THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax Working Group Session: The Fiscal Framework

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Friday 5 June 2009

Thank you for having me here today as you start your work together. There are two parts to this speech. One is a reminder of the economic and fiscal environment we all have to work in. And I want to set out Treasury's thinking on tax. I don't want to leap into design and technical perspectives but to talk about our broad objectives and the challenges we think the country, and so this panel, is facing.

A further challenge for this group is to ensure that it is not only heard – there's going to be a lot of specialist interest in your work – but understood. One of the most difficult things with tax is that we can quickly resort to talking technically about it because we want to be accurate or precise.

Tax really matters, so the public need to understand this isn't about a group talking about complicated matters that have little meaning to them. It's about experts working together to think about how our tax system can work better for New Zealand and for people and that has very important real world effects. I'd rather avoid the cliché of the inevitability of death and taxes, but it emphasises that point.

That's because as long as there's been government, there have been taxes. And notwithstanding the issues we need to address in our system, I think its reasonably clear that the way modern government gathers them now is rather more sophisticated – and consistent and painless – than what used to happen.

The fact is that tax is necessary. Government needs revenue to provide its services and that's what our tax system provides. That key point is often lost in technical discussions about taxation.

But tax also imposes a cost. This is a point, it's fair to say, most people recognise. Government spending now sits at $65 billion a year. The ideal system would account for the cost of providing the necessary revenue and finance the Government's spending at the least cost – and in a way that people agree is fair.

So we want a tax system that helps growth, that keeps New Zealand competitive with other countries, and taxes that are seen to be fair. People will pay their share if they understand what the rules are, if it's hard to avoid it, and if they think other people are doing their bit too. So it's about getting the right amount of money in the right way – the fairest and most painless and least growth distorting way possible.

We don't want people spending time trying to avoid tax. We don't want IRD devoting all its time to chasing tax and compliance issues. As a country we don't need businesses and accountants and lawyers working out how to pay or minimise the amount paid in tax when they could be doing something productive.

We have a good tax system, but the changing world is making it less good. It needs to be better: it needs to fit the purpose of New Zealand in the global 21st century. Looking at it now is critical and timely. We're facing economic challenges we all want to better: how to get growth back; then how to get really strong, productive growth that drives up our incomes and makes this the best possible place to live.

Economic and Fiscal Environment

We are currently in the midst of the worst year economically the world has had in at least the last 60. The impact of the international financial crisis means that every major economy except China is in recession and the global economy is shrinking. UK GDP is forecast to fall 3.7% this year, the US 4% and Japan, the world's second biggest economy, 6.6%.

While downturns don't last forever, the economic and financial stresses globally have become so severe in recent months that we face a tough few years. There is no precedent for such a large and widespread leverage boom – and, hence, little basis for knowing how far the unwinding process may need to go. IMF analysis suggests that the effects of serious financial crises – which typically have their origins in economic imbalances – typically last for several years.

There are indications that some stabilisation is occurring globally – that the rates of decline are slowing. Signs of "green shoots" don't necessarily mean spring's arrived for the world economy. But there is some news that is encouraging and financial markets have been reflecting more positive sentiment, which is important as confidence and investment are prerequisites to growth returning.

Putting the outlook as starkly as possible for New Zealand, the Budget forecasts for growth show the economy nearly $50 billion smaller over the next three years compared to what was forecast last year. In real terms what that means is it will be some time in 2011 before New Zealand's economy is going to be the same size as it was at the end of 2007. We're losing four years' worth of growth.

That presents significant fiscal challenges. A shrinking economy means less tax for government as well as higher benefit payments and we are now facing Budget deficits of $7.7 billion and $9 billion in the next two years. New Zealand has to adjust to the first deficits in 15 years and the fact they are forecast to last until 2016.

In turn this means mounting debt. The Budget forecasts net debt will reach nearly $40 billion in 2011, $52 billion in 2012 and around $62.5 billion in 2013. It will peak at 43% of GDP in 2016/17 before beginning to decline as a percentage of GDP.

