Inland Revenue
Te Tari Taake

Comments on

International taxation and company tax policy in small open economies

by George R. Zodrow

Iris Claus

Victoria University of Wellington Tax Policy Conference
“New Zealand Tax Reform – Where To Next?”

11-13 February 2009

Summary of paper

Summary of paper

International capital mobility

Importance of economic rents

Scope for income shifting

Where to next?

- The paper discusses the implications of the global economic environment for company income taxation in New Zealand.
- It argues that small open economies face increasing international capital mobility, tax competition and tax avoidance.
- An Allowance for Corporate Equity (ACE) tax might be an attractive business tax reform option for New Zealand in the current environment.
- The ACE tax achieves many benefits.
- It is consumption based tax.
- It eliminates the taxation of normal returns by giving deductions for the return on equity.
- But it would be radical reform.

Implications for NZ tax reform

Summary of paper

International capital mobility

Importance of economic rents

Scope for income shifting

Where to next?

- Should medium term tax reform in New Zealand aim for radical change?
- What are the specific circumstances in New Zealand (capital mobility, economic rents, income shifting)?
- Do they argue for or against a complete re-design of the New Zealand tax system?

International capital mobility

- If international capital is perfectly mobile, it should not be taxed and the company tax rate should be zero.
- International capital has been found to be mobile.
- Capital is responsive to tax.
- But the empirical evidence suggests some barriers to capital mobility:
  - Home bias in equity portfolios (i.e. investors engaging in a sub-optimal degree of international diversification)
  - Lack of financial integration of equity markets
  - Existence of liquidity premiums
- Barriers to capital mobility arise because of:
  - Costs of adjusting capital stocks
  - Credit markets frictions

Credit market frictions

Summary of paper

International capital mobility

Importance of economic rents

Scope for income shifting

Where to next?

- Credit market frictions arise because of information asymmetries: borrowers know more about their investment projects than lenders.
- They may be larger in a small open economy like New Zealand.
- New Zealand has a relatively large number of small businesses – acquiring information about small firms is more costly.
- Additional information asymmetries may exist for foreign investors compared to domestic investors.

Credit market frictions

Summary of paper

International capital mobility

Importance of economic rents

Scope for income shifting

Where to next?

- With credit market frictions, the supply of capital becomes upward sloping as the level of external financing increases.
- Capital supply is no longer infinitely elastic in a small open economy.
- An aside:

  – Credit market frictions do <u>not</u> suggest capital income subsidies.

  – They are reduced by government policies that encourage the production of information.

  – Subsidies and concessions worsen credit market frictions and can lead to financial instability …

  … as is demonstrated by current events.

Importance of economic rents

- A qualification to the zero tax argument for companies is the existence of economic rents.
- Economic rents arise because of imperfect competition.
- One condition for perfect competition is that buyers and sellers are price takers, i.e. there is large number of buyers and sellers.
- New Zealand is an economy with not even 4.3 million buyers and only about 471,100 sellers (businesses).
- It has access to international markets with few constraints to trade integration.

Importance of economic rents

New Zealand: World Trade Indicators 2008 (ranking)	
External environment	14 (out of 126)
Trade policy	19 (out of 125)
Institutional environment	2 (out of 181)
Trade facilitation	19 (out of 151)
Trade outcome	87 (out of 161)

Source: World Bank

- A low ranking for trade outcome reflects fewer tradable goods and services in New Zealand (measured by imports plus exports as a percent of gross domestic product, GDP).
- Non-tradable goods and services (not subject to international competition) make up at least 31 percent of GDP.

Importance of economic rents

- Indicative evidence supporting the existence of imperfect competition and economic rents:
  - – sluggish price adjustments by firms
  - – imperfect pass through of exchange rate changes to consumer prices
  - – relative high rates of return to capital in New Zealand

Scope for income shifting

Summary of paper

International capital mobility

Importance of economic rents

Scope for income shifting

Where to next?

- Conclusions of the literature on international tax avoidance:
  - Multinationals aggressively engage in tax minimisation.
  - Transfer pricing
  - Profit shifting
  - Thin capitalisation
  - Most of the literature has focused on the United States and Europe.
- What is the scope of international tax avoidance in New Zealand?
- Multinationals in New Zealand?

Scope for income shifting

- In 2007 according to the *New Zealand Management* magazine …
- Of the top 10 non-financial firms in terms of total assets, only one was foreign (Australian) controlled. The top 10 firms held over 40 percent of total assets.
- In terms of turnover, the top 10 non-financial firms contributed almost 37 percent to turnover. Three were foreign (Australian and UK) controlled.
- New Zealand largest firms are not multinationals but domestically owned and not publicly held in some cases.

Scope for income shifting

Summary of paper

International capital mobility

Importance of economic rents

Scope for income shifting

Where to next?

- Conclusion of the literature in terms of income shifting between personal and company tax bases:
  - High income individuals are very responsive to tax changes.
- Given that some of New Zealand's largest firms are closely held, income shifting between personal and company tax bases could be large.
- Also New Zealand has a large number of self employed.
- Some indicative evidence of income shifting is provided in other papers at this conference.

Where to next?

Summary of paper

International capital mobility

Importance of economic rents

Scope for income shifting

Where to next?

- *Will international company tax rates continue to decline putting pressure on the NZ rate?*

  Maybe not in the medium term … given governments' rising indebtednesses.

- *What are the economic costs of company income taxation in New Zealand?*

  Maybe not as high as in other small open economies given the specific circumstances in New Zealand (capital mobility, economic rents, income shifting).

- *Is it time for a complete re-design of the New Zealand tax system?*

  Maybe not yet.

  But the conclusion may need to be re-visited at a future VUW tax policy conference!