

Tax Working Group Public Submissions Information Release

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Submission to the Tax Working Group

27 April 2018

Personal submission from David Grimmond

[1]

Summary

My recommendation is that the Tax Working Group seriously considers the option of New Zealand replacing its porous income tax system with a *comprehensive expenditure tax* system based on the existing GST infrastructure. That is, remove all forms of income tax and increase the rate of GST in order to meet government revenue requirements. Issues of vertical equity and income redistribution could be addressed via the benefit system, for example through some universal income entitlement and/or a targeted benefit system. A comprehensive expenditure tax system would be more transparent, equitable, economically efficient, and administratively simple than the current mixed income-expenditure tax system.

Independent of this recommendation, but critical should a greater emphasis on expenditure taxes be adopted, is the recommendation that the GST system in New Zealand should be switched from its current *destination* basis onto an *origins* basis. This would remove an existing distortion whereby the implementation of GST promotes returns for goods exporting activities at the expense of service export activities (eg education, tourism). In so doing it would also potentially promote a more environmentally friendly production mix and better future proof the tax system against the growth of E-commerce.

If New Zealand chooses to persist with an income tax system, it is vital that the tax system addresses the current favourable status of home ownership. My recommendation would be to *introduce a tax on imputed rent*. If such a tax was coupled with a tax deduction for mortgage interest payments, then this would reduce the current tax-based inducement for home owners to rapidly pay down their mortgage. The net impact will be to diversify people's savings portfolios and increase capital available for investment in the business sector. is that people currently some form of addressing the inequity in tax treatments . the absence of

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1. COMPREHENSIVE EXPENDITURE TAX SYSTEM

My preference for a comprehensive expenditure tax system relates to my interpretation of the optimal tax literature and in particular issues relating to the appropriate tax on capital.

The appropriate tax on capital

Optimal tax literature suggests that it is probably inappropriate to tax capital. I will provide more detail below, but the gist of the argument was captured by Thomas Hobbes view that a person should be taxed “by what he takes out of the common pool, not by what he puts into it” (quoted in Musgrave 1957).

Theory

Theoretical analysis of the appropriate tax on capital is that it should probably not be taxed, and that a tax on capital is unlikely to serve either efficiency or redistributive purposes. Mankiw, Weinzierl, and Yagan (2009) note that this result, controversial from its beginning in the mid-1980s, has been modified in some subtle ways, and challenged in others, but its strong underlying logic has made it the benchmark. The subtleties mentioned do not overturn the view that the optimal level of taxes on capital should be near zero, but rather as noted by Auerbach (2006a): “a capital income subsidy is just as likely to be optimal as a capital income tax” (p21).

The logic for near zero capital taxes is based on the observations that:

- the supply of capital is highly responsive to changes in the cost of capital,
- capital taxes produce large distortions in consumption decisions, and hence discourage saving,
- capital taxes also produce large distortions in the funding of different capital projects, and
- as capital accumulation is central to the creation of aggregate output, this has sizeable impacts on economic growth prospects.

The nature of capital is that it tends to be long lived, specialised to the production of dedicated outputs, large and lumpy in size and cost, and intertwined with the organisation of surrounding economic activity. This nature of capital increases the importance of tax distortions on investment decisions. As Auerbach and Hines (2001) note, capital taxation is extremely distortionary even at very low rates of tax as the intertemporal nature of investment decisions means that the wedge imposed by taxes on capital grows over time. The misallocation of resources resulting from a tax distorting capital decisions compounds over time.

Mankiw, Weinzierl, and Yagan (2009) note that the intuition of zero capital taxes can be developed in a number of ways:

1. The seminal paper by Diamond and Mirrlees (1971) indicates that the optimal tax on all intermediate goods is zero. This is because taxes on intermediate

inputs of production will distort the allocation of factor inputs. Likewise taxes on corporate accounting profits will distort the return on capital for a subset of the economy, encouraging capital to leave the corporate sector. Likewise human and physical capital should not be taxed as both are used as inputs to future production, so taxing them would put the economy inside its production frontier.

2. A tax on capital is effectively a tax on future consumption, but not on current consumption, and this would violate the Atkinson and Stiglitz (1976) prescription that all commodities should be taxed uniformly¹. In fact, a capital tax imposes an ever-increasing tax on consumption further in the future, so its violation of the principle of uniform commodity taxation is extreme.
3. Based on Chamley² (1986) and Judd³ (1985), there will exist households with long planning horizons that will determine how much they will save based on their discounting of the future and the return on capital in the economy. In the long run, their saving decisions will be perfectly elastic with respect to the after-tax rate of return. Thus any tax on capital income will leave the desired after-tax return to capital unchanged, which means that the pre-tax return to capital must rise, which will reduce the size of the capital stock and aggregate output below potential. This distortion is so large as to make any capital income taxation suboptimal, even from the perspective of an individual with no savings.⁴

This third argument is strengthened by globalisation of capital markets, which can lead to highly elastic responses of capital flows to tax changes even in the short run. The logic remains the same, but rather than changing saving/investment decisions over time, global investors adjust their portfolio geographically to maximise their after-tax return on investment.

An implication of the Chamley argument is that by reducing investment, the incidence of capital taxes can ultimately hit labour income by reducing job opportunities. That is, investors will reduce their investments in certain areas if they are adversely affected by capital taxes, which will reduce job opportunities for workers. In an efficient labour market this will translate into slower wage growth rather than fewer jobs, but the implication

¹ Atkinson, A. B. and J. E. Stiglitz, 1976, "The design of the tax structure: Direct versus indirect taxation," *Journal of Public Economics* 6, 55–75. The original Atkinson-Stiglitz thesis was made using a number of restrictive assumptions, but the results appear to continue to hold when these judgements are relaxed see for example Hellwig (2008).

² Chamley C (1986) "Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives", *Econometrica*, Vol 54(3) pp 607-622

³ Judd K L (1985) "Redistributive Taxation in a Simple Perfect Foresight Model", *Journal of Public Economics*, Vol 28, pp 59-83

⁴ As with the Atkinson and Stiglitz results, the original Chamley and Judd papers made use of a number of restrictive assumptions. Likewise subsequent investigations relaxing these assumptions appear to confirm the original finding. For example, Atkeson, Chari and Kehoe (1999) find that the Chamley (1986) result that the optimal tax rate on capital income is zero continues to hold when the analytical model is generalised so that agents are heterogeneous (rather than identical), economic growth is modelled endogenously (rather than exogenously), and with overlapping generations (rather than living forever).

remains that the buck stops with workers, not investors. It is this implication that leads to the result that capital taxes are not only harmful to aggregate economic prospects, but are also unlikely to provide an effective means of income redistribution.

Implications for taxing labour

Both Ljungqvist and Sargent (2000) and Auerbach and Hines (2001) report that an extension of the arguments for not taxing capital implies that labour income should also not be taxed. This is because labour is also an intermediate input into the production process and thus any tax on labour will also distort production decisions. Since labour income taxes effectively tax intertemporal labour/leisure choices, the optimal dynamic tax path is one in which labour income taxes are zero.

There is also the added issue of human capital accumulation, which means that the arguments about the compounding of tax distortions over time for physical capital are also likely to apply for skill development. The seminal article in this area is Jones, Manuelli and Rossi⁵ (1997) which shows that a zero tax also applies to labour income: that is, the return on human capital should not be taxed; instead the government should resort to a consumption tax.

