

## TAX PERSPECTIVES

NZ'S COMPANY TAX RATE NEEDS TO BE COMPETITIVE WITH OTHER COUNTRIES'— TO ATTRACT INVESTMENT AND MAXIMISE GROWTH. BUT OUR COMPANY TAX HAS STAYED THE SAME SINCE 1989 WHILE OTHER DEVELOPED COUNTRIES HAVE CUT THEIRS. WHAT'S MORE RESPONSIBLE: MORE GOVERNMENT SPENDING OR A TAX CUT?

A NEW ZEALAND PERSPECTIVE

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# TAX PERSPECTIVES IS THE FIRST IN BUSINESS NZ'S PERSPECTIVES SERIES, A SERIES DESIGNED TO PROVIDE CLARITY ON SOME OF THE MOST IMPORTANT BUSINESS ISSUES OF OUR TIME, ALONG WITH RECOMMENDATIONS FOR CHANGE.

Government's fiscal management – how it chooses to tax and spend – affects every company and every individual. High levels of Government expenditure require high taxes, leaving less money in individuals' hands, making it harder to start and grow enterprises, to invest and employ.

The news that New Zealand's tax rates are rising faster than in other countries, and that our company tax rate is now well above the average in the OECD, EU, Asia-Pacific and Latin America, is cause for concern.

Amid growing competition for foreign investment and with investment analysis becoming increasingly sensitive to taxation, it is time to ask: is New Zealand's tax policy attractive to investors? Tax Perspectives seeks to stimulate debate and help you answer the question.



**Terry Arnold**  
President Business NZ

## NEW ZEALAND BUSINESSES ARE AFFECTED BY RELATIVELY HIGH LEVELS OF TAXATION, BOTH CORPORATE AND PERSONAL, AND BY THE COSTS INVOLVED IN COMPLYING WITH TAXATION LEGISLATION.

Business NZ's aim in producing the Perspectives series is to make important issues simple. Taxation is a technical subject that can be daunting. Tax Perspectives summarises the central arguments in simple language, backed up by relevant data from the New Zealand Treasury, the OECD, accountants and economists.

The objective is to shed light on the choices that must be made if New Zealand is to remain competitive and if we are to continue growing our economy.

This publication makes the point that our tax burden is the direct result of Government spending, and asks whether a large increase in Government spending is more or less responsible than tax cuts.

In fact, we think it's more responsible to let taxpayers choose between the two – and believe that information is the best tool to help that choice.



**Phil O'Reilly**  
Chief Executive, Business NZ

## NZ's Tax System – Broad based, but very reliant on direct taxes

### Broad and narrow based tax systems

There are two basic types of tax system. A narrow based system, with fewer people being taxed, and numerous exemptions and concessions – this requires high tax rates. This was the NZ experience until the early 1980s. The other type is a broad based system, with more people being taxed, allowing for lower rates. This has been NZ's approach since the '80s. A broad-based system is simpler to administer and is fairer, as more people contribute towards the cost of services available to everyone.

### Direct and indirect taxes

Tax systems contain both direct and indirect taxes. Direct taxes are those levied directly on individuals' or companies' income. Indirect taxes are where the government imposes a levy on transactions, either generally as in a goods and services tax, or on purchases of specific items such as petrol, tobacco or alcohol.

## Direct and indirect taxes in NZ

	June 2003 Year (\$m)	% of total tax	June 2004 Year (\$m)	% of total tax
<b>Direct Taxation</b>				
Personal income tax (inc. fringe benefit tax)	19,209	48.6%	20,368	48.1%
Company tax (inc. non-resident withholding tax)	6,100	15.4%	6,985	16.5%
Other Income Tax				
• Resident withholding tax on interest & dividends	1,160	2.9%	1,270	3.0%
• Estate & gift duties	2	–	2	–
<b>Total direct taxation</b>	<b>26,471</b>	<b>67.0%</b>	<b>28,625</b>	<b>67.7%</b>
<b>Indirect Taxation</b>				
Goods & services tax	8,771	22.2%	9,455	22.3%
Other indirect taxation				
• Petroleum fuels excise	971	2.5%	944	2.2%
• Tobacco excise	867	2.2%	800	1.9%
• Customs duty	712	1.8%	726	1.7%
• Road user charges	620	1.6%	668	1.6%
• Alcohol excise	461	1.2%	476	1.1%
• Gaming duties	277	0.7%	V 260	0.6%
• Motor vehicle fees	201	0.5%	223	0.5%
• Energy resources levy	97	0.2%	75	0.2%
• Approved issuer levy & cheque duty	51	0.1%	56	0.1%
<b>Total indirect taxation</b>	<b>13,028</b>	<b>33.0%</b>	<b>13,683</b>	<b>32.3%</b>
<b>Total tax collected</b>	<b>39,499</b>	<b>100.0%</b>	<b>42,308</b>	<b>100.0%</b>

Source: Financial statements of the Government of NZ for the year ended 30 June 2004

The table above shows NZ's reliance on direct tax is marked – 67% comes from direct taxation of individuals and businesses. Although less than in the early 1980s when it was 75%, this is still high by international standards.

A high reliance on direct taxes is a problem for growth because direct taxes can distort economic decisions, as individuals seek to avoid tax by 'sheltering' income, moving it offshore, or putting it into non-productive ventures.

