Reflections on the Tax Working Group *Report*

By

John Creedy[1]

Abstract

This article reviews the *Report* of the Tax Working Group of the Victoria University of Wellington, which included individuals from the Treasury and the Inland Revenue Department, as well as from the business community. The *Report* makes an important contribution to the tax policy debate in New Zealand by setting out the reasons for reform, the basic principles used to consider alternative policies, and the advantages and disadvantages of a range of reform proposals. The purpose of this review of the *Report* is not to discuss the proposals and recommendations in detail, but to consider a number of aspects concerning the evaluation of tax structures and to try to clarify some arguments which are not stated explicitly in the *Report*. An indication of useful next steps is also given.

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[1] Department of Economics, The University of Melbourne, Australia. In preparing this paper, I have benefited from discussions with Bob Buckle, Norman Gemmell, Denis O'Brien and David White. This paper is based on two presentations in New Zealand in February 2010. First, a Treasury Guest Lecture, jointly sponsored by the New Zealand Treasury, the Centre for Accounting, Governmance and Taxation Research (CAGTR) and the Institute for the Study of Competition and Regulation (ISCR) at Victoria University of Wellington, was delivered on 23 February 2010. Second, a presentation was made at the Auckland Business School on 25 February 2010.

1 Introduction

The *Report* of the Victoria University of Wellington Tax Working Group (TWG), *A Tax System for New Zealand's Future* (2010) is remarkable for several reasons. It represents a unique collaboration among individuals from the Treasury, the Inland Revenue Department and the Centre for Accounting, Governance and Taxation Research (CAGTR), along with a range of other acknowledged tax experts. Taxation is an area where strong disagreement and argument at cross purposes is notoriously present, and yet the TWG has, under the leadership of Bob Buckle, produced a valuable report that is clearly written, generally non-dogmatic and non-didactic, with balanced arguments and a judicious use of supporting data and charts.

Despite the technical nature of the subject, the *Report* also communicates with a wide audience. The *Report* has also been produced with remarkable speed and relatively cheaply. Favourable comparisons may, for example, be made with the reviews being carried out by the Australian Treasury (*Australia's Future Tax System*) and the Institute for Fiscal Studies (*Reforming the Tax System for the 21st Century*) in the UK. These achievements should not be underestimated: indeed, they are worth celebrating.

What kind of *Report* has the TWG produced? It is probably best described as an exercise in 'Rational Policy Analysis'. By this is meant that its aim is mainly to examine the implications, using a variety of measures, of a range of alternative policies. This involves a clear statement of the criteria against which a tax structure may be compared. It encourages an understanding of why different people may not agree about the best way to proceed, and therefore allows for rational discussion rather than heated argument. The *Report* is refreshingly free of the kind of rhetoric which is so often a part of taxation debates.

It is true (and unfortunate in the present writer's view) that at times (towards the end of the report) the TWG has been unable to resist the pressure to make specific proposals for reform of the NZ tax structure though in doing so it is careful to point out that its members are not always unanimous. However, I understand that the pressure to produce recommendations came from outside the TWG. But rational policy analysis at its best provides the information which enables others, using their own value judgements and views about likely orders of magnitude, to make up their own minds.[2]

The structure of the *Report* is clear. It begins – after a brief discussion of the role of taxes – by outlining the reasons why reforms are needed to the tax structure, arising from both domestic and international changes since the previous major reforms of the 1980s, and why adjustments to existing rates and thresholds are unlikely to be sufficient. Motivated by the extent to which the tax rate applied to corporations, trusts and the top personal tax rate have become 'misaligned', it then considers a range of alternative methods of taxing corporations, keeping in mind the

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[2] An early statement of aims was made in Buckle, R.A. (2009) Towards a world class tax system. Presentation to IRD's Technical Leaders Conference, 25 August. He stated (p. 2) 'The purposes of the Tax Working Group are to provide a forum for informed discussion of the priorities for medium-term tax policy that can feed into advice to Government Ministers and to promote and inform a wider public debate on tax policy. … It was not designed primarily to lead to specific policy recommendations but rather to allow full identification of the issues that will need to be considered in reviewing medium-term tax policy'.

increasing extent of international capital mobility. Reforms such as reductions in personal income tax rates, along with methods to broaden the tax base, involving the introduction of a Land Tax and extensions to the Capital Gains Tax, along with a range of smaller reforms (concerning, for example, depreciation allowances for property investment) are then considered. In each case the advantages and disadvantages are carefully discussed.

