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THE TAX SYSTEM IN NEW ZEALAND: AN APPRAISAL AND OPTIONS FOR CHANGE

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ABSTRACT/RÉSUMÉ

New Zealand's tax system is one of the most neutral and efficient in the OECD. Bases are generally broad and rates are moderate. The full imputation system for dividend payments works to reduce tax distortions for corporate financing decisions, while efficiency in corporate investment decisions is encouraged by the low level of targeted tax incentives. The tax system is also more neutral vis-à-vis private saving than in most other countries, in particular because no general incentives are provided to private pension saving. There is hence no immediate need for major tax reform, but several second order issues should be addressed in order to reap the full benefit of an otherwise well-functioning system. The most important improvement would be to broaden the income tax base by including capital gains on a more comprehensive scale as well as introducing a tax on imputed rental income of owner-occupied housing. These two steps would not only reduce horizontal inequities and hence tax shifting incentives, but also contribute to a better allocation of private savings, which is currently biased strongly towards housing. It should be emphasized, though, that tax policy is unlikely to be very effective in raising the level of private saving in New Zealand.

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Keywords: Taxation, tax policy, New Zealand

Le système fiscal de Nouvelle-Zélande est l'un des plus neutre et efficace de l'OCDE. Les assiettes sont généralement larges et les taux modérés. Le système d'imputation total pour les dividendes aide à réduire les distorsions d'impôts pour les décisions de financement des entreprises, alors que des taux d'imposition ciblés peu élevés favorisent les investissements d'entreprise. Le régime fiscal est également plus neutre pour l'épargne privée que pour la plupart des autres pays, ce qui est plus particulièrement dû à l'absence de mesures en faveur de l'épargne-retraite privée. Il n'y a donc pas de besoin immédiat d'une réforme importante du système fiscal, mais des questions plus secondaires méritent d'être posées, pour tirer les pleins bénéfices d'un système qui fonctionne plutôt bien par ailleurs. La plus importante mesure serait d'élargir l'assiette pour l'impôt sur le revenu, en incluant les gains de capital de façon plus large, et d'introduire un impôt sur la valeur locative imputée des logements occupés par leur propriétaire. Non seulement ces deux mesures réduiraient les différences de traitement horizontales, et donc les incitations à profiter des écarts entre régimes, mais elles contribueraient à améliorer la répartition de l'épargne privée, qui est pour le moment principalement orientée vers l'épargne logement. Il convient cependant de souligner que la politique fiscale actuelle en Nouvelle-Zélande a peu de chance d'entraîner une hausse du niveau de l'épargne privée.

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THE TAX SYSTEM IN NEW ZEALAND: AN APPRAISAL AND OPTIONS FOR CHANGE

Thomas DALSGAARD¹

Introduction

1. After radical reform in the 1980s, New Zealand's tax system became one of the most broadly based, neutral and efficient in the OECD (Box 1). Over time, however, various positive features of the system have gradually eroded, and, as in most other OECD countries, it will come under increasing pressure in coming years due to rising spending demands as the population ages and more mobile tax bases. The challenge for New Zealand is how to respond to these developments without undermining the system's still fundamentally healthy state. The starting point is favourable since distortions and inequities are still more limited than in most other OECD countries, even though many of them have improved their tax systems in recent years. The overall tax burden is reasonably low, especially compared with those of European countries, but higher than those of some of its major trading partners in the OECD, including Australia, the United States and Japan (Figure 1). Revenues have also been more volatile than elsewhere, reflecting strong economic cycles as well as the substantial tax changes that have taken place.

(Figure 1. Total tax revenues in selected OECD countries and regions)

2. The government has announced a review of the entire tax system to be carried out over the next year or so. The first part of the review will take a "top-down approach" to establish which key principles should underlie a future robust tax system. This will be carried out by a group of non-government experts whose recommendations are due by the end of September 2001.² Building on these recommendations as well as the wider public debate, the second part of the review will outline specific proposals for tax changes. This paper addresses many of the issues involved. It first describes some key features of the economic context within which tax policy is formulated, followed by a discussion of major positive characteristics of the tax system as well as its main weaknesses. The final section outlines recommendations for further strengthening equity and efficiency. It is concluded that New Zealand's tax system is basically sound and that there is no urgent need for major systemic reform. However, a range of second-order issues are identified that should be addressed in order to reap the full benefits of what is essentially a well-functioning tax system.

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1. The author is a senior economist at the OECD. This paper was originally produced for the *OECD Economic Survey* of New Zealand published in December 2000 under the authority of the Economic and Development Review Committee. The author is indebted to Val Koromzay, Michael Feiner, Jorgen Elmeskov, Peter Jarrett, Hannes Suppanz, Robert Fay and David Partington for comments and drafting suggestions, and to the New Zealand authorities for their assistance with obtaining the information and clarifications necessary to prepare the paper. Special thanks go to Françoise Correia and Chantal Nicq for technical assistance and to Rosemary Chahed and Jan-Cathryn Davies for secretarial assistance.
 2. The five members of the tax review team as well as the terms of reference of the review were announced by Finance and Revenue Minister Michael Cullen on the 5 October 2000.

Box 1. Key elements of tax reform in New Zealand since 1984

The main elements of tax reform were introduced during the second half of the 1980s. The overall direction was to improve the efficiency and equity of the tax system by implementing a broad-based, low-rate system and removing tax preferences (see, for instance, Stephens, 1993). Key policy initiatives included:

- Reduction of the top individual marginal rate from 66 to 33 per cent (increased to 39 per cent in 2000);
- Reduction of the tax rate from 48 to 33 per cent for resident companies and from 53 to 38 per cent for non-resident companies (later aligned at 33 per cent);
- Substitution of a single-rated and broadly based value added tax, the Goods and Service Tax (GST), for diverse wholesale sales taxes (the initial GST rate of 10 per cent was increased to 12.5 per cent in 1989);
- Removal of most tax expenditures by abolishing a wide range of business investment incentives, including export incentives and investment allowances;
- Introduction of a comprehensive fringe benefit tax payable by employers for in-kind compensation provided to employees;
- Introduction of an imputation scheme for corporate dividends to eliminate double taxation of company income distributed to shareholders;
- Introduction of accrual rules which ensure that all returns on "financial arrangements", broadly defined to include most debts and arrangements where there is a deferral of the passing of consideration, are brought into the tax net on a progressive basis over the term of the financial arrangement concerned;
- Removal of tax preferences for income earned and distributed from pension schemes, placing such saving on an equal footing with other forms of saving;
- Introduction of withholding taxes on interest and dividends;
- Introduction of rules aimed at taxing the foreign-source income of New Zealand residents on a current basis (regardless of the foreign entity through which that income is earned and regardless of when the income is distributed).

The background to these radical changes has been discussed in several *Economic Surveys* on New Zealand (see OECD 1998 and OECD 1999a). Besides a widespread "crisis consciousness" in the public stemming from past policy failures, the reforms were presumably publicly and politically accepted because they were perceived to be fair and administrable, not least because they were deeply rooted, bold and contained a "no exemption" spirit. New Zealand's experience also highlights the importance of sequencing and timing of tax reforms. Taxpayers accepted higher tax burdens from the elimination of investment and savings incentives, broader bases and the introduction of the GST as a trade-off for lower marginal tax rates and more generous allowances to families at the bottom end of the income scale (Toder and Himes, 1992).

The economic context shaping tax policy

International aspects play a key role

3. Tax policy in New Zealand is grounded within a coherent overall strategy, and changes to various parts of the system are generally scrutinised with a view to how these might affect the efficiency, equity and simplicity of the system as a whole. As in other countries, the tax system reflects a mixture of economic characteristics and political preferences. In particular, the openness of the economy implies a strong focus on international aspects of the tax system - how to promote high economic returns on investment carried out by New Zealand residents and at the same time protect the domestic tax base. Since factors like capital and highly-skilled labour are to a large and increasing extent mobile across borders, tax policy in New Zealand must be carried out with a view to developments elsewhere. One example is the recent decision in Australia to lower its corporate tax rate to 30 per cent by 2001/02, which may reduce New Zealand's future room for manoeuvre in this area.

Household savings are low

4. New Zealand's rate of national saving is lower than in most other OECD countries, giving rise to large and persistent current account deficits as investment levels are not correspondingly subdued. In particular, the *household saving rate* is lower than in most other OECD countries (Figure 2), although official national accounts data may give an incomplete picture of both levels and trends in saving insofar as they do not take wealth effects into account (Figure 3).³

(Figure 2. Saving rates across OECD countries)

(Figure 3. Various measures of household saving)

5. The question is whether tax policy could and should contribute to raise national saving levels, either through its effects on private savings, or government savings, or both.⁴ Empirical evidence as well as theoretical considerations do not suggest that tax policy would be very effective in changing private or household saving levels (Box 2). Increasing government savings through higher taxes, assuming government spending is unchanged and private savings not reduced correspondingly, is probably a more effective strategy for raising the national saving rate (Leibfritz *et al.*, 1997 and Edwards, 1995), but the costs would be higher deadweight losses and lower economic activity.⁵ It follows that tax policy in general is not an appropriate instrument for changing saving *levels*. The situation is somewhat different with respect to the *composition* of savings, where international and domestic evidence point to substantial effects from tax changes (see, for instance, Bernheim, 1999 and Arthur Andersen, 1999). Non-neutralities in New Zealand's tax system hence play a significant role in the tendency towards "oversaving" in housing and "undersaving" in productive assets (as discussed below), which to some extent reduces the long-term growth potential of the economy.

Box 2. Empirical and theoretical evidence on the effects of taxation on household saving levels

The effect on household savings from lower income taxes depends on the elasticity of savings to changes in the after-tax rate of interest.¹ This effect is ambiguous since income and substitution effects pull in opposite directions unless the household sector is a net debtor. If this elasticity is positive (higher after-tax returns result in higher savings), it follows that, all else being equal, a tax on income would depress household savings more than a tax on consumption, since the latter does not affect the after-tax interest rate. In that case, a change in the tax mix from income to consumption taxes would increase the level of household savings. Most empirical evidence points to small and/or statistically insignificant effects of such a shift in the tax mix - see Choy (2000) for an application to New

3. For more detailed discussions, see OECD (1998), OECD (1999a), Savage (1997) and Scobie (2000). There are arguments for and against the inclusion of changes in housing wealth in the estimate of household saving rates. In any event, it is possible that part of the decline in household saving rates since 1992 shown by national accounts data may have been a response to the build-up in the capital value of the housing stock during the house price boom from 1993 to 1996 (a wealth effect encouraging higher consumption). There is also a possibility that changes in household saving rates may simply reflect a tendency to offset - at least partly - saving changes in the business and government sectors (Ricardian equivalence). Finally, it should also be noted that the apparent trend decline in the household saving rate, as measured by national accounts data, disappears when adjusted for inflation: measured over the past 30 years, the inflation-adjusted household saving rate seems to have been characterised by a constant mean, but with strong pro-cyclical fluctuations (Scobie, 2000).
4. It could be argued that for an open economy with access to world capital markets, there is no particular reason for economic policy to be concerned with domestic saving levels, since any lack of domestic savings can be covered by inflows of foreign savings. However, to the extent that foreign borrowings are not invested at a sufficient return and/or the level of foreign debt places a risk premium on such borrowings, the need for higher domestic savings is greater.
5. The alternative, keeping taxes unchanged and reducing government expenditure, may imply (but not necessarily) a smaller efficiency loss than raising taxes with unchanged expenditure.

Zealand.² In a survey of empirical work, Bernheim (1997) thus concludes that “there is little reason to believe that households increase their saving significantly in response to a generic increase in the after-tax return”. However, a recent study by Tanzi and Zee (2000) points to more significant positive effects on the level of private savings from lower marginal income taxes when measured across a panel of OECD countries. Overall, however, the theoretical and empirical evidence provides hardly any firm ground for relying on tax policy to affect private savings levels on a significant and permanent basis.

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1. In addition to, and separate from the interest elasticity of savings, there may also be a short-term impact on saving levels from the income elasticity of consumption: if consumption changes by less than disposable income following changes in taxes, the level (and rate) of saving will also change. However, since the income elasticity of consumption is (close to) unity in the long run, this effect will disappear over time.
 2. A massive amount of empirical research has also been carried out on the extent to which tax-sheltered retirement savings schemes (such as the IRAs and 401k's in the United States) have raised private and national saving rates. The evidence is rather mixed. It generally points to small or no effects on overall private savings but a significant reshuffling of existing savings into the tax-preferred instruments (see Bernheim, 1999 for a recent survey).

Ageing of the population and the funding of public pensions put pressure on expenditure and may affect private savings

6. Part of the reason for low household savings may relate to the universal access to welfare benefits and services provided by the government (such as education, unemployment insurance and pensions), which would otherwise constitute key motivations for household saving.⁶ If the government saves sufficiently for these purposes, there is no need for the private sector to do so, although the balance between public and private savings may have an impact on overall allocative efficiency. The overriding concern is whether the combined government and private savings for future retirement benefits are too low and the returns to national savings are sufficiently high. Private pension savings and other long-term savings are lower than in most other OECD countries (Figure 4), partly as a result of the abolition in 1989 of all tax preferences to such savings (Davies, 1995) as well as the generosity of the public pay-as-you go pension scheme, the New Zealand Superannuation (NZS).⁷

(Figure 4. Financial assets of institutional investors in OECD countries)

7. The government recently announced its intention to start pre-funding the New Zealand Superannuation (see Budget 2000). If realised, this will imply that the tax-to-GDP ratio and hence government saving over the next 20 to 25 years will be higher than with a balanced budget strategy. Pre-funding is consistent with the traditional tax-smoothing argument: since economic distortions rise more than proportionally with effective tax rates, it would be desirable to stabilise these tax rates over time (Barro, 1979). This argument, however, relies on the presence of sufficiently effective control mechanisms to avoid expenditure creep in the presence of large and sustained fiscal surpluses during periods of accumulation of government assets (Pinfield, 1998). Moreover, the higher tax/GDP ratio will, at least to some extent, suppress economic activity, capital formation and hence future incomes. It may also induce

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6. This is not the whole story, however: several other countries with universal access to welfare benefits and public services at similar or even more generous levels than New Zealand also have higher household saving rates as well as current account surpluses (such as Denmark, Norway, Finland and the Netherlands).
 7. The life insurance, superannuation and managed funds industry has captured the largest share of growth in household financial assets since the removal of capital market controls in the early 1980s. However, the share of these assets in total household financial assets has been rather stable since the abolition of tax incentives in the late 1980s (Thorpe and Ung, 2000).

private agents to reduce their own long-term savings due to the greater certainty of the public pensions being sustained at a high level.

Positive features of the tax system⁸

Consumption and property taxes are less distortionary than elsewhere

8. More than 50 per cent of total revenues are raised from income taxation, which is a higher share than anywhere else in the OECD and much higher than the OECD average of around 35 per cent (Figure 5). This discrepancy is considerably narrowed when taking into account that New Zealand levies only a very limited amount of social security contributions (*i.e.* the workplace accident insurance premium, ACC). The share of consumption taxes is just above one-third of total revenues, slightly higher than the OECD average. The introduction in 1986 of a broadly based value added tax (the goods and services tax, or GST) has contributed to shifting the tax burden from income to consumption (Panel B). Consumption taxes are also raised more efficiently than elsewhere, since the share of total consumption tax revenue raised through value added taxes is the highest among OECD countries levying such a tax (Figure 6).⁹ The share of revenues from taxation of property is in line with those of other countries, and the composition shows a relatively large share of holding taxes compared with transaction taxes (Figure 7).¹⁰ This indicates that property taxation is not acting as a significant barrier to the efficient use of land.

(Figure 5. Tax mix in selected OECD countries)

(Figure 6. Share of value added tax in total consumption tax revenues in OECD countries)

(Figure 7. Property taxation in OECD countries)

Marginal tax rates are moderate and bases relatively broad¹¹

9. Taxation of personal income is moderate overall, although the interaction between tax rates and the abatement of tax credits and welfare benefits may create excessively high effective marginal rates for some income groups and family types, as discussed below. A special tax credit, the "low-income rebate", was introduced in 1988 to impose a lighter average tax burden on persons with low wage and salary incomes.¹² Hence, labour income is now taxed at a four-rate progressive scale, while other income is taxed at a different scale with three rates. The low-income rebate has the merit of retaining the original higher taxation of the intra-marginal income of middle- and high-income earners, allowing marginal tax rates to remain moderate for income groups outside the targeted regime. Overall, marginal tax wedges on labour

8. Key statutory features of New Zealand's tax system are outlined in Annex I.

9. Other consumption taxes, such as excises or tariffs, are typically found to be more distortionary than value added taxes (see, for instance, Guerin, 1999).

10. However, income tax data do not allow capital gains taxes paid on housing to be singled out from other revenues. Nonetheless, since most gains are untaxed, the share of capital gains tax revenue is presumably marginal.

11. Annex tables A1-A3 compare main statutory features of personal and corporate income taxation as well as the VAT systems for selected OECD countries.

12. It also reduced the marginal tax rate for very low-income earners, *i.e.* those with an annual income below NZ\$ 9 500.

income are moderate for most individuals, as shown by a relatively low average marginal tax wedge, i.e. weighted across the entire distribution of incomes (Figure 8).¹³

(Figure 8. Weighted marginal tax wedges across OECD countries)

10. The recent hike of the top marginal tax rate on personal income to 39 per cent was officially justified by distributional concerns, including the need for raising revenues for re-instating a higher NZS benefit. The increase in the top marginal rate marked a break with the principle of aligning marginal personal and corporate tax rates. This will imply stronger tax-shifting incentives and larger efficiency losses. However, only relatively few taxpayers are immediately affected by the higher marginal tax rate and the economy-wide consequences may hence be limited - although the number of *potentially* affected people, i.e. whose marginal tax rates may run into the 39 per cent range if their income increases, could be more substantial.¹⁴ Moreover, it should be noted that no other OECD country has uniformity of top rates in the personal and corporate income tax systems and that the gap created by the tax increase is still smaller than in many other countries (Figure 9). The comprehensive taxation of most kinds of personal income combined with the dividend imputation system ensures that maximum all-in tax rates for individuals are moderate and uniform across most sources of income (excluding capital gains and imputed rental income of owner-occupied housing, as discussed below).

(Figure 9. Highest all-in tax rates in selected OECD countries)

11. The flat 33 per cent statutory corporate tax rate is in the middle of the range of the rates applied in other OECD countries and is slightly below the unweighted OECD average of 36 per cent. Tax revenue from the corporate tax has been around 4 per cent of GDP in recent years, somewhat higher than the OECD average of 3.3 per cent - a rough indication that the corporate tax base in New Zealand is probably broader than in the average OECD country (Figure 10).¹⁵ Due to the imputation credit system, the corporate tax is merely a withholding levy on the final individual income tax for residents. However, for non-residents, the corporate tax rate may matter to the extent they are not credited for such underlying tax in their home countries. Rules for loss carry-over and consolidation of losses within holding companies are generally less restrictive than in most other OECD countries (cf. Table A2). Although this may have negative consequences for revenues, it allows companies more flexibility for restructuring and lower compliance costs.

(Figure 10. Taxation of corporate income in OECD countries)

12. Tax preferences to corporations are limited, although general tax relief is provided through the accelerated depreciation scheme ("loading").¹⁶ Concessions are also given to forestry and mining as well as certain kinds of intangible assets, such as intellectual property rights. The limited use of targeted tax

13. The marginal tax wedges for different income groups are based on the OECD's tax equations for production workers, which also include social security contributions. A few limitations of these data should be borne in mind. First, take-up rates for deductions and exemptions as well as fringe benefits are not included in the tax equations. Second, large groups of taxpayers, such as the self-employed, retirees and transfer recipients, do not pay social security contributions in many countries.

14. Tax data for 2000/01 show that around 7 per cent of personal tax payers had taxable incomes above NZ\$ 60 000, where the 39 per cent rate kicks in. Some 4 per cent had incomes in the range NZ\$ 50 000 to 60 000, 11 per cent in the range NZ\$ 40 000 to 60 000 and 23 per cent in the range NZ\$ 30 000 to 60 000.

15. This is indicative only since no account is taken for differences across countries in the composition of GDP nor of taxation of income not included in GDP.

16. The depreciation loading allows depreciation rates to be set at 120 per cent of estimated economic depreciation. However, this implies only a modest divergence between taxable income and "true" economic income (Arthur Andersen, 1998).

incentives implies that investments are generally directed to applications with the highest economic returns (Box 3).¹⁷ In comparison with other OECD countries, marginal effective tax wedges across various investment and financing vehicles are almost uniform, pointing to low overall tax-induced distortions to corporate financing decisions (Table 1).¹⁸ Moes (1999) provides evidence that the neutrality of New Zealand's corporate income tax system increased substantially following the tax reforms of the 1980s and the transition to a low-inflation economy.

Box 3. Adverse economic effects of targeted tax incentives to the business sector

While investors base their investment decisions on expected after-tax returns, the value to the whole economy of an investment is determined by its pre-tax return. If some investments are more lightly taxed than others, differences arise between their pre- and post-tax rankings, resulting in investment patterns that do not generate the highest overall return from a national viewpoint. Lower and more even tax rates across investments (as well as organisational business forms) reduce this distortion. Differences in marginal effective tax rates arise mainly from varying depreciation rules and other tax concessions. Targeted tax incentives for certain sectors or activities are particularly harmful to the economy since they:

- Are difficult to target appropriately. Ideally tax incentives seek to remedy market failures, for instance perceived under-investment in R&D, but to identify such failures requires more information than is normally available. The result is that incentives are often given too widely, which is overly expensive, or too narrowly, whereby they may have little effect.
- Encourage unassisted sectors to waste effort (from the viewpoint of the whole economy) in lobbying for concessions for themselves.
- Lead to increased avoidance and evasion (and costly administrative counter-measures) by attempts to characterise otherwise non-qualifying income or expenditure so that it qualifies for the concession. Therefore, subsidies may flow to unintended activities, persons or companies.
- Subsidise activity that would take place anyway.
- Imply a loss of revenue that is difficult to control.
- Are less transparent than explicit subsidies.

