Towards a more Nordic tax system for New Zealand:

Taxing capital income at a lower rate than labour income, to help close the productivity gap

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My proposition today is that income earned on capital (profits, rent, interest, dividends) should be taxed at a substantially lower rate than labour income - that New Zealand should depart from the comprehensive income tax system that has, more or less, guided thinking here since the late 1980s.

This isn't a partisan or ideological claim, nor an argument grounded in some abstract sense of "justice". At a conceptual level it is really quite uncontroversial. It is decades, if ever, since the comprehensive approach dominated the textbooks - 35 years, for example, since Atkinson and Stiglitz showed that under certain restrictive conditions, capital income should optimally be taxed at a zero rate. In a recent paper, Piketty and Saez (no right wing extremists) note simply that "according to the profession's most popular theoretical models, tax rates on capital should be equal to zero in the long-run - including from the viewpoint of those individuals and dynasties who own no capital at all". They go on to further refine and limit that proposition, but still conclude that capital income should be taxed more lightly than labour income. Just this week, the Democrat-supporting economics blogger on Slate, Matthew Yglesias, made exactly that case under the provocative headline "Why Mitt Romney's effective tax rate is so low and why it probably should be".

It isn't a matter of partisan ideology, but of what works - what makes for the highest possible material living standards for the economy as a whole.

And here in New Zealand we need to worry about that. I don't have many slides today. This is the starkest of them.

Figure 1: Gdp per hour worked: NZ vs OECD grouping

It shows just how far labour productivity (real GDP per hour worked) has slipped in New Zealand relative to the average for the group of advanced countries for whom the data were readily available. The NZ data for the early years are probably not to be relied on too heavily but the basic picture is clear - we have fallen along way, and the fall has not stopped in the last 20 years; slowed, but certainly shown no signs of stopping. We need to turn it around - and we need to do so quickly.

[1] Views expressed here are those of the author and should in no way be ascribed to, or associated with, any organisation I may now be, or in the past have been, employed by, including (but not limited to) the Reserve Bank of New Zealand.

Lots of things make for growth. Labour inputs are one of them. By OECD standards we have a high labour force participation rate and hours worked per capita are high. And if one uses tertiary qualifications as a crude proxy for human capital, New Zealand also now scores highly - so highly that the OECD estimates suggests that returns to tertiary education are now among the lowest in the OECD. No doubt things can always be done better, but to a first approximation, New Zealand doesn't really have a labour issue. In other contexts, I will argue that we probably have too much of it.

General microeconomic regulatory policies also play a part. New Zealand's aren't perfect by any means, but on most external assessments they really look pretty good. Early last year, a group of OECD researchers published a cross-country study looking at the effects of a range of micro policies (product market regulation, openness etc). They concluded that on the same model that explained reasonably well how each OECD country scored on GDP per capita relative to the OECD average, our policies should have been consistent with incomes here above those of the OECD average. We, Australia, and the USA scored best. We should have been 20% above average; in fact we are 20 per cent below.

There are probably quite a few advocates here of the importance of size and distance effects. No doubt, they are a part of the NZ story (and Australia's) but if, say, NZ was seemed doomed to relative decline, I think we might have expected to see a couple of a decades of current account surpluses (national savings exceeding domestic investment) rather than continued large current account deficits. And very low interest rates rather than surprisingly high ones. But some of those issues are for another series of debates.

I have stepped through this analysis to help establish the point that what New Zealand lacks isn't labour, it isn't a reasonably good policy backdrop, but it is investment and the associated sense of entrepreneurial opportunities. When people have done growth accounting exercises for New Zealand, they typically find that the amount of capital per worker is quite low, and that total factor productivity (TFP) also falls short. In a well-governed market economy, without too many egregious distortions or subsidies, the two are probably connected - successful firms driving the economy forward are likely to be investing more, and physical investment is one of the key ways in which firms are also able to reach the TFP frontier. This isn't some sort of "lump of capital" model - investment is good and so more investment is better. We tried that - with Think Big. The Chinese are trying it now. But successful fast-growing firms in a high-performing economy are likely to be undertaking more investment. And they will need to - the cost of labour will be rising, and firms need the continuous productivity gains if they are to remain able to pay their employees the market-clearing price.