What that means is without a very firm focus on economic growth and controlled government spending, New Zealanders would be looking at higher tax rates in the future and it's hard to see how this can be other than bad for productivity and prosperity.

In household terms we will spend more than we earn as a country for a few years. We're very clear we need to spend less, and get better value out of what we buy and perhaps buy different things and look at better ways of delivering some services. The Government has taken steps to look at the quality of current spending and to reduce future spending increases.

We also, however, need to look at the other side of the ledger, the government's income, or revenue. Again, the Budget contained major initiatives to maintain revenue – including postponing the second two rounds of planned tax cuts. But the fiscal numbers I've outlined include the positive changes from these major decisions.

So Treasury will be supporting the government to drive value and new thinking, its investment, infrastructure and growth strategy and implement its debt programme and try and trim debt costs. But the stark fact is we still need to cover the cost of government activity through our tax system.

Your challenge, our challenge, is how best to do that.

Two days ago I set out Treasury's view on what we need to do to really drive growth. One key point is that the world recession provides, because of its challenges, extra opportunity and impetus to keep looking at productivity improvements – in the private and public sectors and the policies businesses and organisations work with. We have increased opportunity to do things differently and look hard at the policy settings because there's a greater need to address the hard problems. And there are opportunities vis-a-vis the rest of the world. Everyone is facing similar challenges and New Zealand has the advantage of being small; hopefully nimble; and looking to new, practical ways of doing things better.

Up until the impact of the world recession New Zealand's international competitiveness has slipped on a range of measures including tax. New Zealand had low productivity growth and serious imbalances were showing through the economy before the current shock and these need to be addressed. That is why it is so important to continue to implement policies to increase our economic performance and strength. We want to be wealthier as a country and even better placed the next time a shock happens.

One of the major imbalances I would specifically like you to consider is the vulnerability of our economy because of our very high overseas debt. New Zealand's net international investment position is forecast to reach more than 100% of GDP this year and 107% by the end of 2011. It is one of the reasons there is such a focus on the Government's debt position by ratings agencies and investors. This situation has developed over many years and reflects a long-standing gap between our national savings and investment rates. A question for you is what role tax could have in helping remedy this situation.

Positioning New Zealand well will involve significant change, and we need to consider new ideas and approaches that are outside of traditional comfort zones. That's true for departments like mine and the wider public sector, for firms and for politicians and the public. This group has the opportunity, with a wide brief, to do some "blue skies" thinking and test some boundaries.

In a way, the OECD's recent economic survey poses the challenge. It says New Zealand has to "create advantages" – in other words, set up policies that are "attractive and welcoming enough to overcome the geographic handicap and attract the drivers of prosperity – investment, skills and ideas – to New Zealand."

Tax

That leads me to the issues for our tax system. To summarise my points to date:

- We need a certain amount of tax for public services
- We're not going to get increasing revenue from this economy in the near term
- The government's accounts are under pressure – we can't borrow for major tax cuts.

Add to that:

- There are some issues with the fairness of our tax system
- We are, more than ever, competing with other countries for people, for investment and hence over our tax policies
- So we need some changes. But future tax reform, certainly in the short to medium term, has to be "revenue neutral" – that is, largely funded from within the existing system.

I'm going to briefly expand on these areas.

1. Structure

The New Zealand tax system scores well in OECD benchmarks in terms of administrative efficiency and simplicity. Unlike the 1980's, there is no immediate crisis dealing with a fundamentally broken tax system. But over time pressures will increase and options narrow.

New Zealand currently has:

- a large proportion of total revenue raised through personal and corporate taxes
- a company tax rate among the highest found in the smaller OECD economies

- a wide variety of effective tax rates on capital investment income depending on the type of investment and its source.

