SUBMISSION BY THE
NEW ZEALAND BUSINESS ROUNDTABLE

TAXATION (INCOME TAX RATES) BILL

MARCH 1997

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1.0 Introduction

1.1 This submission is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand businesses. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests. Our submission has been prepared from this perspective.

1.2 In 1996 parliament passed legislation to give effect to the government's tax reduction and social policy programme. The programme provided for a reduction in personal rates of tax in July 1996 and 1997, increases in family support and guaranteed minimum family income (GMFI), and the introduction of an independent family tax credit for low and middle income families that earn market incomes. It also contained changes to benefit and superannuation arrangements. A laudable goal of the programme was to "assist, strengthen, and empower low- and middle- income families in their efforts to achieve higher income and [a] better quality life."[1]

1.3 The purpose of the Taxation (Income Tax Rates) Bill is to defer for a year the personal tax reductions and the increase in GMFI that would otherwise come into effect in July 1997, and to make certain consequential changes to the tax legislation. The planned increase in the independent family tax credit and family support are unaffected by the changes.

1.4 The deferral of the second stage of tax reductions is a direct consequence of the decision by the coalition government to increase spending, most of which in our view is badly targeted. This would reduce overall community welfare. Our submission focuses on these wider economic implications of the Bill.

2.0 General Comment

2.1 The Fiscal Responsibility Act 1994 requires the government to pursue its objectives in accordance with the specified principles of responsible fiscal management. One principle is that the government should generally pursue "policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years" (section 4 (2)(e) refers). This principle recognises that predictable tax rates reduce risks associated with long-term decisions.

2.2 Consistent with the Fiscal Responsibility Act, the government foreshadowed tax reductions, subject to certain fiscal preconditions being met, in the 1995 Budget Policy Statement (BPS). It subsequently designed the tax reduction programme in a medium-term context and legislated for annual tax rates or basic rates of tax through to 1998/99. The major coalition partner's election campaign emphasised its commitment to tax reductions which were widely seen as a core 'credibility promise'. The deferral of the second stage of the tax reductions would diminish the credibility of fiscal policy, increase uncertainty and discourage planning by firms and individuals.

2.3 National is committed to the goal of achieving an average annual economic growth rate of between 3.5 and 5 percent through to 2010. New Zealand First set a goal of 6 percent growth by the end of its first parliamentary term. The 1997 BPS forecasts annual average growth to be between 3 and 3.5 percent through to 1999/00. This is below the bottom of the target range set by National and is, at best, a little over half of New Zealand First's goal. These goals are highly unlikely to be achieved under present policies. Sustainable tax reductions must be part of a credible programme of raising economic growth rates.

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1 Birch, Bill (1996), *Tax Reduction and Social Policy Programme - Details*, Office of the Minister of Finance, Wellington, p.8.

2.4 The tax cuts are to be deferred to accommodate an increase in spending of $0.95 billion in 1997/98. Higher spending is detrimental to growth because:

- much of the existing and proposed new spending is of low priority;

- taxes reduce work effort, investment and savings, and distort a host of choices which individuals make; and

- higher spending and inefficiency within the state sector undermines monetary policy and creates pressures to address symptoms, for instance by exchange rate intervention.

2.5 The new spending is largely of low quality. The business community has indicated that it does not support the poorly conceived spending items totalling around $100 million that are intended to benefit it. Although the coalition agreement states that the government will focus on the pre-school and compulsory sectors of education, an additional $352 million is to be spent on moving toward a system of universal living allowances for tertiary students. As costed, 93 percent of this expenditure would benefit people from high income families (that is, those earning above $50,751 a year). Universal assistance with doctors' visits would benefit many people who would not otherwise go without medical services. The abolition of the superannuation surcharge will benefit people who, on any measure, earn substantial incomes. These examples illustrate that the planned spending is not only of low quality but is also regressive. In contrast, a disproportionate share of the tax reductions forgone will be borne by households that earn low to average incomes. The government gave as its reason for not reducing the top rate of tax the intention to give priority to such households.

