1. Introduction

Iris Claus, Norman Gemmell, Michelle Harding and David White

1.1 BACKGROUND

The idea for this book arose in conjunction with a conference organized by Victoria University of Wellington with support from the New Zealand Treasury and from Inland Revenue in February 2009. Over the years, New Zealand governments have frequently been praised for their commitment to tax reform, for developing a tax system that displays many desirable features, and for avoiding many of the pitfalls of numerous other OECD countries’ tax systems. It is perhaps no coincidence, therefore, at a time when the late-2000s global economic crisis is generating increasing fiscal pressures in many countries, that Wellington was the scene for a major gathering of some of the world’s leading experts on tax policy. The overarching question that the conference sought to address was: ‘what can tax policy makers in open economies learn about beneficial directions for medium-term tax reform in the light of global developments and lessons from the latest taxation research?’ That is also the underlying theme of this book, and in this introduction we bring together some of the lessons learned from the international and country perspectives presented in later chapters.

The book covers a range of tax reform issues from general assessments of different countries’ tax systems to key aspects of taxes on labour, capital, individuals and corporations. The chapters included in this volume cannot resolve many of the issues currently challenging tax policy makers around the world, faced with an increasingly integrated world economy, and the aftermath of the ongoing global recession. However, they do provide some of the latest thinking by some of the world’s most respected contributors to tax debates in the United States, Europe, Australia and New Zealand. In many cases, further work will be required to yield definitive answers to some important tax policy questions – such as the role of global ‘taxes’ to deal with climate change externalities. For many current tax policy questions, however, a number of tentative, and some more robust, answers are possible.
As might be expected from the assembled contributors and conference location, a number of chapters focus on New Zealand, or use the New Zealand context to illustrate arguments or provide evidence. New Zealand is a small island economy in the South Pacific. However, current tax policy reform issues in New Zealand are surprisingly representative of many of those facing other small open economies. In addition, New Zealand has historically provided an interesting ‘test case’ for a number of major tax policy interventions, and it remains one of few countries where governments are prepared to at least look at some of the more radical options for reform.

1.2 SOME TAX POLICY LESSONS

This section summarises the lessons to emerge from the subsequent chapters by first considering ‘general issues’ related to tax structure and design (sub-section 1.2.1) and then considering lessons specific to particular taxes: corporate/capital taxes in sub-section 1.2.2 and personal/labour taxes in sub-section 1.2.3.

1.2.1 General Issues

Three general tax design questions are prominent in current tax policy debates. (1) Is ‘broad base, low rate’ (BBLR) still a useful barometer of tax system efficiency, or should tax rates on capital income be set lower than the (top) rate on labour income? (2) How important is alignment of corporate and top personal tax rates? (3) How far does tax structure design and the mix of different taxes affect economic performance such as gross domestic product (GDP) growth rates?

Broad base, low rate?

A clear message from this book is the importance of adopting a consistent framework between BBLR or tax systems that set different capital/labour tax rates or different corporate/(top) personal tax rates. For a given revenue requirement, taxing all forms of income defined as broadly as possible, at as low a rate as possible, is still widely respected internationally as a useful guiding principle. However, (a) it is often undermined in a number of countries by ad hoc policy interventions designed to deal with specific revenue-raising or social policy concerns; and (b) increased globalisation is making its achievement more difficult, at least in terms of a common low rate for all sources of income. For a given tax base, the general principle of broadening bases in association with rate reductions
remains a good rule of thumb for efficient taxation. International evidence for both corporate and personal taxes point to trends in this direction over the last several decades; see Peter et al. (2008) and Devereux (2008) respectively. Nevertheless, the Nordic countries have demonstrated that a dual tax system that taxes capital and labour income at differential rates can be made to work, if applied consistently, and where it is desired to keep top rates of tax on labour income particularly high (generally 50 per cent or more), and international migration of labour/human capital is not a serious concern.