(Table 1. Marginal effective tax wedges in manufacturing in selected OECD countries)

13. New Zealand's value-added tax, the Goods and Services Tax (GST), was introduced in 1986 at a flat standard rate of 10 per cent. The rate was raised to 12.5 per cent in 1989. This is lower than most European VAT-levying countries but higher than Australia (10 per cent) and several Asian countries (including Japan and Korea). By imposing a single uniform rate, the GST avoids the drawbacks of systems with multiple rates. The level of exemptions is also lower than in most other countries, leading to the

17. This indicates that New Zealand's relatively weak productivity performance over the past couple of decades is presumably not caused by features of the corporate tax system.

18. The smaller the variance in tax wedges across financing and investment instruments, the smaller is the overall distortion. The marginal effective tax wedge reflects the pre-tax rate of return an investment has to earn in order to provide an individual investor with the same after-tax return as a bank deposit earning a pre-tax 4 per cent real rate of interest. The estimates shown in Table 1 are based on the King-Fullerton methodology (see OECD, 1991). The results should be interpreted with caution, since they may not adequately reflect the effects of taxation on incentives when making investment and financing decisions. The marginal investor, for instance, may not be a fully complying individual (as assumed here) but rather a *de facto* tax-exempt entity. Other simplifying assumptions include perfect competition, a rudimentary treatment of financial structures and the intermediation process, the absence of uncertainty, perfect loss offsetting and capital irreversibility. For a discussion of these assumptions and data measurement issues, see OECD (2000).

highest degree of effectiveness of the value-added tax in the OECD (Figure 11).¹⁹ As in other countries, problems of enforcement and equitable treatment are encountered in areas such as imported services, electronic commerce and second-hand goods and may place a constraint on potential future revenues from the GST.²⁰ Like other OECD countries, New Zealand also imposes a range of excises and duties on various activities and products, in particular petrol, alcohol and tobacco, but these amount to a rather small share of the total tax take. Import duties are larger than in most other OECD countries, around 2½ per cent of total tax revenues compared with an OECD average of 1.4 per cent.

(Figure 11. Effectiveness of value added taxes in OECD countries)

14. The role of environmental taxes will be considered as part of the tax review. Revenues raised from environmental taxes (in particular, taxes on fuel and road user charges) comprise a share of less than 5 per cent of total tax revenues, which is somewhat below the OECD average. More telling, perhaps, is the fact that the tax on diesel fuel is much lower than that on unleaded gasoline - indeed the lowest in the OECD (Table 2) - indicating that the main consideration behind the fuel tax structure is to gather revenue rather than pursue environmental objectives.²¹

(Table 2. Shares of taxes in total fuel prices in OECD countries)

15. The overall favourable mix of modest tax rates and broad bases implies that the deadweight costs (or excess burden) of taxation in New Zealand is probably at the lower end of the range of OECD countries. Diewert and Lawrence (1994) found that the deadweight costs associated with labour taxation (primarily taxation on the income of wage earners and the self-employed) in New Zealand are around 18 per cent for the marginal dollar of income tax revenue raised and around 14 per cent of the marginal dollar of consumption tax revenue raised.²² Although these costs are by no means insignificant, they are still moderate compared with estimates of deadweight costs found for other countries, which are typically in the range of 10 to 100 per cent.²³

Preferential tax treatment of pension savings and fringe benefits is limited

16. Unlike other OECD countries, New Zealand does not subsidise private pension plans - *e.g.* life insurance and private superannuation schemes - by preferential taxation. Contributions as well as current earnings of pension funds are taxed, while the benefits are tax free, leaving pension savings to be taxed in a way similar to that of all other kinds of savings (the so-called TTE tax treatment).²⁴ In contrast, most other

19. The effectiveness of the value added tax is measured as the effective rate (defined as value added tax revenues divided by consumption) as a per cent of the statutory rate. High effectiveness indicates that the base is broad and/or that compliance is high.

20. See, for instance, Inland Revenue Department (1999*a* and 1999*b*).

21. It should be noted, however, that truck owners have to pay road user charges for the cost of trucking in terms of road wear (depending on distance driven and the weight of the vehicle).

22. These costs are additional to the collection costs.

23. See Diewert and Lawrence (1994) and Leibfritz *et al.* (1997). In particular, the former study refers to estimates of deadweight costs in Australia ranging from 23 to 65 per cent and 17 to 56 per cent in the United States. Scully (1996) found that a tax/GDP ratio of around 20 per cent would be optimal for New Zealand in a growth-maximising framework. The study, however, contained severe methodological weaknesses and has largely been dismissed by most tax experts as well as the government (see, for instance, Inland Revenue Department, 1999*c*).

24. The first T stands for tax on contributions, the second T for tax on earnings of the funds and the last E states that benefits are exempt from tax.

OECD countries exempt the contributions and earnings of private pension schemes, while taxing benefits. Hence, they apply an EET tax treatment to such schemes (Table 3).²⁵ As the current earnings of private superannuation funds are taxed at the corporate rate of 33 per cent, individual taxpayers with lower marginal rates are overtaxed (compared with ordinary savings). With the recent hike in the top personal tax rate to 39 per cent, taxpayers in this bracket receive a subsidy.²⁶

(Table 3. Tax treatment of private pensions in OECD countries)

17. Employers' contributions to private pension plans are taxed at 33 per cent, which previously prevented this kind of remuneration from receiving tax concessions (and indeed penalised it for low- and middle-income earners). But with the increase in the top personal marginal rate to 39 per cent, high-income earners now receive a tax preference of 6 percentage points on such contributions. There are no restrictions on their amount, but they must stay in the superannuation fund until the employee leaves the job or withdraws the money for reasons of "significant hardship". Otherwise, a 5 per cent withdrawal tax is applied.

18. New Zealand applies a much more comprehensive taxation of fringe benefits than most other OECD countries. The fringe benefit tax, paid at the corporate level, was previously levied at the highest personal marginal tax rate. This was administratively simple and effectively eliminated tax preferences for benefits in kind over straight pay. The drawback was that employees with marginal tax rates below the top rate were overtaxed. With the recent hike in the top personal rate, the fringe benefit tax rate was adjusted accordingly, implying even more over-taxation of middle- and low-income earners. To remedy this deficiency, employers have recently been given the choice of paying a flat tax on all fringe benefits (corresponding to a 39 per cent marginal tax rate at the level of the individual recipient), or to apply a multi-rate system of the fringe benefit tax.^{27,28} The latter implies that some items are now taxed at the marginal tax rate of the individual recipient, while fringe benefits that are not attributed to individuals, are subject to fringe benefit tax at a flat rate of 49 per cent. Although improving the equity of the fringe benefit

25. A more detailed discussion of the various kinds of tax treatment applied to pension saving in OECD countries and their economic effects is given in, for instance, Dilnot (1992), Arthur Andersen (1999) and Dalsgaard and Kawagoe (2000). Besides New Zealand, a few other countries (Australia, the Czech Republic, Denmark, Luxembourg and Sweden) deviate from the general EET treatment of pension saving, although these countries still subsidise private pension saving to some extent. For instance, the pension tax regime in Australia imposes taxes at all three stages (contributions; earnings; and benefits), but at relatively low effective rates. It hence offers some subsidisation of pension saving, but there is a significant reduction in the net value of benefits received compared with an EET treatment (Atkinson, Creedy and Knox, 1999).

26. The previous government attempted to solve the problem of inequitable taxation of the earnings of superannuation funds but did not succeed in passing a proposal through parliament.

27. The flat fringe-benefit tax rate corresponding to 39 per cent at the individual level is 64 per cent. This can be seen as follows: the fringe benefit is tax free at the level of the employee, hence the employee is indifferent between receiving a taxable wage of NZ\$ 1 and a tax-free fringe benefit worth NZ\$ $(1-t^i)$, where t^i is the individual's tax rate. The cost to the company of providing the fringe benefit is thus $(1-t^i)$, which is deductible. In order to ensure that the same total amount of tax is being paid on the fringe benefit as on a corresponding ordinary wage, the company has to pay a tax rate of $t^f \cdot (1-t^i) = t^i$ on the fringe benefit, hence $t^f = t^i / (1-t^i)$. If t^i is 39 per cent, then $t^f = 0.39 / (1-0.39) = 64$ per cent. Since the fringe benefit tax payment is tax deductible at the company level, the total combined tax paid by the company and the employee will be exactly the same whether remuneration takes the form of a fringe benefit or ordinary salary.

28. The new rules for the multi-rate fringe benefit tax were introduced in the March 2000 tax bill. The rules apply as follows: certain benefits (motor vehicles other than pooled vehicles, low interest loans and other benefits with a taxable value exceeding NZ\$ 1 000 a year) must be attributed to the individual employee receiving them and taxed at the employee's marginal tax rate. Fringe benefits not attributed to an individual employee as well as pooled fringe benefits (such as pooled motor vehicles) will be subject to fringe benefit tax of 49 per cent.

tax, compliance costs will also increase, unless the employer chooses the flat-rate option. The scope for avoidance may also have been increased by keeping the pooled-item tax at 49 per cent (i.e. effectively 33 per cent at the personal level).

The international tax regime is relatively comprehensive and sophisticated

19. New Zealand's international tax regime has seen major reforms over the past decade. These have sought to reduce the domestic cost of capital, to limit avoidance and deferral of taxes, and to improve neutrality for residents' between investing at home and abroad, while also observing a practical need for generating revenues from cross-border income flows. These objectives are to some extent mutually incompatible, which requires complex trade-offs to be made. The key principle guiding the international tax regime is that of taxing residents' foreign- and domestically-sourced income as equitably as possible so as to promote an efficient allocation of their investments. The principle of taxing residents on their worldwide income is widely applied in OECD countries.²⁹

20. As most other countries, New Zealand has gradually reduced taxation on the returns from inward investment since the late 1980s. The concern is that such taxes add to the pre-tax return foreigners require for holding New Zealand assets, hence shifting the burden of the tax onto New Zealand residents. This is particularly burdensome for New Zealand, given the rapid accumulation of net foreign liabilities caused by the large and sustained current account deficits. Such considerations have led to the introduction of the foreign investor tax-credit scheme and the approved issuer levy, which effectively lower the tax burden on foreign capital (Annex II). A recent step in the same direction was the introduction of the "conduit regime" in 1998. This regime significantly reduces the effective taxation of foreign shareholders on non-domestic income generated by New Zealand companies.³⁰

21. Counteracting the incentives for residents to divert income through low-tax foreign entities necessitates a battery of anti-avoidance and anti-deferral measures. In the New Zealand case, as for most other OECD countries, these include rules for transfer pricing, thin capitalisation, controlled foreign companies (CFCs) and foreign investment funds (FIFs). With respect to the two latter regimes, New Zealand applies somewhat stricter rules than other OECD countries. The CFC regime basically implies that New Zealand residents (parent companies) are taxed on a current basis on their share of income earned by foreign affiliates in order to disallow income to be accumulated offshore at lower tax rates than domestically. The CFC regime is broader than elsewhere, since it includes all kinds of economic activity, whereas most other countries apply CFC-rules only to "passive" investment income and a limited class of

29. New Zealand, as most other countries, does not apply a pure residence-based taxation as prescribed in the traditional theory of optimal taxation (see for instance Diamond and Mirrlees, 1971 and Feldstein and Hartman, 1979). The theory suggests that a small open economy should tax the return to capital export (net of underlying foreign taxes) at the same rate as domestic capital (in order to avoid any distortion in the allocation of capital invested at home and abroad), and capital imports should not be taxed at all. This result is valid only in the absence of untaxed economic rents on inward foreign direct investment. Depending on the elasticity of supply of inward investment, the optimal tax rate on imported capital may be higher than zero (Hines, 1997). Moreover, the government may in practice be constrained in setting the effective tax rate on capital exports equal to that on domestic capital.

30. See Harris (1998) for a critical evaluation of the conduit regime. He concludes that it is more complex than those of, for instance, Australia and the United Kingdom. He also concludes that it is patched onto, rather than incorporated in the corporate tax framework, and that the mechanism adopted is inequitable and inefficient because New Zealand companies engaged in the same offshore activities are not treated in the same manner. It should also be noted that in order to make the conduit regime entirely coherent, the 15 per cent non-resident withholding tax would ideally have to be abolished (thereby fully exempting non-residents from tax on income earned overseas).

“active” business investments.³¹ The FIF rules may also, in some circumstances, give rise to higher effective taxation of international portfolio investments (excluding investment in grey-list countries - see below) than of domestic portfolios. This is particularly the case since the taxation of capital gains is more stringent under FIF rules.³² Furthermore, New Zealand applies the CFC and FIF regimes to many more jurisdictions than most other countries, where the imposition of such rules is generally limited to jurisdictions classified as tax havens.³³ New Zealand has thus chosen to put more weight on equity considerations (between investing domestically and abroad) and less emphasis on competitiveness of domestic firms operating in foreign markets.

22. After implementing the CFC and FIF rules in the late 1980s, New Zealand chose unilaterally to exempt investment in some countries from these rules, the “grey-list” countries. Countries currently on the grey list are the United States, Japan, Germany, the United Kingdom, Canada, Australia and Norway. They cover around 80 per cent of New Zealand’s income from outward foreign direct investment. The intention of the grey list is to eliminate the high compliance costs associated with the FIF and CFC rules for investment in countries where New Zealand residents are thought unlikely to invest for tax reasons. Hence it reflects a trade-off between enforcement of tax payments from offshore entities and equity considerations on the one hand and the practical necessity of trying to limit compliance costs on the other. Predictably, this has given rise to various loopholes, such as financial institutions in grey-list countries being used as conduits through which New Zealand residents can invest - with tax favouritism preserved - into non-grey-list low-tax jurisdictions. There are look-through rules within the CFC regime to prevent such kinds of avoidance, but these rules do not apply within the FIF regime.

Local governments have a high degree of autonomy subject to balanced budget rules

23. Local governments raise only around 5 per cent of total government tax revenues against an average of around 13 per cent in other unitary-government OECD countries and more than 30 per cent raised by state and local governments on average in federal OECD countries. More interestingly, however, local autonomy in setting tax rates and bases is greater than in any other OECD country (OECD, 1999b). The main source of tax revenues is the so-called “rates”, which are taxes on the holding of real estate. Rates are generally based on a mixture of land (unimproved) values and/or capital (land plus improvements) values, which are determined on three-yearly valuation cycles. Local governments have full discretion to set the rates, subject to a general balanced budget requirement.³⁴ Other revenue sources include user charges and fees as well as surpluses from local government enterprises. There are no block

31. Most countries are willing to forego current domestic tax on undistributed earnings of foreign affiliates of domestic firms if these represent “active” foreign incomes (that is, the domestic corporation is operating in the foreign market for non-tax business reasons). By deferring any additional home-country tax on such earnings, this policy helps place foreign affiliates of domestic firms on a more level playing field with firms subject to the same host country tax burden. New Zealand’s strict application of the CFC rules can be viewed as a way to move the tax system closer to the residence principle (Devereux, 1996).

32. While domestic gains are mostly untaxed - and if taxed, then on a realisation basis - capital gains are always taxed under FIF rules and often even on an accrual basis.

33. New Zealand applies the CFC and FIF regimes to all jurisdictions, except seven countries defined as “grey-list” countries (see below).

34. Local authorities are required by law to set operating revenues at a level sufficient to cover operating expenses in any financial year (with a few relatively narrow exceptions to run deficits). There is no regular, formal role for central government in reviewing or approving the budgets of local authorities and also no obligation on central government to assist those local authorities which experience financial difficulty. For example, the Local Government Amendment Act (No 3) of 1996 states explicitly that local authority loans are not guaranteed by central government. However, in rare cases the central government has provided limited financial assistance to local authorities.

grants from central to local government, but the central government does contribute funding to certain local government functions, in particular transportation as well as road construction and maintenance.

There are ongoing efforts to improve tax administration

24. Administrative and compliance costs form part of the economic costs of the tax system in addition to the efficiency losses caused by tax-induced deadweight costs, as discussed above. Evidence - although inherently very uncertain and fragile - points to compliance costs in the order of 2½ per cent of GDP and administrative costs of around ½ per cent of GDP.³⁵ Compliance costs in particular appear to be relatively significant compared with other countries (Table 4), but as such quantitative estimates are fragile and not readily comparable across countries, they should be interpreted with great caution. Compliance costs in New Zealand are found to be much higher for business tax than for the withholding tax on wages, the fringe benefits tax and the GST. Furthermore, they tend to fall more heavily on small businesses, which are thus put at a disadvantage compared with larger firms - a pattern, which is by no means unusual across OECD countries (Sandford, 1995). Recent initiatives by the authorities to reduce compliance costs and thereby increase compliance include a major rewrite of the tax law to enable taxpayers to understand their obligations more easily and to make the law more accessible; the introduction of a “binding ruling” regime that enables taxpayers to have, as far as possible, certainty as to the future tax treatment of business transactions; new and more efficient dispute resolution procedures; more active involvement of the private sector in designing tax policy through the “Generic Tax Policy Process” and introduction of electronic filing for most personal taxpayers so that most salary and wage earners no longer need to file income tax returns.^{36,37} The next step is to consider extending simplification to the self-employed and other non-wage earners, which will be a more difficult task.³⁸

(Table 4. Estimates of compliance costs in selected OECD countries)

35. See Sandford and Hasseldine (1992). The study was carried out for the income year 1991. No more recent estimates for overall compliance costs are available.

36. The Generic Tax Policy Process was introduced in 1995 as a mechanism to give affected parties a formal voice in the formulation of tax policy changes. The process ensures that extensive consultations between the government and private-sector parties take place from the early stages in the policy process. The purpose is not to give the private sector a veto over policy initiatives, but to enable the government (and its officials) to tap the technical knowledge of the business community, to factor in compliance and administrative effects of policy changes as well as other concerns expressed by the private sector, and to communicate the rationale of policy changes.

37. Until 1999, salary and wage earners were required to file a tax return if their main sources of income were wages and salaries, interest or dividends. As part of a move toward tax simplification, a threshold has been introduced (currently NZ\$ 38 000) under which filing is voluntary unless the taxpayer has Family Support, Child Support or Student Loan obligations. From the 1999/2000 income year most of the 1.2 million wage and salary earners no longer had to file tax returns.

38. This category comprises the self-employed, shareholder employees, partners and any person who has significant other income that has no tax withheld, such as rental income. Such persons are required to pay provisional taxes, provided their final tax liabilities exceed a minimum threshold (currently NZ\$ 2 500). Of the 800 000 taxpayers in this group, 200 000 pay provisional tax, while the rest have relatively small amounts of income.

Main weaknesses of the tax system

Income tax bases are eroded by the absence of a comprehensive capital gains tax

25. Perhaps the single most important issue facing the tax system is the capital-revenue boundary. New Zealand does not have an explicit capital gains tax, but makes a distinction between revenue receipts, which are taxable, and capital receipts, which are tax exempt. This means that gains on shares and other assets not held on revenue account are not taxed³⁹ Furthermore, various other kinds of income, such as certain one-off payments to employees, are defined as capital and hence not taxed. The capital-revenue boundary is thus being used to transform what is, in substance, ordinary taxable income into the form of a tax-exempt capital receipt. Since the guidelines for what defines capital and revenue, respectively, are not always clear and transparent, the Inland Revenue Department often has to take decisions on a case-by-case basis. This involves resource-demanding ongoing discussion and legal cases with taxpayers to develop the necessary jurisprudence, leading to high compliance costs and taxpayer dissatisfaction, and it inevitably invites attempts to try to shift income into non-taxed forms.

26. It could be argued that a capital gains tax would enhance both horizontal and vertical equity since capital gains constitute an accretion of income (and hence raise the taxpayer's ability to pay).⁴⁰ Moreover, there are a number of adverse consequences of *not* imposing a comprehensive tax on capital gains, especially since New Zealand applies an otherwise comprehensive income tax system: the income tax base is narrowed; the allocation of savings and investment is distorted; tax-shifting behaviour is encouraged, in particular among high-income earners and wealthy individuals; and a non-level playing field is created among different financial instruments. These problems gain particular importance where close substitutes exist on both sides of the capital/revenue boundary. Some of the most notorious examples are the distinction between taxable "active" and non-taxable "passive" financial gains (for income not covered by the accrual regime) as well as various tax-exempt one-off payments to employees.^{41,42}

27. The main drawback of introducing a comprehensive capital gains tax is the practical problems of taxing accrued rather than realised gains as well as real rather than nominal gains. As a result, capital gains taxes may cause assets to be locked in to sub-optimal uses.⁴³ Furthermore, a capital gains tax may result in double taxation of retained earnings to the extent these are reflected in capital gains on shares.⁴⁴ Despite

39. Various measures exist that levy taxes on some capital gains, notably the accruals regime, which taxes gains on some financial arrangements in a comprehensive way (cf. Annex I). However, despite these measures, most capital gains remain untaxed.

40. Vertical equity refers to taxation according to ability to pay. Horizontal equity is achieved when individuals with the same economic capacity (measured, for example, by income) are taxed to the same degree.

41. Whether capital gains are classified as "active" or "passive" is determined by applying rather *ad hoc* methods, such as the so-called "trader/non-trader" test, to establish if there is an intention to earn from capital appreciation or not.

42. The government announced in its 2000 Budget various measures to tighten the taxation of such one-off payments. However, as long as the distinction exists between revenue and capital, there will be an incentive for employers and employees to find new ways of re-labelling remuneration as non-taxable forms.

43. Lock-in effects are defined as the holding of appreciated assets in order to defer tax on gains already accrued. This leads investors to accept a lower before-tax rate of return than they would require for new investment without such accrued gains, resulting in a distorted allocation of resources and an inefficient portfolio selection.

44. Assuming that retained profits are in fact deferred dividends that are reflected in the share values, the associated capital gains are already taxed at the company level.

such concerns, many OECD countries have chosen to impose capital gains taxes on a more or less comprehensive scale and for various reasons, including those listed above.⁴⁵ In general, no clear picture emerges when considering the tax treatment of capital gains across OECD countries, except that it generally appears to be lighter than taxation of other kinds of capital income (Table 5).