Auerbach and Hines (2001) argue that an alternative to a zero tax on labour would be to make spending on education tax deductible. However, Hellwig (2008) shows that this result stems from a special case of the Atkinson-Stiglitz theorem, and that a generalisation of the model structure re-confirms the view that one should not tax income, although an argument for some form of subsidy on education can still hold.

The idea of taxing consumption rather than income has a long history, dating back to at least the 17th Century quote of Thomas Hobbes and it is also frequently credited to John Stuart Mill (Ballard et al 1985). The arguments for a consumption tax include:

- It is more reasonable to tax withdrawals from the economic system than on additions to the system (as argued by Hobbes)
- Income taxes distort intertemporal consumption decisions: saving must be made out of net-of-tax income, and the earnings of investments are further taxed before future consumption can occur.
- Administrative efficiency and lower compliance costs: no need to separate income into labour, corporate, capital gains, welfare transfers; nor the calculation of depreciation allowances, fringe benefits, imputed rents.
- It removes the tax wedge distorting investment decisions.
- Consumption is a better measure of the ability to pay

The last point involves a number of important points relating to the preference of taxation systems. A key principle underlying tax systems is that their design should reflect people's ability to pay. Not taking into account people's ability to pay is the critical failing of lump-

⁵ Jones L E, Manuelli R E, and Rossi P E (1997) "On the Optimal Taxation of Capital Income", *Journal of Economic Theory*, Vol 73(1), pp 93-117

sum taxes. Consumption is considered by many to be better than income as a measure of ability to pay (eg see Pechman 1990 or Metcalf 1994). This reflects the permanent income consumption hypothesis that people smooth consumption through swings in year to year income levels based on their longer term income expectations, which reflect life-cycle considerations (eg one's income might be low in old age, but wealth accumulation may mean that one may still have a high level of consumption spending).

Real world issues

It is impossible to produce a perfect tax system. Actual tax systems result from compromising different aims (eg raising revenue, protecting economic efficiency, reflecting ability to pay, and income redistribution goals) and the balance between such aims depend on the values and judgements of both the designers and society in general. The implication is that the benchmark for judging tax systems can be argued to be existing systems rather than some theoretical ideal. In particular one needs to recognise that:

- Taxation is a system of coercively collecting revenues from individuals who will tend to resist (Slemrod 1990).
- Changes in tax policy must pass a political as well as an economic test (Hettich and Winer 1988).
- As reforms in one part of the system may lead to unexpected repercussions elsewhere as the government attempts to establish a new equilibrium, there is likely to be a political bias favouring the status quo (Creedy 2010).

The implication is that substantive tax reform typically has to pass a very high hurdle. Another implication is that tax reform is path dependent – the options available depend on previous tax design and the mandate government has for reform. The pre-conditions for comprehensive reforms to the tax system come along rarely, and are typically associated with political and social upheaval. An example of this is that the adoption of flat tax systems is largely limited to eight newly independent Central and Eastern European countries in the wake of the collapse of the Soviet Union (Rabushka 2005).

Another implication is that a lack of political will, rather than any technical issues, is often the main obstacle preventing the adoption of wealth enhancing tax reforms. The bias towards the status quo also means that adjustments to the tax system tend to be incremental and ad hoc. As a result there is also a tendency for tax systems to become increasingly complicated. The resulting build-up in exemptions, allowances, and attempts to close loop holes have the perverse effects of encouraging tax arbitrage that erode the tax base.

It is worth noting that income taxes are a relatively modern phenomenon. All income tax systems have emerged since the initial introduction in Prussia and Saxony in the second half of the 19th Century. While tax rates were initially set at low levels, the degree of progressivity sharply increased in the first half of the 20th Century. Saez (2002) argues that income taxes were designed to have their strongest impact on the top income earners, the vast majority of whose income comes from capital.

Thus a key purpose of modern tax systems appears to be to redistribute accumulated wealth. That is, if the primary aim is to raise revenue, the secondary one is to redistribute income. But are progressive income tax systems efficient and effective ways of achieving these ends? Not if the rich can effectively reduce their tax liability, and not if the imposition of taxes leads to economic inefficiencies that reduce prospects for economic growth and the purchasing power of incomes. The optimal tax analysis presented above also indicates that taxes on capital are not necessarily effective in redistributing wealth as any initial gains will eventually be offset by reduced job opportunities and wage prospects for workers. This is further compounded if the wealthy can find effective ways of minimising their tax liabilities.

The use of incomes as the base of tax systems that also have a primary aim of redistributing income has resulted in most OECD countries adopting what OECD (2006) characterises as semi-comprehensive income tax systems. Comprehensive incomes can be defined as the amount that can be consumed without reducing wealth (Creedy 2010). This definition implies that a comprehensive income tax system should tax capital gains. In addition rental income from home ownership should be imputed for tax purposes and mortgage interest payments should be deductible (OECD 2006). The notional nature of capital gains and imputed rentals make these factors difficult to calculate and tax accurately, tending to result in gaps in the comprehensive income tax base of most countries.

Gaps in the tax base both open up tax arbitrage opportunities and encourage increasingly complicated tax systems as ad hoc adjustments are made to plug holes in the tax base. Indeed OECD (2006) reports that the main complexities in tax systems arise from the definition of the tax base (eg whether the income in question is taxable or not, along with the use of special tax rates, tax allowances, and tax credits) and not so much from the tax rate structure (p44).

The problems of tax arbitrage behaviour have led to reforms in many countries which have attempted to broaden the tax base and lower tax rates. This potentially lowers the efficiency costs resulting from relying heavily on taxing incomplete assessments of taxable income. However, the optimal tax theory results imply that even very small taxes on capital income can result in distortions in economic decisions that compound over time resulting in large welfare losses.

Indeed one of the implications of optimal tax theory is that the optimal tax on capital is not necessarily zero if there is not a "complete set of flat-rate taxes" (Ljungqvist and Sargent, 2000, p324). If there are activities that escape the tax base, then an optimal tax system would introduce taxes on capital to correct for this distortion. However, the optimal capital tax is only positive if the untaxed activity (or factor) complements taxed activities; if they are substitutes the optimal policy would be to subsidise the taxed activity (or factor). This result would argue, for example, for the imposition of a tax on equipment for the cultivation and manufacture of illegal drugs (which are not taxed), but a subsidy on equipment used in the provision of other, non-drug related, leisure activities. A flat tax system, without a tax on capital would seem to be a simpler approach at promoting economic efficiency. Any income redistribution aims can still be achieved via government spending policies.

Attributes of a comprehensive expenditure tax system

Tax Base

The aim of a comprehensive expenditure tax system is to tax final consumption expenditure based on a value added tax like GST. A key finding of optimal tax theory is that the optimal tax on intermediate goods is zero (Diamond and Mirrlees 1971). Value added taxes like GST, which apply the tax at every transaction, but allow registered producers to claim back the taxes paid on purchased inputs, conform with this principle.

All taxes represent the coercive collection of revenue from people who will tend to resist, primarily by avoiding the activity being taxed. This natural resistance to paying tax imposes costs on society either directly (via the cost of administering and policing the tax) or indirectly (via the distortion to efficient behaviour). Consideration of these factors leads to the rule of thumb that expenditure taxes should cover as wide a range of activities as possible to reduce opportunities for people to avoid paying the tax and hence also minimise the distortions to behaviour induced by the tax.

