

The Tax Working Group, the Budget and the Future

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The fate of tax reviews

- Sandford (1993) suggests three criteria by which to judge successful tax reform:
 - extent to which tax reforms met the objectives the reviewers set themselves;
 - sustainability of the reforms;
 - extent to which the tax reforms had desirable or undesirable by-products.

- “Experience suggests that tax reviews in Australia rarely lead to successful tax reform.”

(Evans and Krever, 2009)

- New Zealand offers exceptions:
 - “it is the NZ reform package of the mid-1980s which offers the only really optimistic prognosis.”
 - “The proposals of the McCaw Report (1982)were vigorously followed up, further refined and successfully introduced by the politically dominant Lange/Douglas government....”

(John Head, 2009)

NZ Government Budget, 2010

- “Tax reform is a centrepiece of this Budget.”

(Hon. Bill English, 2010 Budget, Minister’s Executive Summary, page 2)

The Budget tax package included:

- (a) Tax switching - reducing reliance on taxing incomes, increasing taxation of spending and property, variety of base-broadening measures;
- (b) Compensation of “vulnerable individuals” for GST increase;
- (c) Promise of measures to reduce opportunities for families to structure their financial affairs to qualify for social assistance (WfF);
- (d) Partially funded by borrowing in the short-term with an expectation of self-funding in medium-term.

Embraced reform options suggested by the TWG – give or take some of the base-broadening options proposed.

Fast –reverse 12 months...

- Despite concerns with integrity and fairness of the tax system, and implications of globalisation and population ageing.....IRD and Tsy *Briefings* had not persuaded new Government that tax reform was a priority.
- Tax not a media issue.
- 2009 was a year of intense activity on taxation (IRD/Tsy/CAGTR conference *NZ Tax reform: Where to next*; NZAE conference: *Tax Reform Symposium*; TWG process).
- ShapeNZ poll in January 2010:
 - 79% considered tax system needed reforming;
 - 65% thought system unfair;
 - 56% favoured tax switching and base-broadening.

The TWG process....

- The process underscores:
 - Importance of well-informed policy-advisors prepared to try new approaches to policy reform;
 - Payoff that can arise from the courage of Ministers to risk new and more public approaches to policy advice;
 - Value that can be gained from collaboration between practitioners, academics and policy advisors.

...any lessons for future reviews?

- 6 lessons (based on a sample of 1 !):
 - The power of “rational policy analysis”; backed by
 - Sound research and ‘real time’ analysis;
 - Involve experts;
 - Helps to have solid grounds for a review;
 - Communication, Communication, Communication;
 - Review report should support the process of promoting reform.

- Rational policy analysis:
 - Agree on a set of principles for a good tax system (The TWG pentagon);
 - Identify options for reform;
 - Point out pros and cons of options to help inform Government and public of the implications of adopting different values.
(How do the options impact on the pentagon?).

- Sound research and ‘real time’ analysis:
 - Assess the effect of tax options in terms of the principles (TWG benefited from *NZ Tax reform: Where to next*; NZAE conference: *Tax Reform Symposium*; commissioned research, specialist knowledge around the table);
 - A secretariat prepared and capable of ‘getting hands dirty’ (New work on distributional effects of tax options; fiscal costs of tax reform packages; reviews of proposals, etc);
 - Ensure specific reform options combine to provide a coherent reform package.

- Involve experts:

- Consultation and collaboration with ‘experts’ has been a feature of the NZ tax policy processes, at least over last 25 years.

Much of the success of the mid-1980s NZ tax reform must be attributed to innovative consultation and policy review procedures featuring close and effective interdisciplinary collaboration between lawyers, accountants and economists from the public and private sectors.

David White (2009)

- TWG was a variant on a strong NZ tradition.

- Helps to have solid grounds for a review :

TWG able to draw on:

- Solid body of international research from preceding 15+ years on taxes and growth;
- Decade experience with piece-meal changes to NZ tax system and WfF showing clear adverse effects on integrity and fairness of NZ system;
- Housing price boom and bust underscored concerns over taxation of property;
- Perhaps environment faced by the TWG closer to that for the McCaw review than for Ross (1967) and McLeod (2001) reviews.

