

Tax Reform Depends on Spending Restraint

Expectations about the forthcoming report of the Victoria University-led Tax Working Group may be inflated. This is not a criticism of the TWG or its likely lines of thinking.

The basic terms of reference of the group are to recommend options for improving the tax system subject to raising roughly the current amount of revenue. This constraint – understandable given projected budget deficits – severely limits the scope for meaningful (growth-enhancing) tax reforms.

At first sight, this conclusion may seem paradoxical. It is common ground among tax specialists that tax changes made during the Clark-Cullen years (including creating a gap between the top personal and company tax rates and the proliferation of rates under the Portfolio Investment Entity (PIE) and Working for Families schemes) seriously undermined the integrity and efficiency of the tax system.

There are other mounting problems: in the not-too-distant future, people on average incomes, given real economic growth and inflation, could be facing the highest personal tax rate.

An obvious response, therefore, would be to reverse most of the previous government's changes. This is infeasible in the short term: investment and other decisions have been based on them, and there would be many losers who could reasonably object to such a step.

The TWG's work, as reported at a conference organised by Victoria University last month, has accordingly focused more broadly on possible changes to the tax base and mix of taxes.

One option, promoted by the Treasury, is to extend the taxation of capital gains. However, the conclusion reached during the tax reforms of the 1980s seems robust: the weak conceptual arguments for broader tax treatment are outweighed by the practical difficulties. Moreover, a broader CGT would raise little revenue, particularly if the first home were excluded.

Another proposal considered by the TWG is a tax on land or immobile property.

Land taxes were abolished in the 1990 budget, and they seem unlikely to be restored. The last thing the agricultural sector needs at present is a tax which would increase costs or reduce land values and put more farmers into financial difficulties. There would inevitably be pressure for distorting exemptions, such as for Maori land. In any case, land is already a major tax base for local government.

A further, well-canvassed option is to raise GST with a compensating reduction in income tax. However, calculations presented at the conference suggest this is not an attractive trade-off. An increase in GST to 15% combined with compensation to low-income groups would yield only an additional \$200 million in revenue, which would be insufficient to allow meaningful income tax cuts.

There has been speculation about changes to the tax treatment of investment in rental properties because much of the economic income from such investment is not subject to income tax. However, the income tax system treats rental property investment in much the same way as investment in farms and plant and equipment. The TWG may discuss ring-fencing tax losses or, more likely, limiting depreciation deductions if property does not depreciate. Any economic benefits from such a move could come at the expense of introducing new distortions between investment in rental properties and some other assets, and between different categories of rental property.

There is a stronger argument for reducing accelerated depreciation allowances for businesses, which cost around \$300 million annually.

Many of the options explored by the TWG are structured around the government's commendable goal of aligning the top personal, company and trust income tax rates at 30%. Achieving this goal would be quite feasible, given spending restraint. Indeed the 2025 Taskforce calculated that a 20-20-20 option would be fiscally feasible if core Crown expenses were reduced to below 30% of GDP in the next few years.

That strategy would also help reduce many other distortions, such as the tax treatment of owner-occupied housing.

The TWG should advocate a major overhaul of Working for Families, and might well have useful suggestions to make on detailed aspects of the tax system.

But the bottom line is that not a lot can be done to improve it without significant reductions in government spending.

In the context of the government's overriding goal of catching up to Australian income levels by 2025, major reductions in the government spending share of GDP are imperative, and new or increased taxes make no sense.

Moreover, unless spending reductions are achieved, taxes will have to rise to reduce deficits and debt.

The 2025 Taskforce report notes that Singapore, Malaysia and Hong Kong all have 300 pages or so of income tax legislation whereas New Zealand has 10 times that number. The Clark-Cullen changes added to the complexity of the system.

We need to think in terms of the much smaller governments and lower and simpler tax structures of those countries if we aspire to faster economic growth and higher incomes.

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