This system would incorporate the abolition of income taxes. A consumption tax can be shown to be equivalent to a wage tax, at least over the long term. The critical factor with a comprehensive expenditure tax compared with an income tax system is that it does not tax capital income. The non-tax of capital is also consistent with optimal tax theory: capital equipment is an intermediate input to the production of future output so a tax on capital on income violates the Diamond and Mirrlees (1971) thesis that intermediate goods should not be taxed; the different capital requirements for producing different goods and services means that the presence of capital income taxes will influence the after tax return of different investment opportunities and so will distort investment decisions.

The long run revenue equivalence of comprehensive expenditure tax and flat tax systems means that ease of implementation and the timing of tax incidence become critical criteria for comparing the two systems. Summers (1981) argues that an expenditure tax base has positive growth benefits as it encourages greater saving at younger ages⁶.

⁶ A tax that targets consumption spending and omits savings from the tax base can be shown to raise the same revenue as a tax applying only to labour income and exempting all property income. For example, using a simple two period model with constant interest rates, no gifts or bequests, and thus assumes that all savings from the first period needs to be consumed in the second period then saving in the first period is wage income not consumed:

$$s_1 = w_1 - c_1$$

Consumption in the second period is wage income in the second period plus savings and the income earned with those savings, ie:

$$c_2 = w_2 + (1+r)s_1$$

The net present value of lifetime consumption is thus:

$$NPV(c) = c_1 + \frac{c_2}{(1+r)} = w_1 - s_1 + \frac{w_2 + (1+r)s_1}{(1+r)} = w_1 + \frac{w_2}{(1+r)}$$

GST in New Zealand is raised on a destination basis, which taxes imports and zero-rates exports. In practice it is very difficult to zero rate service exports such as tourism or education, and this will have distorted investment decisions constraining the service export sector. Increasing the importance of GST will accentuate this problem, but we argue that it can be circumvented by converting GST onto an origins basis (see *Argument for designing GST based on the origin principle* on page 19).

Rate structure

On balance, an equal tax rate for all goods, services, and transactions appears the appropriate rate structure for a comprehensive expenditure tax system, but this follows as much from practical considerations as from conceptual considerations. A flat tax structure eases administration and compliance costs, and will also offer horizontal equity properties. A universal rate may not necessarily be optimal from an economic efficiency perspective. This reflects that taxing spending will encourage activities that do not require spending (eg growing your own vegetables). Differential rates that tax complements to these self help activities at a higher rate (eg higher rates on seeds) are potentially more efficient. Even if it was possible to implement an optimally graduated expenditure tax system, the added complications to the overall system would probably negate any resulting benefits.

The removal of income taxes would require a large increase in the GST rate compared with current levels. Simply covering current government revenue requirements would suggest a GST rate of around 45% would be warranted. However, this estimate is potentially on the high side. People continue to pay expenditure taxes long after their income taxes shrink to minimal levels. Thus expenditure tax rates set to meet the government's inter-temporal budget constraint can be set lower than the equivalent wage based tax rate as the tax base is based on whole of life spending which is typically longer than the working life.

Special provisions

There does not appear to be an obvious way for treating financial services within a value added tax system. In one sense taxing financial services could be seen as taxing future consumption and so should be excluded from the tax. In another sense financial services do offer services that add value here and now (eg peace of mind, the ability to smooth consumption, manage cash flows efficiently). From a purely practical perspective, financial service transactions do not fit the credit-invoice system used in GST and other value added tax systems very easily. For example, revenue is often raised as the margin between deposit and lending interest rates or buy and sell exchange rates.

Thus applying the same tax rate would yield the same amount of revenue (or lifetime consumption) whether wage income or consumption is taxed. Summers (1981) demonstrates that this result can be generalised, but notes that there is no reason for the tax collection to be the same in any given period. Indeed because consumption taxes continue to extract revenue beyond retirement age, a consumption tax system encourages more saving in younger years and so encourages earlier capital accumulation and economic growth. Considered from an open economy perspective the Summers results imply that wage taxation encourages debt financing, which might not decrease investment, but it raises the risk profile of a given level of investment. Thus the increase in capital accumulation expected under a consumption tax comes from a lower national (currency) risk premium, which reduces the cost of capital to investors and raises investment levels.

The approach that New Zealand has adopted to dealing with this issue is to exempt financial services from GST. This effectively treats financial service providers as final consumers: they pay GST on their inputs but do not charge GST on their services and cannot claim back GST like other businesses. In the retail market, this does not cause major problems, financial businesses will recoup their GST expense by charging clients more. The clients actually obtain a net benefit as they do not pay GST on the value added by financial service companies.

There are other problems, however, which will be accentuated with an increase in the GST rate. The exemption creates a risk of tax cascades if the direct client is a business (the business client will effectively pay the GST, but cannot claim it back, so it will be passed on with an additional GST component to the final customer). In addition the exemption will encourage financial service companies to in-source key activities that they might otherwise have purchased from a separate entity.

There does not appear to be a clear cut solution to this issue (see Inland Revenue Department 2002). More work would need to be done here before a comprehensive expenditure tax system could be introduced. A cursory examination of the issue would suggest that an option that would warrant further examination would be to zero-rate financial services, where no tax is paid on the supplies of financial services, and a full refund is given for GST paid in making those supplies. This would lower the government's revenue base, but it would remove both the cascade and in-source problems. It would also be simpler to administer than other solutions suggested in Inland Revenue Department (2002).

Revenue capability

VAT/GST type taxes are common. As of 2004, 134 countries relied on value-added taxes as a substantial source of funding. VAT rates 20% plus in 20 countries. No country relies exclusively on spending taxes for revenue, the highest in 2004 was Iceland at 29.7% of revenue. New Zealand collected 24.7% of tax revenue through its GST in 2004 (Hines 2007).

Expenditure taxes cover much of the grey economy and may even entice registration and identification of illegal activities. Although an expenditure tax will not stop hard core criminal activities, shifting the tax base away from incomes onto spending means that there is at least an opportunity to tax their ill-gotten gains.

Administration costs

The collection costs for British VAT has been estimated at about 3% of revenue raised (Slemrod 1990). Value added taxes have a large fixed cost setting up the appropriate collection systems so the collection cost per dollar raised falls as tax rates increase. The New Zealand GST is a simpler system than the British VAT, so collection costs for GST are likely to be proportionally lower.

VATs are largely self-enforcing. The biggest risk is at the retail end where as much as half the tax base can be compromised. Slemrod quotes Hemming and Kay (1981) estimated that evasion of UK VAT was 1.5% of potential revenue. This level of tax evasion is very low compared with income tax evasion and avoidance, which has been estimated to exceed 10%

of potential revenue (Slemrod 1990). However, an increase in the GST rate will increase incentives to evade the tax. It is likely that more resources will be required to police a higher GST, but the removal of income taxes will spare IRD resources focussed on income tax collection issues. Given the higher level of income tax evasion and avoidance, the overall administration cost of a comprehensive expenditure tax system is likely to be lower than the current system.

