New Zealand Tax Reform – Where to Next?

Panel Discussion on Key Issues for the Future
5.30pm Wednesday 11 February 2009

Although I want to focus on the future, I need to preface my remarks by making two important points, one about the past and one about the present.

- We must learn from past mistakes with tax policy in designing a system for the future.
- The current tax system is not sustainable.

Current system not sustainable

I need to justify that remark. I think the tax system has done quite a good job over the last 25 years. From the absolute train wreck that was our tax system in 1983, NZ has built a system which has by in large coped well with changing political economic social and technological times. It has delivered handsome rewards in a fiscal sense to successive Governments. But there are four main reasons why it is not sustainable:

- We are now expecting the tax system to go a long way further than just raise tax. Increasingly we are using it as a tool to influence behaviour and the resulting changes have undermined its design.
- The system is increasingly reliant on a small percentage of the working population to pay the lion's share of the tax – about 15% of the working population pay between 60 and 65% of all personal tax.
- Because of the way it interacts with various social platforms such as Working for Families a large percentage of the working population with children faces extraordinarily high effective marginal tax rates, routinely 70% or higher. I think that's unfair on workers', and it clearly operates as a significant disincentive.
- The system is now characterised by significant structural problems caused by the lack of alignment of tax rates and by special rules such as the PIE regime.

Cohesion in design

As we look to the future, first and foremost I think we need to sign up to a cohesive design or framework for our tax system. Some fundamental principles need to underpin our policy development. The ones that I subscribe to are:

- Recognition that the tax system is there primarily to raise tax rather than to influence behaviour.
- That fairness and perceptions of fairness are critical to the integrity of the system.
- That the rebuttable presumption for all tax policy initiatives should be adherence to the low rate broad base principle.
- That incentives for avoidance and arbitrage should be minimised.

- That the administering department (IRD) must be able and willing to provide a high level of certainty as to how the system works – linked to this is the need for the system to be as simple as possible.

Principles such as these need to be challenged. That is the role of forums such as this. I am not saying that the ones I have just run through are the be all and end all, but I am convinced that we need a stable framework against which we can benchmark the myriad of "great tax ideas" that are promulgated from time to time.

The need for a cohesive framework is exacerbated by the current global financial crisis. I am troubled that the financial crisis may be used as a Trojan horse for the reintroduction of some measures that have already been proven to be of very dubious quality. eg A couple of senior company directors have told he in the past week that it's a no-brainer that NZ should follow Australia in introducing bonus depreciation to stimulate investment and create jobs. I do not think that proposition is a no-brainer at all. I'm not saying it's wrong. But the trade-offs need to be evaluated and, more importantly, the assumption that it is the best way of creating jobs must be tested.

Excess reliance on the taxation of labour

Both Treasury and IRD's briefing papers to the incoming Ministers identify one of the major risks that our tax system faces at the moment is the mobility of capital (and therefore corporate profits) and labour (and therefore employment income). These two tax bases produce by far their largest portion of our total tax. About two-thirds in fact. I worry a lot over the fact that even without a recession our corporate tax base is significantly at risk at a result of significant overseas ownership and the fact that corporates can in large part determine the country in which they pay their tax. That factor, compounded by the economic situation, would suggest that the amount of tax we collect from businesses over the next few years may well be at best flat or in fact even drop. The position is further compounded by the very competitive global tax situation meaning that we can ill afford to have corporate tax rates that are in any material sense higher than those in our trading and investment partner countries.

An inevitable consequence of all of this is Governments having to turn their attention to the working population to a greater extent to supplement their tax appetite in order to fund spending priorities. As I said at the outset, we already have very high effective marginal tax rates for a lot of taxpayers, and with our top tax rate (soon to be 38%) cutting in at such a modest level of income there is no headroom here.

It was this background, compounded by the significant spending promises of both major political parties, that led me to speculate before the last election that sooner or later GST will rise. Such comments tend to bring a howl of protest and a degree of derision but I do not think that we should resile from debating the question of the appropriate mix of taxes. Would it be better to have say a 15% rate of GST and reduce the tax rate on personal services income below 30% at the middle-income level? Very clearly now would not be the time to increase GST, but for both fiscal reasons and tax policy reasons I certainly believe it is worth considering that ahead of further increase in tax at the level of personal labour. I recognise that both GST and tax on individuals are effectively taxes on labour, but I see a significant difference between hiking tax rates on peoples' employment income and collecting the same amount of revenue through an increase in tax on spending.

Broad base/low rate

You may gather from these comments that I am a fan of the broad base low rate approach to taxation. This was not a philosophy I signed up to easily. Until I witnessed first hand the devastating effects of the inefficiencies, and rorts caused by tax incentives, I used to think that they were a sensible idea. But I lived through the era when the Tax Act became pregnant with them, and saw the carnage that they created. So I am now very supportive when the studies of successive experts, including most recently the committee chaired by Rob McLeod, and on which David Patterson served, advocate the broad base low rate approach.

The one qualification to this is that I do acknowledge we are currently in extraordinary financial times. This crisis is bringing understandable focus on short-term consumption and employment creating investment. The pressure is on to identify short-term temporary measures that will stimulate both. The challenge is how to do this without severely undermining the longer-run growth objective that underpins the design of the tax system.

The contrast in the policy initiatives that might be appropriate long term versus short term is stark:

- Long-term growth: reduce tax on capital and labour, increase tax on consumption

- Short-term consumerism – reduce tax on consumption

  – short-term incentives for investment

I simply don't know whether it is appropriate to use tax as a lever to help address some of the worst aspects of the current financial downturn, and by worst aspects I mean in particular the impact on jobs. I will listen with interest to arguments on the pros and cons of using tax to help address this crisis, and I am taking a keen interest in the way in which foreign jurisdictions – most recently Australia with its bonus depreciation – is resorting to tax to stimulate investment behaviour. I have doubts as to whether this is sensible policy, but I am hoping that by the conclusion of this conference on Friday all will be revealed.

J B Shewan
11 February 2009