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**WHITHER TAXES?**

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## **WHITHER TAXES?**

Thank you for the invitation to talk to you this evening about tax reform. The topic of tax always reminds me of Mark Twain's question: what is the difference between a taxidermist and a tax collector? The answer is: the taxidermist only takes your skin.

I am not a recognised tax specialist so I will not go into the depths or intricacies of the recent Tax Review and the detail on the more exotic aspects of the international tax regime.

But what I do want to explore – from the viewpoint of tax policy – are some of the issues the McLeod report raised and perhaps should have pursued further.

There are some fundamental questions to be asked about tax such as:

- Are we a low tax country or not? Our maximum personal rate is 39 percent, but is that a good indicator of the overall tax burden?
- Are there parts of the potential tax base that are not taxed at all – such as our homes – and how can these distortions best be remedied?
- Are there some activities that are taxed irrationally because some people think it is good for us for them to be taxed – like cigarettes, alcohol and gambling?
- How bold was this report and could it have gone further?

The terms of reference of the Tax Review were to consider whether the structure of our current tax system is sound and to identify ways of improving it.

The Review began with an absolutely critical point that is too often overlooked in discussing tax, namely that tax begins with government spending. The main reason for

raising tax is to fund spending programmes. Broadly speaking, governments have to raise as much money through taxes (including local body taxes) as they spend. Thus government spending is the best broad measure of the overall tax burden.

Therefore in New Zealand, where total central and local government spending amounts to around 40 percent of national income, the true tax rate of the average person is around 40 percent. This means that the average person spends two days or 16 hours of a 5-day, 40-hour working week working for the government.

It's important to bear this benchmark in mind when making comparisons with other countries. At 40 percent of GDP, government spending in New Zealand is higher than the average of OECD countries (around 38 percent). It is much higher than in countries like the United States and Ireland where the figure is around 30 percent, not to mention Singapore and Hong Kong where it is under 20 percent. Thus New Zealand is a highly taxed country whereas we should be aiming for a tax burden that is lower than that of comparable countries to improve our economic performance.

People are sometimes confused about the level of this tax burden because they look at New Zealand's top personal tax rate of 39 percent and note that it is not higher than many other countries' top tax rates. For example, the top tax rate in the United States was 39.6 percent before the Bush administration's tax cuts this year.

But this comparison is misleading. The 39 percent rate in New Zealand applies to a much broader base of income than is the case in many other countries. Like the old New Zealand system, their tax regimes often have multiple deductions and concessions which limit the amount of income on which people pay tax. Moreover, New Zealand's top rate cuts in at \$60,000 whereas the similar rate in the United States did not apply until earnings exceeded about NZ\$700,000. New Zealand also has a comprehensive goods and services tax, so that the combination of a 39 percent income tax rate and a 12.5 percent GST amounts to an effective tax rate of nearly 47 percent once income is spent. This rate is more than three times the top tax rate on salaries and wages in Hong Kong, which has no GST or its equivalent. For these and other reasons, the government spending ratio more accurately measures the tax burden. Bear in mind also that many countries have

been reducing their top tax rates whereas New Zealand has recently gone in the opposite direction.

Big government and high taxes are bad for economic growth. No country has achieved sustained annual growth rates of 4 percent or more with government spending amounting to 40 percent of the economy. Our present government's plans to restore New Zealand to the top half of the OECD income rankings are not credible at current levels of spending and taxation. A recent study undertaken for the Business Roundtable by Winton Bates estimated that if New Zealand had levels of government spending similar to the United States or Ireland, our sustainable annual growth rate would be at least half a percentage point higher over 10 years – say 3 percent instead of 2.5 percent, a substantial 20 percent improvement.

High government spending undermines growth in a number of ways, and an important one is because of the so-called deadweight costs of taxation. Taxes harm incentives to work, save, invest and take risks. If you tax something you usually get less of it. People who argue for higher taxes on tobacco or alcohol understand that such taxes reduce consumption of those products. The McLeod Review seriously questioned the tax policy rationale for these taxes.

