



Inland Revenue  
Te Tari Taake

# Tax administration reform – retaining a coherent tax policy framework through change

David Carrigan

12 June 2014

# Overview

- What I think this exercise is about
- Importance of retaining a tax policy framework that makes correct trade-offs between efficiency, fairness, compliance costs and administration costs:
  - BBLR as an example of a coherent framework
  - Why BBLR works for New Zealand
- Beware of changes to the framework that don't properly balance the objectives
- Why a coherent tax policy framework is important for a well-functioning tax administration

# Focus of the exercise

- A tax system is a combination of (i) the rules that determine tax obligations; and (ii) the rules governing how that obligation is to be satisfied
- The focus of this exercise is on (ii) not (i)
- Covers a vast array of issues – including:
  - **Payment of tax for individuals and business**
    - when and how often
    - use of withholding regimes
    - accuracy of interim payments
    - end-of year square-ups

# Focus of the exercise

## – **Underpayments and debt:**

- rules creating incentives to pay on time
- penalty rules
- use-of-money interest
- smarter, more painless ways to collect debt
- flexibility versus prescription
- adjusting withholding rates to collect past debt

## – **Speed and certainty for business:**

- determining and satisfying a tax obligation not always just a processing issue – for businesses often much more complex
- fast and certain resolution of these issues important for economy. How can we improve?

# Focus of the exercise

## – Role of Inland Revenue:

- degree of prescription in the rules – flexibility of the Commissioner
- customer channels – moving people to 'e'
- smarter use of information and how this can improve audit strategy
- relationship of Inland Revenue with intermediaries
- information sharing across Government
- secrecy rules

# Focus of the exercise

## – **Social policy:**

- Inland Revenue not just a tax collector – also administers:
  - working for families (WfF) tax credits
  - child support
  - student loans
  - KiwiSaver
- How to make the experience better for customers, while reducing administration costs and preventing accumulation of debt
- A key issue is extent to which delivery of social policy – e.g WfF tax credits – should be forced into the tax year

# Keeping a coherent policy framework

- While we are doing this work vital that we retain a coherent tax policy framework
- To be coherent a tax policy framework needs to appropriately balance:
  - efficiency
  - fairness
  - compliance costs
  - administration costs
- This balancing act requires trade-offs
- The broad-base low rate (BBLR) framework is one of several coherent frameworks

# History of BBLR

- Before mid-1980s
  - Tax system had narrow bases and high rates
  - Riddled with exemptions / credits
  - Inefficient and great for lawyers
  - Couldn't raise sufficient revenue – by mid 1980s NZ close to bankrupt



# 1981 statutory tax rate scale

<i><b>Taxable income (1981 dollars)</b></i>	<i><b>Taxable income (2012 dollars)</b></i>	<i><b>Statutory rate</b></i>
\$0	\$0	0%
\$1-\$5,000	\$1-20,523	14.5%
\$5,001-\$11,683	\$20,524-\$47,953	35.0%
\$11,684-\$16,266	\$47,954-\$66,764	48.0%
\$16,267-\$22,000	\$66,765-\$90,299	55.0%
Over \$22,000	Over \$90,299	60.0%

# Massive export subsidies

<i><b>Export Subsidies (as refundable income tax credits)</b></i>	<i><b>Tax costs</b></i>
Goods	\$237m
Services	\$4m
Overseas Projects	\$3m
Tourist Services	\$11m
EMDI (export market development initiative)	\$146m
Tourist Promotion	\$33m
<b>Total Credits (1981 dollars)</b>	<b>\$434m</b>
<b>Total Credits (2012 dollars)</b>	<b>\$1,781m</b>



# and special allowances

<i><b>Special Allowances</b></i>	<i><b>Tax costs</b></i>
First-Year Accelerated Depreciation	\$91m
Increased Exports – goods	\$51m
Export Investment	\$11m
Regional Investment	\$5m
Farming/Fishing Investment	\$8m
Energy Conservation	\$4m
Industrial Development	\$5m
<b>Total Allowances (1981 dollars)</b>	<b>\$175m</b>
<b>Total Allowances (2012 dollars)</b>	<b>\$718m</b>

