

**TAX REDUCTION PROGRAMME**  
**A SUBMISSION TO THE MINISTER OF FINANCE**

**THE NEW ZEALAND BUSINESS ROUNDTABLE**  
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# TAX REDUCTION PROGRAMME

## Executive Summary

- This paper discusses the principles that should be taken into account in designing a taxation reduction programme that extends beyond the measures that have been announced.
- Tax reductions present an opportunity to enhance efficiency, growth, investment and employment, and to encourage individual responsibility and initiative.
- Economic growth provides the only way of raising the incomes of New Zealanders, including those on low incomes, on a sustainable basis.
- New Zealand is a high tax country relative to its past and to its emerging trading partners. Lower taxes can help to boost the rate of growth.
- The government is using resources that could be put to more productive use in the private sector. Total expenditure should be reduced substantially after allowing for additional expenditure on priority needs. This should be an integral part of the tax reduction programme.
- The redistribution of income through the tax and welfare systems has been compared to carrying water in a leaky bucket - much of the contents are lost in the transfer process.
- Spending on health, education and social welfare has actually increased by a massive \$13 billion or 4.3 percentage points of a much increased GDP since 1984/85.
- Tax reductions will need to be concentrated on those taxes that impose the largest deadweight or efficiency costs on the community if they are to make the largest possible contribution to lifting national output and incomes. This generally requires a reduction in high effective marginal tax rates (EMTRs) that apply to large amounts of income. The top personal and company rates of tax are important marginal rates.
- The EMTR on income from capital, which arises from both company and personal taxes, has probably increased substantially over the past decade, despite a reduction in statutory rates of tax, as a result of policies that broadened the tax base.
- New Zealand taxes generally raise the cost of capital, that is, the rate of return required by foreign and domestic investors. The cost of capital affects asset prices and investment decisions throughout the economy. Capital is a highly mobile input and is sensitive to small changes in taxes. Appropriate tax reductions would lower the cost of capital and thereby encourage investment and foster innovation and enterprise.
- It is becoming increasingly difficult for countries to apply a comprehensive income tax with high EMTRs in an open and integrated world economy.
- Higher revenue since 1990/91 (\$5.9 billion) explains the change in the government's fiscal position. Company tax showed the largest percentage increase, rising by 125 percent between 1990/91 and 1994/95.
- Most revenue committed to the tax reduction programme should be used to lower income tax. In reviewing rates of tax and tax brackets the following factors should be taken into account:

- high EMTRs which impose the largest costs on the community. A flat tax scale is desirable on efficiency grounds;
  - targeted assistance, such as family support, is generally more efficient than universal assistance. A tightening of the qualifying criteria for income-tested benefits reduces the impact of high EMTRs;
  - The high EMTRs that arise from income-tested benefits have a cost which is related to the choice of abatement rate. For a given EMTR, lower income tax rates allow a higher abatement rate, reducing the number of individuals subject to that EMTR and reducing government expenditures and tax burdens more generally;
  - the closer integration of the taxation of individual, family (in some instances only), company, superannuation and life insurance income;
  - the broadening of the tax base since 1984; and
  - compliance and administration costs.
- The tax reduction programme should also include:
    - provision for international tax reform;
    - a review of the treatment of tax losses;
    - the phasing out of customs duty as tariffs are reduced;
    - a review of thresholds that apply to GST;
    - completion of indirect tax reform; and
    - appropriate tax base broadening and maintenance.
  - The government should take a planned, medium term approach in developing its tax reduction programme.
  - Tax cuts will not put undue pressure on monetary policy if a medium term approach to fiscal policy is adopted, if tax reductions are signalled well in advance and if government spending is reduced. Complementary policies, such as further regulatory and welfare reforms and privatisation, would enhance the flexibility of the economy and help to offset any inflationary pressures.
  - The efficiency advantages of tax reductions to the community should be publicised to build support for them.
  - Quality leadership, comparable to that which led to the Employment Contracts Act and to the tariff reduction programme, will be required if the potential benefits from a favourable fiscal outlook are to be fully realised.

# TAX REDUCTION PROGRAMME

## 1 Introduction

Fiscal matters will be among the most important issues to be addressed by the government over the next few years. An improving fiscal outlook will provide considerable scope to reduce taxes once net debt is reduced to a prudent level. Tax reductions present an opportunity to improve efficiency and to enhance growth, investment and employment, and to encourage individual responsibility and initiative. The New Zealand Business Roundtable's views on the principles that should be taken into account in designing a taxation reduction programme are presented in this paper.

Our focus is on the broad thrust of the tax reduction programme over the medium term rather than the specific steps that were announced in February 1996. The conditions for tax reductions that were set out in the 1995 Budget Policy Statement are endorsed. They are not discussed further.

Provided that spending is tightly controlled and the economy continues to expand, the government should be able to reduce taxes by at least \$8 billion by 2004/05 and by a considerably larger amount if low priority spending is cut.<sup>1</sup> This implies a reduction in average tax rates of 24 percent or more. A coherent programme of reductions should be implemented over the next few years so that the maximum possible gain in community welfare is realised.

