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HONG KONG NEW ZEALAND BUSINESS ASSOCIATION

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NEW ZEALAND BUSINESS ROUNDTABLE**

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You have asked me to talk about tax, and I want to begin with two real life stories.

When President Bill Clinton was in office, he phoned the tennis champion Venus Williams to congratulate her on her win at the US Open. The president got more than he bargained for. Williams told him she had worked hard to win the prize money, and she deserved to keep more of it. "I'm a good citizen", she said. "Can you lower my taxes please?"

About the same time a story in the headlines was the departure to London of the French model Laetitia Casta, said to be the most beautiful French woman alive, partly to escape France's high tax rates. *The Economist* calculated that a single woman (or man) earning US\$100,000 or more was more than US\$11,000 better off in London than in Paris. The Paris newspaper *Le Monde* lamented France's brain drain of entrepreneurs and high achievers. "You can't have a dinner party without a guest mentioning the exodus [of tax refugees] to Great Britain", it wrote.

These stories bring out two key points. One is that high taxes create incentives that discourage productive effort, and as a result average incomes in a country are lower than they could be. The other is that if people think they are paying too much tax they will take steps to avoid it, ultimately by leaving the country. These were among the messages of the report of the 2001 Tax Review chaired by Rob McLeod. Regrettably, the government has so far disregarded them.

Economists think that incentives matter because they alter people's behaviour. William Easterly, a former World Bank economist and specialist in economic growth who visited New Zealand last year, has gone as far as to say that economics is only about incentives: "All the rest is commentary".

When it comes to incentives, the government seems to present a strange case of 'doublethink' - George Orwell's term for the ability to hold two contradictory beliefs at the same time.

Much of the time the government seems to think that incentives don't matter. We see this in a variety of areas. When it came to office, the government was concerned about the levels of student debt. It reacted by making loans interest-free while students are studying, presumably thinking this would not alter incentives to borrow. Of course it did, and student debt has mushroomed. Similarly, the government made access to sickness and invalids benefits more lenient, seemingly in the belief that people would only apply for such benefits if they genuinely needed them. It seems to be puzzled by the steep rise in the numbers of people on these benefits.

At other times the government obviously thinks that incentives *are* important. For example, in the name of economic development it is handing out subsidies to businesses on a scale that we have not seen since the Muldoon days. The most recent is the subsidy to big-budget movies. Plainly the government believes that the favoured firms or industries will increase investment, production and job creation in response to these incentives. And it doesn't seem concerned about favouring the so-called 'rich' - whether large multinational companies, America's Cup promoters or Hollywood moguls.

We see the same 'doublethink' when it comes to tax. On the one hand the government understands that incentives matter. Why would it have increased taxes on cigarettes and so-called light spirits if it didn't think they would discourage smoking and teenage alcohol consumption? Why is there currently talk about a tax on foods with a high fat content? And the government has shown itself to be one of the world's most fervent believers in the idea of taxing fossil fuels in the interests of curbing CO₂ emissions to reduce global warming.

Yet when it comes to work, saving, investment and risk-taking - the things that matter for personal incomes and economic growth - the government is largely in denial about the incentive effects of taxation. Ministers are wont to say that they wouldn't work any harder themselves if they paid less tax. Finance minister Michael Cullen usually asserts that there is no evidence that the level of government spending and taxation affects economic growth.

Simple commonsense calls these claims into question. If wages are taxed at 100 percent, how many people would turn up to work? Perhaps some ministers would attend cabinet meetings, but I think we would soon see factories and offices shut and a booming underground economy. And if a 100 percent tax rate would put an end to most formal work, isn't it likely that a tax rate of, say, 70 percent or 50 percent or 30 percent would have some effect? My example is not fanciful: at one stage Britain had a top tax rate of 98 percent and New Zealand a 66 percent top rate. Even today, the combination of a top income tax rate of 39 percent and a goods and services tax of 12.5 percent means an effective top tax rate of close to 50 percent on income spent in New Zealand. Because of the disincentive effects of high tax rates there has been a worldwide move to lower them in the past 20 years.

