Hon Dr Michael Cullen

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Speech Notes

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One of the central tensions in setting and administering fiscal policy is the need both to create certainty and stability and yet to respond to changing conditions, in particular changing economic conditions. If we imagine the taxation and spending policies of government as a large (some might say vast) algorithm, the objective is to reduce the number of variables and simplify the relationships between them so as to provide sufficient certainty for businesses and individuals and those who advise them to plan for the future with the minimum quantum of policy-related risk.

While that may seem like a tall order, it is something I believe we have achieved in large part. The major uncertainties on the horizon relate to the New Zealand economy, and in turn the global economy. As a government, we have set and maintained a clear fiscal approach. And we are engaged in a programme of tax policy work which we are happy to signal in advance, so that those likely to be affected can be informed and involved.

I want to address each of these in turn.

The Government's long-term fiscal objectives and short-term fiscal intentions are clearly set out in the 2004 budget policy statement. The general fiscal approach is to run operating surpluses on average across the cycle sufficient to meet NZ Superannuation Fund contributions, while meeting capital pressures and priorities, and managing debt at prudent levels.

In terms of core Crown revenue and expenses, that will require:

- Maintaining tax-to-GDP around current levels;
- Core Crown expenses (plus the net payment to the NZS Fund) averaging around 35 percent of GDP over the forty year horizon used to calculate NZS Fund contributions;
- Maintaining a robust, broad-based tax system that raises revenue in a fair and efficient way; and
- State Owned Enterprises and Crown entities contributing to surpluses, consistent with their enabling legislation and Government policy.

Over time this approach will increase the Crown's net worth consistent with the operating balance objective. There will be a focus on quality investment in assets needed to support government functions.

Within this framework, we have determined as a priority for the next Budget a family assistance package aimed at increasing the incomes of low to middle income New Zealanders and assisting the transition from welfare to employment. Alongside our investment in education and health care, this package will support our aim of an inclusive economy based on a skilled workforce.

These expenditure plans take account of the outlook for the New Zealand economy. As we know, New Zealand has been bucking the global trend in the last three years:

- Our GDP growth rate was 3.9 percent over the year ended September, which was considerably faster than in the United States, the UK, Europe, Japan or Australia.

- Steady economic growth has brought jobs. The unemployment rate has fallen from a peak of 7.7 percent in 1998 to 4.6 percent in December 2003, in spite of rapid working-age population growth.

- Government debt, at 28 percent of GDP, is the lowest it has been since the mid 1970s.

- Short-term interest rates are low compared to the historical average, although higher than global rates. The Reserve Bank has not reduced interest rates by as much as central banks in other countries because of the strong domestic demand growth New Zealand has experienced. Most recently, the Reserve Bank actually increased the official short-term interest rate by 25 points, to ensure that the inflation rate remains stable and low over the medium term.

The concern, however, is the imbalance between the domestic and external economies. Consumer and business spending, and investment in housing in particular, have grown strongly and are expected to remain strong in the short term. But while export volumes have increased steadily over the last year, and export incomes remain high compared to the historical average, the rising exchange rate and falling international prices for some commodities led to a reduction in nominal export earnings by 6.4 percent over the year to September.

The New Zealand dollar has rightly come in for a lot of attention. Standing back and seeing the bigger picture, we should note that it underwent a protracted decline between 1997 and 2000, and therefore a significant appreciation against the currencies of our major trading partners was inevitable given the stronger than average performance of our economy.

Even so, as I have said on several occasions recently, I believe the New Zealand dollar is currently over-valued given the strength of the New Zealand economy relative to our major trading partners, especially Australia, and given the rising current account deficit. This is my judgement, based on the facts of the case. Unfortunately, the money markets beg to differ and are valuing the currency accordingly.

My major concern is that a continued high dollar may lead to lasting damage to our export sector by discouraging investment in future capacity. We do not want a situation where our ability to take advantage of a global upturn and a lower dollar is impaired.