2.6 Tax reductions are beneficial to growth as the government has correctly argued. Research has consistently shown that taxes result in large output losses or deadweight costs. Diewert and Lawrence found that the taxation of incomes from labour (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.[2] For consumption tax (mostly GST), deadweight costs are 14 cents for the marginal dollar of revenue. A separate study by McKeown and Woodfield produced much higher estimates of the marginal deadweight cost of taxes on labour income in 1988.[3] Their estimate was between 24.6 and 146.2 cents for each marginal dollar of revenue. Neither Diewert and Lawrence nor McKeown and Woodfield took the taxation of income from capital or administration and compliance costs into account. Nevertheless, their studies imply that each dollar spent by the government must yield benefits well in excess of a dollar (perhaps as high as $2.46) before there is a net benefit to the community.

2.7 Spending is the best measure of the tax burden. The government plans to increase spending by $5 billion through to 1999/00. As a result taxes will be $5 billion, or almost $1,400 for every person and $3,900 for every household, higher than they would otherwise be.

2.8 If the government is committed to proceeding with some of its new spending, it should do so by making savings elsewhere. The 1997 BPS indicates that no savings in existing policies are anticipated by the government, despite its announced intention to make such savings.

2.9 The government has been emphasising the importance of national savings. Higher spending, lower surpluses and specific initiatives such as the abolition of the superannuation surcharge are likely to discourage national savings. On the other hand, income tax reductions encourage savings by increasing the after-tax return earned by savers and by encouraging people to have confidence that if they work harder and save more, the government will not simply raise its spending and taxes.

2.10 The Treasurer's announcement that the company tax rate along with personal rates of tax could be lowered within the next three years is welcomed. Business organisations have advocated lower taxes

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2 Diewert, W E and Lawrence, D A (1994), *The Marginal Costs of Taxation in New Zealand*, report prepared for the New Zealand Business Roundtable, Swan Consultants (Canberra) Pty Ltd, Canberra.

3 McKeown, Paul C and Woodfield, Alan E (1995), 'The Welfare Cost of Taxation in New Zealand Following Major Tax Reforms', *New Zealand Economic Papers*, Vol. 29(1), pp.41-62.

in preference to selective forms of industry assistance. The company rate of tax directly affects inward foreign investment and the cost of capital faced by all firms. Personal rates of tax, including the top rate of tax and that paid by superannuation funds and life offices on behalf of contributors and policyholders, are important for resident businesses as company tax is effectively a withholding tax in respect of resident investors.

2.11 Lower taxes on capital income would encourage savings and investment. A reduction in personal taxes would also increase the return from work effort (each hour's work would enable more goods and services to be bought) and could be expected to increase the supply of labour. This would reduce pressure on wages and encourage investment in education and training.

2.12 Other things being equal, tax reductions would generally help moderate inflationary pressures over the medium term whereas government spending increases are unhelpful from an inflation viewpoint.

2.13 Future tax reductions should not be linked to the outcome of the referendum on compulsory superannuation. Evidence clearly suggests that compulsory savings schemes have little or no effect on overall national savings but merely on savings patterns. From a macroeconomic perspective a medium-term programme of tax reductions can be managed with or without a compulsory savings scheme, provided government spending is controlled.

2.14 Compulsory superannuation is equivalent to a tax increase for those people who would not otherwise save at the level and in the form required. A contribution level of 8 percent on top of the proposed 1998/99 tax scale could increase the marginal tax rate for a person with an annual income between $9,500 and $34,200 from 21.75 percent to 29.75 percent, an increase of 37 percent. It would constitute one of the largest increases in income tax ever imposed, if not the largest.

2.15 The 1997 BPS observed that the cumulative fiscal easing created by additional spending is at the "upper limit [of that] considered to be prudent." In our view it is at an imprudent level. New Zealand ought to be taking urgent action to reduce expenses to below 20 percent of GDP while demographic factors allow it to do so.

3.0 Concluding Comment

3.1 We believe that it is a mistake to defer the tax reductions that are currently scheduled to apply from July. The decision is inimical to the achievement of the government's growth objectives. Instead the government should be reconsidering spending and maintaining certainty by extending the multi-year programme of tax cuts. The tax rates enacted for 1997/98 should be retained and further reductions should be implemented in 1998/99 and beyond.

3.2 The priority should be to lower those taxes that impose the largest deadweight costs, such as high marginal rates of tax and taxes on capital income. This would lead to a flatter tax scale. The gap between the top tax rate and the middle effective rate, which was widened by the tax reduction programme, is excessive and needs to be reduced. Among other things, this would reduce distortions such as the penalty treatment of investment in superannuation funds which have been accentuated by recent changes to tax rates.