Compliance costs

Compliance costs relate to having GST systems in place, registering and putting in returns. These compliance costs are largely in place, and will be little affected by an increase in the rate. The replacement of income taxes with a comprehensive expenditure tax would greatly reduce compliance costs for businesses and individuals. The removal of income taxes removes complexities associated with calculating capital gains, issues with inventories, depreciation. There is no need to adjust for inflation. No need to deal with issues relating to property and speculation.

Economic efficiency issues

Final expenditure taxes comply with many of the findings of optimal tax theory: They effectively tax commodities at the final point of consumption and so do not tax the factors of production. They imply a zero capital income tax. They are eventually equivalent to taxes on wage income but, by taxing expenditure and not income, the tax will not influence the allocation of labour between different activities. A consumption tax will place a wedge between consuming and leisure (which is untaxed) and thus will reduce the supply of labour compared with a lump sum tax, but not necessarily worse than the existing bias against working imposed by income taxes. The lack of tax on capital income in conjunction with the longer time scale on the spending tax base (cf income) means that there is larger early life saving, which allows greater capital accumulation and growth (Summers 1981).

Optimal tax theory suggests that the optimal commodity tax has variable rates based on the elasticity of demand for different products. The unobservable nature of non-constant individual preferences means that it is not practical to implement a tax like this. However an implication is that a uniform tax will potentially distort consumption patterns away from commodities where preferences are highly price sensitive, due to the income effect.

Horizontal equity issues

There are a couple of issues relating to the current design of New Zealand's GST. The tax's implementation needs to be shifted from a destination basis to an origin basis to ensure that exports of services are treated the same as exports of products and to ensure that international electronic commerce does not erode the tax base. There is also an issue with taxing financial services, which was discussed in Special provisions on page 9).

Vertical equity issues

There is a perception that GST is a regressive tax that will harm the political acceptance of a comprehensive expenditure tax. Although a comprehensive expenditure tax does not actively redistribute income from rich to poor households (except via higher spending and therefore high tax payments by rich households) the regressive reputation of spending taxes

is more perception than reality. In practice an expenditure tax is not more regressive than a flat income tax system. However, societies tend to prefer more income redistribution than can be provided by a flat income tax rate alone. The options available to provide more income redistribution with a comprehensive expenditure tax is to somehow collect more tax from the spending of the rich or provide additional income support via the benefit system. The former approach would greatly complicate the tax system and potentially lead to economically costly distortions to spending patterns. Thus the practical approach is to have a flat tax rate coupled with a benefit system that directly delivers the amount of income redistribution that society prefers.

Intergenerational/transition issues

Retired elderly will want to draw down on assets which have been built up using after tax income. If the tax system moves from an income base to an expenditure base the elderly risk being effectively taxed twice: when they earned their income originally and then when they consume during their retirement years. This is a transition issue that would require "grandfathering". This could be done via some form of age based compensation or differentiation in the effective GST rate.

Issue of taxing bequests

There are moral/value arguments that bequests should be taxed to mitigate inter-generational inequalities. Parental wealth and the anticipation of bequests give recipients a head start in life, which is not necessarily correlated with ability. Kotlikoff (1988) notes that "there is strong evidence that intergenerational transfers play a very important and perhaps dominant role in US wealth accumulation" (p41). Kotlikoff however notes that the precise explanation for intergenerational transfers remains unclear. Intergenerational altruism might appear to be a likely candidate, but at least some stylised facts are at odds with the altruism model. For example, parents tend to allocate bequests equally among children, which is at odds with the altruism model which would predict differences in bequests as parents compensate for differences in children's earning prospects. Also there is no evidence of differences in asset decumulation between elderly with or without children.

Instead it seems that life cycle motives, but with uncertainty about life expectancy, drive saving behaviour and asset accumulation. If this is the case what does a tax on bequests or assets achieve? If family altruism is the motivation for bequests, then an unavoidable tax on bequests will encourage a greater accumulation of assets and therefore welfare loss for parents. If lifecycle considerations dominate, the bequest tax will have minimal impact on parental behaviour, but it will reduce the windfall gain for children.

Presuming that life cycle motives dominate, the absence of bequest taxes means that the next generation will be taxed more heavily if income from capital is taxed, but their bequest will escape taxation unless consumption is taxed. A comprehensive expenditure tax will ultimately tax all bequests that are not reinvested.

What about a tax on the stock of capital? A key motivation is that it will encourage greater productive use of assets. But if bequest motives dominate people will be encouraged to shift resources offshore to escape the tax. On the other hand if life cycle factors dominate, the incentive will perhaps be more in line with the motivation for taxing the stock of capital,

however the resulting decrease in the after-tax return on capital is still likely to encourage an outflow of capital offshore. The net impact is likely to be a depreciation in the currency, resulting in a decline in the purchasing power of New Zealand domiciled households. Those households that own overseas assets are likely to be hedged, but those without assets will simply experience a fall in purchasing power.

The potential offset will be a relative increase in wages. The decline in the exchange rate will also provide a competitive offset to the capital outflow. The net distributional impacts will be for the capital tax to encourage a shift towards more labour intensive production areas and (perhaps paradoxically) for the exchange rate depreciation to encourage a shift of production from non-tradeable towards tradeable sectors. This reallocation of activity may enhance the productive capacity of the economy, but it is not guaranteed. A first best option still seems to be to remove the tax wedge on investment decisions.

Impact of inflation

The tax base will be automatically adjusted for inflation. This will have powerful efficiency benefits compared with progressive income tax systems. Inflation can still impose equity issues via the benefit system.

Interaction with benefit system

The key interaction with the benefit system is the interaction between the required tax rate and the degree of targeting in the benefit system. A universal income entitlement introduces a direct trade-off between the generosity of the entitlement and the required tax rate. A targeted benefit system reduces the government's revenue requirement and so also the required GST rate, but introduces issues about appropriate proxies for targeting groups for support, adverse selection problems, and equity issues relating to people close to entitlement boundaries.

International issues

International issues disappear if GST is moved onto an origins basis (discussed in full in *Argument for designing GST based on the origin principle* on page 19). The removal of income taxes, particularly on capital income will attract inflows of capital. Ultimately the key influence will be a fall in the New Zealand risk premium reflecting higher savings and greater economic growth as the economy performance improves.

Implementation issues

Taxation is a system of coercively collecting revenues from individuals who will tend to resist. The coercive nature of taxes implies that the resource cost of implementing a tax system is large (Slemrod 1990). The budget for the Inland Revenue Department in New Zealand in 2009 was \$660m, or about 1% of revenue collected by the Department. In addition there is the compliance cost of taxes imposed on individuals and companies. Other costs include equity issues associated resulting from the evasion of tax payments, which ultimately forces a higher tax burden on those who are less willing or able to evade.

Even in the absence of evasion, any tax system will inevitably cause distortions as individuals substitute away from relatively highly taxed goods or activities to relatively lightly taxed items. This is known as tax arbitrage. It extends to taxing different bases, ie if one taxes

spending/wages/capital it will encourage people to re-arrange their activities to minimise their tax exposure. At the extreme this will be via illegal evasion, but a poorly designed tax system will offer legitimate means for reducing their tax liability. Such arbitrage results in an erosion of the tax base. For example if one wishes to tax a \$100m activity with a 30% tax rate, one's expected tax revenue will be \$30m. If, however, if the imposition of the tax results in evasion, avoidance or a reduction in the activity one might see, say, a 10% reduction in the activity from \$100m to \$90m, which would result in an equivalent 10% reduction in the amount of tax collected (from \$30m to \$27m). Implying that while the statutory tax rate might be 30%, the effective tax rate is just 27%.