(Table 5. Taxation of financial gains in OECD countries)

Base erosion through tax preferences and boundary problems are compounded by the corporate entity structure

28. Together with the absence of a comprehensive capital gains tax, tax preferences given to certain kinds of investment, such as forestry and the acquisition of intellectual property rights (such as films), constitute vehicles for tax avoidance for (high-income) individuals. These investments are immediately deductible, and, since the stream of income only materialises over a very long time horizon or as untaxed capital gains, taxation can be avoided or deferred. Tax avoidance through such instruments is facilitated by the corporate tax structure, which allows “loss attributing qualifying companies” to allocate deductible losses to their individual shareholders (Box 4). Other avoidance vehicles include trusts, partnerships or setting up personal service companies between the individual taxpayer and his or her employer. These vehicles became more attractive as a result of the increase in the top personal marginal tax rate to 39 per cent, but have since then been weakened by the introduction of an attribution rule. This rule makes sure that income is attributed to the individual who delivers the service, regardless of whether a company structure has been set up between the individual and the employer (effectively a “look-through” rule).⁴⁶ However, some scope for avoidance remains, not least in the area of trusts, where business income, interest and dividends can be channelled to people with low marginal tax rates (for instance children or non-working spouses) as trust beneficiary income.⁴⁷

Box 4. Loss attributing qualifying companies

A loss attributing qualifying company (LAQC) is a closely held company with five or fewer unassociated shareholders, satisfying certain requirements (see Greenheld, 1998). Losses incurred by a LAQC *must* be attributed to shareholders in the year in which the losses are incurred. If shareholders have sufficient income (from other sources) to absorb the loss attribution, it is generally advantageous for a loss-making qualifying company to become a LAQC. However, this is not necessarily the case if shareholders are in a loss position or have marginal tax rates less than 33 per cent. In such cases the benefits forfeited by the company (not being able to carry the loss forward to future periods) may outweigh the benefits gained by the shareholders (a reduction in taxable income that is negative anyway, or obtaining a tax saving of less than 33 per cent). The number of LAQCs almost doubled over the period 1994-98 (from 15 000 to 30 000 companies) and so did the losses passed on to the shareholders (from NZ\$ 200 to 400 million, or from 0.2 to 0.4 per cent of GDP).

45. Some countries, including Japan and Korea, have attempted to use capital gains tax as an anti-speculative device, but only with limited success. Some countries also find that increases in private asset prices, such as land, caused by externalities from public development projects, should be taxed to capture some of the rent accruing to private owners (Dalsgaard, 2000).

46. The rule will apply only if certain criteria are met, most notably that at least 80 per cent of the income of the intermediary company is derived from the services of a single person or a single group of related persons. This is akin to the look-through rule applied in Australia.

47. For instance, in 1998 a total of NZ\$ 27 million of income stemming from business activities was distributed to children under the age of six. This figure excludes interest and dividend income distributed by trusts. The government is currently considering introducing legislation to tax trust distributions to minors at 33 per cent rather than the minor’s marginal tax rate, which would in many cases be 19.5 per cent.

29. The variation in tax treatment between different corporate entities implies that the choice of ownership is sometimes based on tax considerations rather than economic objectives such as risk sharing, governance or transaction costs (Arthur Andersen, 1998). The corporate tax system also contains other distortions, which may not be crucial for New Zealand's macroeconomic performance, but nevertheless contribute to less than optimal investment behaviour. One of the more remarkable flaws in the corporate tax law is the current tax treatment of R&D expenditure on capital goods (R&D outlays on wages and salaries are, of course, expensed). Depending on whether these expenditures are classified as being for "scientific research" or "development", the tax treatment of R&D investment can be concessional or penal relative to the treatment of other capital assets. R&D capital expenditures for "scientific research" can generally be written off immediately. This is concessional compared with the costs of creating or acquiring other capital assets (which are generally amortised over the life of the asset). On the other hand, R&D capital expenditure on "development" may not be deductible at all, the so-called "black hole" expenditure. The definitions of which R&D expenditure falls under which category are not at all clear, which adds to the uncertainty of the R&D investment decision (even though most companies are in practice able to manoeuvre their accounts so as to avoid falling into the R&D "black hole").

Personal income tax credits may discourage labour market participation of exposed groups

30. Unlike other OECD countries there are virtually no deductions in the personal income tax system, but several tax credit schemes are in place to lower effective tax rates for low- to middle-income taxpayers (see Annex I). The annual budgetary costs of these credits amounts to 1½ to 2 per cent of GDP. The credits mostly benefit individuals (and families) in the lower five income deciles, whose actual average tax rates are substantially below the rates that would have applied in the absence of such credits (Figure 12).⁴⁸ The abatement of the credits (as well as welfare benefits such as the domestic purpose benefit and the accommodation supplement), while helping to contain revenue losses, also implies potentially very high marginal effective tax rates (METRs) for persons in the abatement ranges. High METRS, up to the vicinity of 100 per cent, are to be found mostly for low-income earners with children, in particular sole parents (Figure 13 and Box 5). This is not surprising, since most tax preferences - as in many other OECD countries (OECD, 1997) - are targeted at families with children and since the domestic purpose benefit is mainly paid to sole parents.⁴⁹

(Figure 12. Average implicit tax rates)

(Figure 13. Marginal effective tax rates for various family types)

Box 5. Marginal effective tax rates for individuals

The likelihood of facing high METRs (say, over 50 per cent) for individuals in various family and income situations can be illustrated using the New Zealand Treasury's tax model and data from household expenditure surveys (Figure 14). Considering both marginal and discretionary income changes, it turns out that the likelihood of facing a METR above 50 per cent for low-income individuals (earning less than NZ\$ 25 000 per year, or two-thirds of an APW) is substantially higher when considering an income increase of NZ\$ 10 000 (one-quarter of an APW) rather than NZ\$ 1.¹ The reason is that more substantial income increases may take these persons into higher tax brackets and, more significantly, into the various credit abatement ranges, where METRs tend to be high. In particular, many sole parents and social assistance recipients find themselves in a position where their disposable income cannot be increased significantly unless full-time work can be found. The tax and benefit systems thus

48. The median taxable income in the fifth decile is as low as NZ\$ 14 400 per annum, only around one-third of the earnings of an average production worker.

49. Tax in New Zealand is levied on individual income, whereas welfare benefits and family assistance are targeted with reference to family income. The main objective for these instruments is to supply income support to low-income families. The various tax credits combine with the statutory tax rates and income-tested welfare benefits to yield a complex set of marginal effective tax rates (METRs).

interact to discourage part-time work.² Although this may encourage the search for full-time jobs, there is also a risk that it may keep people in long-term benefit dependency (an effect that is exacerbated by the absence of time limits for unemployment and domestic purpose benefits). Few persons earning more than NZ\$ 25 000 face METRs above 50 per cent (Panel B). For those who do, effective marginal tax rates tend to drop if an additional NZ\$ 10 000 is earned rather than only NZ\$ 1. This reflects the fact that such a large income increase may place them beyond the abatement range of income-tested assistance.

(Figure 14. Marginal effective tax rates: marginal versus large income increases)

1. Most labour market decisions are not “marginal” in the sense of working a few more hours or trying to earn a slightly higher wage but consist of large, discrete changes in status - from not working to working, from working part time to full time, or from changing between jobs with substantial differences in remuneration.
2. However, it should be noted that the share of part-time work in New Zealand is no lower than elsewhere in the OECD area. On the contrary, part-time employment is around 23 per cent of total employment against an OECD average of 14 per cent. The female share of part-time employment - around $\frac{3}{4}$ - is close to the OECD average (OECD 1999c).

31. High METRs may have substantial adverse consequences for the labour supply of disadvantaged groups such as sole parents.⁵⁰ However, there is no reason to assume that wider macroeconomic implications are substantial, basically since these groups are rather small.⁵¹ Moreover, New Zealand does not appear to have particularly high METRs for most family situations and income ranges compared with other OECD countries (Figure 15). The share of New Zealand taxpayers facing relatively low marginal tax rates (below 40 per cent) is also large compared with many other countries, while the share facing very high marginal rates (above 80 per cent) is more or less equal to those of other countries (Figure 16). Even though such shares may not give the full picture of those affected by high tax rates, since taxpayers respond to taxation, at least they provide an indication that overall labour market distortions caused by taxation are not more substantial in New Zealand than elsewhere - possibly quite the contrary.

(Figure 15. Marginal tax wedges on labour income in selected OECD countries)

(Figure 16. Distribution of marginal effective tax rates in selected OECD countries)

Allocative efficiency of household savings is hampered by horizontal inequities

32. Household saving rates in New Zealand are not only lower than in most OECD countries, the allocation of savings may also be less efficient, at least from a growth-maximising perspective. Many households hold basically one major asset (their residence) and one major liability (the associated mortgage). Since the implied rental value as well as capital gains on the residence are untaxed and, since the mortgage interest is non-deductible, the optimal saving strategy is to pay down debt, rather than diversifying the portfolio of assets. By exempting investment in housing from taxation other than the local property tax, a tax preference is (generally) allowed to such investment compared with financial

50. It should be stressed, however, that some of the credits causing the high METRs (the family tax credit, the child tax credit, the parental tax credit and the transitional tax allowance) are earned income tax credits, specifically designed to shift the balance between income in and out of work and thus to encourage labour force participation.

51. In particular, there are only around 150 000 sole parents out of a total working-age population of around 3 million individuals. The vast majority of the potential workforce is subject to moderate METRs of 50 per cent or less (Treasury, 2000). Unfortunately, there is not much empirical evidence available for New Zealand on structural labour market parameters such as the elasticity of labour supply and demand with respect to taxation.

investments, which are taxed on income and in some cases also on capital gains.⁵² The relative advantage allowed to housing investment depends on the amount of debt financing: non-deductibility of mortgage interest claws back the tax advantage so that only investors with fully equity-financed houses receive the full benefit of the preferential tax treatment. Comparing historical returns to various assets, there is a clear pattern that pre-tax returns to housing investment are significantly lower than those on equity investment. However, when taking into account the tax advantages allowed to housing, the *relative* after-tax performance of housing against other savings instruments is much more favourable (Table 6).⁵³ Over the 1990s as a whole, after-tax returns to investment in housing even turned out to match those of investment in equities (Westpac Trust, 2000).

(Table 6. Effect of taxation on asset returns)

33. The preferential tax treatment of housing implies that investment is diverted from more productive uses and possibly contributes to a higher cost of equity capital.⁵⁴ The share of owner-occupied housing in New Zealand is thus relatively high compared with other countries, as is the share of housing capital in household portfolios (Figure 17).⁵⁵ Preferential tax treatment of owner-occupied housing is widespread among OECD countries (Table 7), but it could have more adverse effects in New Zealand than elsewhere, since private pension saving is not subsidised as in other countries. Hence, there is not the same amount of pension assets to be invested in productive capital formation. This is a consequence of the New Zealand tax system being more neutral with respect to pension saving than elsewhere, but still not fully neutral across different kinds of saving. The high concentration of households' wealth in housing assets may also imply an undesirable macroeconomic exposure to the performance of the housing market. A "first-best" solution to reduce the "oversaving" in housing would be to align the tax treatment of such savings with that of any other savings instrument (imposing neutrality *vis-à-vis* more productive saving). This would require taxing the imputed rental value, while allowing mortgage interest as well as depreciation and maintenance costs to be deducted from the rental value.

(Figure 17. Housing investment in selected OECD countries)

(Table 7. Tax treatment of owner-occupied housing in OECD countries)

Further strengthening neutrality and efficiency

34. New Zealand has come a long way in implementing a truly comprehensive income tax system with broad bases and moderate rates. However, distortions stemming from remaining tax concessions have adverse consequences for equity and efficiency and should be addressed in a more thorough manner in order to reap the full benefits of an otherwise well-functioning tax system. Implementing a comprehensive capital gains tax as well as introducing taxation of the imputed rental value of owner-occupied housing

52. The exception to the general tax concession given to home-owners is where losses are incurred: since home-owners are not taxed, they cannot offset imputed losses (deficits in imputed rents less interest and maintenance) against other or future income, whereas commercial investment can use such losses to offset other income or carry them forward.

53. See, for instance, Westpac Trust (2000), Joint Working Group, Treasury Officials and ISI (1999) and Arthur Andersen (1999). These conclusions obviously depend on the time period over which the returns are considered and what implied rental values are assumed for housing. Moreover, they should be taken with some caution, since differences in risk between various investments were not considered.

54. This claim is valid only to the extent some market segmentation exists across countries, as shown by Feldstein and Horioka (1980), for instance.

55. There may be other - and more significant - explanations than taxation for the relatively high share of housing in total household assets, including the relatively low average disposable incomes of New Zealand households (Joint Working Group, Treasury Officials and ISI, 1999).

would be instrumental in this respect, in particular by contributing to an improvement in the allocative efficiency of household savings. Introducing tax incentives to other kinds of savings would not be a proper solution to the problem of savings allocation nor would it be effective in raising the level of private or national savings. A summary of recommendations for possible tax changes are given in Box 7 at the end of the chapter.

Broadening the base should be given first priority

35. Introducing a comprehensive capital gains tax would eliminate or substantially reduce many of the weaknesses of the tax system discussed above, in particular the non-neutralities arising at the capital/revenue boundary. Tax revenues from the capital gains themselves would presumably be marginal, but a much more significant effect would come from limiting tax-shifting possibilities and hence protecting the income tax base. A capital gains tax would also have re-distributional consequences since such gains accrue mostly to high-income and/or wealthy households. Broadening the income tax base by including capital gains would therefore effectively make the tax system more progressive without having to increase marginal tax rates - thereby improving the trade-off between equity and economic efficiency objectives.

36. The most obvious way of implementing the tax would be simply to include capital gains in the income tax base, but it could also take the form of a separate tax with a single flat rate somewhere in between the statutory rates in the income tax system.⁵⁶ Theoretically, the capital gains tax should be levied on an accrual basis, covering real gains arising from all household assets. In practice, however, it could be modified in several ways without limiting the bulk of beneficial effects. Taxation of gains on an accrual basis tends to create significant administrative problems with asset valuation and could have adverse effects on liquidity-constrained individuals and companies. In most countries, therefore, such a tax has been implemented on a realisation basis, and that would be appropriate here as well. In order to mitigate lock-in effects, interest could be charged on the deferred tax payment although this not a common practice in other OECD countries.⁵⁷ The potential double-taxation of retained earnings associated with a capital gains tax on shares could be overcome by taxing only the part of the gain that exceeds the increase in the stock of retained earnings of the company.⁵⁸ As the rest of the tax system, the capital gains tax could be on a nominal basis without causing undue distortions, assuming that the current low-inflation environment is sustained. A specific issue is whether it should apply to principal residences or not. Only very few OECD countries tax gains on owner-occupied housing, but practices in other countries may not be the best benchmark in this case⁵⁹. If introducing a full-scale capital gains tax is not feasible in the short term, a partial tax - taxing only the gains on listed and unlisted stocks as well as those on commercial real estate - would make a good starting point. If implemented along with a more stringent taxation of various kinds of remuneration of employees currently defined as capital payments, the vast majority of boundary problems would be solved. If this is not feasible either, at a very minimum the rules determining what are (non-taxable) capital transactions and what are (taxable) current revenues should be made clearer, and it should be ensured that close substitutes are given identical tax treatment.

56. The latter option would retain most of the beneficial effects and at the same time mitigate the “bunching-problem” a capital gain that has accumulated over several years will be taxed in one specific year and hence may be taxed at a marginal tax rate that is “too high” in a progressive tax system.

57. In practice, this can be done *ex post* by distributing the observed capital gain linearly over the holding period. This would significantly mitigate lock-in effects, although not entirely eliminate them.

58. Such a system, the so-called opening value adjustment method, is applied in Norway for instance (Van den Noord, 2000).

59. If such gains are included in taxable income, the issue arises of how to correct for improvements and whether to tax gains on land only (since buildings ultimately depreciate to zero without maintenance). Furthermore, taxing capital gains on residences may have adverse implications for inter-regional mobility in the labour market.

37. Another important area of base-broadening, which would take the income-tax system a significant step forward towards a truly comprehensive base, would be to include imputed rental values of owner-occupied housing in the tax base (with deductibility for mortgage interest, depreciation and repairs). This is already done in several other OECD countries, cf. Table 7 above. Such a step would improve the tax system, although there would be both positive and negative effects. First, since mortgage interest becomes deductible (in order not to discriminate against housing investment), the pay-off from using available funds to reduce the mortgage relative to other investment will decline. The bias towards housing investment implied by the current preferential tax treatment would be reduced, which in all likelihood would lead to an improved allocation of savings and higher overall economic returns to national savings. It is important to stress that such positive effects cannot be achieved solely by allowing tax deductibility of mortgage interest; it requires imputed rent to be taxed as well (Box 6). Second, there would be an increase in the tax base that could potentially be substantial.⁶⁰ However, the main purpose of including imputed rent is not to raise more revenues but to improve the allocation of savings, and there could thus be offsetting cuts elsewhere in the tax system in order to make the change revenue neutral. But, on the other hand, compliance costs would increase as there would be a need for regular estimates of market rents for owner-occupied homes as well as depreciation and maintenance costs. Obviously, some trade-offs would have to be made between accuracy of the assessment and the need to contain compliance costs.⁶¹ In addition, relative after-tax returns to housing would fall which would lead to a downward adjustment in housing prices and hence to potentially substantial capital losses for current owners.

Box 6. Tax deduction of mortgage interest should not be separated from taxing imputed rent

A proposal has been put forward to allow a tax deduction for mortgage interest without taxing imputed rental income (Arthur Andersen, 1999). In order to curb avoidance and contain revenue losses, the proposal suggests that deductions should be allowed only against capital income. The proposal would imply a zero marginal tax rate on all investment income up to the amount of the mortgage interest, which would indeed encourage households to hold additional financial assets. However, it is not obvious that any substantial reallocation of investment would take place.¹ The proposal would also imply a significant subsidy to wealthy households with large investment incomes, without affecting their marginal savings decisions. The income effects thus created for these groups may even result in a lower overall household saving rate. Moreover, there would be a substantial risk of initiating a tax-induced price spiral in the housing market, because many taxpayers would be encouraged to borrow more and buy larger houses, with adverse macroeconomic and distributional consequences. Finally, the costs in terms of revenue foregone could be very substantial. Total interest payments on household mortgages are estimated at around 5 per cent of GDP, corresponding to a tax value of 1 to 1.5 per cent of GDP (Figure 18). There is also an administrative issue, since mortgage borrowing in New Zealand allows the use of home equity to secure loans for cars and other consumer items, and banks do not report loans for pure housing separately. In conclusion, the issue of mortgage deductibility should not be seen in isolation from taxation of imputed rental values.

(Figure 18. Household debt and interest payments)

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1. The home-owner's acquisition of financial assets would be financed by higher debt, which, in a world of substantial capital mobility, would imply an offsetting change in the portfolios of other, possibly foreign, investors, who would simply hold more mortgage bonds and less equity.

38. In order to protect the tax base and minimise efficiency losses and inequalities, introduction of new tax concessions should generally be avoided. There is currently an unwritten "code of conduct" that is

60. According to Statistics New Zealand, imputed rent and other rents in 1997 were equal to around 12 per cent of GDP. From this should be deducted mortgage interest payments of approximately 5 per cent of GDP as well as (unknown) maintenance and depreciation. It is probably not unrealistic to assume that the net increase in the income tax base would be of the order of 5 per cent of GDP, potentially resulting in additional tax revenues of 1 to 1.5 per cent of GDP.

61. One option could be to use the assessments carried out for the local property tax every third year.

quite unique internationally, where demands for tax concessions by various interest groups are almost absent - partly because there is an almost unanimous public opinion that tax concessions are undesirable, and partly because these groups have come to the conclusion that lobbying for tax concessions does not pay off. If this consensus is undermined, even by a few limited tax incentives, the road may be paved for much more lobbying and eventually more substantial base erosion in the future. The political risk of introducing tax incentives to savings or investment, including pensions or R&D investment, may thus be much more important than the immediate revenue and efficiency losses.

Streamlining tax credits could reduce complexity and perhaps also marginal effective tax rates

39. Earned income tax credits may help to encourage welfare benefit recipients to seek work and have indeed proved to be effective in several countries, in particular in raising labour force participation of disadvantaged groups such as sole parents.⁶² One partial response to the dilemma of promoting part-time work without necessarily discouraging full-time work is to recognise that for some groups, such as lone parents, part-time work may be the more realistic option. The idea is that some work effort by these groups is better than none, not least with respect to keeping benefit recipients in touch with the labour market and alleviating poverty.⁶³ The tax credits and welfare benefits could be adjusted to lower the combined abatement rates for these groups in order to remove the current disincentives for taking on part-time work. A step in this direction was already taken by lowering the abatement rates for sole parents in 1996 but further moves along these lines may be warranted.⁶⁴ Such efforts could also re-consider the coverage of the various tax credits and welfare schemes, since these have gradually been extended well beyond the low-income range and into the middle class (thereby substantially exceeding the original objective of alleviating income shortfalls of poor families). The issue is whether the coverage of tax credits could be reduced without conflicting with equity objectives or creating poverty traps. In this context, it should be noted that targeting of the assistance is made easier by the widening of the market income distribution that has taken place over the past 15 years (O'Dea, 2000). In any case, the sheer number of credits and welfare benefit schemes as well as their mutual interactions make the system unduly complex, and there may be some scope for streamlining without compromising distributional objectives.⁶⁵

62. For a discussion of the effects of earned income tax credits (EITCs), see for instance OECD (1997), Hotz and Scholz (2000) and Dilnot and McCrae (2000). A basic finding is that EITCs are most likely to work in countries where benefits are low relative to average earnings and the market earnings distribution is wide. Meyer and Rosenbaum (1999), for instance, find that for the United States the EITC has had substantial positive effects on single mothers' labour supply decisions (both in terms of labour market participation and hours worked).