By mid 2004 the impact of declining export incomes should be felt more widely than just the export sector. Currency hedges will have worn off by then, and exporters are likely to cut back their domestic spending. Also a lower number of immigrants is expected to reduce economic growth.

It is important to note that the growth rate is not expected to slow much. Growth is forecast to “bottom out” at 2 ½ percent over the next year or so. By 2005/06, it is predicted to return to an average of 3-3½ percent per annum, thanks to a recovering global economy, and some assumed exchange rate depreciation, which will revive export earnings.

Along with the slower rate of GDP growth, the rate of job creation will ease. Nevertheless, employment growth will still be above zero, and the unemployment rate is expected to remain in the 4½-5 percent range.

What we should see is that our strong “economic fundamentals” and flexible economy allow us to adjust to a changing international environment and fluctuating prices without getting caught in a large economic cycle.

To turn to the detail of tax and revenue matters, I am pleased to announce that the government’s tax policy work programme has been updated, and I am releasing it this morning for public information.

The tax policy work programme is a fundamental part of the government’s generic tax policy process. Its publication ensures that tax professionals, businesses and other interested taxpayers are informed about what is likely to emerge in tax policy over the coming months.

I say “what is likely to emerge” because the work programme cannot be set in stone, of course. Priorities change over time, and new issues emerge that sometime demand attention sooner than others. And, for obvious reasons, measures designed to protect the revenue base cannot always be announced ahead of time.

The latest work programme is an update of the one announced in October 2002 and covers the period to December next year. The two main areas of the previous work programme were tax measures to support the government’s Growth and Innovation Framework, and social cohesion. These priorities were supported by some base maintenance and a number of other matters.

The updated work programme continues with the two main themes as priorities but gives more emphasis to revenue base maintenance. Extra resources have been allocated in both the policy and operational areas of Inland Revenue for base maintenance. That is because maintaining the tax base, by ensuring that all pay their fair share of tax, is essential to the government's achieving its broader economic and social objectives.

New matters on the work programme include the taxation of venture capital, depreciation issues and increased emphasis on social assistance.

As a whole, the work programme includes issues that are important to both the government and to you, the private sector.

Tax-related growth and innovation measures are those that will aid good business outcomes. They include reducing the extent to which tax is a barrier to New Zealanders doing business with the rest of the world, and simplifying the tax system.

In the international arena, late last year the government published a discussion document setting out proposals aimed at reducing tax barriers to overseas recruitment, designed to benefit New Zealand businesses that recruit overseas. As you may know, the idea is to introduce a temporary exemption from New Zealand income tax on overseas income of people who come here to work as employees, whether they are foreigners or expatriates who have been non-resident for tax purposes for ten years.

I had hoped that it would be possible to include the proposal into the first taxation bill of the year, but submissions on the proposal as set out in the discussion document indicated that more policy development is needed – for example, on whether the proposal should be extended beyond employees. For this reason, legislation will be postponed until later in the year.

Extending and maintaining New Zealand's network of double tax agreements with other countries remains a priority. We currently have 27 such agreements, which are designed to reduce tax impediments to cross-border trade and investment.

This year will see significant progress. Our double tax agreement with South Africa is close to conclusion: all that remains to be done for the agreement to take effect is for a New Zealand Order in Council to be made, and I expect that to occur within the next few months.

At the same time, we will be giving legal effect in New Zealand to our double tax agreements with Chile, our first with a Latin American country, and with the United Arab Emirates, our first with a Middle Eastern jurisdiction. Protocols to agreements with the Netherlands, United Kingdom and Philippines are also expected to be updated in the same group of Orders in Council. We will also begin negotiations this year with Austria, and are exploring the possibility of doing so with one or two other countries.

