MICHAEL CULLEN

A TIME TO REAP – NO ROOM FOR LARGESS

Instead of celebrating strong economic growth and a massive operating surplus with tax cuts, Finance Minister and deputy Prime Minister Michael Cullen claims it's time to squirrel away what we don't need for today, for less prosperous times ahead. He explains to MARK STORY why the devil is in the detail and what's in store for the economy during election year.

Ensuring our tax system neither encourages nor discourages particular types of investment - but instead allows investment to flow to where it gives the highest pre-tax return. No it's not a pipedream it's something the current Government has been talking about for years but as yet is unable to deliver on. Claiming it as the most difficult part of the tax system, Finance Minister Michael Cullen has been reluctant to tinker with the current tax inconsistencies (on investments) in fear of making things worse.

Levelling the play-field

He ultimately wants to provide an environment that encourages Kiwis' to save more. He's also eminently aware that negative household saving rates and low holdings of financial assets doesn't make for strong sustainable growth. And what arguably puts long-term saving under the spotlight in election year is the balance of payments deficit which only accentuates how much Kiwis' depend on other countries' savings for its investment and consumption.

But short of compulsory superannuation (which Cullen doesn't subscribe to) – that means creating a level tax playing-field where one asset class isn't given preferential treatment over the other. He expects the eventual removal of tax inconsistencies to give Kiwis' greater incentive to save. "I don't think property is being particularly over favoured right now, it's just that we're under investing in other asset classes," says Cullen. "Economically sound savings will occur only if the tax rules governing different kinds of investments are as neutral as possible. And it's undesirable for taxes to drive investment decisions."

What's broken?

So what's wrong with existing tax rules exactly? For starters, very different tax rules and results apply, depending on whether you save directly or through a savings vehicle. For example, if the savings vehicle route is taken, some taxes apply, (depending on the vehicle). Then there are different tax rules that apply to offshore savings. For example, an investment in a so-called 'grey list' country yields a particularly benevolent tax result - and can provide tax planning opportunities - while the same investment in a 'non-grey list' country is taxed in full.

Confused? Well that's one of the many reasons why the tax system is in dire need of over-hauling. Cullen has hinted that after all the rhetoric about levelling the (tax on investment) playing field we're finally going to see some action. In fact, he told Investor Monthly to expect a clear outline of future reforms (on the tax treatment of investment income) within this year's budget.

No quick fix

But Cullen reminds investors not to expect a "quick-fix" to current tax anomalies. The way he sees things the devil is in the detail. And given the complexity created by the numerous savings vehicles available, the question nobody seems to be able to answer is whether to tax at the fund or saver's level. "If we can get the rules relating to the taxation of savings right, some of the current disincentives to saving will be removed," says Cullen. "This will create a good platform to develop measures to increase work-based savings for retirement."

He believes NZ's solid fiscal position gives the government some room to manoeuvre on the tax issue. But while Cullen expects sensible reform to reduce the overall "tax-take" he's not in favour of carte blanche tax concessions for the savings industry. In his view there's overwhelming international evidence to suggest they simply don't work. "I am attempting to reduce (tax) distortions rather than to increase them. I also remain concerned that such incentives benefit those already saving rather than generate new savers," explains Cullen.

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Likely priorities

It's premature to speculate what reform will be announced during the next budget and Cullen is giving little away. But based on his discussions with members of the savings industry he suspects there's nothing more pressing than to remove the tax on capital gains levied on savings through actively managed unit trusts and super schemes - when it's not levied on individual investors or passive funds. "This seems unfair because in practice, a harsher tax treatment is likely to apply to small investors. It's also inefficient because it represents an implicit tax on the use of institutional savings," says Cullen.

While he doesn't want to pre-empt the report (Toward Consensus on the Taxation of Investment Income) recently prepared by former BT Funds Management CEO Craig Stobo he appears sympathetic to changes along these lines. Stobo's own preference is for an "Investment and Savings Tax" incorporating the elements of a risk free return method to tax a deemed rate of return on investment by managed funds. While Cullen doesn't necessarily share this view he does believe good tax policy can and should make a positive contribution to an open, dynamic economy that doesn't hinder access to capital or misallocate it.

Case for tax cuts

Interestingly enough, while broader tax cuts may not be on the Government's agenda this year the National party is trying hard to turn the spiralling "tax-take" into an election issue. According to National's finance spokesman John Key, if the government keeps collecting tax at the current rate by the middle of next year it will have collected 53% more than the amount it took in 1999.But despite stronger economic growth and fatter Government revenues than expected, Cullen says the economic timing for tax cuts just doesn't stack up.

