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TAX POLICY: WHERE TO FROM HERE?

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TAX POLICY: WHERE TO FROM HERE?

Taxation is usually the largest intervention in any economy. Even in free-market Hong Kong, where personal and company rates of tax are 15 and 16.5 percent respectively, tax arguably has a greater impact on most people's lives than any other government impost or control. Sweden, where the government plays a much larger role, has a flat personal rate of income tax of 56 percent and the state appropriates from its citizens more than half the national income.

Taxes inevitably affect the behaviour of individuals and firms, and they are costly to administer. The tax imposed when we earn wages and salaries, make a profit and spend is the price we pay for being productive, innovative and successful. As taxes rise, work, output, consumption and innovation are reduced. These losses are known as the deadweight or efficiency costs of taxation.

One study for New Zealand found that labour taxation (mostly taxes on the incomes of wage earners and the self-employed) imposes deadweight costs of around 18 cents for the last dollar of revenue raised. In other words, the total value of goods and services produced in the economy falls by 18 cents as an extra dollar is transferred from taxpayers to the government. For consumption tax (mostly the goods and services tax (GST), deadweight costs are 14 cents for the marginal dollar of revenue. These estimates do not take into account administration and compliance costs. The study found that income taxes impose a higher marginal deadweight cost than consumption taxes. Because capital is highly mobile, the economic cost of taxes on income from capital is almost certainly higher.

These findings mean that government spending needs to generate benefits of at least \$1.14 for each extra dollar spent, otherwise the community is worse off. They raise the issue, for example, of whether it is better for taxpayers on around the average income or above to pay a dollar themselves for, say, their health services, or at least \$1.14 to have the same services funded by the government. The redistribution issue is whether it would be better if a smaller amount of tax were raised, thus increasing the size of the national cake, with

taxpayer assistance concentrated on those some distance below the average income.

I'm not one of those who believes that all taxation is theft, but nor do I believe that a society is more civilised the higher its level of taxation. High taxes are a brake on economic growth. The dynamic countries of Asia enjoy much lower levels of tax than the stagnant European economies. They also tend to have a remarkably even distribution of income. High taxes make it harder for people to take care of their own needs. They also discourage philanthropy and charity.

Professor Gerald Scully's claim that the rate of growth in New Zealand would be maximised if the government sector accounted for 20 percent of gross domestic product (GDP) has been widely publicised. His conclusion that lower taxes would increase New Zealand's growth rate is undoubtedly right, but his study is not a good one. There are problems with the analysis and the figure for the optimal size of government spending is almost certainly too high.

From the viewpoint of both growth and equity, the right level of government expenditure can best be determined by focusing on the outlays required to produce or fund public goods that cannot be efficiently provided by the private sector, and to provide a safety net for people who are unable to be assisted in other ways. As Simon Upton and others have been pointing out, an analysis along these lines would show that government spending should be progressively reduced to well below 20 percent of GDP. Technological change continues to offer solutions to public goods problems (e.g. in broadcasting and roading), thereby reducing further the optimal size of the public sector.

The tax burden in any economy is indicated by the ratio of tax-funded spending to GDP. If that ratio is 35 percent, then the average rate of tax is 35 percent. Therefore, if there is a concern about the tax burden, the spending ratio must be reduced. Besides reducing the ratio by shrinking the public sector to its justifiable size, it will also fall if government spending grows more slowly than GDP. Strong economic growth in New Zealand from 1993 to 1995 largely accounts for the fall in spending from 42 to 35 percent of GDP. Since then the ratio has been static and the government forecasts little change over the next three years.

The much less impressive economic performance since 1995 is largely due to a progressive loss of fiscal discipline. The coalition agreement provides for new spending of \$5 billion over three years. Two features of this spending stand out. First, the amount of additional spending is massive and comes on top of the strong growth in spending in the two years before the election. Moreover, despite the government's announcement that existing spending would be reviewed, the 1997 budget indicated that no meaningful savings were achieved.

Secondly, much of the new spending is of low quality and is poorly targeted. The proposed \$100 million of business assistance is a throwback to the days of businesses handouts and subsidies. Around 93 percent of the planned increase in tertiary allowances will go to people from families earning over \$50,000 a year. The abolition of the superannuation surcharge will mainly benefit retired people on above average incomes.

