The New Zealand Economy and Tax Policy

Speech delivered by

Gabriel Makhlouf,

Secretary to the Treasury

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Introduction

Good morning. Today I want to talk about what has changed in the past few years, and what has not changed. And I want to leave you with a simple message: our tax system, overall, is in pretty good shape. By international standards, we stack up well.

I am going to talk about three things: the dramatically different economic situation, the nature of tax policy in New Zealand, and the changing nature of the government's interactions with citizens.

The economic situation: what has changed

Before I address tax, I want to briefly talk about the global economic situation.

I think it is safe to say that economists have really struggled over the past five years to get their heads around the nature of the global financial crisis and the solutions to it.

As an economic ministry, the Treasury has been wrestling with the complex public policy issues that the crisis has thrown at us.

New Zealand went into the crisis in a pretty strong fiscal position. However, in a small country, open to investment and trade, advantages can evaporate startlingly quickly.

Our terms of trade, the prices of the commodities we sell, are all masking a more difficult problem.

There are undoubtedly many causes of the global financial crisis. Just as academics today still debate the causes of the Great Depression, I anticipate that the academic community will still be debating the so-called "Great Recession" for many years to come.

But, as with any sharp, sudden, and protracted economic crisis, we always learn one thing: the conventional wisdom was in many respects, wrong. At the very least, we have learned that risk and return can be badly mispriced.

Whether it was finance company debentures or mortgage backed securities, too many people took on too much risk without knowing they were doing so, because promised returns did not match the risk.

Putting aside the causes of the crisis, the relevant question from the perspective of New Zealand is how to best manage the situation – and that is a question that is only answered through both the public and private sector addressing some of the issues that the recession has created.

On top of the financial crisis, the tragic and devastating events in Canterbury have reminded us all we live in the shaky isles. No part of the country is immune from natural disasters. We are all in the same boat.

Aside from advising on the rebuilding effort, the Treasury, as the government's lead advisor on economic, financial and regulatory policy, is being called upon to advise on how we can minimise the financial and social costs of the natural disaster risks we face.

As you would expect and probably be well acquainted with, the earthquakes have thrown up an enormous amount of policy issues, tax issues not the least of them.

We have been taking a pragmatic but principled approach to these problems. Maintaining revenues is a critical part of managing the government's fiscal position.

Currently there's a gap between what we are spending and what we are collecting. In the medium term, our goal is to close that gap.

Reflection on global tax trends in the recent past

Tax holds a special place in my heart because for many years I was a tax official. I chaired the Organisation for Economic Cooperation and Development's (OECD) committee of fiscal affairs and worked at the Inland Revenue in the United Kingdom.

Eleven years ago I gave a speech on tax and tax reform when I was at the Inland Revenue. When preparing for today, I dug out that speech to see what relevance it still has.

As I reflected back, it occurred to me that some things have changed completely, and others have remained the same. First I will talk about what has changed.

Even though I described "globalisation" as one of the most overused words in the dictionary, I still felt obliged to give a definition of "globalisation" in that speech.

But today, it is no longer a buzzword about the exciting future – it is the ordinary and mundane present. It is not a new trend, it is a fact of life, and I am sure we have all got a working definition in our heads.

Needless to say, globalisation brings many tax challenges and opportunities. One of those challenges is the level of tax on companies, when New Zealand is focussed on being as competitive a business destination as possible.

In the last thirty years, OECD countries have dramatically reduced – in fact almost halved - their corporate income tax rates. Up until the year 2000, New Zealand's company tax rate was lower than the OECD average.

The trend across the OECD has always been downward, although that trend has slowed since the global financial crisis.

After the year 2000, New Zealand fell behind, and we are now catching up. But we have some limits on how low we can drop our company rate.

On tax reform generally, in that speech eleven years ago I said "tax reform never ends". That's still my view. Taxpayers will always be looking for ways to reduce their personal cost of funding government services.

But the cost of government is largely determined by government. And accordingly, taxpayers who restructure their affairs are really playing part in a prisoners' dilemma – trying to get other people to bear the burden, with the effect that taxes are higher on all of us.

Even if at a moment in time a tax system is completely perfect, it will not remain so as the wider environment and government priorities change. So we never get to declare final victory, dust off our hands and congratulate ourselves for a job well done.

The first income tax in New Zealand was implemented in 1891, and we are still working on it.

According to Professor John Prebble, in 1891 the first 300 pounds of income – far above the average income – was exempt. Corporate income was taxed at one shilling in the pound – for those unfamiliar with old money that's 5% - and professional income at half that rate.

The idea that such an income tax could finance a modern government is ludicrous.

As the burden of taxation has risen, so has the need to ensure that it achieves neutrality, while also responding to the other, competing needs of a democratic state.

This brings me to the nature of tax policy in New Zealand.

Tax policy in New Zealand

As I said eleven years ago, the world changes, and the tax system needs to change with it. What I did not predict then was how fundamentally the global situation would change, and how that would force the state sector to change.

New Zealand is somewhat unusual in the arrangement we operate for developing tax policy. It is a joint process between Inland Revenue and the Treasury.

There are modest differences between Inland Revenue and the Treasury's approaches, and due to our different roles we are always going to have different strengths. Inland Revenue will always have a better perspective on the underlying technical detail and the practical effects of policy.

Similarly, the Treasury, as the government's lead advisor on economic, financial and regulatory policy, owns the aggregate effect of all government policy. Therefore an important part of our role is to join up Ministers' disparate strands of policy across government.

Both the Treasury and Inland Revenue are committed to the tax policy process we have in New Zealand.

Just last week Matt Benge from Inland Revenue was presenting at a conference in Oxford on the way New Zealand has formalised our generic tax policy process. This process is well regarded internationally as well as domestically.

When it comes to tax, we aim to locate tax advice within the government's broader economic, fiscal and social policies and objectives. The differences between the Treasury and Inland Revenue are about weight and judgment rather than any fundamental difference in how we think about tax policy.