Rate alignment
On the second question – is rate alignment a good idea? – clearly taxing similar forms of income similarly makes sense to avoid unnecessary distortions and tax arbitrage. However, the global drive towards lower corporate tax rates as capital becomes more mobile, while governments appear to want to maintain progressive personal income taxation, makes achieving alignment more difficult. Where labour is also highly mobile, as in countries like Ireland, Luxembourg and New Zealand, the case for alignment is stronger, alongside a case for moving the tax mix towards less mobile tax bases such as land or immovable property. The alternative is rigorous, enforceable anti-avoidance legislation that prevents tax-motivated incorporation and other undesirable responses to the tax rate differential. This is not easily achieved, however, as recent UK experience suggests (with a small company rate below 20 per cent and a top personal rate of 40 per cent); see Crawford and Freedman (2009).

Taxes and growth
Common questions asked by policy makers are whether higher tax rates are bad for economic growth and, if so, are some taxes more harmful than others? Is globalisation affecting this relationship as capital becomes more mobile? Answering these questions has been difficult with plenty of micro-level evidence of individuals or businesses changing their behaviour in response to various tax settings, but mixed evidence at the macro level that such responses matter for aggregate growth of GDP or productivity. However, recent OECD and other aggregate-level evidence has been complemented by new evidence at the firm and sector levels, and both seem increasingly to tell a consistent story (see Chapter 2).

This points to a tentative ‘tax and growth’ ranking of (from most to least harmful): corporate, personal income, consumption and ‘recurrent taxes on immovable property’. However, as noted above, allowing a wedge to develop between personal and corporate tax rates can create avoidance opportunities, leading the OECD to more circumspect advice:
that moving the revenue mix from the first two to the last two should be growth enhancing via improvements to productivity and investment. OECD evidence also suggests a number of other features of ‘pro-growth’ tax systems – such as less progressive rate structures (but at some cost to equity considerations); levying consumption taxes at a single rate with as few exemptions as possible; and reducing high marginal and average tax rates on low-wage workers in countries where these act as a disincentive to work.

The aftermath of the global recession
At the time of writing (March 2009) it is unclear how deep or long the recession will be that was initiated by the global financial crisis of 2008–09. However, it is already clear that governments in many major economies are engaging in very large fiscal stimulus packages, involving unprecedented deficits, with ongoing public debt burdens for decades to come. This will put pressure on many OECD governments to raise additional tax revenues over the next decade at least, raising questions regarding how governments will, and should, attempt to achieve this. A number of responses can be made.

First, given the need to raise average tax burdens – tax revenues to GDP – the global decline in corporate tax rates may slow, together with a slowing or even reversal of recent trends towards lower and less progressive personal income tax rates. Second, however, tax rate rises are likely to be least harmful to efficiency if levied on relatively immobile factors, and rate rises can be kept lower to the extent that countries can extend the relevant tax bases. Third, countries that have managed to maintain relatively low post-crisis public debt levels will be better able to compete more effectively for mobile tax bases via lower tax rates on capital and/or corporations. Hence the desire by more indebted governments to raise their corporate tax revenues may be thwarted both by the need to stimulate business investment after the crisis and by international competition over corporate tax rates from less-indebted governments. In this context, general OECD governments’ hostility towards multinationals’ use of tax havens can also be expected to intensify.

Finally, one benefit of the financial crisis and subsequent recession is that governments may become willing post-crisis to undertake, and persuade voters to accept, major tax system reform as the imperative of raising additional revenue as efficiently as possible becomes more acceptable. Understanding better which taxes have most/least impact on both static and dynamic efficiency is an important objective for tax research.
1.2.2 Corporate and Capital Taxes

Given historical trends, an obvious question for tax reformers in small open economies is: will international downward pressures persist, and force further corporate tax rate reductions? Most researchers working in this area conclude that the long-term trend towards lower corporate tax rates looks set to continue (perhaps after a short-term interruption following the financial crisis as described above). The trend may, however, be slower in future with fewer base broadening options left to exploit. But, with further opportunities for increased capital mobility (as larger fractions of economies become more open to international competition), a continuing downward trend could be expected.