OECD (2006) notes that governments might increase overall tax compliance by simplifying their tax system. This is because the main complexities in tax systems arise from the definition of the tax base (eg whether the income in question is taxable or not, along with the use of special tax rates, tax allowances, and tax credits) and not so much from the tax rate structure (ie what tax rates apply in different situations).

The costs of a tax relate to its administration, its compliance burden, and its excess burden or deadweight cost. Deadweight costs result when people turn to less preferred substitutes or employ less satisfactory methods of production as a result of the imposition of taxes. The size of this deadweight cost will be influenced by the incompleteness of the tax base, differentiation in effective tax rates for different activities, the availability of exemptions and allowances, and the responsiveness of people to prices on different goods and services (including in the production process) (Diewert and Lawrence, 2000).

Although tax evasion represents a deliberate illegal action, which can have serious consequences for those caught, tax evasion appears to be a significant and pervasive problem. For example, Slemrod (2007) reports that the National Research Program estimated a \$345 bn gross tax gap or 16.3% of estimated actual tax liability (paid plus unpaid) in the US. The equity implications of tax evasion are highlighted by the uneven distribution of where tax evasion occurs. Only 1% of wages and salaries were measured as being under-reported in the US study. Likewise just 4% of taxable interest and dividends were under-reported. Instead the main culprit was non-farm proprietor income where **57%** of income was estimated not to have been reported! The lesson being that a complex tax system favours self-employed at the expense of employed wage and salary earners. Another finding reported by Slemrod (2007) is that higher income people evade less than those on low incomes, a result consistent with the adage that the poor evade, and the rich avoid.

There has been a perception that value add tax (VAT) systems, like our goods and service tax (GST) are less susceptible to fraud and evasion due to a number of self enforcing aspects of their design. For example the ability for registered producers to claim back tax paid on inputs provides an incentive for businesses to register and comply with tax requirements. Indeed initial estimates of evasion of VAT were very low. For example, Slemrod (1990) reported that the revenue loss from evasion from the UK VAT in the 1980s were estimated to be around 1.5% of potential revenue. More recent estimates suggest that the gap between VAT receipts and the estimated true tax liability could be a magnitude higher at around 15% of the tax liability (Keen and Smith 2007). The types of fraud associated with VAT systems are described in the box: Typology of VAT fraud and design issues, below.

As Keen and Smith note:

“There is no doubt that the VAT is susceptible to evasion and fraud, running all the way from the occasional concealed sale to sophisticated and large scale attacks by organized crime.

“But this is not cause for panic. All taxes face problems of noncompliance. One dollar paid in a fraudulent VAT refund is no more costly than one dollar of under-declared income tax. The question is not whether VAT is vulnerable to fraud and evasion – it obviously is – but whether it is more or less vulnerable than other taxes.” (p28)

Where the tax applies may have greater influence than the exposure to fraud and evasion on the resulting economic consequences. For example, although evasion on VAT might have the same revenue consequences as avoidance of capital taxes, the consequences in terms of economic efficiency and resulting national welfare may be quite different.

On the positive side Keen and Smith consider that most VAT fraud issues can be resolved by good design. A VAT system with the following characteristics is likely to have a relatively low exposure to fraud:

- one single rate,
- reasonable high thresholds for registration (but ideally linked to a low-burden modest lump-sum tax for small operations),
- limited zero-ratings and exemptions, and
- effectively insulates international trade transactions from the tax (where we would argue for the shift in the implementation of GST from a destination to an origins basis).

As Slemrod (1990) notes no tax system can stand alone without an enforcement mechanism supporting it. The question ultimately becomes which system can be more effectively policed. Also it is worth noting that the valid comparison is not the potential for evasion and avoidance of different tax systems but the overall integrity of the systems. A new system will be superior to the status quo so long as the combined administration, compliance and deadweight costs of the new system are less than the combined costs of the existing system. In this respect it is worth noting that the other benefits involved with a replacement of income taxes with an expenditure tax system include:

- lower compliance costs (no income tax forms, no calculation of depreciation, no need to calculate capital gains, imputed rents, fringe benefits),
- no need to police income tax issues,
- the removal of the wedge distorting investment decisions, and
- the tax system will capture a larger chunk of the proceeds from illegal activities when criminals make purchases.

Typology of VAT fraud and design issues

From Keen and Smith (2007)

Under reported sales: when a trader reports only a proportion of sales. The highest risk is with personal services where the final stage is large relative to inputs, eg hair dressing. In this case the competitive advantage of offering the service without tax is more likely to outweigh foregone refunds. The incentives for this type of fraud are compounded if the evasion also incorporates not declaring income for income tax purposes.

Failure to register: The incentives for this type of fraud are probably highest with small scale operations with turnovers that only just require registration. Concern about the costs of complying with the tax may be a key motivation for evasion. Once again firms selling to final consumers (or to unregistered businesses) and with low relative inputs are likely to predominate. This is also likely to be more predominant if firms also wish to evade income tax.

Misclassification of commodities: occurs when there are variable tax rates for different commodities (ie people reclassify commodities to be the lower taxed commodity). This type of fraud is not likely to be an issue if the VAT rate remains uniform, as with New Zealand's GST.

Omission of self-deliveries: when goods produced by the business and consumed by the proprietor, in principle taxable but not declared. This is particularly an issue with agriculture in less developed economies.

Tax collected but not remitted: registered businesses charging customers VAT but disappearing before paying tax to authorities.

Imported goods not brought into tax: This type of underpayment potentially increases with internet commerce. It is also dependent on the VAT being designed using the *destination* principle. This type of fraud would disappear in a VAT designed under an *origins* basis.

False claims for credit or refund: false claims for exaggerated or non-existent purchases. This appears to be the most prevalent fraud in a VAT system. The risk of fraud from this source is likely to decline with the age of business as it implies implausibly low margins. The zero rating of exports makes the risk of diversion fraud high, ie claim that it has been exported to obtain zero rating, but sell domestically. Once again the risk of this form of fraud reduces/disappears with an origins based system.

Credit claimed for VAT on purchases that are not creditable: A prime form of this type of fraud is when items are bought for private consumption but misrepresented as business inputs, allowing VAT to be recovered. The presence of income taxes increases the incentive for this type of fraud as the false business expense also helps to reduce the businesses' income tax liability. This type of fraud is already prevalent in relation to under-reporting of self-employed incomes

Bogus traders: companies may be set up solely to generate invoices that allow recovery of VAT

What matters is not the number of possibilities for evasion but their quantitative significance. This is likely to be affected by the number of taxpayers in a position to exploit particular possibilities for abuse, the risks of detection, the effectiveness of enforcement activities, and the way in which the tax is designed.

Key design issues:

Rate differentiation: scope for fraud increase with different rates, zero-ratings, and to a lesser extent exemptions (the benefit of exemptions is that one does not have to deal with refunds, but the efficiency issues of differentiated rates persist).

Level of VAT: The higher the rate the higher the potential return from successful fraud. High VAT rates are likely to encourage informality (non-registration): although high rates raise the unrecovered tax that informal operators will bear on their inputs the high rates also increase the output price they can charge while still undercutting formal operators.