I now turn to the vexed issue of the taxation of offshore portfolio investment. As you will no doubt be aware, my officials released an issues paper at the end of last year outlining two options to reform the tax rules in this area. One was the standard return approach – based broadly on the Tax Review's risk-free rate of return method. The other was the offshore portfolio investment rules – essentially, a modified version of the current foreign investment fund rules. Under both options, the so-called "grey list" would be removed.

It is fair to say that the proposals have generated significant interest and, among some commentators, a little concern. This is not surprising – there are no easy answers in this area.

As an experienced politician, I should not have been surprised at some comments made that this is a devious attempt to introduce a capital gains tax or an across-the- board wealth tax.

Let me assure you that I have no such agenda. My position is very simple. I cannot see sense in rules that, for example, tax an individual on accrued capital gains on investments in most countries of the world but impose almost no tax on such investments in a few selected countries – and, as a result, expose the tax base to Australian unit trust-type structures. I cannot see any sense in that.

Nor can I see sense in rules that penalise investors using savings intermediaries, especially if the funds are actively managed and based in New Zealand rather than offshore.

The issues paper raised options to try to bring a little more sense to this area. That is my objective. The options set out in the issues paper are not perfect. On the other hand, current rules seem to me to be far from perfect. If there are better options please raise them. But remember that viable options must continue to raise tax revenue and must not penalise investment in our own country.

With your help I think we can have a process to work through these issues.

Officials continue to receive submissions on the proposals and will report to me once these have been considered. I hope then to be in a position to make a final decision on the direction for reform.

Meanwhile, as signalled in the issues paper, the savings industry is keen to consider whether a version of the risk-free rate of return method could be developed to tax the investments of domestic savings entities. Such an approach is worth exploring because it has the potential to provide improved consistency to the taxation of savings.

There are a number of very complex issues that would need to be addressed before this approach could be implemented. I would like to work closely with industry representatives in the coming year to see if these issues can be addressed and an appropriate solution developed.

This work has a greater chance of success if the taxation of offshore investment is considered along with domestic investment. This inevitably means that any offshore solution cannot be applied from the 2005-06 year.

I am prepared to accept this delay on the basis that an interim solution is enacted to deal with the Australian unit trust issue. I am advised that a significant and growing amount of investment is now flowing into these structures, giving rise to a serious base maintenance concern. If officials can develop an interim solution to plug this leak, the government will be recommending it for enactment as soon as practicable.

The use of a risk-free rate of return method to tax the investments of domestic savings entities also provides an opportunity to consider approaches to removing some of the disincentives to invest in retirement savings vehicles such as superannuation funds. By taxing the investor under a risk-free rate of return method, it is possible to tax that income at the marginal tax rate of the investor, thereby removing the current over-taxation or under-taxation of members of superannuation funds. That has appeal but is, of course, dependent on where we get to on the wider issue of the viability of the risk-free rate of return method generally.

I am also keen to develop policy options that would increase work-based retirement savings schemes. The Periodic Report Group, in its December report, noted that there was value in promoting greater use of work-based savings schemes as a way for new Zealanders to save for retirement – the reasons being that as such schemes provide deduction at source, economies of scale and an avenue to reach a high proportion of the population. The report group recommended that the government establish a work-based savings group to develop an agreed approach to promote work-based savings. This recommendation has merit and I am in the process of developing terms of reference for a group to be established to look at the design of a work-based savings product. It is my intention to announce the membership of this group and its terms of reference before this year's budget.

The whole issue of saving for retirement – and New Zealand's lack of it – has been a long-standing concern of mine. Some progress has been made in areas such as the superannuation fund. The Saving New Zealand forum last year provided a platform to move forward.

One of the main areas of reform under the growth and innovation banner is the proposal to remove tax barriers to international venture capital. The proposal attempts to increase international venture capital by providing a tax exemption for the venture capital profits that certain non-residents derive from New Zealand.