The same thing goes for savings. Consider the position of someone who puts \$1000 on a term deposit of 6 percent for a year. Gross interest of \$60 is reduced to \$40 after tax with a 33 percent tax rate. The real value of the \$1000 deposit is reduced by \$25 over the year with inflation at 2.5 percent – around the average of the past three years. So our saver winds up with only a real gain of \$15 or 1.5 percent on a \$1000 deposit – not a great incentive to save.

To be fair, the government occasionally acknowledges some of these things. Dr Cullen recently told a Grey Power conference that if taxes had to go up in the future to fund superannuation, that would damage the economy. Since coming to office he has talked about some form of concessional tax treatment for saving. But when people talk tax concessions they are really talking about lower taxes on some activity they happen to favour. They understand that higher taxes are harmful.

All this suggests that, to put it as mildly as I can, the government's attitudes to incentives – and to the incentive effects of taxes in particular – are a bit incoherent. And because incentives matter for economic growth and the government says growth is its top priority objective, the debate about incentives, taxes and the size of government is a very important one.

A comment by Professor James Gwartney, a leading researcher on economic growth, has been much debated over the past couple of years. Gwartney wrote:

... New Zealand is still a big government welfare state. Government spending [central plus local government] continues at nearly 40 percent of GDP, a figure much too high for maximum growth. I do not know of any country that has sustained per capita income growth of 4 percent or more with that level of government spending.¹

Dr Cullen asserted that claim "is simply wrong". However, the Business Roundtable has shown that among Organisation for Economic Cooperation and Development (OECD) countries, only Luxembourg, which is hardly comparable to New Zealand, has achieved that feat. It follows that if New Zealand is to grow at the rate which the government is targeting, government spending and taxation need to be reduced to well below the current levels as a proportion of the economy.

It also follows that any serious discussion of lower taxes, whether selective or across-the-board, has to start with government spending. Generally speaking, what any government spends has to be raised as tax revenue. Thus there's no point arguing for lower taxes if you're not prepared to argue for lower government spending as well. And when it is proposed that government spending should be reduced to, say, 30 percent of gross domestic product (GDP), the immediate political question is 'What government spending are you going to cut?'

In fact, the answer to that question is not difficult. Indeed a credible answer would be none at all: a policy which simply held the rate of growth of government spending below the growth rate of the economy would see a steady fall in the government spending ratio. A large part of the fall in Ireland's government spending ratio from over 50 percent of GDP in the late 1980s to around 30 percent today was achieved in this way. Some US states have institutionalised a policy rule along these lines: Colorado, for example, limits increases in government spending to the inflation rate plus population growth.

In addition, there is an enormous amount of government spending that is wasteful and badly targeted, and much could be done to reduce it. The OECD has commented

¹ Quoted in Winton Bates (2001) *How Much Government? The Effects of High Government Spending on Economic Performance*, New Zealand Business Roundtable, Wellington.

that 95 percent of government spending in New Zealand is not properly reviewed.² Better growth, labour market and welfare policies could significantly reduce welfare spending. Much spending simply involves wasteful 'churning' of income among people in upper and middle income categories who could pay for many government services themselves given lower taxes. More could be saved by getting the government out of commercial activities and eliminating business welfare.

The United States, Australia and Ireland, which all have government spending ratios around the 30 percent level, demonstrate that a smaller size of government is not only feasible but desirable. All have had faster growth rates and achieved much higher per capita incomes than New Zealand. And many would argue that even in these countries governments have expanded well beyond their proper limits.

With a lower level of government spending, there would be ample scope to cut taxes substantially, as these countries have done. In my view the McLeod Review correctly identified the priorities for tax reform in recommending moves to a lower and flatter income tax structure. Other McLeod proposals, including a limit on the total liabilities of any individual taxpayer, lower taxes on foreign investment and the scrapping of excise taxes, are desirable as well.