In considering changes, an important feature is that the TWG restricted its attention to reforms which are revenue neutral. That is, the total tax revenue is estimated to remain unchanged. Revenue neutral changes examined by the TWG assume an absence of behavioural responses to tax changes, such as profit shifting by corporations and labour supply responses by individuals. Such behavioural responses may be substantial.[3] To the extent that a policy change improves incentives and increases taxable incomes (including profits), post-reform tax revenue is likely to be understated.

The restriction to revenue neutral changes is necessary because any change in revenue involves another unspecified policy, so that alternatives cannot properly be compared. Thus, for example, the argument that concerns about the future adequacy of tax revenue would disappear if only government expenditure were cut would be irresponsible, unless at the same time a detailed set of proposals for cutting expenditure were produced and their implications examined. Expenditure considerations were outside the scope of the review.

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[333] For examples using a behavioural microsimulation model for Australia, see Buddelmeyer, H., Creedy, J. and Kalb, G. (2008) *Tax Policy Design and Behavioural Microsimulation Modelling* (Cheltenham: Edward Elgar).

Any revenue neutral change in the tax structure must of course involve some winners and some losers. Hence unanimity cannot be expected and distributional value judgements cannot be avoided. It is therefore important to attempt to make such value judgements explicit, since they are the source of many disputes about tax policy. Given the inevitability of there being some losers from a tax policy change, a strong desire on the part of policy makers to avoid losers clearly creates a bias towards the status quo.

The main points of the TWG are well made. These include: the case for significant reforms in view of the domestic changes in New Zealand since the previous major reforms of the 1980s and which involve expenditure and revenue-raising concerns; the need for changes which place less reliance on taxes (such as personal income taxes and corporation taxes) where there are efficiency problems and where labour and capital are mobile; the need for some base-broadening in a number of areas; the need to bring corporation, trust and personal tax rates into closer alignment; and the need to review the interaction between personal income taxes and the structure of benefits, giving rise to very high effective marginal tax rates.

There is little point here in simply going over the detail of the various proposals. The aim of this review of the TWG *Report* is to consider a number of aspects concerning the evaluation of tax structures and to try to clarify some points which are not stated explicitly in the *Report*. The evaluation of tax structures is discussed in Section 2. Some indication of the required next steps is then given in Section 3, and brief conclusions are in Section 4.

2 Evaluating Tax Structures

This section discusses the TWG *Report's* approach to the evaluation of tax structures. The basic principles adopted by the TWG are examined in subsection 2.1, and this is followed by discussion of some features which, it is suggested, need some further elaboration and more clarity. The choice of tax base is considered in subsection 2.2. The distinction between 'rules of thumb' and tax principles is explained in subsection 2.3. Subsection 2.4 argues that further precision is needed when discussing the concept of tax progressivity. The treatment of elasticities and their role in tax evaluations is examined in subsection 2.5. It is suggested that an appreciation of these points should help readers to obtain a clearer understanding of the main arguments of the *Report*.

2.1 Basic Tax Principles

The TWG *Report* sets out six 'principles of a good tax system'. These are: efficiency and growth; equity and fairness; revenue integrity; fiscal cost; compliance and administration cost; and coherence (as part of a multi-tax and benefit structure). Any statement of tax principles inevitably brings to mind Adam Smith's famous 'four maxims', which are frequently discussed and extended.[4] A fundamental problem is

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[4] Smith's maxims, stated in *The Wealth of Nations* (1776), were: payment according to benefit received (though there was some ambiguity as to whether this coincides with ability to pay); certainty; convenience; and economy (in collection). A longer list was produced by G.W. Norman, whose list included: frugal; computable; simple; constant; divisible; popular; non-interferent; equal; uncorruptive; unvexatious; and unevasible. See O'Brien, D.P. with Creedy, J. (2009) *Taxation and the Promotion of Human Happiness: An Essay by George Warde Norman*. Cheltenham: Edward Elgar.

that, even if these principles were substantially elaborated, it would not be possible to treat them as axioms and from them derive an implied ‘ideal’ tax structure. The TWG appeared to recognise that even the production of a table, listing tax policies in the rows and the principles in columns, with ticks and crosses in appropriate boxes, would not in the present context provide sufficient information (given the nature of the principles). The *Report* thus more usefully produced tables listing various advantages and disadvantages of each alternative. These features in fact include further criteria such as ‘certainty regarding future taxes’ (see pp. 28, 64).