Both departments share strong, and fairly conventional, tax policy frameworks – in short, taxes should distort behaviour as little as possible while achieving government revenue objectives and contributing appropriately to wider social or distributional goals.

We have reviewed the relationship between the Treasury and the Policy Advice Division of the Inland Revenue in the last year and our view is that it is the healthiest it has ever been.

As we know, the ability for government departments to collaborate and break down artificial institutional barriers is a key focus of this Government.

Combining the drive to make New Zealand more competitive with the fiscal demands, the focus is very much on chipping away at loopholes, inconsistent treatment of some expenditure, and broadening the base where possible and appropriate.

Global mobility of people and capital always puts pressure on our personal and company tax rates and in the long term, further reductions to improve incentives to work, save and invest are important.

We also recommend mutual recognition of imputation credits with Australia. This would promote freer flows of capital across the Tasman and would extend to capital the trans-Tasman single economic market that largely operates for goods, services and people.

Mutual recognition of imputation credits is a growth enhancing strategy for both New Zealand and Australia.

While further company rate cuts may be desirable in the future, in the short term our primary constraint is, of course, fiscal – the need to balance tax revenue with government expenditure.

The Government’s strategy is to achieve surplus by 2014/2015, and accordingly, in the short term anyway, reductions in the corporate income tax rate are unlikely.

The second constraint is how we think about alignment between tax on different types of income, and how far we can deviate from the goal of alignment while still retaining income neutrality.

In an uncomplicated world we would want to align the top personal income tax rate with the corporate income tax rate. Because they are both final rates, we know a six percentage point difference between the top personal rate and the trust rate distorts behaviour and is unfair – the Government changed that in 2010.

We can live with the current five percentage point difference between the company rate and the top personal rate, with the trust and top personal rates aligned. This is because for New Zealanders, the company rate is an interim rate before any extra tax is paid on dividends.

But with a larger non alignment between the company rate and the top personal rate the timing advantage of operating as a company starts to bite.

So while we are concerned about pressures within our tax system, we must always be aware of the pressures that the systems of others impose on us.

Speaking about the global situation eleven years ago, I talked about tax competition, and the difference between healthy competition and abusive anti-competitive tax practices.

Talk of tax competition all seems a bit quaint and out of date now, while governments around the world seem to be increasing taxes or introducing new ones to shore up their finances.

But outside of that immediate landscape sits a long-term trend of decreasing company and personal tax rates, with revenues supported by base-broadening measures and increasing VAT and GST rates.

It has been said plenty of times before but it still bears repeating: New Zealand's GST is the best VAT in the world and our strong consistent advice is that it should be protected from exemptions that undermine it.

GST is a simple tax that raises a large amount of revenue, with minimal distortions. Using the GST system to promote particular policies comes at great cost.

The compliance cost, uncertainty, and complexity of bringing in exemptions and multiple rates are overwhelming as compared with asserted benefits.

There are far more effective ways to promote social outcomes than by fiddling with the consumption tax on a good or service, and far more effective ways to achieve redistribution than taking GST off whole swathes of goods and services.

GST remains our best designed and most efficient tax.

There have been 17 VAT increases in the EU in the last 2 years. In 2011 an average VAT rate across the OECD was 18.5% - it is 20% in the United Kingdom.

One reason these countries have higher value added taxes is because they exempt all sorts of goods and services. As with income tax, we prefer a broad based low rate to a narrow base with a high rate.

The increasingly popular "Tobin tax" is proposed by some as a solution to shrinking revenues. A Tobin tax is usually thought of as a tax on foreign currency exchanges, but now the name seems to be used to describe more general financial transaction taxes.

Nobel-prize winning economist James Tobin came up with the idea. The purpose was to reduce speculation in currency markets, which Tobin thought of as dangerous. Tobin came up with the idea soon after the end of the Bretton Woods system, before which each country maintained its currency within a fixed value of the price of gold.

The idea gained popularity after various "capital flight" scenarios in Mexico, Asia, and Russia in the 1990s.

Somehow, the idea has been resurrected in the aftermath of the financial crisis as a means of raising revenue.

Now it seems to be simply an attempt to target banks, or, in some circles, as an anti-globalisation measure. These views seem to ignore the difference between tax liability – who literally pays the tax; and tax incidence – who really bears the cost of the tax.

To the extent the idea is supported by those who oppose globalisation, such support is misguided. Before his death in 2002, Tobin laid out his position [interview with *Der Spiegel*]:

> I am an economist and, like most economists, I support free trade. Furthermore, I am in favour of the International Monetary Fund, the World Bank, the World Trade Organisation. [The Tobin tax supporters have] hijacked my name. ... The tax on foreign exchange transactions was devised to cushion exchange rate fluctuations.

It's fair to say that exchange rate fluctuations played next to no part in the financial crisis.

In fact, countries like Iceland, with floating exchange rates and the ability to regain competitiveness by dramatic exchange rate revaluations, are in a much better position than a country like Greece, without the ability to devalue its own currency.

The Tobin tax is a solution in search of a problem, and we do not see a role for any such tax in New Zealand.

Countries searching for extra revenues would do far better to follow the advice of the OECD's recent paper on inequality and growth - tidy up their tax codes to remove tax expenditures, which typically favour higher-income taxpayers, so that more revenue can be raised without increasing tax rates.

A "tax expenditure" is a tax concession or exemption given to a particular industry, group, good, service, or type of income which is not given more generally.

It is, in effect, a subsidy by another name, and the work on tax expenditures is focussed on identifying such expenditures in the interests of transparency.

With its broad-based, low-rate approach and its comprehensive goods and services tax, New Zealand does not have many tax expenditures. Perhaps because of this, we have not been particularly good at spelling out the ones we do have.

As part of each Budget since 2010 we produce a list of expenditures made through the tax system.

The methodology of doing this is riddled with tough questions, and it always raises the ire of some who think the concept implies that government is entitled to all your income and is awarding a "tax expenditure" by allowing you to keep some.

But the real goal is to have a comprehensive tally of all the implicit and explicit subsidies that government awards, so they can be appraised on their merits.

