From Inland Revenue's Briefing for the Incoming Minister of Revenue

OVERVIEW OF TAX POLICY

Inland Revenue's Policy Advice Division, jointly with the Treasury, advises the Government on all aspects of tax policy and social policy measures that interact with the tax system. Its other roles include:

- forecasting tax revenues
- drafting tax legislation
- negotiating and maintaining New Zealand's network of double tax agreements with other countries
- providing ministerial services.

The Policy Advice Division has a relatively small staff. It includes about 40 policy analysts directly responsible for the management and delivery of the tax policy work programme.

The Policy Advice Division aims to be the best possible professional strategic manager and communicator of tax policy and related social policy projects. We achieve this by good management of all aspects of the Generic Tax Policy Process, managing policy projects through from initial identification of issues to final implementation and review.

Policy project management

The stages of our project management are:

1. Identifying issues in tax and related social policy areas through our linkages and communication with:

    - our Minister(s)
    - the taxation profession
    - the private sector
    - other parts of Inland Revenue
    - other government departments such as the Treasury, Ministry of Economic Development and Ministry of Social Development.

2. Developing those issues into policy proposals, taking into account how this will be managed through to implementation and review. This involves early

identification of potential problems and options and how these might be handled.

3. Managing the consultation process in accordance with the Generic Tax Policy Process.

4. Supporting the process through to Ministerial and Cabinet stages.

5. Supporting the process through the legislative phase from drafting through to the House, select committees and enactment.

6. Implementation and review of the policy.

No policy project is a success until it is successfully implemented and operating. This requires Inland Revenue to provide appropriate information on the new rules to taxpayers and their advisors and Inland Revenue staff. It also requires the new rules to be integrated into existing operational systems by way of form design and necessary changes to the computer system. These issues need to be considered throughout policy development and carried through after legislation is enacted. This means that the Policy Advice Division needs to work closely with all areas of Inland Revenue, and there must be adequate time for operational requirements to be met.

An example of a project requiring this coordination are the new, fairer and more consistent debt and hardship rules determining how Inland Revenue should treat taxpayers who are in financial difficulty and cannot immediately meet their tax obligations. A bill introducing the new rules is still before Parliament, awaiting its second reading. It provides for an application date of 1 July 2002, but this will need to be deferred to later in the year to allow for the six or more weeks necessary to implement the final stages of the relevant system and process changes.

After a new policy has been implemented and has been operating for a period, it is desirable to review it to identify and correct problems that have emerged in practice. An example of such a review is the progressive, post-implementation review of GST, which resulted in an initial discussion document in 1999, with ensuing legislation in 2000, and a second discussion document last year. The previous Government also announced its intention to begin a post-implementation review of the taxation of fringe benefits later this year.

The importance of good tax policy

Tax policy necessarily involves complex technical issues. In providing advice on such matters we analyse the technical arguments and communicate the policy consequences of the options. What can appear to be issues of a quite technical nature often have significant implications for:

- the Government's overall fiscal position
- businesses and other taxpayers
- overall government policy, by altering the incentives to work, save or invest in one activity over another.

About 85 % of total government revenue comes from income tax and GST. Both taxes are levied on a broad base, meaning that they affect most things that happen in the economy. One consequence of this is that tax policy issues arise across the broad spectrum of government activity and policy. For example, over the past few years tax policy has had an involvement with about 29 policy areas.

