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NEW ZEALAND TAXATION SUMMIT

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SOME ISSUES IN THE CURRENT TAX DEBATE

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## **SOME ISSUES IN THE CURRENT TAX DEBATE**

### **1. Introduction**

In this paper I plan to cover four topics:

- how to think about the size of the tax burden in New Zealand;
- the linkages between spending, taxing and economic growth;
- the 2001 McLeod Tax Review recommendations on tax priorities; and
- some more specific issues in the current tax debate.

### **2. Is New Zealand a high-tax country?**

We can approach this question in three ways: by comparisons with other countries today; by historical comparisons; and by comparisons with economists' notions of core government functions.

#### ***New Zealand's tax burden relative to other countries***

It is often suggested that New Zealand is not a high-tax country. Thus journalist Rod Oram recently observed that "The government's tax take as a percentage of GDP is the 12th lowest in the OECD so 18 countries are more highly taxed."<sup>1</sup>

The first point to make here is that the best measure of the overall tax burden is the ratio of government spending to gross domestic product (GDP). Deficits and surpluses tend to balance out over time, and most of what governments spend must be raised in tax.

A second point is that some of the OECD economies are large with low ratios of spending and taxation to GDP, but many are small with high ratios. Using an unweighted measure, as Oram does, biases the average ratio upwards.

Thus, for example, for 2004 the average unweighted ratio of spending by governments at all levels for the OECD as a whole ('total government

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<sup>1</sup> *Sunday Star-Times*, 28 August 2005.

outlays') is put at 40.3 percent compared with New Zealand's ratio of 38.7 percent. However, the average OECD ratio is boosted by the European Union ratio of 48.4 percent. New Zealand's spending ratio is higher than that of Australia (36.2 percent), Ireland (35.8 percent) and the United States (35.2 percent), as well as being higher than those of the more dynamic countries of the Asia-Pacific region.

Using weighted averages gives a more economically meaningful picture. Two relevant weights are GDP and population. Using tax ratios instead of spending ratios, Sinclair Davidson found that the average OECD tax take is 31.2 percent when weighted for GDP, while on a population-based weighting it is 30.9 percent.<sup>2</sup> The tax ratio for New Zealand, 34.9 percent, is considerably higher.

As the following table from Davidson's study shows, that ratio is also high compared with the Anglosphere countries. On an unweighted basis, the average tax take of these countries is 31.8 percent. Based on a GDP weighting, the average falls to 28.3 percent; on a population basis the average is 28.7 percent.

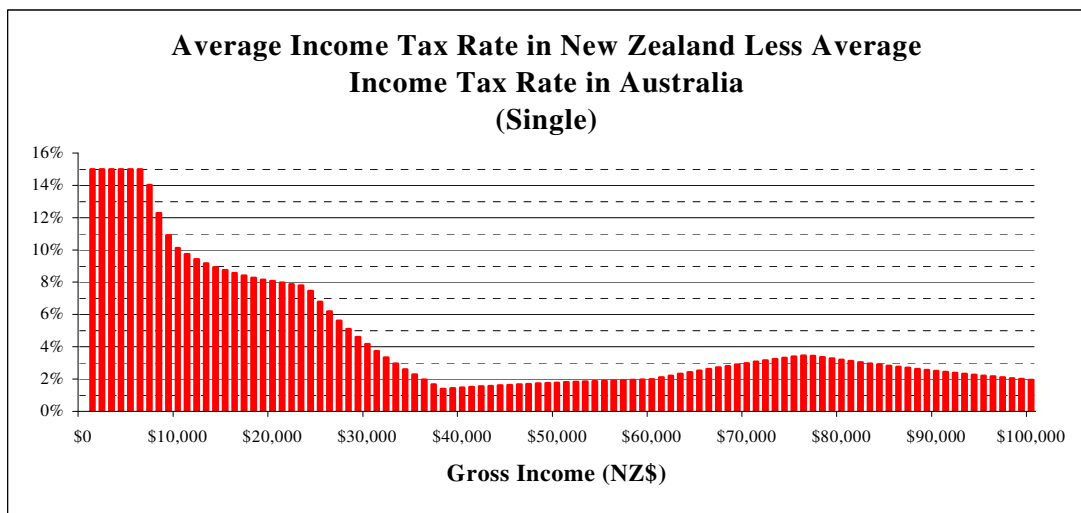
<b>Weighted and unweighted total tax to GDP ratios, 2002</b>				
	Unweighted (%)	GDP (PPP)	Weighted (%) GDP (Forex)	Population
OECD	36.3	31.2	31.4	30.9
OECD Americas	26.1	26.3	26.5	25.0
OECD Pacific	29.2	26.3	26.3	26.2
OECD Europe	38.9	38.7	39.0	37.5
English-speaking	31.8	28.3	28.3	28.7
Euro-Zone	39.8	39.8	39.8	39.5