By allowing total spending to expand when the economy was growing, when interest costs and unemployment benefits were falling, and when higher revenue was being generated by earlier tax measures, the government passed up the opportunity to progress tax reform and thus encourage stronger growth in the future. The second round of tax cuts that had been legislated for in 1996 were deferred. They should have been boosting disposable incomes now. Strong employment growth has benefited tens of thousands of people who were previously unemployed. Tax cuts on low and middle incomes would distribute the benefits of the reforms to most income earners.

Tax reform thus begins with government spending. The task is then to find ways of raising revenue which do the least damage to economic growth, consistent with equity objectives. New Zealand has a good tax system compared with many other countries. The OECD, for instance, reported in 1989 that New Zealand's tax system was "probably the least distortionary in the OECD". This reflects the effort that was devoted to tax reform in the 1984-88 period and the principled approach that recent governments have generally adopted. The comment relates to the design and structure of the tax system rather than the level of taxes. The basic strategy has been to develop a broad-based, low-rate system.

This strategy included the removal of many income tax concessions, the lowering of income tax rates and the introduction of GST. It is often claimed

that the reduction in personal tax rates that accompanied GST was unfair. This view seems to have discouraged the government from lowering the top personal and company rates of tax in designing the recent tax cuts. It is wrong for several reasons:

- the real degree of tax progressivity prior to the reduction of personal tax rates was much less than was implied by the statutory tax scale. Taxpayers who faced the top rate of 66 percent were disproportionately represented among those who took advantage of numerous concessions;
- the broadening of the tax base offset or largely reduced the apparent reduction in the progressivity of the tax system. The ratio of tax to GDP has increased substantially. Much of the growth in tax revenue reflects the abolition of business concessions, the taxation of superannuation schemes and the accrual rules. People on high incomes have undoubtedly paid a disproportionate share of the additional tax;
- half of the initial revenue raised by GST was used to replace or reduce other indirect taxes, such as the wholesale sales tax, and low income earners were compensated through family assistance and other income support measures;
- GST is a proportionate tax if people consume all their income over their lives and the rate of tax is constant. It is not a highly regressive tax as its opponents commonly claim;
- it is irrelevant to focus simply on who will benefit most from tax cuts in absolute terms. Almost any tax cut will appear to benefit middle and high income people because they will be paying the most tax when it is implemented; and
- the ultimate incidence of taxes is affected by dynamic factors. A static and simplistic analysis of statutory rates of tax is misleading. The tax burden is shifted from the initial payer to consumers, employees and asset holders. Its ultimate incidence is hard, if not impossible, to determine. The relative incomes of people change significantly over time. Progressive taxes tend to shift the tax burden among different stages of a person's life rather than among people. To the extent that lower and more uniform rates of tax increase economic growth, real incomes are

increased. Thus even if low income people were to bear a higher share of total tax, their overall welfare may be improved when these factors are taken into account.

With a generally sound tax structure now in place, future tax reform should focus on the level and rates of tax. The evidence strongly suggests that priority should be given to reducing income tax relative to GST because it causes the most harm to the economy. The development of an international tax regime which does not unduly discourage or favour inward or outward capital flows relative to domestic investment is also a priority. The indirect tax reform programme which envisaged the abolition of almost all indirect taxes with the introduction of GST should be completed. The argument for specific taxes on gaming activities and on alcohol are weak, and the remaining stamp duties are an anachronism.

Earlier this year the treasurer, Winston Peters, suggested that the company rate of tax should be reduced. However, this approach to income tax reform is too narrow. Companies are owned by people. Personal rates of tax are the relevant taxes for resident shareholders because, with imputation, the company tax is a withholding levy rather than a final tax. With unchanged personal taxes, lower company tax would not reduce the adverse effects of tax on investment undertaken by companies and funded by resident shareholders. However, a reduction in the personal rate of tax would do so. It is encouraging that the treasurer appears to have recognised this point and has recently foreshadowed general reductions in top rates.

