

Towards a Nordic tax system for New Zealand:

Taxing capital income at a lower rate than labour income, to help close the productivity gap

Michael Reddell¹

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My proposition today is simple: that income earned on capital (profits, rent, interest, dividends) should be taxed at a substantially lower rate than labour income - that New Zealand should depart from the comprehensive income tax system that has, in a more or less raggedy way, guided thinking here since the late 1980s.

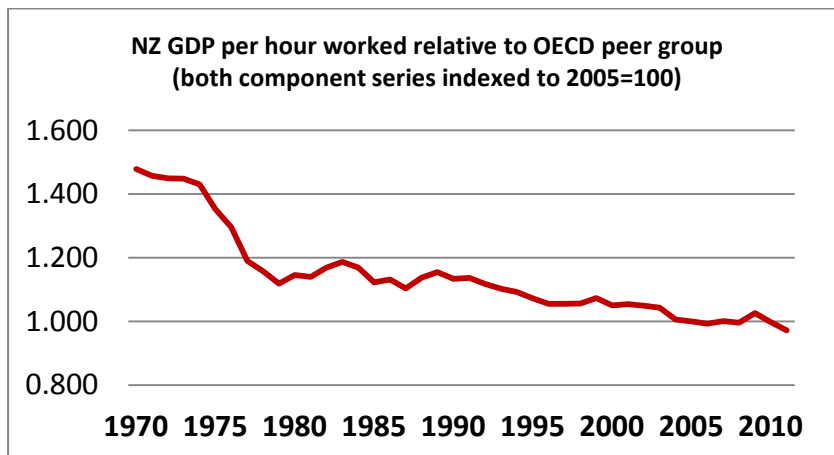
This isn't a partisan or ideological claim, nor is the argument grounded in some abstract sense of "justice". At a conceptual level it is really quite uncontroversial. It is decades, if ever, since the comprehensive approach dominated the textbooks - 35 years, for example, since Atkinson and Joe Stiglitz showed that under certain restrictive conditions, capital income should optimally be taxed at a zero rate. In a recent paper, Piketty and Saez (no right wing extremists) note simply that "according to the profession's most popular theoretical models, tax rates on capital should be equal to zero in the long-run - including from the viewpoint of those individuals and dynasties who own no capital at all". They go on to further refine and limit that proposition, but still conclude that capital income should be taxed more lightly than labour income. Just this week, the Democrat-supporting economics blogger on Slate, Matthew Yglesias, made exactly that case under the provocative headline "Why Mitt Romney's effective tax rate is so low and why it probably should be".

It isn't a matter of partisan ideology, but of what works. Taxing capital income, and especially the capital income of foreigners, isn't the way to lift New Zealanders' living standards.

New Zealand needs to worry about lifting productivity and material living standards. I don't have many slides today. This is the starkest of them.

¹ Views expressed here are those of the author and should in no way be ascribed to, or associated with, any organisation I may now be, or in the past have been, employed by, including (but not limited to) the Reserve Bank of New Zealand.

Figure 1: Tracing New Zealand's economic decline



It shows just how far labour productivity (real GDP per hour worked) has slipped in New Zealand relative to the average for the group of advanced countries for whom the data were readily available. The NZ data for the early years probably can't be relied on too heavily but the basic picture is clear - we have fallen a long way, and the fall has only slowed, and not stopped, in the last 20 years. We need to turn it around.

But why focus on tax on capital income?

Lots of things make for growth. Labour inputs are one of them. By OECD standards we have a high labour force participation rate and hours worked per capita are high. And if one uses tertiary qualifications as a crude proxy for human capital, New Zealand also now scores highly - so highly that the OECD estimates suggests that returns to tertiary education are now among the lowest in the OECD. Things can always be done better, but to a first approximation, New Zealand doesn't really have a labour issue. In other contexts, I will argue that we probably have too much of it.

General microeconomic regulatory policies also play a part. New Zealand's really look pretty good. Early last year, a group of OECD researchers published a cross-country study looking at the effects of a range of micro policies (product market regulation, openness etc). They concluded that our policies should have been consistent with incomes here above those of the OECD average. We, Australia, and the USA scored best - not perfect any means, but best of the bunch. Our incomes "should" have been 20% above average; in fact we are 20 per cent below.