This paper is organised in 10 sections. The next section (section 2) discusses New Zealand's economic performance and argues that there is ample scope for further improvement. Additional privatisations and asset sales to facilitate growth are suggested in section 3. Section 4 discusses the tax burden and notes that high taxes impair growth. The need to focus on marginal rates of tax is explained in section 5. The source of the improvement in the government's fiscal position - higher tax collections - is analysed in section 6. The main priorities for the tax reduction programme are presented in section 7. Macroeconomic and presentational issues are discussed in sections 8 and 9 respectively. The tax reduction and social policy programme that was announced in February is examined in section 10. The main conclusions are summarised in section 11.

## 2 Improving Community Welfare

The benefits of the post-1984 reforms are now obvious to the majority of New Zealanders. Since June 1991, the economy has expanded by 18 percent, investment is high and around 190,000 additional people have been employed. The growth in employment has exceeded most expectations. What is more, the unemployment rate for Maori and Pacific Islanders has fallen at a faster rate than that for Europeans, and further reductions in both rates will be recorded over the next few years.

Despite these encouraging outcomes, the economy continues to perform at a level that is well below its potential. The rate of economic growth has been slowing, in response to firmer monetary policy, after reaching 5-6 percent in 1993 and 1994. The Treasury has projected an average growth rate of 4 percent for the next few years. While this rate is higher than the dismal rate recorded in the 1970s and 1980s, it is not particularly high when compared with the long-run average of about 3.5 percent that was achieved before 1970. It is well short of

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<sup>1</sup> The Budget & Fiscal Strategy Report 1995 suggested that revenue could be reduced from 38 to 29 percent of GDP by 2004/05. Based on the current level of GDP this amounts to \$7.8 billion.

the rate of growth recorded by successful Asian countries. New Zealand's income per head remains one of the lowest in the OECD.

The living standards of New Zealanders, including those on low incomes, can only be raised on a sustainable basis if they have adequate freedom and incentives to get jobs, improve their skills and invest, and if they have adequate capital equipment, infrastructure and technology to work with. Rising GDP per capita is the key indicator of rising material living standards over the longer term for all income groups. Seemingly modest improvements in the annual rate of growth produce over time remarkably large differences in the average level of income per head. Shortly after World War II, the average living standards of Japan, the Philippines and India were comparable. Japan's annual income per capita is now US\$31,490 compared with US\$850 for the Philippines and US\$300 for India.

Unemployment is far too high and too many people are dependent on welfare support. Employment provides the main source of income over most people's lives. The Household Economic Survey shows that current employment provides around 75 percent of the total income for all households. The absence of an income earner within households because of unemployment or a breakdown in a marriage, rather than low pay, is the most important cause of poverty. The provision of opportunities to participate in gainful employment is the key to addressing many equity issues.

There is no reason why full employment cannot be achieved aside from short, voluntary periods of job search and limited cyclical unemployment. However, more appropriate labour market and welfare policies are required. In particular, employment needs to be made more attractive than welfare support. The government's response to the recommendations of the Employment Task Force includes some useful initial steps such as the introduction of a work test for certain spouses of unemployment beneficiaries and recipients of the DPB. On the other hand, it does not go far enough towards introducing appropriate sanctions such as phased stand down periods according to duration of benefit receipt and for first and subsequent breaches of the work test. Tax reductions could help by reducing the high effective marginal tax rates (EMTRs) that apply to beneficiaries who contemplate taking up employment but they will not be sufficient.

During the twentieth century many governments have assumed vastly expanded responsibilities for the provision of welfare with a consequent reduction in personal and family responsibility. Governments are unable to distinguish clearly between people who should be assisted and those who should not, and the stigma of becoming a beneficiary no longer constrains welfare dependency. This results in rigid rules with income-tested benefits in order to contain fiscal costs and leads to high EMTRs. Private insurance schemes and charitable organisations would not normally apply such rules.

The redistribution of income through the tax and benefit system assists some groups at the expense of others. This is, however, achieved at the cost of a lower total level of national income because taxes that are required to fund assistance adversely affect incentives, for example to produce goods and services and to work and save. The redistribution of income has been compared to carrying water in a leaky bucket - much of the contents are lost in the transfer process.

Existing resources need to be used more efficiently and additional resources are required if a higher rate of growth is to be achieved. Additional investment in physical and human capital will be important to sustain growth in output and higher incomes as full employment is approached. The level of investment is affected by the effective rate of tax that applies to inward foreign investment. The company rate of tax is critical in this respect. There is considerable scope to encourage a better use of resources and to facilitate the provision of additional resources by implementing appropriate policies. Lower expenditure and taxes can contribute to the achievement of a higher rate of growth.

### 3 Privatisation, Asset Sales and Debt Reduction

Efficiency can be improved by implementing a vigorous privatisation and asset sales programme with the proceeds being used to reduce debt. The net contribution to the operating balance could be returned to taxpayers once debt is reduced. The privatisation programme has lost momentum at a time when other nation's governments are pressing ahead. The central case for privatisation is that in general privately held enterprises are more efficient and productive, and ultimately more accountable to consumers, than those run by bureaucracies. There are no valid grounds for continued government ownership of many entities, businesses and assets. A vigorous privatisation and asset sale programme is required to substitute full commercial disciplines for political control, and to allow debt and taxes to be reduced. Unresolved regulatory issues, if any, should be addressed before the government businesses are sold.