Tax policy in wider government activities

- Accident compensation reform – Inland Revenue's role as a collector of premia
- Agriculture – producer board reform
- America's Cup – taxation of yacht crews
- Art and culture – taxation of films
- Business – tax compliance cost reduction
- Defence – taxation of personnel on active service outside New Zealand
- Economic policy – the role of tax in promoting growth and innovation, taxation of savings and protecting the fiscal position
- Education – student loans and taxation of school trustees
- Electronic commerce – Electronic Transactions Bill
- Environment – carbon charge and environmental taxes
- Foreign Affairs – OECD work on Pacific Island tax havens, double tax agreements
- Gambling – review of gambling taxes
- Health – taxation of hospital boards
- Immigration – relationship between immigration status and tax residence
- Justice – Bill of Rights and human rights issues
- Labour – Paid Parental Leave
- Local government – taxation of local authority trading enterprises and GST treatment of rates
- Mäori policy – Mäori authorities review
- Racing – amortisation rates for stallions and broodmares, Racing Bill
- Science and research – deductibility of research and development costs
- Social policy – Child Support, Family Tax Credit, Paid Parental Leave and taxation of charities
- Statistics – use of IRD income and GST data
- Sport – taxation of amateur and professional sports
- State-owned enterprises – tax status of SOEs
- Telecommunications – GST rules
- Tourism – GST treatment of tourists
- Transport – taxation aspects of shipping review, taxation of toll roads
- Treaty of Waitangi – tax treatment of Treaty settlements
- Women's Affairs – deductibility of child care expenses

The importance of tax issues and the potential impact of tax on a wide area of government policy means that it is especially important for tax policy to be well managed.

The policy development process

Since 1995 tax policy has been developed in accordance with the Generic Tax Policy Process. This is a process designed to ensure better, more effective tax policy development through early consideration of key policy elements and trade-offs of proposals, such as their revenue impact, compliance and administrative costs, and economic and social objectives. Another key feature of the process is that it builds external consultation and feedback into the policy development process, providing opportunities for public comment at several stages.

Consultation throughout the process contributes to greater transparency of policy-making, allowing the government to set out the policy objectives of proposals and the trade-offs it has made in developing them. Therefore it helps the private sector to understand the rationale behind government policy proposals.

Major tax initiatives are now subject to much greater public scrutiny at key stages in their development—from broad proposal through to post-implementation review. As a result, we now have more opportunity to develop workable options for reform by drawing upon information provided to us by the private sector early in the process.

The increased opportunity for consulting on tax policy has resulted in increasing numbers of individuals and organisations making submissions on proposals, whether set out in a discussion document or introduced in a taxation bill. Submissions are becoming increasingly technical, lengthy and detailed, which in turn makes the process lengthier and requires greater policy and parliamentary resources.

The tax policy work programme

One of the first steps for the new Government in relation to the Generic Tax Policy Process is to develop a three-year revenue strategy that is effectively linked with the Government's economic strategy. It sets out the Government's tax policy objectives. The next stage is the development of a rolling three-year tax policy work programme that gives effect to the revenue strategy.

Developing the three-year work programme involves scoping broad policy proposals and prioritising and sequencing the development of initiatives. We also look at budgeted resource requirements to develop the initiatives, the time needed to develop, legislate for and implement them, and modes of consultation and communication to be employed throughout the process.

This stage of the Generic Tax Policy Process culminates in a joint report by Inland Revenue's Policy Advice Division and the Treasury to the Treasury Ministers and Minister of Revenue that outlines a policy work programme proposed by officials. Once approved, that joint work programme becomes a detailed tax policy purchase agreement between the Government and the two Departments.

When it is made public, as it usually is, the work programme is received with much interest by the tax and business communities, to whom it provides certainty and an understanding of the Government's direction in tax policy.

As time passes, it is inevitable that policy initiatives not considered when the work programme was developed will need to be added to it, and there will be more items on the programme than can be progressed during the three-year period. There is a danger, however, that initiatives will be added without reviewing priorities. This places a major strain on finite tax policy resources and parliamentary resources, and results in slower progress for some existing priorities. It is important that when items are added to the work programme, existing priorities are reviewed to ensure that the Government's expectations across the work programme are met.

The management of the work programme will be a key issue for both Ministers and officials in ensuring that priorities are delivered as agreed.