Source: Data from *OECD Revenue Statistics 1965-2003*, *OECD in Figures* (2004) and author's calculations.<sup>3</sup>

<sup>2</sup> Sinclair Davidson (2005) *Personal Income Tax in New Zealand: Who Pays, and Is Progressive Taxation Justified?*, New Zealand Business Roundtable, Wellington.

<sup>3</sup> *Ibid*, p5.

There has been considerable debate about whether New Zealanders are more highly taxed than Australians – finance minister Michael Cullen is one who has claimed they are not. It is clear from the foregoing comprehensive expenditure and tax ratio measures that this claim is wrong. There is a tendency to focus on the two top Australian personal rates of 42 cents and 47 cents and overlook the fact that the Australian income tax base is narrower than New Zealand's (for example, there is a A\$6000 tax-free zone) and that the 42 cent rate only applies to income over A\$70,000. The comparison in the accompanying chart shows that for a single taxpayer, the average income tax rate in New Zealand is higher than the comparable rate in New Zealand for the whole of the income range up to \$100,000. (The result is similar if ACC and Medicare levies are included.)



The chart excludes ACC and Medicare levies.

### ***Historical comparisons***

In New Zealand and other Western countries, big government has only been a phenomenon of the post-1960s period. Prior to that time even countries like Sweden had relatively modest government sectors by today's standards – and Sweden, which is now an economic laggard, had enjoyed strong economic growth over the previous hundred years. Until the First World War, a tax take of about 10 percent of GDP was the historical norm. Writing in the 1940s, John Maynard Keynes thought the upper limit for the size of government was 25 percent of GDP.

The trajectory of government spending in New Zealand has been similar to that of other countries. Before the First World War, central government (mainly current) spending was only a bit over 10 percent of the economy. It was still below 20 percent in the late 1930s, then rose to 25 percent in the 1960s and to over 30 percent today. Local government spending seems to have expanded more or less in line with GDP.<sup>4</sup> In broad terms, inflation-adjusted GDP per capita has risen four-fold in New Zealand since 1900, while central government taxation per capita has risen twenty-fold.

Thus spending and taxation in New Zealand today are high by historical standards. James Gwartney, a US expert on economic growth, has stated:

New Zealand is still a big government welfare state. Government spending continues at nearly 40 percent of GDP, a figure much too large 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.<sup>5</sup>

IMF economists Vito Tanzi and Ludger Schuknecht have found that since 1960, the further large increase in the share of government spending in industrial countries was associated with a slowing, or even reversal, of improvements in social indicators. They also found that economic performance since 1960, as measured by GDP growth and rates of unemployment, has been on a par or better on average in countries with small governments than in countries with big governments.<sup>6</sup>

### ***Comparisons with core government functions***

A standard economic analysis indicates that the core role of government is to ensure the provision of public goods and a social safety net. The latter includes underwriting access to services such as health and education.

A 1997 paper for the Treasury by Australian economist Ted Sieper (a member of the government's 2001 Tax Review) concluded that spending on core public goods plus as much as a third of health, education and welfare spending would require central government spending to be no more

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<sup>4</sup> Total government spending currently comprises central government current spending of 30-33 percent of GDP, local government current spending of 2-3 percent of GDP, gross capital formation (both sectors combined) of 2-3 percent of GDP, and other capital spending of perhaps 0.5-1.0 percent of GDP.

<sup>5</sup> Quoted in Winton Bates (2001) *How Much Government?: The Effects of High Government Spending on Economic Performance*, New Zealand Business Roundtable, Wellington.