Investment as a share of GDP is pretty much around OECD averages in New Zealand. But remember that NZ is a poor OECD country.

Figure 2: Real $ non-residential investment per worker

An economy on the path to closing the income and productivity gaps would be likely to see more investment (especially one, like NZ, with relatively rapid population growth). As Figure 2, drawn from a recent OECD Survey on NZ, shows real investment per worker lags well behind that in most OECD countries. (this chart excludes residential investment, but contrary to many reports, that doesn't really change the picture).

But this is a debate about tax, and my time is short.

Simply put, New Zealand should be taxing capital income much more lightly because we need more entrepreneurial activity, and investment, as part of a process that we finally see us realise our potential - closing the gaps. We probably need more savings too - investment needs to be financed, and most would get a little queasy at the prospect of New Zealand running an even larger negative net international investment position for too long. That isn't a dogmatic position: a rising NIIP position resting on firm foundations of rapid sustainable growth is a quite different proposition from one fuelled by, say, large fiscal deficits or a domestic property boom.

At present, we lean in the opposite direction. The data are less than ideal, but such as they are it appears that we are more reliant than most on taxation on capital income, despite not having an unduly large amount of capital. New Zealand is the only OECD country not to have any material social security taxes – such taxes hit labour income, but not capital income, and are often very substantial in other countries. And our move in 1988/89 from an EET to a TTE system for the taxation of life insurance and retirement savings, while subsequently softened a little (PIE and Kiwisaver), means that we tax income derived from these forms of savings more heavily (relative to other forms of income) than other OECD countries do. Perhaps it matters economically less than some other distortions, but the interaction between inflation and the tax system means we tax fixed income returns particularly heavily - as Andrew Coleman has noted, the poor pensioner with $25000 in the bank can face a higher effective tax rate on her real income than a million dollar a year CEO. Even our 28 per cent company tax rate is not low by international standards, and our broad base and limited number of exemptions means the effective tax rate is higher than it looks (relative to those in other countries). Curiously, the tax reforms of 2010 actually **raised** the overall average tax rate on capital income. Of course, on the other hand we don't have a capital gains tax - we should give thanks for small mercies.

And this is where something like a Nordic model comes in. From my reading, the Nordic countries wanted to do three things. They wanted to keep a progressive tax system, they wanted a large state (higher total government spending as a share of GDP), and they wanted to ensure they provided a climate in which capital continued to be accumulated in, and invested in their countries. They wanted, in other words, to grow strongly, recognising that capital is mobile, and that business investment and entrepreneurship are quite sensitive to expected after-tax returns.

So, stylised, what the Nordics did was to say, lets tax capital income at a low flat rate (perhaps the lowest marginal tax rate on labour) and then keep a quite progressive labour income tax rate. In the Norwegian case, for example, the capital tax rate is half the maximum labour tax rate.

Of course, it is harder to care about these issues if one has a very small government, or thinks one should have a very small government. In that case, low tax rates all round will provide the minimum distortion to investment, labour and consumption choices. Views will differ about the appropriate size of government. It is fair to say, however, that in the literature there is a lot more debate about the potential damage from a large size of government (crudely measured, as say total tax or spending to GDP) than there is about the distortionary effects of taxes on capital income. In advocating that New Zealand move to something like a Nordic system, I am not taking a strong view on size of government per se: if size of government remains relatively large then shifting the focus of our tax system offers a way to jump start medium-term growth. If, eventually the consensus of political and public opinion shifted in favour of much smaller government, there would probably be some additional growth and income benefits. But in the next 10-20 years, with mounting pressures on government spending, it is difficult to envisage us getting to a point where government is so small that we could be relaxed about treating capital and labour income the same for tax purposes (where administrative simplicity considerations outweighed potential growth and allocative efficiency gains). [In principle, there is no reason why capital income taxes could not also be progressive, but on a lower rate schedule than that for labour income - but no one has actually done so]. A Nordic tax system is about keeping to a minimum the inevitable damage to growth from big government - perhaps a reason why some on the right wing have been reluctant to embrace it.

