NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE 2007 BUDGET POLICY STATEMENT

FEBRUARY 2007

Summary

- This submission on the Budget Policy Statement 2007 (BPS) is made by the New Zealand Business Roundtable, an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.
- The greatest weakness of the BPS is its failure to address the central problem of ensuring the future prosperity of New Zealanders by achieving faster growth in average incomes. This has been the government's stated 'top priority' goal. Promoting economic growth, rather than strengthening an already strong fiscal position, would also be a better strategy for meeting future spending demands.
- In our view, living standards for New Zealanders are now more likely to fall rather than rise relative to many other wealthier countries, particularly Australia. It is clear that New Zealand is not on track to achieve 4 percent per annum gross domestic product (GDP) growth on a sustained basis.
- The government deserves credit for its commitment to maintaining a prudent level of public debt in order to maintain New Zealand's credit rating. This is important to the private sector. However, the BPS proposes to tax New Zealanders excessively in order to fund wasteful and unnecessary spending and to build up Crown net worth. Greater spending discipline is necessary. A source of such discipline would be greater accountability to taxpayers in the form of a tax and spending limitation rule in the Public Finance Act.
- We consider that any review of the tax system should follow the main recommendations of the McLeod tax inquiry of 2001. In our submissions to the McLeod review we advocated reductions in both personal and company tax rates and an alignment at a maximum rate of 25 percent over a few years. Broad-based taxes at a low rate are economically desirable. Special exemptions based on arbitrary definitions of savings, exports or R&D will undermine this framework and create economic distortions.
- There is widespread concern in the business community that standards of living in New Zealand are being held back by an excess of ill-justified government regulation. We see the concept of a Regulatory Responsibility Act as a desirable approach to achieving greater regulatory discipline.

1 Introduction

1.1 This submission on the Budget Policy Statement 2007 is made by the New Zealand Business Roundtable, an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 In this submission, section 2 reviews the BPS's strategy, goals and means. Section 3 assesses the BPS from an economic growth perspective. Section 4 addresses the issue of taxation. Section 5 raises some other considerations, notably government regulation. Section 6 makes some concluding observations.

2 The BPS's strategy, goals and means

2.1 The BPS states that the government's fiscal strategy is to strengthen the fiscal position in order to help manage future spending demands, particularly those associated with an ageing population. It identifies superannuation and health as two key long-term fiscal challenges for New Zealand. The government's response is to continue to raise real per capita government spending while running large fiscal surpluses. This implies government ownership of an increasing proportion of the nation's wealth, as indicated by indefinitely increasing Crown net worth as a ratio of GDP.

2.2 The accompanying half year economic and fiscal update (HEFU 2006) forecasts that core Crown government spending will rise from 31.7 percent to 33.2 percent of GDP between 2006 and 2007, thereafter dropping progressively to 32.0 percent of GDP by 2011. This rise in spending is on top of earlier substantial increases. The following chart combines the HEFU forecasts with other numbers in Treasury's long-term model in 2006 in order to provide a perspective on the overall growth in core Crown operating expenses since 2003-04.[1] This indicates

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1 The chart shows a small projected reduction in the ratio of government spending to GDP in 2007-08. However, in recent years there has been a marked tendency for actual government spending in any given year to exceed initial forecasts of spending in that year in earlier budgets by a wide margin. For example, the 2003 Budget forecast that core Crown operating spending, which was 30.7 percent of GDP in the year ended June 2002, would fall to 30.4 percent for the year ended June 2006 and to 30.1 percent of GDP for the year ended June 2007. HEFU 2006 reports an actual outcome for the year ended June 2006 of 31.7 percent of GDP and a forecast outcome for

that Core Crown spending in 2006-07 is likely to be close to 20 percent higher

the year ended June 2007 of 33.2 percent of GDP (over 3 percentage points higher). Forecast spending for the year ended June 2007 has increased by 15.8 percent whereas forecast GDP for the same year has increased by only 5.0 percent.

than in 2003-04 in real per capita terms (using the GDP deflator) and 4 percentage points higher when measured as a percentage of GDP.[2] The increase in per capita spending is of the order of $2,000 per capita, taking operating spending per capita to around $13,000 a year. This would be a concern even if all government spending were efficient and productive because the economic (or deadweight) cost of the associated tax burden would be damaging for economic growth. We have long pointed out that no comparable OECD country has achieved sustained annual growth of 4 percent per capita with total government spending at New Zealand's level (indeed not many have sustained 3 percent per capita growth), and it is implausible to think that New Zealand might be an exception.[3] However, it is also clear that much government spending is not rigorously evaluated and is ill-justified.[4] Much government spending is on private goods, which should be the domain of private spending and private sector provision.

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2 This analysis assumes no change in Treasury's GDP deflator series from the values in its 2006 long-term fiscal model.