<sup>6</sup> Vito Tanzi and Ludger Schuknecht (2000) *Public Spending in the 20th Century: A Global Perspective*, Cambridge University Press, Cambridge, United Kingdom.

than 14–15 percent of GDP. A study by Bryce Wilkinson concluded that spending on core public goods and welfare, including by local government, of around 20-30 percent of GDP might be justified.<sup>7</sup>

Currently, governments are involved in the provision of a large number of private goods and services that could be more efficiently supplied by the private sector. In respect of commercial activities, there is compelling evidence that, on average and over time, privately owned enterprises outperform state-owned enterprises.

It follows that on the basis of all three criteria – international comparisons, historical comparisons and the core role of government – the size of government is beyond its optimal level in New Zealand and it is a highly taxed country.

### **3. Spending, taxation and economic growth**

Up to a certain level, government spending on core public goods (such as running the legal system, providing a sound currency, and supplying necessary infrastructure) facilitates economic growth. However, beyond that point (where the costs of spending, including the economic costs of taxation, exceed the benefits), big government harms growth.

Excessive spending and taxation affect growth through several channels:

- government provision may crowd out more efficient private provision;
  - big government often involves waste of resources;
  - government spending finances harmful regulatory interventions;
  - income redistribution programmes reduce incentives to be productive;
  - much government spending encourages wasteful lobbying activities;
- and

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<sup>7</sup> Bryce Wilkinson (2004) *Restraining Leviathan: A Review of the Fiscal Responsibility Act 1994*, New Zealand Business Roundtable, Wellington.

- taxation has efficiency or deadweight costs that increase more than proportionately with tax rates.

Deadweight costs arise from diminished incentives to work, save, invest and take risks. In 1994 Diewert and Lawrence estimated the marginal deadweight costs of *labour* taxation in New Zealand at 18 percent and of *consumption* taxation (through GST) at 14 percent.<sup>8</sup> These estimates ignore taxes on capital, which have generally higher deadweight costs (because capital is internationally mobile and investment is sensitive to after-tax returns). Moreover, these estimates are at the low end of the range found in similar studies overseas. The costs of administering the tax system and compliance and avoidance costs are additional to these estimates; Diewert and Lawrence put them at around 8 percent of revenue raised.<sup>9</sup> Since these estimates were made, the top marginal tax rate has been increased to 39 cents. Winton Bates suggests that:

... when account is taken of deadweight costs associated with both taxation and delivery of benefits it is likely that these costs are equivalent to more than half of each additional dollar of government spending in New Zealand.<sup>10</sup>

The marginal costs of taxation of capital income are probably also of the order of 50 percent. On this basis, the current tax system in New Zealand imposes economic costs of at least 50 cents for the last dollar of revenue raised. To produce a net gain in welfare, therefore, \$1 of marginal government expenditure has to deliver a benefit of at least \$1.50. This is a high test and it is not generally applied. Stated differently, the government has the choice of handing back the last (marginal) dollar of revenue and leaving \$1.50 with taxpayers, or allocating an extra \$1 to government spending. Many people regard the trade-off as being \$1 in private hands for \$1 in the public sector, which is a big mistake. Tax revenue should be treated as a scarce resource and taxes should not be used to finance activities that could be undertaken privately.

In its most recent report on New Zealand, the OECD stated unequivocally

<sup>8</sup> W Erwin Diewert and Denis A Lawrence (1994) *The Marginal Costs of Taxation in New Zealand*, New Zealand Business Roundtable, Wellington.

<sup>9</sup> W Erwin Diewert and Denis A Lawrence (1995) 'The Excess Burden of Taxation in New Zealand', *Agenda* 2.1, pp 27-34.

<sup>10</sup> *Op cit*, p viii.

that “higher taxes have a negative impact on economic growth.”<sup>11</sup> It reported estimates that an increase of about one percentage point in the tax burden could be associated with a direct reduction of about 0.3 percent in output per capita, rising to 0.6–0.7 percent if indirect effects via investment are taken into account. The Treasury has estimated that a flat income tax of around 20 percent would add about one percentage point to New Zealand’s growth rate over the medium term. An increase in annual per capita GDP growth from, say, 2 percent to 3 percent would mean average per capita incomes in New Zealand would rise by 80 percent over 20 years instead of 50 percent. Few, if any, other public policy reforms would deliver gains of that magnitude.