However, it is suggested that there are some important principles which are implicit in the *Report*, but which really need to be made explicit. Thus, only on p. 56 is mention made of the fact that ‘value judgements are necessary to determine the priorities and respective weighting of these objectives’. The fact that value judgements play such an important role in tax policy decisions explains also why there is usually so much disagreement in tax policy debates.[5] It is seldom clear if opponents disagree because they hold different value judgements, or because they form different views about the way people respond to tax changes (given that complete information is never available). This is precisely how rational policy analysis can help – by indicating the implications of adopting different values, so that readers can make up their own minds.

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[5] This point is discussed in detail in Creedy, J. (2010) Tax and transfer tensions: designing direct tax structures. *Australian Economic Review* (forthcoming).

2.2 The Tax Base

A fundamental judgement taken by the TWG – and not fully articulated in the *Report* - is that taxes should reflect 'ability to pay', rather than the 'benefits received' as a result of the subsequent public expenditure. Thus, it is stated that, 'a good tax system should [ensure that] taxes paid reflect ability to pay' (p. 59). In considering ability to pay, a further important step is taken in suggesting that it 'should' be measured by 'comprehensive income'. Unfortunately the *Report* never states this explicitly, suggesting for example only that, 'taxing capital gain "on accrual" would bring the tax system closer to taxing comprehensive income' (p. 48) and referring to a capital gains tax as 'a more comprehensive option for base broadening' (p. 11).

The term 'comprehensive income' means simply that income is defined as the amount that can be consumed in a given period without reducing wealth. This term is familiar in the public finance literature, but of course it is precisely the same as the Hicksian income concept and Friedman's 'permanent income' concept which is widely used in economics. The important point here – perhaps not brought out sufficiently clearly in the *Report* – is that the adoption of this concept as the appropriate tax base is the fundamental reason for attempting to tax capital gains. Such taxes obviously face problems in dealing with those gains which accrue but are not realised, and the *Report* recognises that a 'comprehensive capital gains tax' is an impossibility. Nevertheless, there may be scope for extending CGT along the lines used in other countries.[6]

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[6] The *Report* discusses the use of a risk-free rate of return method (RFRM) on property, but is generally not supportive.

In popular debates regarding the introduction of, or extension to, a tax there is perhaps a tendency to judge a proposal against a 'perfect' tax, when of course no existing tax is perfect. And, there is always some resistance to a new tax. As the writer of the first English language full length treatise on public finance, John Ramsay McCulloch, declared: 'it is sometimes better "to bear those ills we have, than to fly to others that we know not of"'.[7] It is therefore likely that the TWG's discussion of extending CGT in New Zealand will meet with some resistance, even among those who may not expect to lose by such a change, but it provides a useful starting point for debate.

2.3 Rules of Thumb

An important position taken by the *Report* is that, 'the TWG considers that the broad-base low-rate [BB-LR] option is generally a sound principle to adopt' (pp. 16, 64). However, the adoption of BB-LR is not in fact a 'principle', but a rule of thumb.[8] It is nevertheless a useful rule. It arises from recognition that the efficiency cost (in terms of the excess burden) of a tax is approximately proportional to the square of the tax rate.[9] Hence it is useful, other things being equal, to keep the rate low, and this is

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[7] See McCulloch, J. R. (1863) *A Treatise on the Principles and Practical Influence of Taxation and the Funding System* (Edited with introduction by D.P. O'Brien, 1970. London: Allen and Unwin). Here McCulloch is quoting from probably the most famous speech in Shakespeare (Hamlet, 'To be or not to be …'), and so does not bother to give his readers the source.

[8] For further discussion of this rule of thumb, see Creedy, J. (2009) Personal income taxation: from theory to policy. *Australian Economic Review*, 42, pp. 495-506.

[9] For an introduction to the excess burden concept and explanation of the approximation, see Creedy, J. (2004) The excess burden of taxation. *Australian Economic Review*, 37, pp. 454-464.

achieved by keeping the tax base as broad as possible. But of course in evaluating a tax structure there are other considerations (as indeed are indicated in the TWG's own list of criteria), involving distributional value judgements, along with 'merit good' and externality arguments.

The BB-LR rule of thumb leads, in the *Report*, directly to the suggestion that the top marginal income tax rate should be reduced. But it is important to recognise that such a judgement requires more detailed information. For example, using the Australian tax microsimulation model, *The Melbourne Institute Tax and Transfer Simulator* (MITTS),[10] it has been found that there is considerable heterogeneity in excess burdens and marginal welfare costs of tax changes. Many individuals below the top marginal rate face high burdens, depending on demographic and other characteristics. Using a utilitarian type of social welfare function which allows for a degree of aversion to inequality, the analysis of 'optimal' marginal tax reforms does not always suggest cutting the top rate. When inequality aversion is very high, optimal reforms may involve cutting other rates first.[11] This is a further example of the point that economic 'efficiency' criteria alone are not sufficient to determine policy – value judgements play an important role.

