

**(Claus I. et al.,
2004: 18)**

**Financial systems and economic
growth: An evaluation framework
for policy**

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and Brock Jera**

NEW ZEALAND TREASURY

WORKING PAPER 04/17

SEPTEMBER 2004



THE TREASURY
Kaitohutohu Kaupapa

3rd

**NZ TREASURY
WORKING
PAPER 04/17**

Financial systems and economic growth: An evaluation framework for policy

MONTH/YEAR

September 2004

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**ACKNOWLEDGE
MENTS**

We would like to thank Rienk Asscher, Felicity Barker, Matt Benge, John Bryant, David Carrigan, John Creedy, Nick Davis, Kerryn Fowlie, Ruth Gabbitas, Arthur Grimes, Kirstie Hewlett, Geoff Lewis, Brian McCulloch, Andrew McLoughlin, Duncan Mills, Brendon Riches, Clive Thorp, Bruce White and Ian Woolford for useful comments at various draft stages. Thank you to Bronwyn Croxson for her editorial work. Thanks are also due to Anand Kochunny and Raewyn Peters for research assistance.

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Abstract

The purpose of this paper is to develop an analytical framework for discussing the link between financial systems and economic growth. Financial systems help overcome an information asymmetry between borrowers and lenders. If they do not function well, economic growth will be negatively affected. Three policy implications follow. First, the analysis underscores the importance of maintaining solid legal foundations because the financial system relies on these. Second, it demonstrates the necessity for reforming tax policy as it applies to investment, as this is demonstrated to significantly affect the operation of the financial system. Finally, given the importance of financial development for economic growth, a more in-depth review of New Zealand's financial system in the context of financial regulation and supervision would be valuable.

JEL CLASSIFICATION G10 - General Financial Markets - General
G20 - Financial Institutions and Services - General
G38 - Government Policy and Regulation
H25 - Public Economics - Business Taxes and Subsidies
K20 - Regulation and Business Law - General
K34 - Law and Economics - Tax Law
O16 - Financial Markets; Saving and Capital Investment

KEYWORDS Economic growth, financial development, financial systems, financial regulation; legal system; institutions; tax

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7.1 Development of the current capital-revenue boundary in New Zealand tax policy

New Zealand considers itself to be a country without a capital gains tax (CGT), with the common assumption being that gains from the sale of assets that have appreciated in value are not taxable.³¹ In practice a significant amount of capital gain in New Zealand is classified as taxable income, and the difference between what gains are or even should be taxable is a contested issue. As a result, the question of whether to adopt a comprehensive capital gains tax is a beehive that is prodded every so often in New Zealand. In each instance, after the buzzing has died down, New Zealand has remained "CGT-free".

While a comprehensive capital gains tax may or may not be optimal tax policy (a separate issue with a substantial dedicated literature), a country without a capital gains tax does not escape the need to police the difficult boundary issue as to whether a particular sum received should be classified as income or capital (Oliver 2000). These boundary issues arise because of the substantial return to reclassifying income streams (taxed at marginal tax rates) as capital gains (untaxed). Indeed, New Zealand currently faces many of the challenges associated with capital gains taxes because of the practical operation of the capital-revenue boundary which polices against this type of reclassification. As a result, the debate on a capital gains tax has remained a staple of New Zealand tax policy.³² Underneath this unresolved debate remains an approach to taxing capital with serious deficiencies that are likely to affect the country's growth potential.

The boundary between capital and revenue is a core element of the New Zealand tax system.³³ It seems straightforward to suggest that proceeds from the sale of capital items are generally untaxed, while sums obtained on the revenue side of the boundary are defined as income and so are typically taxed at full marginal rates. In practice the boundary generates widespread uncertainty.³⁴

The history of New Zealand tax law related to capital gains may seem odd to some. While New Zealand's income tax legislation provides inclusive guidance, it does not define the central term "income". Judges, when faced with the question of what constitutes income, have borrowed concepts from trust law, which predates income tax law and is inherited by New Zealand's historical connection with the United Kingdom. The purpose of these trust law concepts is to "differentiate the interests of the life tenant (entitled to income) from the interests of the remainderman (entitled to capital and so to the realisation of capital assets of the trust)" (Royal Commission on Social Policy 1988: 450).

³¹ Tax systems typically distinguish between income and capital gains. Capital gains, when they are not counted as income, are often taxed by an explicit capital gains tax, which is often set at a different rate than the tax on income. When capital gains are considered to be regular income, as is the case for some gains in New Zealand, then normal personal tax rates apply to those gains.

³² While there has not been recent high level advocacy of a capital gains tax, the 2001 McLeod Tax Review proposed a Risk-Free Return Method (RFRM) approach as one tool that may address some of the issues inherent in the definition and taxation of capital. The debate on this issue is beyond the scope of this paper (see Burman and White 2003 and The Treasury and Inland Revenue 2003). It is sufficient to say here that RFRM may improve or exacerbate issues associated with this boundary, as RFRM is a tool that can be implemented in a number of ways to differing effect. Many of these options will not represent an effective solution to the problems described in this paper, so careful consideration is advised. This paper provides some guidance on potential growth impacts of any reform of the current capital-revenue boundary.

³³ This storied history even extends to the argument by some that one of the first significant revenue raising devices in New Zealand, a tax on land purchases from Maori from 1840-1859, was in fact "a capital gains tax in substance" (Hooper and Kearns 2002).

³⁴ Sir Ivor Richardson has declared that drawing the boundary is "an intellectual minefield in which the principles are elusive and the analogies treacherous" *CIR v Thomas Borthwick & Sons (Australasia) Ltd* (1992) 14 NZTC 9,101.