Of course, not all economic activities are equally vulnerable to foreign competition – there are ‘location-specific’ advantages to some industries and some foreign firms may need to locate in host countries in order to serve these markets or access their natural resources. Across the world, these aspects are likely to stop the corporate tax ‘race to the bottom’ reaching a zero tax rate. However, within a country, if a common corporate tax rate has to be applied to both mobile and immobile corporations, and both types compete for similar resources (labour, financial capital and so on) it will be more difficult to maintain a relatively high corporate tax rate to exploit location-specific factors. Perhaps for this reason, the review of Australia’s tax system is considering recommending different tax regimes for these two types of corporation – in Australia’s case by granting foreign and domestic firms differential access to imputation credits.

As noted earlier, how far rates of tax on capital or company profits fall will depend on how responsive firms are to tax rates and on the ease of ‘profit-shifting’ across countries. A growing body of research is producing clear evidence that both real and intangible (patents/trademarks) capital and multinational firms’ profits are becoming increasingly internationally mobile over time, and governments are increasingly competing over corporate tax rates to attract/retain that capital and profit. US multinationals seem to be especially tax sensitive. However, specific incentives targeted at investment may not be very effective. As Jane Gravelle argues in Chapter 3, even if they are effective in stimulating investment, their impact on aggregate output and consumption would still be limited. This largely reflects the fact that capital is only one factor of production, and diverting resources to investment involves immediate consumption sacrifices for modestly higher levels later on.

Given all of this, and expected future trends towards greater globalisation, a sensible corporate tax policy would be to aim to broaden the base as much as possible to allow a lower rate.
1.2.3 Personal/Labour Taxes and Transfers

Labour supply responses
A great deal of research over the years has examined how far levels of, or changes in, effective tax rates and social welfare payments affect labour force participation. Some tendency towards greater consistency of results has emerged as, for example, single men and secondary earners appear in most countries to be at opposite ends of the spectrum of labour supply responses (lower and higher respectively). However, the chapters in this book point to two important caveats.

First, labour supply responses for any particular group are not independent of the institutional context in which these labour supply decisions are made. As a result, some groups (for example single men) may be more responsive in some countries (New Zealand seems to be an example) than in others. Careful attention to country-specifics and the heterogeneity of different taxpayer sub-groups may therefore be important, as tax micro-simulation models generally confirm. Second, failing to observe large changes in employment numbers, for example, when tax rates change does not necessarily imply low tax responsiveness – it may simply reflect a tendency for income and substitution effects to cancel. Third, countries such as the UK and New Zealand, which have introduced family-related and work-related tax credits designed to encourage increased labour force participation appear to have had some success, but the opportunity costs in terms of the (foregone) tax revenue cost per job created can be substantial.

Fourth, population ageing will affect all mature economies to varying degrees in coming decades. This throws up an array of policy choices relating to both tax and pension systems. Perhaps surprisingly, relatively little is known about labour supply responses of the over-65s such that it is hard to predict the impact of demographic ageing on participation. Whatever the responsiveness of older age groups now (with relatively generous pensions typically in place), the responsiveness of older taxpayers in future could be quite different when faced with a new institutional setting (for example changed pension entitlements) and increased longevity.

Tax progressivity
Progressive rate structures are a common feature of personal income taxes in many countries though, as John Creedy points out in Chapter 7, it was not always so. In particular progression is not a necessary characteristic of a ‘fair’ personal tax structure. In fact, optimal tax theory does not give unambiguous guidance on how personal income tax rates should be
structured. Much depends on value judgments such as how individuals’ ‘welfare’ should be measured (for example consumption, sense of well-being, and so on), how averse society is to supporting the less well-off, and which/how far individuals change their behaviour in response to changes in tax rates.