In the same way taxes on income discourage productive work and investment. Franklin Roosevelt recognised this point at a time when taxes were far below today's levels. As he put it:

Taxes are paid in the sweat of every man who labors because they are a burden on production and are paid through production. If those taxes are excessive, they are reflected in idle factories, in tax-sold farms, and in hordes of hungry people, tramping the streets and seeking jobs in vain. Our workers may never see a tax bill, but they pay.

That quotation should be on the wall of every minister of finance.

The Review correctly noted that the deadweight or efficiency costs of taxation are generally highest at the top end of the rate scale. The marginal economic cost per dollar

of taxes rises with each dollar of tax imposed. To get the greatest contribution to growth for a given loss of revenue, high rates of tax should be reduced. The Review calculated that a \$1 billion cut in government spending would enable the top personal and corporate tax rates to be cut to around 31 percent.

After the problem of the high tax burden arising from government spending, the problem of high tax rates – the top personal and company rates and the high effective rates faced by people moving from welfare benefits to paid work – are the most serious problems with the current tax system. The Review did not address the tax-benefit problem but it recommended moves towards a much lower and flatter tax scale, with a top income tax rate for individuals, companies and trusts of 33 percent in the first instance and a lower rate of 18 percent for income up to \$29,500.

There are always strong political pressures to redistribute income by taxing people on higher incomes heavily. As George Bernard Shaw once said, "the government that robs Peter to pay Paul can always depend on the support of Paul". But is this a wise policy?

Virtually the only argument that is raised against cutting top tax rates is that it benefits better-off people. This is inevitable because better-off people pay most of the tax the government collects. In the current financial year the top 2 percent of individual taxpayers will pay around 22 percent of total income tax, the top 12 percent will pay 50 percent and the top 45 percent will pay 85 percent. You can't reduce the taxes of people who don't pay any.

More importantly, cutting high tax rates doesn't only benefit better-off people. The most important benefit is that it improves incentives for productive effort and stimulates economic growth – the exact opposite of what happens when you increase rates.

Strong growth does far more for people on low incomes than any feasible amount of income redistribution. Even though only about 10 percent of taxpayers currently pay tax at the top rate, they are not always the same 10 percent – people's income in retirement typically falls while others are moving up. Many more people are therefore affected by

the top rate. Thus tax cuts are not a zero-sum game: gains at the high end do not come at a cost to the lower end.

Other relevant arguments can be made. Evidence shows that cutting high tax rates can lead to an increase in tax payments as higher income earners work harder and reduce tax avoidance planning efforts. Those on higher incomes would still pay much more than those on lower incomes even with a proportional tax. With a single rate of tax of 20 percent, for example, a person earning \$200,000 pays tax of \$40,000 whereas someone on \$30,000 pays only \$6,000. Thus even a flat tax involves significant redistribution, especially because in practice it would be accompanied by a rebate mechanism as at present for low income earners. The fiscally neutral proportional tax rate is 25 percent. Most income redistribution occurs because of expenditure on education, health and social welfare benefits to people who pay little or no tax.

The folly of looking at tax policy primarily in terms of redistribution rather than growth is best illustrated by reactions to the proposal to limit any individual's tax liability to a maximum of \$1 million. The aim of this recommendation is to retain top entrepreneurs and professional people and attract others from abroad rather than have them use their talents elsewhere. As the report noted, people earning income at these levels are of critical importance to New Zealand because of their international connections and ideas. The Review estimated that the government would actually gain revenue from this step: its choice may be to get \$1 million if a taxpayer stays or get nothing at all if they go. There would be gains all round from this move. The reasons for rejecting it can only be based on ideology or envy; they clearly have little to do with the benefits to the economy or government revenue.