There are other reasons for focusing on high marginal tax rates. There is a well-established finding in the tax literature that deadweight costs rise more than proportionately as marginal rates of income tax increase. This is a reason why many countries have adopted flatter income tax scales. Between 1986 and 1990 nearly all the OECD countries reduced their top rates of personal income tax or announced their intention to do so, and most did so by a considerable margin. In contrast, 12 countries increased their bottom tax rate, four made no change and only seven reduced it.

High effective marginal rates of tax may arise where statutory rates of tax interact with the abatement of government assistance such as welfare benefits and the accommodation supplement. The government had a case for

addressing this problem in the first round of tax cuts. Ongoing reductions in statutory tax rates would further ease the problem.

Lower marginal taxes reduce the incentive to avoid and evade taxes. They also make it possible to apply taxes to a broader range of activities. Distortions between different activities and investment vehicles can be reduced. When countries had extremely high top rates of tax, they invariably had substantial gaps in their tax bases. Many people who would otherwise be subject to punitive rates of tax were encouraged to look for escape routes.

Cutting the top tax rates would also enable the tax scale to be flattened. An important advantage of flatter tax scales is that they simplify the tax system. If, for the sake of argument, a flat tax scale were adopted, income earned through entities such as companies could be taxed at the company level at the single rate of tax. Dividends could then be distributed tax free and the imputation system could be dropped. Investors on low incomes would not be taxed at penal rates, as happens at present with superannuation funds. Financial institutions could deduct tax on interest earned by depositors and such interest could be exempted from further taxation.

With a flat tax system, substantial numbers of taxpayers who only earn income that is taxed before it is paid, such as salaries, wages, dividends and interest, could be exempted from filing a tax return. Tax rules that try to limit the scope for income splitting among high and low rate taxpayers could be abolished. The number of people required to administer the tax system could be reduced. The expertise of tax accountants could be employed more productively on other tasks.

After making good progress towards a flatter scale, recent tax moves have gone in the wrong direction and widened the gap between rates again. Prior to July 1996 the top rate of personal tax was generally 33 percent while the middle marginal rate was 28 percent. What is more, few people in employment earned an income of less than \$9,500 a year (\$183 a week) which was taxed at 15 percent. While the top tax rate is to remain unchanged, the new middle marginal rate will be 11 percentage points lower at 21 percent from July 1998. One consequence of more than doubling the gap between these rates is that the government is now having to look at ways of addressing the over-taxation of middle income earners who invest in superannuation funds. Any solution other than a return to a flatter tax scale will add complexity to the tax system.

People rightly think that those on higher incomes should pay more tax. But that is exactly what happens with a flat or proportionate tax. As the Kemp Tax Commission in the United States recently put it:

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.

Indeed that was broadly the deal from the early days of the income tax. The biblical tithe was a proportionate tax. So, largely, was New Zealand's first income tax. From 1892 to 1909 the first 1,000 pounds of taxable income was taxed at the rate of 2.5 percent (sixpence in the pound) while additional income, and all company income, was taxed at 5 percent (one shilling in the pound). Very few people would have earned sufficient income to be subject to the 5 percent rate.

In early New Zealand, the first 300 pounds of personal income was free of tax. Most flat tax proposals include such a tax-free threshold, which reduces the effective rate of tax paid by people on low incomes and minimises compliance costs for people, such as most children, with limited income. Although a single marginal rate of tax – the flat rate – applies to each dollar of income in excess of the threshold, the average rate of tax rises as income increases.

It is widely accepted that governments should redistribute income from people who earn high incomes to those on low incomes. But this does not call for a so-called progressive tax, whereby marginal tax rates rise with income levels. Because high income earners pay more tax than low income earners with a proportionate tax, income is automatically redistributed, assuming people receive roughly the same amounts of government services. Moreover, on the spending side, many government programmes are directed at people on low incomes. The philosopher John Rawls, a fervent advocate of the redistribution of income, concluded that a proportionate expenditure tax – GST would be an example – may be the best way of raising revenue. Thus the argument for less progressive taxes is not an argument against redistribution.

Highly graduated taxation enables one group to impose on another burdens which it is not asked to share. The direct link between the cost borne and the benefit received is broken. This creates large incentives for interest groups to promote spending programmes that benefit them in the belief that almost all of the costs will be borne by others.