Some ambivalence is also present in the TWG's discussion of the 'alignment' of the corporation tax rate, the rate applied to trusts and the top personal income tax

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[10] On the MITTS model, see Creedy, J., Duncan, A.S., Scutella, R. and Harris,M. (2002) *Microsimulation Modelling of Taxation and The Labour Market: The Melbourne Institute Tax and Transfer Simulator*. Cheltenham: Edward Elgar.

[11] See Creedy, J. and Hérault, N. (2009) Optimal Income Tax Reforms: A Microsimulation Analysis. *University of Melbourne Department of Economics Working Paper*.

rate. It sometimes appears that the *Report* treats alignment as a basic principle, while recognising that it would involve a loss of degrees of freedom in policy choices. Yet again it is more appropriate to consider it as a rule of thumb rather than a principle. Starting from some specified objectives, and given other features (such as regulations regarding allowances and deductions, the costs of income shifting and the precise extent of behavioural responses to tax changes), it would be extremely difficult (as mentioned above) to produce an optimal structure: there is little reason *a priori* to expect identical rates to emerge from such a problem. And of course the relevant rates on trusts and corporations are proportional, while the average personal income tax rate is below the top marginal rate. However, there can be little doubt, as the *Report* argues, that the rates have now become seriously out of line and some movement towards alignment, if not necessarily to equality, is a high priority.

2.4 Precision Regarding Concepts

Perhaps surprisingly, one major concept is not defined by the TWG, leading to some potential misunderstanding. A tax structure is progressive if, over the relevant income range (where income is the tax base), the average tax rate (tax divided by income) increases with income. However, progressivity does not require ‘marginal rate progression’, which refers to an increasing marginal tax rate as income increases. Indeed, a considerable degree of progressivity can be achieved with a proportional tax, combined with a basic income (that is, a fixed and unconditional transfer payment).

This is relevant when considering a change in the tax mix – a shift from personal income taxes towards indirect taxation in the form of the GST. This can of course be achieved in a variety of ways, including reductions in all marginal income tax rates, or as part of a rate-flattening exercise with reduction in the top personal rate of taxation. A revenue-neutral tax shift must, as suggested earlier, involve losers as well as winners. However, the approach adopted clearly depends on the value judgements regarding income distribution. Where concern is largely with low-income groups, a cut in higher income tax rates can be combined with an increase in the GST rate, along with a suitable adjustment to benefit levels to maintain their real values. After all, this was done when GST was first introduced. With reference to the GST, it is worth stressing yet again (as mentioned by the *Report*) that a uniform tax on all goods and services is not regressive at all – the appropriate tax base is total expenditure, not income.[12] In New Zealand, the combination of several excise taxes with GST produces a very slightly regressive indirect tax structure.[13]

2.5 Taxes and Elasticities

The TWG *Report* suggests that, 'taxing those bases that are least likely to be subject to significant behavioural change … (inelastic bases) is also a sound principle to adopt when … broadening the tax base' (p. 10). This is of course an allusion to the efficiency effects of taxes, concerning the distorting effect of non-uniform taxes on behaviour. Reference is made to a result obtained by Ramsey and Pigou early in the last century. Where the aim is to minimise a measure of the sacrifice arising from

[12] In the same way, any uniform increase in all prices – for example brought about by inflation – would not be considered as regressive.

[13] On indirect taxes in New Zealand, see Creedy, J. and Sleeman, C. (2006) *The Distributional Effects of Indirect Taxes: Models and Applications from New Zealand*. Cheltenham: Edward Elgar. The *Report* (p. 47) shows that GST as a proportion of total expenditure is similar across income decile groups.

taxation, the appropriate tax structure turns out to be one that reduces the consumption of all goods by the same proportion, hence implying a higher tax on inelastic goods. However, this result is severely limited because it refers to a single-person economy, and thus excludes any equity concerns.