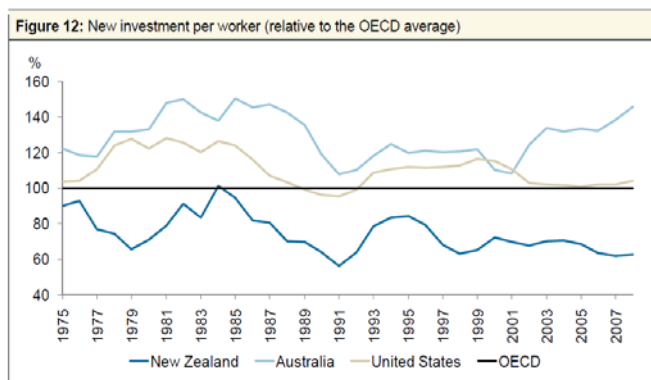
Some cite size and distance effects. No doubt, they are a part of the NZ story (and Australia's) but if, say, NZ was doomed to relative decline, I think we might have expected to see a couple of a decades of current account surpluses (national savings exceeding domestic investment) rather than continued large current account deficits. And very low interest rates rather than surprisingly high ones. But those are issues are for another series of debates.

We have lots of good quality labour, and we have a reasonably good policy backdrop in most areas. Where we lag is in investment and the associated sense of entrepreneurial opportunities. When people do growth accounting exercises for New Zealand, they typically find that the amount of capital per worker is quite low, and that total factor productivity (TFP) also falls short. In a well-

governed market economy, with proper market disciplines for failure, and without too many egregious distortions or subsidies, the two are probably connected - successful firms driving the economy forward are likely to be investing more, and physical investment is one of the key ways in which firms are also able to reach the TFP frontier. This isn't some sort of "lump of capital" model – in which investment is good and so more investment is always better. We tried that - with Think Big. The Chinese are trying it now. But successful fast-growing firms in a high-performing economy are likely to be undertaking more investment than firms in underperforming economies. Apart from anything else, such firms will need to be investing - the cost of labour will be rising, and firms need the continuous productivity gains if they are to remain able to pay their employees the market-clearing price.

Investment as a share of GDP is pretty much around OECD averages in New Zealand. But remember that NZ is a poor OECD country.

Figure 2:



Source: OECD
 Note: Non-residential gross fixed capital formation per worker at current prices and current PPPs (OECD = 100).

This chart is drawn from a recent OECD Survey on NZ. It shows real investment per worker (\$ per worker in PPP terms) lags well behind that in most OECD countries. (This chart excludes residential investment, but contrary to many reports, that doesn't really change the picture.) An economy on the path to closing the income and productivity gaps would be likely to see much more investment (especially one, like NZ, with relatively rapid population growth).

But this is a debate about tax, and my time is short.

Simply put, New Zealand should be taxing capital income much more lightly: we need more entrepreneurial activity, and investment, as part of a process that will finally see us realise our potential - closing the gaps. We probably need more savings too - investment needs to be financed, and most would get a little queasy at the prospect of New Zealand running an even larger negative net international investment position for too long.

At present, we lean in the opposite direction. The data are less than ideal, but such as they are it appears that we rely more than most on taxation on capital income, despite not having an unduly large amount of capital. Until recently we taxed all factor incomes at the taxpayer's labour income tax rate: very few other countries do that. New Zealand is the only OECD country not to have any

material social security taxes – such taxes are often very substantial in other countries and they hit labour income, but not capital income.

The significance of our move in 1988/89 from an EET to a TTE system for the taxation of life insurance and retirement savings - as much for the short-term revenue gains as anything, so I'm told – [while subsequently softened a little (PIE and Kiwisaver)] is probably greater than is often appreciated. Our (largely) TTE system means that we taxed income derived from these forms of savings much more heavily (relative to other forms of income) than almost any other OECD countries do².