Important candidates for privatisation include the following entities or their assets: the Accident Rehabilitation Compensation and Insurance Corporation; Coal Corporation of New Zealand; crown health enterprises; crown research institutes; electricity generation and transmission businesses; Forestry Corporation of New Zealand; Government Property Services; Housing Corporation of New Zealand; Housing New Zealand; Land Corporation; New Zealand Post; Public Trust; Radio New Zealand; Television New Zealand; and the Crown's interests in international airports at Auckland, Wellington and Christchurch. In addition, units within departments and crown entities which essentially supply private goods and services should be privatised. In many countries most of these activities are now undertaken by the private sector. Social objectives in many of these areas are better pursued through contracts with private providers than government provision.

### 4 High Spending and Taxes Reduce Welfare

New Zealand is a high tax country relative to its past and to its emerging trading partners. Government expenditure is the best measure of the real tax burden. A broad measure of spending, including central and local government expenditure and outlays by agencies that are financed by compulsory levies such as ACC, puts the tax burden at not less than 40 percent of GDP. New Zealand's spending ratio is around the average for OECD countries and is higher than that of Australia, Japan and the United States. More importantly, it is well above the ratio for the fast-growing countries of Asia, where government spending does not generally exceed 15-20 percent of GDP. These countries now account for around half of world GDP.

High taxes reduce output and incomes. They discourage work, investment and savings, and they distort a host of other choices that individuals and firms make every day. The adverse effects of taxes lead to deadweight costs. A study by Diewert and Lawrence, published by the New Zealand Business Roundtable, found that labour taxation (mostly taxes on the incomes of wage earners and the self-employed) produces deadweight costs of around 18 cents for the last dollar of revenue raised. For consumption taxes (mostly GST), deadweight costs amount to 14 cents for the marginal dollar of revenue. The implication of Diewert and Lawrence's findings is that government spending should yield at least \$1.18 of benefits for each additional dollar spent, otherwise the community would be better off if the money were returned to taxpayers.

A separate analysis by McKeown and Woodfield of the University of Canterbury produced much higher estimates of the deadweight cost of taxes on labour income. Their estimate of such costs is between 24.6 and 146.2 cents for each marginal dollar of revenue. These results are broadly comparable to those obtained in similar studies undertaken for other countries whereas Diewert and Lawrence's estimates are lower than most other findings.

The taxation of income from capital and administration and compliance costs were not taken into account in either study. They could be expected to increase significantly the reported estimates of deadweight costs. A 1992 study commissioned by the Institute of Policy Studies showed that the costs of complying with business taxes in New Zealand amounted to about 2.5 percent of GDP. At current levels of GDP, such costs would exceed \$2 billion. If they were funded by the government, compliance costs would constitute the fifth largest category of expenses, ranking below social security and welfare, health, education and finance costs.

Marginal expenditure programmes are most unlikely to generate sufficient benefits to justify the present level of government spending. Government expenditure was equal to about 25 percent of GDP before the 1970s when the economy performed better and when spending on activities that are now undertaken by SOEs was included. There are many spending programmes where the net benefits are doubtful. New Zealand Superannuation, for instance, transfers income from low income families to retirees who earn other income and/or own significant assets. The Todd Taskforce on tertiary education noted that tuition subsidies largely benefit people who come from families that are relatively well-off or who will later earn above-average incomes. They are partly funded by people who are in less fortunate circumstances than many students and/or their parents. Reports published by the New Zealand Business Roundtable have identified many areas where expenditure can be reduced without undue hardship or a reduction in overall welfare.

Despite the common claim that spending on health, education and social welfare has been drastically cut, it has actually increased by a massive \$13 billion or 4.3 percentage points of a much increased GDP since 1984/85. This amount includes an additional \$2 billion that has been spent on those activities since 1990/91. Spending on education has increased from 4.4 percent of GDP in 1984/85 to 5.6 percent in 1994/95 while spending on health has increased from 4.8 to 5.7 percent of GDP during the same period. Welfare reforms introduced by the National government and faster growth reduced the ratio of welfare spending to GDP by 1.8 percentage points since 1990/91, offsetting only a part of the growth in this ratio between 1984/85 and 1990/91 (see Annex).

Continuing public criticism of health and education services suggests that many people do not believe that higher spending on these activities has produced commensurate benefits. The poor performance of government agencies (for example in education), adverse incentives (for instance affecting ACC, social welfare and health) and poor quality expenditure, rather than higher expenditure, may well explain the public's dissatisfaction with these services. In addition, successive governments have raised the public's expectations of the government's ability to fund health and education beyond their capacity to fulfil them.

There are compelling grounds for believing that the government sector is using resources that could be put to more productive use in the private sector. Thus total expenditure should be reduced substantially after allowing for additional expenditure on priority needs. This should be an integral part of the tax reduction programme. It would enable some taxes to be eliminated over the next decade, would facilitate simplification of the tax system and lower compliance costs.