Registration thresholds: the revenue lost by setting a high threshold may be small compared with the saving of administration costs to authorities and compliance costs to the taxpayer.

Simplified and lump-sum schemes for small traders: such schemes may offer both firms and the authorities substantial savings, while reducing evasions opportunities and competitive distortions.

Timing of payments and refunds: quick payment of refunds by authorities increase the opportunity for false refund claim frauds.

Summary

A comprehensive expenditure tax system based entirely on a VAT/GST type tax system, with the abolition of income taxes, has many desirable attributes. It addresses ability to pay via its link to voluntary spending decisions. It is administratively simple to run, and as it can be based on existing GST systems already has all of the requisite infrastructure in place. It has minimal impacts on economic decision making, as it does not tax either capital or direct labour income, which suggests it will encourage a resource allocation close to optimal. The lack of tax on income removes the key administration and compliance costs associated with most tax systems.

The lack of a tax on capital will encourage higher levels of early life saving and thus encourage capital accumulation and growth. This higher saving is reinforced by the expenditure tax base, which allows a lower effective tax rate. Under an expenditure tax one is taxed throughout one's spending life as distinct from income tax systems that are constrained by the shorter working life.

GST type taxes are perceived by many to be regressive taxes. In fact expenditure taxes are equivalent to proportional income tax schedules. This means that like a flat tax system the tax is proportional in the sense that those who spend more pay more tax. They do not, however, impose a higher tax rate on higher spenders. Vertical equity issues can still be addressed in an expenditure tax system through the benefit system. Targeted or universal income entitlement systems would both result in a transfer of income from rich to poorer households.

A remaining issue is that reliance on GST as the prime source of government revenue will require very high tax rates. Back of the envelope calculations suggest that a GST rate of 45%

might be required to replace the existing income and company tax rates. A higher GST rate will increase incentives to evade paying GST than is currently the case. But in net the amount of tax evasion should be lower under a comprehensive expenditure tax compared with income tax systems. To begin with the need to register in order to claim back tax on expenses provides a self enforcing element to value added tax systems. Secondly expenditure taxes are more effective in taxing the proceeds from illegal activities. International evidence suggests that evasion to GST-type taxes is considerably lower than facing income taxes (1.5% of potential GST revenue compared with 7% of potential income tax revenue). The removal of an income tax system would free considerable resources to police the GST system, without the need to increase the size of IRD.

Finally a move to a concentration on GST would require the closure of an existing loophole in the GST system that discourages the net export of services. This could be addressed by shifting GST from a destination to an origin basis.

2. ARGUMENT FOR DESIGNING GST BASED ON THE ORIGIN PRINCIPLE

History

New Zealand introduced a goods and service tax (GST) on 1 October 1986. This tax can be characterised as a consumption type value added tax. It taxes virtually all transactions within New Zealand at one uniform rate (initially 10%, 12.5% from 1 July 1989 to 30 September 2010, and 15% since 1 October 2010).

The design of the New Zealand GST adheres to the “destination principle”. The destination principle is used as a means of arbitrating on any jurisdictional issues with regards to taxing decisions. Effectively the destination principle implies that if a good or service is purchased (or rendered) in New Zealand it should be liable for GST. In principle this means that imports should be subject to GST, as the goods and services will be purchased (or rendered) in New Zealand. Exports on the other hand are zero rated (ie exempt) as final consumption will be offshore.

Application of the destination principle in the design of value added taxes is a logical progression from the Diamond-Mirrlees conclusion that aggregate production should be efficient. This means that just as no taxes should be raised between firms, no taxes should be imposed on transactions between countries, and international trade would then take place at producer prices (Kay 1990).

An alternative to using the destination principle to determine the jurisdictional boundaries of a commodity tax system is to use the origin principle, ie where the origin of production (rather than destination for consumption) guides the tax design. Although it is typically the case that income taxes are levied on the origin principle and consumption taxes on a destination basis, there is nothing inherent in the structure of these taxes that requires this result (Kay 1990).

One can see why the New Zealand Government chose to design its GST around the destination principle given the institutional arrangements prevalent in the 1980s. The destination principle was (and still remains) the international norm in value added tax design. When officials instigated the process of designing a GST in 1984, New Zealand still operated under a fixed exchange rate regime and there was a high degree of wage rigidity given the preponderance of compulsory unionism in many sectors of the economy. The combination of these factors (fixed exchange rates, wage rigidities and the dominant use of the destination principle internationally) would have encouraged policy makers to favour a GST designed using destination principles ahead of one based on origin principles.

The reason for this is that the combination of the three factors mentioned would have meant that an origins based GST would have imposed competitive disadvantages onto the New Zealand export sector. In an environment when the real exchange could not readily adjust (ie fixed exchange rate and wage rigidities) applying a tax onto exports would increase the world price of products produced in New Zealand. The tax system would unfairly

disadvantage New Zealand based exporters until wages eventually adjusted to the changed environment. However, the presence of wage rigidities would mean that the disruptive impact would have a devastating impact on the export industry during the slow adjustment.

However, it has been demonstrated by Lockwood, de Meza and Myles (1995) that these pre-conditions disfavouring the origins based approach is a special rather than a general case – easing just one of these rigidities results in virtual equivalence between the destination and the origins approach. Indeed the special case no longer applies in New Zealand: a flexible exchange rate system was introduced in March 1985 (actually in the middle of the time when the GST system was being designed) and wage rigidities have been eased considerably since the introduction of the 1991 Employment Contracts Act.

The destination principle implies that rather than taxing either value added created in New Zealand, or the genuine consumption of New Zealand residents, GST has effectively become a tax on consumption that takes place within New Zealand. As will be discussed below this geographical determination of GST incidence imposes a distortion to economic behaviour that is likely to be detrimental to economic performance and the living standards of New Zealanders.

Implications of the imperfect application of destination principle

For the most part the GST operating in New Zealand is well designed:

- It is broad based
- It is based on real transactions and so easy to enforce and apply
- It does not interfere with production efficiency by taxing intermediate consumption
- It is broadly speaking self-policed
- There is just one uniform tax rate, which simplifies collection and enforcement

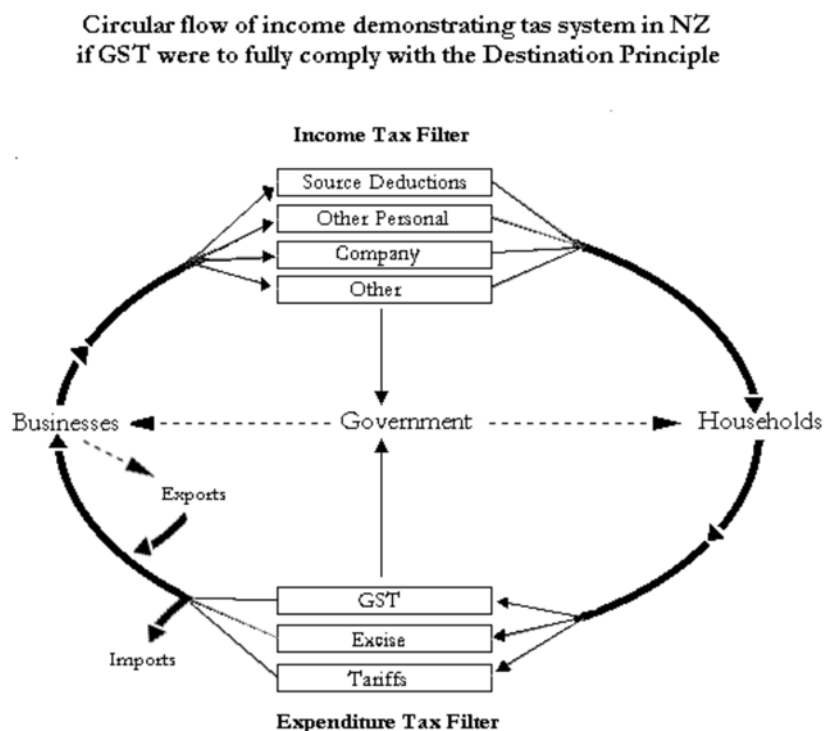
The key problem with GST is its reliance on the destination principle and the difficulty in applying the destination principle to services. In principle all imports should be liable to the tax and all exports should be exempt. This is illustrated in the following circular flow diagram of income flows in the economy, which is drawn to illustrate the impact of how GST should impact on the economy in principle.