3 For an update of the analysis, see Roger Kerr, 'Memo To All Parties: Big Government Harms Growth', New Zealand Business Roundtable, 2 July 2006, at www.nzbr.org.nz/documents/speeches/speeches-2006/060712_all_parties.pdf

4 For a discussion of the problem of the quality of government spending, see Roger Kerr, 'The Dilemma of Public Sector Spending: Getting the Quantity and Quality Right', New Zealand Business Roundtable, 19 September 2006, at www.nzbr.org.nz/documents/speeches/speeches-2006/060919dilemma.pdf

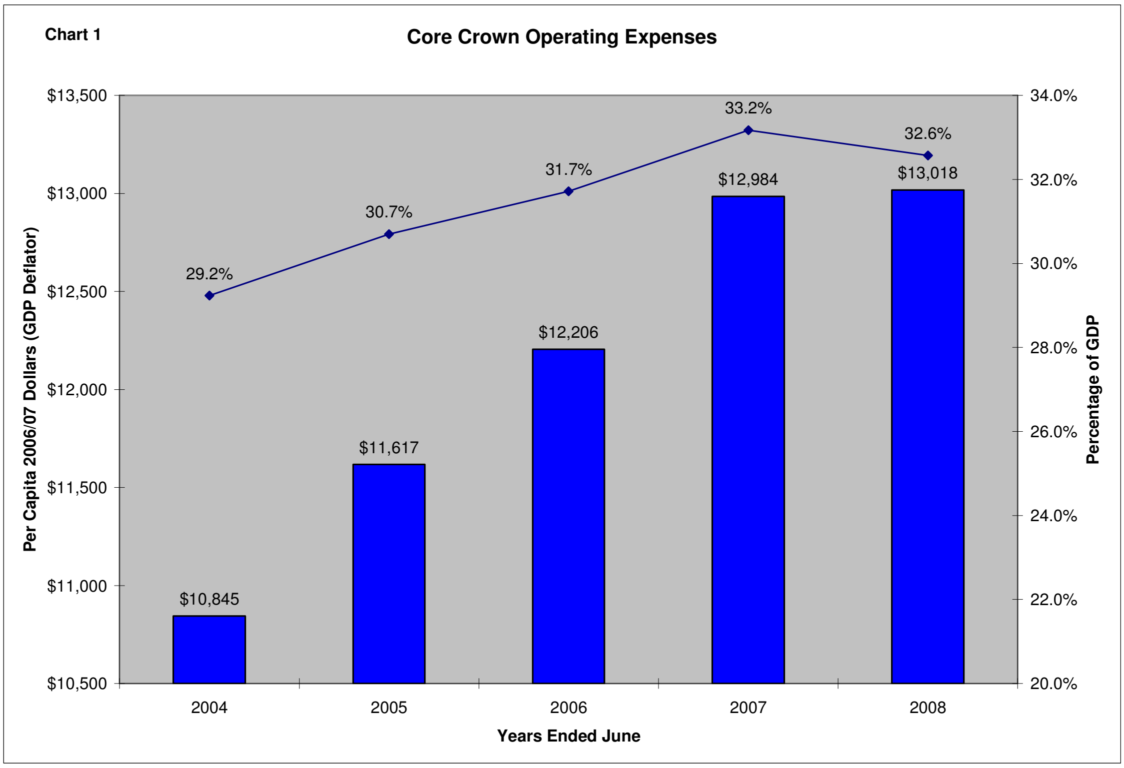
Chart 1
Core Crown Operating Expenses
Per Capita 2006/07 Dollars (GDP Deflator)
Percentage of GDP
Years Ended June
$13,500
$13,000
$12,500
$12,000
$11,500
$11,000
$10,500
34.0%
32.0%
30.0%
28.0%
26.0%
24.0%
22.0%
20.0%
2004
2005
2006
2007
2008
$10,845
$11,617
$12,206
$12,984
$13,018
29.2%
30.7%
31.7%
33.2%
32.6%

2.3 Even apart from the problem of low quality spending, strengthening the fiscal position is a flawed strategy for achieving the goal of managing future spending needs. The government can 'strengthen' the fiscal position in the short term by over-taxing citizens and tolerating wasteful spending, but only at the expense of economic growth and thereby the ability to spend in the future. Over-taxation is likely to lead to spending for political purposes (to win elections) rather than to underwriting the security of citizens in the future.

2.4 The government deserves credit for its commitment to maintaining a prudent level of public debt in order to maintain New Zealand's credit rating. This is important to the private sector. However, a prudent debt level can be maintained at lower levels of spending and taxation.

3 The absence of a credible strategy for economic growth

3.1 A better strategy for achieving the goal of satisfying future needs would be to promote economic growth. No government in recent years has had a credible strategy for raising economic growth, and there is none in the BPS. Instead, the emphasis remains on income redistribution, not on increasing incomes overall. Income redistribution is a weak policy for improving the position of those on low incomes over time.[5] Moreover, much of the government's recent spending on redistribution has been directed at households on middle or higher incomes. The BPS seems to deliberately avoid mentioning the subject of economic growth. Instead it refers to investing in the "productive capacity" of the economy in order to lift New Zealand's economic performance and to "enhance", "propel", and "drive" economic transformation. No mention is made of the need to ensure that spending provides citizens with value for money.