## **5 Marginal Tax Rates Matter Most**

Tax reductions will need to be concentrated on those taxes that are judged to involve the biggest deadweight or efficiency costs if they are to make the largest possible contribution to lifting national output and incomes. This generally requires a reduction in high EMTRs. EMTRs take account of all relevant rates of tax including both income and consumption taxes. These are the rates that influence the choices of individuals and firms the most. Because the deadweight cost of taxes rises more than proportionately as the rate of tax increases, tax cuts should generally aim at reducing high EMTRs that apply to large amounts of income. The top personal rate and the company rate of tax are important marginal rates for these reasons.

A reduction in intra-marginal rates of tax (tax rates that do not apply to the last dollar of income) would increase the recipient's personal income without reducing deadweight costs. Such tax reductions would not increase efficiency because the all-important marginal decisions of the recipient are unaffected. This point can be illustrated by reference to the marginal rate of tax of 15 percent which applies to an income up to \$9,500. If the 15 percent rate of tax is cut to, say, 10 percent, taxpayers who earn \$9,500 or more a year would gain the maximum increase in after-tax income of \$475 ( $0.05 * \$9,500$ ) a year. This would not, however, alter the after-tax income that those taxpayers would earn by working an extra hour or by earning an extra dollar from further education or training because such additional income would be taxed at the taxpayers' higher marginal rate. The tax cut would not therefore affect such decisions. The *Wall Street Journal Europe* (September 22-23 1995) expressed this key point in these terms:

*It's tax cuts at the margin, not handouts, that create economic incentives for growth.*

Provided that tax reductions affect important EMTRs they will encourage higher participation in the workforce, increased work effort and additional investment in education and training by raising the after-tax return from such activities. They would also lower the cost of capital and thereby encourage investment and foster innovation and enterprise. New Zealand's before-tax cost of capital is set in the international market. New Zealand taxes generally raise the after-tax rate of return required by foreign and domestic investors. Capital is a highly mobile input and is therefore sensitive to small changes in taxes. The cost of capital affects asset prices and investment decisions throughout the economy. A reduction in the cost of capital could therefore be expected to be particularly beneficial.

It is becoming increasingly difficult for countries to apply a comprehensive income tax with high EMTRs in an open and integrated world economy. Furthermore, the benefits of an efficient tax system are accentuated by openness and integration while the costs of an inappropriate tax system are increased. The enhanced mobility of resources in an open economy is one reason for this finding. Many countries have reduced company and personal rates of tax over the past two decades. They will be under pressure to make further reductions.

## **6 The Improved Fiscal Position Reflects Higher Tax Collections**

There is a widespread perception that lower expenditure accounts for the improved fiscal position. This is a myth. Almost all of the \$5.1 billion increase in the operating balance recorded since 1984/85 occurred after 1990/91. Moreover, higher revenue since 1990/91 (\$5.9 billion), rather than spending reductions, explains the change in the government's fiscal position. Spending increased by \$0.3 billion and the net surplus of SOEs and Crown entities absorbed a further \$0.5 billion (see Annex).

Company tax showed the largest percentage increase, rising by 125 percent between 1990/91 and 1994/95. Its strength reflects the cumulative effect of base broadening measures that have been implemented since 1984, a run-down in tax losses and the recovery. Higher tax paid by individuals has also contributed to the improvement in the fiscal position.

The EMTR on income from capital, which takes account of company and personal taxes, will have increased substantially over the past decade, despite a reduction in statutory rates of tax. A rise in company tax from 6.7 percent of total income tax in 1983/84 to 13.1 percent in 1994/95 supports this view. This is the largest contribution of company tax to total tax since 1974/75. Although New Zealand's statutory rate of company tax is lower than that of some other countries, its tax base is broader. The higher EMTR on income from capital will have discouraged investment and will constrain output and incomes in the longer term.

## 7 Tax Reduction Programme

The main priorities for tax reductions and other reforms are presented under the following headings. They are not listed in priority order.

### *Income Tax Rates and Brackets*

- Most revenue committed to the tax reduction programme should be used to lower income tax. This would result in relatively greater weight being placed on GST as a source of revenue than is currently the case. Savings would be encouraged since savings are taxed twice under an income tax. Although GST is often claimed to be a regressive tax, it is more akin to a proportional tax because total spending tends to equal aggregate income over the taxpayer's life.

In reviewing rates of tax and tax brackets the following factors should be taken into account:

- life cycle considerations. A life cycle approach recognises that many people are temporarily on low incomes, for instance because they are participating in education and training, or are young and have few skills, or are retired. There is considerable mobility within low and other income groups over relatively short periods.

Research undertaken in a range of countries confirms this point. An analysis for New Zealand showed that at least 25 percent of people who were in the bottom income quintile in 1980 had moved to higher quintiles a year later. This percentage grew to 45 percent after 7 years. The Institute of Fiscal Affairs reported that half the people in the bottom income decile in the United Kingdom moved to higher deciles each year. The Institute's researcher stated:

The crucial conclusion [of the report] is that there is no such thing as an unchanging lump of the poor who are gradually getting worse off ... Household circumstances may vary considerably from one year to the next ... .

Finally, a survey by the United States Treasury found that 85 percent of taxpayers who had started off in the bottom income quintile had moved to higher quintiles and 14 percent had reached the top quintile over a ten year period.

