vague on how they would work and exactly what business activities would fit under each category.

Exemptions for certain activities provide a strong incentive for tax avoidance and evasion. Loopholes encourage businesses to spend time trying to minimise their tax returns and fit their activities into bureaucratic categories, rather than just getting on with business and being productive. As with income tax, it would inevitably mean more resources devoted to tax lawyers and accountants.

Moving back to a 'hands-on' tax system would be a major change in philosophy and policy.

The OECD has noted the inefficiency caused by applying tax rates selectively: 'This lack of neutrality, in turn, increases the compliance and administration costs, reduces tax compliance and tax revenues and impairs the efficiency and equity of the tax system.'[19]

There is also an element of gambling in providing tax breaks for exporters. The New Zealand Institute reports that one of the main reasons why firms choose not to expand overseas is because the returns just aren't worth it.[20] But if the firms themselves don't think it's a good investment, why does the government know any better? Why should taxpayers' money be put at risk if a business considers it too risky to use their own funds?

Another problem with targeted incentives is that someone has to pay for them. Taxpayers and other businesses will be forced to pick up the tab through higher taxes than would otherwise be necessary, in order to subsidise a lucky few corporates.

Finally, it is worth considering the views of those who would be most affected by a return to an interventionist tax policy. Business New Zealand, the Business Roundtable, Federated Farmers, the New Zealand Chambers of Commerce and Industry and the Institute of Chartered Accountants have all come out strongly in favour of lower taxes and against tax concessions.

Even the IRD has warned the government against using concessions:

> ... that can add to the strain on tax policy resources and, if implemented, could undermine the broad tax bases our tax system and moderate statutory rates rely upon ... Sector-specific concessions will increase the impediments faced by other sectors and, therefore, need a high level of justification. Moreover, sector-specific concessions raise boundary problems and can be open to abuse.[21]

New Zealand rejected this kind of system in the 1980s for good reason; because it is too expensive, complicated and unfair.

A solution: lower and flatter taxes

Realistically, the government has two options for countering avoidance: tighten the enforcement and crack down on loopholes, or change the system itself.

The problem with tighter enforcement is that it is unlikely to work. The government and IRD have already been trying hard to plug numerous gaps, with limited success. Rules around the distribution of trust income and personal attribution have been tightened, and fringe benefit tax has been raised. Yet as the above section on avoidance shows, they are not keeping up. Band-aid solutions are not the answer.

Tightening the rules further would not only be very difficult, but would unfairly impact on many people who use those vehicles (such as trusts and companies) legitimately. It would be a crude, sledgehammer approach and the amount of revenue that it might generate in return is uncertain.

Attacking symptoms is not the answer, because the fundamental problem is the system itself. A progressive tax system with different rates will always provide the incentive and opportunity for avoidance.

A flat tax, with one low rate for all levels of income (personal and corporate) would be a massive improvement to the system. It would put an end to income shifting, and the benefits would include:

- less work for tax lawyers and accountants;
- lower cost of administration and compliance (for the IRD and taxpayers);
- more difficulty in avoiding tax; and
- less incentive to avoid tax.

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Even simplifying the system by reducing the number of different rates would be a major improvement. The government's tax review recommended a two-scale system as the '... best compromise between economic efficiency and fairness goals.'[22]

New Zealand is a highly taxed country, with a budget surplus of $9 billion for 2006—well above original forecasts.[23] Clearly the government has the fiscal headroom to make a two-scale system happen, if it only had the willpower.

Less evasion and avoidance means increased tax revenue for the government and so the cost of tax cuts might be even less than forecasts suggest.

Scrap the top rate

If a two-rate system is too radical for the government then it could start by removing the 39% top rate of tax.

The damage caused by the top rate is outlined in the sections above, through the increased compliance and administration costs and the widespread avoidance it facilitates. This means the burden of taxation is disproportionately spread, undermining the integrity of the entire system.

Has it been worth it? In fiscal terms, introducing the new rate was completely unnecessary. The original goal was to raise an additional $450 million in revenue a year, and after six years it now raises $780 million annually. But this pales in comparison with the extra revenue generated thanks to economic growth. The government now receives 50% more tax revenue than it did in 2000.[24]

In fact, income tax could have been *cut* and there still would have been far more revenue than was ever expected. For example, the forecast tax revenue for 2007 is already $5 billion ahead of what was predicted just five years earlier.[25]

The top rate also has little impact on progressivity. It does not guarantee any extra money to people on lower incomes and has only a minor impact on higher incomes—for those who actually pay it, that is. The government's tax review in 2001 modelled alternative rates and found that 'a progressive personal income tax rate scale does not redistribute income substantially more than a proportional [flat] one.'[26]

Higher income earners would undoubtedly benefit from a shift to flatter rates, but they would still pay the vast majority of tax. At present the top 3% of taxpayers contribute 27% of all income tax, and the top 12% (those on the top personal rate) contribute 50%.[27] Moving to a flatter scale with tax cuts would lessen this burden slightly, but not at the expense of any other group.