3.2 The failure of the BPS to focus on economic growth may reflect a desire to avoid drawing attention to the relatively poor outlook for economic growth in New Zealand. Australian GDP growth in 2005-06 was 2.9 percent, compared to 2.2 percent in New Zealand. The Australian government's mid-year update issued in December 2006 forecast real GDP growth of 2.5 percent for 2006-07 despite the

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5 See Mark Harrison, *The Outcomes of Income Transfers*, New Zealand Business Roundtable, forthcoming.

drought and 3.75 percent for 2007-08.[6] The corresponding forecasts for New Zealand in HEFU 2006 are 1.8 percent and 2.3 percent respectively. The latest quarterly predictions of the New Zealand Institute for Economic Research forecast GDP growth rates for New Zealand's trading partners of 3.9 percent, 3.5 percent and 3.6 percent for the three calendar years commencing in 2006. The latest OECD forecasts project that OECD member countries as a whole will grow at 3.2 percent, 2.5 percent and 2.7 percent respectively in the same three calendar years (and many non-OECD countries, including high-income countries such as Hong Kong and Singapore, are achieving higher growth rates).

3.3 The latest OECD data confirm that New Zealand is nowhere near to achieving the government's 'top priority' goal. For 2005, the OECD assesses the purchasing power parity value of New Zealand's real GDP per capita to be US$25,300. New Zealand ranks 21st amongst the 30 countries in the OECD, sitting between Spain (US$27,300) and Greece (US$23,200). Finland currently occupies the mid-ranked position (15th) at US$31,400. Australia is 11th ranked at US$32,900. The table in Annex I shows how much faster per capita economic growth would need to be in New Zealand to close the gap with any of the other member countries of the OECD in the next 10, 15 or 20 years. For example, to catch up with Finland (currently 24 percent ahead of New Zealand) or Australia (currently 30 percent ahead) in the next decade, New Zealand would have to grow *faster* than Finland by 2.2 percent per annum and *faster* than Australia by 2.7 percent per annum. Such prospects are pure fantasy given current policies. New Zealand's *absolute* rate of growth in real GDP per capita in the decade to 2006 (years ended March) was 2.0 percent per annum, and falling. A key consideration here has been the much-reduced multifactor productivity growth in New Zealand since the government took office in 1999. Moreover, Treasury's long-term model 2006 has real GDP growing at 2.5 percent per annum in the decade to 2015 – a plausible projection – while population grows at 0.8 percent per annum, giving a growth rate for real GDP per capita of only 1.7 percent per annum.

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6 See http://www.budget.gov.au/2006-07/myefo/html/index.htm

3.4 Budget 2002 set a goal of lifting New Zealand's rate of GDP growth to 4 percent per annum in order to see a long-term rise in the relative standard of living of New Zealanders.[7] At the same time, finance minister Michael Cullen commented that the growth rate after 2006 was so uncertain that "only the next couple of years would show if New Zealand was on the right track".[8] Over four and a half years later it is absolutely clear that New Zealand is not on this track.

3.5 Realistically, the gap with Australia is expected to widen. Australia is growing faster than New Zealand and official projections are for continuing faster labour productivity growth in Australia. The latest measures of economic freedom – the lodestar for economic growth – by the Heritage Foundation and the *Wall Street Journal* put Australia ahead of New Zealand on this measure, for the first time in data going back to 1996. Australia has increased its score on this measure now every year for the last 10 years, while New Zealand has faltered. The World Economic Forum similarly ranks Australia well ahead of New Zealand for Growth Competitiveness. Also, OECD statistics show that unit labour costs in New Zealand rose faster than in any other OECD country between 2000 and 2006, pointing to a reduction in international competitiveness.[9] These trends augur badly for future competitiveness and growth.

3.6 Australia outperforms New Zealand even when the focus is narrowed to fiscal burdens, despite the extra layer of government arising from its federal structure. The member countries of the OECD are disproportionately high tax countries, and New Zealand is typical of this group with a government spending ratio that is projected by the OECD for 2008 to be 41.2 percent of GDP, compared to a ratio for the OECD as a whole of 40.2 percent. But the ratio for Australia is projected to be only 34.1 percent, the third lowest in the OECD. The relative burden of government in New Zealand looks greater again when the size of government is measured using the OECD's forecasts of tax and non-tax receipts as a percentage of GDP. The 2008 forecast for New Zealand is 43.3 percent of GDP

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7 Budget Speech 2002, p 5.

8 *The Daily Post*, May 25, 2002, p 8.

9 OECD, *Economic Outlook*, December 2006, Annex Table 43. The increase in New Zealand was 46.5 percent in this period, compared with a rise of 34.7 percent for Australia and 21.5 percent for the OECD average. New Zealand also lost competitiveness against Australia and the OECD average during this period on the OECD's relative consumer price measure, but not to the same extent.

– almost the same as for Germany – compared to 35.5 percent for Australia and 38.4 percent for the OECD as a whole. This result reflects in part over-taxation – the large fiscal surpluses being run in New Zealand. The OECD forecasts New Zealand's cyclically adjusted general government balance in 2008 to be 2.8 percent of GDP. This is higher by 1.0 percent of GDP than the next highest forecast surplus (which is for Finland). The Heritage Foundation/*Wall Street Journal* freedom indexes assess fiscal burdens in the OECD countries in the context of the world as a whole. For 2007, they indicate that 136 countries have greater fiscal freedom (that is a smaller fiscal burden taking tax rates and revenue burdens into account) than New Zealand. These data refute the government's claim that New Zealand is not a high-spending, high-tax country.

3.7 A more credible strategy for enhancing economic growth would focus on enhancing New Zealanders' economic freedom.[10] People can generally spend their own money more wisely than politicians. Competition and choice is usually better than state monopoly and its common bedfellow, mandatory purchase from government providers (eg ACC). Government spending should be low and focused on the provision of public goods and a social safety net that is geared to protecting people in need while minimising state dependency. Government-owned commercial enterprises should be sold – the evidence is clear that, on average and over time, they perform better in the private sector. Taxes should be modest, broad-based and at a low rate.