My officials have now consulted on this broad proposal with interested parties from the private sector – including the venture capital industry. As a result of the very useful feedback gained during consultation, the package has been enhanced in a number of areas. One of the more significant of these improvements is widening the scope of "eligible investor" to include certain "foreign funds of funds".

The venture capital changes will be included in the next taxation bill and will apply from 1 April 2004.

The government is also undertaking work in relation to capital investment in New Zealand, specifically to identify whether there is a problem with capital adequacy. This work will look at the drivers of New Zealand capital investment and identify specific problem areas and their policy implications. The impact of the tax system, particularly the depreciation rules, on the cost of capital and whether there are any tax policy options to address cost of capital issues will be considered as part of that work.

Although this wider work is important in terms of identifying potential obstacles to capital investment, the government is also looking at the tax depreciation rules more generally, to see whether there are further enhancements that can be made. As part of that work, in the near future officials will be releasing an issues paper outlining potential enhancements. The issues paper will also provide an opportunity for further public consultation on a number of concerns about the tax depreciation rules that have been brought to the government's and officials' attention.

The government is also working through the recommendations of the Private Sector Liaison Group on Research and Development. A number of the recommendations have implications for the tax depreciation rules, as they deal with capital expenditure that cannot be depreciated – so called "black hole" expenditure. As a starting point, the government has agreed to allow deductibility for costs associated with patent and resource management consent applications that are not granted or are withdrawn. This change will be included in the next taxation bill. The issue of how to deal with "black hole" expenditure, generally, is more complex and the government hopes that officials and the liaison group can work together to find appropriate solutions.

The closing date for submissions on the recent discussion document setting out proposals for streamlining the taxation of fringe benefits is near. There has been a lot of interest in the proposals and – in particular – on those related to car parks, reduced rates for motor vehicles, and raising the de minimis thresholds. Officials are working through the details of submissions received so far. I look forward to discussing the suggestions made in the submissions with officials in the near future. Our aim remains to achieve a workable package that is fairer and easier for businesses to apply.

Plans are for two taxation bills to be introduced this year. The early one, planned for late March or early April, would include – for example, the masthead issue, changes arising from the review of tax dispute resolution procedures, and simplification measures, in addition to matters I indicated earlier.

The later bill, perhaps in November, could include issues such as changes to fringe benefit tax amendments, reform of legal professional privilege and simplification measures resulting from the discussion document "Making tax easier for small businesses".

The bill bringing into being the new Charities Commission is expected to be introduced into Parliament this month. The commission will oversee the registration of charities that seek tax-exempt status, which will introduce greater accountability and transparency into the process.

Finally, the bill that rewrites the first five parts of the Income Tax Act is expected to be passed on 8 April this year, which will be a milestone for the project, which began back in the early 1990s.

To turn briefly to the floods that ravaged parts of the lower North Island last month, the government is aware that their economic effect will have to be accounted for – both in the short and medium terms. A very preliminary estimate of the damage across the dairy, sheep, beef, deer, crops and forestry sectors is up to $180 million, a figure that may increase.

The response to flood victims across government departments has been significant. Departments have been working together to provide a co-ordinated service that deals with matters ranging from income support, housing and health issues, through to child support and tax–related issues.

Operationally, Inland Revenue has been at the front line in places like Bulls and Marton, and doing great work. Inland Revenue's policy people have been working alongside the Ministry of Agriculture and Fisheries and the Institute of Chartered Accountants, and they will be advising the government on any areas of the law that may not adequately accommodate the extreme circumstances of the situation.

I would like to conclude today by thanking you – the individuals and the organisations you may represent – for your repeated efforts in responding to calls for consultation on proposed tax policy – whether it is a matter of proposals set out in a government discussion document, proposed tax legislation that is before a select committee, or informal requests from policy officials for your views on specific issues.

I am aware that this consultation takes a lot of time and resources on your part, as it does on the government's part. However, your contributions are an essential part of the development of good tax policy and law, and they are valued.

I wish you a very successful conference. Thank you.