It is clear that some tax expenditures we do have, like the concessionary treatment of specified mineral mining, need to be looked at, and are being looked at as part of the tax work programme.

Apart from the need to raise revenue for government spending and transfers, there is a second justification for taxes – aligning social cost with private cost to remove spillover effects to third parties.

Alcohol and tobacco excise taxes are one area where New Zealand attempts to remedy this problem.

One of the most obvious other areas where this occurs is in environmental damage. If an individual's private interactions affect the wider community through environmental damage, there is a spillover cost on society and, under certain circumstances, the activity should face an additional cost or be regulated.

The important thing is that we get the signals rights.

From a tax perspective, the challenge is in designing a pricing mechanism that addresses the problem, is simple to understand and apply, and is set at the right level.

If the price is set too high, it can be as inefficient as having no price at all.

We anticipate that as environmental resources come under increasing pressure and conflicts between competing users become more stark, there will be an increasing move to the use of economic instruments, including environmental taxes and trading schemes, to help manage those pressures.

Of course other regulatory mechanisms will continue to be important, and we need to tailor each policy response for the environmental problem to be addressed.

If the Treasury is to provide good advice and improve the living standards of all New Zealanders, this is an area where we have to get the balance right.

Changing nature of government's interactions with citizens

We know that over the medium term, the Government is focussed on breaking down artificial barriers between departments and having a "whole of government" approach to a citizen's interactions with the State.

As you will have heard this week, this Government is focussed on results. Inland Revenue is close to all of this work because it is an agency which delivers services for citizens and services for businesses. On top of this, it helps to deliver social policy as well.

Two weeks ago I spoke to NZICA in Wellington about the challenge for the Treasury and the state sector to gain more traction on critical outcomes and results in a world of flat budgets.

I said that the only option available to us is to get greater value out of existing spending and out of the assets that the Crown owns.

This means the state sector has to change.

We have to better measure our performance and we need to perform better by finding new and different ways of working. Like other departments, Inland Revenue faces a number of challenges which will require it to be bold and innovative to find solutions.

A perfect example of the challenges facing Inland Revenue – and this is a very mundane but realistic aspect of their challenges – is their computer system. The computer system

FIRST, that Inland Revenue started using in 1992, was built in a world without the internet, in a programming language that no one uses any more. The founder of Facebook was eight years old.

Updating this system, as part of the business transformation of Inland Revenue and the transformation of the tax administration system, is an investment in a core piece of infrastructure of New Zealand – the infrastructure that pays for all the other infrastructure.

We do not have a firm idea of the cost of this investment, but the $1- 1.5 billion number that has been in the press cannot be far off.

It is going to take years, and we are thinking about this as a ten to fifteen year, rather than a two year project.

Twenty years for software is a pretty good run, and the challenge for us is to make sure we future proof, to the greatest extent possible, any investment we make.

Recently, as part of preparing a document on the Treasury's tax policy priorities over the next few years, the Treasury reflected on how Inland Revenue's role has changed over the past ten years. We are releasing the document.

Most of us still probably think of Inland Revenue as simply a tax department, but that is an outdated view. Now, more than a third of Inland Revenue's departmental expenditure is on social policy programmes.

That is *Working for Families*, Child Support, Student Loans, *KiwiSaver*, and Paid Parental Leave. Operationally, that creates enormous pressures, and those pressures are only increasing.

Inland Revenue also has a social policy role due to the inter-relationship between the tax and welfare systems.

In my speech on state sector reform I emphasised the need for agencies to find new and more effective ways of working together to deliver the results that New Zealanders need.

The interface of tax and welfare provides an example of the importance of agencies working together – not just in the delivery of policy, but in policy design.

Many people regard the relationship between tax and welfare as tax paying for welfare. But the application of welfare benefits – and in particular their abatement – can act as effective taxes. We need to provide the right level of support to people who need it, without creating punitive disincentives.

The complicating factor here is the effective marginal tax rate on an individual. If we look at tax without looking at welfare, we ignore the potential for policy to create poverty traps where people see no reward for getting ahead.

Whether it is an explicit tax rate or an implicit benefit abatement, at the end of the day people know how much extra money they get from starting a job, going to full time from part time, or working more or getting promotions. We have got to make those calculations stack up.

And this is not just in the narrow fiscal sense of making sure people have a financial incentive to get ahead. That is important. But it is also important to make sure that there is a pathway for people to get more involved in society, in work, and in their community. We know that these measures are fundamental to subjective wellbeing.

The Treasury's *Living Standards Framework* emphasises these broader measures of wellbeing, and we make sure we're thinking about all of this when we provide advice to government.

Conclusion

In tax policy, there will never be any silver bullets. Changes are brought about by a confluence of factors – the practice of taxpayers, the international environment, competing social policy goals, developments in tax administration, and the need for revenue to fund essential services.

Right now our focus is on ensuring that the books are balanced while increasing our global competitiveness. That means that, while we have delivered tax cuts, we will be looking very hard for well considered base-broadening measures.

On top of all of this we are determined to get the best results possible out of our tax administration system.

So overall, we are satisfied with the fundamental framework of our tax system.

As we look ahead we see amazing opportunity for New Zealand to sell our goods and services to the world.

China is now our second-largest trading partner. The economic geography is changing from West to East, and it turns out we are geographically closer to the East than most of the West. I am excited about this opportunity.

If I look back at what I have said today in ten years time, I know that some of what I have said will look naive, or will have been overcome by events. But fundamentally, the direction we are moving is absolutely the right one.

There are going to be bumps along the way. Some of those bumps we can predict, but others are unpredictable.

The Treasury's objective is to best situate New Zealand for the coming opportunities and challenges. Improving the living standards of all New Zealanders requires us to do that.

Thank you all very much for listening to me. I hope you enjoy the rest of your conference.

The New Zealand Tax System

The New Zealand tax system is well regarded ...

The broad base low rate (BBLR) approach raises revenue relatively efficiently compared to other OECD countries.