Of course, different groups of taxpayers are often affected quite differently by alternative tax policy changes so that assessing the merits of these changes requires a disaggregated approach. Simple unambiguous statements about preferred tax changes are rarely possible on efficiency or equity grounds. Nevertheless, Creedy shows that for the New Zealand structure of personal income tax rates and thresholds (which, apart from the absence of an initial tax-free zone, is fairly representative of many countries’ systems), the distributional gains from a higher top personal rate could well be small and would be achieved at a significant cost in terms of distortions created.

A related issue is whether distributional concerns are best dealt with via social welfare systems. Again, answers here are likely to differ by country and tax/transfer regime – for example a well-designed tax may be more effective than a badly-designed transfer system. Nevertheless, distributional measures often appear more sensitive to changes in social welfare payments suggesting that these may better target poverty and inequality aspects. This, of course, involves an additional trade-off. More targeting of social welfare payments often implies high withdrawal (abatement) rates that damage efficiency, whilst low targeting can be both fiscally costly and less redistributive. Countries like Australia, New Zealand and the UK that rely more on income-tested tax credits, payable across a wide range of income levels, face this challenge more acutely with high effective marginal tax rates facing many lower and middle income earners.

1.3 OUTLINE OF THE BOOK

The various chapters of the book have been organised into five parts. The two chapters in Part I explore the impacts of taxes (and subsidies) on productivity and investment. Part II examines recent thinking and evidence on corporate and capital taxation, paying particular attention to international dimensions, while Part III focuses on personal income taxation and the welfare systems that often operate in conjunction with them. Part IV turns to a particularly prominent issue in recent international tax debates – the use of tax and other instruments to deal with environmental externalities, both national and global. Finally, Part V reports some tax reform experience – for Australia and New Zealand – where tax policy debates are
currently very much alive and are seeking to learn from past reform, and non-reform, episodes.

In a major series of papers, economists at the OECD have studied the effects of various types of taxes on the economic growth of developed nations within the OECD. In their overview in Chapter 2, Chris Heady and his co-authors note that both the level of taxes and design of tax instruments affect the decisions of households to save, supply labour and invest in human capital; the decisions of firms to produce, create jobs, invest and innovate, as well as the choice of savings channels and assets by investors. Their chapter focuses on the effects of changes in tax structures on GDP per capita and its main determinants. It finds that, in general terms, corporate taxes are most harmful for growth, followed by personal income taxes, consumption taxes and then recurrent taxes on immovable property. It does not, however, set out a policy prescription for individual countries, noting that taxes depend on country-specific factors and that tax shifts require a non-trivial trade-off between tax policies that increase GDP per capita and equity concerns, which are likely to be evaluated differently by different countries.

In Chapter 3, Jane Gravelle addresses two issues on the impact of taxes and subsidies on investment. The first is the potential magnitude of effects on the economy from investment subsidies, including the enhancement of long-run standards of living in closed and open capital-importing economies. She finds that in a closed economy model, an investment tax incentive is likely to yield a very small benefit for a large welfare cost in terms of increases in sustainable consumption. For an open economy that imports capital, the economy can even suffer a welfare loss, depending on the elasticity of supply of imported capital.

The second set of issues involve the pitfalls in the design of investment subsidies, including the difficulty of designing and enacting neutral subsidies that will not lead to welfare losses. Of the different forms of incentives, Gravelle argues that ‘investment subsidies have generally favoured equipment investment, and arguments advanced for favouring these assets are difficult to justify. Large investment subsidies for debt-financed investment can lead to very low or negative tax burdens, which are difficult to justify on any grounds’.

