THE TREASURY
Kaitohutohu Kaupapa Rawa

Securing New Zealand's Prosperity: The Economy, Living Standards and Tax

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Good morning. I'm delighted to be here with you today at the 2016 Tax Conference.

Taxation is a central element of a government's fiscal strategy, alongside decisions on expenditure and debt. It is also a key economic instrument, partly because of its fiscal role but also because of the impact it has on incentives or on the costs of compliance by taxpayers, or the costs of administering the system.

Of course this week's earthquake also reminds us of the important role that tax plays in strengthening the government's books and its ability to respond to major shocks. Revenue from taxation helps ensure we can meet the costs of responding to the earthquake in the short and medium term, and helps us keep on top of debt and rebuild our fiscal buffers so we can manage future shocks over the long term. And these future shocks aren't just earthquakes; they include adverse economic events – domestic or international – that may impact important sectors of the economy.

A week ago it was International Accounting Day, a date chosen – I am told – to mark the publication in 1494 of an essay on double-entry bookkeeping. No doubt members of CAANZ know all about that date. Tax is of course even older than accounting, although I suspect some accountants may take issue with that statement. A date you may be less aware of is 16 November – yesterday in fact – which is the feast day (in the Orthodox Church at least) of St Matthew, reputedly a tax collector. According to Wikipedia, he unites the accountancy and tax professions by being the patron saint of both.

It would be good to talk about the history of taxation but I will resist the temptation. The one thing I will say is that, for all the commentary and debate that tax issues generate, there are a few things that the majority of people continue to agree with: in the words of Oliver Wendell Holmes Jr, the US Supreme Court Justice, "taxes are the price we pay for a civilized society" or, as tax scholar Ferdinand Grapperhaus once wrote, tax is "an individual sacrifice for a collective goal".

Tax policy settings are at the heart of the government's ability to meet New Zealand's economic objectives and today I want to focus on four things:

First, I'm going to talk about what's happening in the economy right now. Second, I want to share with you some of the Treasury's thinking as we prepare both our next economic and fiscal update (which looks at the next four years) and our long-term fiscal statement (which looks to the next forty years). Third, I want to explore some implications for tax policy and administration. And finally, I want to touch on 'globalisation'.

The economy

So how is the economy looking for New Zealand? The headline is that it's been performing well, relative to both the potential growth rate of the economy (of around 2.7 per cent), and to most advanced economies. Over the last four years, our growth rate has averaged 2.8 per cent while the average growth rate of OECD economies has been around 1.7 per cent. We have price stability and – something I wouldn't normally highlight – positive interest rates. Our unemployment rate is at 4.9 per cent and our participation rate at 70.1 per cent. And at the same time, we've seen the Crown's books return to surplus, debt kept under control, and New Zealand in the position to start rebuilding buffers against future shocks. Growth has been supported by net migration, construction and tourism. The primary sector has been doing well, even before the recent increases in dairy prices. Terms of trade have been improving, also helped by the fall in oil prices.

We saw a 4.2 per cent rise in nominal GDP in the year ended June which has flowed through to higher than expected tax revenue, mostly from income tax, reflecting a stronger-than-expected labour market.

As I said, the Crown's books are also in a sound state. New Zealand has a broadly balanced Government budget with increasing surpluses expected over the years ahead.

International economic conditions remain more of a challenge. Our trading partner growth eased in 2015, with China's growth slowing as its economy continues with its planned transition from investment to more consumption-based. This weighed on growth in other Asian trading partners and Australia. And of course growth in the rest of the world has been relatively modest.

The contrasting fortunes of the domestic and international economy have been reflected in the appreciation of the New Zealand dollar over much of the year to date. This appreciation, together with weak external prices more generally, has been contributing to very low rates of CPI inflation this year. However, over the past month, the TWI has depreciated and international oil prices have increased. And events last week and this have seen a slight fall in the currency's value against the US dollar.

Overall I would say that global risks remain skewed to the downside.

Looking ahead

In a few weeks' time, the Treasury will publish its Half-Year Economic and Fiscal Update alongside the Government's Budget Policy Statement. The Update will be our best view of what economic activity is likely to be over the next four years and the implications for the Government's books, in the light of the Government's fiscal strategy.

The long-term

But before we publish HYEFU, we will also be publishing our latest Long-term Fiscal Statement which will look at the next forty years, something we are required to do by the Public Finance Act. The Statement will explore the fiscal challenges and opportunities New Zealand faces.

We have developed the Statement using our Living Standards Framework. The Framework sets out what we believe are necessary to promote intergenerational wellbeing, the four capital stocks that together comprise our 'economic capital' or 'comprehensive wealth': human capital, natural capital, social capital, and financial and physical capital.

The aim is to grow these capital stocks by focusing public policy on investing, on behalf of people today and into the future, towards increasing the growth potential of the economy, improving equity across society and generations, sustaining social cohesion, enhancing resilience to systemic risks, and ensuring sustainability of wellbeing as people go about their daily business of living and improving their lives.

When we use the Living Standards Framework to consider fiscal policy, it shows the important links between economic and social outcomes. Income is affected by economic growth, the employment and skills of our workforce, and the way tax is used to raise revenue. Expenditure is considered in terms of how we can use the investment approach to achieve a sustainable improvement in our collective wellbeing, how it enhances social inclusion, and whether money is being used efficiently and effectively. Everything interconnects.

There are of course synergies and tensions between the four capitals and policy development is often about managing tensions and any competing objectives. Government is often faced with the uneasy reality of having to make trade-offs.

The Living Standards Framework doesn't remove any of those tensions, but it does enable a more comprehensive and better-informed view of the impact of any necessary trade-offs. Put simply, we believe the Framework gives us the opportunity to improve our decision-making.