63. As Stephens, Frater and Waldegrave (1999) note: "The 1996 Census showed that only 36 per cent of sole parents were in either full-time or part-time employment, and as the sole parent benefit is below the 60 per cent poverty line, it is interesting to speculate whether it is the Accommodation Supplement plus part-time earnings which are the mechanisms how sole parent families escape poverty".

64. The abatement rate of the domestic purpose, widows and invalids benefits was reduced from 70 to 30 per cent over the range of NZ\$ 80-180 of weekly non-benefit income.

65. An extreme solution to simplifying the tax/benefit system has been proposed by the Investment Savings and Insurance Association of New Zealand Inc. (ISI). It suggests replacing all the current tax credits and welfare benefits by a guaranteed minimum income to each individual, leaving only some strictly targeted benefits for persons in extreme need, such as invalids requiring high-cost care. Abandoning the principle of targeting would make the tax/benefit system much simpler and pave the way for a substantial lowering of marginal effective tax rates at low- to middle income ranges. But it would also be much more costly. For example, in order to generate the same net revenue from personal taxes (personal income tax minus total expenditure on social welfare), a flat tax rate of 37 per cent would have to apply to *all* market income just to finance a guaranteed minimum income of NZ\$ 7 500. This is substantially lower than the net income

40. The fact that most tax credits and welfare benefits are means-tested at the level of family income implies that the incentive for one member of a family to work can be affected by the labour market position of another (the earnings of one spouse reduce the benefits entitlement of the other). Individual entitlements may alleviate this problem, but they do not remove the work disincentives created by the abatement of benefits. It may also prove to be an overly expensive option, either because it overcompensates households with two recipients of welfare benefits and/or since the incentives to misreport family status will increase if such households receive less than the sum of two individual benefits. Overall, however, the experiences gained in Australia from a switch to individual benefit entitlements in 1995 have been positive, in particular by improving the incentive for unemployed couples to take on part-time work or low-paid full-time work (OECD, 1996).

Enhancing the quality of savings and investment is difficult to achieve by tax concessions

41. The first-best solution to achieve a higher quality of saving and investment would be to broaden the tax base along the lines discussed above. To the extent this is not feasible, limited tax preferences may be applied as second-best ways of improving allocative efficiency. This would not be without costs, however, since it would in effect alleviate existing distortions by creating new ones. Revenues foregone as well as the political risk of encouraging pressures for new concessions may also be considerable.

42. Household saving decisions can be influenced by applying tax incentives to private pension plans. This could strengthen the role of institutional investors and possibly encourage long-term saving by households.⁶⁶ While employer-sponsored pension plans are already subsidised for top income earners, the government is currently contemplating the introduction of a new tax concession for long-term pension savings. The idea is to replace the current TTE-regime with a TET-regime for such savings. This would increase the tax liability for short-term holdings but reduce it over time as the fund accumulates free of tax. The number of years required before the TET-regime “breaks even” depends on the rate of return and the tax rate applied during accumulation and at withdrawal. If, for instance, the rate of return is 10 per cent and the tax rate is 33 per cent, effective taxation will be lower in the TET-regime if funds are held for more than 14 years (Figure 19). The problem with the TET-regime is that the tax savings are “back-loaded”, and hence the effects on savings allocation may be limited. It may even be more efficient to switch to an ETT system instead, as the tax savings are then given up front (in terms of deductibility of contributions).⁶⁷ This would also preserve the “no concession” spirit of private pension plans, although the effective tax rate tends to be lower at retirement age when benefits are withdrawn than when contributions are paid in.⁶⁸ A shift to ETT would, however, also give rise to immediate and potentially significant revenue losses for the government against uncertain future gains.⁶⁹ Considering more generous schemes, such as the EET treatment applied in most OECD countries, would run counter to the efforts carried out in New Zealand

currently received by many beneficiaries and superannuitants, in particular those belonging to single-adult households. See ISI, 1999.

66. Arguments that governments should subsidise long-term savings are based mainly on moral hazard considerations: given the existence of public pension schemes, individuals may not save “enough” for their retirement, which would increase future demands on the government. This argument is valid mostly in countries where public pensions are means tested, and the future savings for the government would in any case have to be weighed against the revenue loss created by the tax concession.

67. This basically assumes that households are myopic. Several studies have found that this is indeed the case, i.e. that upfront incentives are more likely to be successful than an equivalent-value downstream initiative (Arthur Andersen, 1999). This implies that ETT is probably better than TTE for encouraging long-term savings.

68. ETT and TTE are similar if the effective tax rate at the point of contribution equals that upon withdrawal.

69. Although it could also be argued that such a time profile for revenues could be more appropriate in order to match the expenditure pressure arising over the next decades due to the ageing of the population.

over the past 15 years to abolish tax concessions to private pension savings and put the consensus on the undesirability of tax incentives at risk. The conclusion is therefore that there are no overriding reasons why New Zealand should change its existing taxation of pension savings.

(Figure 19. Examples of TTE versus TET taxation)

43. The scope for improving the quality of investment is probably rather limited, given the overall neutrality of the corporate tax system. The most pressing concern is the tax treatment of R&D capital expenditure. This should be defined more clearly and the rather arbitrary distinction between scientific research and development abandoned. Some inspiration could perhaps be gathered from the accounting treatment of such expenditure, even if the purposes are different. To be precise, for accounting purposes, research costs are expensed in the period in which they occur. If development costs relate to a clearly defined, technically feasible product or process that is useful or marketable, the costs are amortised over the economic lifetime of the asset. If these criteria are not met, the development costs are written down or written off. Also, the concessions given to forestry, mining and intellectual property rights should be phased out (perhaps using sunset clauses) or substantially reduced.

44. The taxation of various corporate entities could be streamlined. Although steps have already been taken to limit tax avoidance through corporate vehicles such as trusts, partnerships or personal service companies, there is still some scope for using such vehicles to reduce taxation of personal investment and employment income. The ability to use loss-attributing qualifying companies (LAQCs) for tax planning should be reduced, preferably by removing the underlying cause for using them as avoidance vehicles (absence of capital gains tax, concessions to forestry, etc.). However, the existence of LAQCs is linked with the issue of how to place new start-up companies on a more equal footing with more mature firms: since new firms are normally not in a tax-paying position, they are not able to use write-offs immediately. Even though they may carry over losses, these are not properly discounted, and new firms may also face significant liquidity constraints. The LAQCs help to alleviate this disadvantage, but the question is whether it is possible to construct an alternative mechanism that is less vulnerable to tax avoidance, for instance allowing the losses of new firms to be tradable (whereby the new start-ups could immediately cash in the tax value of the loss). In any event, supplementary regulation or restrictions would seem to be needed to prevent abuse and put a brake on revenue losses caused by such arrangements.

A tax system for the future - is a change in the tax mix desirable?

45. While the basic structure of New Zealand's tax system is sound, it may nonetheless be worthwhile to consider options for more fundamental changes in tax policy in the longer term. This is especially true since the recent increase in the top marginal personal tax rate and the problems of achieving a truly comprehensive income tax base, as well as steps taken in other countries to lower marginal income tax rates, may put the current tax structure under pressure in the future. The upcoming tax review is also expected to investigate such long-term issues. Two options may be of particular interest. One is increasing value-added taxation while lowering income taxes. The other is to move towards a dual income tax system, where the taxation of capital and labour income is separated. The two options are not mutually exclusive, and the first option would also be compatible with the current comprehensive income tax system.

46. Increasing the value added tax and lowering the income tax would move the tax system in the direction of an expenditure tax. This would reduce the inherent distortions to private savings embodied in all income tax systems as well as allow for lower marginal tax rates on labour income, thereby reducing deadweight costs.⁷⁰ Such a change in the tax mix would also reduce the size of the "hidden" economy,

70. As mentioned above, Diewert and Lawrence (1994) found that, at the margin, the deadweight loss of the GST was smaller than that of the personal income tax. Note that the reduction in distortions to savings

although probably not significantly (Giles, 1999). The effects on personal savings from lower income taxes would probably at best be moderate, as discussed above. A change in the tax mix would also result in a one-off increase in the price level and, as most welfare benefits are indexed to consumer prices, part of the increased revenues from a higher GST would presumably go to finance compensating increases in benefit levels, leaving less room for income tax cuts. Higher consumption taxes may have immediate undesirable distributional effects, although the evidence does not seem to vindicate such concerns. Indeed, a study by Creedy (1998) found that the GST in New Zealand generally does not bear on lower-income groups any more than on high-income groups and that distributional effects are moderate overall.⁷¹

47. In terms of income taxation, the most obvious alternative to the current comprehensive structure would be to introduce a so-called dual tax system, as applied in the Nordic countries.⁷² The basic principle is to separate the taxation of labour and capital income, thereby allowing countries with high marginal tax rates to maintain a heavy (progressive) tax burden on labour while taxing capital income at a lower uniform rate. The main objective is to reduce barriers to capital formation and avoid capital flight. Such a system is also better suited for avoiding non-neutralities across various kinds of capital income. However, applying different tax schemes to labour and capital income raises tax-shifting incentives, which require complex administrative countermeasures, and reduces vertical equity (see Van den Noord, 2000). In countries with relatively low personal tax rates, it is normally better to combine the taxation of all income into one comprehensive schedule (the Shantz-Haig-Simons principle). With a top marginal tax rate of 39 per cent on personal income, New Zealand is in an intermediate position, making it unclear whether comprehensive taxation of capital or a dual system is preferable. Maintaining a comprehensive tax system in the long term probably requires base broadening in the personal tax system along the lines described above. This would allow tax rates to be sufficiently low to avoid capital flight and excessive emigration of highly skilled labour.⁷³ Otherwise, a dual tax system may be the better option, since it would not impose the same straight-jacket on the top personal rate (on wage income).

Box 7. Recommendations for tax changes

New Zealand's tax system compares favourably with those of other OECD countries and is not in urgent need of major reform. However, in order to reap the full benefits of an otherwise well-functioning tax system, New Zealand should consider addressing a number of second-order issues. It should hence:

- Consider implementing a comprehensive capital gains tax, at a minimum with respect to gains on listed and non-listed equities as well as commercial buildings. To make it administerable, the tax could be imposed on realised nominal gains, but possibly with interest charged on deferred tax payments. Such a tax could solve many of the problems faced by the tax current system and would, in all likelihood, not create excessive lock-in effects. The government has recently taken steps to strengthen the taxation of various kinds of employee remuneration currently considered as capital payments, but more efforts may be required in this area to ensure a truly comprehensive taxation of wage and salary income.

would not necessarily entail higher saving levels (as income and substitution effects may work in opposite directions, as discussed above).

71. These findings basically confirm previous research by the Treasury, see Lewis (1995). The Treasury found the GST to be regressive at both ends of the income distribution but roughly proportional for 80 per cent of households. If distributional concerns should arise despite such findings, it would be wrong to address them by introducing multiple GST rates or tax exemptions. Such steps would undermine the neutrality of the system and increase compliance costs, whereas distributional effects would at best be marginal. Indeed, the Creedy study finds that the increase in progressivity that could be achieved through exemptions of food and domestic fuel and power would be negligible.
72. For a survey of tax systems in the Nordic countries, see Sørensen (1998).
73. It could also be argued that the need to reduce tax rates on capital income is less apparent in New Zealand than elsewhere given its strict taxation of foreign source income.

- Consider taxing the imputed rental value of owner-occupied housing in order to broaden the income tax base and improve the neutrality of households' savings decisions. If - and only if - such a tax is implemented, mortgage interest should be made deductible, but only against the imputed rental income.
- Not allow new concessions in the corporate tax scheme (for R&D etc.). Various corporate entities should be taxed on a more uniform basis, and loopholes should be closed (e.g. loss attributing qualifying companies and trusts).
- Address some unfinished business in the area of international taxation, in particular how to counteract tax avoidance taking place through the grey-list regime without unduly increasing compliance costs.
- Not apply new tax incentives to private pension savings. The over-taxation of low- and middle-income earners in superannuation and life insurance schemes should be addressed, as should the concessions given to high-income earners through employer contributions to private pension plans.

- Consider streamlining of the tax-credits/welfare-benefit system. Reducing marginal effective tax rates at the lower end of the income scale would help to promote part-time work by disadvantaged groups, but such a step may conflict with the need for targeting in order to contain revenue losses. In this context, a change to individual entitlement of welfare benefits may be considered as a way of improving incentives for labour force participation. A more general issue is to what extent the coverage of tax credits and welfare benefits can be reduced without compromising equity objectives.
- Consider how the tax system should best respond to the increased mobility of tax bases and the future expenditure pressures stemming from an ageing population.

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Table 1. **Marginal effective tax wedges in manufacturing in selected OECD countries¹**

Per cent, 1999

	Sources of financing ²				Type of assets ³				Overall	
	Retained earnings	New equity	Debt	Standard deviation	Machinery	Building	Inventories	Standard deviation	Average	Standard deviation
United States	1.67	4.90	1.43	1.58	1.51	2.54	2.02	0.42	1.91	1.20
Japan	2.66	3.88	0.36	1.46	0.97	3.14	2.79	0.95	1.98	1.23
Germany	1.08	2.21	1.21	0.51	0.85	1.40	1.91	0.43	1.24	0.48
United Kingdom	2.74	2.24	1.46	0.53	1.88	2.21	3.09	0.51	2.24	0.53
Canada	4.36	5.42	1.92	1.47	2.66	4.14	5.13	1.02	3.62	1.26
Australia	2.22	0.98	1.96	0.53	1.62	2.16	2.69	0.44	2.01	0.53
Ireland	1.51	3.95	0.66	1.40	1.12	1.44	2.23	0.46	1.45	1.07
New Zealand	0.99	1.33	1.33	0.16	1.17	0.95	1.32	0.15	1.14	0.16
Sweden	1.73	2.17	0.68	0.62	1.14	1.43	1.99	0.35	1.41	0.51
OECD average	1.72	2.59	0.99	0.65	1.17	1.71	2.25	0.44	1.55	0.56

1. These indicators show the degree to which the personal and corporate tax systems scale up (or down) the real pre-tax rate of return that must be earned on an investment, given that the household can earn a 4 per cent real rate of return on a demand deposit. Wealth taxes are excluded. See OECD (1991) for a discussion of this methodology. Calculations are based on an inflation rate equal to the 1998-99 per cent change in the private consumption deflator.
2. Calculated using the following weights: machinery 50 per cent, buildings 28 per cent, inventories 22 per cent.
3. Calculated using the following weights: retained earnings 55 per cent, new equity 10 per cent, debt 35 per cent.

Source: OECD calculations.

Table 2. Shares of taxes in total fuel prices in OECD countries

Per cent, 1999

	Gasoline ¹ (premium unleaded)	Diesel ²	Ratio of diesel/gasoline tax share
Australia	55 ³	n.a.	n.a.
Austria	68	55	81
Belgium	74	56	76
Canada	48 ⁴	39	81
Czech Republic	63	50	79
Denmark	72	36	50
Finland	74	54	73
France	79	67	85
Germany	74	62	84
Greece	63	57	90
Hungary	67	65	97
Ireland	68	56	82
Italy	73	64	88
Japan	n.a.	56	n.a.
Luxembourg	64	54	84
Netherlands	73	58	79
New Zealand	50	1	2
Norway	75	59	79
Poland	63	49	78
Portugal	68	60	88
Spain	67	56	84
Sweden	73	50	68
Switzerland	69	76	110
Turkey	71	64	90
United Kingdom	82	78	95
United States	28	n.a.	n.a.
Unweighted average of countries listed above	64	51	70

1. 95 RON.
2. For commercial use.
3. 1995.
4. 1994.

Source: IEA, *Energy Prices and Taxes, first quarter 2000* and OECD calculations.

Table 3. Tax treatment of private pensions in OECD countries

1999

Country	Contributions out of taxed income or exempt	Fund income tax (per cent rate) or exempt	Pensions annuities taxed or exempt	Pension lump sum taxed or exempt
Australia	T	15	T	T/E
Austria	P(C)	E	P(T)	-
Belgium	C	E	T	T
Canada	E	E	T	T
Czech Republic	T	E	T	T
Denmark	E	33.8	T	T
Finland	E	E	T	T
France	E	E	T	E
Germany	T/E	E	T	T/E
Hungary	E	E	E	E
Iceland	E	E	T	T
Ireland	E	E	T	E/T
Italy	E	E	T	T
Japan	E	E	T	T
Korea	T/E	T/E	E	E
Luxembourg	T/E	50	T	T/E
Mexico	E	E	T/E	T/E
Netherlands	E	E	T	T
New Zealand	T	33	E	E
Norway	E	E	T	T
Poland	E	E	T	-
Portugal	E/C	E	T	T
Spain	E	E	T	T
Sweden	E	15	T	-
Switzerland	E	E	T	T
Turkey	E	E	E	E
United Kingdom	T/E	E	T	E
United States	E	E	T	T

Note: Key to abbreviations

C = credit
E = exempt
T = taxed
P = partial

Source: OECD Tax Database.

Table 4. **Estimates of compliance costs in selected OECD countries¹**

Country	Year	Compliance costs as a percentage of GDP
United States	1989	0.9
United Kingdom	1986/87	1.0
Canada ²	1994	0.8
Australia	1990/91	2.1
Netherlands	1989	1.5
New Zealand	1990/91	2.5
Spain	1990	1.1
Sweden	1990/91	0.7

1. Excluding administrative costs.
2. Excluding corporate income tax.

Source: Sandford (1995).

Table 5. **Taxation of financial gains in OECD countries**

1999; resident taxpayers

Country	Taxation of financial capital gains (top personal rate of taxation; per cent) ¹
United States	Typical rate: 20. Capital gains are subject to special treatment. The maximum tax rate for capital assets held more than 12 months is 20 per cent.
Japan	Typical rate: 26. For listed companies a central rate of 20 per cent augmented by a local rate of 6 per cent applies. Alternatively, if the sale of the asset is entrusted to a securities company, a separate withholding tax applies. In this case, the central rate of 20 per cent can be applied to 5 per cent of proceeds.
Germany	Typical rate: 0. Capital gains realised through private transactions of resident individuals are generally not subject to income taxation.
France	Typical rate: 26. In most cases, capital gains on securities are taxed at a flat rate of 26 per cent. This comprises the basic rate of 16 per cent plus social surcharges (CSG, CRDS and Social Levy).
Italy	Typical rate: 12.5. Net capital gains on shares and other securities are subject to a flat rate. For gains on non-substantial holdings, the rate is 12.5 per cent.
United Kingdom	Typical rate: 40. Capital gains of an individual are aggregated with income and are taxed at income tax rates. The first £6 800 are tax exempt.
Canada	Typical rate: 54.1. Treated as ordinary income, but only 75 per cent of capital gains net of losses are subject to taxation.
Australia	Typical rate: 48.5. Treated as ordinary income, but only 50 per cent of net nominal capital gains of individuals are taxed.
Austria	Typical rate: 0. In general capital gains are not included in taxable income.
Belgium	Typical rate: 0. Capital gains realised by individuals not engaged in a business activity are in principal not taxable.
Czech Republic	Typical rate: 0. Gains from the disposal of securities held for 6 months are exempt from taxation.
Denmark	Typical rate: 40. Capital gains are taxable as capital income if held less than three years or if they exceed Dkr 36 000.
Finland	Typical rate: 28. Income from capital is subject only to a national income tax levied at 28 per cent.
Greece	Typical rate: 0. Gains derived from the sale of securities (other than non-listed companies with limited shares and limited liability companies) are not taxed.
Hungary	Typical rate: 20. Capital gains on securities and on listed derivatives are taxed at a flat rate of 20 per cent. In absence of documentation of acquisition price, 25 per cent of the proceeds are taxed.

Table 5. Taxation of financial gains in OECD countries (cont'd)

Country	Taxation of financial capital gains (top personal rate of taxation; per cent) ¹
Iceland	Typical rate: 10. Gains from the sale of privately owned shares are generally included in taxable investment income and are taxed at a rate of 10 per cent. Gains may be exempt up to a maximum of IKr 349 911 (IKr 699 822 for a couple) provided that the company has been approved by the Internal Revenue Directorate.
Ireland	Typical rate: 20. Capital gains are generally taxed at a flat rate of 20 per cent.
Korea	Typical rate: 0. In general capital gains are not included in taxable income.
Luxembourg	Typical rate: 47. There is no separate capital gains tax. Capital gains are generally included in taxable income.
Mexico	Typical rate: 0. Gains on specified shares or other securities traded through an authorised stock exchange or similarly active market are tax exempt.
Netherlands	Typical rate: 0. In general capital gains are not included in taxable income.
New Zealand	Typical rate: 0. In general capital gains are not included in taxable income.
Norway	Typical rate: 28. There is no separate capital gains tax, but capital gains are included in taxable income. With respect to the computation of gains on disposal of shares of a resident company, special rules apply to avoid double taxation of company profits and gains to the shareholder.
Poland	Typical rate: 40. Capital gains are included in the taxable base as part of income from money investments, income from the sale of real estate, or business income.
Spain	Typical rate: 48/20. Treated like ordinary income. For holding periods in excess of 2 years, capital gains are subject to a flat rate of 20 per cent.
Sweden	Typical rate: 30. In general, all capital gains realised by an individual are included in the category income from capital. Income from capital is taxed separately at a flat rate of 30 per cent nationally (no municipal taxes apply).
Switzerland	Typical rate: 0. Capital gains are exempt.
Turkey	Typical rate: 50. Capital gains are generally included in capital income.

1. These rates apply to capital gains that arise from the disposal of securities, excluding speculative (or short holding periods) transactions, disposal of substantial interest holdings, or from gains realised in the course of a regular business activity.

Source: National sources and the European Tax Handbook (1999).