Following changes adopted in *Budget* 2010, there are generally few distortions in the tax system. There does remain, however, wide variation in the tax rates that apply to different types of income from savings and investment. There may be potential for savings and investment tax changes to encourage a more productive allocation of capital.

The *Budget 2010* tax switch shifted the tax burden toward more growth efficient taxes – away from direct taxation and towards indirect taxation.

... but working groups have identified weaknesses

The Tax Working Group (2010) (TWG) and the Savings Working Group (2011) drew attention to the taxation of savings and investment and New Zealand's poor savings record.

Recent tax reforms have improved savings incentives. More reforms in this area could further reduce tax disincentives to save and invest, and flatten any distortions in the system.

Given New Zealand's poor savings record, capital thinness and macro imbalances, examining possible options to improve current settings in this area is an ongoing priority.

Contents

KEY MESSAGES

- **The New Zealand tax system has a good base, although there is room for improvement.**
- **New Zealand's productivity is ultimately determined by how successfully we trade with other countries. That requires an internationally competitive tax system that encourages people to live, learn, work, save and do business here.**
- **Current work on potential reform focuses on the taxation of income from savings and investment.**
- **Inland Revenue generally performs well but will need substantial investment in IT and business infrastructure over the next decade.**
- **Changes to the tax system must consider equity and compliance impacts – not just economic impacts.**

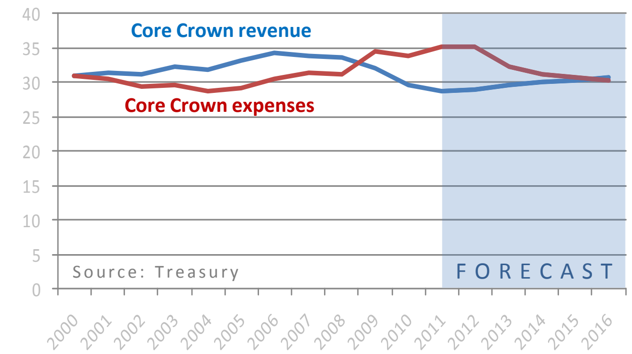
IMMEDIATE PRIORITIES

1. The review of the taxation of savings and investment

2. Transform Inland Revenue

Crown revenue and expenditure

As a percentage of GDP (2000-2016)



- *Core Crown revenue* includes more than just tax revenue (e.g ACC levies).
- In 2011, tax revenue made up 89.5% of core Crown revenue.

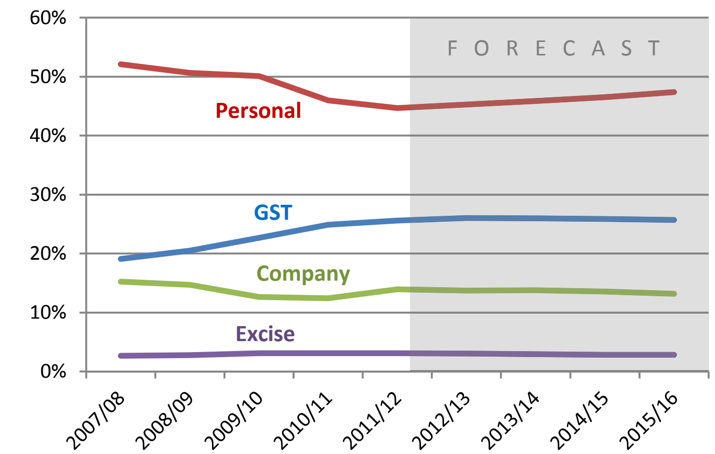
The tax burden on workers, savers and business has dropped in recent years.

Core crown revenue as a proportion of GDP has dropped from **34.4%** in 2006, to **28.7%** in 2011.

There are limits on the ability to cut tax rates without cutting spending or broadening the tax base.

Taxes by type

(As a percentage of total tax)

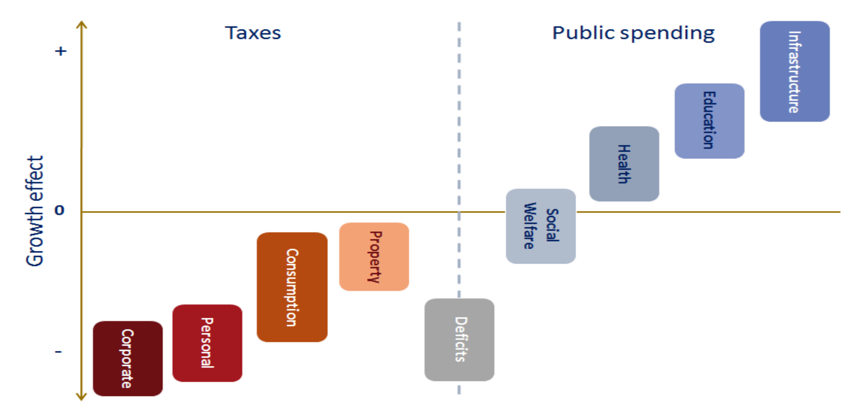


Source: Treasury

Over the past few years there has been a significant shift **away from direct taxes** (personal and company income tax) **towards indirect taxes** (GST).

This is growth enhancing.

