NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON REDUCING TAX BARRIERS TO INTERNATIONAL RECRUITMENT

December 2003

1. Overview

1.1 This submission on the government discussion document, *Reducing Tax Barriers to International Recruitment* (the document), is made by the New Zealand Business Roundtable, an organisation comprising primarily chief executives of major New Zealand business firms.[1] Its purpose is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 The government proposes to introduce a temporary exemption from some of New Zealand's international tax rules for people who are non-resident for tax purposes, including returning New Zealanders, and who are recruited to work in New Zealand. The purpose of the proposed exemption is to reduce tax-related costs to New Zealand businesses of recruiting internationally mobile labour. Such costs are likely to be borne initially by New Zealand firms rather than by the individuals concerned.

1.3 This submission focuses on the thrust of the proposal contained in the discussion document and the broader context within which the proposal should, in our view, be examined.

1.4 The Business Roundtable supports the proposal in the absence of a broader strategy to reduce tax rates generally. The underlying problem is the excessive level of government spending and taxation. This problem should be addressed directly. Much government spending is of low quality. Measures to mitigate the adverse impact on economic performance of excessive spending and taxation, such as the government's proposal, are at best partial.

1.5 Lower and more uniform rates of tax, as advocated by the Tax Review 2001, would encourage work, investment and innovation in all industries. They would help boost economic growth, consistent with the government's stated objective of raising average per capita incomes into the top half of the OECD rankings.

[1] Cullen, Michael and Cunliffe, David (2003), *Reducing Tax Barriers to International Recruitment,* Inland Revenue Department, Wellington.

1.6 We recommend that the government should reconsider its rejection of the Tax Review 2001 recommendation that a tax cap be introduced. It makes little sense to assist firms to recruit immigrants (including New Zealanders who have not been resident for tax purposes for at least 10 years) by reducing New Zealand tax on their offshore income while taking no steps to reduce the tax disincentives facing successful New Zealanders to remain tax residents.

1.7 The balance of this submission is presented in 4 sections. The next section (section 2) discusses the proposal contained in the discussion document. The underlying problem is examined in section 3. Section 4 discusses other issues. Our main conclusions are presented in section 5.

2. The proposal

2.1 The Tax Review 2001 made several recommendations on international taxation, including the following:

- The introduction of a tax holiday in respect of the overseas income of immigrants. The income, other than New Zealand sourced income, of immigrants with no previous connection to New Zealand who become New Zealand residents for tax purposes would be exempt from New Zealand tax for seven years.

- The introduction of a cap on the level of tax payable by New Zealand resident taxpayers. The suggested maximum level of income tax payable by an individual taxpayer in any one year was $1 million. A taxpayer would need to earn a taxable income of about $2.6 million or more a year to benefit from the cap.

- A reduction in the effective rate of tax on inward foreign investment.

- The application of the risk free rate of return method of estimating taxable income to all portfolio investment.

The Tax Review 2001 also recommended that the top rate of personal income tax be reduced to 33 percent and thereby realigned with the rate of company tax. This would reduce the level of tax paid by New Zealand resident taxpayers on incomes of $60,000 or more.

2.2 The above proposals recognised that the level of taxation in New Zealand unduly discourages internationally mobile people from coming to New Zealand and discourages inward foreign investment, while encouraging high net worth taxpayers to cease to be residents of New Zealand for tax purposes. High costs are likely to be imposed on the community as a consequence.

2.3 The level of income received by internationally mobile people is set in the international labour market. If New Zealand seeks to impose higher taxes and other costs on such labour than other countries, they will tend to be borne by New Zealand firms, in the first instance, rather than those people. In the longer term, such costs are likely to be shifted to immobile factors of production and/or reflected in higher prices charged to consumers of non-traded goods and services.

2.4 The proposal advanced in the discussion document relates to the Tax Review 2001's tax holiday recommendation. The government's proposal is, however, narrower. It only applies to immigrants recruited as employees. Thus the self-employed (with an exception for a member of a partnership in certain circumstances), and immigrants who wish to establish a business would be excluded under the government's proposal. They were included in the Tax Review's recommendation. On the other hand, returning New Zealanders have been included in the government's proposal.