Michael Cullen has contested Gwartney’s view that per capita income growth of 4 percent or more cannot be sustained with government spending of around 40 percent of GDP. However, an analysis confirms that no OECD country comparable to New Zealand has achieved that feat.<sup>12</sup> This took ‘sustained’ growth to mean a period of 10 years. Dr Cullen has argued that four OECD countries have averaged 4 percent per capita income growth over 5 years since 1985. Such a period, which may cover a recovery from a deep recession, does not represent long-term sustainable growth. Gwartney has stated that “At least a 10 year period is needed to avoid the bias introduced by cyclical factors.”<sup>13</sup> Moreover, New Zealand would have to sustain a rate of annual per capita GDP growth of more than 4 percent for more than 10 years to achieve the government’s ‘top priority’ goal of returning the country to the top half of the OECD income rankings.

Economic growth is the tide that lifts all boats. The potential of spending and tax reform (and other pro-growth policies) to increase living standards swamps feasible gains from income redistribution. As Robert Lucas, the 1995 Nobel laureate in economics, has put it:

Of all the tendencies that are harmful to sound economics, the most seductive, and in my opinion the most poisonous, is to focus on questions of distribution ... [O]f the vast increase in the well-being of hundreds of millions of people that has occurred in the 200-year course of the industrial revolution to date, virtually none of it can be attributed to the direct redistribution of resources

<sup>11</sup> *OECD Economic Surveys: New Zealand*, July 2005.

<sup>12</sup> Roger Kerr, ‘Memo to Dr Cullen: Big Government Harms Growth’, speech to Rotary Club of Wellington South, 23 September 2002.

<sup>13</sup> *Ibid.*

from rich to poor. The potential for improving the lives of poor people by finding different ways of distributing current production is *nothing* compared to the apparently limitless potential of increasing production.

The chronic failure of New Zealand governments to restrain growth in spending and taxation has led the Business Roundtable to propose the inclusion of a tax and expenditure limit (TEL) in the Public Finance Act, together with other supplementary disciplines. A TEL might limit growth in spending to the rate of population growth plus inflation unless voters supported higher spending in a referendum. Surplus revenues would be returned to taxpayers. Michael Cullen has argued that such a legislative provision would be undemocratic. This argument is invalid as any government could repeal or modify it, just as it could repeal or modify any of the other fiscal responsibility provisions of the Public Finance Act. Several OECD countries (as well as 27 US states, one Australian state and two Canadian provinces) have implemented some form of statutory tax or expenditure limit.<sup>14</sup>

#### **4. The 2001 McLeod Tax Review and priorities for tax policy**

The central recommendation of the 2001 Tax Review chaired by Rob McLeod was to move in the direction of a lower, flatter tax scale.

In making this recommendation, the Review recognised the harmful effects of high marginal rates of tax on economic growth. Not only is the top personal rate of 39 percent above \$60,000 relevant here but also the high effective marginal tax rates that apply as welfare benefits and family assistance are abated. The government's (revised) Working for Families package has many taxpayers facing EMTRs of 53 or 59 percent, and in some cases even higher rates, over wide income ranges. These are likely to be unsustainable.

The Review also recognised that policy should aim to minimise taxation of internationally mobile capital, because of the harmful growth consequences of such taxation. The most relevant taxes for investors are the top personal rate, the company rate, and the taxes faced by international investors in New Zealand. Light taxation of capital income has been a major factor in

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<sup>14</sup> See Wilkinson, *op cit*.

Ireland's economic success.

A flatter tax scale – ultimately a single or proportional rate of tax – would also greatly simplify and reduce the costs of the tax system, reduce incentives to split income, minimise the distortions created by the tax treatment of housing and human capital, facilitate taxation of companies, trusts and superannuation funds, treat taxpayers with variable income more fairly, and discourage tax avoidance.

Richard Epstein has also made a constitutional case for a flat or proportional tax. He argues that taxes should bear some relationship to benefits received, and that groups that advocate higher government spending should pay a proportionate share of the costs.<sup>15</sup>

The main argument raised against a proportional tax is that it is said to be unfair. People making this argument, however, often overlook the fact that those on higher incomes pay more with such a tax: in simple terms, those on, say, 10 times the income of a low-income taxpayer pay 10 times as much tax. The real issue is whether those on higher incomes should pay *more than* a proportional share. The ethical case for such a so-called 'progressive' tax turns out to be weak, based only on envy.<sup>16</sup> Through the amount of tax collected from higher-income taxpayers, a proportional tax allows governments the scope to redistribute income. In addition, the McLeod Review pointed out that most redistribution occurs through government spending. It concluded that there are philosophical arguments both for and against proportionality and progressivity, and that each can be described as 'fair'.