3.8 Many countries have demonstrated stronger fiscal discipline than New Zealand and achieved outstanding improvements in prosperity. Ireland reduced the share of government spending in its economy from over 50 percent to just over 30 percent in the 1990s (it is now back around 35 percent). In Hong Kong, the 2006-07 budget reported that public expenditure for 2006-07 was on track to be around 18 percent of GDP, as the government followed the principle "big market, small government". This was down from a peak of 22 percent of GDP a few years earlier and the goal is to keep it below 20 percent. The top tax rates of Hong Kong and Singapore are 20 percent or below. New Zealand's fiscal

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10 The reasons for this emphasis and framework have been explained in Business Roundtable submissions on previous Budget Policy Statements.

policies are out of line with those of countries committed to increased overall prosperity.

4 Taxation

4.1 As the data above indicate, New Zealanders are much more highly taxed than the citizens in many wealthier countries. Well-designed tax reductions would stimulate economic growth, as the Treasury pointed out in its briefing to the incoming government in 2005. Greater restraint in spending than the government is planning would facilitate larger tax reductions. The 2001 McLeod inquiry was the most comprehensive recent review of the tax system. It advocated a lower, flatter tax structure for personal and company income. Ideally, the company rate and the top personal rate should be aligned.

4.2 In 2006 the Business Roundtable joined with other business organisations in recommending cuts in both personal and company tax rates to below Australia's company tax rate of 30 percent, and opposed selective tax concessions. A copy of our submission is attached as Annex II. In the context of savings, the minister of finance stated in the 2002 Budget: "The Government is not considering upfront tax incentives … Their abolition in the mid-1980s represented sensible tax policy on both equity and efficiency grounds." The OECD has also commended New Zealand's policy of generally maintaining a broad tax base without concessions. Recent indications are that sound tax policy principles are going out the window. We are very concerned that the changes to business tax that are being contemplated might make the existing structure more distorted and less broadly based. Any tax concessions for savings, exports or research and development would be based on arbitrary and unsatisfactory distinctions which invite tax-avoiding arrangements and distract businesses from their prime role – providing consumers with value-for-money products and services. Distorted tax systems also attract self-serving lobbying for further, or different, concessions.

4.3 The government appears reluctant to cut taxes for fear that doing so would add to inflationary pressures in the short term. Its analysis of the impact is unfounded. Inflation is a monetary phenomenon – the Reserve Bank has full control over medium-term inflation – not a fiscal policy issue. New Zealand demand is far too small to put pressure on the global supply of traded goods, so any short-term problem could only conceivably be an issue in respect of non-traded goods. Since resources (eg labour and capital) can often be switched readily between the production of traded and non-traded goods, the government should reduce its spending on non-traded goods as it reduces tax rates and government spending on private goods.[11] Given such a strategy, responsible tax reductions would be quite consistent with maintaining low inflation.[12] Tax

[11] First NZ Capital's 8 December 2006 'NZ Weekly Pulse' argues that the expansion of the public sector in recent years, along with generous public sector wage increases, have had an inflationary effect.

[12] The Business Roundtable is concerned that inflation has been running at a rate that is not consistent with the price stability objective in the Reserve Bank Act. However, this is an issue that needs to be addressed independently of reductions in taxes. Ill-advised changes to the Bank's Policy Targets Agreements may well have contributed to higher inflation expectations and trends.

reductions add less to demand than expenditure increases of the same magnitude because some proportion of them is saved. Less government spending on non-traded goods would also reduce pressure on monetary policy and the exchange rate, and do more to help exporters than interventionist policies such as tax concessions.

4.4 Economic growth and fiscal drag provide a government with extra money to spend without having to seek the explicit permission of taxpayers. This undoubtedly makes it easier for governments to spend simply because the money is available and partisan political considerations are favourable. However, people generally work hard to make the money that flows to the government in taxes. Governments should not be able to spend loosely and without their permission. New Zealand's experience with the Fiscal Responsibility Act 2004 (now part of the Public Finance Act) suggests the legislation has been successful in helping to rein in deficits and debt but not successful in reining in expenditure and taxation. There is a case for making governments more directly accountable to taxpayers for spending decisions. Milton and Rose Friedman proposed the concept of democratically determined tax and spending limitations in their book *Free to Choose* in 1979. Since then a number of national governments have adopted some form of tax or spending limit and around 30 US state governments have tax and expenditure limitation rules on their books. A report prepared for the Business Roundtable in 2004 put forward a detailed proposal in a New Zealand context for such a 'fiscal constitution'. In essence, this would limit spending and taxation growth to the rate of inflation and population growth, unless governments secured the consent of taxpayers to vary these limits in a referendum. We think it merits serious consideration and public debate.[13]

5 Other considerations

5.1 Another report commissioned by the Business Roundtable pointed out the ways in which ill-justified government regulation reduces economic growth and

13 See, Bryce Wilkinson (2004) *Restraining Leviathan: A Review of the Fiscal Responsibility Act 1994*, New Zealand Business Roundtable, Wellington, section 3.

community welfare more generally.[14] The government is aware of the widespread concern in the business community about this problem and has responded with its so-called Quality Regulation review. While it is true that New Zealand ranks highly internationally for the overall quality of its regulations, it is just as true that poor quality regulation is an OECD-wide concern and that other countries with much the same ranking as New Zealand believe they also have an excess of regulation.