And the interaction between inflation and the tax system means we tax fixed income returns particularly heavily - as Andrew Coleman has noted, the poor pensioner with \$25000 in the bank can face a higher effective tax rate on her real income than a million dollar a year CEO [it may not matter much economically, but as a matter of justice....]. Even our 28 per cent company tax rate is not low by international standards (only 9 OECD countries are higher this year), and our broad base and limited number of exemptions (eg lack of over-generous depreciation provisions) means the effective tax rate is higher than it looks (again relative to those in other countries). Curiously, the tax reforms of 2010 actually **raised** the overall average tax rate on capital income. Of course, on the other hand we don't have a capital gains tax – on that count, we should give thanks for small mercies (but properly inflation-adjusted real capital gains taxes have very little expected revenue anyway).

So why not try the Nordic system instead? From my reading, the Nordic countries wanted to do three things. They wanted to keep a progressive tax system, and they wanted to keep a large state (high total government spending as a share of GDP), but they wanted to ensure that their economies continued to grow strongly, recognising that capital is mobile, and that business investment and entrepreneurship are quite sensitive to expected after-tax returns.

So, stylised, what the Nordics did was to say, let's tax capital income at a low flat rate (perhaps the lowest marginal tax rate on labour) and then keep a quite progressive labour income tax rate. In Norway, for example, the capital tax rate is half the maximum labour tax rate.

Of course, it is harder to care about these issues if one has a very small government, or thinks (whether for economic or other reasons) one should have a very small government. Low tax rates all round would provide the minimum distortion to investment, labour and consumption choices. Views will differ about the appropriate size of government. It is fair to say, however, that in the literature there is a lot more debate about the potential damage from a large size of government (crudely measured as, say, total tax or spending to GDP) than there is about the distortionary effects of taxes on capital income. The OECD, for example, tends to be the mushier centrist international economic agency - its own research highlights the distortionary effects of corporate taxes, and after a long period endorsing New Zealand's comprehensive income tax system, their 2007 survey -

² New Zealand is the only OECD country using TTE. Denmark, Italy, and Sweden are reported as having ETT schemes, which (on certain assumptions) are time value equivalent.

focusing in on the lack of the sorts of investment rates consistent with closing the income gaps - suggested that NZ look seriously at the Nordic option

In advocating that New Zealand move to something like a Nordic system, I am not taking a strong view on size of government per se: if size of government remains relatively large then markedly shifting the focus of our tax system offers a way to help accelerate medium-term growth prospects. If, eventually the consensus of political and public opinion shifted in favour of much smaller government, there would probably be some additional growth and income benefits. If so, labour tax rates could be cut in future. But in the next 10-20 years, with mounting pressures on government spending, it is difficult to envisage New Zealand getting to a point where government is so small that we could be relaxed about treating capital and labour income the same for tax purposes (where administrative simplicity considerations outweighed potential growth and allocative efficiency gains). Many, perhaps most, would not want to. [In principle, there is no reason why capital income taxes could not also be progressive, but on a lower rate schedule than that for labour income - but no one has actually done so]. A Nordic tax system is partly about keeping to a minimum the inevitable damage to growth from big government - and perhaps that is a reason why some, though not all, on the right wing have been reluctant to embrace it.

[I don't have time to go much into the question of why not simply go the Irish route - a much lower company tax rate. The essence of the economic arguments for that system is similar to the Nordic one: investment is sensitive to expected after-tax returns]

A Nordic tax system, done seriously, would mean giving up considerable capital tax revenue. If pushed my serious recommendation would be for a capital tax rate of 12.5 per cent (I'm not needing then to resolve the debate between the simple models that recommend zero tax on capital income and the refinements that suggest some positive rates). A cut of that size has to be paid for - and might cost 3-4 percentage points of GDP in headline revenue losses. There is no point pretending that there are free lunches on offer - and we shouldn't spend the dynamic gains before we earn them.

