Is ‘Tax the Rich’ Good Policy?

The Labour Party plans to increase the top personal tax rate on higher income earners if it wins office at the November election.

We have gone down this path before. The last Labour-led government raised the rate from 33 to 39 cents, ostensibly to gain more revenue for social spending.

The move was unnecessary. With economic recovery and reasonably prudent spending in its first term of office, that government soon found itself with large fiscal surpluses.

As always happens, there were unintended consequences.

One was to fuel increases in house prices as taxpayers shifted some of their investments to owner-occupied housing, which is a tax-preferred asset.

Another was to encourage perfectly lawful tax avoidance. With the gap between the top personal rate of 39% and the trust and company rates at 33%, many taxpayers re-arranged their affairs to channel income through these structures.

The company rate is now 28%, so any increase in the top personal rate would create an even larger gap unless the company rate was also increased. But this would be a backward move: New Zealand’s company rate is still above the OECD average.

More generally, the last thing New Zealand needs right now is higher taxes. They would only set back the current weak recovery.

Taxing the so-called ‘rich’ is a standard populist policy. But there are never enough wealthy people for such a policy to make much of a difference to government revenue.

President Obama has been a ‘tax the rich’ advocate in the United States. In that country, individuals who make more than US$200,000 (about NZ$250,000) and families whose income exceeds US$250,000 total only 2.5% of taxpayers. The proportion would be significantly lower in New Zealand.

In any case, over the years higher income taxpayers have paid an increasing proportion of total taxation.

According to an OECD study, the top 10% of New Zealand households pay 35.9% of all income taxes. This is the sixth highest ratio of the 24 OECD countries covered in the study.

The study also looked at the ratio of the share of tax paid by the top 10% of households to their share of market income. Again New Zealand came out above the OECD average.

In other words, those in the top income brackets in New Zealand are already taxed relatively heavily by international standards. This poses real dangers for a small country in a world where both capital and labour are highly mobile. Firms and individuals can easily relocate to more tax-friendly regimes.

Such mobility increases the so-called ‘deadweight’ or economic costs of taxation. These costs rise more than proportionately with the tax rate. A New Zealand study found high economic costs from New Zealand’s top marginal tax rate of 39%.

Another consequence of labour mobility is that if the top tax rate is raised in New Zealand, many firms will have to increase the wages and salaries of valuable workers in order to retain them.

This will increase pre-tax income gaps in New Zealand and give rise to complaints about widening income inequality.

A ‘tax the rich’ policy also polarises a democratic system. It leads to an increasing disconnect between the benefits government provides and the cost of those benefits to most citizens. A voting majority increasingly demands more government benefits for which they want others to pay.

Arguments such as these have led many countries to reverse the trend in earlier decades towards more progressive tax systems – in which tax rates rise more than proportionally with income.

They have done so for reasons of both economic efficiency and equity.

A broad-base, low rate tax system, as advocated by the 2001 Tax Review and the Tax Working Group, improves incentives to work, save and invest and lowers deadweight costs.

Rigorous analysis also demonstrates that equity considerations favour a flat or proportional tax and that a progressive scale can only be motivated by envy for those on high incomes.

Interestingly, Russia and a number of East European countries – which long maintained a socialist culture of envy – have moved to essentially flat tax regimes.

Because cuts to high tax rates encourage economic growth and reduce tax avoidance, they may actually produce more government revenue.

As President Kennedy said when he cut US tax rates in the 1960s, "It is a paradoxical truth that tax rates are too high today and tax revenues are too low, and the soundest way to raise revenues in the long run is to cut rates now."

Those who have given up on economic growth – like the authors of *The Spirit Level* – are left wanting to pull the 'rich' down.

Such a policy replaces the means by which the poor have traditionally risen – especially through education, moral values, aspiration and hard work – with a sense of hopelessness and entitlement. High taxes harm their interests too.

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