Part II consists of three chapters. In Chapter 4, Rosanne Altshuler appraises the evidence on the impact of globalisation on corporate behaviour in the United States, and the implications for tax policy. She proposes several key lessons from recent experience and evidence, associated with US multinationals. First, both real and intangible (for example patents) capital and corporate profits are becoming increasingly internationally
mobile and more responsive to international differences in tax rates. At the same time, governments are increasingly competing with each other to attract and retain these mobile resources. Altshuler’s conclusion is that the taxation of international capital income cannot be isolated from the rest of the tax system. That system needs to be made simpler, with lower tax rates across broader tax bases in order to limit the extent of tax planning and protect domestic tax revenues.

Chapter 5, by Peter Sørensen, looks at one solution to the problem of taxing mobile capital while avoiding the need to sacrifice revenues from taxes on immobile tax bases – the ‘dual income tax’ system adopted by a number of Nordic countries in the early 1990s. This combines progressive taxation of labour income with a low flat uniform tax on all income from capital. Sørensen explains the historical background for the ambitious Nordic tax reforms and discusses the rationale for dual income taxation, and its implementation in Finland, Norway and Sweden. A central issue raised by the dual income tax is how to separate labour income from capital income and how to prevent taxpayers such as small businesses from shifting income from one tax base to the other to reduce their total tax liability. The chapter discusses alternative ways of achieving this split and describes the principles and methods adopted by the Nordic countries.

In Chapter 6, George Zodrow examines the impact of increasing globalisation for company income tax policy in small open economies, focusing on the implications of international capital (and labour) mobility and international tax competition. The chapter considers how robust the arguments are for setting zero or negative tax rates on capital income. This analysis pays particular attention to the implications of the existence of firm-specific and location-specific economic rents and the issues raised by various forms of international tax avoidance. Zodrow’s conclusion is that ‘setting company tax in a small open economy is an exceedingly difficult task, and no single tax structure will simultaneously deal with all the issues’. However, he argues that international tax considerations generally strengthen traditional closed-economy ‘broad base, low rate’ arguments.

Part III turns to labour taxation. In Chapter 7, John Creedy considers how far the large and complex literature on optimal income taxation can guide the practical design of income tax structures. He begins by showing that maximising welfare for even the simplest linear tax structure produces complex results unless highly restrictive assumptions are made. A more general consideration of optimal tax structures can lead to quite different results depending on the nature of the social welfare function being maximised. Creedy then considers marginal income tax reforms using a behavioural tax microsimulation model to illustrate such reforms in the
context of the widely-used multi-step income tax function (calibrated to approximate the New Zealand income tax and transfer structure). Creedy shows that changes to the top marginal tax rate have little effect on progressivity and redistributive measures, and are dependent on the income distribution. He also shows that the labour supply decisions and welfare of individuals, even with similar preferences, can vary widely on introduction of a top marginal tax rate.

In Chapter 8, Guyonne Kalb shows how behavioural tax microsimulation models, which incorporate a large amount of detail on the relevant tax/transfer systems, can be used to model discrete labour supply choices in response to tax structure changes. Models for Australia and New Zealand are described, with separate models for each country estimated for single men, single women, single parents and couple families. Kalb derives average wage elasticities and compares these for a range of different subgroups. Comparing the results across the two countries, she finds that the magnitude of the elasticities are generally similar. However, whereas Australia conforms to the familiar pattern observed internationally, that single parents and married/de facto women are the most responsive demographic groups, in New Zealand these appear to be single men and women.

Finally, in Part III, Chapter 9 by Jacinta Dalgety and co-authors present evidence for New Zealand on the impact of a series of changes in financial incentives and support for working, including subsidised childcare, on sole parents’ labour market behaviour. The chapter examines both the additional employment generated by these work incentives and the effects on the duration of benefit receipt. Separating policy impacts from wider economic changes is not straightforward; hence this chapter adopts a number of methods. A key finding from this exercise is that the introduction of in-work tax credits appeared to result in an estimated additional 8000 sole parents engaged in some form of paid employment. The number of sole parents working 20 hours or more per week (who qualified for the in-work tax credit) also appeared to increase, with numbers on benefits for sole parents falling by 12 per cent over four years.