Quite how it is paid for is not my focus today. Spending/GDP is still much higher than it was even in the middle of last decade - although there is still a fiscal deficit to bring down to sustainable levels. But materially reduced taxes on capital income probably mean some combination of higher taxes on consumption (especially, given the windfall gain to domestic owners of capital³) and on labour income. Tax wedges on labour are smaller here than in most countries, and our maximum marginal tax rate on labour is also relatively low (none of the old OECD countries has a lower rate). Although it might not raise much revenue, and is not my focus here, I think we should be open to favouring an inheritance tax over the taxation of lifetime capital income. In principle, a land tax could offer an attractive long-term option or a (now low) tax on the net imputed rent on owner-occupied housing.

So why not change?

³ Consumption taxes tax both labour income and the capital income of residents once. They are not simply equivalent to taxes on labour, as was asserted at the debate.

Some have argued that while the zero/low capital income tax might make good sense in a closed economy, New Zealand is in fact an open economy. And open in a particular way: the claim is made the NZ labour force is more than usually mobile (the TWG report for example asserted this), citing the high number of NZ born and educated people now living overseas, and the high number of foreign born people living here. But no one has yet produced much evidence that labour flows into and out of NZ, **at the margin**⁴, are materially more responsive to changes in **income (or consumption) tax rates** specifically than such flows are in other countries (the large stocks of NZers abroad and foreigners here probably tells mostly of (a) our fairly open immigration policy, and (b) NZers' responses to the gap between overall living standards here and those on offer abroad (in Australia in particular). It seems at least as plausible that, to the extent taxes influence migration, it is (implicitly) expected lifetime tax burdens, and expected future after-tax income and consumption prospects that influence migration behaviour⁵.

If labour were as responsive to taxes as capital is, the argument for a dual tax system would be materially weakened. But in general, the prices tell the story: wage differentials across countries far exceed differences in interest rates and cost of capital across countries. Capital is simply much more mobile, and responsive to taxes, than labour.

Others argue that much lower capital (or company) taxes are a bad idea for New Zealand because of our existing reliance on **foreign** capital. First, much of the foreign capital is debt - on which we already levy little or no tax, because we know we'd be paying it, not the owners of the capital. Second, it is argued that if New Zealand lowers its company/capital tax rates this will largely represent an unreciprocated gift to foreign tax systems. But this point should not be overstated: profits of foreign-owned NZ subsidiaries are typically taxed abroad only at the point where dividends are paid, a largely discretionary choice, especially in a fast-growing economy with plenty of investment opportunities. Finally, some have argued that capital income taxes on foreign investors are a way of capturing the value of location-specific rents for New Zealand. I have never been convinced by this argument - largely because the evidence for such rents being material is elusive at best. To the extent that they arise out of natural resources, the appropriate point to capture rents, whether from NZ or foreign operators, is through royalties or other usage fees. Mostly, we fool ourselves if we believe that we can have foreigners pay taxes to fund our public services.

According to the IIP data, total equity investment in NZ is around \$67 billion - possibly higher at market values, but at least on those numbers only around one third of annual GDP, and a much smaller proportion of the capital stock. Successful economic transformation of New Zealand is likely to involve significantly higher levels of investment, domestic and foreign - it is the future we need to look primarily to.

Some critics of a dual approach for NZ, and some modelling results I have seen, tend to focus on who writes the tax cheques rather than on who bears the economic burden of those taxes. Stage I economics told us they aren't the same and that the difference matters. Just as costs to employers of payroll taxes or Kiwisaver levies will, in the medium-term, almost wholly be borne by workers (in

⁴ Which is surely what the concept of mobility, or responsiveness, is about.

⁵ After all, changing residency changes the capital tax regime one is subject to, not just the labour tax. For most people the two cannot readily or legally be unbundled.

lower wages than otherwise), so it is likely that a considerable chunk of capital taxes are borne not by the owners of capital, but by wage earners - in the form of lowering investment leading, over time, to wage levels in the economy being lower than otherwise. US studies have suggested that the overwhelming bulk of capital taxes will be borne by workers, even in a relatively more closed economy like that of the US. Shareholders don't seek pre-tax returns, but post-tax ones. Lower the tax rate on capital income, and pre-tax returns will over time tend to fall.