There are other compelling arguments for moves towards a lower and flatter tax scale. Most of the problems with the present income tax structure come from the wide spread of rates. This makes for complexity, cost, abuse and distortion. It benefits accounting firms like mine as well as tax lawyers, but not many other people.

The list of such problems is a long one. The increase in the top rate to 39 percent required

47 pages of new tax law and has made the fringe benefit tax regime a nightmare for employers. The distortions associated with the tax treatment of housing that the Review drew attention to – and which warranted a principled debate – would be reduced with lower tax rates. The same goes for the non-taxation of certain capital gains. Many of the problems with the tax treatment of savings arise from the progressive scale. Income splitting would be less of an issue with a narrower spread of rates. Lower rates would reduce the problems associated with the international tax regime. This list is not exhaustive.

If New Zealand's income tax scale were similar to that of Hong Kong – which has a top rate of 15 percent on salaries and wages and a company rate of 16 percent – we would not be having these debates. Even top income tax rates in the 20-25 percent range would greatly reduce many of the problems – in its submission to the Review, the Business Roundtable recommended a reduction in all rates to a maximum of 25 percent as a medium-term goal. It should not be hard for politicians to make arguments of this kind against views that do not stack up on either efficiency or equity grounds.

Business tax rates should be reduced along with personal tax rates, but there should not be a disproportionate focus on them. It is true that companies are the initial source of a good deal of tax – currently companies account for 15 percent of total revenue, far more than they were paying 10 years ago when Council of Trade Union economists were complaining that the tax changes of the 1980s had grossly benefited businesses. But companies are ultimately owned by individuals, and with the imputation system it is individuals who ultimately bear tax. Thus for New Zealand shareholders the key issue is their personal tax rate. For foreign investors the Review has rightly argued the case for a lower tax rate on equity investment, just as they face a lower tax rate on debt investment. Contrary to some media commentary, this would not be a concession to foreigners as any tax they bear is generally passed on and results in a higher cost of capital for all New Zealand firms – it is not paid by the foreign investor. Nor does a lower tax rate for non-resident investors competitively disadvantage New Zealand-owned firms. A tax regime that taxes foreign investment lightly has been an important factor in Ireland's economic success.

The McLeod Review found that the broad architecture of New Zealand's tax system as it has been reshaped over the last 15 years is sound. It rightly rejected proposals for new or alternative taxes. It highlighted the case for particular attention to the international tax regime. I agree with its conclusions with two important qualifications.

First, as I noted earlier, the overall tax burden is much too high. This is imposing a heavy penalty on New Zealand in today's open international economy. There is not a lot of scope for improving the tax system unless the government's overall revenue requirements are reduced.

Secondly, the full benefits of the reshaping of the tax system in the 1980s were dependent on the directions of reform being maintained. The essence of the reforms was the creation of two broad tax bases, consumption and income, and low rates on both.

This conception has only been partly realised. On the consumption side, a raft of poorly justified excise taxes have been left in place, as the McLeod report argued. On the income side, the aim was to reduce tax rates well below present levels. Recall that the company rate was at one point reduced to 28 percent; it is now 33 percent. Roger Douglas aimed for a flat personal and company tax rate of around 22-23 percent. The much higher tax rates that we have ended up with have created a greater bias against savings in the tax system than was intended, led to the complexities I have mentioned, and failed to realise the gains that a more coherent reform package would have delivered.

Until the previous direction of tax reform is reaffirmed, I believe there are risks of further unraveling, pressures to reintroduce concessions and incentives, and a return to interest group privileges and favours. Thus the McLeod report comes at an important time. The government's budget is clearly under stress and New Zealand faces a risk of higher rather than lower taxes over the next few years. It was disappointing that the government summarily rejected key recommendations of the report, which I believe are widely supported by the business and professional tax communities. Politics must not be allowed to close off the debate. There is a need for serious engagement with the issues

that have been raised. Tax policy should be a major issue for political parties going into the next election.