The arrows represent flows of income between households (the spenders) and businesses (the producers) and back again. As households spend money on goods and services, the government raises revenue by filtering income of households through expenditure taxes such as GST, excise duties and tariffs. With this income, plus income earned through income taxes, the government redistributes income to households and businesses (providing public services along the way).

Some of the household's spending is on imports, which are a leakage from the system (income is spent abroad). Note this leakage occurs after the expenditure tax filter, as imports are taxable under GST, excise duty and tariffs. While imports represent a leakage

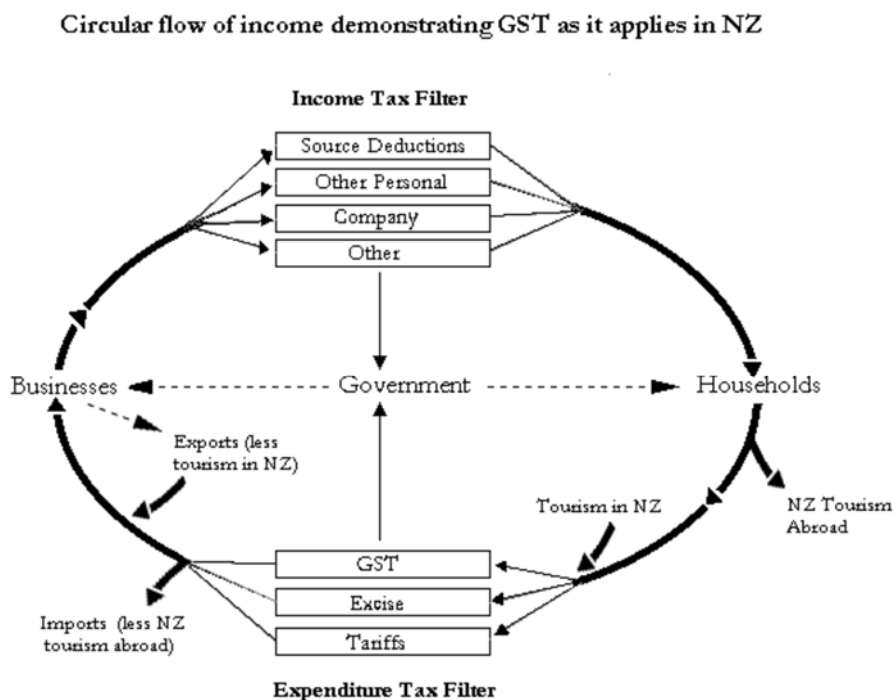
from the system, exports represent an income injection, which under the destination principle are not liable for GST. Income earned by businesses are eventually paid out to households, after the government takes its cut through income taxes (potential foreign leakages, eg profits abroad, are ignored as the focus here is on expenditure taxes).

Figure 1



If GST was implemented comprehensively in this way there would be no significant problems with the design of GST. However, GST does not operate in this pure way in practice. This is because of the difficulty in applying the destination principle to services, and in particular tourism. The national accounts rightly treat the expenditure by New Zealanders abroad as an import and the expenditure of foreigners visiting New Zealand as an export. However, the way that the destination principle is applied by the New Zealand GST means that the expenditure of New Zealanders abroad escapes having to pay GST (though they may have to pay expenditure taxes in the countries that they visit). It also means that tourists who visit New Zealand are liable to pay GST and other expenditure taxes during their stay in New Zealand. The impacts of this are illustrated in our amended circular flow diagram below (Figure 2).

Figure 2



The reason why New Zealand governments have been comfortable with this approach could be because the fiscal implications are generally positive. New Zealand usually runs a net surplus on travel. In the year to December 1998, for example, travel credits in the balance of payments (ie spending by overseas visitors) were \$3.2 billion (implying a GST contribution of \$358 million, assuming that the \$3.2 billion includes GST). Over the same period New Zealanders are estimated to have spent \$2.6 billion on travel abroad, which would have raised the marginally lower amount of \$330 million.

From a government finance perspective the difference is actually quite trivial. But the costs to the government (and indeed to New Zealand citizens) of correcting this problem in applying the destination principle to GST would not be trivial. For example, it would be more correct to allow overseas tourists the right to claim back GST on expenses during their visit to New Zealand and to attempt to raise GST of New Zealanders spending while abroad. But in practice this alternative is likely to be a dog's breakfast; it would add exceedingly to the costs of administering the tax and could potentially undermine the integrity of what is generally a well functioning expenditure tax. Allowing tourists the ability to reclaim GST from their spending in New Zealand would be open to abuse (eg tourists purchasing products or services on behalf of New Zealanders). It is also unlikely that countries will ever be very successful in taxing activities that take place wholly within other jurisdictions (Kay 1990).

It would seem at first sight that the cure is worse than the disease. But the issue is wider than just one of fiscal integrity. The aim of the destination principle is to ensure that taxes are not imposed on the transaction between countries and so ensure that international trade takes place at producer prices. The application of GST in New Zealand does not ensure this. Indeed it places a significant wedge between the earning power of different activities (eg between farming or running a home-stay) and the costs to consumers of different activities (eg holidaying on the Gold Coast or at Taupo). In this way it encourages a misallocation of resources that must be detrimental to the economy's performance.

The GST raises the relative returns of exporting goods above that of exporting services. It also encourages consumers to spend their money on trips abroad ahead of travel within New Zealand or indeed on any other product available within New Zealand. Although the misapplication of GST looks like a tax on overseas tourists it is in reality a tax on the incomes of those in the tourist industry and other traded services industries.

For example, if a tourist arrives in New Zealand with a budget of \$NZ1000, the tourist industry is likely at most to receive \$888.89 of this while the remainder is collected as GST by the Government (ignoring other duties such as excise and tariffs). If the same person spent their money on sheepskin products (either overseas or at a duty free store) the export sector (including associated services) would receive the entire \$NZ1000.