5.2 For example, there is widespread international concern about labour market regulation. Labour law that reduces freedom of contract between a worker and an employer tends to reduce the supply of jobs and make it harder for marginal workers to find work. Involuntary unemployment or discouraged worker effects alienate would-be workers from cooperative social activity and reduce their incomes. HEFU 2006 projects a rising rate of unemployment to 2008 when it reaches nearly 5 percent. This would be wasteful, unnecessary, undesirable and inconsistent with the prime minister's stated goal in 1999 of achieving a 3 percent rate of unemployment after one term in office (also not achieved).[15] A more flexible labour market featuring greater freedom of contract is needed to achieve this goal.

5.3 In recent years, regulations in electricity, telecommunications, forestry, fishing, pharmaceuticals, building, banking and securities markets, to name just a few, have caused major concerns to firms in those industries. New Zealand scores poorly in international surveys for the burden of its environmental regulations, and additional Kyoto measures have recently been proposed. Common problems include the poor quality of regulatory analysis by officials and the tendency to take private property rights from a minority for the benefit of others without compensation. Last year's regulation of Telecom is a case in point. Such events inhibit desirable investment and thereby economic growth. New Zealand needs to do better than other countries with its public policies to offset natural economic disadvantages. We believe that a wide-ranging reappraisal of New Zealand's regulatory process is required, and commend the concept of a

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14 See Bryce Wilkinson (2001) *Constraining Government Regulation*, New Zealand Business Roundtable, Federated Farmers of New Zealand and the Auckland and Wellington Chambers of Commerce.

Regulatory Responsibility Act. We trust the government will vote to allow a current member's bill along these lines to get a first reading. Not to do so would suggest that its professed concerns about regulatory impacts are not serious and that it is closed-minded about remedies.

6 Concluding comment

6.1 In the 2002 Budget the minister of finance noted that there was a "broad consensus" that New Zealand's sustainable growth rate needed to be increased "in the first instance to somewhere around the 4 percent mark if we are to see a long-term rise in our standard of living relative to the rest of the developed world." The BPS projections indicate that after a decade in office the government will not achieve that goal. We think that New Zealand will see its average living standards relative to Australia or the OECD as a whole fall rather than rise.

6.2 In the same budget the minister also stated that "There is far less consensus about the means to achieve that lift in performance" (a 4 percent growth rate). The government has taken the view that a strategy involving greater intervention rather than more economic freedom would be more successful. It is no longer credible for the government to maintain that its view is correct.

6.3 The elements of a more credible growth strategy are well known. They include greater respect for property rights, lower government spending and taxation, less regulation, private sector operation of commercial enterprises, more efficient infrastructure policies (including a greater role for the private sector), greater competition and choice in health, accident insurance and education, and policies to reduce welfare dependency. We believe that stronger constitutional constraints in the form of tax and expenditure limits and regulatory responsibility legalisation would help shape better policies in these areas.

6.4 The intention of the Budget Policy Statement process introduced in the Fiscal Responsibility Act was to facilitate a dialogue between the government and interested parties on fiscal and economic policy. In this spirit we would be interested in a dialogue with the government members of the Committee, in particular, on the following questions:

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15 'Labour aims to halve jobless', *Sunday Star-Times*, 31 October 1999.

- Do they accept that there are no indications that the government is achieving its goals for economic growth?

- Do they agree that changes in the government's economic policies are needed to achieve those goals?

- Do they agree that these changes must include reductions in the government's share of the economy, as well as the elimination of wasteful spending, given that rapid growth is not possible at current spending levels?

- What is their attitude to the McLeod review's advice in favour of a lower and flatter tax scale and against selective tax concessions?

- Will they support government consideration of constitutional constraints on government expenditure and taxation and on regulatory decision-making?