A couple of key facts are important here. Our 30% corporate tax rate is relatively high, with small OECD countries having an average company tax rate of 26% in 2008. And in terms of personal taxation, around half our "taxpayers" do not pay net income tax. In other words because New Zealand has a large transfer system – such things as independent earner tax credits and working for families tax credits – many people receive more in tax credits than they pay in tax. An example is someone, married, with three children who earns $50,000. The effect of tax credits means their income grows to over $51,500 rather than decreasing through paying tax.

This latter point has two significant impacts. One is that there are relatively high effective personal marginal tax rates – over 50% for around 15% of primary earners (the main income earners in households) – when we look at the real impact of tax rates including the abatement of tax credits.

The other is the impact on IRD. It has moved from being a revenue gatherer to having a far wider brief – for example administering and monitoring child support and student loans and paying working for families and independent earner tax credits. This has major implications for its people, its systems and on the efficiency of the tax system and the cost of collecting revenue.

Both these impacts touch on issues on fairness and public perception of the tax system. It's hard to find people who actually like paying tax, but they are far more likely to comply when the system is easy to understand and when its systems and outcomes are trusted. The relative simplicity of the New Zealand tax system has been one of its strengths.

However, it is becoming increasingly complicated. And the effect of that is that people with the same incomes can pay very different rates of tax depending on how they receive that money. The starkest example is that someone who makes a $200,000 profit on the sale of their holiday home pays no tax, while another with a $42,000 salary will pay, after tax credits, over $7,000.

As well as fairness issues, the variability of tax rates actually changes peoples' behaviour, driving investment into areas where there are lower taxes applicable. The IRD's figures show compelling evidence of individuals using companies and trusts to shelter personal income from higher rates of personal tax.

Such behaviour is perfectly understandable. The question is whether it is good for the economy, for maintaining revenue, and fair.

2. Fiscal

In the current fiscal environment decisions on tax policy and reductions cannot be considered in isolation. They are dependent on decisions on controlling spending or tax increases elsewhere. The days of major policy initiatives that reduce overall revenue are gone for the foreseeable future. The government has also indicated in its Fiscal Strategy Report that longer term net debt should be close to 20%.

Fiscal policy-making will also get increasingly challenging over time. Population aging will increase spending pressures over the next several decades, particularly around health and superannuation. At the same time, on the revenue side economic and technological progress continues to break down national boundaries, bringing many benefits but also increasing the efficiency and productivity costs of raising tax revenues, as activities become increasingly mobile. Policy makers will face increasingly sharp pressures to both increase spending and reduce taxes. That is difficult.

An ageing population also has implications for tax design. Over the next 20-50 years more taxpayers will rely on untaxed pensions and consume a greater fraction of their incomes.

Government expenditure pressures and options over the next few decades is a speech in itself and I won't go there. On the tax side, the heart of the problem is that demands for revenue, and the costs of raising that revenue, will increase. Something will need to give.

3. Productivity and competition

Despite recent changes, the New Zealand tax system relies too heavily on the taxes that are most damaging for economic growth. Importantly, these taxes are also in areas where the country must compete internationally.

The mobility of skills and capital – and international competition for people and investment – is of particular relevance to our tax system and economy. New Zealand has one of the most internationally mobile labour forces in the OECD, with the second highest proportion of ex-pats after Ireland and strong migrant flows, and we have very high levels of inward investment.

Firms' decisions on where to invest or people's decisions on where to work increasingly span international borders. International competition for labour, capital and goods means that our tax system must be in line with other key economies and, ideally, better. So New Zealand's tax system can no longer be considered in isolation, and international considerations will increasingly shape the economic landscape in which domestic taxes are set. The ease of resource flows and our close geographic proximity to Australia are especially important in this respect. Without medium term reform, there is a risk that the current mix of our revenue base will undermine productivity growth, and will deteriorate as sources of tax, skilled people and businesses for example, move offshore.

There is growing evidence that high corporate tax rates are bad for productivity and we raise a large amount or revenue from the most growth-inhibiting types of tax. Business and personal income taxes are the most negative for growth. Nearly 60% of our revenue comes from these two sources.