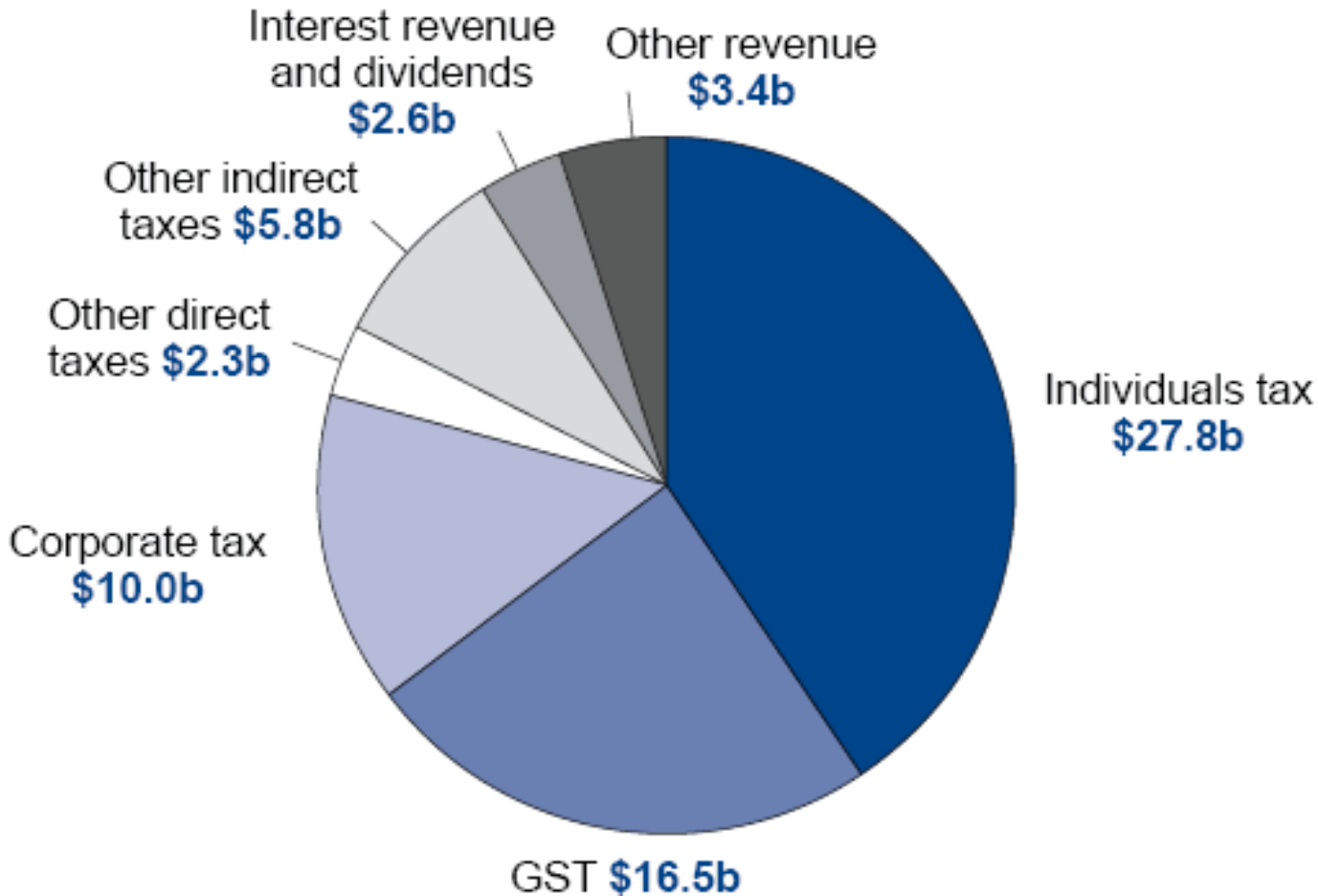
# Introduction of a BBLR framework

- Labour Government of the 1980s radically reformed the tax system
- Decided on a broad base low rate (BBLR) revenue tax model
- Idea was to broaden the tax base to allow for a much lower and consistently applied top tax rate to apply (top personal rate reduced from 60% to 33%)
- Did this by removing tax exemptions, introducing a broad based GST, introduction of dividend imputation etc

# BBLR is still intact

- Collect bulk of revenue from 3 broad bases – personal income, company income and consumption
- Base still broad – system not used to deliver incentives – e.g. no R&D tax credit, little in way of accelerated depreciation
- Broad bases allow low top individual tax rate of 33%  
- aligned with trust rate and close to 28% company rate