The primary concern from an equity perspective should be to provide people with an adequate opportunity to increase their incomes through employment, education and training, and the exercise of individual initiative;

- the effects of progressive tax scales. First, they redistribute life-time income over each taxpayer's life. Such scales provide a higher after-tax income than otherwise when a person earns a relatively low gross income, for example when young. They also result in a lower after-tax income than otherwise when a person earns a high gross income. Secondly, progressive taxes transfer income from people who earn relatively high life-time incomes to those with lower life-time incomes. Some international research indicates that the first effect (redistribution over each person's life) is far more important than the second (redistribution among people) when the distribution of government spending is also taken into account. There are no strong public policy grounds for the first form of redistribution as capital and insurance markets and other mechanisms

(for example the student loans scheme) generally assist people to implement such consumption choices;

- high EMTRs. They should generally be reduced because high EMTRs are likely to impose the largest costs on the community. Unlike the 15 percent tax rate, the 28 and 33 percent (individual, company and related) rates are marginal rates for a large proportion of total income;
- targeted assistance, such as family support, is generally more efficient than universal assistance. Universal assistance requires higher EMTRs for the population as a whole to compensate for the additional revenue forgone. A zero rate of tax on earnings up to a set level provides a handout for most taxpayers but requires higher EMTRs than otherwise to raise the required level of revenue;
- the high EMTRs that arise as assistance - such as welfare benefits, family support and the accommodation supplement - is phased out have a cost notwithstanding the immediately preceding point. They may have their greatest effect on people who have a weak attachment to the workforce and who are easily discouraged from taking up additional employment. The trade-off is between a slower phase-out of support with lower individual disincentives for a greater number of beneficiaries and higher efficiency costs from additional taxes on the incomes of other taxpayers. Lower statutory tax rates for low income groups allow a higher abatement rate, affecting fewer individuals for any given EMTR. Lower assistance and tighter eligibility rules are other parameters that could be reviewed. A balance is required between net efficiency costs and the benefit from addressing perceived equity concerns;
- the closer integration of the taxation of individual, family (in some instances only), company, superannuation and life insurance income. The relevant issue from efficiency and equity perspectives is the EMTR on income that, in an economic sense, is attributable to an individual regardless of whether it is earned directly or through an independent legal entity. The greater the progressivity in the tax scale, the larger is the incentive to split income among family members and to divert income to entities that are taxed at a lower marginal rate. At the same time, people on low to moderate incomes are penalised if they earn income through entities that are taxed at a higher rate than their personal marginal rate. A person who faces a marginal personal tax rate of 15 percent would, for instance, pay tax at 33 percent on any income earned through a superannuation fund. Particular classes of business may be unfairly advantaged relative to others, which imposes additional efficiency costs. Direct investment by individuals is, for instance, disadvantaged by the superannuation surcharge relative to investment through superannuation funds.
- the broadening of the tax base since 1984. Although the top personal tax rate was reduced from 66 percent to 33 percent, with smaller reductions for most other personal rates of tax, total personal tax collections have increased. This outcome reflects a substantial increase in the tax base which has largely affected people on higher incomes and which was linked to the reduction in rates. The concessional treatment of fringe benefits, contributions to superannuation funds, investment in life insurance, and certain interest deductions and income has been removed. Investment through companies, life insurance offices and superannuation funds and in film and livestock ventures are now taxed on a more neutral basis. These base broadening moves are often overlooked when the perceived fairness of post-1984 tax changes are discussed; and

- compliance and administration costs. The literature has increasingly focused on compliance and administration costs imposed by tax and welfare systems. Studies show that they are substantial. Lower government expenditure, and therefore reduced incentives for tax avoidance and evasion, would be the best way of reducing compliance and administration costs. Beyond this, a balance must be struck between administration and compliance costs and other efficiency costs that arise if rates of tax need to be higher than otherwise to raise the required revenue.

Changes to tax and welfare arrangements can impose high adjustment costs for firms and individuals. Frequent changes to tax and welfare systems, especially those that require significant changes to computer programmes, should be avoided. This points to the need for a planned and coherent programme of tax reductions that is signalled in advance.

### *International Tax*

- International tax arrangements need to be reformed. High and uneven rates of tax are applied to inward and outward foreign investment, and to domestic investment. They have the potential to raise the cost of capital, to distort investment and to impair growth in output and incomes. Consultations between the Treasury and private sector experts indicate that analytical work has not yet reached the point at which specific policy proposals can be examined. They do, however, emphasise the need for an integrated approach to be taken in reviewing company, personal and other tax rates that apply to income from capital. The reform of international tax is a top priority and any revenue cost that may be involved should be accommodated within the tax reduction programme.

### *Tax Treatment of Losses.*

- The inability of firms to obtain a refund of tax (equal to the loss times the rate of tax) in the year in which a loss is incurred discourages the establishment of new firms, investment in large projects that may incur losses in their initial years and risky projects. In 1991 the New Zealand Business Roundtable presented a detailed submission on the treatment of tax losses. It advocated a relaxation in the present restrictions. This issue should be addressed.

### *Customs Duty*

- The tariff reduction programme will determine the future of customs duty. The government is committed to achieving free trade beyond the year 2000. The favourable fiscal outlook should support broader efficiency arguments for an early move to free trade in all goods. The tax reduction programme should recognise that customs duty will be phased out over the next few years.