You'll be able to read our Long-term Fiscal Statement next week and I encourage you to do so. I won't say much more about it now.

Tax policy

One thing is clear however. Tax policy and an effective tax strategy and tax administration will remain core to the effective management of the country's fiscal challenges.

New Zealand raises revenue through a broad-based, low-rate approach (BBLR). Introduced in the mid-1980s, this approach was endorsed by the 2010 Tax Working Group, and it retains widespread support.

It provides the government with the revenue it needs to meet its objectives, while minimising distortions in economic behaviour.

The broad-based, low-rate approach is exemplified by our GST system, undoubtedly the best GST system in the world. The Treasury's advice has been and will remain that it should be protected from exemptions that would undermine it. GST raises a large amount of revenue with minimal distortions. Using it to promote particular policies would come at great cost. The compliance cost, uncertainty, and complexity of bringing in exemptions and multiple rates are overwhelming as compared with any asserted benefits.

You only need to look at the EU's VAT systems to see the impact that exemptions have had on its structure, efficiency and administrative cost. In New Zealand, with the 6th lowest rate among the 35 members of the OECD, we collect the highest amount of the tax as a proportion of GDP.

The stability and certainty that the BBLR approach provides is extremely valuable, along with the Generic Tax Policy Process. One does not need to look very hard for examples of where uncertainty in other countries' tax systems has contributed to poor economic performance and even economic, and sometimes political, disruption.

In assessing tax policies against the BBLR approach, we use the principles in the Living Standards Framework that I talked about just now.

For example, we think about the impact of tax policies:

- on growth, and how tax rates affect people's decisions to work, save or invest or how to ensure our tax regime is competitive and makes it easy for international firms to invest
- on equity, and the redistributive effects of the system
- on cohesion, and how we ensure that everyone pays their fair share and people don't restructure their affairs in order that others bear their share

- on resilience, and how tax can act as an automatic stabiliser in the economy, and
- on sustainability, to ensure we continue to raise sufficient revenue.

We also consider other important principles beyond the Living Standards Framework, such as simplicity, integrity and the costs of administration, for both taxpayers and the government.

To illustrate how we apply these principles, let's take personal income tax as an example.

In terms of equity, we obviously need to consider how the burden of taxation falls across the income distribution, and how that burden is affected by things like fiscal drag.

Looking at the tax and transfer system as a whole, we see that New Zealand has a highly redistributive system. Going by recent numbers I have seen, the top 10 per cent of households contribute around 70 per cent of income tax (after transfers).

In terms of growth, we need to consider the effects that tax rates have on people's incentives to work. And I'm not just talking about the top rates of income tax. Again, looking at the tax and transfer system together, we see some very high effective marginal tax rates in New Zealand, of more than 100 per cent in some cases.

Many people regard the relationship between tax and welfare as tax paying for welfare. But the application of benefits – and in particular their abatement – can act as effective taxes. We need to provide the right level of support to people who need it, without creating punitive disincentives.

The complicating factor here is the effective marginal tax rate on an individual. If we look at tax without looking at welfare, we ignore the potential for policy to create poverty traps where people see no reward for getting ahead.

Let's take the taxation of savings and investments as another example. In terms of efficiency, we want to, as far as possible, equalise the effective tax rates on different forms of investment, so that one form doesn't distort decision-making by having a more attractive tax treatment than another.

And we also need to be clear on what the tax system is ultimately for, in terms of simplicity and effectiveness, among other things.

For example, there has been lots of discussion recently about using taxes to address a wide range of issues, from how to fund particular types of infrastructure to how we discourage the excess consumption of sugar.

But in considering these issues, we always have to ask ourselves whether tax is the best tool for the job, whether we understand the incentives we may be creating so that we avoid unintended consequences and whether, in fact, other instruments, in particular user charges or regulation or even the re-prioritisation of existing spending, would be better and more effective.

And when it comes to introducing new taxes to provide hypothecated funding for a particular area of spending, the benefits can be questionable. In general, taking a broader view might lead us to the conclusion that funding should be distributed according to the principles of value-for-money and need, rather than tied to a particular revenue stream.

Tax administration

The design of a tax is important but it is only part of the story. Tax policy cannot be successful without an effective tax administration. I have no doubt the Commissioner will talk to you about Business Transformation. I just want you to know that the Treasury considers BT – the transformation of the tax administration system – as one of the most significant investments the Government is undertaking.

Institutions matter and BT is an investment in one of the most important institutions in modern society, its tax system. It's an investment in a core piece of New Zealand's infrastructure, the infrastructure that pays for all the other infrastructure.

Conclusion – Globalisation

I want to finish by saying a few words about 'globalisation', something very relevant to tax practitioners. We have been hearing a lot in recent months – and it's been a little louder in the last week or so – of the death of globalisation. I disagree.

In my view the increased interconnectedness of the world isn't about to end. Certainly there is a debate in many countries about how the benefits of globalisation have been shared and there are people who believe that protectionism offers a path to prosperity. But to me the 'death of globalisation' appears to be proclaimed and debated in Europe and North America, in what the media like to describe as 'the West'. We shouldn't import those arguments into New Zealand.

We are part of the Asia-Pacific region, the fastest growing region in the world and one that is likely to remain the growth engine of the world for most of this century. The death of globalisation doesn't appear to be a big issue in Asia (or in many other 'non-Western' parts of the world). Most of the world's people live in Asia and they appear to be debating about how to grow, how to improve their infrastructure, how to connect with trade partners in the region and beyond, how to enjoy their increasing prosperity and, yes, even how to manage climate change. 'Globalisation' may be changing but it doesn't look to me as if it's dying. Strengthening and deepening New Zealand's connections with the world matter, and doing so with Asia matters a lot.

Thank you and enjoy the rest of the conference.