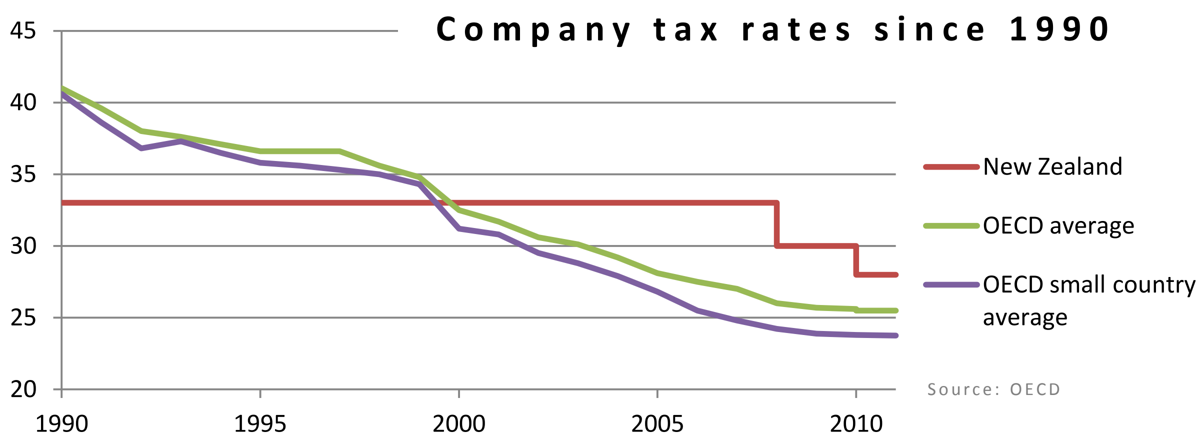
Estimated impact of different taxes & spending on economic growth



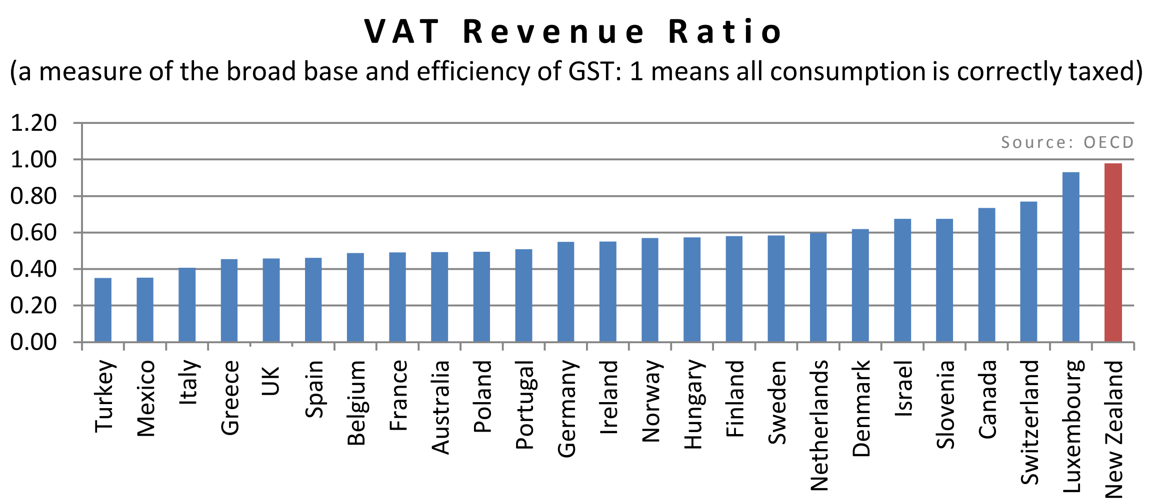
The International Setting

The New Zealand tax system competes with other tax systems. The past twenty years have seen dramatic decreases in top personal and company rates around the world.

In many ways New Zealand led this move in the 1980s, but since then has been surpassed by changes in other countries. Another international trend has been the move to value added taxes, like GST.



Despite a drop of five percentage points in recent years, the New Zealand company tax rate is still above the OECD average, as it has been since 2000.



New Zealand's GST is the most efficient VAT in the world

This is largely due to its design, comprising a single rate with very few exemptions.

Other countries recognise VAT is a relatively low-cost tax and are increasing VAT rates to raise revenue to close budget gaps:

- The average GNP-weighted EU VAT rate is now 21% (up from 19% in 2009).
- There have been 17 different VAT increases in the EU in the past two years.

To be **internationally competitive**, the tax system must...

- $ Raise enough revenue to meet government spending
- Support taxpayer decisions that direct effort and resources to where they are most valuable
- Contribute to wider government goals
- Tax income at relatively low rates, to help keep New Zealand an attractive place for people to work, save, invest and establish businesses
- Operate in a consistent manner that creates certainty for taxpayers
- Be fit for a small open economy with one of the most internationally mobile labour forces
- Be relatively cheap to comply with and administer

Recent **international reviews** in Australia and the UK offer some insight...

The Mirrlees review (United Kingdom)

Many recommendations in line with current NZ practice:

- No separate social security contribution (National Insurance).
- Broaden the base subject to VAT (GST)
- Remove stamp duties

But also suggests more fundamental changes:

- Move to an Allowance for Corporate Equity (ACE) system
- Reduce the tax rate from income from savings and investment

The Henry review (Australia)

Recommendation to tax **four broad bases**:

- Comprehensive personal income
- Business income
- Rents on natural resources and land
- Private consumption

Taxes on **savings and investment**:

- 40 per cent savings income discount for interest and other passive income.

Company tax rate should be reduced to **25%** over the short to medium term

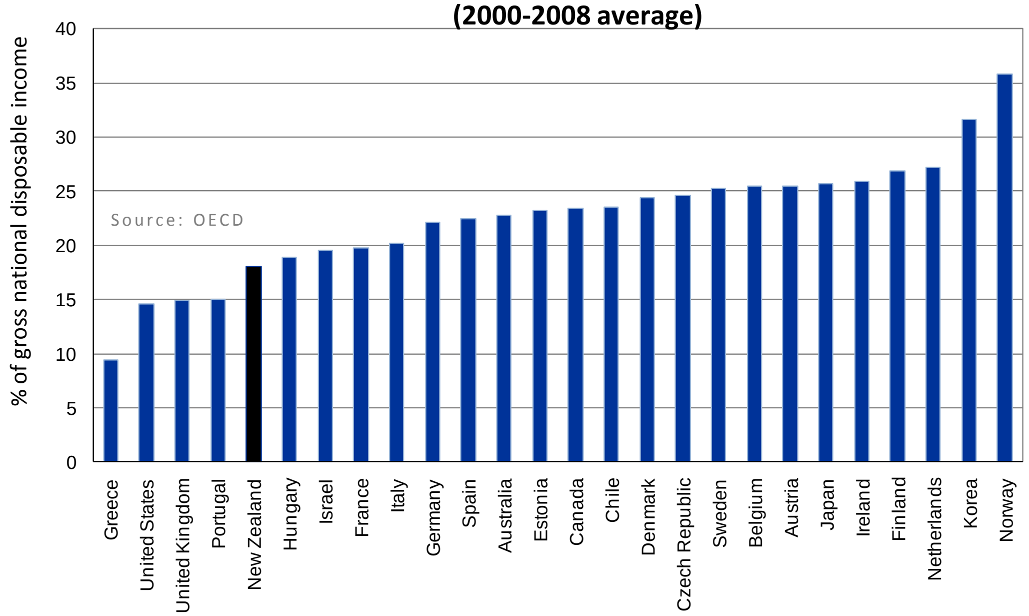
Remove stamp duties and move to taxes on broad **consumption** or **land** bases