Importantly, the most widely accepted modern measures of the efficiency effects (excess burdens) arising from taxation are based on ‘compensating variations’ and ‘equivalent variations’. These measures depend not on market price or income elasticities, but on ‘compensated’ (or ‘Hicksian’) elasticities, where the ‘income effects’ of the price changes are excluded.[14] This is not merely a pedantic point about definitions. In examining excess burdens per dollar of revenue paid by individuals in Australia using the microsimulation model, MITTS, many cases were found where the marginal welfare costs are very high, even for those whose labour supply was found to change very little.[15]

Here is the appropriate point to consider how the TWG’s discussion of a Land Tax fits in with their list of tax principles. It is not in fact motivated by the use of a comprehensive income measure of ability to pay. Indeed, the comprehensive income concept gives no support to any kind of wealth (or net worth) tax – only tax on the income arising from assets (both human and non-human capital). The proposal for a Land Tax therefore relies exclusively on the desire to find an additional tax base,

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[14] For an introduction to these concepts, see Creedy, J. (2004) The excess burden of taxation. *Australian Economic Review*, 37, pp. 454-464.

[15] See Creedy, J., Hérault, N. and Kalb, K. (2009) Measuring Welfare Changes in Behavioural Microsimulation Modelling: Accounting for the Random Utility Component. *University of Melbourne Department of Economics Working Paper*.

using the criterion relating to the elasticity (that is, concerned only with a definition of efficiency). Transition, tax shifting and equity effects are clearly important considerations which need further analysis.

3 Some Next Steps

The TWG *Report* recognises that further analyses need to be carried out. Given the remarkable short time scale within which the *Report* was produced, and the low level of resources made available to the TWG, this is of course inevitable. One area mentioned concerns the transfer system and its integration with the personal income tax structure. In particular, Working for Families (WfF) has introduced substantial marginal tax rates applying to middle income groups, and high levels of government expenditure. It also appears that there are unintended consequences whereby some individuals who are not in the ‘target group’ considered by the designers of the system are in receipt of WfF transfers. It is suggested here that a comprehensive review of WfF needs to be given very high priority

Additional areas where further work is needed, not mentioned explicitly by the *Report* but undoubtedly supported by it, include behavioural responses. Despite the potential importance of foreign direct investment, and profit-shifting by corporations (both real and that achieved by the exploitation of transfer pricing), very little solid empirical evidence is available regarding companies operating (or previously operating) in NZ. Similarly, there no longer exists a behavioural model in NZ that is capable of producing estimates of labour supply responses to tax changes and their associated efficiency (welfare) costs.[16]

One suggestion made several times in the *Report* is that there should be some kind of review body, or organisation, charged with, and sufficiently equipped to carry out, the task of conducting regular independent evaluations of the tax structure in NZ. This, it seems, is not intended to propose yet another quasi non-governmental organisation **(**QUANGO), but presumably the TWG has in mind something like the role played (among other things) by the Institute for Fiscal Studies in London. The aim is to inform public 'rational debate', by investigating the detailed implications of tax policy changes. It is suggested that this could impose some constraints on politicians, with a propensity to tinker with a tax structure in ways that have insufficient regard for the integrity of the complete system. It could also help to make the system less vulnerable to the inevitable special pleading by interest groups. The question of the funding and location of such a body was not discussed in the *Report*.

4 Conclusions

In any discussion of taxation, it is important to recognise the inevitability of disagreement and a lack of consensus.[17] There are simply too many value judgements

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[16] For a description of the only large scale New Zealand microsimulation model, and examples of policy simulations, see chapter 12 of Buddelmeyer, H., Creedy, J. and Kalb, G. (2008) *Tax Policy Design and Behavioural Microsimulation Modelling* (Cheltenham: Edward Elgar).

[17] For further elaboration of the reasons for this comment, see Creedy, J. (2010) Tax and transfer tensions: designing direct tax structures. *Australian Economic Review* (forthcoming).

involved and too many areas where only informed guesses must be made in the absence of direct information. It is certainly no weakness of the TWG *Report* that it does not report unanimous support for various policy reform proposals. However, the TWG members clearly managed to agree on a broad framework for discussing reforms, and the need for some action. A *Report* which simply set out a dogmatic agenda for reform, using the kind of rhetoric that is familiar from the commentaries of special-interest groups, would have little value and would be read only by like-minded people.

The influence of the TWG on the tax debate, indeed in making taxation itself more prominent in public debate, is clear from even the most casual examination of the media in New Zealand. The suggestion that there are substantial revenue risks and that the distorting effects of some forms of taxation have growth effects as well as the less visible – but nonetheless substantial – excess burdens, has clearly influenced the government in its thinking about tax structure changes.

As mentioned earlier, the strength of the report is in its attempt to contribute to rational policy debate by rehearsing the various arguments in a clear and dispassionate manner, so that those on different sides of the debate can come to understand just why they differ. That a disparate group of individuals from a range of backgrounds have established some common ground in a way of thinking about taxes is itself sufficient cause for praise. The *Report* can be read with interest and profit by all those interested in tax policy.