2008 Budget Personal Tax Package

Introduction

Economic growth is a priority objective of the government. Growth requires improvements in productivity and workforce participation. Both would be assisted by lower taxes.

The reduction in the rate of company tax from 1 April 2008 is a welcome move. However, personal tax rates are more important for many small and medium-sized businesses and professional organisations, and for new equity invested in companies by resident taxpayers. A coherent, medium-term strategy for personal taxation is needed which is consistent with the decisions on business taxation in the 2007 Budget. At present New Zealand's tax policy is lacking in strategic direction and vision.

The Tax Review 2001 (McLeod Review) remains a sound guide for such a strategy. A key recommendation was the adoption of a lower, flatter income tax structure. This would reduce the deadweight costs, complexities and other inefficiencies of the present system.

Proposed tax package

To have the maximum benefits for growth, reductions in the highest effective marginal tax rates are needed, ie those that most influence the productive effort of taxpayers. The top two personal rates (39% and 33%) should be lowered and aligned with the company tax rate and related rates. This would foster greater work effort, including investment in education and training, and encourage unincorporated firms to use resources more efficiently. A reduction in the effective rate of tax (business and personal) on new equity-financed investment could be expected to increase the proportion of investment that is financed by residents.

From a growth perspective, reducing tax rates is preferable to adjusting thresholds because incentives to work, save and invest at the margin are increased. Threshold changes only change marginal rates for a relatively small number of taxpayers. (If the two top brackets were indexed for inflation since 2000, only around 15% of individual taxpayers and about 12% of taxable income payable by individuals would be affected.) Also, as the Inland Revenue Department has documented, tax thresholds induce many taxpayers to arrange their affairs in ways that enable them to avoid higher tax rates, which does little for growth.

Nevertheless, fiscal drag (the increase in revenue collected as taxpayers move into higher tax brackets) is a problem with the present scale. This is best dealt with by flattening the tax scale, as many countries around the world are doing, but adjustments to thresholds, which could benefit lower income taxpayers and others, could form part of an overall package.

This analysis suggests that aligning the top personal, company and trust rates at 30%, as the minister of revenue has suggested, in one or two steps would have major benefits for the economy and New Zealanders.

The case for not reducing higher rates (the 33% and 39% rates) on equity grounds founders when looked at alongside recent tax initiatives (eg the lower company tax rate, tax concessions and the Portfolio Investment Entity (PIE) rules) which will reduce the tax rate on much taxable income to 30%. The Working for Families and KiwiSaver schemes also provide significant tax relief for many taxpayers who earn incomes that are subject to the top personal rate of tax. Reducing and aligning the personal, company and trust rates would significantly reduce the incentives and costs of avoiding the top personal tax rate. It would also restore equity between self-employed persons and those subject to PAYE who have less scope to avoid the higher tax rates. The Working for Families scheme should also be adjusted by reductions in assistance to higher income earners (many of whom would benefit from a tax cut), a reduction in the abatement rate and possibly by introducing a universal element.

Fiscal headroom

There is scope, over time, to implement a much larger tax package than that implied in the 2008 Budget Policy Statement (BPS). The BPS forecasts suggest that core Crown operating spending will increase by 0.9 percentage points of GDP by 2011/12. Slower growth in operating spending and a lower provision for new capital spending could help fund additional tax reductions. A somewhat higher proportion of capital spending could also be funded from debt without any significant change in forecast debt ratios. The BPS forecasts take no account of the impact on growth over time of improved incentives that arise from lower effective marginal tax rates. Over the medium term, perhaps up to 40 percent of tax revenue initially forgone might be recouped from higher growth and less tax avoidance. We think that net tax reductions of up to $2.5 billion annually could be responsibly implemented in stages over the next few years.

Tax criteria

We consider the proposed package would meet the criteria laid down by the minister of finance:

- it need not involve increased borrowing for operating purposes;

- it would allow expenditure on public services to be maintained in real terms;

- it would not exacerbate inflation, which is a monetary phenomenon. Firm monetary policy is necessary and sufficient to control inflation. Growth-oriented tax cuts would have a smaller impact on prices than redistributive measures because they would increase output (reducing the problem of ‘too much money chasing too few goods’). At most, tax cuts could have a one-off, not ongoing effect on the CPI; and

- it would be unlikely to have a measurable effect on income inequality since, as the McLeod Review demonstrated, the difference between the impact on the distribution of income of a flatter tax scale compared with a more progressive one is small. Moreover, as their incomes rise, lower income people benefit

> from facing a flatter tax scale, and it is misleading to look at immediate (static) impacts alone. In addition, prices and wages adjust to changes in complicated ways (for example, the increase in the top tax rate to 39% in 2000 appears to have pushed up house prices) so it is difficult to say which groups might ultimately benefit from tax cuts. A general proposition is that the burden of taxes (in the form of higher prices for goods or lower wages) falls on those who have the least ability to avoid these effects, for example, by emigrating or raising their prices or wage rates. These are more likely to be the poor with limited skills than the wealthy.

Other issues

We do not support the introduction of further tax concessions. Recent moves in this direction have added to the cost and complexity of the tax system. Existing concessions should be removed or reduced.

A general tax 'dividend', possibly of a one-off nature, would have no incentive effects.

A tax-free income threshold should not be introduced because the revenue cost of such a move would be substantial and other tax rates, including effective marginal rates for most taxpayers, would have to be set at higher levels than otherwise. This is the Australian experience. The low income rebate is a better means of helping those in need. The case against a tax-free threshold was well argued by the McLeod Review.

A ceiling of 30% on personal, company and trust rates should be lowered in future, having regard to countries in our region such as Singapore and Hong Kong which have top rates of 20% or below.