In the interests of avoiding a tax increase on low-income earners, and in recognition of community perceptions about progressivity, the Review recommended a two-step personal income tax scale (18 percent up to \$29,500 and then 33 percent). The Business Roundtable has favoured a lower structure, with the top personal and company rates aligned at 25 percent, in the interests of reducing deadweight costs further, especially on

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<sup>15</sup> Richard Epstein (2004) *The Case for a Flat Tax*, New Zealand Business Roundtable, Wellington.

<sup>16</sup> See Sinclair Davidson, *op cit*; also Cathy Buchanan and Peter Hartley (2000), *Equity As a Social Goal*, New Zealand Business Roundtable, Wellington.

the taxation of capital income. Current fiscal conditions allow more room for tax reductions than was available at the time of the McLeod Review.

It is also worth noting that a strategy of reducing marginal rates was preferred by the Review to one of adjusting tax thresholds. The Australian counterpart to the Business Roundtable, the Business Council of Australia, endorsed this strategy in a recent report, arguing:

A rate change is needed, not a threshold change. Raising the threshold at which the top marginal tax rate cuts in would reduce the average rate of tax paid by these individuals and increase their after-tax income. However, it would not alter the marginal tax rate that these individuals face when they are deciding to undertake additional saving and investment.<sup>17</sup>

The BCA report also supported the Review's concern to reduce the tax rates faced by non-resident investors. It noted:

As a small economy, Australia has virtually no capacity to influence the international price of capital ... Any tax imposed on non-resident suppliers of capital will either prevent the supply of that capital to Australia or be passed on as an additional cost to the resident borrower, unless the non-resident lender is able to fully offset any Australian tax paid against their local taxes.

These are important points.

The tax policy put forward by the National Party in the context of the 2005 general election is consistent with the principles of the McLeod Review to the extent that it is growth-oriented (it seeks to reduce the overall burden of taxation, and it creates a long income range – \$12,500 to \$50,000 – that would be subject to a flat 19 cent marginal rate, thus increasing incentives to be productive). However, it focuses on threshold adjustments not rate reductions, and it does not involve immediate cuts to the top personal and company tax rates (which are most important for growth).

The government's Working for Families package, on the other hand, is focused on income redistribution, not growth, and indeed will harm growth by raising the average effective marginal tax rate for those affected by it.

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<sup>17</sup> Business Council of Australia (2005) *Taxation Action Plan for Future Prosperity*, Business Council of Australia, Melbourne, p 95.

## 5. Some issues in the current tax debate

### *'Tax cuts for the rich'*

Proposals to cut top personal tax rates are commonly met by the criticism that they mean 'tax cuts for the rich'. However, any strategy to flatten the tax scale in the interests of growth will have this (static) effect. As tax scales became more progressive, higher income earners paid an increasing share of tax – currently the top quarter of taxpayers pay nearly two thirds of personal income tax (the bottom 22 percent pay only 1 percent). Taxes can only be cut on those who pay tax. Reversing the historical trend to greater progressivity in the interests of achieving a flatter scale inevitably means larger cuts to high rates; if low rates are cut by as much or more, the progressivity of the tax scale is unchanged.

While higher income people initially benefit most in terms of money in the hand from such a strategy, this is a static analysis. People's income typically rises and then falls over their lifetimes. What is relevant to them is not just the tax rate they face today but the rate(s) they will face if they get ahead. Even more important, lower income people stand to gain from the faster economic growth to which a better tax structure would contribute. The 2004 Nobel laureate in economics, Edward Prescott, points out that:

Lower tax rates are good for all taxpayers. We're barking up the wrong tree if we think that 'taxing the rich' will solve all our problems ... The whole economy suffers under such a scenario – not just those few individuals who are taxed at a higher rate.<sup>18</sup>

Moreover, the point is often overlooked that, as the 2001 Tax Review put it:

... we will often reach misleading conclusions about the fairness of the tax system if we simply assume the economic consequences of a tax fall on the people who are legally obliged to pay it.<sup>19</sup>

People have varying abilities to shift the incidence of the taxes they pay on to others, through changes in prices, wages or behaviour. For example, many IT firms with internationally mobile personnel had to increase gross wages to offset the impact of the increase in the top personal tax rate to 39

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<sup>18</sup> Edward C Prescott, 'The elasticity of labor supply and the consequences for tax policy', in Alan J Auerbach and Kevin A Hassett (eds) *Toward Fundamental Tax Reform* (Washington: The AEI Press, 2005), p 127.