Part IV examines the use of tax, and tax-related policies to address environmental externality issues. In Chapter 10, John Freebairn compares the differing effects of a carbon or emissions tax versus a tradable permit scheme aimed at reducing greenhouse gas emissions. He shows that within a conventional environmental economics framework (of public and private costs) the two interventions are equivalent in a world of perfect information and perfect global implementation. He then explores the consequences of introducing more realistic assumptions including imperfect information, technological innovation and information revelation over
time. Freebairn concludes that, once these real-world considerations are allowed for, whether a carbon tax is superior to emissions permits depends on whether greater certainty regarding the ‘cost increment’ (price change) or greater certainty of emissions adjustment (quantity change) from the policy is preferred. Freebairn argues in favour of the greater price certainty associated with the carbon tax. He also concludes that a carbon consumption tax base is superior to a carbon production tax base; that is the tax should apply to domestic production plus imports, but exclude exports.

In Chapter 11, Suzi Kerr and Kelly Lock turn to a rather different environmental issue, that is, how public policy should respond to allocating the social costs of abating water pollution – in this case, Lake Rotorua, one of New Zealand’s largest lakes. At issue here is a long and continuing episode of artificial nutrients being applied to farmland in Lake Rotorua’s catchment area which are leaking into, and polluting, the lake. This chapter examines how the social benefits and costs of water quality improvements in Lake Rotorua are likely to be shared in the absence of a nutrient trading system and presents different perspectives on, and principles for, deciding how costs should be allocated. Kerr and Lock then show how different options for allocating nutrient allowances and achieving pollution reductions over time conform with those cost-sharing principles. They argue that, unlike typical textbook examples, there is no single ‘correct’ answer to the question of who should pay, but will depend on what the community thinks is fair and what will be politically feasible.

In a final Part V, two chapters examine lessons to be learned from past tax reform exercises in Australia and New Zealand. This is especially relevant for both these countries as they each consider significant medium-term reform to their tax and transfer systems. In Chapter 12, Greg Smith, an external member of the recent Australian Tax Review conducted by the Australian Treasury, examines the Australian case. Smith begins by detailing the extensive tax and transfer reform agenda pursued in Australia since 1983, broadly in pursuit of a ‘broad base, low rate’ system. At the same time tax and transfer arrangements continued to be based heavily on income, and on delivering relatively steep progressivity. As Smith puts it: ‘[t]he intrinsic complexities and idiosyncrasies of the income base and progressive rates provide ongoing fertile ground for reform-minded policy attention’. As a result future tax policy review must address ‘high marginal tax rates, relatively high taxes on capital and saving relative to labour and current consumption, and ever-increasing complexity and compliance cost’. On a positive note, Smith suggests that a defining feature of Australian (and New Zealand) political economy over much of the last 25 years is the strong track record of reform in the aftermath of adverse
economic times. Perhaps there will be a ‘silver lining’ to the global recession of the late-2000s.

Finally, in Chapter 13, Matt Benge and David Holland assess the case for reform of company taxation in New Zealand. Steering away from radical reform options, such as ‘Allowance for Corporate Equity’ (ACE) or cash-flow taxation, they concentrate on possible reforms to tax rates and structures within OECD norms. A cornerstone of New Zealand’s tax paradigm, they argue, has been the alignment of the company and top personal tax rates. The chapter outlines the problems that have arisen from the divergence of these rates in recent years and examines a number of possible approaches, drawn from international experience, for resolving these problems in New Zealand. The conclusion the authors come to is that the preferred option would be to align the company and top personal tax rates and apply this to a broad tax base.

REFERENCES

Peter, K.S., S. Buttrick and D. Duncan (2008), Global reform of personal income taxation 1981–2005: evidence from 189 countries, Georgia State University, Andrew Young School of Policy Studies, Andrew Young School of Policy Studies Research Paper Series No. 08–08.