Table 6. **Effect of taxation on asset returns**¹

Asset	Nominal pre-tax return (per cent)	Nominal post-tax return (per cent)	Post-tax return as per cent of pre-tax return
Housing	14.0 ²	13.0 ³	93
Funds held in financial institutions	9.5 ⁴	6.4	67
Private shareholdings	27.4 ⁵	18.3	67
Passive investment funds	27.4	18.3	67
Managed funds	27.4	14.3 ⁶	52

1. Average annual nominal returns (1970-98).
2. Residential housing including an estimate of 2.5 per cent per annum for implicit rental minus maintenance.
3. Although capital gains and imputed rents on owner-occupied housing are not taxed, local government rates are still payable (assumed to be 1 per cent of market values) and no deductions for interest expense or maintenance allowed. This return figure could be lower for rental housing as rental income could be taxable, but deductions would be allowed for interest expenses, maintenance and depreciation.
4. Average six-month deposit rate (1970-98). Interest income taxable at 33 per cent.
5. Average return for the NZSE 40 (and previously Barclays index) for 1970-98, including dividend returns, and grossed up to reflect the effect of tax on company earnings.
6. Fund manager may be able to delay payment of tax until assets are sold.

Source: Joint Working Group -- Treasury Officials and ISI (1999), "Saving Rates and Portfolio Allocation in New Zealand", New Zealand Treasury Working Paper No. 1999/9.

Table 7. Tax treatment of owner-occupied housing in OECD countries

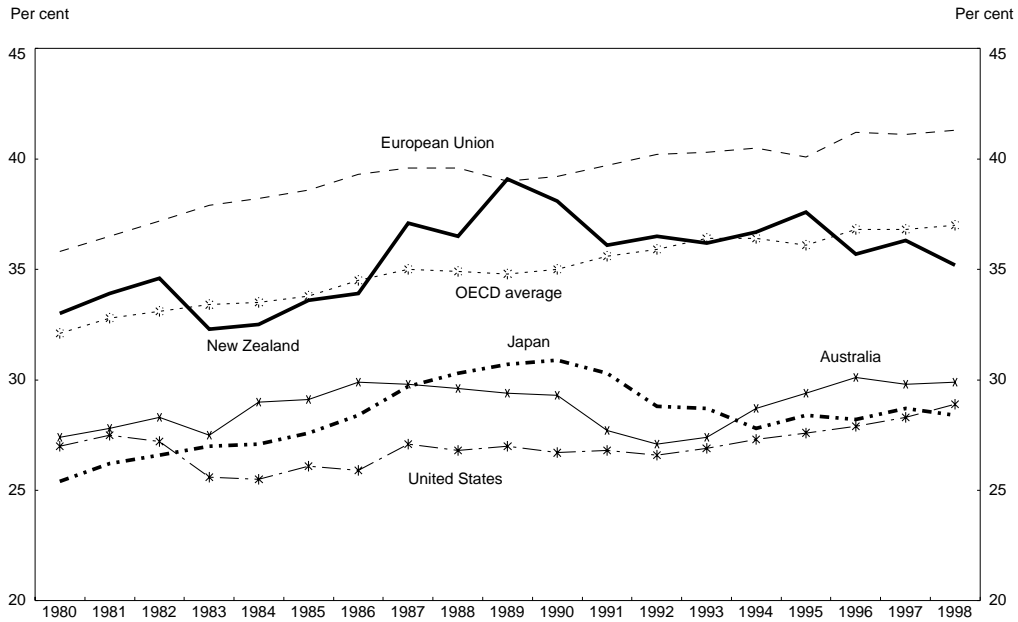
1999

Country	Acquisition cost payable out of taxed income or deductible	Interest on loan for acquisition payable out of taxed income or deductible	Capital gain taxable or exempt	Imputed rental income taxable or exempt
Australia	T	T	E	E
Austria	PD	PD	E (if owner-occupied for at least two years)	E
Belgium	D	D	E	T
Canada	T	T	E	E
Czech Republic	T	D	E (if owner-occupied for at least 2 years)	E
Denmark	T	D	E (if owner-occupied for at least 2 years)	T
Finland	T	D	E (if owner-occupied for at least 2 years)	E
France	T	T	E	E
Germany	T	T	E (if owner-occupied for at least 2 years)	E
Hungary	T	PD	T	E
Iceland	T	T	E (if owner-occupied for at least 2 years)	E
Ireland	T	T	E	E
Italy	T	D	E	E
Japan	T	T	T	E
Korea	T	T	T/E	E
Luxembourg	T	D	T/E	T
Mexico	D	T	E	E
Netherlands	T	D	E	T
New Zealand	T	T	E	E
Norway	T	D	E	T
Poland	D	T	T/EX	T
Portugal	PC	PC	E	E
Spain	D	PC/C	E	E
Sweden	T	D	T	T
Switzerland	T	D	T/E	T
Turkey	T	T	E	T
United Kingdom	T	PD	E	E
United States	T	D	E	E

Note: D = deductible
E = exempt
T = taxed
C = credit
PC = partial credit
PD = partially deductible

Source: The OECD Tax Database.

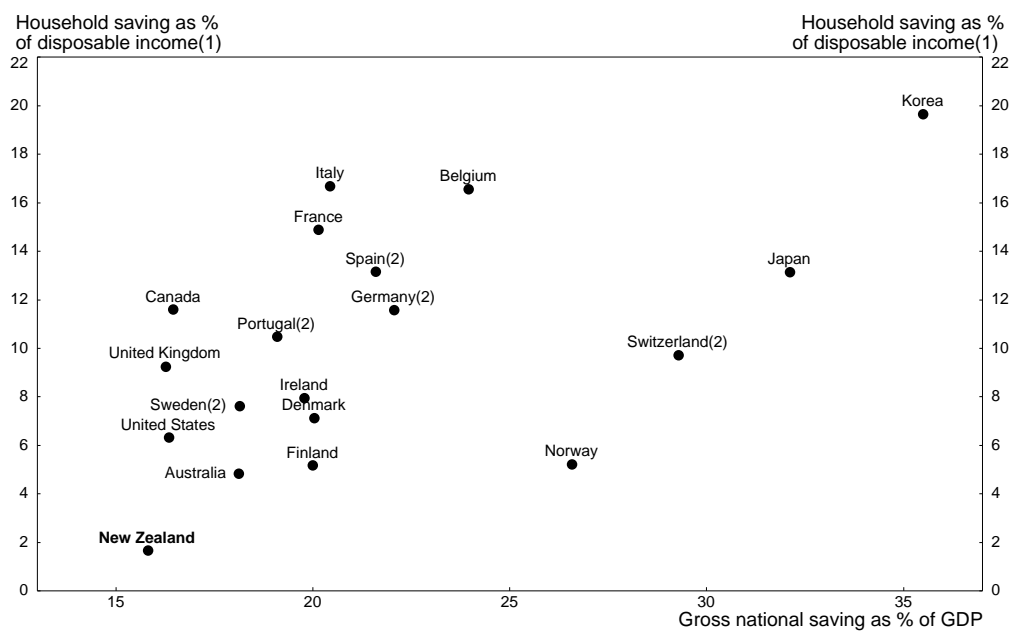
Figure 1. Total tax revenues in selected OECD countries and regions (1)
Per cent of GDP



1. General government total tax revenues, including social security contributions. Note that numbers may not be fully comparable across countries and over time due to changes of national accounts from SNA68/ESA79 to SNA93/ESA95. Sources: OECD Revenue Statistics, 2000.

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Figure 2. Saving rates across OECD countries
Average 1990-98



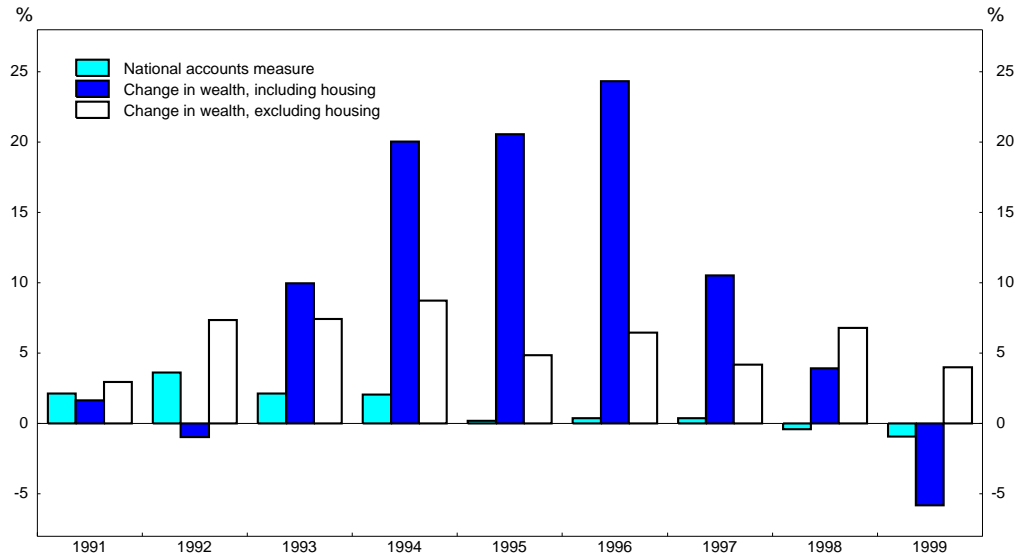
1. Household saving ratios may not be fully comparable across countries due to differences in definitions (gross versus net saving).

2. 1991-98 for Germany; 1995-98 for Portugal and Spain; 1993-98 for Sweden; 1990-97 for Switzerland.

Source: OECD and OECD National Accounts.

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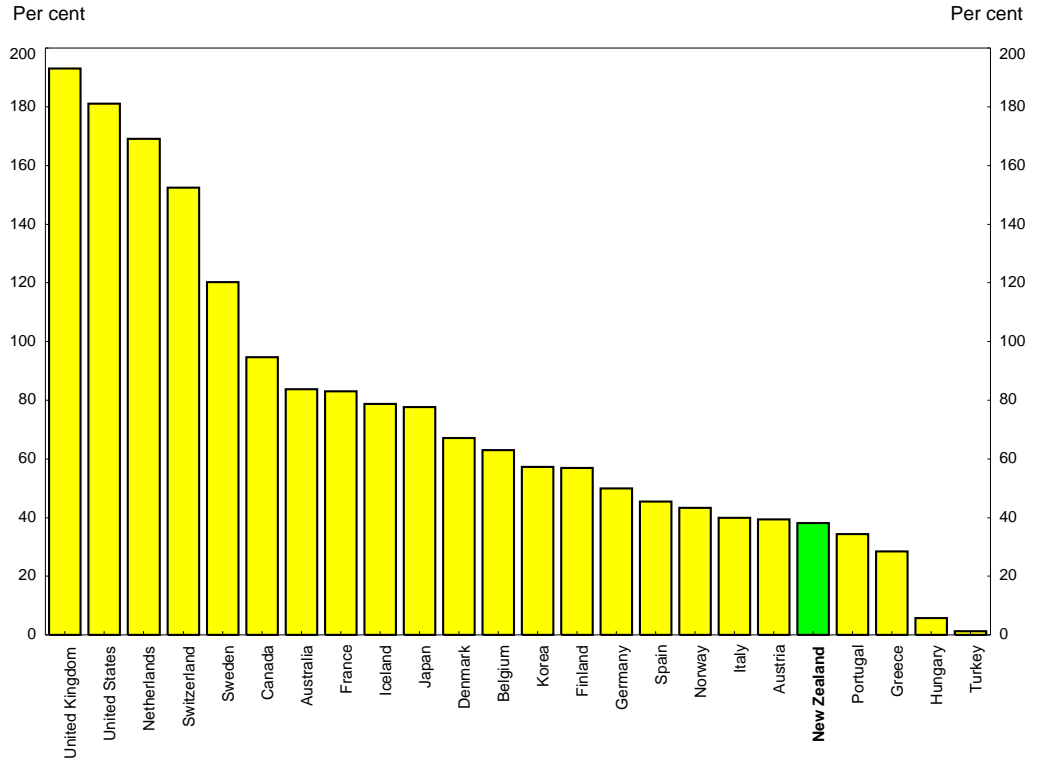
Figure 3. Various measures of household saving
Per cent of GDP



Source: Treasury estimates from SNA data; WestpacFPG (now Morningstar) household savings indicators.

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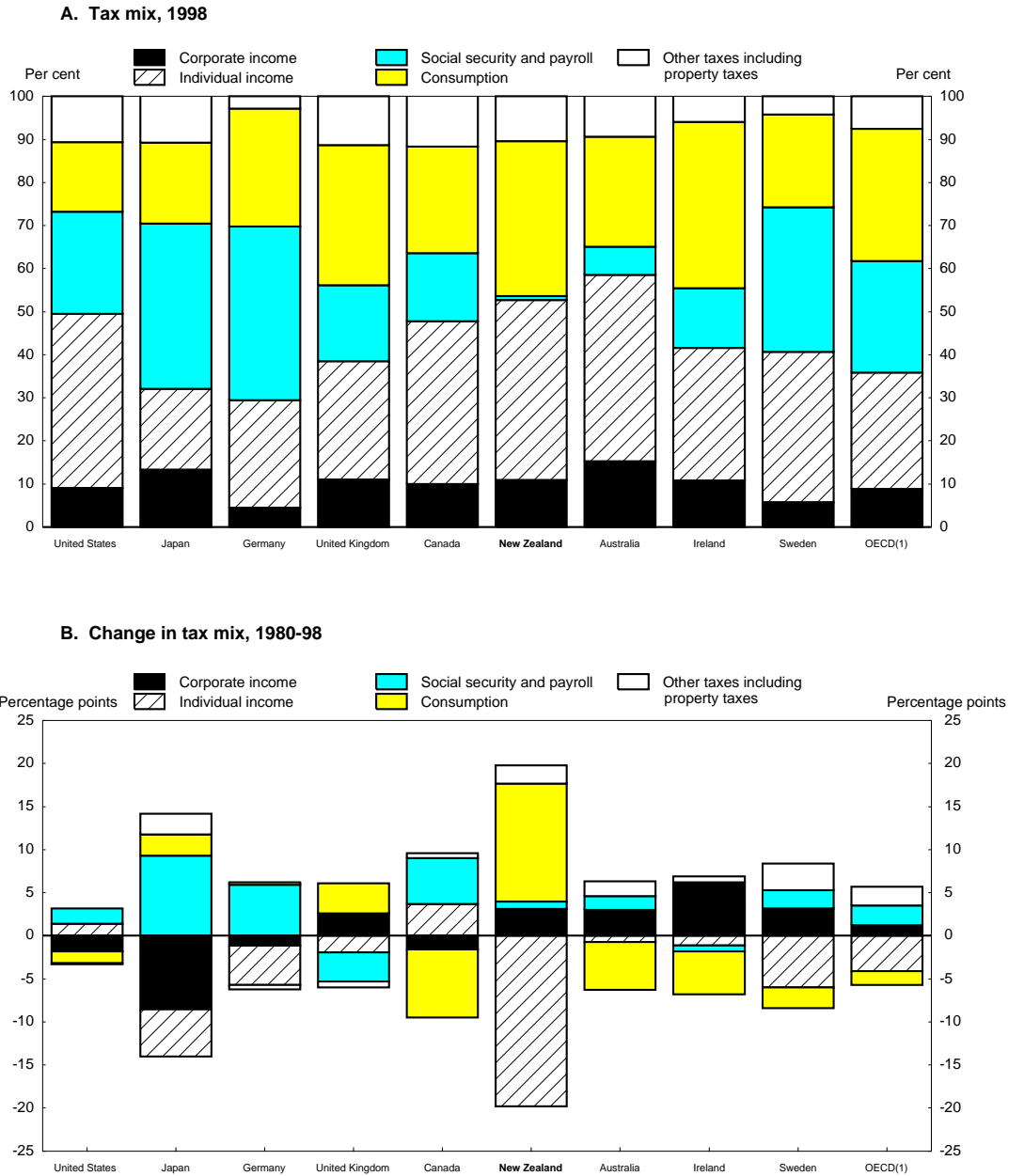
Figure 4. Financial assets of institutional investors in OECD countries
Per cent of GDP, 1996



Source: OECD, Institutional Investors, 1998 Statistical Yearbook.

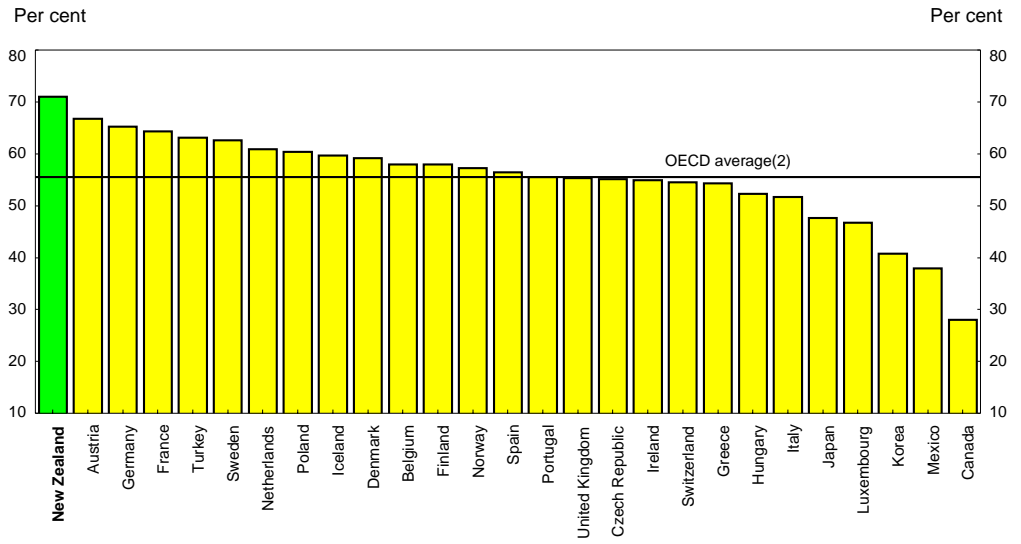
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Figure 5. Tax mix in selected OECD countries



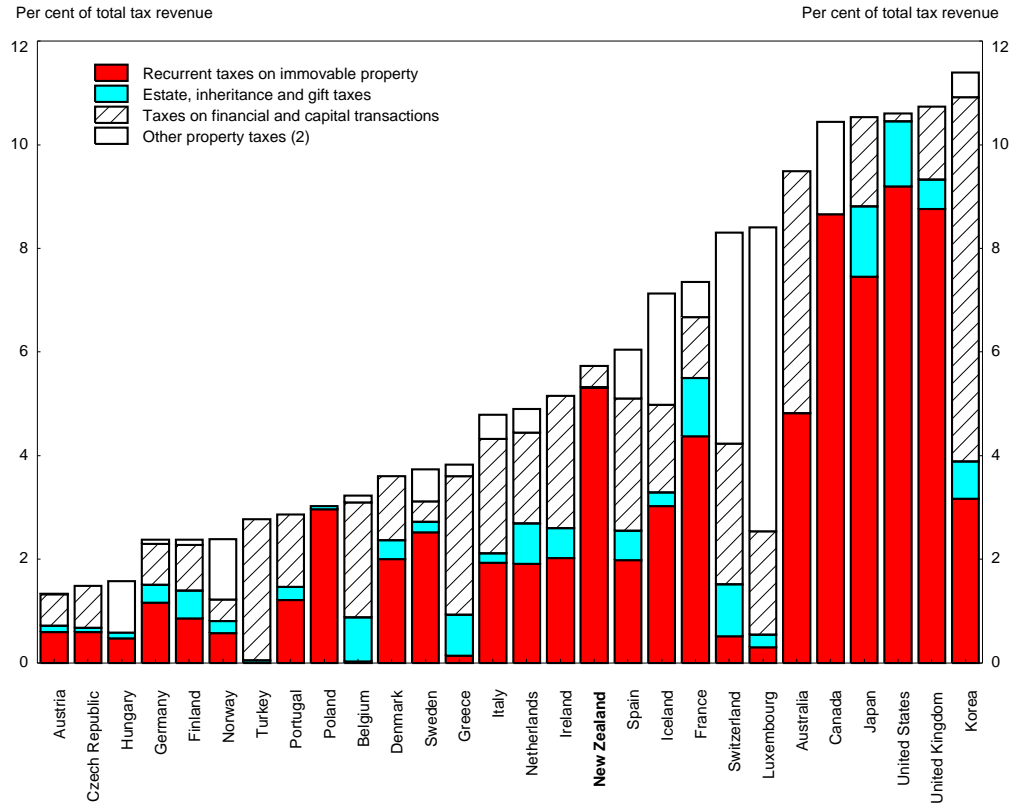
1. The OECD average is unweighted and excludes Mexico.
Source: OECD, Revenue Statistics, 2000.

Figure 6. Share of value added tax in total consumption tax revenues in OECD countries 1998(1)



1. 1997 in the case of Greece.
 2. Unweighted average.
 Source: OECD, Revenue Statistics, 2000.

Figure 7. Property taxation in OECD countries
1998 (1)



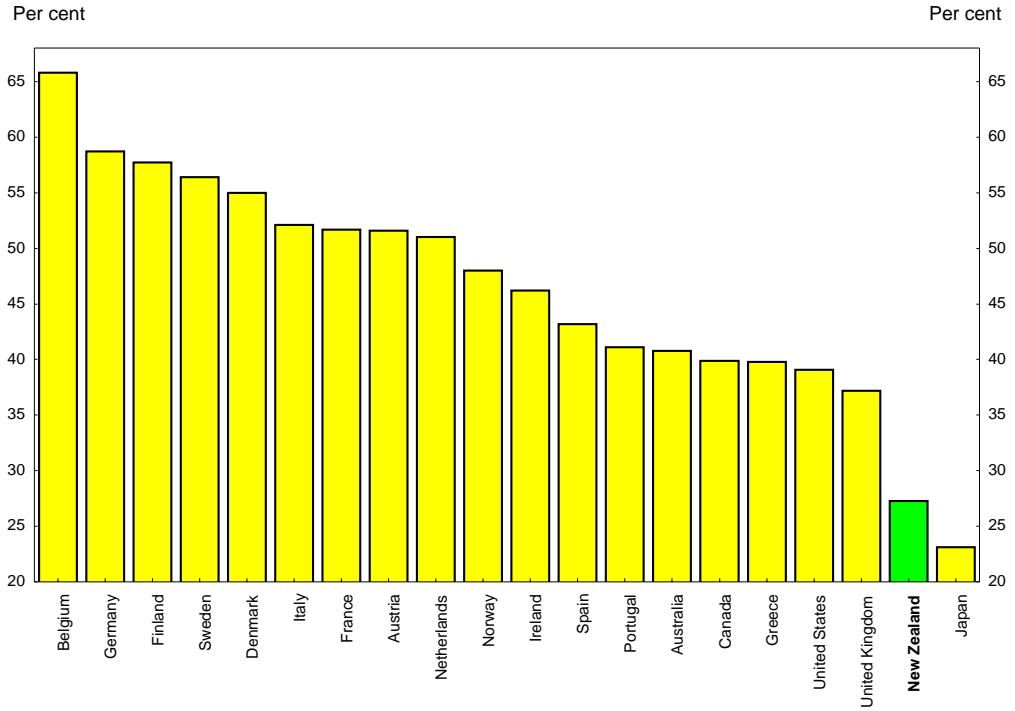
1. 1997 data for Greece.

