Tax Working Group Information Release

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The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

Coversheet: **Company tax rate issues – review of Secretariat modelling**

Discussion Paper for Session 14 of the Tax Working Group

July 2018

Purpose of discussion

In Session 6 a Business Tax Paper was presented which considered the pros and cons of a cut to the company tax rate. In Session 8 we provided further information on the theory of a company tax cut in a small open economy and modelling results. We discussed both the Australian Treasury's modelling of company tax rate reductions and the Secretariat's preliminary modelling of the effects of company tax rate reductions in New Zealand. We mentioned at the time that we were putting out our modelling for external review. Professor Norman Gemmell (Chair of Public Finance at Victoria University) has reviewed the modelling as well as papers that have gone to the Tax Working Group. The aim of this note is to let the Tax Working Group know the results of the review.

Key points for discussion

- Does Professor Gemmell's review cause the Group to reconsider its earlier decision that the company tax rate should not be reduced?

Recommended actions

We recommend that you:

a **note** that Professor Gemmell has reviewed the Secretariat's initial modelling of reductions in the company tax rates and considers that there could be a stronger case for company tax rate cuts than suggested by the Secretariat because he considers that economic rents may not be material

b **consider** whether Professor Gemmell's review would cause the TWG to reconsider its decision that the company tax rate should not be reduced.

Company tax rate issues – review of Secretariat modelling

Discussion Paper for Session 14
of the Tax Working Group

July 2018

Prepared by Inland Revenue and the Treasury

Discussion

In session 8 of the Tax Working Group we discussed modelling by the Australian Treasury estimating the economic effects of a company tax rate cut as well as some preliminary modelling of the effects of the cut in New Zealand. Our preliminary modelling had been prepared in response to requests within the TWG for information on the likely size of the economic effects of a company tax rate cut in New Zealand.

Our modelling of the effects of a company rate cut was very much rougher and simpler than the Australian modelling. While the Australian Treasury has developed a quite sophisticated Computable General Equilibrium (CGE) model of the Australian economy to investigate the effects of company tax rate changes in Australia, no such model is available in New Zealand. The Australian modelling involves four economic decision makers and has 111 different sectors which can employ 12 different primary factors. Ours is a much simpler single sector model with capital and labour the only factors of production.

The Australian model had been used to examine the likely effects of a 5 percentage point cut in the company tax rate in Australia with the revenue forgone being made up in a number of ways. These included a lump-sum tax increase, a cut in personal tax rates and a cut in Government spending. Lump-sum tax increases are unlikely to be practicable options because they are completely non-distorting replacement taxes. The Australian Treasury modelling of a cut in government spending assumed that this was costless to the public because it assumed that government spending itself was of no value to public. This seemed likely to overstate the benefits of a cut in the company tax rate balanced by a cut in government spending. For this reason we chose to analyse the effects of a company rate cut that was financed by a personal tax rate increase so we could benchmark our results against the Australian study.

The Australian study considers a number of different scenarios but in their base case find that real GDP would rise by 1.0%, after-tax real wages would increase by 0.4%, real gross national income (GNI) would increase by 0.6%, and welfare would increase by 0.1%. Our preliminary modelling suggested a rise in GDP of 0.57%, an increase in after-tax real wages of 0.34% and an increase in net national income (NNI) of 0.11%.

The Australian study had factored in a potentially important downside of cutting the company tax rate. This was the loss of tax on economic rents accruing to non-residents investing into Australia. By contrast our simple model did not take account of economic rents. Even under the Australia estimates, we considered that the economic gains from cutting the company tax rate and replacing it with higher income tax rates looked very small (an increase of only 0.1% in welfare). This gain looks very small against the integrity concerns that would arise in New Zealand from a greater difference between the company tax rate and the top personal marginal tax rate if there were to be a company tax rate cut in New Zealand.

We commissioned Professor Norman Gemmell (Chair in Public Finance) to review two papers that had gone to the Tax Working Group on this issue. He also commented on two Inland Revenue technical notes that were prepared for internal discussion rather than publication. These explain details of the modelling.

The papers reviewed were as follows:

- Paper 1: Appendix – Company tax rate issues (Appendix to the Business tax paper presented to session 6 of the TWG;
- Paper 2: Company tax rate issues – further information (presented to session 8 of the TWG)
- Paper 3: Technical note: Impact of a Company Tax Cut on NZ Capital Stock
- Paper 4: Technical note: Incorporating Profit Shifting

His detailed comments on these papers are provided in the Appendix.

Professor Gemmell has picked up some inconsistencies and made helpful comments on the modelling itself. These will be useful as we attempt to improve our modelling in the future. He argues that it would be good to benchmark our model for Australian settings so that we can find whether or not it provides similar answers in aggregate to the much more complex Australian Treasury model. As he points out this is helpful because of their complexity CGE models are always shrouded in a degree of mystery. This is a good suggestion but all of this work will inevitably be beyond the timeframes for the Tax Working Group.

Probably his biggest concern with the papers considered by the TWG is the lack of evidence on the size of economic rents in New Zealand. He believes that, in the absence of clear evidence otherwise, it is safer to consider that economic rents may be quite modest, which increases the potential case for a company tax rate cut in New Zealand. He notes that no evidence is provided in the papers on the size of economic rents and that none is readily available at present. He argues that cutting the company tax rate may attract additional FDI into New Zealand and new firms may lead to competitive pressures which make New Zealand firms more efficient. Nevertheless, he comments that, even ignoring the argument for maintaining the company rate due to the presence of economic rents, the case for a reduction in the company tax rate appears weak based on simple, but probably reasonable, modelling of foreign investment responses to company tax rates.

These FDI responses may happen to some extent, but even if economic rents were very small in New Zealand we consider that the integrity pressures that would be opened up if the company rate and top personal tax rates were to move further apart would make cutting the company tax rate an unattractive option. These pressures were considered in Session 6 when we looked at Business Tax and Close Companies. At the same time other issues that are being considered by the TWG including broadening the taxation of capital income may alleviate some of these integrity pressures.

Professor Gemmell argues that a company tax rate cut possibly balanced by increases in tax on sectors where economic rents are likely could be a reform direction worth considering. He expresses concern that this option has not been explored further. However, a current difficulty in this direction of reform is the lack of an evidence base on the size of economic rents in different sectors.

Professor Gemmell also expresses surprise that we are not more focused on future possible company tax rate cuts in Australia and implications for New Zealand. We see these as uncertain and some time off. Moreover, even if the Australian company tax rate were to be reduced to 25 percent, we see it as an open question whether New Zealand should also cut its company tax rate. At the same time company tax rate cuts in Australia obviously create some pressure (including transfer pricing concerns) for New Zealand to do likewise and officials will continue to be monitoring.

A question for the Tax Working Group is whether Professor Gemmell's review causes the Group to reconsider its earlier decision that the company tax rate should not be reduced.