### *GST*

- GST is a soundly-based tax which should be retained. It contains a number of thresholds, such as the annual turnover of \$30,000 or more at which a firm or individual is required to register, that are intended to contain compliance costs. Unless such thresholds are adjusted from time to time their value in real terms is eroded, thereby undermining their purpose. GST thresholds should be reviewed and increased where desirable.

### *Other Indirect Taxation*

- Indirect tax reform which was announced with GST has not been completed and should be re-activated:
  - stamp, cheque and credit card duties are taxes on selected financial transactions. The rate of tax payable in relation to the value of the transaction or related income can vary substantially. These taxes are unlikely to form part of an optimal tax system. They should be abolished;
  - excise duties on petroleum products largely constitute user charges to fund roading. They also contribute to the government's general revenue. There is no compelling justification for the latter element; and
  - excise duties on tobacco, beer, wine and spirits have been justified on social cost and revenue grounds. The social cost argument is doubtful and, in any event, the tax levied on these products is well beyond any plausible estimate of the net social costs involved. This is especially the case for beer, wine and spirits where medical research points to the benefits of light to moderate consumption. From a revenue perspective, selective taxes applied to a narrow range of goods or services are usually inefficient and inequitable. A phased programme of reductions should be implemented.

### *Base Broadening and Maintenance*

- Economically neutral tax treatment should apply to all industries including forestry and mineral and petroleum mining, and to depreciation. In addition, ongoing work aimed at maintaining the integrity of the income and GST base should be undertaken. An erosion of either tax base would lead to higher EMTRs than otherwise on unaffected income with adverse efficiency effects. The opportunity to reduce rates of tax may assist in addressing some tax base issues.

The government's tax reduction proposals should be subject to a quantitative analysis that is available for public review. It should, for example, be possible to estimate the efficiency benefits of the proposed changes to income tax rates and tax brackets and to compare those benefits with other options.

The government should take a planned, medium term approach in developing its tax reduction programme. The programme needs to be sustainable beyond the short term, otherwise firms and individuals will tend to make marginal decisions on the basis that tax reductions are temporary. Each element and stage of tax reductions should contribute to a coherent programme. A credible programme that is clearly signalled would encourage firms and individuals to anticipate future tax reductions in making investment and other decisions and thus bring forward their benefits. Anticipated changes in tax and other policies reduce uncertainty and lower adjustment costs.

## **8 Macroeconomic Considerations**

Tax cuts will not put undue pressure on monetary policy provided that a medium-term approach to fiscal policy is adopted, tax reductions are signalled well in advance and government spending is reduced. The tax cuts will be known well in advance and incorporated into behaviour over an appreciable period. Even with the impact of the tax cuts to take into account, it should be easier for the Reserve Bank to manage monetary policy over the next few years than it was for much of the past decade when monetary policy had

little credibility, producer subsidies were being reduced and effective tax rates were increasing.

While there is no simple relationship between monetary and fiscal policies, the timing of the tax reduction programme will need to take account of its possible impact on the rate of inflation. The following points should be noted in this regard:

- the amount of the tax reduction programme over the next four years is likely to be about equal to the improvement in the operating balance that occurred between 1990/91 and 1994/95. Thus inflationary pressures arising from the stimulus to economic activity might, as a first approximation, be equal to that of the improvement in the operating surplus but of the opposite direction.

Fifteen economists from the University of Auckland suggested in 1991 that the reduction in the fiscal deficit would further depress economic activity but this did not happen. Similarly, suggestions that tax reductions will excessively stimulate economic activity may prove to be unduly pessimistic. The outcome will be affected by factors such as the extent to which people and firms increase savings and the ability of producers to boost output without increasing their prices. There can be little doubt that the economy is substantially more flexible than previously;

- complementary policies, such as further regulatory and welfare reforms and privatisation, would enhance the flexibility of the economy and help to offset inflationary pressures. The introduction of competition for the provision of accident insurance would, for example, assist in containing the costs of ACC which amount to 1.8 percent of GDP. Local government has a part to play in this process. For example, the Auckland City Council's intention to restrict the increase in housing permitted in its eastern suburbs from about 100 percent under its old district plan to 30 percent with the new plan will put pressure on housing prices. Such proposals should be subject to closer scrutiny;
- tax reductions that result in a more efficient use of resources and therefore higher productivity would result in lower inflationary pressures than otherwise. This reinforces the arguments advanced above for the tax cuts to focus on lowering important EMTRs, including the top personal and company tax rates;
- existing direct and indirect taxes can be expected to be reflected in prices. Thus, over time, a reduction in marginal rates of tax can be expected to result in lower wage and interest rates, and lower prices for goods and services than otherwise; and
- tax reductions that arise from lower government expenditure would not increase inflationary pressures.

The Reserve Bank views the demand effects of the tax cuts as important in assessing the impact on inflation of tax cuts. This seems to be inconsistent with its emphasis on cost-plus inflation when taxes are raised.

There is a high risk that the government will be unable to withstand pressure for additional spending on low priority activities if fiscal surpluses are allowed to build up once debt is reduced to a prudent level. Community welfare would be lower than otherwise and the opportunity to boost growth on a sustainable basis would be lost. This consideration points to the desirability of implementing tax reductions as soon as the stated conditions have been met, with supportive measures to contain any inflationary pressures.