Current Challenge: Savings and Investment

Poor investment and savings performance is creating challenges across government, including for the tax system

New Zealanders do not save as much as citizens from other countries. Additionally, the mix of savings may be distorted due to tax reasons. The Productivity Commission is investigating housing affordability and is looking at tax settings.

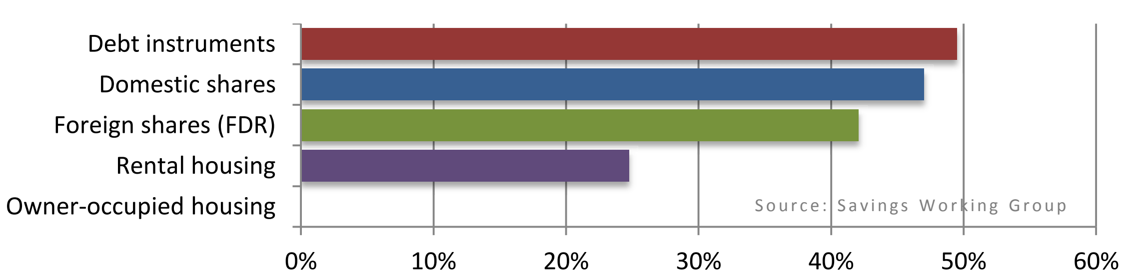
Gross national savings rates
(2000-2008 average)



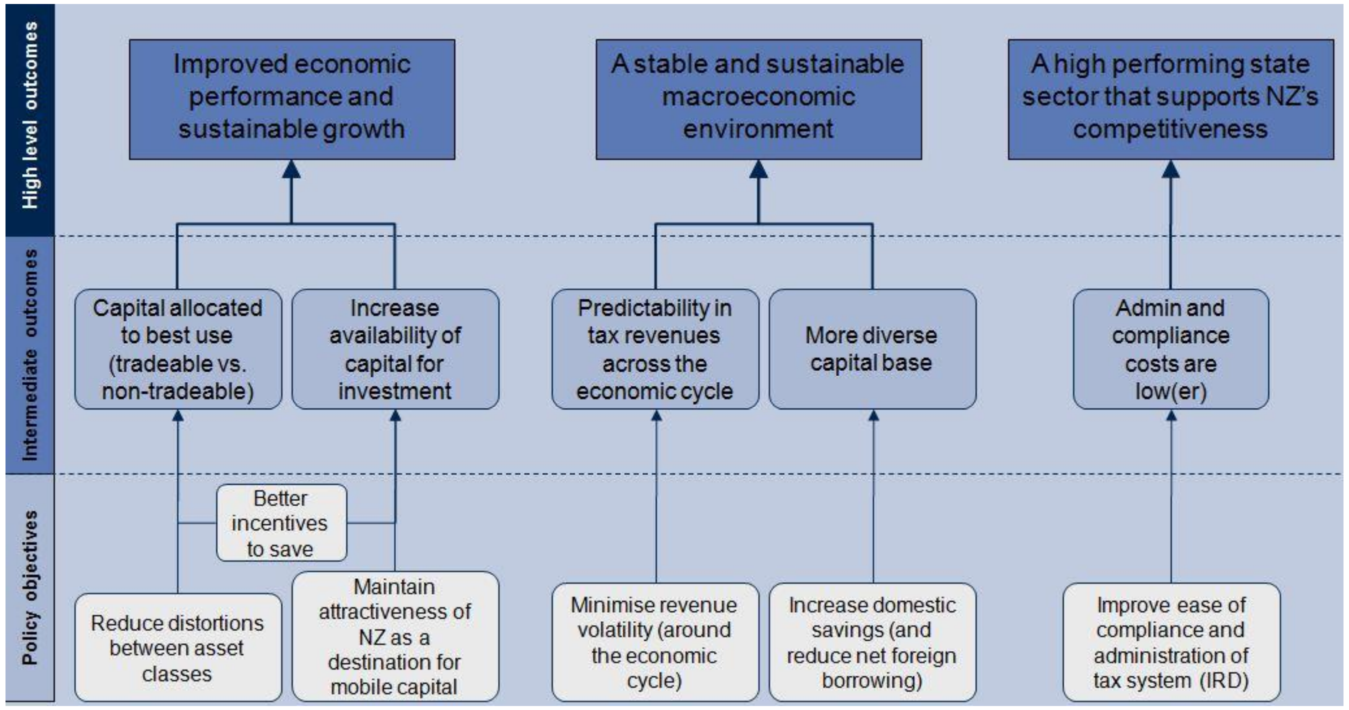
Whether or not tax plays a major role in capital allocation is difficult to answer – New Zealand has a culture of property ownership (although perhaps this in itself is driven by tax).
Ultimately, there is underlying concern with the allocation of capital in the New Zealand economy.

If further work supports substantial reform, Ministers may face a difficult strategic choice between the current well-regarded model and something else

Real effective tax rates on different investments
(33% marginal rate; results are sensitive to assumptions)



The **taxation of income from savings and investment** can deliver wider priorities



The inconsistent treatment of income from savings and investment affects the NZ economy in two ways:

1. The **level of tax** affects the amount of capital invested in the economy:

Changes in tax rates will affect incentives to save and invest. Higher levels of capital investment generally increase productivity and economic growth.