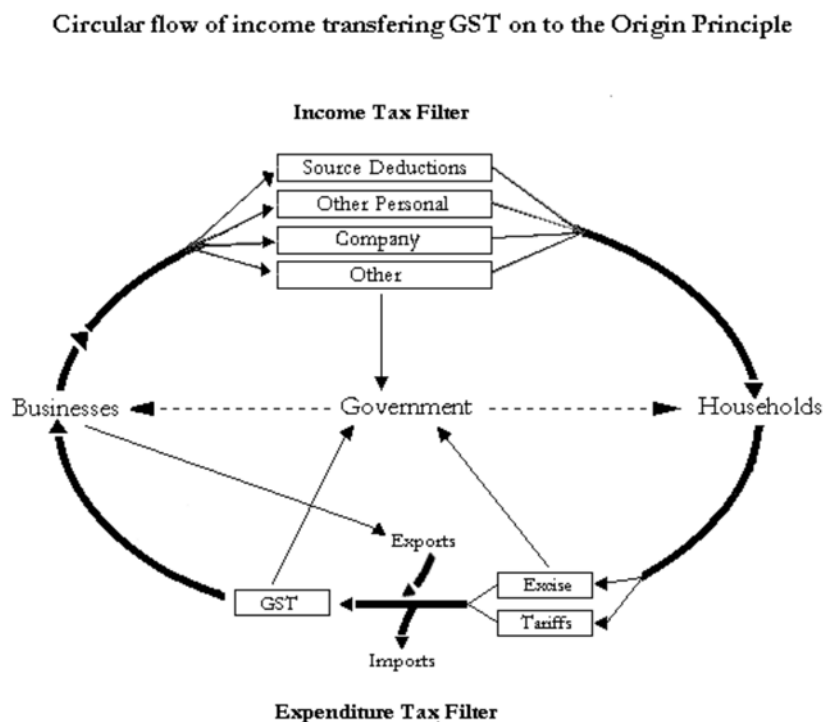
By lowering the relative returns from tourism, GST will reduce incentives to invest in the industry and so hamper the industry's ability to grow. Instead the application of the tax encourages resources into other (primarily export good) sectors that have a lower potential for growth – except through the advantage provided by the unfair application of GST.

The solution

There is in fact a surprisingly simple solution to the GST problem faced by tourism and other service exporters. The answer is simply to convert the application of GST from being destination based to origin based. That is rather than attempt the exceedingly complex task of removing the unfair tax on the tourism industry, simply remove the dispensation currently provided to other exporters. Similarly instead of attempting the impossible task of taxing New Zealanders who travel abroad, simply remove all taxes on imports. The impact of moving GST onto an origins basis is illustrated in Figure 3 below.

By taxing all exports and exempting all imports, all trade is moved to the same side of the expenditure tax filter, thus removing distortions between different types of economic activity and preserving the aim of not taxing transaction between countries. Although it might not seem immediately obvious, as long as a country does not attempt to tax both exports and imports, but only one or the other, then the country is not actually taxing the transactions of another country. A pure origins based system taxes value added (ie production within New Zealand) while a pure destination based system would effectively tax consumption (ie the spending of New Zealanders). In both cases only New Zealand transactions are being taxed. Indeed the chief culprit in this regard remain tariffs which distort spending and production decisions until their final removal.

Figure 3



An obvious objection that many might have to this approach is to question what the impact of applying GST to our exports will do to the competitiveness of the export sector. The short answer is probably nothing. In the presence of a flexible exchange rate, one would expect the introduction of an origins based GST system to trigger a one-off compensating reduction in the nominal exchange rate. Indeed Lockwood, de Meza and Myles (1995) demonstrate that a unilateral switch to an origins based system will have neutral inter-country impacts under virtually all circumstances.

Unlike the complexities involved in attempting to clean up the destination approach, a move to an origin approach is actually likely to reduce the administration burden faced by IRD and the government. The taxing of exports would end IRD or Customs' role in administering and policing the zero rating of exports. Customs would also not be required to apply GST to imports.

Although adopting the origin principle for determining on which transactions GST should apply seems to be the most straightforward and efficient way of determining GST incidence, getting the government to change this policy could prove to be a challenge. Proposing a tax system that taxes exports and exempts imports will represent a disconcerting leap of logic to many. It will just not feel right and the neutrality of the scheme will not be obvious for many.

Winners and losers

The distortions created by the current application of GST means that it favours:

- exporters of physical goods (eg primary producers and manufacturers),
- firms that service these exporters, and
- people who have a propensity to travel abroad.

Moving the application of GST from a destination to an origin principle will yield a more neutral tax system, but it does mean that these groups who are currently benefiting from the current system will be relatively worse off.

It is not so much that these groups will face an absolute cost, but rather that they will not benefit from the exchange rate depreciation to the same degree as service exporters. In other words a shift in the GST regime will raise the profits of service exporters, but it should not affect the profits of goods exporters. Stronger relative returns for service exporters will increase the willingness of people to invest in the service export sector, and so encourage faster sector growth than the current discriminating tax system is allowing. As the origin based system is economically more neutral, plus the benefits of it having lower administration and enforcement costs, it is highly probable that the redistribution of resources emanating from the regime change will yield a faster expansion in national real incomes than would occur under the current system.

The increase in service sector profits has to come from somewhere. Their source is the impact of the exchange rate depreciation on encouraging overseas residents to spend more on New Zealand services like tourism and on discouraging the import of overseas services. The fall in the dollar will encourage more visitors to visit New Zealand and to spend more while here. It will also make it relatively more expensive for New Zealanders to travel abroad. This will have further positive impacts on the New Zealand travel industry, to the extent that this encourages New Zealanders to holiday in New Zealand rather than abroad. Making overseas travel more expensive implies a short-term fall in New Zealand living standards. However this short-term fall should be eventually compensated for by the extent that the more neutral tax system improves long-term income prospects.

3. TAX TREATMENT OF HOME OWNERSHIP

The special tax status of home ownership is causing a growing divide in New Zealand society that poses one of the most serious risks to future social harmony. The tax free status of home ownership is a financial incentive that accelerates the demand for home ownership. According to the Reserve Bank non-financial wealth (primarily housing and land) accounts for about 55% of household net wealth. The national accounts indicate that the service from owner-occupied houses (ie the imputed rent from home ownership) contributes 7% to GDP each year. While the income from other investments are taxed, the return from home ownership is tax free as home owners are effectively receiving the benefit of rent-free living tax-free. The implication is that the return on housing will typically outperform the after-tax returns from non-housing investments. As a result there is considerable demand for home ownership and the rapid repayment of mortgages that leads to rapid inflation of house prices and a high concentration of wealth in illiquid housing assets.

Much of the debate about housing tax issues has focused on capital gains taxes. As I have argued above, I consider the optimal solution would be for New Zealand to abolish all forms of income tax and replace it with a comprehensive expenditure tax system. This would circumvent the need for any form of capital gains taxes.

If New Zealand chooses to persist with an income tax system then the second best approach would be to introduce a system of taxing the imputed rent from home ownership. The purpose of a tax on imputed rent is less about raising revenue and more about removing distortions to saving and investment behaviour. This can be achieved if the tax liability from imputed rents can be offset against mortgage interest payments. This will induce homeowners to be more circumspect about rapidly paying off their mortgages. The net result will be that households will be more likely to invest in non-housing assets, thus diversifying their savings portfolios and increasing funds available for non-housing investments. The introduction of the imputed rent tax will also reduce the (tax-induced) incentive for home ownership. The resulting fall in demand for home ownership will slow the pace of house price increases, lower potential capital gains and reduce the size of the wealth divide between home owners and renters.

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