

## **Budget Tax Package Should Focus on Economic Growth**

The forthcoming budget will announce significant personal income tax reductions. Not all tax cuts are created equal. What form should the tax package take?

The prime minister recently reaffirmed that economic growth to raise New Zealanders' incomes is the government's "top priority" objective. Tax policy is an important lever of economic growth.

If the government means what it says, the thrust of the budget package should be to lift the economy's trend growth rate, which is now very mediocre.

Revenue taxes are needed to finance necessary government spending, but they are a drag on the economy. As the Tax Review which I chaired noted in its 2001 Issues Paper, "Quite apart from compliance and administration costs, taxes will generally impose 'economic costs' because they induce individuals to make decisions that they would not have made in the absence of the tax."

The paper gave examples of the economic or 'deadweight' costs of taxation, which rise more than proportionally as income tax rates rise.

They affect the trade-offs people make between work (which is taxed) and leisure (which isn't), and thus their decisions on work effort.

They affect decisions on education and training because they reduce after-tax income from returns to additional human capital.

They affect decisions to consume or save because, under an income tax, returns on saving are subject to tax.

They also affect decisions to invest or save because taxes on income from capital increase the cost of capital to business and/or decrease rates of return to savers.

The marginal economic cost of income taxes in New Zealand is likely to be at least in the 20-30% range (including administration and compliance costs). The Treasury uses a 20% figure in public sector cost benefit analysis. On this basis, a school which costs, say, \$10 million annually to run if paid for by parents through fees would cost \$12 million if paid for by taxes.

The taxes on income that do most harm to the economy are those with the highest effective marginal tax rates. These are the high personal and company tax rates (those over 30%) and the even higher rates generated by Working for Families and welfare arrangements as assistance is abated.

In its 2005 report on the New Zealand economy, the OECD stated unequivocally that “higher taxes have a negative impact on economic growth.” One recent US study found that a tax increase of 1% of GDP lowers real GDP by roughly 2-3%. A 2007 report by Australian economist Alex Robson (*No Free Lunch: The Costs of Taxation*, [www.nzbr.org.nz](http://www.nzbr.org.nz)) surveyed 98 different countries and found that “on average, countries which significantly cut taxes on upper incomes between 1980 and 2000 enjoyed average per capita growth rates of nearly three times those that did not.”

These and similar findings contradict claims by the government that taxes do not harm economic growth. Because they did not involve cuts to top rates, the income tax cuts of 1996 and 1998 may have had a smaller effect than otherwise. No serious economist would argue, however, that the earlier cuts to the top personal tax rate of 66% and the company rate of 48% did not contribute to the economy’s outstanding performance in the 1990s.

For these reasons, the 2001 Tax Review recommended that New Zealand should move towards a lower and flatter income tax structure.

In February a group of business and professional organisations endorsed this recommendation. The Business Roundtable, Federated Farmers, the New Zealand Chambers of Commerce and the New Zealand Institute of Chartered Accountants recommended that the budget should reduce the

top personal and trust rates and align them with the company rate of 30%, as well as cut lower rates.

This proposal was supported by the minister of revenue, Hon Peter Dunne. The Treasury has made similar recommendations.

Such a package would be consistent with equity objectives. As the 2001 Tax Review demonstrated, the impact on the distribution of income of a flatter tax scale compared with a progressive tax scale is small.

Moreover, the government has reduced many effective tax rates to 30% or below by moves such as Portfolio Investment Entity (PIE) rules which apply to most KiwiSaver schemes, the lower company tax rate which applies from April this year, and tax concessions. However, these have come at the cost of substantial increases in the complexity of the tax system. Establishing an income tax ceiling of 30% would greatly simplify it.

The average wage gap with Australia and other countries won't be closed by income redistribution – it requires growth. New Zealand's trend rates of productivity and economic growth performance are declining and need to be reversed.

A bold package that aligns all income tax rates at 30% or below would increase productivity, be positive for business, reduce unnecessary compliance costs, help stem the outflow of enterprising New Zealanders, and greatly improve the country's economic outlook.

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