2. Includes recurrent taxes on net wealth and some non-recurrent taxes on property (for instance land development permission charges).

Source: OECD, Revenue Statistics, 2000.

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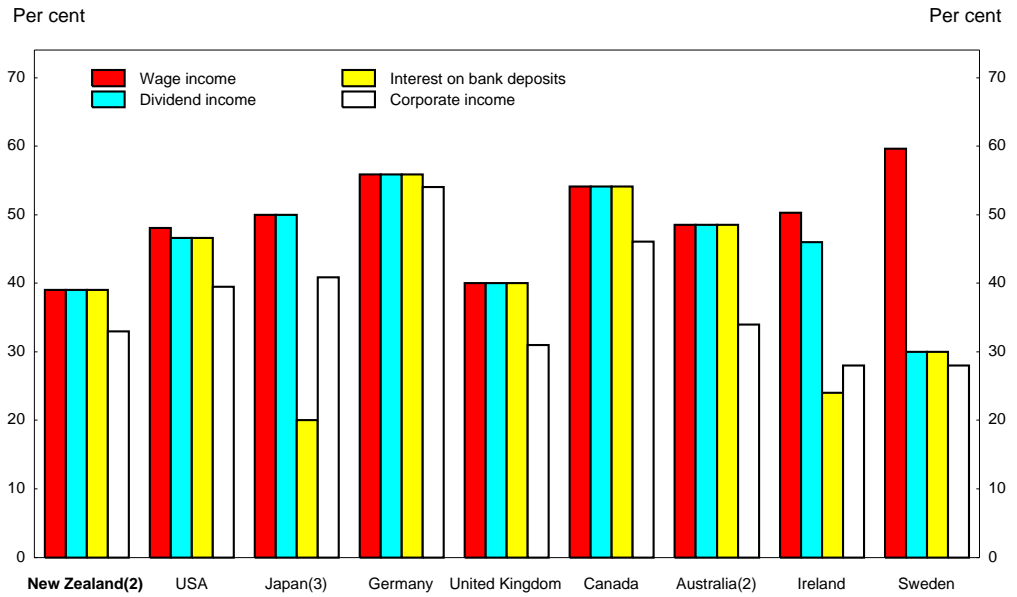
Figure 8. Weighted marginal tax wedges across OECD countries(1)
1998



1. The weighted marginal tax rates combine information on marginal effective tax wedges (including social security contributions) for various income groups with the actual income distribution.
Source: OECD, Taxing wages 1999 and OECD calculations.

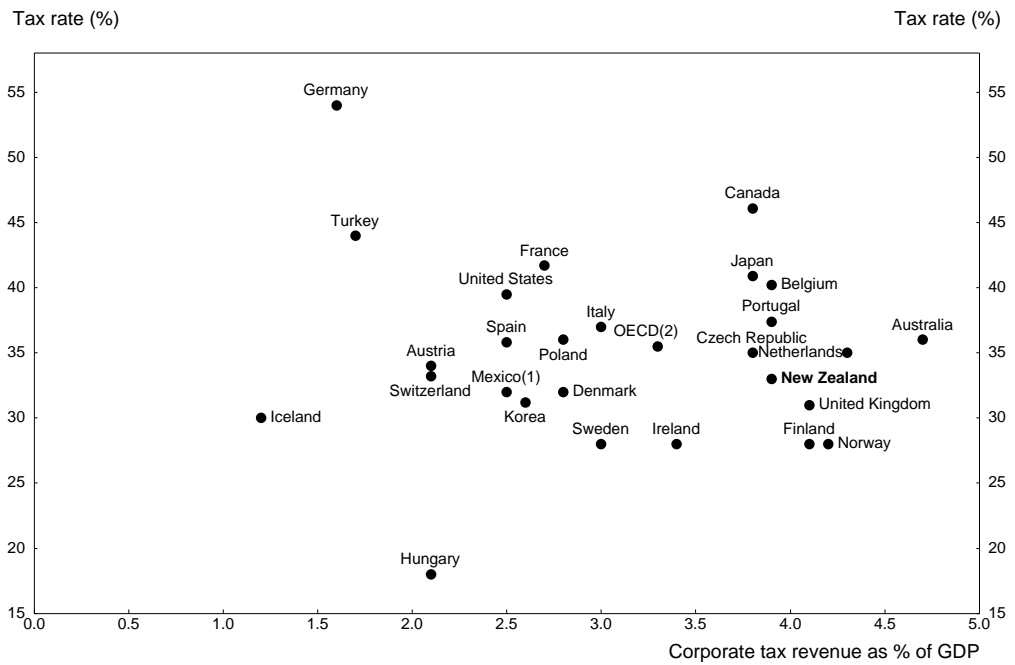
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Figure 9. Highest all-in tax rates in selected OECD countries(1)
1999



1. The all-in tax rates for wage, dividend and interest income are those applying to individual top-income earners. They include central and sub-central government taxes as well as social security contributions where these are not capped. The all-in tax rates on corporate income include central and sub-central government taxes as well as surcharges.
 2. FY 2000/2001.
 3. Tax on dividends depends on the size of payment. Tax credits are not included.
 Source: OECD Tax Database.

Figure 10. Taxation of corporate income in OECD countries
1998



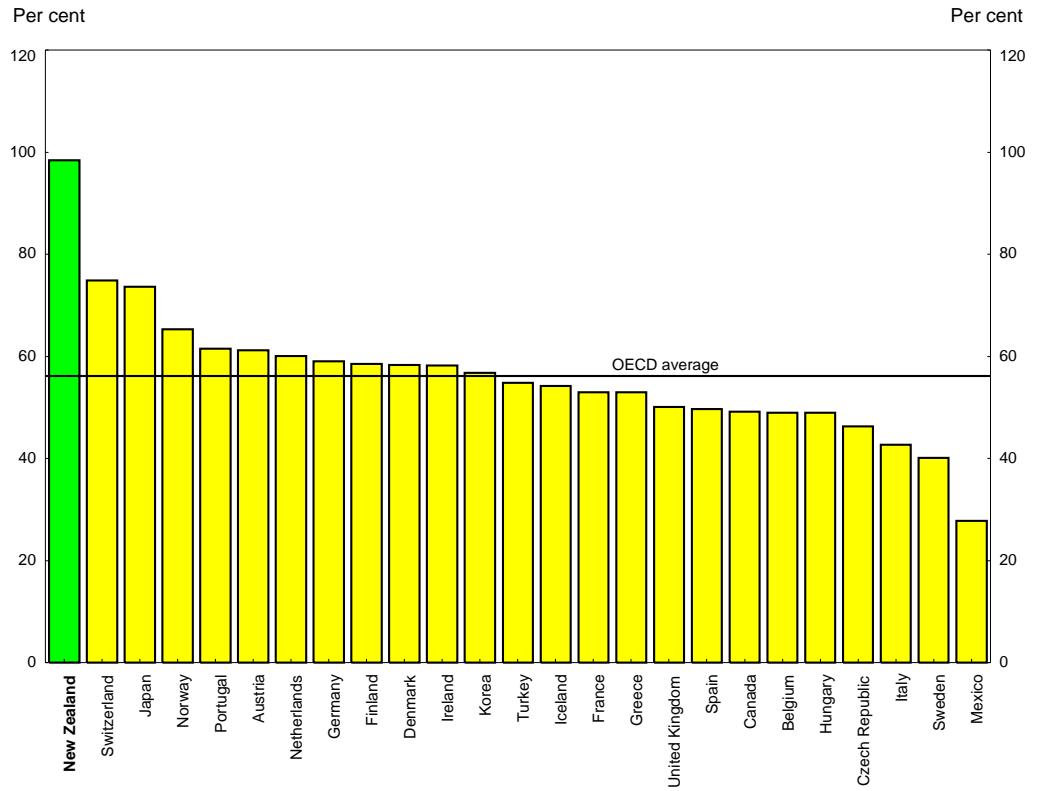
1. Retained earnings.

2. Unweighted average.

Source: OECD, Revenue Statistics, 2000; OECD Tax Database.

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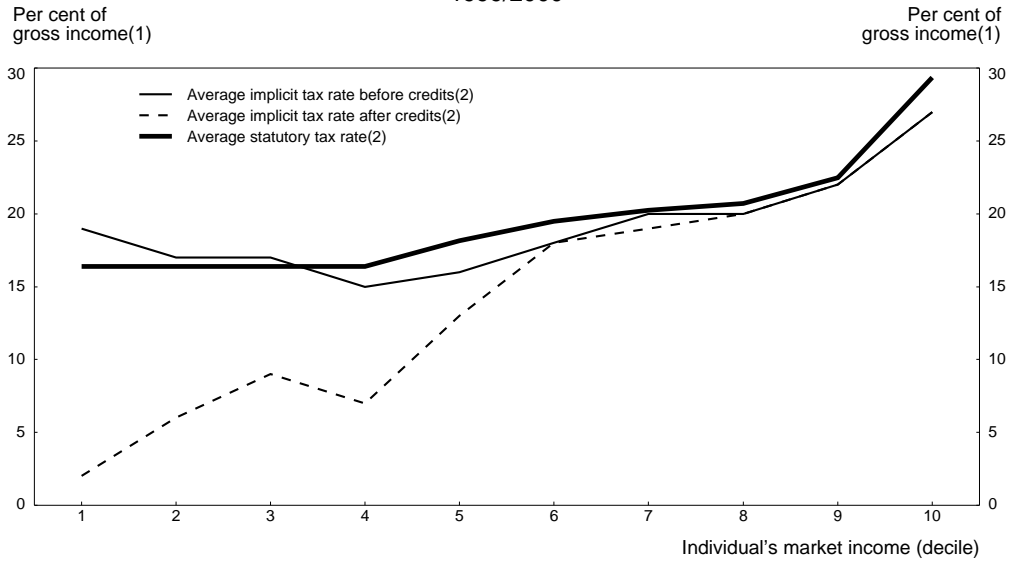
Figure 11. Effectiveness of value added taxes in OECD countries
1998



Note: Effectiveness of the VAT is measured as the effective VAT rate as a per cent of the standard statutory rate, where the effective rate is VAT revenues divided by the potential VAT base (i.e. consumption minus VAT). The effectiveness of the VAT reflects the broadness of the VAT base and the level of compliance.

Source: OECD calculations.

Figure 12. Average implicit tax rates
1999/2000



1. Gross income includes market income and gross transfers.

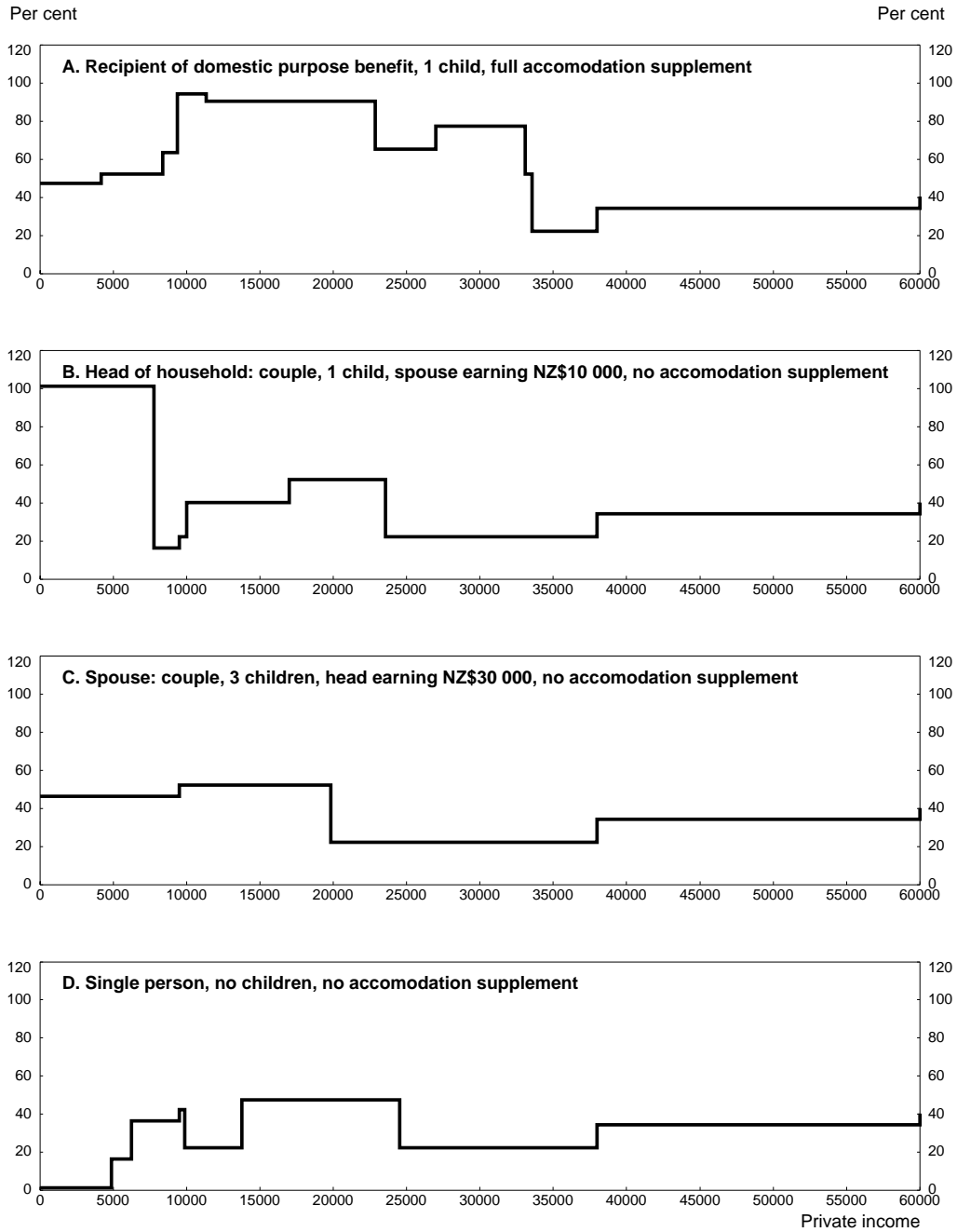
2. The average implicit tax rate is income taxes actually paid (including the ACC premium) by each income decile divided by the average gross income of each decile, before and after deduction of tax credits.

The average statutory rate measures the average tax rate that should be paid by an average taxpayer in each decile in the absence of any tax credits, earning wage income only. The main difference between the average implicit tax rate before tax credits and the average statutory rate in the lower income deciles is due to individuals earning capital income (hence is taxed at a minimum rate of 19.5 per cent).

Source: Treasury's tax model (based on data from the 1997/98 Household Expenditure Survey inflated to 1999/2000) and OECD calculations.

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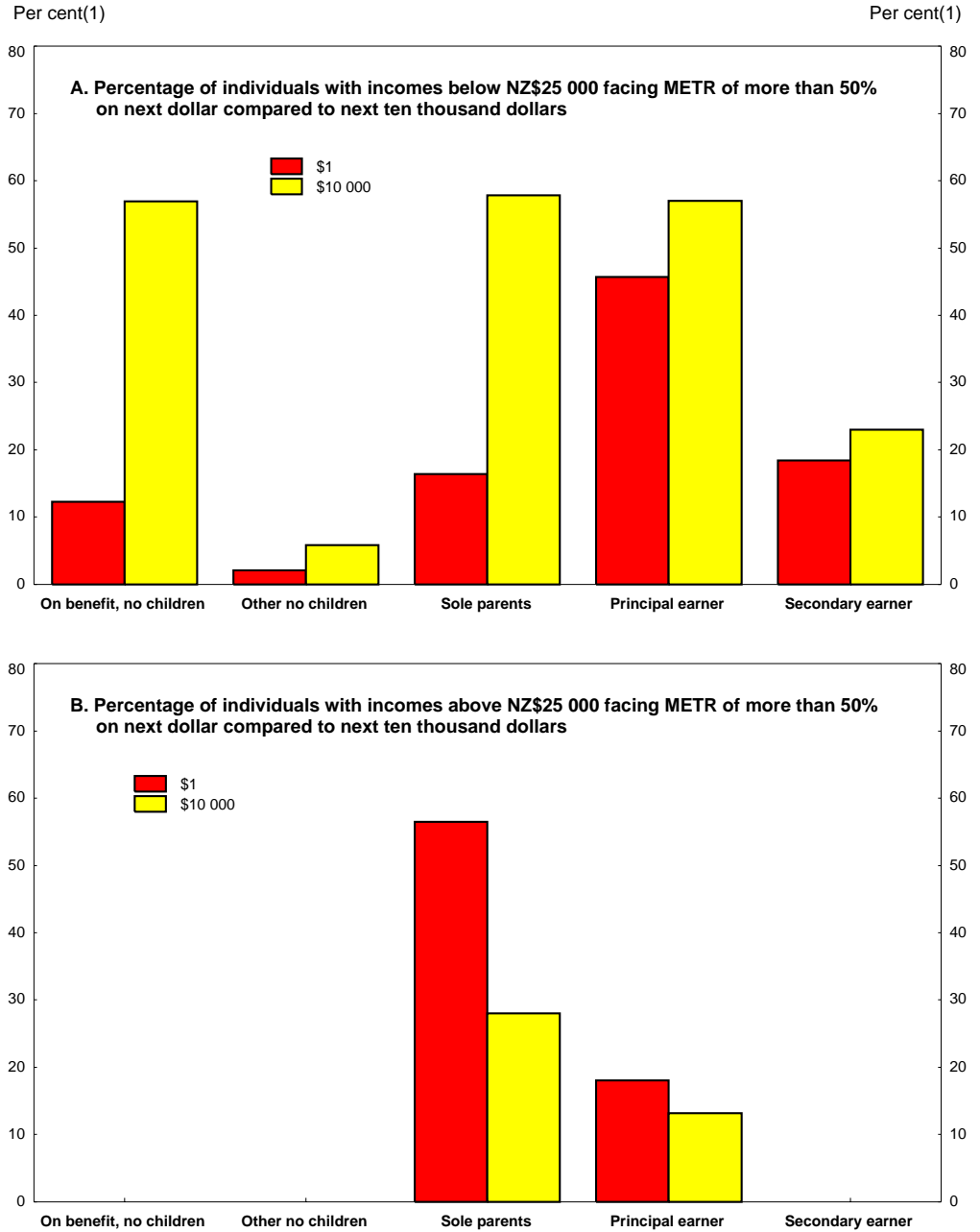
Figure 13. Marginal effective tax rates for various family types
1999/2000



Source: Treasury.