2.5 The document proposes two options for discussion. Under the narrow option, the exemption would cover a selected group of rules where New Zealand's approach to international tax is particularly comprehensive and would last for seven years. Under the broader option, the exemption would include all foreign, non-employment income and would last for three years. At the expiry of the exemption affected taxpayers would be taxed on the same basis as other resident taxpayers.

2.6 In the absence of a broader approach to the problem, the Business Roundtable supports the government's proposal. It has not focused on which option would be preferable.

3. The underlying problem

3.1 The government's proposal does not address the underlying problem which is the excessive level of government spending and taxation. Unless marginal government spending programmes provide benefits that are at least equal to all related opportunity costs, including the deadweight costs of tax, potential community welfare and GDP will be sacrificed. If such programmes do not yield sufficient benefits, the resources would earn a higher return in other uses. There are grounds for doubting whether marginal spending programmes provide the required level of benefits.

3.2 New Zealand governments, and governments in other developed countries, have over-extended themselves, particularly since about 1960, by engaging in more and more activities.[2] Arguments in support of this view include:

- The returns from some government spending are low or negative. Government production of goods and services has frequently been found to be more costly than private production. The private provision of accident insurance, for example, resulted in a large reduction in premiums for most employers.

- A good number of welfare programmes are badly targeted and have unintended consequences. They commonly assist the middle class and lead to harmful behaviour, for instance by weakening the work ethic and the institution of marriage.

[2] For a more extensive discussion in relation to New Zealand, see Bates, Winton (2001), *How Much Government? The Effects of High Government Spending on Economic Performance*, New Zealand Business Roundtable, Wellington.

- As government grows, it becomes more heavily involved in the redistribution of income and wealth and in regulation. These activities encourage individuals and firms to seek income via government favours rather than by producing goods and services that consumers value. As this happens, resources are shifted away from wealth-creating activities toward the pursuit of income transfers. This shift impairs growth.

3.3 Vito Tanzi and Ludger Schuknecht concluded that:

> Though the evidence available is limited, various government performance indicators suggest that growth in spending after 1960 may not have brought about significantly improved economic performance or greater social progress. In a sense this growth in spending was less socially productive than that before this period. The group of countries with 'big governments' – those that increased spending the most – did not perform better than the ones with small governments ...
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> In conclusion the evidence available ... suggests that small governments did not 'produce' less desirable social indicators than big governments. Furthermore, they had better economic and regulatory efficiency indicators.[3]

3.4 It is often argued that New Zealand's marginal tax rates are not particularly high relative to those other developed countries. That view is misleading because it omits the following factors:

- New Zealand's top and penultimate marginal tax rates apply at relatively low levels of income compared to some other countries.[4]

[3] Tanzi, Vito and Schuknecht, Ludger (1995), 'The Growth of Government and the Reform of the State in Industrial Countries', working paper, International Monetary Fund, Washington, pp 20-23. New Zealand was classified among countries with a medium-sized government (government spending between 40 and 50 percent of GDP) for the purposes of the study. Australia was included with countries that have a relatively small-sized government.

[4] Only 3.5 percent of all tax filers in the United States are in the 28 percent or higher federal tax bracket. More than a fifth of all New Zealand taxpayers are subject to the 33 or 39 percent rates. See Aaron, Henry J, Gale, William and Sly, James (1999), 'The Rocky Road to Tax Reform', in Aaron, Henry J and Reischauer, Robert D (editors), *Setting National Priorities: The 2000 Election and Beyond*, The Brookings Institution Press, Washington, p 216 and Cullen, Michael (2003), 'Budget 2003: Key Facts for Taxpayers', The Treasury, Wellington.

- New Zealand's tax base is broader than that of many other countries, as the discussion document acknowledges. Exemptions and loopholes are commonly available in other countries in respect of activities that are particularly sensitive to high effective marginal rates of tax. This is one reason why comparisons of statutory rates of tax alone can be misleading.

