Toward a World Class Tax System

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1. Taxation and New Zealand’s economic challenges

Recent speeches by the Prime Minister\(^1\) and the Minister of Finance\(^2\) have focused on New Zealand’s three key economic policy challenges. They considered these to be: (i) increasing our productivity growth; (ii) maintaining high-levels of employment; and (iii) reducing our vulnerability to adverse events.

They identified six key policy pillars toward meeting those challenges. One was regulatory reform; another was better, smarter public services; third was investing in productive infrastructure; a fourth was education and skills; fifth was innovation and business assistance; and sixth was a world-class tax system. The clear implication from these speeches is that New Zealand currently does not have a world-class tax system.

Prior to 1999, New Zealand was considered to have had a sound tax system by international standards. That system was characterised as one that was relatively broad base and low rate. Although New Zealand at this time had a comparatively heavy reliance on taxing incomes, corporate tax rates were comparatively low and the top company tax rate and the top personal income tax rates were aligned. Furthermore, we had a comparatively efficient tax collection and monitoring system. Earlier fiscal reform and economic growth had produced successive fiscal surpluses that had markedly reduced New Zealand’s gross and net public debt levels, thereby reducing the revenue demands on the tax system.

In the last decade, a number of tax and welfare policy changes have eroded the quality of our tax system prompting concerns about the suitability of our tax structure. Furthermore, we have learnt more about the way in which tax structures can influence economic growth. In particular, research

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on the effects of taxes on investment, entrepreneurship, and labour supply responses have provided important insights into the way different taxes and the structure of the tax (and public expenditure) system can influence economic performance. Globalisation has accentuated these issues and we have learnt more about the implications of population ageing. What is more, as a consequence of a deficient fiscal framework that masked unsustainable public sector expenditure growth during the last decade and the current recession, the fiscal position has eroded markedly. The erosion of our fiscal position will leave a legacy of higher fiscal deficits and higher net public debt that will be with us for probably a decade. This will increase revenue demand on the tax base.

For this audience these issues, of course, will not be new. The excellent briefings to the incoming Government prepared by the Inland Revenue Department\(^3\) and also the briefings on taxation from the New Zealand Treasury\(^4\), highlighted a number of these issues and underscored the importance of focusing attention on the tax system. This attention was given further impetus by a conference run in collaboration between the Inland Revenue Department, New Zealand Treasury, and Victoria University in February of this year.\(^5\)

2. The role of the Victoria University Taxation Working Group

With this backdrop, to ensure impetus for the development of taxation policy advice is maintained and public attention is drawn to these concerns with the current taxation system, the Inland Revenue Department, Treasury, and Victoria University of Wellington proposed the establishment of a Tax Working Group. This proposal was endorsed by the Minister of Finance and the Minister of Revenue. The Group is made up of tax practitioners, financial market practitioners, experienced economists, academics, and tax policy officials from the Treasury and the Inland Revenue Department.\(^6\)

The purposes of the Tax Working Group are to provide a forum for informed discussion of the priorities for medium-term tax policy that can feed into advice to Government Ministers and to promote and inform a wider public debate on tax policy. The process can be viewed as a part of the process of preparing the background for the examination of medium-term tax policies by Ministers. It was not designed necessarily to lead to specific policy recommendations but rather to allow full identification of the issues that will need to be considered in reviewing medium-term tax policy. Nevertheless, the Group has decided that it would be worthwhile at the end of the process to produce


\(^6\) For a list of members of the Victoria University Taxation Working Group go to [http://www.victoria.ac.nz/sacl/CAGTR/taxworkinggroup/index.aspx](http://www.victoria.ac.nz/sacl/CAGTR/taxworkinggroup/index.aspx)
a report and give its views on to the direction in which it considers tax reform should take in the medium-term.

The Group has agreed on a work agenda which includes a sequence of meetings covering the following issues. The first meeting held on the 5th June covered the fiscal framework, the fiscal outlook, and the principles of a sound tax system. The second meeting held on the 31st July discussed the structure of personal taxes, transfers, and the Goods and Services Tax (GST). The third meeting to be held on the 16th September will cover tax base broadening options. The fourth meeting to be held on the 9th October will cover the corporate tax system. The fifth meeting in November will consider various taxation reform scenarios. In early December there will be a public conference and in late December the Group will finalise its report.

The idea of the Tax Working Group is a rather interesting one in my view and represents a departure from the typical development of public policy advice. It is not a formal Government commissioned advisory group of the type that has previously been established to review taxation, such as the 2001 Tax Review. This is a more informal structure designed to enhance the opportunity for IRD and Treasury policy officials to test ideas and receive feedback from a group of people with expertise in New Zealand’s taxation system and with different backgrounds and perspectives. Another feature is that at the end of each meeting the Group summarises its deliberations and makes them publicly available on the internet, along with the supporting papers discussed by the Group.