Annex I

New Zealanders' Lagging Living Standards

Rank	OECD Country	GDP per capita in 2005 (PPP basis) at current market prices USD	GDP per capita as a multiple of NZ's GDP per capita Times	How much faster NZ would have to grow annually to close the gap in 10 yrs	15 yrs	20 yrs
1	Luxembourg	67,700	2.68	10.3%	6.8%	5.0%
2	Norway	43,200	1.71	5.5%	3.6%	2.7%
3	United States	41,900	1.66	5.2%	3.4%	2.6%
4	Ireland	39,200	1.55	4.5%	3.0%	2.2%
5	Switzerland	36,200	1.43	3.6%	2.4%	1.8%
6	Iceland	35,800	1.42	3.5%	2.3%	1.8%
7	Denmark	34,400	1.36	3.1%	2.1%	1.5%
8	Netherlands	34,200	1.35	3.1%	2.0%	1.5%
9	Austria	33,600	1.33	2.9%	1.9%	1.4%
9	Canada	33,600	1.33	2.9%	1.9%	1.4%
11	**Australia**	**32,900**	**1.30**	**2.7%**	**1.8%**	**1.3%**
12	Sweden	32,700	1.29	2.6%	1.7%	1.3%
13	Belgium	32,500	1.28	2.5%	1.7%	1.3%
14	United Kingdom	32,100	1.27	2.4%	1.6%	1.2%
15	**Finland**	**31,400**	**1.24**	**2.2%**	**1.5%**	**1.1%**
16	Japan	30,500	1.21	1.9%	1.3%	0.9%
17	France	30,200	1.19	1.8%	1.2%	0.9%
18	Germany	29,800	1.18	1.7%	1.1%	0.8%
19	Italy	28,500	1.13	1.2%	0.8%	0.6%
20	Spain	27,300	1.08	0.8%	0.5%	0.4%
21	**New Zealand**	**25,300**	**1.00**	**0.0%**	**0.0%**	**0.0%**
22	Greece	23,200	0.92	-0.9%	-0.6%	-0.4%
23	Korea	21,900	0.87	-1.4%	-1.0%	-0.7%
24	Czech Republic	20,200	0.80	-2.2%	-1.5%	-1.1%
25	Portugal	19,900	0.79	-2.4%	-1.6%	-1.2%
26	Hungary	17,200	0.68	-3.8%	-2.5%	-1.9%
27	Slovak Republic	15,000	0.59	-5.1%	-3.4%	-2.6%
28	Poland	12,800	0.51	-6.6%	-4.4%	-3.3%
29	Mexico	10,800	0.43	-8.2%	-5.5%	-4.2%
30	Turkey*	8,100	0.32	-10.8%	-7.3%	-5.5%
7	**G7**	**35,200**	**1.39**	**3.4%**	**2.2%**	**1.7%**
19	**Euro area**	**29,400**	**1.16**	**1.5%**	**1.0%**	**0.8%**
18	**EU-15**	**29,900**	**1.18**	**1.7%**	**1.1%**	**0.8%**
19	**OECD total**	**29,000**	**1.15**	**1.4%**	**0.9%**	**0.7%**

Source: ***OECD in Figures 2006-2007, p 12.***

FEDERATED FARMERS OF NEW ZEALAND (INC)

NEW ZEALAND BusinessROUNDTABLE

NEW ZEALAND CHAMBER OF COMMERCE
Business Vitality

31 March 2006

Rt. Hon Helen Clark
Prime Minister
Parliament Buildings
WELLINGTON

Copy: Hon Dr Michael Cullen,
Minister of Finance
Hon Peter Dunne,
Minister of Revenue

Dear Prime Minister

The business community at large has welcomed the government's review of business taxation. There is strong business support for the government's commitment to raising the rate of economic growth and to a "bold" review, and the two issues are obviously closely connected.

The business organisations associated with this letter accordingly felt it might be helpful to the government if we were to formulate a collective view of the main elements of what we would like to see come out of the review. You will note that we represent directly or indirectly a very broad cross-section of New Zealand business.

Our main criteria in developing a proposal were to reform business taxation in a way that would benefit investment, employment, productivity, competitiveness and economic growth in New Zealand; make New Zealand's tax structure internationally attractive, particularly in relation to Australia; and be fiscally responsible.

We think it is important to recognise that the rates of tax on companies and other entities cannot be considered in isolation from personal tax rates, since individuals are the ultimate owners of business entities. Personal and company tax are interrelated through the imputation system. Many businesses, such as sole traders and partnerships, including many farming operations, would not benefit from a business tax review that focused on company taxation alone.

We have based our approach on the conclusions of the government's 2001 Tax Review which advocated moves towards a lower, flatter income tax structure. This was a comprehensive and competent exercise. Like the review group, we do not see a need in present circumstances to extend the tax base or to introduce new taxes, and we do not favour selective business tax concessions. We want to see changes that would simplify the tax system and reduce business compliance costs.

Accordingly the essence of the proposal in the attached paper is to lower the company rate of tax to 25 percent and the present top and upper middle personal tax rates to 28 percent in two steps at the start of the 2007/08 and 2009/10 tax years. We see this as a substantial step towards the widely agreed goal of aligning the rates of tax on company, trustee and other income with the top personal tax rate. We also see it as consistent with the government's commitment to a 'bold' review. However, if the government is not prepared to go that far, we recommend reducing the top personal tax rate to 33 percent and the company rate to 28 percent as an immediate step.

We believe that a move to a lower and flatter tax structure could be readily funded by a combination of existing provisions for additional spending or revenue reductions; reductions in base spending; a lower operating surplus; and the revenue benefits of the impetus to the economy of a lower tax structure. As the McLeod Review noted, the capacity for redistribution of public expenditure programmes and a less progressive tax scale would not put at risk the government's equity goals.

It is also our view that, given the government's major tax review in 2001, there is no need for the tax review to be protracted. Indeed decisions on the lines suggested could be announced in the 2006 Budget.

The New Zealand Institute of Chartered Accountants supports the thrust of our proposal but would prefer an alignment of lower company, trustee and top personal tax rates.

We are aware that other business organisations generally support the suggested package and we are confident that it would be widely endorsed and welcomed by the business community at large.

We hope you find this initiative constructive and we would appreciate the opportunity to discuss it with you and responsible ministers.

