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Insight

Bolder reforms needed to stop the rot

Anyone who seriously thinks that the Tax Working Group's (TWG) recommendations are radical needs a reality check. The TWG report is a valuable contribution to the economic debate, and deserves a good airing. But if New Zealand is to close the income gap with Australia, we need to do much more than matching Australia's personal income and business tax rates.

A broad suite of growth-friendly policies – including bolder tax reform – needs to be implemented and a shared economic vision established. We need to accept that the adjustment to a higher long-term growth path might cause some short term pain, and we need political leaders to commit to seeing the reforms through.

The slow corrosion

In an insightful and thoughtful, but ultimately meek report, the TWG[1] confirms that New Zealand's current tax system is harmful to growth through its heavy reliance on taxing personal and corporate income. The tax structure distorts people's employment, saving and investment choices.

This shows up clearly in the significant increase in the use of tax structures (trusts, LAQCs, etc) to reduce tax liability. Data show that employees choose to stay at lower income bands to retain access to Working For Families payments.

The TWG also argues that our personal and corporate tax rates are becoming less competitive internationally. This makes our tax base vulnerable to international competition for capital and labour.

Over time, the accumulated effect of these distorted decisions and vulnerabilities is to retard productivity and suppress our potential growth rate.

[1] Available from http://www.victoria.ac.nz/sacl/cagtr/pdf/tax-report-website.pdf , accessed 20 January 2010.

TWG report is a positive start…

So far, so good. The TWG report has shed light on the major issues with the current system and has canvassed the pros and cons of the main orthodox policy options. It has generated debate. We agree with the report's diagnosis – the tax system is indeed a long way from best practice. And we agree with the intent and spirit of the recommendations. However, the report needs to be seen as a starting point for a more concerted discussion about what we, as a nation, want the economy to deliver and what that requires.

…but a mild affair

The TWG recommends that the top personal, corporate and trust tax rates be aligned, and that the company tax rate be set to be competitive with that of Australia. These changes would be funded by an increase in GST and a land tax. There are also recommendations to address the under-taxing of returns on residential rental property, review Working for Families, and to introduce checks and balances against future changes to tax that are not 'best practice'.

The Group's recommendations are sensible and orthodox, but somewhat mild. As a package they are hardly controversial or radical, despite some of the immediate hip pocket reactions to specific proposals. There will be some that might be adversely affected by the changes. But the suite of changes are not unfair, and in part are intended to address currently unfair and inefficient situations where some taxpayers have been paying while others avoid the burden.

Short term-ism is a threat to long run prosperity

Our concern is the longer-term prospects for the economy as a whole, rather than specific parts of it. Successive generations will miss out on higher living standards if we keep choosing second-best options based on worries about short term adjustment costs.

These short term costs can be hard to stomach for some, but that is the essence of bold policy making: it is about tradeoffs and there will necessarily be short term winners and losers. But far more would be lost in the medium term if there were to be no change and the present distortions continue – we would all be losers.

Nevertheless, adjustment costs are real, and any change in economic and tax policy needs to be taken in conjunction with social welfare policy, to ensure that those severely affected by change – even if temporarily – are looked after.

Bolder, broader changes need to be debated

Understandably, in the current economic climate, the report's authors have been cautious. The report's recommendations are restrained, reflecting constraints such as the need to be fiscally neutral and within a politically feasible set (the latter in order to avoid the apparent fate of the 2025 Taskforce report). But they offer a sound basis for debate, followed by a firm and farsighted decision.

The alignment of top personal, trust, and company tax rates, the shift in the balance away from taxing income to taxing consumption, taxing immobile factors rather than mobile ones, and an overhaul of Working for Families are much needed changes that should contribute to restarting the growth engines in New Zealand. Such changes would address the distortions and disincentives introduced over the past decade in particular.

Given the growth challenge New Zealand faces, our concern is that the proposals of the TWG do not go far enough. Matching Australia and the rest of the world in corporate tax rates will not be enough for a country as small as New Zealand to keep up. It is far too timid an approach if we genuinely aspire to catch up ground already lost. We should be looking at genuinely radical reductions in tax rates on mobile capital and labour, increases in GST, and tax arrangements that support growth and innovation. This requires a vision of what kind of New Zealand we want to be in 10 years' time, and debating what kind of tax system would support that.

Part of that debate also has to be what institutions can be put in place to avoid a reformed tax system slipping back into bad old habits. The TWG notes that in 1989 the New Zealand's tax system was regarded as the least distortive in the OECD. But we have not stayed the course; not only have other countries now surpassed us, but a number of well-intentioned but poorly designed tax and welfare policies since have set us back. The increase in the top personal tax rate and Working for Families are key examples of this.

There is time for a debate. One of the implicit messages of the Working Group is that change is essential but it does not all need to happen immediately; the system is suffering from a wasting disease, but is not yet in shock. The debate, though, must be the prelude to action – not a delaying tactic.

Other policy reforms also needed

Changes to the tax system are necessary but not sufficient. Tax policy needs to form a plank in a broader agenda of economic and social reform. Government spending needs to be reined in, better targeted and more explicitly evaluated for effectiveness. Education, health and justice need to excel in an international setting, and be backed up with a deep pool of a well trained population and well tooled businesses. What we have done over the past 25 years has clearly not delivered enough change. More is needed. And this is the decade for it. All our politicians have to rise to the challenge and we all have to stop thinking about the short term effects on personal circumstances and start thinking about the positive longer term consequences of implementing good tax and other policies.

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