The 1999 – 2002 tax policy work programme

Following the implementation of Labour's pledge commitment to increasing the top marginal tax rate, the main themes of the 1999 – 2002 tax policy work programme were:

- *New Zealand in a world economy.* This covers, for example, expanding our network of double tax agreements with other countries, extending the New Zealand and Australian imputation systems to relieve double taxation of companies operating in both countries, and considering issues relating to the taxation of inbound and outbound investment.
- *The coherent taxation of savings and the entities through which people invest and save.* Gathered under this theme, for example, are initiatives such as reviewing the application of GST to financial services and introducing a progressive tax for employment-based superannuation.
- *Tax simplification and reduction of tax compliance costs.* Recent examples include looking at ways to reduce compliance costs for small to medium-sized businesses, modernising the taxation of organisations that manage Mäori assets held in communal ownership and rewriting the Income Tax Act.
- *Protecting the revenue base.* This includes, for example, closing loopholes as they are identified and considering legislation to counter mass-marketed tax schemes.

The New Zealand tax system

In the tax policy area, the last government put considerable resources into the Tax Review 2001, chaired by Robert McLeod. The main conclusion of that review was that the basic features of our current tax system are sound, a conclusion with which we agree.

Fundamental Features of the Tax System:

- *Reliance for most of our tax revenue on a broadly based income tax and consumption tax (GST).* The Government relies on these taxes for about 85% of its revenue. Both tax bases have relatively few concessions by international standards. This enables them to collect relatively high levels of revenue at relatively low tax rates.
- *An income tax that is moderately progressive in nature.* As the Tax Review noted, our income tax rate structure is never likely to be really effective at redistributing income between different New Zealanders. That is because there are few high-income earners, and lower-income earners tend to be on welfare benefits that are set in after-tax terms. The bulk of income tax revenue is collected from the group of middle-income earners. Thus any income redistribution objective is more effectively met through government expenditure.
- *A company tax system based on imputation.* The imputation system, introduced in 1988, provides shareholders with a credit for tax paid at the company level, which offsets tax on dividends. This reduces the cost of new equity raising needed by expanding companies and ensures that companies are not penalised relative to other forms of commercial organisation.

Features of our tax system that seem to vary most from those of similar overseas countries:

- *Our lack of a threshold level of income before tax is payable.* We achieve a similar result in net terms through the family tax credit mechanism. The difference between our threshold and those of other countries is that ours is targeted at low-income families and does not, for example, apply to the children of high-income families. This is why a one-income family with three children under 13 pays no net tax until parental income exceeds $30,435.
- *Our lack of a capital gains tax.* The Tax Review 2001 investigated this issue and concluded that such a tax would collect relatively low levels of revenue at a substantial economic and compliance cost.
- *Our relative lack of special incentives and exemptions in our income tax and GST bases, such as tax incentives or exemptions for retirement savings.* This has allowed us to raise a relatively high level of tax revenue at what are, in international terms, moderate marginal rates.

This is not to suggest that the tax system is perfect. It can be improved, which needs to be the focus of the next tax policy work programme.

Key challenges in tax policy

A new work programme

A big challenge in constructing the next work programme will be balancing competing demands for the resources of Ministers, Parliament, officials and the private sector. The Generic Tax Policy Process has, in our view, been a success in producing better quality tax policy, although it has led to an ever increasing requirement for consultation and information. Major tax policy initiatives can now require consultation, an issues paper or discussion document, further consultation, a business compliance cost study, a regulatory impact statement, a bill commentary and the release of a lengthy (often 100 or so pages long) officials' report on submissions on a bill to Parliament's Finance and Expenditure Committee. This is a very resource-intensive process to which further requirements are continuously being added.

Setting priorities

There is also a need to balance the resource requirements of maintaining the revenue base and the Government's main tax policy initiatives against initiatives of non-Finance/Revenue Ministers in, for example, the areas of social policy or sectoral assistance, which can have substantial tax implications. It is also necessary to provide room in the work programme to meet private sector concerns where tax legislation is identified as causing unintended practical problems. Finally, there is an increasing demand for tax policy resources to be allocated to international tax matters such as the OECD and trans-Tasman tax matters. This reflects the increasing extent to which New Zealand needs to take into account international tax trends in setting its domestic rules.

