Hon Dr Michael Cullen

Deputy Prime Minister, Minister of Finance, Minister of Revenue, Leader of the House

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Speech Notes

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Address to Auckland Branch of ICANZ

You have given me a fairly broad mandate to talk to you on whatever I think might interest a group like yours. I have taken the liberty of defining what I think a group of corporate Chief Financial Officers would be interested in from a professional point of view. The three areas I have listed are the immediate outlook for the economy, and what that means for the business conditions your companies face; the financial environment that you are having to adjust to, and in particular your responses to interest and exchange rate trends; and what might be happening with tax.

If we look back to the March 2003 year, all of the economic indicators are remarkably strong. GDP grew by 0.6 per cent in the March quarter, leaving annual average growth at 4.3 per cent for the March year. Construction has continued to drive a lot of the growth.

The economic outlook built into the budget envisaged us hitting a soft spot in the middle of the year as dry conditions, SARS and uncertainties over electricity supply impacted on farm production, tourism, export education and process industries that use a lot of electricity. I stress that these pressures were assessed as temporary, and the best guess was that they would cause the economy to soften rather than stagnate. As events have unfolded, these negative pressures have eased, and the latest advice I have from the Treasury is that they remain comfortable with the budget scenario of growth slowing to a bit over 2 per cent in the March 2004 year.

That picture is consistent with last week's National Bank Business Outlook. I am always cautious about confidence surveys. I suspect that they reflect a view through the rear vision mirror rather describe the road ahead as it appears through the front windscreen, and of course confidence indices are massively more volatile than real economic indicators ever turn out to be. We also have the problem of reconciling the almost inevitable divergence between what businesses report as their assessment of future conditions for the economy as a whole and what they see for their own activity.

Those reservations aside, the bank itself interprets the level of confidence as indicative of growth of about 2 per cent: a forecast that is in line with budget and post-budget assessments.

I do not take this as a negative. One lesson we have to learn from the exuberances of the eighties and nineties is that the business cycle is not dead. If our economy slows, it is slowing after a long and strong expansion in terms of our recent history. It is slowing with unemployment at relatively low levels, and with the base level of activity generating strong cash flows pretty much across the board. From a fiscal point of view, that growth rate is consistent with an operating surplus of $3.8 billion and with Crown debt falling in both nominal and real terms.

While it may be slowing, the softness is caused by temporary rather than structural impacts, so the outlook is for an improvement, rather than further softness.

We must always remember that averages mislead. Concealed within the aggregate numbers are big differences between the sectors, and these differences are again largely consistent as between budget outlook and National Bank confidence numbers.

It is this divergence between the activity rates of different sectors that is exercising the mind of Reserve Bank Governor Alan Bollard, and I have no intention of making any comment on how he might play the hand he has been dealt.

I will, though, make some general comments about the exchange rate. This is not new, but it is worth repeating.

Our dollar is a microscopic element in the global financial system. It is not so much what we have done in relation to the US dollar but what the greenback has done in relation to the rest of the world, of which we are but a tiny part. Important as the exchange rate may be, we are global price takers not price makers. There is a big question mark about how strongly our relative interest rate will impact on the US-Kiwi cross, so there is not a simple relationship and nor are there predictable effects from pulling particular levers.

I also think it is worth repeating the results of the recent Westpac study that tried to isolate the main drivers of the Aussie-Kiwi cross. According to that study, the variations in our exchange rates were explained by differences in relative country performance on productivity, inflation, commodity prices and savings, not by interest rate differentials or speculative financial flows.

If – and I always have to put a big "if" in front of drawing conclusions from selected economic models – the Kiwi is rising because we are lifting our game on the productivity front, because inflation is under control here, and because our commodity prices are relatively robust, that should not in itself be a worry. New Zealand producers remain competitive.

We should also perhaps keep an eye on what is happening in Japan and in the USA. I am very interested in commentaries coming out of those economies that are now starting to worry that low interest rates – in effect interest rates that are hovering around zero – do not seem to be stimulating investment. They are

helping to hold up consumer demand, and have kept housing markets buoyant, but when it comes to industrial investment it is a bit like pushing on a piece of string.

One speculation I have seen is that the massive expansion of global manufacturing capacity during the last quarter of the last century has made investors wary of greenfields investment.

If that is so, we need to focus on where our opportunities for investment might lie, rather than being fixated with the cost of investment funds. It is no use having cheap money if there is nothing constructive that can be done with it. If we look at global capacity, and how New Zealand can grow market share given the composition of that capacity, there is a reasonably good story – or at least an optimistic story - to tell.

The question that arises for us is whether we are entering another age when primary production – admittedly high productivity, knowledge intensive, smart, value-added primary based production – gives countries like us a national advantage.

This advantage can lie in two areas. Because there is global overcapacity in traditional lines of manufacturing: clothing, motor vehicles, electronic goods and so on, investors have to increase the pace of innovation. They have to find new lines of product development, and primary products, in combination with exploding biotechnologies, offer new opportunities for product development across a range of uses from food to fibres to pharmaceuticals.

The second area of advantage emerges from the flip side of industrialisation. The effect of it has been that vast numbers have left subsistence agriculture and moved in to urban based wage employment. They have to be fed and clothed.

Primary products may well be moving away from being the poor relations of manufactured goods to becoming the new scarce resource and the basic ingredient for the next wave of innovation. This is why the government is looking to put some momentum behind the technological, skills, and infrastructural needs of innovation rather than relying on macroeconomic stimuli to solve the growth problem. The short message is that interest rates are not a cure all.