Unless the government is required to show either that it is combating some recognised harm or providing compensation in cash or kind to those whom it taxes, there can be no effective limit on the level of government spending. Moreover, there is no reason why a little more tax on someone else's income cannot be represented as just and reasonable.

Progressive taxes have bedevilled governments' revenue systems for most of the last hundred years. Early critics of progressive taxes included the 19th century tax expert, J R McCulloch. He advised that:

The moment you abandon ... the cardinal principle of extracting from all individuals the same proportion of their income or their property, you are at sea without rudder or compass, and there is no amount of injustice or folly you may not commit.

McCulloch's concerns were realised when the maximum rate of graduated tax in Great Britain rose from 8 percent to 97 percent and in the United States from 7 percent to 91 percent within a 30 year period.

Marx and Engels certainly had injustice and folly in mind when they proposed a "heavy progressive or graduated income tax" as one of the measures by which, after the first stage of the revolution, "the proletariat will use its political supremacy to wrest, by degrees, all capital from the bourgeois, to centralize all instruments of production in the hands of the state." They saw progressive taxation as one means of making "despotic inroads on the right of property."

A pattern of steep progression at high levels of taxation does not blend comfortably into a society that relies heavily on private property for its economic well-being. If governments were to tax private property at 100 percent, it would be destroyed. Another way of looking at this is to recognise that currently the average taxpayer in New Zealand works from 1 January to about 7 May just to pay taxes levied by central government. The black American economist, Walter Williams, has made the point that a working

definition of slavery is that you work all year and you do not have the right to the property derived from your labour.

Highly progressive taxes are still advocated today by some parties on the political left. Implicitly they continue to believe that the government can make better spending choices than private citizens. Admittedly there are contrasts. Tony Blair's Labour government in Britain pledged no increases in income tax rates and cut the corporate tax rate from 33 to 31 percent in its first budget. On the other hand, going into the last election in New Zealand, Labour promised to raise the top tax rate to 39 percent and the Alliance to 49 percent. These rates would put great strain on the tax system if the post-July 1998 middle effective tax rate of 21 percent is retained. With a 12.5 percent GST on top of income tax rates, many New Zealand taxpayers would be spending over half the year working for the government. On Walter William's definition, they would be half slave and half free.

For the reasons I have outlined, the increase in progressivity of the New Zealand tax system arising from the first two rounds of the tax cuts is in my view a mistake which should be addressed in subsequent rounds. It is encouraging that the treasurer appears to share this view. To make room for ongoing tax reductions while still reducing debt, the ratio of spending to GDP must be reduced by eliminating unjustified programmes and ensuring that the rate of increase in spending is lower than the growth in GDP. Taxes could then be cut without reducing the surplus. If that strategy is pursued, there is no reason why the top personal tax could not be reduced to 20 percent or below over the next few years. The top personal and company tax rates could be reduced by more percentage points than the middle effective tax rate so that we returned to a flatter income tax scale. People on lower incomes would still benefit directly, and they would gain further as they moved up the income ladder. With reduced spending, the whole tax scale could be progressively lowered and the tax system simplified.

Getting income tax rates down to 20 percent or below would go a long way to putting New Zealand in the same league as dynamic countries like Hong Kong. Annual per capita incomes in Hong Kong, which were once far below New Zealand's, are now US\$22,990 – some 60 percent higher than ours – and the gap is continuing to widen. As Hong Kong's experience shows, it is growth, not redistribution, which generally raises living standards – only a rising tide will lift all boats.

The government needs to set its sights much higher. New Zealand's growth performance is falling well short of the country's potential. The National Party has a target of 3.5–5 percent annual growth to 2010, and New Zealand First aims to raise the growth rate to 6 percent by 1999. Neither target is remotely plausible with present policies. A strategy for achieving more rapid growth must involve lower government spending and lower and more uniform rates of income tax. The Manufacturers Federation has recently challenged the government to commit itself to a goal of reducing government spending to 25 percent of GDP and reducing the top marginal tax rate to 25 cents in the dollar over the next 5 years. These are not over-ambitious goals – indeed achieving the government spending target would allow the tax rate to be cut further. Their realisation would mean a huge boost to confidence, investment, jobs and growth in New Zealand.