To some extent, the sectors where existing foreign investment is concentrated may matter to how we in NZ think about the transitional and distributional issues we would face in considering moving to a Nordic system. If, for example, most of our foreign investment was in the farm sector, lowering the tax on farmers might provide a pure windfall to foreign investors - given that final product prices are determined in world markets. But that isn't the New Zealand situation. Only a small share of farmland is foreign-owned at present, and few of our other major tradables producers are (indeed Air NZ and Solid Energy remain largely/wholly state-owned). The biggest single chunk of foreign investment actually appears to be in the financial sector. Markedly drop the tax rate on capital income and it is hard not to envisage an intensely competitive market narrowing intermediation spreads and other charges, to the benefit largely of the domestic economy (firms and households) as a whole. The potential dividends the foreign shareholders will be interested in won't have been materially altered one way or the other.

People who are more expert in the intricacies of these things than I could probably devise clever ways to capture some lump sum value of the tax change in respect of existing capital (especially foreign-owned capital). I probably wouldn't bother, but these are areas where distributional concerns run hard up against administrative feasibility ones, with little probable implication for future economic performance. There would be single generation windfall gains for domestic owners of capital: to the extent this is a concern (and windfalls positive and negative flow from all sorts of public policy changes) it is probably best dealt with by funding the lower capital income taxes primarily through higher consumption taxes [and perhaps inheritance taxes].

The administrative challenges of a dual rate system are perhaps the most often-cited objection. For large and listed companies, the challenges are not undue - it is relatively easy to distinguish capital from labour income. But the challenges are much greater for the self-employed and for closely-held incorporated businesses - of which, of course, there are many in most countries, including New Zealand. For those firms, at least the ones of any size, some sort of rule-based assignment of income is needed: a model used abroad has been to impute a return to capital based on the assets held within the business, and taxed as such, with the rest of the income assigned to labour. No doubt, such an assignment rule could be complemented by some sort of minimum deemed labour income. Rules of that sort will always have an element of arbitrariness to them, and we should not pretend otherwise.

But equally we shouldn't pretend that there are not material boundary issues in any conceivable real world tax system. Managing and enforcing such boundaries in a Nordic system would keep the highly-regarded and capable people in IRD busy. We should not multiply artificial boundaries where they are unnecessary - doing so simply increases the costs of maintaining regulatory systems. But equally we should be wary of prioritising administrative simplicity over economic substance, when

there are real behavioural differences. Boundary issues exist all over government - it is almost in the nature of the beast. And, given the scale of New Zealand's economic challenges, we should keep in mind the big picture - we want a tax system that does not act as more of a drag on entrepreneurship and investment (domestic and foreign) than is absolutely necessary.

What would we expect to see from a whole-hearted shift to a dual tax model?

A tax system better aligned with the insights of the economics literature will stimulate business entrepreneurship and lead to materially higher investment - which will, in time, lift wage rates as well, particularly for the least mobile and most vulnerable (who have fewest alternatives). Some economic opportunities which are not viable - cannot generate required after-tax rates of return under current tax rates, will be shifted into the viable column. That will probably be most obvious in the (lagging) tradables sector of the economy where New Zealand producers will have little or no medium-term pricing power. For some activities, New Zealand will become a better place to base a business than it was hitherto. I'm not suggesting New Zealand can become some sort of Antipodean Ireland (the good dimensions): becoming a production hub for those vast markets on our doorstep. We don't have such markets. But if we have one fifth of Ireland's success, a tax change of this sort [the details of the Irish system differ, but the salient point here does not] we will have gone a material way towards setting NZ on the right track⁶.

We shouldn't focus just on additional foreign investment. Getting on the road back to top tier first world incomes is likely to need them (the idea, technology, contacts, markets, and savings they bring), but just as important - perhaps more so in the long haul - is the creation of culture that keeps out of way of domestic entrepreneurs, and the ideas, products, and markets they can generate. Global openness is an important part of prosperity, perhaps especially for a small country. But long-term sustained prosperity for New Zealanders is ultimately about the climate we make, and sustain for ourselves. Going Nordic keeps the critical feature of the comprehensive vision - we won't be using the tax system to try to pick winners across sectors. In fact, in some areas we will further level the playing fields (the tax bias in favour of (lightly-leveraged) owner-occupied housing will be reduced)⁷.