Finally, it is worth noting that many people hit by the top rate of tax are hardly rich. 'Bracket creep' means that over time tens of thousands of extra people have gradually moved into the top rate. This now includes professions such as teaching, police and nursing that were never meant to be affected.

It is hard to escape the conclusion that raising the top rate was merely a symbolic move meant to represent a redistribution of income from the rich to the poor, even though in reality it does little to achieve that. The price New Zealand is now paying for this symbolic gesture is too high.

There are also very important economic arguments for lowering tax, such as the negative impact it has on economic growth, and this is the topic of a following paper. However the practical arguments for scrapping the top rate are compelling enough on their own.

New Zealand's tax system has become like an overloaded and unbalanced boat. The answer is to release some of the excess weight and get everybody above deck and rowing, rather than chasing leaks.

Conclusion

New Zealand's tax experience over the last six years illustrates the danger of politics superseding good policy.

Symbolic gestures such as raising the top rate of tax and providing concessions are easy for politicians to sell, but they can have a devastating impact on the integrity of the system.

New Zealand's tax system has become like an overloaded and unbalanced boat. Plugging leaks is not the answer because as soon as one hole is fixed, another one appears. The answer is to release some of the excess weight and get everybody above deck and rowing, rather than chasing leaks.

The government's response to the Business Tax Review later this year will be a key indicator of which direction New Zealand tax policy moves. Adopting tax concessions would be a major philosophical shift and would end 20 years of consensus around a broad-based, low rate system.

At the very least, there needs to be more honesty around the true cost that taxation entails.

Endnotes

[1] See Michael Bassett, *The State in New Zealand 1840–1984* (Auckland: Auckland University Press, 1998), chs 11 and 12 for an excellent portrayal of how tax was used as an economic tool and the associated rent-seeking behaviour.

[2] Hon Richard Prebble, Budget speech, 28 May 2004.

[3] Robert McLeod, David Patterson, Shirley Jones, Srikanta Chatterjee and Edward Sieper, *Tax Review 2001—Final Report* , ch 1, p 6 and ch 2, p 1.

[4] Phil Rennie, *Are New Zealanders paying too much tax?* Issue Analysis No 71 (Sydney: Centre for Independent Studies, May 2006).

[5] Inland Revenue Department (IRD), *Briefing for the Incoming Minister of Revenue—2005*, (Wellington: IRD, September 2005), p 12.

[6] As above, p 35.

[7] As above, p 34.

[8] IRD press release, 'Countering salary sacrifice', 15 February 2006.

[9] Gareth Morgan, 'Graphing 'Ideological Burps', 23 November 2005, http://nbr.infometrics.co.nz/graphing-'ideological-burps'_1038.html.

[10] IRD, *Briefing for the Incoming Minister*, p 34.

[11] As above, p 35.

[12] Warren Hughes, 'Taxation: It's definitely time for a change' in *Regional Economic Bulletin* (Waikato: Waikato University, June 2005), p 2.

[13] IRD, *Briefing for the Incoming Minister*, p 35.

[14] New Zealand Institute of Chartered Accountants press release, 'Institute backs tax cut call', 17 November 2005.

[15] *Budget 2006*, Vote Revenue expenses, p 1042. Annual departmental output expense costs have increased by $163.721 million from $367.747 in 2001/2002.

[16] IRD, *Briefing for the Incoming Minister*, p 40.

[17] See David Skilling and Danielle Boven, *Developing Kiwi global champions* (Auckland: New Zealand Institute, August 2006) and speech by John Key MP, 'Mood of the Boardroom', 8 August 2006, which floats the ideas of a 100% write off for R&D, purchases of plant and equipment, and a lowered tax rate for new businesses in certain 'defined high-growth sectors'.

[18] Speech to *New Zealand Herald*'s 'Mood of the Boardroom' breakfast, 8 August 2006.

[19] 'Reforming Income Tax', OECD Policy Brief (Paris: OECD, March 2006), p 4. http://www.oecd.org/dataoecd/43/21/36346567.pdf.

[20] David Skilling and Danielle Boven, *The Flight of the Kiwi: Going Global from the End of the World*, Discussion Paper 2006/1 (Auckland: New Zealand Institute, July 2006), p 12: 'Our analysis suggests that many New Zealand firms do not see a compelling commercial imperative to expand internationally.'

[21] IRD, *Briefing for the Incoming Minister*, p 17.

[22] Government Tax Review 2001, *Issues Paper*, ch 4, p 85.

[23] See Rennie, *Are New Zealanders paying too much tax?* for more detail.

[24] See above, 'Tax to spend: Cullen's billion dollar gamble', *New Zealand Herald*, 30 March 2002, and Treasury's Ready Reckoner.

[25] See Rennie, *Are New Zealanders paying too much tax?* for more detail.

[26] Government Tax Review 2001, *Issues Paper*, ch 4, p 85.

[27] Treasury's Key Facts for Taxpayers, 2006.

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