

Tax: Facts and Fallacies

There has been a flurry of debate on tax issues recently, prompted by Labour's tax package.

It includes an increase in the top personal income tax rate to 39%, a \$5000 tax free threshold, a capital gains tax, and the removal of GST from fresh fruit and vegetables.

The most unfortunate feature of the total package is that it is focused on income and wealth redistribution, not economic growth – to an even greater extent than the policies of the last Labour government. This is no way to raise overall living standards.

None of the proposals was recommended by the two major tax reviews of the past decade, the 2001 McLeod Review and the 2010 Tax Working Group.

The McLeod review argued for a lower, flatter tax structure on a broad base. The government has moved slightly in this direction by cutting the top personal rate to 33% and the company rate to 28%.

Labour's plan to reverse this move would have the same consequences as it did last time. One would be to push up the wages and salaries of internationally mobile workers as firms were forced to gross up their pay or lose them. Another would be to push house prices up as owner-occupied houses would become a more tax-preferred asset. The large gap between the personal, trustee and company rates would open up new avoidance possibilities.

But what about the argument that the so-called rich should pay more tax?

The recent budget tables show that the average income tax paid by the bottom 75% of individual taxpayers is \$2,740. The average tax paid by the top 5% is \$42,430.

On a household basis, the lowest 43% of households currently receive more in income support than they pay in tax. The top 10% of households pay over 70% of income tax, net of transfers.

Just how much more of the tax burden do Labour and the Greens think those in the top brackets should bear? Their mindset is radically different from the ex-communist countries that have adopted low (under 20%) flat taxes.

Introducing a \$5000 tax-free threshold is costly in revenue terms (cumulatively costing between \$17 billion and \$19 billion up to 2024/25) and hence pushes tax rates up. The current structure is the main reason why, compared with other OECD countries, New Zealand collects substantial personal income tax with relatively low marginal rates. Those earning under \$5000 are largely recipients of income support or spouses and children of high income families. As finance ministers, Robert Muldoon and Michael Cullen both considered and rejected the idea.

Misconceptions about capital gains taxation abound. New Zealand already taxes some capital gains – the debate should be about how wide to cast the net. With a low-rate, broad-base tax structure, the absence of a separate CGT is not as anomalous as it might seem. The Nordic countries and others which have high taxes on labour income and low taxes on capital income apply CGTs to prevent large-scale tax avoidance.

Adding a CGT to New Zealand's tax structure would be particularly unwise. The revenue from a CGT is highly volatile and unlikely to be consistently anywhere near the level suggested by Labour. Taxing capital income already imposes high deadweight costs and a CGT would increase them. In taxing gains on shares that are sold, Labour's CGT seems to tax retained earnings on which income tax has already been paid, thereby discouraging an important source of business capital.

It is a mistake to think that the absence of a CGT benefits wealthy people. Asset prices adjusted long ago and after-tax returns are the same as they would otherwise be. A new CGT would impose a loss on asset holders but why would that be fair? Stressing over inequities of untaxed

entrepreneurial gains is as pointless as worrying about not taxing lotto winners (forgetting about all the entrepreneurs and punters who make losses).

The idea that a CGT would slow house price increases is a fallacy. Both theory and evidence suggest it would have little more than a one-off effect. Australia, with a CGT, has experienced faster house price increases than New Zealand over the past decade. Similarly, a CGT on land that is in fixed supply cannot shift it to so-called more productive uses.

I am unaware of any country with anything approximating a sound and stable CGT.

For well-known reasons, removing GST from selected items is foolhardy: it complicates administration and encourages lobbying for further exemptions. Once more the broad-base principle applies.

As if this list of fallacies is not enough, it is distressing to hear would-be finance minister David Cunliffe arguing that the government would be worse off financially if it partially sold SOEs because it would forgo dividends. Any financially literate adviser could tell him they would be capitalised into the sale price. Tax policy and SOE policy should be seen as separate issues.

High tax burdens – arising from high levels of government spending – damage growth and prosperity. According to the OECD, higher tax rates are the major reason why European per capita income is about 30% lower than in the United States.

With a still-weak economy and unexciting growth prospects, the last thing New Zealand needs is new or higher taxes. Anyone for a Tea (Taxed Enough Already) Party?

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