Whenever political parties propose moves to cut top tax rates and flatten the tax scale, the cry goes up that they want to 'favour the rich'. We saw that with the Bush administration's tax proposals last year. Yet the United States and many other countries around the world are continuing to move in this direction. Even Germany is cutting its top rate to 42 percent, only just above New Zealand's 39 percent level.

I think the response to such criticisms is again relatively easy. First, any party that is seriously committed to growth must reflect that priority in its tax policy. The taxes that are most damaging to growth are generally those with the highest effective marginal rates (including those that apply when welfare benefits are abated). The economic damage – what economists call the marginal excess burden of tax – rises exponentially as tax rates increase. Using reasonable assumptions, it can be shown

² Organisation for Economic Cooperation and Development (2002) *Economic Survey of New Zealand*, Paris, p 71.

that if the marginal excess burden is 10 percent with a 10 percent tax rate (meaning that it costs \$1.10 for every extra dollar of revenue raised), it rises to nearly 60 percent with a tax rate of 40 percent.³ Yet the government is saying that next year, if circumstances permit, it plans to reduce lower tax rates (and so widen the tax scale further). This is another case of the government favouring income redistribution over wealth creation and economic growth, despite its stated priorities.

Secondly, there are strong arguments on grounds of fairness for a broadly proportional tax rather than a steeply progressive one. The American economist Steven Landsburg illustrates one of them in his book *Fair Play*.⁴ He takes the example of three people each with wooded lots who need to build shelter for themselves. A and B are accomplished woodsmen but C is not, and risks perishing without help. A builds a splendid house but B, being content to commune with nature, builds a simple lean-to. Now the question is, if A and B are in any sense obligated to help C, is one more obligated to do so than the other? Surely not, Landsburg concludes – both are equally competent woodsmen. Yet the principle behind the progressive tax code would have A, who worked long hours and created a valuable asset, contribute more than B who spent his time picking wildflowers.

Or consider two people who are equal in all respects including their earning rate except that A values travel highly and spends 3 months each year abroad whereas B works full time for the whole year. With a single rate of tax B's tax bill is a third higher than A's, but with a progressive rate it is more than a third higher. Why is this fair?

It turns out on more rigorous analysis that the idea of a progressive tax is based on envy, not fairness.⁵ People rightly think that those on higher incomes should pay more tax, but that is exactly what happens with a flat or proportional tax. As the Kemp Tax Commission in the United States put it:

³ Winton Bates, *op cit*, pp 52-53.

⁴ Steven Landsburg (1997) *Fair Play: What Your Child Can Teach You about Economics, Values and the Meaning of Life*, The Free Press, New York.

⁵ See Cathy Buchanan and Peter Hartley (2000) *Equity as a Social Goal*, New Zealand Business Roundtable, Wellington.

If one taxpayer earns ten times as much as his neighbour, he should pay ten times as much in taxes. Not twenty times as much – as he would with multiple and confiscatory tax rates. Not five times as much – as he might with special loopholes. Ten times as much income, ten times as much tax. That's the deal.

Landsburg adds that a fair deal would also recognise the principle that there is some limit to a person's social responsibilities. His own "gut preference" is that nobody should ever be required to pay more than five times the average tax bill. That is considerably less than the McLeod Review proposal for a tax cap of \$1 million a year. People facing high levels of tax tend to vote with their feet – whether they are Laetitia Casta or some of New Zealand's most talented entrepreneurs. The government loses tax revenue and the country loses their skills. Only envy or spite, not fairness, can explain opposition to such a policy.