Given the breadth of government policy areas that have tax implications, the complexity of tax issues and the limited resources available to deal with them, it is essential for Ministers to discuss and set out their tax policy priorities. Since many areas of government raise important tax policy issues, the allocation of tax policy resources is likely to affect the Government's ability to pursue non-tax policy objectives. This is especially the case in areas of economic development and social policy. It is therefore desirable for Ministers in those areas to be clear about the implications of the tax policy work programme for policy development in their areas.

Budgetary fiscal rules

The tax policy work programme can also be affected by any budgetary fiscal rules the government decides to adopt. There is a need to ensure that any fiscal discipline on expenditure also applies in an equal way to initiatives that would reduce tax revenue. Otherwise there is an incentive for expenditure initiatives to be packaged as tax initiatives.

On the other hand, if tax initiatives reducing revenue must always be balanced by initiatives increasing revenue, this can force the Government to adopt a tax policy work programme that unintentionally places too heavy a tax burden on the economy. The ability to trade off the costs and benefits of law changes against changes in compliance and enforcement as alternative means of maintaining revenue bases also needs to be accommodated within the fiscal rules. The tax policy implications of any fiscal rule proposals, therefore, need to be considered before such rules are adopted.

Tax concessions

There has been an increasing trend by those looking to reduce impediments to the growth of priority economic sectors to seek sectoral tax reductions or concessions. This adds to the strain on tax policy resources and could undermine the broad tax bases our tax system and moderate rates rely upon. Inevitably, because tax collects a proportion of any businesses profits, it is an impediment to the development of all sectors of our economy. That, however, is the inevitable cost of raising revenue to meet government expenditure commitments. Sector-specific concessions will increase the impediments faced by other sectors and therefore need a high level of justification.

Tax simplification and compliance cost reduction

Tax simplification and business compliance cost reduction is another area where there is strong demand for change. The need to raise revenue at low overall cost places limits on the amount of simplification possible, although we consider there is still room for progress. Tax simplification tends to be an incremental process as there is no big, single solution that suits all taxpayers or businesses. Moreover, there are limits on simplification, as a revenue loss is usually involved, and taxpayers often want more accurate, tax calculations, even if they are more complex. A problem for New Zealand in achieving substantial compliance cost reductions is that relative to similar countries overseas, our tax system is already reasonably simple. Much simplification work overseas involves mitigating or removing complexities which do not exist in our system.

Officials' current focus is on reducing compliance costs for small business. Small businesses form a large group, 85% of New Zealand enterprises having fewer than five employees. Each small business faces similar compliance obligations as those of much larger businesses, making their costs high relative to the tax they pay. There is a concern that these compliance costs may be hindering small business growth at critical stages in their development. This can only be to the detriment of New Zealand's economic development. We are therefore reviewing policy and processes that impose compliance costs and developing a continuing programme for their reduction. Not all compliance costs arise because of legislative requirements—taxpayers may also be incurring unnecessary business costs because of the way Inland Revenue operates. Therefore simplification requires review of both the policy and operational aspects of the tax system.

International tax issues

Tax policy over the next few years will also need to focus increasingly on international tax matters. The world is becoming more integrated and tax systems more affected by overseas developments. Both capital and labour are becoming more mobile and more sensitive to tax. This makes it necessary to consider the international tax issues raised by the Tax Review 2001 and to monitor our company tax base, which is the most susceptible to threat from international competition. An increasing focus is also needed on trans-Tasman tax issues and developments in liaison with Australia. The growth of electronic commerce also poses risks and opportunities that we need to meet, such as through GST reverse charging.

Taxation of savings

A final challenge in the tax policy area will be to settle the debate on the future tax treatment of the savings of individuals. On one hand, our tax impost on savings is relatively high by international standards (because of the lack of concessions). On the other hand, it is the very lack of savings tax concessions that allows us to retain moderate tax rates. There is no easy way to reduce our tax on savings without a substantial increase in tax rates applying elsewhere.