Yours sincerely

Charlie Pedersen
Federated Farmers of New Zealand (Inc)

Roger Kerr
New Zealand Business Roundtable

Charles Finny
New Zealand Chambers of Commerce (Inc)

REVIEW OF BUSINESS TAX: RECOMMENDED STRATEGY

1. Introduction

This memorandum outlines the main elements of a business tax package that is consistent with Labour's coalition agreements with New Zealand First and United Future, and recognises the broad constraints within which the business tax review is being conducted.

The package focuses on a lower and flatter tax structure funded from the existing provision for additional growth in operating spending or revenue reductions; modest savings in base spending; a lower operating balance; and the revenue benefits of the impetus to the economy of a lower tax structure.

2. Tax rates

We think that the central outcome of the review should be a reduction in the rate of company tax (and related rates of tax) and a narrower gap between the top personal and company tax rates.

We propose a company tax rate of 25 percent. The present top and upper middle personal tax rates would be reduced to 28 percent.

The changes could be introduced in two steps at the start of the 2007/08 and 2009/10 tax years (see the appendix for details).

The following factors have been taken into account in proposing the above rate structure:

- The government's commitment to raising the rate of economic growth and to a 'bold' review.

- We think the medium-term objective should be to lower the company rate of tax and the top personal rate to 25 percent, or below, in parallel with a reduction in the ratio of government spending to GDP. This would enhance efficiency and stimulate economic growth. Progress should be made toward this objective in the present parliamentary term.

- The 2001 McLeod Tax Review was a recent comprehensive and competent examination of the tax system. We see no need for a further protracted review. The McLeod Review supported a lower, flatter income tax structure and saw no need for additional taxes. It recommended a two-step personal tax scale of 18 percent and 33 percent, and a company tax rate of 33 percent. The Tax Review observed in its final report, "At these tax rates … New Zealand would be likely to remain an unattractive destination for internationally mobile capital and people" (page vii). Given changes in the fiscal position, there is more latitude for tax reductions today than in 2001.

- The coalition agreements envisage a tax system that provides better incentives for productivity gains and improved competitiveness with Australia. The reporting in Australia of 'income' generated in New Zealand points to a company tax rate that is no higher, and preferably lower, than Australia's rate of company tax. Australia's present rate is 30 percent. Australia is expected to reduce personal income tax, and could well lower its company rate over the next few years.

- Personal rates of tax – not the company rate of tax – are generally the relevant tax rates for new domestic equity-financed investment through companies and for investment by sole traders and partnerships, such as self-employed farmers, trades people and members of certain professions. A reduction in the company tax rate alone would not generally be relevant to sole traders and partnerships.

- Reductions in high effective marginal tax rates, such as the top personal rate of tax, and in taxes on capital income, are the most important from a growth perspective. Lower personal rates of tax would also help to address the high effective marginal tax rates associated with the phase-out of family and other income-related assistance.

- The principle of a lower and flatter tax structure, which acknowledges the inter-relationship between entity and personal tax rates, has substantial merit. The suggested package would constitute a significant step in that direction. The desirable goal of alignment of entity and personal tax rates, including taxation of trustee income and fringe benefit taxation, would greatly reduce administration and compliance costs and reduce tax planning.

- A broad income tax base which, as far as possible, treats particular classes of businesses and all business activities on an even-handed basis, enhances economic efficiency. Concessional tax treatment for selected businesses, categories of spending or income are unlikely to achieve the government's growth objectives. Higher productivity in all industries should be encouraged, consistent with the coalition agreements. Preferential tax treatment for some activities or classes of taxpayers would not address the business community's call for lower rates of tax.

- We do not see a need to extend the tax base or to introduce new taxes. The introduction of a payroll tax, for example, would be opposed. The economic effect of a payroll tax would be similar to an increase in GST (which we do not favour) and involve much higher compliance and administration costs. In the long run, the tax would largely be borne by labour through a reduction in post-tax wages and lower employment than otherwise. Feasible payroll taxes are problematic. Australian state payroll taxes reflect the need for an independent state tax base and do not provide a good model for central government. A move in the direction of Australia's company tax rate does not necessitate the adoption of other features of Australia's tax system. At the last election, no party advocated new taxes or higher taxes to fund a reduction in company tax.

- Lower income tax rates could be announced in the 2006 budget and implemented with the first step effective from the 2007/08 tax year (ie from 1 October 2006 for companies with 'early' balance dates). There is no need for lengthy investigations and extensive legislation. There was wide support at the last election for tax reductions.

- As suggested below, the package can be funded without introducing a new tax and without unduly increasing any inflationary pressures in the short term.

We see this proposal as consistent with the government's commitment to a 'bold' review. However, if the government is not prepared to go that far, we recommend reducing the top personal tax rate to 33 percent and the company rate to 28 percent as an immediate step.

3. Funding

On a static basis, the above tax rate changes might cost about $4.4 billion a year (2.7 percent of GDP) when fully implemented. The first step would cost around $1.75 billion while the second step would cost an additional $2.65 billion. (These figures reflect 2006/07 income and tax data and provide a 'ballpark' estimate only.)

The total package could be financed as follows:

- allocating, say, $2 billion (about 35 percent) of the provision made in the 2006 Budget Policy Statement for additional operating spending or revenue reductions between 2007/08 and 2009/10 (inclusive);

- achieving savings of, say, $0.5 billion from lower spending or reduced tax concessions;

- reducing the forecast operating surplus by $1.9 billion, thereby funding more capital spending from debt. The ratio of the operating surplus to GDP would be around 1 percentage point lower than otherwise while the ratios of the deficit in cash available and gross debt to GDP would be about 1 percentage point higher.