Thirdly, there is a raft of practical advantages from moving towards a lower and flatter tax scale. Most of the problems of complexity, cost, distortion and abuse come from having a wide spread of rates. Problem areas such as the tax treatment of company income, fringe benefits, capital gains, housing, superannuation, income splitting and many others would all be ameliorated with a lower and flatter scale. It is far better to aim for such a tax structure than to go in for selective tax concessions. These benefit favoured categories of taxpayers but mean higher taxes for everyone else. The tax system has grown in complexity since the tax reforms of the 1980s, and Dr Cullen's moves to increase the top rate to 39 percent resulted in 47 more pages of tax legislation. We have now reached the absurd point where the government in its last budget announced that it would subsidise small employers to compensate for the costs of handling some of the tax obligations it is imposing on them! The motto in tax, as in many other areas, should be 'Keep it simple, stupid'.

Like the case for a single rate of GST, the case for a single rate of income tax is very powerful. Steeply progressive taxation was a Marxist idea, and deserves to be buried with Marx. Politicians such as Jim Anderton still espouse it but Russia and the Ukraine – countries which long maintained a socialist culture of envy – now have maximum individual tax rates of 13 percent, and Slovakia is considering the adoption of a flat tax with a 19 percent rate. The new rate in Russia has been in effect for two years, and government revenue from personal income taxes has more than doubled.

Hong Kong has had a tax on wages and salaries of 15 percent which is being raised to 16 percent. Singapore is cutting its top personal and company rates to 22 percent.

Defenders of big government and high taxes, particularly on the left of politics, couch their arguments in terms of concerns for public services and the poor. What I have tried to show in the brief compass of this talk is that these arguments need to be stood on their head. Both concerns are better dealt with by focusing squarely on economic growth, which implies smaller government with lower taxes.

No country can grow fast with big government. We need governments, but we need them to be focused on their indispensable core roles so as not to crowd out personal choice and blunt incentives for work and enterprise. Countries with smaller governments such as the United States, Australia, South Korea, Singapore and Ireland are out-performing the high tax states of Europe. Irish deputy prime minister Mary Harney has said that "low taxes are the *central* reason for Ireland's economic success" (emphasis added).⁶

The disparities are dramatic. A recent study by a leading economist found that tax accounts for most of the 30 percent gap in average income between the United States and France. Not only do people enjoy higher personal incomes in wealthy countries but they enjoy more and better public services as well. Ireland is spending far more on services such as health and education than it was a decade ago thanks to its phenomenal economic growth and the larger revenues it generated even with lower taxes. As President John Kennedy pointed out when he cut taxes in the United States 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.⁷

The lesson is simple: it's better to have a smaller slice of a large and fast-growing pie than a big slice of a small and slow-growing one.

⁶ Mary Harney, 'Harmonisation of EU taxes is out', *The Irish Times*, 24 February 2002.

⁷ Speech to the Economic Club of New York, 1963.

The arguments about tax and the poor are similar. It's perfectly true that cuts to top rates benefit better-off people initially, and may even widen income disparities. But they do not only benefit better-off people. Lower marginal tax rates fuel overall growth and strong growth does more for the poor than the most aggressive income redistribution policy. This isn't a trickle-down theory – there is no such theory in economics – but simply standard economic teaching about growth. African-Americans now enjoy a higher average level of per capita income than New Zealanders not because of income redistribution but because the United States is a much wealthier country. If people are motivated by compassion rather than envy, the plight of the least-well off should be of greater concern than income disparities at any point of time – especially because people move up and down the income ladder over their lifetimes. So the tax game is not zero sum: gains at the high end also work to the advantage of the poor.

All this should be straightforward to anyone who understands incentives. You don't need fancy economic studies to work out what happens when incentives are changed. If you subsidise something you will generally get more of it – we saw that with Muldoon's supplementary minimum payments for sheep. If you tax something, you will generally get less – whether it is smoking or CO₂ emissions on the one hand or work, savings, investment and risk-taking on the other. All that economic studies help clarify is whether the reduction is a little or a lot. I don't know whether Venus Williams is a budding tax expert but she seems to have the right general instincts. She knows tax punishes success, and if we want more success as a country we should listen to her message.