And so to tax, a matter dear to the hearts of all Chief Financial Officers, who seem to have a life mission of outwitting the fiscus

I have to say that like interest rates, tax is not a cure all. If a company has inadequate earnings, increasing what is left of those earnings does not make them adequate. This is why the government puts so much emphasis in trying to build an economic environment that is profit friendly. I fully acknowledge that tax can complicate the business environment, and so I have put a lot of store by continuing to make the tax rules clear, clean and comprehensive.

You will see some progress on that front over the next few months.

A taxation bill that is before Parliament will bring into effect New Zealand's part in a landmark agreement with Australia to relieve a longstanding problem of the double taxation of certain trans-Tasman investments. The joint initiative reflects the commitment of both governments to the continued strengthening of the Closer Economic Relations agreement and promoting trans-Tasman business by reducing the tax impediments to operating in both countries.

Under the agreement, the imputation systems of both countries are being expanded to include companies resident in the other country that want to take part. New Zealand's bill makes it possible for Australian companies to join New Zealand's imputation credit rules. Similar legislation has been enacted in Australia.

The same bill better aligns the GST treatment of the financial services sector with that of other industries. Financial institutions will be allowed to recover GST on purchases related to the supply of their services to businesses, which will reduce over-taxation of the sector. This is a major change that has been welcomed by the financial services sector.

Another important reform in the bill is the introduction of a GST reverse charge to tax certain imports of services. The measure is designed to ensure that GST does not unfairly disadvantage New Zealand interests at a time when we are making increased use of electronic commerce and importing many more services than we did in the past.

The government perseveres in its commitment to simplify tax and reduce tax compliance costs, and work continues apace.

A number of simplification measures aimed at business have been enacted so far. Perhaps one of the most significant changes, from the perspective of the people here today, was the enactment a couple of years ago of legislation to clarify and simplify the general interest deductibility rules for most companies.

Although almost all interest incurred was deductible under the previous law, the rules that companies were required to work with were complex, and companies sometimes had to structure their affairs to fit within the rules. This could create significant compliance costs.

The new law ensures that interest on borrowing is deductible for most companies without requiring them to overcome these technical hurdles.

The government's tax simplification focus is now on small to medium-sized businesses, which form a more significant component of the economy than they do in other OECD countries.

They are important in numbers and in their tax contribution. In New Zealand, businesses with fewer than twenty employees make up 97 per cent of all companies, employ 43% of all workers, and produce 39 per cent of all goods and

services. Meeting tax obligations can take up disproportionate time and effort for a small business.

A government discussion document setting out further proposals for reducing the time and effort required of small businesses will be released in a few weeks' time. It will contain a number of proposals to make tax matters easier for them.

They include proposals for the government to cover part of the costs involved in businesses making use of payroll agencies to help with PAYE, and aligning the payment dates for provisional tax and GST. The government is aware that what suits one business may not suit another, and what suits small businesses may not suit large businesses, so we will be consulting extensively on the proposals.

Also to be released later in the year is a discussion document setting out proposals for simplifying fringe benefit tax, reducing the associated compliance costs and improving its effectiveness. This is the first major review of the fringe benefit tax rules since they were introduced in 1985. The focus of the discussion document will be on reducing the difficulty and cost to employers of complying with fringe benefit tax and removing anomalies, while ensuring that the revenue base is maintained.

I shall now turn briefly to an issue that has been attracting media attention. It concerns investment products aimed at New Zealand investors that claim virtually to remove any tax being paid on the resulting income.

As I understand it, the arrangement works something like this. A New Zealand resident purchases units in an Australian unit trust, and the unit trust uses those funds to buy – for example – New Zealand Government bonds. Interest from the bonds is paid to the Australian unit trust, with only a 2% levy deducted. Because Australia, unlike New Zealand, taxes the entity as a trust, rather than as a company, the interest is not taxed in Australia under Australian tax rules because it is not sourced in Australia and does not relate to an Australian beneficiary.

The unit trust distributes its income by way of non-taxable bonus issues so that the New Zealand investor ends up with more units. Given the way New Zealand and Australian tax law inter-relates, no New Zealand or Australian tax is payable at this stage.

Gains that New Zealand residents derive from the eventual sale of their units may, however, be taxable, depending on whether the investment was held on capital or revenue account. The answer to this question will vary depending on the specific facts and, in particular, on the purpose for which the investor acquired the original investment. I am not a tax expert but it seems to me to be a mighty effort to argue that shares or units with no realistic dividend yield were purchased otherwise than for the purpose of sale. That would make all the gains taxable. I note that a few tax experts have also raised this warning.

Regardless of the intricacies of the capital versus revenue law, the main point is that New Zealanders *may* be able to derive interest from New Zealand

Government bonds virtually tax-free if they invest through one of these Australian unit trust structures. An identical investment through a New Zealand vehicle would be clearly subject to New Zealand tax. From the Government's perspective this is unacceptable and, if necessary, we will change the law to ensure that this option is not available.

As a first step, October will see the release for consultation of an issues paper that will raise options to deal with this problem and other issues that arise under the foreign investment fund rules. One of the options canvassed will be a version of the McLeod Review's risk-free rate of return method.

The lesson of the last forty years is that loopholes are not in anybody's interest. They distort the flow of funds and to the extent that they are effective in eroding the tax base they simply increase the pressure on the tax rate in other parts of the system.

My message overall is that we are making steady progress on a number of fronts. In an era of intense global economic instability and uncertainty, New Zealand is performing very well. We cannot take continued progress for granted, and we need to work on that, but by the same token we must avoid our natural propensity to always find dark cloud inside the silver lining.

Thank you.