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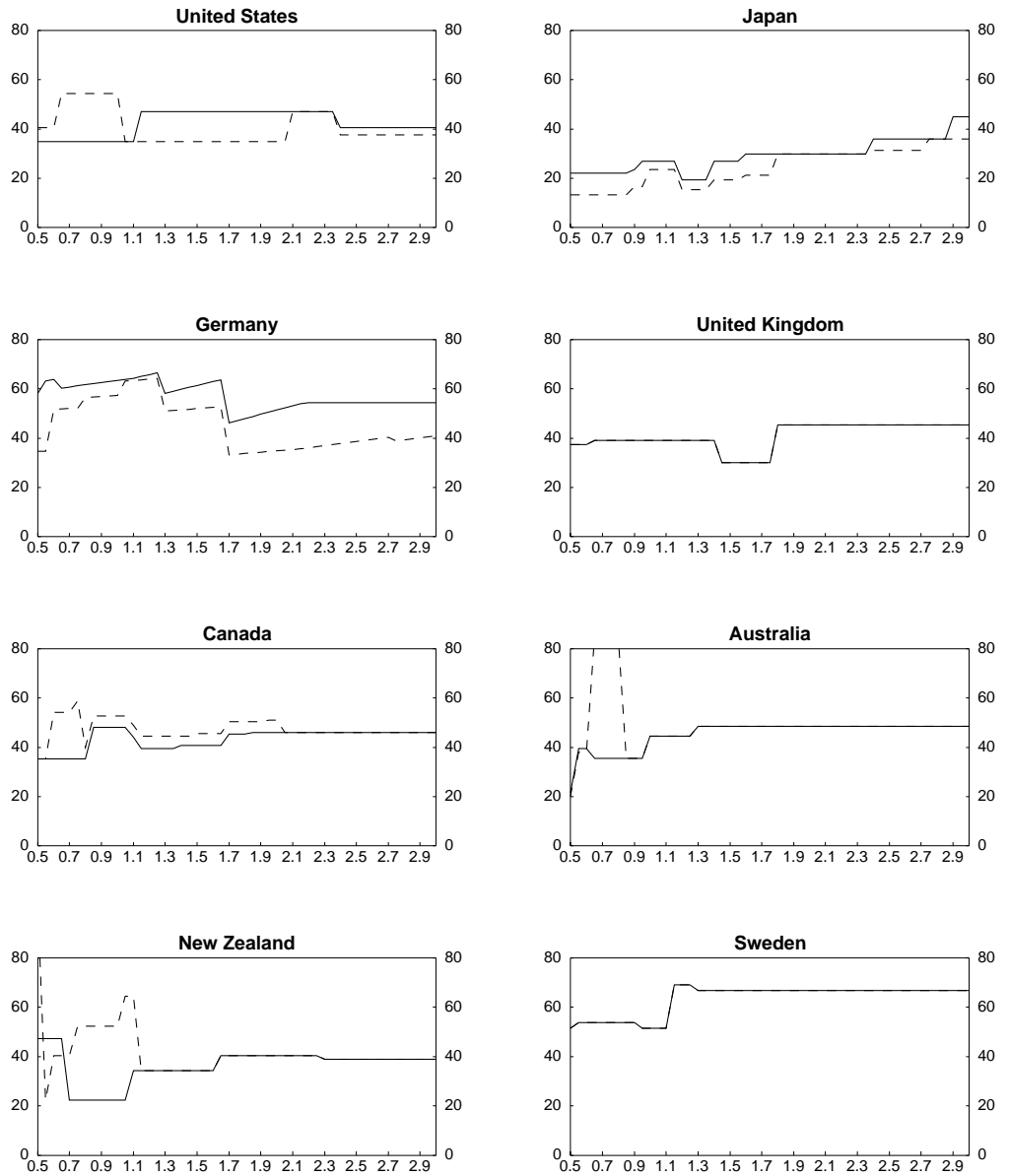
Figure 14. Marginal effective tax rates : marginal versus large income increases
2000/2001



1. Per cent of population in the family category concerned.
Source: Treasury, 2000.

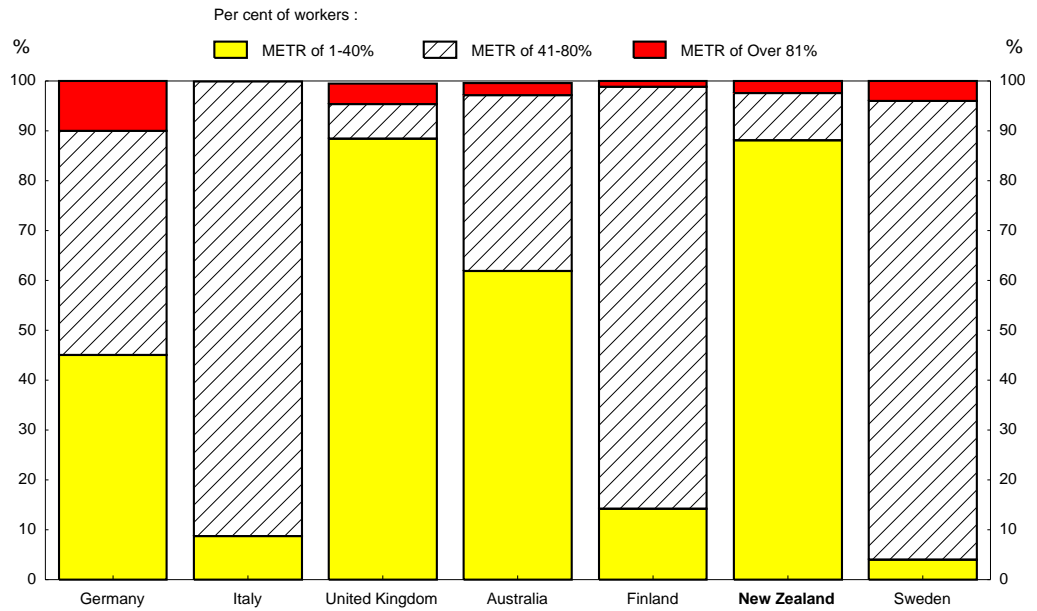
Figure 15. Marginal tax wedges on labour income in selected OECD countries (1)
 At multiples of average production worker earnings, 1998

— Single - no children - - Married - 2 children



1. Marginal tax rate, covering employees' and employers' social security contributions and personal income tax, with respect to a change in gross labour costs, by family type and wage level, assuming spouse earns no income. Data for New Zealand are for 1999/2000.
 Source: Treasury; OECD Tax equations.

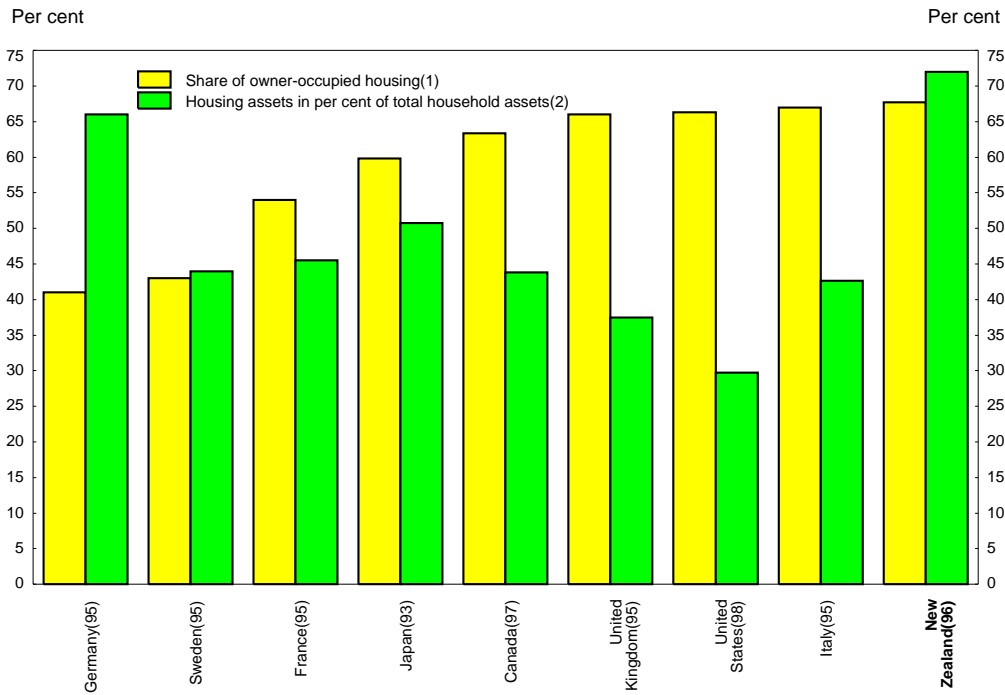
Figure 16. Distribution of marginal effective tax rates in selected OECD countries(1)
Early/mid 1990s



1. Marginal effective tax rates calculated for employed persons only because data on the unemployed and non employed are not comparable across countries.
Source: OECD (1997).

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Figure 17. Housing investment in selected OECD countries

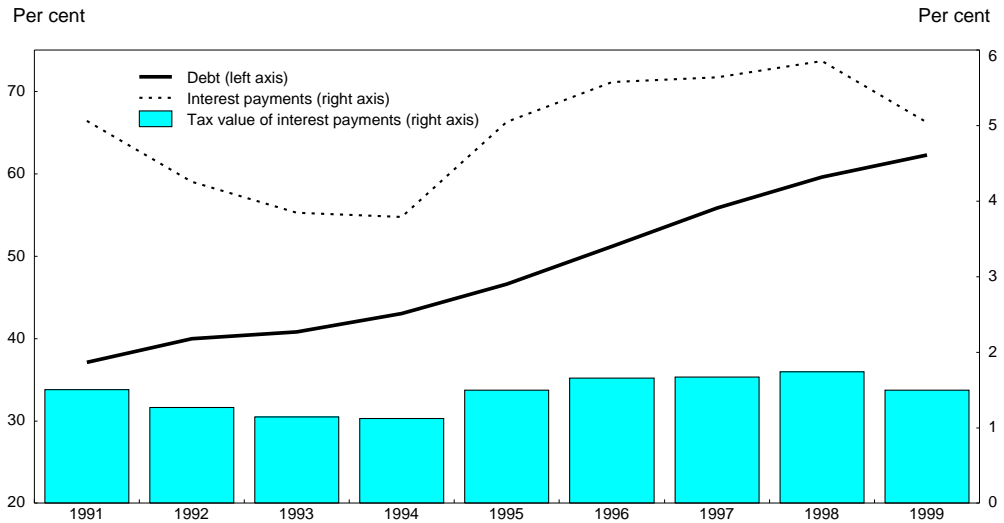


1. Data in brackets is the census year.

2. 1998 figures for all countries. The data are particularly fragile due to difficulties of measurement of household portfolios and may hence not be fully comparable across countries.

Source: National sources and Mylonas et al. (2000).

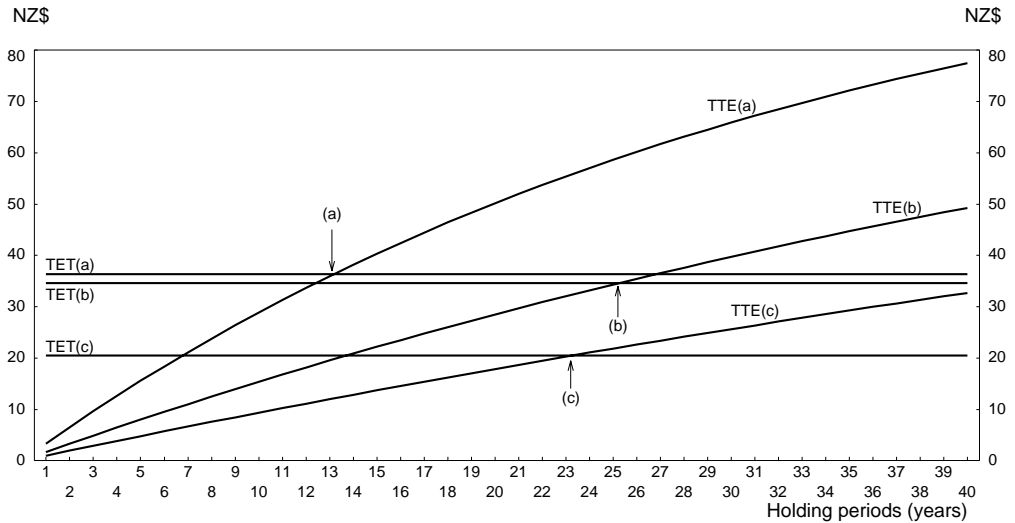
Figure 18. Household debt and interest payments(1)
Per cent of GDP



1. Debt and interest figures include mortgages as well as other household liabilities (roughly around 10 per cent of the total). The tax value of interest payments is calculated assuming a personal marginal tax rate of 33 per cent and mortgage interest amounting to 90 per cent of all household interest expenditure.
Source: Thorpe and Ung (2000).

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Figure 19. Examples of TTE versus TET taxation(1)
Present value of total tax payments



1. The figures shows, for varying holding periods, the present value of tax payments on a 100 dollar deposit in a pension plan with TTE and TET taxation, respectively (disregarding tax on the initial contribution which is identical under the two regimes). Three different situations are shown : a) tax rate of 33 per cent on both earnings and withdrawal, rate of return 10 per cent; b) tax rate of 33 per cent on both earnings and withdrawal, rate of return 5 per cent; c) tax rate 19.5 per cent on both earnings and withdrawal, rate of return 5 per cent. The points at which the TET breaks even compared with TTE are marked a, b and c respectively (these are the points where total tax payments on a TTE pension scheme starts exceeding those on a TET pension scheme). The household discount factor is assumed to be identical to the rate of return.
Source : OECD calculations.

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ANNEX I

THE TAX SYSTEM IN 2000

I. Personal income tax⁷⁴*Tax unit: the individual*

Tax base: besides labour income, the statutory personal tax system applies separately to investment income (interest income, dividends and certain kinds of capital gains). The statutory rates for investment income combine with the Low Income Rebate (LIR) to produce the effective tax scale for labour income (including self-employed, welfare benefits, recipients of New Zealand Superannuation and veterans' pension income). The LIR is applied to labour income only but abated on all income. Domestic withholding taxes apply to wage and salary income, dividends and interest income. Self-employed, shareholder employees, partners and any person who has significant other income that has not had tax withheld (such as rental income) are categorised as "other persons" (i.e. having income apart from wages and salaries). These taxpayers have to file an income tax return but are otherwise taxed at the same rate as wage and salary earners.

Tax rates:

National	Local	Highest all-in marginal rates
Statutory rates: NZ\$ 0-38 000: 19.5 per cent NZ\$ 38 000-60 000: 33 per cent Above NZ\$ 60 000: 39 per cent Effective rates on labour income (statutory rates adjusted for LIR): NZ\$ 0-9 500: 15 per cent NZ\$ 9 500 – 38 000: 21 per cent NZ\$ 38 000-60 000: 33 per cent Above NZ\$ 60 000: 39 per cent	New Zealand has no state or local income tax.	Residents: Wage income: 39 per cent Self-employment income: 39 per cent Dividends: 39 per cent Interest: 39 per cent

74 Annex Table 1 compares main features of New Zealand's personal income tax system with those of other selected OECD countries.

Withholding taxes:

Residents: dividends at 33 per cent; interest income at 19.5/33/39 per cent (the choice of rate is optional for the taxpayers - but if no Inland Revenue Number is provided the default rate is 39 per cent). The PAYE is a withholding tax on salary and benefit income.

Non-residents withholding tax (NRWT) of 15, 15 and 30 per cent is levied on interest, royalty payments and dividends, respectively, but these rates are generally reduced to 10, 10 and 15 per cent under New Zealand's double taxation agreements. Relief from double taxation on dividend distribution is provided through New Zealand's Foreign Investor Tax Credit (FITC) regime, which extends New Zealand's imputation system to non-resident shareholders of New Zealand companies. Non-resident withholding tax on interest and royalty payments is deductible to the company to ensure that no double taxation arises. For certain registered securities, resident borrowers are subject to an approved issuer levy (AIL) of 2 per cent. There is no obligation to deduct the non-resident withholding tax from interest paid to offshore investors for these securities.

Foreign dividend withholding payments (DWP): when companies, unit trusts (including Group Investment Funds, category A income) and superannuation funds derive dividend income from overseas, they are required to deduct a dividend withholding payment on behalf of their shareholders. The withholding rate is currently 33 per cent. A credit for the foreign dividend withholding payment is deducted from the shareholder's liability once the dividend is passed on. This is similar to the way imputation credits can be passed on to shareholders.

The taxation of dividends, interest and royalties can be summarised as follows:

From/to	Companies		Individual investors	
	NZ resident	Non-resident	NZ resident	Non-resident
Dividends				
NZ resident company	Imputation credit available	NRWT; FITC available	Imputation credit available	NRWT; FITC available
Non-resident company	DWP with underlying foreign tax credit if ownership > 10 per cent	-	Credit for withholding taxes paid	-
Interest				
NZ resident company	Resident withholding tax to extent not imputed	NRWT/AIL Deduction may be subject to thin capitalisation rules	Resident withholding tax to extent not imputed	NRWT/AIL Deduction may be subject to thin capitalisation rules
Non-resident company	Credit for withholding taxes paid	-	Credit for withholding taxes paid	-
Royalties				
NZ resident company	Taxed as part of income	NRWT	Taxed as part of income	NRWT
Non-resident company	Credit for withholding taxes paid	-	Credit for withholding taxes paid	-

Tax credits and allowances:

The Low Income Rebate applies where income is below NZ\$ 38 000 (cf. rate schedule above).

The Transitional Tax Allowance is available to persons who work for more than 20 hours per week and the person and his/her spouse do not receive family assistance. The rebate is NZ\$ 728, reduced by 20 cents on each dollar earned over NZ\$ 6 240 - thus the rebate is exhausted at NZ\$ 9 880. Children are not entitled to the Transitional Tax Allowance.

The Family Support Tax Credit allows a tax credit for low- and middle-income families with dependant children according to the following schedule: for the eldest child aged 0-15: NZ\$ 2 444 per annum; aged 16-18: NZ\$ 3 120 per annum. For each other child: aged 0-12: NZ\$ 1 664 per annum; aged 13-15: NZ\$ 2 080 per annum; aged 16-18: NZ\$ 3 120 per annum. It is reduced by 18 cents for each dollar of gross family income between NZ\$ 20 000 and 27 000 per annum, and by 30 cents for each dollar of gross family income above NZ\$ 27 000 per annum. The Family Support Tax Credit can be paid in addition to income-tested benefits.

The Family Plus Tax Credit (merging the former Independent Family Tax Credit, or IFTC, and the Guaranteed Minimum Family Income, or GMFI, and also adding a new element, the Parental Tax Credit) is assistance for working families with children, i.e. it is generally not available to those receiving welfare assistance. It consists of three separate components:

- *The Family Tax Credit* (formerly GMFI) is available to sole parents who work at least 20 hours a week and to couples who work at least 30 hours a week in total. It provides a guaranteed income level net of tax below which a family's income cannot fall. If a family's net-of-tax income drops below the guaranteed level (currently NZ\$ 15 080 per annum), the government tops up the difference. The Family Tax Credit is payable to a family receiving payments from the workplace accident insurance, ACC.
- *The Child Tax Credit* (formerly IFTC) is a top-up of the Family Support Tax Credit, but for working families only. It allows a tax credit of NZ\$ 780 per dependent child per annum provided that the family does not receive welfare benefits, and has not been on accident compensation for a period of greater than three months. The full amount of the credit is available to eligible families with taxable incomes up to NZ\$ 20 000 per annum. It is reduced by 18 cents for each dollar of family income between NZ\$ 20 000 and 27 000 per annum, and by 30 cents for each dollar of family income above NZ\$ 27 000 per annum.
- *The Parental Tax Credit* (in effect from October 1999) provides a payment of NZ\$ 1 200 after the birth of each child for families who also qualify for the Child Tax Credit. The same abatement criteria apply.

The abatement is applied first to the Family Support Tax Credit, second to the Child Tax Credit and last to the Parental Tax Credit.

Children: No credit to parents. A child below 15 years of age, or under 18 and attending an educational institution, may claim the child rebate against their own earnings. The rebate is calculated as 15 per cent of gross earnings from employment, up to a maximum allowance of NZ\$ 156 on NZ\$ 1 040 of income. Interest and dividends are excluded from the calculation of this rebate.

Non-standard allowances: none

The main welfare benefits are and their abatement rates are:

- The community wage (unemployment benefit) - abatement rate of 70 per cent for non-benefit income above NZ\$ 80 per week.

- Invalids, widows and domestic purpose benefits - abatement rates of 30 per cent for non-benefit income above NZ\$ 80 and below NZ\$ 180 per week, thereafter 70 per cent (the income test on the domestic purpose benefit is sometimes applied on an annual, rather than weekly, basis, which provides greater scope for income smoothing). For full-time work-tested domestic purpose benefit recipients (i.e. if youngest child is aged above 14), the abatement rate is 70 per cent on income above NZ\$ 80 per week.
- The accommodation supplement - for welfare benefit recipients the abatement rate is 25 per cent for non-benefit income up to NZ\$ 80 per week. For those who do not receive welfare benefits, the abatement rate is 25 per cent when weekly income exceeds the rate of the gross invalidity benefit plus NZ\$ 17.92 (e.g. NZ\$ 239.92 per week for a single person with no children). For a couple, the gross rate of invalidity benefit is calculated on the basis that the entire net rate is paid to one taxpayer.
- The most common transfer payment, the New Zealand Superannuation (the public pension), no longer affects marginal effective tax rates after the elimination of the NZS-surcharge in 1998/99.

Other notable features of the personal income tax system

Income taxed at preferential or discriminatory terms:

New Zealand does not have an explicit capital gains tax. This means that certain items of economic income are exempt from tax. The main examples are gains on shares, housing, commercial real estate and other assets (excluding financial arrangements) not held on revenue account. There are taxes in place that have the same effect as a capital gains tax for certain areas:

- a) The accruals regime taxes all gains from some financial arrangements - with the notable exceptions of equity, life insurance, etc. - as being held on revenue account (but does not necessarily treat them for deductibility purposes).
- b) There are rules that buttress the “business” and “income from ventures” tests. These rules are more extensive for land. Some gains that would ordinarily be regarded as capital are caught by these rules as taxable income.

Employers’ contributions to private superannuation schemes, irrespective of the marginal personal tax rate of the employee, are taxed at the corporate rate of 33 per cent. There are no restrictions on employers’ contributions to superannuation funds as a way of remunerating employees, but in order to curb tax avoidance, the contributions must stay in the superannuation fund until the employee leaves the job or withdraws the money for reasons of “significant hardship”. Otherwise, a 5 per cent fund withdrawal tax will apply.

Income accumulating in life insurance and private superannuation funds is taxed at 33 per cent, irrespective of the marginal tax rate of the investor. Thereby a subsidy is given to individuals with a marginal tax rate of over 33 per cent, while a penalty is imposed on individuals with lower marginal tax rates.

A comprehensive multi-rate fringe benefit tax is levied at the employer level. New rules for the fringe benefit tax were introduced by the March 2000 tax bill. Employers will have the choice of paying a flat 64 per cent tax on all benefits (corresponding to a 39 per cent marginal tax rate at the level of the

individual recipient), or to apply a multi-rate system. The rules applying to the latter are as follows: certain benefits (motor vehicles other than pooled vehicles, low-interest loans, other benefits with a taxable value of NZ\$ 1 000 a year or more and miscellaneous fringe benefits with a taxable value of NZ\$ 2 000 per year or more) must be attributed to the individual employee receiving them and taxed at the employee's marginal tax rates (i.e. 27, 49 and 64 per cent, respectively, corresponding to individual marginal rates of 21, 33 and 39 per cent, respectively). The value of the attributed benefits will be included in the calculation to determine the fringe benefit tax payable on these benefits. Fringe benefits not attributed to an individual employee as well as pooled fringe benefits (such as pooled motor vehicles) will be subject to fringe benefit tax at 49 per cent. Some small fringe benefits are untaxed.

Taxation of pension saving: Life insurance schemes and private savings plans (superannuation) are taxed as TTE, i.e. contributions are made from after-tax income, the current earnings of the funds are taxed at a flat rate of 33 per cent and the payments are untaxed.