[I don't have time to go much into the question of why not simply go the Irish route - a much lower company tax rate. The essence of the economic arguments for that system is similar to the Nordic one: investment is sensitive to expected after-tax returns]

A Nordic tax system, done seriously, would mean giving up considerable capital tax revenue. For the sake of argument, and if pushed my serious recommendation would be for a capital tax rate of 15 per cent (I'm not needing then to resolve the debate between the simple models of zero tax on capital income and the refinements that suggest some positive rates). That has to be paid for. There is no point pretending that there are free lunches on offer. Quite how it is paid for is not my concern here. Spending/GDP is much higher than it was even in the middle of last decade - but then we have a fiscal deficit to close already. We need to be prepared to think of terms of paying for reduced capital taxes, through some combination of higher taxes on consumption and labour income. Although it might not raise much revenue, and is not my focus here, I think we should be open to favouring an inheritance tax over the taxation of lifetime capital income.

In discussions on this issue over the last several years, a variety of objections have been advanced. They fall under three/four broad headings, two of which could be caricatured as "NZ is different" - a line I find as compelling here as "this time is different" typically is in financial markets

- Labour mobility and responsiveness
- Foreign investors/location specific rents
- Administrative simplicity
- Savings won't respond to tax
- And a focus on who writes the cheques rather than economic incidence

To elaborate:

Some have argued that while the zero/low capital income tax might make good sense in a closed economy, New Zealand is in fact an open economy. And open in a particular way: the claim is made the NZ labour force is more than usually mobile (the TWG report for example asserted this).

Evidence in support of this claim is the high number of NZ born and educated people now living overseas, and the high number of foreign born people living abroad. If labour were as responsive to taxes as capital is, the argument for a dual tax system would be materially weakened. But, in fact, no one has yet produced any evidence that labour flows into and out of NZ, **at the margin**, are more responsive to changes in income (or consumption) tax rates than such flows are in other countries (the large stocks of NZers abroad and foreigners here probably tells mostly of (a) our immigration policy, and (b) NZers' responses to overall living standards, here and abroad. More generally, even if NZ labour were to be more responsive to personal tax rates, the prices tell the story: wage differentials across countries far exceed differences in interest rates and cost of capital across countries. Capital is simply much more mobile than labour.

It has also been argued that much lower capital (or company) taxes are a bad idea for New Zealand because of our starting point: our existing reliance on foreign capital. First, much of the foreign capital is debt - on which we already levy little or no tax, because we know we'd be paying it, not the owners of the capital. Second, it is argued that lower company/capital tax rates will largely represent a gift to foreign tax systems. There is some truth in this, although only at the point where the profits in New Zealand are paid as dividends (which is when the profits of foreign-owned NZ subsidiaries are typically taxed abroad). Finally, it has also been argued that capital income taxes on foreign investors are a way of capturing the value of location specific rents for New Zealand. I have never been convinced by this argument – largely because the evidence for such rents being material is elusive at best. To the extent that they arise out of natural resources, the appropriate point to capture rents, whether from NZ or foreign operators, is through royalties or other usage fees.

This is also an issue where static vs dynamic issues arise. According to the IIP data, total equity investment in NZ is around $67 billion - possibly higher at market values, but at least on those numbers only around one third of annual GDP, and a much smaller proportion [a tenth?] of the capital stock. Economic transformation of New Zealand is likely to involve significantly higher levels of investment.

Critics of a dual approach for NZ, and some modelling results, tend to implicitly assume that the people who write the tax cheques are those who bear the economic burden of those taxes. It is a common myth, and also one that Stage I economics told us was wrong. Just as costs to employers of payroll taxes or Kiwisaver levies will, in the medium-term, almost wholly be borne by workers (in lower than otherwise wages), so it is likely that a considerable chunk of capital taxes are borne not by the owners of capital, but by wage earners - in the form of lowering investment leading, over time, to wage levels in the economy being lower than otherwise. US studies have suggested that the overwhelming bulk of capital taxes will be borne by workers, even in a relatively more closed economy like that of the US. Shareholders don't seek pre-tax returns, but post-tax ones. Lower the tax rate on capital income, and pre-tax returns will over time tend to fall.