The level of capital invested by **non-residents** is considered to be more sensitive to tax than the level of capital invested by **residents.**

2. The **structure of tax** affects how capital is invested:

Different patterns of capital investment, influenced by tax structure (see graph to the left), can have different effects on economic growth.

Because of the different regimes in place and the effects of inflation, income from different assets is taxed inconsistently.

Debt instruments are taxed at the highest rates. Owner-occupied housing has a zero percent effective tax rate (no tax on imputed rents and no tax on the capital gains). Other investments fall somewhere in between these.

Current Challenge: Transform Inland Revenue

Inland Revenue is performing well…

In general, Inland Revenue does very well with a challenging portfolio of responsibilities – including the administration of a wide range of taxes and a growing focus on the administration of *social policy programmes*. Millions of taxpayers interact with IRD each year.

Recent assessments

PIF Review May 2011	Scored highly, but highlighted the need for successful transformation. *"on balance, a very well managed department"*
BASS April 2011	Administration and support services are generally very efficient compared with cohort.
NZICA Satisfaction Survey Oct 2010	78% of respondents gave an overall experience rating of either *excellent*, *very good*, or *good*.
Performance Measures Annual Report 2011	84% of performance measures were met or exceeded, despite the impact of the Canterbury quake.

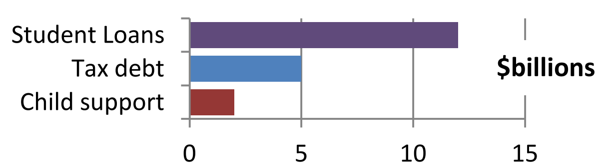
Key Taxes & Levies	Social Programmes
Income Tax: *PAYE* *Company tax* *RWT*	Working for Families
GST	Child Support
ACC Levy	Student Loans
Duties	KiwiSaver
	Parental leave

Departmental expenditure

New Zealand has one of most efficient tax systems in the world in terms of ease of compliance for taxpayers.

IRD is considered something of a flagship department in the NZ public sector.

IRD manages the largest portfolio of **Crown debt** of any department



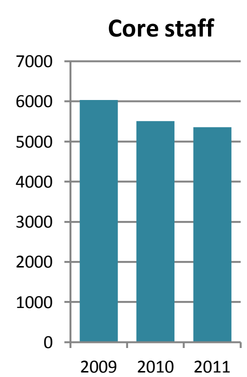
Inland Revenue has an increasing focus on improving the value of the debt book, which continues to rise despite recent measures around debt collection.

Money received in Budget 2010 for additional tax collection has had high returns. The upcoming programme of work focussing on the improvement of **debt management** and collection **should be a priority** as part of Business Transformation.

Recent efficiency exercises have revealed that IRD is operating well

The department is handling greater capacity than in the past, but through efficiency enhancements has still delivered savings.

The *Future Direction of Service Delivery* project has led to decreasing staff numbers, while transaction volumes have continued to rise.



…but faces a **transformation** challenge.

IRD is responsible for the collection of 84% of core Crown revenue ($48 billion in 2010/11), on top of social policy administration.

The collection process is supported by an ageing IT system (FIRST), which handles over 30 different tax and transfer types. Changes to social programmes can also have a large impact on this system.

Previous attempts to migrate from this system have been unsuccessful.

The IRD is in the process of refining its plan for *Business Transformation*. Two reports went to Ministers in September, outlining:

1. **An assessment of FIRST**
2. **A high-level plan for transformation**

One key component of this is the transformation of the IT systems. This will be done in a number of phases, and…

KEY FACTS (2010/11)

Total Crown revenue collected through the IRD tax system	$48b
Percentage of tax returns filed electronically	47%
Current age of the core IT system used to administer tax (FIRST)	19yrs (b.1992)

…initial estimates put the cost at $1-1.5 billion over the next 10-15 years.

Transformation presents a range of opportunities:

- Simplifications in the policy space
- Greater flexibility to make tax changes
- Ongoing administrative savings

Transformation is wider than just IT systems, being *business-led, but technology enabled*.

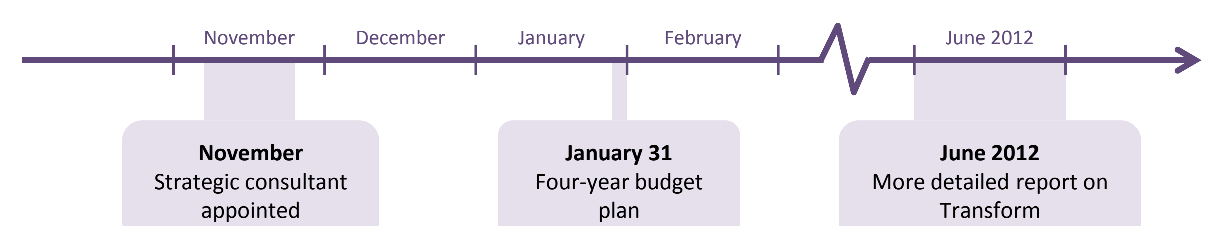
It will also involve a move towards more electronic and self-management based approaches to taxpayer compliance.

Transformation will enable greater efficiency, but is made more challenging by a top-down drive for efficiency across the public sector.

Getting this right will be vital given the importance of the tax system as a piece of core government infrastructure.

The IRD's efficiency targets mean the core baseline will reduce by **$18m** over the next three years.