Taxation of trusts: the current tax system allows business income, interest and dividends to be channelled from trusts to people with low marginal tax rates (for instance, children or non-working spouses) as trust beneficiary income. The government is currently considering introducing legislation to tax trust distributions to minors at 33 per cent rather than the minor's marginal tax rate, which would in many cases be 19.5 per cent.

II. Social security contributions

New Zealand has no compulsory social security contributions to schemes operated within the government sector (or outside of the government sector for that matter). However, the workplace accident insurance scheme (ACC), which was recently transferred back to the public sector (see Chapter III),⁷⁵ is a payroll tax levied at the rate of 1.3 per cent on all employees. It is paid by the employer on behalf of the employees and thus deducted from wages and salaries. The contribution is capped at an annual income of NZ\$ 83 017 at which point the levy reaches NZ\$ 1162.24.

III. Corporate income tax⁷⁵

Tax units: Corporate taxes are levied on all New Zealand resident companies, local government trading enterprises, unit trusts (including Group Investment Funds, category A income), and superannuation funds. New Zealand resident corporations are taxed on their worldwide income with an allowable credit for tax paid overseas. Non-resident companies operating and investing in New Zealand are taxed only on their income derived from New Zealand. Business profits and interest derived by non-residents with a fixed establishment in New Zealand are subject to corporate taxes. Other interest income and dividends or royalty payments are subject to NRWT.

Income tax rates

National	Local
33 per cent	No local corporate income taxes are levied.

75 . Annex Table 2 compares main features of New Zealand's corporate tax system with those of other selected OECD countries.

Other key features of the corporate tax system:

Capital gains: No capital gains tax is levied in New Zealand. However, resident companies are taxed on all gains derived from certain types of financial arrangements and from certain property transactions. These gains are subject to tax at the standard corporate tax rate.

Dividends received from other New Zealand resident companies are taxable. However, dividends received from a wholly owned subsidiary resident in New Zealand are exempt as are dividends received from non-resident companies.

Tax credits are allowed for corporate taxes paid to foreign governments. The tax credit is limited to the amount of New Zealand tax payable on that income.

Losses may be carried forward for an unlimited duration, subject to continuity provisions for shareholder ownership (if at all times, from the beginning of the year of the loss to the end of the year of the offset, the same group of persons hold an aggregate minimum voting interest in the company and, in certain circumstances, minimum market value interest of at least 49 per cent). If these provisions are breached, then the losses expire. No carry back is allowed. The so-called loss-attributing qualifying companies (LAQCs) are not allowed to carry losses forward, but must pass on the loss immediately to their shareholders, who can then deduct these losses against other taxable income. Certain criteria must be met to become a LAQC: the company generally must be a qualifying company; it must have five or fewer natural persons as shareholders; all shares in the company must carry the same rights as each other share in the company; a notice in writing electing that the company be a LAQC must be received by the Commissioner of Inland Revenue before the first day of the year for which LAQC status is sought.

Consolidated income reporting: Losses incurred within a group of companies may be offset against other group company profits either by election or subvention payments. Subvention payments are inter-corporate payments specifically made to effect the transfer of company losses. They are treated as deductions to the paying (profit) company and as taxable income to the recipient (loss) company. The loss- and profit-making companies must be in the same group of companies throughout the relevant period. The required common ownership is 66 per cent. Wholly-owned corporate groups may elect income tax consolidation in which intra-group transactions are largely ignored for tax purposes.

Imputation system: New Zealand's dividend imputation system enables a resident company to allocate to shareholders a credit for New Zealand income tax. This credit can be offset against any tax payable by that shareholder.

Inventories must generally be valued at cost (according to generally accepted accounting principles) or market value (although market value may not be used for shares or "excepted financial arrangements") if it is lower than cost. Simplified rules apply to small taxpayers (annual turnover of less than NZ\$ 3 million).

Depreciation: Most assets can be depreciated using the declining-balance or straight-line methods (for fixed life intangible property only straight line is available). Assets valued at less than NZ\$ 2 000 may be pooled. Property costing less than NZ\$ 200 may be expensed immediately. Only economic depreciation rates may be applied to newly acquired buildings, second-hand property bought in New Zealand and imported used cars. An accelerated regime exists ("loading") by which assets can be depreciated by 20 per cent the first year.

Preferential depreciation regimes (immediate deduction of all expenses) exists for forestry, mining, intellectual property rights and certain kinds of R&D. Deduction of R&D expenditures may fall under one of three provisions in the income tax act:

- If the R&D expenditures are not of a “capital nature” (for instance, ongoing modifications of an existing product), they are immediately deductible.
- If the R&D expenditures are of a “capital nature” and classified as expenditures for “scientific research”, they are generally immediately deductible, but may also in some circumstances be deductible over the life of the asset.
- If the R&D expenditures are of a “capital nature” and classified as expenditures for “development”, they may be deductible over the life of the asset if they result in an intangible, depreciable asset (such as patents and copyrights). If these expenditures do not result in an intangible asset, no deduction is allowed (so-called “black hole” expenditure).

IV. International taxes

Foreign investments by New Zealand companies can be organised as foreign-incorporated entities (subsidiaries) or as branches of the home company. Income earned by a *foreign branch* of a New Zealand company is consolidated with that earned by the parent company and taxed by New Zealand upon accrual. New Zealand provides a tax credit for underlying foreign corporate taxes paid by the branch (limited to the amount of tax that is payable under New Zealand law). Dividend distributions from firms earning profits in foreign branches are taxable to individual recipients in New Zealand, with imputation credits available for New Zealand (but not foreign) taxes paid on the underlying income. Individual resident investors thus effectively pay full New Zealand tax on all after-foreign-tax source income. Individual taxes are not due until income is distributed as dividends, i.e. most of the New Zealand tax on income earned by foreign branches is deferred until that date.

In the case of income earned abroad by *subsidiaries*, the New Zealand tax system distinguishes between controlled foreign investment (CFC: “Controlled Foreign Company”) and portfolio investment (FIF: “Foreign Investment Fund”). The CFC and FIF regimes were enacted in 1988. These regimes tax the income that residents accumulate in foreign entities that are resident in any other country (except for countries on the grey list). Under the CFC rules, individuals and corporations are subject to tax on their pro-rata share of the annual total income of CFCs in which they own an income interest of 10 per cent or more⁷⁶. Income in such corporations is taxed annually under the same general rules applied to income from domestic corporations and foreign branches. Residents may claim tax credits for foreign income taxes paid by CFCs up to the amount of tax that is payable under New Zealand law. A foreign entity that is not a CFC is by definition a FIF, unless it qualifies for an exception.⁷⁷ Under FIF rules, residents are taxed on their net cash receipts from the foreign entity plus the change in the market value of their interests - thereby taxing distributed as well as undistributed income of the foreign entity.

The CFC and FIF regimes do not apply to the so-called “grey-list” countries, i.e. the United States, Japan, Germany, the United Kingdom, Canada, Australia and Norway. There are “look through” rules within the CFC regime to prevent grey-list countries from being mere conduits for non-grey-list investment. These look-through rules do not, however, extend to FIFs.

76. The act defines a foreign corporation as a CFC if 50 per cent or more of the shares of the corporation are held by five or fewer New Zealand residents or their associates; or one New Zealand corporation owns 40 per cent or more of a foreign affiliate and no single non-resident has a greater ownership interest; or a group of five or fewer New Zealand corporations otherwise control the affiliate.

77. Such as the grey-list country exception, cf. below.

Transfer pricing: Transactions between related parties must be made at arms-length prices (assuring fair-market valuation) as determined under OECD principles. Binding rulings with respect to transfer pricing issues are available from the Commissioner of Inland Revenue.

Thin capitalisation: If a non-resident-controlled New Zealand company over-allocates interest expenses to the New Zealand affiliate, the excess interest is disallowed a tax reduction. A safe harbour 3:1 debt/equity ratio is allowed before the clause applies. If the safe harbour is breached, the New Zealand company's debt/equity ratio is compared with that of the non-resident owner's worldwide debt/equity ratio. If the New Zealand ratio is higher (by some percentage), the interest on the excess debt is not deductible.

Foreign investor tax credit. Imputation credits from New Zealand companies may not be used to offset withholding tax on dividends paid to non-residents (generally 15 per cent withholding tax under double tax agreements). However, the New Zealand company may pass on the benefit of such credits to non-resident investors through payments of supplementary dividends. The foreign investor tax credit regime ensures that the sum of the company tax and non-resident withholding tax imposed on distributed earnings cannot exceed the company tax rate of 33 per cent. Hence, it extends the benefits of New Zealand's imputation system to non-resident shareholders of New Zealand companies.

The approved issuer levy. For certain registered securities, resident borrowers are subject to an approved issuer levy (AIL) of 2 per cent on interest payments to non-residents. There is no obligation to deduct the non-resident withholding tax from interest paid to offshore investors in these securities.

The conduit relief regime exempts non-residents from tax on non-domestic income derived by New Zealand companies (except for the 15 per cent non-resident withholding tax).

V. Property, inheritance and gift taxes

The only local taxes on land are the so-called "rates" charged by local and regional authorities. These vary by location but are typically charged on the improved value. There are no central government taxes on holding land or stamp duty on transactions of land. There is no capital gains tax on land *per se*, but the rules that "buttress" land held on revenue account result in the taxation of some gains that would otherwise be capital. If capital gains are held on a firm's revenue account, they are assessable as taxable income. The treatment of individuals is almost the same as the treatment of companies and trusts, although there are some personal exemptions for individuals and businesses from the buttressing rules.

New Zealand does not apply separate inheritance tax or stamp duties. A gift duty is levied at rates ranging from 5 to 25 per cent. The lowest rate applies when the value of the gift exceeds NZ\$ 27 000, while the top rate kicks in at NZ\$ 72 000.

VI. Consumption taxes⁷⁸

GST (Vat) rate: 12.5 per cent standard rate. For long-term stay in a commercial dwelling GST at standard rate is levied on 60 per cent of the value of the supply (i.e. an effective rate of 7.5 per cent). A *zero vat rate* applies to export of goods and services; the supply of fine metal (gold, silver or platinum) from a refiner to a dealer; and the supply of the local authorities' petroleum tax (the distribution of the local authorities' petroleum tax between local authorities).

78. Annex Table 3 compare main features of New Zealand's GST with VAT systems in other selected OECD countries.

Exemptions: Unlike most other OECD countries, New Zealand *does not* provide a number of “standard exemptions”.⁷⁹ This means that exemptions are limited to financial services; rental accommodation; life insurance and reinsurance; and unconditional gifts.

Special regimes for small taxpayers:

Basic concession providing relief from VAT registration is given to small traders with annual gross sales up to NZ\$ 40 000.

Major excises. Specific excises are levied on alcohol, tobacco and petroleum. A special duty is levied on gambling.

VII. Local taxes:

Almost all revenues stem from the rates (real estate taxes). Rates are generally based on a mixture of land (unimproved) values and/or capital (land plus improvements) values, which are determined by three-yearly valuation cycles. Local governments have full discretion to set the rates, subject to a general balanced budget requirement. Other revenue sources include user charges and fees as well as surpluses from local government enterprises.

Local authorities are required by law to set operating revenues at a level sufficient to cover operating expenses in any financial year (with a few relatively narrow exceptions to run deficits). There is no regular, formal role for central government in reviewing or approving the budgets of local authorities and also no obligation on central government to assist those local authorities which experience financial difficulty: for example, the Local Government Amendment Act (No. 3) 1996 explicitly states that local authority loans are not guaranteed by central government.

79. These are postal services; dental care; charitable work (other than unconditional gifts); education; non-commercial activities of non-profit making organisations (other than unconditional gifts); cultural services; insurance and reinsurance (other than life insurance and reinsurance); letting of immovable property (other than rental accommodation); lotteries and gambling; supply of land and buildings (other than land and buildings which have been used for the provision of residential accommodation for five years or more).

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Table A1. Taxation of personal income in selected OECD countries
1999

	United States	Japan	Germany	United Kingdom	Canada	Australia	Ireland	New Zealand ¹	Sweden
Taxes raised by central government									
Range of statutory rates (per cent)	15-39.6	10-37	0-53.0	20-40	17.5-31.3	20-47	24-46	15-39	20-25
Number of tax schedules ²	5	4	4	3	4	4	2	4	2
Rates of sub-national taxes (per cent)	0-11.6	5-13	-	-	12.7-22.8	-	-	-	25.2-34.7
Marginal tax rate for top income									
Earners ³ (per cent)	48.1	50	55.9	40	54.1	48.5	50.3	39	59.6
Effective tax threshold ⁴ (proportion of APW income)	0.8	0.9	1.0	0.3	0.7	0.2	0.6	0.7	0.04
Highest tax bracket starts at (proportion of APW income)	9.5	4.3	2.0	1.7	1.8	1.2	0.6	1.7	1.7

1. Statutory rates apply for 2000.

2. Excluding zero band or basic allowance.

3. Wage income.

4. For an employee with a non-working spouse and two children (1998 except for Japan (1999) and Korea (2000)). In Japan, one child is between 16 and 22 years of age. In the United States, one child is below 16 years of age. APW = average production worker in manufacturing

Source: OECD Tax Data Base, 1999; OECD, *Taxing Wages*, 1999; Ministry of Finance, Japan (1999).

Table A2. Taxation of corporations in selected OECD countries

1999

	Central Government basic rate, per cent	Top marginal rate ¹ , per cent	Dividend wedge ² , per cent	Special rates (including small profits rate), per cent	Consolidation of losses within a group of companies	General rules of ownership, per cent ³	Loss carry forward, in years	Loss carry back, in years
United States	35	39.5	67.7	15	Yes	80	20	2
Japan	30	40.9	70.5	29.3	No	-	7	1
Germany	42.2/30 ⁴	54 ⁵	50.2	-	Yes	Several pre-requisites (Organschaft)	Unlimited	1
United Kingdom	31	31	48.3	21	Yes	75	Unlimited	1
Canada	29.1 ⁵	46.1	73.6	13.1/22.1 ⁵	No	-	7	3
Australia	34 ⁶	34	48.5	Pooled development funds; offshore banking units	Yes	100	Unlimited	0
Ireland	28/10 ⁷	28	56.3	10	Yes	75	Unlimited	1
New Zealand	33	33	39	-	Yes	66	Unlimited	0
Sweden	28	28	49.6	-	No (but income may be distributed within a group of companies)	90	Unlimited	0

1. Including local taxation and surcharges.
2. Differences between the pre-tax profit earned by the distributing company and the net dividend received by a top income shareholder.
3. The ownership rules normally refer to the percentage of ownership of equity (or voting power) that the parent company has over the subsidiary. In some countries the rules may include both direct and indirect ownership. Several countries allow consolidation among resident companies only.
4. Germany and Mexico apply split-rate systems (i.e. different tax rates apply to distribution and retaining of profits).
5. Including surcharges.
6. From FY 2000/2001. The rate will be further reduced to 30 per cent in FY 2001/2002.
7. The higher rate applies to trading income from non-manufacturing activities, the lower the rate for manufacturing activities and certain financial activities. The rate was reduced to 24 per cent from 1 January 2000 and will be reduced to 12½ per cent (25 per cent on non-trading income) from 2003. The 10 per cent rate will then be phased out.

Source: The OECD Tax Data Base, 1999; Ernst and Young, *The 1999 World Corporate Tax Guide*.

**Table A3. Main features of VAT systems in selected OECD countries
1998**

	Year VAT introduced	Initial standard rate	Current standard VAT rate ¹	Tax-exempt threshold sales for small traders (in thousand 1998 PPP-US\$)	Departures from standard exemptions ²		Coverage of lower rates	
					Exemptions other than "standard exemptions"	Taxation of "standard exemptions"	Zero rate ³	Lower rates
Japan	1989	3	5	183	Social welfare services.	Letting of commercial buildings; postal services; non-commercial activities of non-profit making organisations; cultural services; supply of buildings.	-	-
Germany	1968	10	16	16	-	-	-	Books; food; newspapers; certain cultural events; charitable work if not exempt; transport (applies only to passenger transport by ship and to local public passenger transport). Rate = 7 per cent.
United Kingdom	1973	10	17.5	76	Burials and cremations; sports competitions; certain luxury hospital care.	The freehold sales of new commercial buildings are standard rated for three years from completion date. Furthermore there is an "option to tax" for other supplies of commercial buildings which would ordinarily be exempt from VAT. Gaming machines and certain gambling in licensed clubs.	Certain services and goods supplied to charities; children's clothing; food; passenger transport; books; newspapers; domestic sewage and water; prescribed drugs; medicine; certain aids for disabled; new housing; residential and some charity buildings; alterations to listed buildings.	Fuel and power for domestic and charity use (5 per cent); certain energy saving materials supplied together with fitting services to recipient of "Passport benefits". Rates = 2.5/5 per cent.

Table A3. Main features of VAT systems in selected OECD countries (continued)

1998

	Year VAT introduced	Initial standard rate	Current standard VAT rate ¹	Tax exempt threshold sales for small traders (in thousand 1998 PPP-US\$)	Departures from standard exemptions ²		Coverage of lower rates	
					Exemptions other than "standard exemptions"	Taxation of "standard exemptions"	Zero rate ³	Lower rates
Canada	1991	7	15/7	26	Child care; legal aid; ferry, road and bridge tolls; standard municipal services.	Lotteries and gambling; supply and leasing of commercial land and buildings; domestic postal services.	Medicine; basic groceries; certain financial services (usually to non-residents); certain agricultural and fishing products; medical devices; international travel and transportation services; international organisations and officials; agriculture; precious metals (sales of 25 cents or less made through mechanical coin-operated devices).	-
Australia	2000	10	10	n.a.	n.a.	n.a.	n.a.	n.a.
Ireland	1982	16.4	21	57	Passenger transport; broadcasting; supply of water by public authorities; admissions to sporting events; funeral undertaking and travel agents/tour operators.	Long-term letting of commercial immovable property; supply of land and buildings.	Books; children's clothing and footwear; oral medicine; certain medical equipment; food products; seeds; fertiliser.	Newspapers and certain periodicals; fuel for certain purposes; electricity; works of art; veterinary services; agriculture services; car and boat hire; driving instruction; photographs; concrete; holiday accommodation; restaurant/hotel meals; building services; immovable goods; repair services; waste disposal; certain foods; tour guide services; admission to cinemas/certain musical performances; and sporting facilities.

Table A3. Main features of VAT systems in selected OECD countries (continued)
1998

	Year VAT introduced	Initial standard rate	Current standard VAT rate ¹	Tax exempt threshold sales for small traders (in thousand 1998 PPP-US\$)	Departures from standard exemptions ²		Coverage of lower rates	
					Exemptions other than "standard exemptions"	Taxation of "standard exemptions"	Zero rate ³	Lower rates
New Zealand⁴	1986	10	12.5	25	Supply of fine metal (gold, silver and platinum).	Postal services; medical care; dental care; charitable work (other than unconditional gifts); education; non-commercial activities of non-profit making organisations (other than unconditional gifts); cultural services; insurance and reinsurance (other than life insurance and reinsurance); letting of immovable property (other than residential accommodation); lotteries and gambling; supply of land and buildings (other than land and buildings which have been used for the provision of residential accommodation for five years or more); transport of sick/injured persons.	The supply of taxable activities (business) as a going concern; the supply of fine metal (gold, silver or platinum) from a refiner in fine metal to a dealer in fine metal; the supply by a local authority of the local authorities petroleum tax (the distribution of the local authorities petroleum tax between local authorities).	For long-term stay in a commercial dwelling, certain services - if provided as part of the right to occupancy - are subject to tax at the standard rate of 60 per cent of the value of the supply (an effective lower rate on such services of 7.5 per cent).
Sweden	1969	11.1	25	-	Public television and radio; certain memberships; publications; authors' rights; public cemetery services.	Postal services; most cultural services.	Commercial aircraft and ships; 'aircraft fuel'; prescribed medicine; printing of certain membership publications.	Accommodation; food; passenger transport; 'ski lifts'; 'newspapers'; works of art owned by the originator; import of antiques; collectors' items and works of art; culture (theatre, cinema, etc.); 'authors' rights'; commercial sports events; commercial museums, etc. rate = 6/12 per cent.

1. As of 1 January 1998. For Germany, this rate is applied as of 1 April 1998; for the United Kingdom, the standard rate is applied to a reduced value on imports of certain works of art, antiques and collectors items, resulting in an effective rate of 2.5 per cent. For Canada, 15 per cent Harmonised Sales Tax (HST) applies in those provinces that have harmonised their provincial retail sales tax with the federal GST (the 15 per cent HST is composed of a provincial component of 8 per cent and a federal component of 7 per cent).
2. Standard exemptions are the following: postal services; transport of sick/injured persons; hospital and medical care; human blood, tissues and organs; dental care; charitable work; education; non-commercial activities of non-profit making organisations; insurance and reinsurance; letting of immovable property; financial services; betting, lotteries and gambling; supply of land and buildings; certain fund-raising events.
3. All countries apply zero rates to exports.
4. 2000 rules.

Source: OECD, Consumption Tax Trends (1999).

ANNEX II

THE FOREIGN INVESTOR TAX CREDIT AND THE APPROVED ISSUER LEVY

The approved issuer levy (AIL) is charged at 2 per cent on interest payments to non-residents (for certain debt instruments that are registered with the tax department). The liability for AIL rests with the payer of the interest. Since the AIL is a deductible expense, the net tax rate for a company is 1.34 per cent.

The foreign investor tax credit (FITC) results in the combined New Zealand company tax and non-resident withholding tax (NRWT) being a maximum of 33 per cent for non-residents. This regime extends the benefits of New Zealand's imputation regime to non-resident shareholders of New Zealand companies. The FITC effectively implies that New Zealand foregoes the revenue from the non-resident withholding tax. The extent of the shareholders' benefits depend on their home country treatment of dividends received and tax credits. Since most countries allow full tax credit for withholding payments, the majority of revenues foregone by New Zealand accrue to the foreign investor, thereby contributing to a lower cost of capital in New Zealand. This would not be the case if the NRWT was simply abolished: in that case, the tax revenue foregone by New Zealand would mostly accrue to foreign governments, leaving the cost of capital in New Zealand unaffected.

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