As well as New Zealand company tax rates being relatively high, average OECD rates have been trending down. For example, South Korea is reducing corporate rates from 25% to 22% this year and to 20% in 2010. Canada has a goal of having the lowest business taxes of major industrialised countries and is targeting a combined federal and provincial rate of 25% by 2012. Its federal corporate tax rate will be 15.9% in 2012.

Keeping corporate tax rates competitive will be a priority, especially if the major review of Australia's tax system underway leads to further company tax cuts across the Tasman.

4. Solutions

Given these considerations Treasury's view, which was set out extensively in our Briefing to the Incoming Minister last November, is that we need to shift to taxes from bases that are internationally mobile and have the most detrimental impact on growth to those that are less mobile and less damaging to productivity growth.

Policies that would help productivity improvements and revenue sustainability include:

- reducing high marginal personal tax rates in order to improve incentives for work, entrepreneurship and the retention of skilled labour within New Zealand

- equalising rates of tax on different forms of investment to improve savings and investment, including reducing the rate of tax on some existing forms of investment income and shifting the boundary on income subject to capital gains tax to reduce the diversion of investment into tax-favoured or tax-exempt forms

- moving towards a tax system more heavily weighted towards consumption taxes and, longer term, with a greater contribution from property taxes.

The exact mix and sequencing of these policies requires further analysis and debate.

I've outlined these issues earlier in terms of their impact on growth, and fairness. They are also important in terms of supporting some of the rebalancing that's required in the economy. We know that there are incentive and disincentive impacts from taxes. Features of the New Zealand economy have been over-consumption rather than saving; and investment in housing and the housing market driving cost pressures elsewhere.

I have also mentioned that to remain within a workable fiscal strategy, some of the more significant changes above would need to be matched with appropriate expenditure control or revenue-raising measures.

These can have major equity or distributional effects as well. For example, reductions in the top personal tax rate do affect the distribution of taxes across the population. But broadening the tax base to include capital income and gains would help offset any negative distributional implications, since these returns are skewed to higher-income individuals.

Overall, however, equity concerns are often more effectively addressed through suitably targeted transfers and spending than through tax. The scope for getting lots of distributional impact through the tax system is much more limited than people think, with the top 1% of taxpayers already paying 15% of income tax.

Government expenditure and especially economic growth and getting people into jobs (and more productive jobs at that) is much more effective at raising peoples' incomes and creating less wealth disparity than tax policy.

If we were to take a complete view of the way government taxes and pays income support and the end result of that process for people – collecting money from taxation, then turning it into transfer payments of different kinds that give the net effect of many people not paying income tax, we could have flatter, lower taxes across the board.

This is what Australia is currently doing and Australia's Treasury succinctly framed the issues they – and we are facing: *"… Australia is a small, open and developed country operating in an increasingly globalised world with freer flows of ideas, investment and labour, there is increasing pressure for Australia's tax-transfer system to remain internationally competitive. The demographic challenge of an ageing population is also profound. As our population ages the proportion of people in the workforce will fall. This has significant implications for economic growth and our future standards of living.*"

Conclusion

Our belief is that these pressures are best addressed through a strategy of incremental reform towards a clear long-term vision for the New Zealand tax system. This would have a number of advantages including: guiding each step in a series of tax reductions; introducing more certainty and clearer expectation around the direction and motivation for change; and establishing a debate focussed around medium-term strategy rather than immediate issues.

Your work is to help clarify that vision.

As with all policy change, early, evolutionary action enables progress to be made while allowing for longer, less disruptive adjustment paths.

The other reason to act now is that the "medium-term" issues of last year are more pressing now as we focus on growth and positioning New Zealand for a post-recession world. Now, when we are at the bottom of the business cycle, is the best time to start making any changes.

Finally, our challenge as tax policy advisers and in your case, tax experts, is to talk to people about these issues in ways that mean something to them. And it's not so that we can feel that tax work or policy is important. It's so that the public understand that it is – that getting tax settings right is about people, fairness, incomes and living standards.

That way, the wider community can be involved in the process of debating and making these choices.