This process is not without risk. One risk is that what we put on the internet will be interpreted as recommendations rather than deliberations. We have already experienced this and initially the media did interpret what we posted on the internet as recommendations. But as we continue with this process, I think it will have the advantage of revealing to the public that we are not just focusing on one aspect of the tax system but on the tax system as a whole and that we are working sequentially through various aspects of the tax system. Eventually we will be looking at the overall tax structure and will be considering various tax reform scenarios. I think broader understanding of that point will probably only be apparent once we publish the various scenarios after the fifth meeting. So in terms of public policy development, I think this is an interesting experiment, one which is challenging but hopefully proves to be worthwhile.

Another aspect that I hope Inland Revenue also see as an advantage is that this process has attracted the attention of the media and offered the opportunity for the policy departments, Treasury and IRD, to discuss with the media in more detail some of the issues which officials and members of the Tax

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Working Group has thrown up. For example, Vernon Small followed up the initial discussion on our concerns with the implications of the intersection between the Working for Families scheme and differences in tax rates for personal taxes and various taxes on investment activity, with an article in the Dominion Post which was supported by the Editorial column\(^8\) He provided more detail on the scope for higher income-earning households to qualify for the Working for Families benefits.

The publicity around the Tax Working Group process has also started to get ahead of our agenda. This isn’t necessarily a bad thing. Vernon Small, for example, published an article in The Independent entitled “Land Tax on Cards from Tax Review”.\(^9\) We are yet to discuss that, but it is certainly something we will be considering. But to date I think the process has been beneficial by broadening understanding of why there are concerns with the current tax system and I hope it has broadened understanding of options for taxation reform or at least an understanding that the options for reform extend beyond simply a capital gains tax. The recent article in the Dominion Post by Colin James was helpful in this respect.\(^{10}\)

3. **Characteristics of a sound taxation system**

One of the first tasks of the Tax Working Group was to agree on the characteristics of a sound tax system. We have actually referred to these as “principles” and have identified six principles that should guide the design of the tax system. The six are:

1. growth and efficiency;
2. equity and fairness;
3. revenue adequacy;
4. revenue integrity;
5. simplicity of administration and compliance;
6. coherence.

I will comment briefly on each of those characteristics because it helps, I think, to illustrate why it is important that Government give attention to the tax system. There are clearly going to be trade-offs in some cases between these six principles and it is important the Tax Working Group understand these trade-offs as we work through various options for changing the tax structure. For example, a tax change that might enhance growth and efficiency may have distributional effects that have implications for the equity and fairness principle. Let me consider briefly each of these in turn.

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\(^{10}\) Colin James (2009), “Bill English’s really taxing question”, *Dominion Post*, 24\(^{th}\) August, p B5.
The growth and efficiency principle refers to the goal of designing a tax system that will enhance employment participation, innovation, entrepreneurship, and economic growth. The Minister of Finance clearly regards this as important. In his speech to the Trans-Tasman Business Circle in which he discusses why a world-class tax system was one of the six policy pillars for improving New Zealand’s economic performance, the Minister commented that “we want a tax system that rewards effort, provides better incentives to get ahead, and allows our businesses to thrive, both at home and on the world stage”. He also said that we need a tax system that helps New Zealand become more competitive but at the same time, preserves the necessary revenue flows.

A number of features of the New Zealand tax system lead us to question whether it is in fact designed to enhance efficiency and growth. International research on the effects on growth of taxes and government spending suggests there is a hierarchy of taxes in respect to the way they affect economic growth. That literature tends to suggest that corporate taxes and personal income taxes are more damaging for growth than taxes on spending, such as GST, and more damaging than taxes on property.

Another important issue is the effect that globalisation is having on the international mobility of factors of production. Because capital and labour tend to be relatively mobile, national taxes on corporate and personal taxes will be more damaging for national growth than taxes on consumption and property, which are less mobile. I say less mobile because it is possible for consumers to shift the source of their supply of some goods and services across national borders, although this tendency is likely to vary across countries according to geographical characteristics. It may be a more serious in the European countries, for example, than in New Zealand. The growth in purchase opportunities via the internet will also is likely to have also influenced the “mobility” of consumers.

Whereas in the early 1990s New Zealand had a relatively competitive company tax rate and was certainly below the OECD average and the average for small OECD countries, that is no longer the case. New Zealand’s corporate tax rate, even after being reduced from 33 to 30 percent, is now above the OECD average and the average of small OECD countries.

Furthermore, the structure and level of New Zealand’s personal tax rates compared to countries such as Australia, for example, are likely to have an important effect on the location decisions of skilled labour. New Zealand tends to have a highly mobile skilled labour force. About 24% of “highly skilled” native born New Zealanders live overseas, a level that is very high compared to most other economies. The proportion for Australia is only around 4%. It should therefore be of concern that as a proportion of the New Zealand average wage, relative to Australians, New Zealand salary and wage earners are increasingly paying a higher proportion of their average wage in the form of income taxation. Furthermore, New Zealand has a fairly progressive income tax system and, particularly as
a result of the advent of the introduction of the Working for Families tax credits, there is a complex interaction with the transfer system which has resulted in some income earners facing high effective marginal tax rates, which could be creating adverse incentives for the entry into the workforce.

