

VICTORIA UNIVERSITY TAX WORKING GROUP

First Session: The Fiscal Framework and Situation 5th June 2009

The day

- Discussion of the objectives of the Tax Working Group
- Presentations by
 - Secretary to the Treasury John Whitehead
 - Governor of the Reserve Bank of New Zealand Dr Alan Bollard
 - NZ Treasury and Inland Revenue Department officials
- Discussion on the current fiscal and macroeconomic environment; medium-term objectives of, and key issues with, the current tax system; and consideration of the content and direction of future working group sessions.

Objectives of the Tax Working Group (TWG)

As an independent, Victoria University led group, the aim of the TWG is to consider the appropriate design of New Zealand's tax system in the medium-term and identify the key issues that Ministers will need to consider.

The group will focus primarily on the long-term objectives for the tax system and the implications of these for medium-term and short-term policy changes. These objectives should include how the tax system impacts on economic growth, ensuring the coherence and integrity of the tax system, and its sustainability over time.

Presentation themes

Forecast fiscal deficits and public debt mean that there is no scope in the short-term for tax reform that reduces government revenue - but there are issues within the current taxation system that need to be addressed to find a fairer, more efficient and a more sustainable tax system. Taxes are necessary to finance government expenditure but the way they are designed can impact on other objectives. As the Reserve Bank says, we need to ensure the structure of the tax system is one that increases the "speed limit" (that is, growth and potential output) of the economy.

Key features of the New Zealand tax system are:

- heavy reliance on personal and corporate taxes, and a comparatively high corporate tax rate. The backdrop to this is New Zealand's positioning to compete internationally, especially for skills and capital, in a post-recession world – *these taxes are most highly growth-distorting and affect skills, investment and the location of business, where there is strong international competition.*
- a complex regime of capital taxation, with varying tax rates on capital investment and many capital gains that are not taxed - *this leads to incentives to borrow rather than to*

save, and to buy long-term assets and affects such things as the country's level of overseas debt and exchange rate.

- complex interactions between the tax and income transfer systems, particularly arising from the Working for Families scheme - *this creates high effective marginal tax rates (which can be greater than 50%) and highlights integrity problems in the tax system caused by the different tax rates on personal income, corporate income, and trust income.*

What is required is policy that supports growth by encouraging labour supply and investment. This requirement is accentuated by globalisation and an aging population. To achieve this will require lower effective marginal tax rates and a broadening of the tax base to remove distortions.

Treasury's advice is that achieving these goals will require:

1. Reducing high marginal personal tax rates to improve incentives for labour supply, entrepreneurship, and retention of skilled labour;
2. Equalising tax rates across different forms of investment to improve savings and investment and widening the tax net to reduce the diversion of investment into tax-favoured or tax-exempt forms;
3. Reducing high statutory and effective average tax rates on corporate income to make New Zealand a better place for foreign and domestic businesses to invest, earn and declare profits.

Inland Revenue noted that although surpluses are projected in the medium-term, fiscal drag over this period means that, on current policy settings, average personal tax rates will increase significantly, and that the highest marginal tax rate will apply to average wage and salary earners. This is not sustainable or desirable. It also does not align tax rates at the government's medium term goal of 30%. To align at higher rate is also not sustainable, as it would involve raising the corporate tax rate.

Therefore, Inland Revenue Department (IRD) considers that alternatives need to be considered:

1. Increase the growth rate of the economy. Although uncertain about the contribution of the tax system to growth, the tax system can certainly impede growth: hence there is a need to examine whether the tax system is impeding growth. Ensuring that labour and capital markets are flexible is also a key to enhancing growth.
2. Reduce government expenditure. This is outside the scope of the TWG, except for two areas: tax expenditures and the tax benefit system.
3. Increase revenue, and to at least reduce the impact of fiscal drag, by either:
 - a. Broadening the tax base. This could involve the addition of new taxes such as a capital gains tax (which, in theory, should be based on accrual grounds, although this is difficult to achieve in practice), death, wealth, land, and Tobin taxes, or stamp duties. Inland Revenue is doubtful about the practicalities or desirability of any of these major base broadening options but agrees that they should be explored.
 - b. Increasing rates in the current system: e.g., rates on personal taxes and GST.
 - c. Greater enforcement.

These options are not exclusive and could be combined.

The Group will focus on these issues in subsequent meetings. In doing so, it is fundamentally important that the future structure of the tax system delivers a system that is coherent, and sustainable.

Discussion

Following the presentations by John Whitehead, Alan Bollard, and Treasury and Inland Revenue Department officials, some of the issues that were then discussed in addition to the points mentioned above included:

Revenue-neutral reforms - Because of expected fiscal constraints, the Group needs to assume that recommended changes to the tax system have regard to the fiscal cost, and are broadly revenue neutral when taken as a whole. Broadly, revenue neutral could be defined as the direct impact of a reform on the government's tax revenue. However, this should also take into account possible growth effects - for example, a reform which lowers taxes could have a direct fiscal cost, but over time could increase growth and therefore raise the tax base.

The level and structure of taxes- Both the structure of the tax system and the levels of taxes need to be considered. The structure of the system relates to the type of taxes, and their incidence, as well as the more specific design elements of different taxes. The levels relate to the rates and thresholds, at which existing and proposed taxes are levied. Both the levels and structure of taxes matter for growth. The levels, particularly in the company tax area as a result of falling corporate rates in other OECD countries, are important for New Zealand's competitiveness. Research also suggests that some taxes are more damaging to growth than others, and this type of insight should influence the structure of the tax system.

Corporate tax -The 'headline' company rate tax and design aspects like imputation influence the effective rate of corporate tax for different companies. Both elements need to be evaluated. The impact of Australian tax policy on NZ's tax base ((for example, changes that might arise from the current Henry review) will have important implications for New Zealand because of the mobility of capital and labour across the Tasman. It may be necessary to distinguish between inbound and domestic investors.

Residential property - At present there are discrepancies in the treatment of housing assets relative to non-housing assets. How much the tax system affects house pricing and investment was identified as an issue for future consideration.

Equity and compliance - Any increases in taxes needs to consider the impact on compliance, and behavioural changes. More information is required on the amount of revenue that could be raised if IRD focussed more on collection, and the impact of the "black economy".

The Group's future work

It was agreed that the following proposed set of three future sessions was a useful way to proceed:

- Structure of the personal income tax and GST systems;
- Revenue raising options (or base broadening options);
- Corporate taxes and tax integrity.

Issues that will be covered in the next three sessions will also include: the broad-base, low-rate objective of the current system; the Government's intention to align rates at 30% in the medium-term; abatement rates and high effective marginal tax rates; and the pros and cons of property and capital gains taxes.

The group will focus primarily on the long-term objectives for the tax system and the implications of these for medium-term and short-term policy changes. These objectives should include how the tax system impacts economic growth, ensuring the coherence and integrity of the tax system, and its sustainability over time.