<sup>19</sup> Tax Review 2001, *Issues Paper*, June 2001, p 5.

cents (which then led to more complaints about growing 'income inequality').

This increased their costs and reduced their competitiveness. In general, the main burden of taxes is likely to fall ultimately on people who are least able to avoid or pass on taxes, ie those with the least options in the community. One study speculates that entrepreneurs are able to shift high personal tax rates on to their employees, likely to be lower-income individuals, "leading to counter-intuitive effects on the distribution of after-tax income."<sup>20</sup>

### ***Dynamic scoring***

It has long been recognised that forecasts of the revenue losses from tax cuts usually suffer from a static basis of estimation. As President J F Kennedy observed:

It is a paradoxical truth that tax rates are too high and tax revenues are too low and the soundest way to raise the revenues in the long run is to cut the rates now ...

Elaborating on this point, Kennedy explained:

Lower rates of taxation will stimulate economic activity and so raise the levels of personal and corporate income as to yield within a few years an increased – not a reduced – flow of revenues to the federal government.

This argument should not be taken to extremes. Michael Cullen is right to pour scorn on the view of naïve US 'supply siders' in the 1980s that tax cuts would quickly pay for themselves. But he is wrong not to acknowledge that they are partially self-funding: they do not require spending cuts of the same magnitude.

Tax cuts have both static and dynamic effects.

The static or first-round effect is that cuts in income tax boost after-tax incomes and spending. As a result we expect lower income tax collections but higher tax collections from GST, other indirect taxes and the corporate tax. Treasury's best estimate is that a one dollar cut in the amount of personal income tax collected will increase revenue from other taxes by 17

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<sup>20</sup> Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey S Rosen, 'Income taxes and entrepreneurs' use of labor', *Journal of Labor Economics* 18:2 (2000), pp 324-351.

cents, for a net short-term revenue loss of 83 cents.

However, there are also second-round or dynamic effects. One is that people may respond to tax cuts by reducing tax planning or 'cash economy' activities. If so, taxable income will rise, reducing the revenue cost of the tax cut. Second, people are likely to change their work effort or output in response to changes in tax rates. Tax rates can affect, for example, people's labour force participation, age of retirement, overtime hours, desire for promotion, and emigration decisions. So tax cuts could increase the overall level of output and income in the community as a 'one-off' effect. Third, tax cuts could lift the rate of economic growth (ie future incomes) by improving incentives to save, invest and innovate.

These factors are very important but are more difficult to quantify. A lot of research effort is going into assessing their size. A reputable estimate is that for the United States, aggregate taxable income is likely to rise by around 0.4 percent within three years from a tax cut that would reduce static after-tax income by 1 percent.<sup>21</sup>

On this basis, a reduction of one cent in the top statutory rate of income tax (eg from 39 cents to 38 cents on income of \$60,000 or over) could increase taxable income by around 0.2 percent for a taxpayer earning \$100,000. The initial cost to income tax revenue of that drop in the tax rate would be \$400. Allow for Treasury's 17 cents offset and the static revenue loss is \$332. If pre-tax income lifts within three years to \$100,200, as research suggests, the revenue loss in year three would drop to \$235. This combination of static and dynamic effects is a little under 60 percent of the initial \$400 cost to revenue, ie about 40 percent of the initial loss is recouped.