## 9 Presentational Issues

The initial public reaction to the announced tax reductions has been unduly negative. The following advantages of tax reductions need to be emphasised to help build public support for them:

- tax reductions are possible because the economy is performing better and because the tax base has been substantially broadened since 1984;
- the positive effects on growth, individual initiative and responsibility of lower spending and taxes. Tax cuts should be presented as an integral part of the government's economic and social strategy;
- growth is the only means of raising incomes on a sustainable basis;
- incentives matter. Higher taxes discourage work, investment and individual initiative, and encourage tax avoidance and evasion;
- tax reductions are one means by which the benefits of the reforms are shared among all New Zealanders;
- tax cuts will benefit people who are in work and whose gross wages have been constrained as unemployed people have been absorbed into employment;
- the reforms are generating jobs for people that are out of work. The government could not have created 190,000 jobs in the last five years through make-work schemes. It is simply wrong to argue that people on low incomes are not benefiting from the reforms;
- social spending has been increased - it has not been slashed, nor has the welfare state been dismantled as is often claimed. The benefits gained from higher spending on health and education need to be identified and publicised;
- while the government has an important role to play, a large government sector is bad for growth and discourages individual responsibility and initiative. The growth in the size of government is a recent development; and
- governments throughout the world are looking to the private sector to increase output, incomes and jobs. New Zealand's strategy is consistent with mainstream thinking.

Quality leadership, comparable to that which led to the Employment Contracts Act and to the tariff reduction programme, will be required if the potential benefits from the most favourable fiscal outlook in at least two decades are to be realised fully.

## 10 The 1996 and 1997 Tax Reduction and Social Policy Programme

The first stage of the tax reductions was announced in February 1996. The rate of tax on labour income up to \$9,500 a year will remain at 15 percent. This rate of tax tends to be a marginal rate of tax for certain:

- part-time or part-year workers;
- young workers who are on low wages, perhaps because they are engaged in training. The minimum wage for an adult amounts to \$13,000 a year. Guaranteed minimum family income is also set above the \$9,500 a year threshold;

- beneficiaries, many of whom earn low incomes for a limited period - for example while engaged in job search; and
- self-employed persons who often report highly uneven incomes.

The vast majority of income which falls within the \$9,500 tax bracket is, however, intra-marginal income that is earned by moderate and high income earners that face a higher marginal rate of tax. The decision to retain the bottom tax rate and to target assistance to families through an increase in family support is commended.

The middle marginal rate of tax on labour income will be reduced from 28 to 21 percent. The bottom marginal rate of tax on income, other than labour income, will be reduced from 24 percent to 19.5 percent. The top rate of 33 percent will remain unchanged although it will apply to income over \$38,000 a year rather than over \$30,875 at present. These changes will take place over two years. The rate of tax applicable to companies, superannuation schemes and life insurance funds will remain unaltered at 33 percent. The rate of fringe benefit tax, which is set to reflect the top personal rate of tax, is also to remain unchanged at 49 percent.

Since 1984, tax policy has progressively moved toward a flatter tax scale which, other things being equal, reduces deadweight costs. A flatter tax scale facilitates a more uniform treatment of income which is taxed in the hands of the recipient and that which is earned through business entities such as life insurance funds, superannuation schemes and companies, thereby reducing the impact on the choice of investment vehicles of tax treatment. The substantial widening of the tax base would have been difficult, if not impossible, to implement without a flattening in the tax scale.

The new tax scale moves in the opposite direction. The difference between the effective rate of tax on labour income earned by people earning over \$38,000 and that applying in the \$9,500 to \$38,000 a year bracket will increase from 5 to 12 percentage points (that is from 33-28 to 33-21 percent). In respect of other income, the comparable difference will increase from 9 to 13.5 percentage points (that is from 33-24 to 33-19.5 percent). There are three main efficiency concerns that arise from these arrangements:

- a substantial part of the revenue cost of the package appears to arise from cuts in intra-marginal tax rates, especially from a life-cycle perspective. All tax cuts that accrue to taxpayers who will pay the 33 percent rate of tax on their next dollar of labour or investment income fall within this category. Since lower intra-marginal tax rates do not affect incentives, there is no efficiency gain from reducing them. The government does not appear to have achieved the largest possible gain in efficiency from the amount of revenue committed to the tax cuts. No attempt appears to have been made to assess the efficiency gains from the package;
- the incentive to engage in income splitting will be substantially increased by a widening in the tax rates that apply to most taxpayers and by raising the threshold at which the top rate applies. The maximum saving in splitting income between a principal income earner and a spouse or a child with no other income is \$2,779 ( $\$30,875 \times 0.09$ ) a year at present. Under the new tax scale this benefit increases to \$5,130 annually ( $\$38,000 \times 0.135$ ). There is substantial avoidance of the present superannuation surcharge which imposes an additional tax of 25 percentage points on certain income. The extra gain from income splitting will encourage extra resources to be devoted to this activity. From a national economic perspective, such resources are wasted because they do not lead to an increase in output; and
- low to middle income earners will be further discouraged from saving for retirement and other purposes through entities which are taxed at the 33 percent rate. Tax concessions for savings through superannuation schemes and life insurance funds have been abolished. The 33 percent rate applicable to such funds and schemes imposes a

penalty in respect of investors who faced a marginal rate of less than 33 percent. This penalty will be increased from 9 to 13.5 percentage points for many taxpayers. Superannuation schemes and life insurance funds will be further disadvantaged in competing with other institutions. People on low to moderate incomes will be discouraged from saving for their retirement through such vehicles.