We'll get more investment, and we'll also get a higher savings rate. Higher savings should not be some sort of policy goal in their own right, but the current tax system bears inappropriately heavily on them - people are taxed for deferring consumption, rather than for undertaking it (the socialist British/Hungarian economist, Nicky Kaldor, who favoured an expenditure tax had a nice soundbite: people should be taxed on what they take from the pot, not what they put into it).

There is some scepticism about the likely savings response - I think mostly around on household savings. I find it plausible that any response of middle income household savers to a much lower capital tax rate might be quite muted - empirical research tends to suggest as much, difficult as it is to do really compelling studies on the subject. The response might well be muted because for many

⁶ As Geoff Lewis has noted, Ireland accelerated growth was not particularly capital-intensive (outside the residential housing sector).

⁷ And for those who are exercised about loss-offsetting in respect of rental property, the economic value of the ability to deduct those losses will be reduced.

savings is done with a retirement consumption goal in mind. For those people, the income effect of increased after-tax returns will reduce the need to save out of current income. For others, higher returns to savings will make deferring current consumption more attractive.

But NZ debates about saving seem to focus inordinately on household savings. I am fairly persuaded that business saving (as a % of GDP) will increase materially in response to lower capital income tax rates. Much investment tends to be self-funded (through retained earnings and depreciation - both gross saving) and the level of investment would be likely to increase materially. Optimistic firms, both New Zealand owned and foreign, are more likely to borrow but are also more likely to save; to retain more profits within the business. Retained earnings of foreign-owned companies don't count as "national" saving, but they are still available to support activity in the domestic economy.

Would labour supply fall? That, of course, depends partly on precisely how the cut in capital taxes was funded (there are ways in which government spending could be cut which would **lower** marginal tax rates for many, or create income effects encouraging participation [eg NZS changes]). Frankly, I am fairly sceptical of how large any sustained deterrent effect on labour supply would be (especially now that the big, more discretionary component of labour force participation in recent decades, female participation is levelling off). And I doubt that we would get more outward migration - that headline personal tax rate effects would swamp the beneficial impact in lifting New Zealand incomes as a whole, or even of (actual and expected) cuts in the taxation of the income earned on saving⁸.

In the end, when one taxes something more heavily one tends to get less of it. We should expect more capital (capital is highly responsive to taxes) and a bit less labour. Labour is much less tax sensitive, and - **given the size of the state the NZ political process has chosen to adopt** - we have probably been taxing labour too lightly.

Weighing up the literature, Greg Mankiw, former chair of the US Council of Economic Advisers, observed:

The logic for low capital taxes is powerful: the supply of capital is highly elastic, capital taxes yield large distortions to inter-temporal consumption plans and discourage saving, and capital accumulation is central to the aggregate output of the economy.

Successful countries can afford all sorts of affectations and policy weaknesses. There are risks they can comfortably choose not to take. We are not a successful country - at least relative to our aspirations, and the aspirations of the staggering numbers of our people who leave NZ permanently every year (high by any international or historical standards). We've done a lot of good things, and slipped back on others. I'm not arguing that the way we taxed capital income historically was a major cause of our relative decline. I'm also not arguing that it is the only thing that matters now to reverse our decline - although it would probably be one of my top two. But if we are serious about providing a climate in which (domestic and foreign) businesses will invest more heavily in, and build businesses in, New Zealand, in ways that allow us to once again offer top-tier first world incomes - especially to the least mobile and most vulnerable - then a much more hard-headed approach,

⁸ A middle-aged person with taxable assets five times wage income could face a 3-4 percentage point increase in their average labour income tax rate (or equivalent in consumption taxes) and still come out square in year one, before any dynamic gains (or expected future capital tax savings) have been factored in or realised.

prioritising substantial reductions in the taxation of capital income, could play a large part. Closing the income and productivity gaps won't come easily - small measures simply don't fit the scale of the challenge we face. A shift to a dual income tax model does have its risks and uncertainties: all reform does, but we can't keep on with policy much as it has been for the last 25 or so years and expect much better outcomes.

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