It should also be noted that Treasury's ready reckoner, which was applied to estimate the static revenue cost of the package, does not take account of second-round macroeconomic effects and indirect effects on other taxes of tax cuts or increases. We agree that tax reductions are not generally self-funding over the medium term. Moreover, all tax reductions are not equal. Whether they are growth-oriented or not has a major bearing on their economic impact. It is clear, however, that well-designed tax reductions can materially increase economic growth. In those circumstances, a larger proportion of the initial revenue cost would be recovered over the medium term than is reflected in Treasury's ready reckoner. Treasury implicitly takes any such additional recovery into account when it updates its tax forecasts over time.

Some research undertaken in the United States suggests that a 10 percent reduction in income tax may increase taxable income by 4 percent. If this elasticity (net of the recovery of revenue through first-round effects which Treasury takes into account) is applied to the tax reductions proposed above, the cost of the package might be $3.3 billion or up to $1.1 billion (0.6 percent of GDP) lower than the static analysis suggests.

The level of company tax collections reflects the rate of company tax, the structure of company and other tax rates, the tax base and the performance of the economy. Company tax collections increased from 2.8 percent of GDP in 1984/85 to 5.4 percent in 2004/05. In nominal terms collections increased more than 6-fold. (In 1984/85 the company tax rate was 45 percent, it was increased to 48 percent in 1986/87, reduced to 28 percent in 1988/89 and was set at the present rate of 33 percent in 1989/90.) Australia cut its company tax rate from 36 percent in 1998 to 30 percent in 2001. Its company tax revenue is reported to have risen by over 100 percent between 1997/98 and 2004/05.

Finally, we submit that if the tax review extends beyond the lowering of tax rates, it should be examined in the context of the generic tax policy process.

Appendix

DETAILS OF SUGGESTED TAX PACKAGE

Existing tax rates	
Company rate	0.33
Top personal rate	0.39
Upper middle rate	0.33

Existing income tax brackets	$
Upper tax bracket applies over	60,000
Upper middle rate applies over	38,000

Treasury ready reckoner	
A 1 percentage point change in:	$m
Company rate	
Gross (ie if personal rate is also changed)	300
Imputation clawback	85
Net (ie if personal rate is unchanged)	215
Top rate of personal tax	130
Upper middle rate	105

Source: Treasury ready reckoner for 2006/07, December 2005

Treasury forecast of GDP	2005/06	2006/07	2007/08	2009/10
	$m	$m	$m	$m
GDP (June year)	158,947	163,062	169,897	187,853

Source: HEFU, December 2005, p 27

Proposed package	2007/08 & 2008/09	2009/10
Company rate	0.30	0.25
Top personal rate	0.35	0.28
Middle personal rate	0.30	0.28

Cost based on 2006/07 incomes	2007/08 & 2008/09		2009/10		Total package	
	Percentage Points	$m	Percentage Points	$m	Percentage Points	$m
Reduction in company tax	3	900	5	1,500	8	2,400
Reduction in top rate	4	520	7	910	11	1,430
Reduction in upper middle rate	3	315	2	210	5	525
Other nei, say		15		30		45
Total cost		1,750		2,650		4,400
Cost to GDP 2006/07 (%)		1.07		1.63		2.70

Funding - static	2007/08	2009/10	Total package
	$m	$m	$m
Reduction in growth in spending comprising 35% of new spending provision for 2007/08 to 2009/10	800	1,200	2,000
Spending reductions/efficiency enhancing tax chang	200	300	500
Reduction in surplus/higher debt financing of capex	750	1,150	1,900
Total funding	1,750	2,650	4,400

Funding - dynamic	
Fiscal cost of total package - static	4,400
Change in cost due to dynamic effects	
Personal tax	-534
Company tax	-542
Total dynamic effects	-1,075
Cost after taking account of dynamic effects	3,325
Cost to GDP 2006/07 (%)	2.04

Dynamic effects are additional to the claw back of indirect taxes taken into account by Treasury

Fiscal indicators	2007/08		Total package	
	$m	% GDP	$m	% GDP
OBERAC/operating balance HEFU	4,103	2.4	5,091	2.7
OBERAC/operating balance with package - static	3,353	2.0	3,191	1.7
OBERAC/operating balance with package - dynamic			5,916	3.1
Cash available HEFU	-2,687	-1.6	-1,366	-0.7
Cash available with package - static	-3,437	-2.0	-3,266	-1.7
Cash available with package - dynamic			-2,191	-1.2
Gross sovereign-issued debt	35,728	21.0	36,195	19.3
Gross sovereign-issued debt with package - static	36,478	21.5	38,095	20.3
Gross sovereign-issued debt with package - dynamic			37,020	19.7

Base forecasts are for relevant year but funding costs reflect 2006/07 incomes

Source: HEFU, December 2005, p 29

General notes:
Costings are 'ballpark' only
Costings depend on a number of assumptions and incomplete information
Costings are based on estimated income levels and tax revenue for 2006/07
FBT, SSCWT and tax on trustee income have not been explicitly taken into account, although an allowance for items not included has been made
Detailed calculations of the dynamic cost of the package are available on request
Excludes behavioural and transitional effects, except where noted