# Where do we get revenue from in NZ?



# BBLR model – pros

- BBLR model is a simple, understandable and coherent framework
- It means that all areas of economy are taxed reasonably consistently
- It generally reduces economic distortions
- The key bits of it are understood by public
- Simplicity and coherence = durable

# BBLR model - cons

- Most of the cons are theoretical cons – ie:
  - The most efficient revenue tax would apply different tax rates depending on elasticities – BBLR doesn't do this
  - BBLR does not correct for positive and negative externalities
- Economic argument to have lower income tax rates on capital income – we don't do this – but:
  - Achieved indirectly through broad-based GST



# **BBLR – overall the best available system**

- BBLR is theoretically not first-best – but in practice it's as good a way of structuring a tax system as we have available
- Balances efficiency, fairness, compliance costs and administration costs
- A number of reviews have endorsed BBLR:
  - McLeod Review (2001)
  - Tax Working Group (2009)

# Properly balancing the policy objectives

- Tax administration reform – our focus will be on proposals to reduce compliance and administration costs
- Tempting to consider changes to, e.g, our core income tax rules that would reduce compliance and administration costs
- Need to be very careful here. Even though proposal results in simpler and easier to administer rules, good chance of causing economic damage.

# Plumber example

- Under NZ's BBLR a person's business income is, like most other sources of income, taxed on a net basis at standard tax rates
- This means that we work out what's taxable by taking what's received and subtracting the expenses – i.e. we tax the profit
- Let's say we thought this was too complex – particularly for sole traders - and for this group we replaced the net tax with a lower final tax on gross income

# Plumber example

- This would probably be simpler as sole trader now doesn't need to keep track of receipts
- Would also be easier for Inland Revenue to audit
- So it reduces compliance costs for sole trader and administrative costs for Inland Revenue
- Must be good right?

# Plumber example

- Probably not. Here's why. Compare simple "low margin" transaction under old net rules and our new "lower tax on gross" rules:
  - *Fiona is a busy plumber. She is offered a small job that pays \$110 gross and takes 4 hours. She will use Mike, her employee, to do the job. His wage costs are \$25 per hour.*
  - **Q.** *Does it make economic sense for Fiona to take the job?*
  - *In a world with no tax clearly **yes**. She makes \$10 profit (110 minus 100 wage costs).*
  - *In a world with a 30% tax on profits, **yes**. She makes \$7 profit (110 minus 100 wage costs = 10 minus tax of 3)*
  - *In a world with a 15% tax on gross, **no**. \$10 profit before tax becomes a \$6.50 loss after tax (15% of 110 = 16.50 tax)*

# Simple rules for small business example

- We can get tempted in the same way in the area of simpler tax regimes for SMEs
- Legitimate concerns that the full force of the income tax rules are too complex for SMEs and we should come up with simpler rules for SMEs
- Therefore, proposals in this area are often around defining an SME (e.g. by turnover, employee number etc) and then providing “simplification” concessions – e.g:
  - Write-offs for certain capital assets instead of depreciation
  - Concessions around accounting for trading stock

# Simple rules for small business example

- This reduces compliance costs for SMEs so must be good – right?
- Not necessarily – will often have nasty economic effects as concession ceases to apply if firm grows and breaches SME definition - result:
  - SMEs now have tax advantage over larger firms – at the margin business could shift into smaller firms
  - Disincentives to grow
  - Incentive to break-up firms so each smaller entity can take advantage of concession
  - SME regimes often optional – removes any compliance savings as firms calculate best result under both regimes
- NZ approach – de-minimis thresholds for small transactions where gains of additional accuracy outweighed by cost of compliance

# Never say never – it's all a matter of trade-offs

- Shouldn't overweight efficiency either
- A proposal that has a small efficiency cost may be sensible if there are bigger compliance, administrative or fairness gains
- For example, when we removed the ability for employees to deduct work expenses:
  - we reduced efficiency at the margin
  - but judgment at the time that this was outweighed by bigger simplicity gains
- We may find more of these as we go through this process



# Coherent tax policy framework vital part of well-functioning tax administration

- New Zealand's tax system depends on voluntary compliance.
- Many people comply with tax system as they broadly understand and see it as fair.
- BBLR is very important here. Lowish, similar tax rates applying to most parts of the economy is an easy concept to understand and feels fair.
- This basic acceptance could be eroded if we had lower rates or exemptions in different areas of the economy.
- This basic acceptance is ultimately why the BBLR has endured