To some extent, the sectors where existing foreign investment is concentrated probably matter. If, for example, most of our foreign investment was in the farm sector, lowering the tax on farmers might provide a pure windfall to foreign investors - given that final product product prices are determined in world markets. But that isn't the New Zealand situation. Only a small share of farmland is foreign-owned at present, and few of our other major tradables producers (indeed Air

NZ and Solid Energy remain largely/wholly state-owned). The biggest single chunk of foreign investment appears to be in the financial sector. Markedly drop the tax rate on capital income and it is hard not to envisage an intensely competitive market, narrowing intermediation spreads and other changes, to the benefit largely of the domestic economy as a whole - while the potential dividends the foreign shareholders will be interested in won't have been materially altered one way or the other.

People who are more expert in the intricacies of these things than I could probably devise clever ways to capture some lump sum value of the tax change in respect of existing capital (especially foreign-owned capital). Given the sectors where the capital is, I wouldn't bother, but these are areas where distributional concerns run hard up against administrative feasibility ones, with little probable implication for future economic performance.

The administrative challenges of a dual rate system are perhaps the most often-cited objection. For large and listed companies, the challenges are not undue - it is relatively easy to distinguish capital from labour income. The issues are more challenging for the self-employed and for closely-held incorporated businesses - of which, of course, there are many in most countries, including New Zealand. For those firms, at least the ones of any size, some sort of rule-based assignment of income is needed: a model used abroad has been to impute a return to capital based on the assets held within the business, and taxed as such, with the rest of the income assigned to labour. No doubt, such an assignment rule could be complemented by some sort of minimum deemed labour income. Such rules will always have an element of arbitrariness to them, and we should not pretend otherwise. Managing and enforcing such boundaries would keep the capable people in IRD busy. We should not multiply artificial boundaries where they are unnecessary - doing so simply increases the costs of maintaining regulatory systems. But equally we should be wary of prioritising administrative simplicity over economic substance, when there are real behavioural differences. Boundary issues exist all over government - it is almost in the nature of the beast. And, given the scale of New Zealand's economic challenges, we should keep in mind the big picture - we want a tax system that does not discourage entrepreneurship and investment.

What would we expect to see from a whole-hearted shift to a dual tax model?

- Greater business entrepreneurship and higher investment (to elaborate)

Sceptics have tended to play down the potential gains in respects of savings. Again, higher savings are not a goal in their own right, but the current tax system bears unduly heavily on them. My impression is that most of the scepticism focuses on household savings. I find it plausible that the response of household savings to a much lower capital tax rate might be quite muted - empirical research tends to suggest as much, difficult as it is to do really compelling studies on the subject. The response might well be muted because for many savings is done with a retirement consumption goal in mind. For those people, the income effect of increased after-tax returns will reduce the need to save out of current income. For others, higher returns to savings will make deferring current consumption more attractive.

Debates about saving, in this country in particular, seem to focus inordinately on household savings. I am fairly persuaded that business saving (as a % of GDP) will increase materially in response to lower capital income tax rates. Much investment tends to be self-funded (through retained earnings and depreciation - both gross saving) and the level of investment would be likely to increase materially. Not all of that would be national savings - ie done by NZers - some would be retained earnings of foreign companies who would find more profitable investment opportunities at the much lower rate of tax. Those retained earnings are still available to support activity in the domestic economy.

Would we get less labour supply? It might depend on precisely how the cut in capital taxes was funded. Frankly, I am fairly sceptical of how large the deterrent effect on labour supply would be.......

When one taxes something less one tends to get more of it

Successful countries can afford all sorts of affectations and policy weaknesses. We are not a successful country - at least relative to our aspirations, and the aspirations of the staggering numbers of our people who leave NZ permanently every year (high by any international or historical standards). I'm not arguing that the way we tax capital income caused our relative decline. I'm also not arguing that it is the only thing that matters now to reverse our decline - although it would probably be one of my top two. But I am arguing that, if we are serious about providing a climate in which businesses will invest in New Zealand, in ways that allow us to once again offer first world incomes, a much more hard-headed approach, prioritising substantial reductions in the taxation of capital income could play a very large part. Closing those gaps won't come easily - small measures simply don't fit the scale of the challenge we face.

[kaldor: tax what is taken from the pot, not what is put into it.}
OECD 2007 report recs
Mankiw quote