Upcoming deliverables



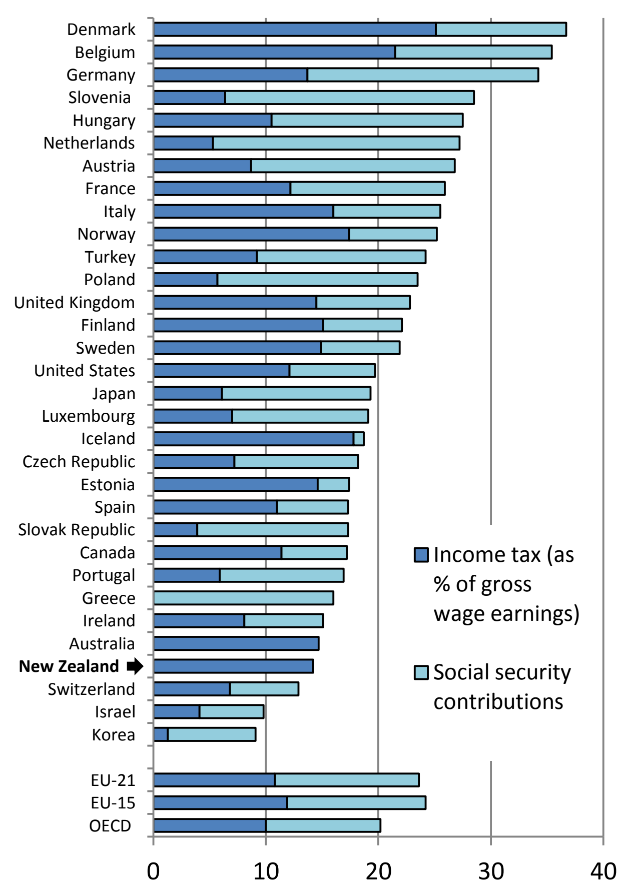
Equity Considerations

Efficiency gains from tax changes must be weighed against the **equity outcomes** from changing the tax mix

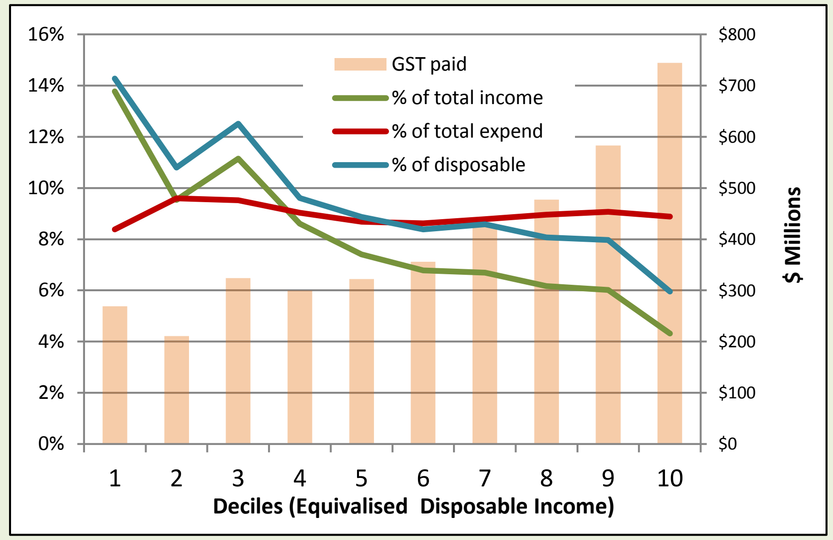
Under Treasury's Living Standards Framework, the way living standards are distributed across society is emphasised.

Any tax or social policy change can alter the burden of tax and effective marginal tax rates borne by different groups, which has labour supply implications. These and other equity issues must be taken into consideration when developing policy.

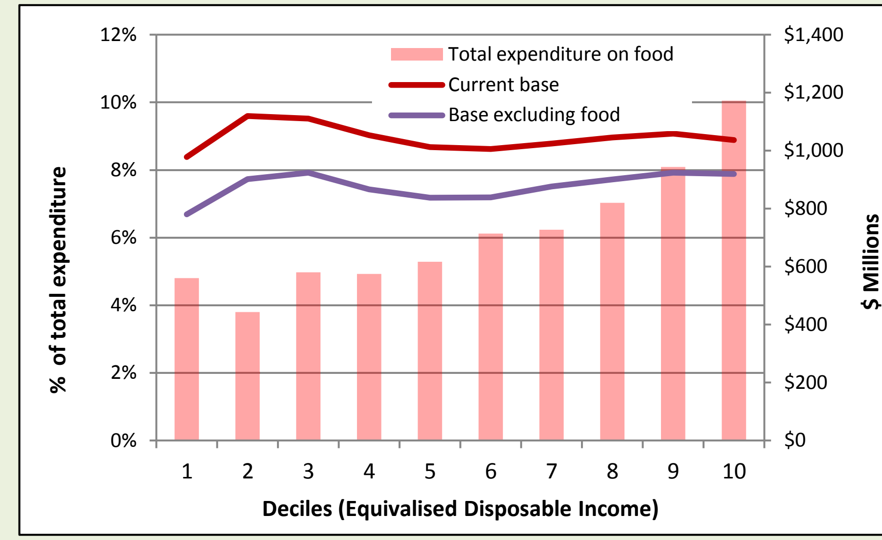
Average tax paid by an individual earning 67% of the average wage



Source: OECD



Source: Tax Working Group



Source: Tax Working Group

GST

The TWG noted that removing GST from food does not materially affect the distribution of the GST burden and results in a 20% drop in GST revenue.

There are more effective ways to alter the distribution of the tax burden than exempting some products from GST.

Income tax

Although New Zealand has no tax free zone, nor do earners pay social security contributions. Once these are included, New Zealand has the 4th lowest income tax burden in the OECD for a low-income worker (defined as 67% of the average gross wage in 2010, $31,779).

The effect of Working for Families is to make the tax system much more redistributive to families. New Zealand is the only OECD country where a married couple with one average earner and children pays no net income tax.

Next Steps

Key upcoming vehicles for making/signalling changes in the tax policy space:

Inland Revenue's Four Year Budget Plan — JAN
31 January 2012

The review of the taxation of savings & investment — EARLY 2012
Full report likely in early 2012

Decision to reinstate lapsed tax bills — FEB-MAR
February and March 2012

Detailed report on Transform IR — JUNE
To Ministers around June 2012

Development of the tax policy work programme and Revenue Strategy — 2012
Early 2012