- **Communication, Communication, Communication:**

Crucial for preparing ground for acceptance of recommendations:

- Develop a communication strategy;
- Focus initially on ‘problems’ to create appetite for ‘solutions’;
- Fairness concerns created more interest than economic concerns:
 - Show stoppers - 9700 households with rental properties claiming WfF, large diversion of higher incomes into trusts post 2001 - got media attention;
 - Tax switching tended to be viewed as a “money-go-round”.

- Review report should support the process of promoting reform:

Two types of reports:

- Academic – tend to be prescriptive and educational for academics and tax policy specialists;
- Policy focussed – directional and educational for public.

TWG Report intentionally the latter (with background technical papers assigned to the internet)

Where to next for NZ tax reform?

- Saving, investment and growth:
 - TWG ‘tax switching’ proposal motivated, in part, by impact of tax mix on saving, investment and growth;
 - 2010 Budget accepted this argument;
 - Concerns with investment mix and saving/investment balances (along with fairness and integrity concerns) likely to remain key concerns of tax policy;
 - 2010 Budget essential step forward, but is there more to do?

- Inflation adjustment:

- Inflation causes significant unevenness in the effective tax treatment of alternative investments;
- McCaw Report (1982): “an investigation should be undertaken with a view to introducing a comprehensive system of inflation adjustments ...”. See also 1989 Consultative Document and recent papers by Andrew Coleman (Motu);
- Problem doesn’t go away with low inflation;
- Typical policy responses tends to be *adhoc*:
 - partial exemption of fixed interest from tax liability; partial indexation of tax rate thresholds.

A “comprehensive system of inflation adjustment” :

- Taxing all capital returns on a post-inflation basis;
- Making only real (inflation-adjusted) interest taxable;
- Adjusting depreciation bases upward by inflation;
- Adjusting inventory profits so that real component of any rise in inventories is not taxed;
- Inflation adjusting income tax thresholds so that only real increment in value of human capital is taxed.

Introduces added complexity

- Extending capital gains taxation:
 - Another lever to even up taxation of investment incomes;
 - Whether capital gain in NZ is taxed depends on : (a) asset class, (b) form of entity making the investment, (c) location of the investment, (d) period of the investment, (e) investment intentions;
 - TWG: “Breaches all the principles of a good tax system; but
 - Could not agree on whether the efficiency gains from a more consistent treatment of investment incomes and reduced uncertainty would outweigh the efficiency costs associated with a CGT (such as ‘lock-in’ effects) and transactions costs of compliance and administration.

- The welfare/tax interface:
 - Also relevant to investment and growth is the impact of the welfare/tax interface on emtrs;
 - TWG recommended a review of the welfare/tax interface, especially how WfF impacted on emtrs and incentives for labour participation and skill development;
 - Budget 2010 reduces emtrs by some 2 – 5 %;
 - But still very high for families eligible for WfF.

- Institutional support:

- TWG recommendation 13:

“Government should introduce institutional arrangements to ensure there is a stronger focus on achieving and sustaining efficiency, fairness, coherence and integrity of the tax system when tax changes are proposed.”

Summary

- While tax reviews have often failed to satisfy Sandford's three criteria, there might be some useful lessons from the TWG process;
- Significant progress was made in the 2010 Budget to restore the coherence and fairness of the tax system and to reduce its damaging effects on growth and efficiency;
- But important issues remain for further consideration, including:
 - Extent to which inflation adjustment and a more extensive capital gains tax can provide more consistent taxation of alternative forms of capital investment income;
 - Whether, if we remain with a non-aligned system, other measures will be required to sustain the integrity of the system;
 - How to improve the welfare/tax interface to reduce emtrs and improve incentives for labour participation and skills investment;
 - Whether we can be confident, under current institutional arrangements, that a systematic focus on the efficiency, integrity, fairness and coherence of the tax system will prevail.