Economic indicators

At face value the economy is tracking along pretty nicely, and the economic indicators supporting this conclusion include:

• A massive operating surplus of $5.6bn.
• Economic growth in the year to June 2004 well above forecast at 4.4%.
• Unemployment rate falling to 3.8% in the September quarter from around 7% in 1999.
• Total gross labour income increased 7.5% between June 2003 and June 2004.
• Private consumption expanded 5.7% and residential investment 13% in the year to June.

Why the surplus?

Contributing to operating surplus was tax revenue up 9.1% ($1.2 billion) on the same period last year due to higher PAYE deductions (courtesy of a stronger labour market), growth in company tax driven by strong profits and more GST fuelled by the continued strength of consumer spending. Meantime, health and welfare spending was down by just over $200m, due to delays in implementing programmes, and lower than expected unemployment benefit payments. "Strong growth of 0.6% in the September GDP data means that the economy has grown almost 20% in the last five years. This translates in real income per person to an increase of 15%. That's a good result for Kiwis' and is reflected in high household consumption, up 6.1% over the September year," says Cullen.

No cash-pile

But despite having a set of government accounts envied the world over, Cullen's worried about the latest forecasts that suggest budget surplus will start tumbling as the economy continues to slow down. With the pace of global growth looking set to slow, company profits are also expected to slip back this year. In fact, with a weaker housing cycle, coupled with consumers' carrying higher debt levels, retail sales are expected to remain soft. And from Cullen's perspective operating surplus is mistakenly regarded as a pile of ready cash by the "fiscally illiterate".

It's only befitting, argues Cullen for government's

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revenue streams to exceed costs so the country can invest in the future, through capital spending (and strengthening the country's financial position) to meet future expenditure pressures. What accounted for the bulk of recent operating surpluses explains Cullen were:

- $1.3bn in capital purchases like new machines for hospitals, building new roads and prisons.
- $1.7bn for loans to students, Health Boards and others.
- $1.9bn for future NZ Superannuation costs.
- $1.2bn represents the non-cash element of surpluses retained by SOEs and Crown entities which they can use for future investment.

Avoiding cyclical dips

Once these items have been accounted for, the Crown's cash surplus for the year was $520m. To Cullen it just makes good sense not to base these sorts of important long-term decisions on cyclical elements – underlying the current trends in revenue and expenditure – that are notoriously hard to forecast. That said, he challenges those who advocate use of the surplus for pet projects (tax cuts or increased expenditure on health or law and order) to indicate which part of the capital or operating budget should be forfeited to pay for it.

Cullen's the first to admit that the growth path of some areas of government expenditure – like healthcare up 4% annually - look unsustainable. Base on this reality he recommends a more cautious approach to revenue and expenditure, rather than the enthusiasm for extravagance that a healthy operating surplus seems to engender. "If you want tax cuts you have to come up with a significant cut in the growth in government spending and that looks quite difficult in the medium to longer-term."

Falling surpluses

While there may be the money available for a spend-up in the next couple of years or so, he argues that's much less true for the long term. What the latest forecasts show, explains Cullen is the budget surplus falling as the economy inevitably slows. The net effect? We may well see a fatter surplus in the short term, but within four years he suspects it will only be enough to cover contributions to the NZ Superannuation Fund and keep gross Government debt from growing faster than the economy. That said, Cullen's adamant operating surpluses are no guide to the affordability of tax cuts. "Any other significant fiscal move in the short term will require over the longer term a significant reduction in the expenditure growth which is driven by demographic and other factors," Cullen adds.

Fiscal risks

He regards such a move as risky because the effective cuts in spending required may be potentially unsustainable. He's also fearful that any significant worsening of the short to medium term economic outlook would quickly make the numbers look sick. Then there's the prospect that a rising debt-to-GDP ratio will impact on the cost of borrowing. A subsequent loss of confidence in our economic stability and management, argues Cullen, could see an about-face in overseas investor sentiment towards the NZ$.

As far as Cullen's concerned, voter confidence over the government's economic management (and social policy), is more likely to surface as a key election issue than tax cuts or race related issues. What voters have to ask themselves, ponders Cullen is whether they want to continue pushing forward without the major structural changes some parties are advocating.

Stable management

Amongst the important drivers of NZ's sustained growth argues Cullen is the regime of stable, predictable fiscal management instigated in the last five years. He says this has delivered significant reductions in net public debt, and a slight reduction in the ratio of government expenditure to GDP. Meantime, core government operating spending has dropped from 32% of GDP in the 2002/03 fiscal year to 29.7% in the 2003/04 fiscal year.

"This has been achieved by careful management rather than by an excess of taxation. We've set the scene for future fiscal stability by establishing the NZ Superannuation Fund in order to partially pre-fund the cost of the state pension at the height of the demographic bulge. This fund will provide future governments with a significant hedge against the rising cost of superannuation. And will also have the effect of placing the Crown in a position of eliminating its net debt within the next decade."