Turning to the equity and fairness principle, this is really concerned with the progressivity of the tax system and how the tax system affects the distribution of income tax burdens, how far people with similar incomes pay similar taxes, and how the tax system impacts upon measures of economic hardship. As we move through various options for changing the tax system, we are systematically assessing how any changes impact on progressivity, the distribution of the tax burdens, and measures of economic hardship.

I mentioned a moment ago that taxes on consumption, such as GST, are less damaging for growth than say taxation on personal and corporate taxes. However, in order to finance a reduction in corporate and personal income tax rates, consideration may have to be given to raising revenue through alternative means, such as a higher GST rate. The may be trade-off with distributional goals arising from a higher GST rate because, at least as a proportion of current income, GST tends to be regressive. However, GST is less regressive if measured by expenditure or on a lifetime income basis.\(^\text{11}\)

This example raises two challenges in considering distributional or equity issues. One is that if a tax such as the GST is raised, one may have to consider other welfare measures to try and compensate for the disadvantaged. Secondly, there is the vexed issue of how one measures the distributional effects. Should we be concerned with static or dynamic distributional effects? Furthermore, it is well understood that government expenditure and transfer programmes have distributional effects. Hence, there may be opportunities to design government expenditure programmes to compensate for any adverse distributional effects of a chosen tax structure, whether they be static or dynamic. This would imply that the extent to which trade-offs exist between the distributional and other principles of a sound tax system will depend on the scope to design effective expenditure compensating programmes.

Turning to the revenue adequacy principle, this states that the tax system should be designed in such a way that it raises sufficient revenue to finance current government expenditure consistent with the fiscal framework. In the New Zealand case, this would imply taxation revenue collection consistent with maintaining a target net public debt level. Ultimately, all government expenditure has to be paid by taxes and public debt can only be repaid by taxes or by rolling over debt. It is therefore important

to understand how the design of the tax system can affect taxation revenue adequacy and the sustainability of the tax revenue base. If investment and labour are internationally mobile then internationally uncompetitive corporate tax and personal income tax rates are likely to undermine the tax base through the migration of capital and labour. In that situation, it would be appropriate to put a greater emphasis on the collection of taxation revenue from less mobile factors, such as land.

Another commonly cited concern with respect to revenue adequacy is the potential implications for the tax revenue base of population ageing. Interestingly, the research that has been done on this with respect to New Zealand population dynamics suggests that the population ageing effect will not necessarily reduce the income tax base. This is because, even though a higher proportion of the population will be moving into the retirement age bracket, simultaneously the younger age bracket will be moving through their peak income earning years, thereby offsetting the reduction in overall participation rates on the income tax base. However, on the expenditure side population ageing clearly does impact on the revenue claims on the tax system and this is particularly through the effect of population ageing on the cost of New Zealand superannuation.

Revenue integrity refers to the idea that a tax system should be designed to minimise opportunities for tax avoidance and arbitrage. In other words, we should be aiming to design a system which does not create incentives for people to restructure their activities to avoid taxation or increase the size of the underground economy. Lack of integrity in the tax system would also impact on the viability of satisfying the revenue adequacy principle.

The fifth principle, simplicity of administration and compliance, is something which the Inland Revenue Department is clearly an expert. While by international standards you run an efficient system, I understand expansion of your role in managing KiwiSaver, for example, has posed new and costly challenges. There is clearly an important relationship between revenue integrity and the costs of administering a taxation system.

The sixth principle of coherence refers to the idea that component parts of the overall tax system form a coherent whole in the sense that they conform to the same principles. A coherent system would be one which is designed in a manner consistent with the goals of the taxation system. For instance, the alignment of personal and corporate tax rates and a broad base system that minimises the adverse effects on growth and enhances integrity of the system would be coherent.

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http://www.victoria.ac.nz/sacl/CAGTR/taxworkinggroup/session-two.aspx
4. **Concluding remarks**

As the Tax Working Groups moves through the personal income tax system, the GST system, base broadening options, the corporate tax system, and other options for raising tax revenue, we will be weighing up the implications of changes to the current system and the introduction of new taxes against these various principles. They represent a discipline on our work and on our assessment of options for restructuring the tax system.

To summarise, from the perspective of the importance of the tax system for economic performance and the importance of a tax system that satisfies fairness, revenue adequacy, and integrity, administrative simplicity and coherence, the New Zealand tax system is in need of review and reform. Furthermore, I sense there is a political opportunity to change the tax system, at least if we accept the comments in the recent speeches by the Prime Minister and the Minister of Finance who have both emphasised the importance of a world-class tax system as one of the six pillars in their policy agenda for improving New Zealand’s economic performance.

Thank you for the opportunity to speak with you and best wishes for a successful conference.