These points reinforce the need to lower the top marginal rate of tax with a view to flattening the tax scale. The next stage of the tax reduction programme should address this issue.

The following additional points concerning the package are noted:

- the increase in the superannuation surcharge thresholds by 25 percent over two years represents a weakening in the targeting of New Zealand Superannuation and will discourage private provision for retirement income. The NZBR has consistently argued that superannuitants are not generally facing hardship. They will receive considerable benefits from the tax cuts;
- the decision to exclude accident victims from the independent family tax credit is motivated by the laudable objective of discouraging unjustified dependency on ACC. However, it treats ACC as a welfare programme rather than as an insurance scheme whereas ministers have repeatedly stressed that it is an insurance concept. The problem of dependency on ACC arises from fundamental flaws in its design and operation which need to be addressed as a matter of urgency; and
- a widening in the gap between after-tax income arising from employment and benefits is a helpful step to reduce welfare dependency. The boundary problems that will arise in implementing the independent family tax credit will lead to political pressure to relax the criteria to allow beneficiaries to qualify. The government should resist any such pressure.

## 11 Conclusions

The main conclusions of this submission are as follows:

- a substantial reduction in public expenditure, further privatisation and debt reduction should be an integral part of the tax reduction programme;
- tax reductions provide the government with an important opportunity to lift community welfare;
- tax reductions should be concentrated on those taxes that impose the largest deadweight costs on the community if they are to make the largest possible contribution to lifting national output and incomes. They should therefore focus on lowering high effective marginal rates of tax that apply to large amounts of income;
- the top personal and company tax rates, and high tax rates faced by beneficiaries as support is phased out, are important marginal rates of tax;
- tax reductions can assist in lowering the cost of capital and thereby encourage investment and foster innovation and enterprise;
- a planned, medium-term programme of tax reductions is required; and
- quality leadership by the government will be necessary to build public support for tax reductions.

## Annex

**Table 1**  
**Change in Expenses, Revenue and Financial Balance**  
**1984/85 to 1994/95**

	1984/85	1994/95	Change	Change
	\$m	\$m	\$m	%
<b>Taxation</b>				
Individuals	7,185	14,857	7,672	107
Company	1,113	3,967	2,854	256
GST/sales	1,561	6,809	5,248	336
Other	2,054	4,580	2,526	123
<b>Total taxation</b>	11,913	30,213	18,300	154
Other revenue	620	3,435	2,815	454
<b>Total revenue</b>	12,533	33,648	21,115	168
<b>Net surplus SOEs and Crown entities</b>		-553	-553	
<b>Expenses</b>				
Social security and welfare	4,458	11,724	7,266	163
Education	1,729	4,803	3,074	178
Health	1,911	4,886	2,975	156
Other functional expenses	4,572	5,781	1,209	26
Finance costs	2,563	3,757	1,194	47
Foreign exchange	-246	-551	-305	23
<b>Total expenses</b>	14,987	30,400	15,413	103
<b>Operating Balance</b>	-2,454	2,695	5,149	-210
	%	%	Percentage Points	
Memorandum items:				
Total revenue: GDP	31.6	38.9	7.3	
Total expenses: GDP	37.8	35.1	-2.7	
Social expenses: GDP	20.4	24.7	4.3	
Balance: GDP	-6.2	3.1	9.3	

**Table 2**  
**Change in Revenue, Expenses and Operating Balance**  
**1990/91 to 1994/95**

	1990/91	1994/95	Change	Change
	\$m	\$m	\$m	%
<b>Taxation</b>				
Individuals	12,692	14,857	2,165	17
Company	1,762	3,967	2,205	125
GST	6,163	6,809	646	10
Other	5,180	4,580	-600	-12
<b>Total taxation</b>	25,797	30,213	4,416	17
Other revenue	1,943	3,435	1,492	77
<b>Total revenue</b>	27,740	33,648	5,908	21
<b>Net surplus SOEs and Crown entities</b>		-553	-553	
<b>Expenses</b>				
Social security and welfare	11,005	11,724	719	6
Education	4,401	4,803	402	9
Health	3,986	4,886	900	23
Other functional expenses	6,283	5,781	-502	-8
Finance costs	4,624	3,757	-867	-19
Foreign exchange	-217	-551	-334	154
<b>Total expenses</b>	30,082	30,400	318	1
<b>Operating balance</b>	-2,342	2,695	5,037	-215
	%	%	Percentage points	
Memorandum items:				
Total revenue: GDP	37.9	38.9	1.0	
Total expenses: GDP	41.1	35.1	-6.0	
Welfare expenses: GDP	26.5	24.7	-1.8	
Balance: GDP	-3.2	3.1	6.3	