### ***Increasing complexity of the tax system***

The 1980s reforms to the tax system greatly reduced its complexity and administrative cost. Recent changes have had the opposite effect. The increase in the top tax rate to 39 percent required an additional 47 pages of

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<sup>21</sup> Jon Gruber and Emmanuel Saez, 'The elasticity of taxable income: evidence and implications', *Journal of Public Economics*, 84 (2002), pp1-32.

tax legislation initially (and more subsequently). Fringe benefit tax has become much more complicated. Tax concessions for businesses, such as the 2005 budget policy on depreciation, have been reintroduced. The Inland Revenue Department now employs over 4,750 people and its operating expenses in 2005/06 are forecast to be \$475 million. New Zealand's total 'tax army' of tax lawyers and accountants, as well as IRD staff, is more than four times the size of its 'real army'.<sup>22</sup>

These trends look set to continue. The government's KiwiSaver scheme seems likely to boost the 'tax army' considerably. The high EMTRs facing middle and higher income earners under the Working for Families package will certainly trigger a new round of tax planning involving companies, trusts and, if implemented, qualifying collective investment vehicles. The National Party's tax proposals involve a rate scale in which the company tax rate is not aligned with any personal tax rate, as well as two new tax concessions (for childcare and interest on student loans). All such departures from a broad-base, low-rate tax structure exacerbate complexity, encourage dishonesty by more taxpayers (as they perceive others are ripping off the system) and undermine an ethic of voluntary compliance on which tax administration depends. Many of these problems stem from the progressive rate scale. They add to the case for a lower, flatter structure.

### ***Are tax cuts inflationary?***

In the election debate about tax cuts, arguments have been made that they would push up prices, and that the Reserve Bank would have to raise interest rates to curb inflation.

To any serious economist, this argument is an embarrassment. Even at a superficial level, tax *increases* are more likely to push up prices and *reductions* in tax are likely to lower them.

This is easy to see with GST. When the Goods and Services Tax was introduced there was a relatively brief spike in prices. Increases in excise tax on petrol push up the CPI.

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<sup>22</sup> Alex Robson (2005) *No Free Lunch: The Costs of Taxation*, New Zealand Business Roundtable, Wellington (forthcoming).

Changes in income taxes have similar effects. When the Muldoon government imposed a wage-price freeze in the early 1980s, it cut income taxes to encourage wage earners to be more moderate in their wage demands. The idea of a wage-tax trade-off was to reduce taxes in order to *reduce* pressure on wage costs and prices.

Conversely, when the government lifted the top tax rate from 33 to 39 cents in the dollar in 2000, some firms had to increase wages so that the post-tax incomes of their workers did not fall, in order to retain them. This added to their costs and price pressures.

Where, then, does the idea that tax cuts push up prices come from?

The answer is that it is a hangover from the era of Keynesian economics. Economists then were taught that the causes of inflation were 'cost push' or 'demand pull'. Increased taxes were an example of 'cost push' inflation. 'Demand-pull' inflation was said to derive from a surge in the demand for goods and services in general ('aggregate demand'), especially when 'aggregate supply' (the production of goods and services) was held back by capacity limitations.

But how realistic is this analysis? The answer is, not very.

First, if tax cuts replaced government spending of the same amount, a Keynesian model would predict a *fall* in demand, as some of the tax cuts would be saved rather than spent.

Second, the Keynesian model essentially represents a closed economy – ignoring capital flows and exchange rate responses. New Zealand is a small, open economy and producers in the rest of the world can easily respond to increased demand by New Zealand consumers without affecting the prices of tradable goods.

Third, tax cuts would ease capacity constraints and increase supply in New Zealand over time by improving the incentives to work and invest.

Fourth, and most important, the analysis is static. Inflation is a sustained increase in the general price level, not a one-off change in prices. Even if there were a one-off effect of tax cuts on prices, why would that matter?

Inflation is a monetary phenomenon, as Milton Friedman demonstrated in his attack on Keynesian economics. Only central banks can generate inflation by printing money. The widespread acceptance of Friedman's argument has led the main central banks of the world to target inflation and reduce it to low levels since the 1980s. Non-monetary theories of inflation based on 'demand-pull' ideas have fallen by the wayside, discredited by the stagflation of the 1970s.

The empirical evidence on tax cuts is consistent with this analysis. Opponents of President Reagan's tax cuts argued that they would be inflationary, but inflation in the United States fell steeply in the 1980s.

The Bush administration has cut taxes twice and is proposing further cuts (while also hiking government spending and sending the budget into deficit). The spending and deficit budgeting can rightly be criticised, but the tax cuts have not triggered inflation and US interest rates are at historical lows.

The reality is that there is scarcely any relationship between the state of the government's budget and inflation in an open economy with a floating exchange rate. This conclusion is well established in the economic literature.