- The OECD accounts for about half of world GDP. The more dynamic countries of Asia that are growing faster than OECD countries typically have much lower tax rates than New Zealand. New Zealand competes with those countries in attracting foreign investment.

3.5 The minister of finance has claimed on several occasions that a reduction in the level of taxation would have no beneficial effect on behaviour or growth.[5] The economic literature is unambiguous in finding that feasible revenue taxes reduce efficiency. There is also a growing body of economic literature which suggests that an increase in tax is detrimental to economic growth.[6]

3.6 The claim that tax increases do not adversely affect behaviour conflicts with the perceived rationale for a host of government policies. Does anyone, for instance, seriously think that a tax at the rate of 100 percent would have no adverse effect on people's willingness to work and invest in the formal economy? Why impose higher tax on cigarettes if it has no effect on the level of smoking? Why give grants (negative taxes) to selected firms and activities such as the large tax breaks associated with the production of the *Lord of the Rings* if such subsidies have no effect on investment decisions?

[5] See, for example, Cullen, Michael (2002), 'Desperately Seeking Anybody', press statement by New Zealand Government, 15 April, www.newsroom.co.nz.

[6] See, for example, research summarised by Leach, Graeme (2003), *The Negative Impact of Taxation on Economic Growth*, Reform, Institute of Directors, London; and Gwartney, James, Holcombe, Randall and Lawson, Robert (1998), ‘The Scope of Government and the Wealth of Nations’, *Cato Journal*, vol 18(2), pp 168-169; Leibfritz, Willi, Thornton, John and Bibbee, Alexandra (1997), *Taxation and Economic Performance,* Economics Department working papers, No 176*,* OECD, Paris*;* Prescott, Edward C (2003), 'Why Do Americans Work So Much More Than Europeans?', Research Department Staff Report 321, Federal Reserve Bank of Minneapolis, Minneapolis.

3.7 A substantial reduction in the level of spending and taxation is desirable. Lower and more uniform rates of tax, as advocated by the Tax Review 2001, would encourage work, investment and innovation in all industries. They would help boost economic growth, consistent with the government's stated objective of raising average per capita incomes to the top half of the OECD rankings.

4. Other issues

4.1 The government has rejected the tax cap idea. We think it should be reconsidered.

4.2 It is common knowledge that a number of high net worth New Zealanders have become domiciled in countries that have more attractive tax arrangements. New Zealand suffers if taxpayers who are among the most successful and enterprising residents and who have strong cultural and other commitments to New Zealand are driven overseas by excessive taxation. In addition to the loss of skills and the diversion of their attention to opportunities and endeavours elsewhere, tax collections are reduced.

4.3 Taxpayers on high incomes generally contribute far more in tax than their share of the cost of government-provided services and transfer payments. The Tax Review 2001 concluded that its tax cap proposal would be fiscally positive.

4.4 It makes little sense to assist immigrants (including New Zealanders who have not been resident for tax purposes for at least 10 years) to take up employment in New Zealand by reducing New Zealand tax on their offshore income while taking no steps to reduce the tax disincentive facing for successful New Zealanders to remain tax residents of New Zealand.

4.5 We cannot identify any principled objective to the tax cap idea. The government's objections can only be ideological.

5. Conclusions

5.1 The Business Roundtable submits that:

- The underlying problem is that the levels of government spending and taxation in New Zealand are excessive. Lower and more uniform rates of tax are required to encourage work, investment and innovation, and would constitute a much more effective tax strategy. High effective marginal rates of tax should be reduced. Spending cuts should finance such reductions.

- The government's proposal to introduce a temporary exemption from some of New Zealand's international tax rules for people who are non-resident for tax purposes, including returning New Zealanders, and who are recruited to work in New Zealand should be adopted in the absence of a broader strategy to reduce tax rates generally.

- The tax cap proposal should be reconsidered and adopted.