The legislative programme

A heavy tax legislation programme awaits Parliament when it reconvenes. One of the two taxation bills carried over from the previous Parliament has as its main feature the comprehensive reform of the taxation of organisations that manage communally owned Mäori assets; that bill is awaiting select committee consideration. The main feature of the other is the introduction of new rules for the administration of tax debt. The bill has been reported back and is awaiting its second reading. We see the passage of this second bill as a particular priority, given the wide impact of the new debt and hardship rules, which were originally proposed to apply from July 2002.

As well, a bill containing the rewrite of the Income Tax Act, to make tax law easier to understand and apply, was scheduled to be introduced this year. Although this bill is not intended to incorporate policy changes of significance, it will probably be the largest bill ever to be introduced and inevitably covers complex technical issues.

The Responsible Gambling Bill is before the Government Administration Committee. The Bill is concerned with the regulatory environment for the gaming industry but also introduces a problem gambling levy that Inland Revenue would collect. Final decisions on other tax matters related to gambling are still to be made.

The 2002 legislative programme also included the provision of drafting instructions to the Parliamentary Counsel Office for a Child Support Amendment Bill to be introduced next year.

We have the resources to draft and progress two taxation bills a year, provided they do not overlap at two highly resource-intensive stages: when a bill is being drafted and its accompanying commentary being prepared for publication, and when officials are preparing their report on submissions on a bill that is before a select committee.

Other policy initiatives

As well as progressing legislation still before Parliament, the previous Government had announced tax reform proposals in a number of areas. These will need to be reviewed or advanced. These reform proposals (and their current status) are:

1. *GST on Imported Services.* A discussion document was released in June 2001. The Government announced in March 2002 that further action would be deferred until the issues could be considered in tandem with those in a forthcoming discussion document, *GST and financial services*.

2. *Tax Review 2001.* It was announced in the 2002 Budget that the Government would consider implementing the Tax Review's recommendations on changes to the foreign investment fund tax rules and the taxation of migrants, and would release for discussion officials' analysis behind their advice that tax rates for non-resident investors should not be lowered.

3. *Mass-marketed Tax Schemes.* An officials' issues paper published in January suggested legislative changes to defer tax deductions on schemes seen as undermining the tax base and would require their registration. Consultation has continued.

4. *Trans-Tasman Triangular Tax.* In March the Australian and New Zealand Governments issued a jointly prepared discussion document outlining proposals to relieve the double taxation of investments in Australian and New Zealand companies that operate in both countries. Consultation has taken place here and in Australia.

5. *Charities.* A discussion document on tax and charities was released in June 2001. It led to the establishment of a working party in November that issued its first report in March 2002 and a second report in May 2002. Legislation related to the first report, an increased maximum rebate for donations and extension of the corporate tax deduction, is in a bill before Parliament. The Government announced that a charities commission would be established to approve and register organisations seeking charitable status for tax purposes.

6. *Tax and Privilege.* A discussion document narrowing the ambit of legal privilege for documents prepared by lawyers but widening privilege to tax advice produced by non-lawyers was released in May 2002. Submissions are being received and considered.

7. *Post-implementation Review of Fringe Benefit Tax.* Ministers stated that a review of the fringe benefit tax rules would begin this year.

8. *Review of Specified Superannuation Contribution Withholding Tax.* With Ministerial approval, consultations have taken place on how the withholding tax on employer superannuation schemes can be aligned with the tax rate of employees for whom those contributions are paid.

9. *Review of the compliance and penalty legislation. A* review of the relatively new compliance and penalty legislation, which was introduced in 1997, began in October 1999. The review has continued, with the release in August 2001 of a discussion document on proposed changes that were included in the two taxation bills that are still before Parliament. Planning for the next stage of the review is under way. It is expected to consider how taxpayer behaviour has changed as a result of the new rules; examine whether the rules encourage voluntary compliance; and compare New Zealand's rules, including the extent of non-compliance and the scale of penalties, with those of other countries.