NZ is one of the OECD countries most reliant on direct taxation of income of individuals and companies, as shown by the table below.

### Revenue from major taxes as percent of total tax revenue (2001)

Country	Personal Income	Company Income	Social Security & Payroll Taxes	Property Taxes	Goods & Services Taxes	
					Total	Of Which General Consumption
Australia	40.8	14.9	6.3	9.0	29.1	13.2
Canada	37.1	10.0	16.7	9.9	24.7	14.5
Denmark	52.7	6.3	5.0	3.4	32.2	19.5
Finland	30.5	10.6	26.8	2.3	29.4	18.5
France	17.7	7.6	38.6	6.9	25.2	16.7
Germany	27.1	1.7	39.8	2.3	28.8	18.2
Ireland	29.7	12.1	14.6	5.8	37.3	23.0
Italy	25.9	8.6	29.0	4.8	25.6	14.8
Japan	20.1	12.7	37.7	10.3	19.0	8.9
Korea	14.1	12.3	18.5	11.4	39.6	17.2
Netherlands	16.3	10.4	36.0	5.2	30.7	18.8
<b>New Zealand</b>	<b>42.9</b>	<b>11.3</b>	<b>0.9</b>	<b>5.2</b>	<b>35.5</b>	<b>25.7</b>
Norway	24.2	21.7	20.5	2.2	31.3	18.8
Spain	19.6	8.1	35.9	6.4	29.3	17.1
Sweden	31.9	5.7	33.8	3.1	25.1	17.7
Switzerland	32.0	10.2	25.5	9.1	23.2	13.4
United Kingdom	30.2	9.5	17.0	11.6	31.3	18.3
United States	42.3	6.5	24.6	10.6	16.1	7.7
<b>OECD Average</b>	<b>26.5</b>	<b>9.4</b>	<b>26.1</b>	<b>5.4</b>	<b>31.3</b>	<b>18.5</b>
<b>EU 15 Average</b>	<b>25.8</b>	<b>8.9</b>	<b>28.8</b>	<b>4.9</b>	<b>30.1</b>	<b>18.6</b>

Source: OECD

On average around 36% of tax revenue in OECD countries comes from direct taxes, while NZ's proportion is 54%. Only Denmark and Australia have higher shares of direct taxes.

NZ also differs from other OECD nations in its low reliance on revenue from social security and payroll taxes – 0.9% of total tax revenue. NZ's only 'payroll tax' is the ACC levy for employers and the self-employed. Social security in NZ is funded out of general taxation, not by specific taxes on employers – a virtue, as such taxes add complexity for employers and discourage employment.

**TAX – ITS GOING UP AND UP IN 2000 EACH NEW ZEALANDER PAID ON AVERAGE \$8,300 TAX. IN 2004 THIS INCREASED TO AVERAGE OF \$10,500 (UP 26%). ON CURRENT FORECASTS THIS WILL RISE TO AROUND \$13,000 BY 2009 (A FURTHER INCREASE OF 24%).**

## Personal income tax

Almost half of all NZ tax revenue comes from personal income tax, much collected on a 'pay as you earn' (PAYE) basis – employers make deductions from their employees' wages and salaries at a rate dependent on their level of income.

Since 1999 personal income tax rates have become more progressive (a steeper increase in the rate of tax the more an individual earns). This table shows the changes since 1999 (the statutory tax scale shows the rates before the application of a low-income rebate, while effective rates are what you actually pay).

## Personal income tax levels 1999 and 2004

Annual taxable income	1999		2004	
	Statutory rate	Effective rate	Statutory rate	Effective rate
\$1-\$9,500	19.5%	15.0%	19.5%	15.0%
\$9,501-\$38,000	19.5%	21.0%	19.5%	21.0%
\$38,001-\$60,000	33.0%	33.0%	33.0%	33.0%
Over \$60,001	33.0%	33.0%	39.0%	39.0%

Source: NZ Treasury

The difference between 1999 and 2004 was a change in 2000 increasing the tax rate for those earning \$60,000 or over, from 33% to 39%. The Government required more revenue to pay for its spending plans and also desired more progressive tax scales to reduce income inequality.

## Flatter tax – simple and fair

However, flatter tax systems are simpler, more efficient and less distorting than steeply progressive systems. They are also fairer, in better rewarding effort and innovation. Over the last decade nine countries – Estonia, Lithuania, Latvia, Russia, Serbia, Ukraine, Slovakia Georgia and Romania – have adopted flat tax on income; some of these have also aligned their company tax at the same rate. Results so far have included less tax avoidance, stronger economic growth and higher tax revenues. A weakness in the current NZ tax system – increased progressiveness, muting the incentive to work and produce – could be righted by moves over time to flatten tax scales.

## Bracket creep – more paying higher tax

An associated weakness with the current system is that there has been no adjustment in tax thresholds since the last round of reductions in 1998. This is despite average incomes having risen by 30%<sup>1</sup> and cumulative inflation amounting to 13% in the six years to June 2004. The result is more and more wage and salary earners moving into higher income bands. Although originally intended to apply to the top 5% of income earners, the \$60,000 top tax rate is now capturing an increasing number of 'middle income' earners – around 22% of fulltime workers and rising.

The Government has responded to this 'bracket creep' by targeting extra income support through the tax system for lower and middle-income families via the Working for Families package, rather than providing tax cuts for those it regards as wealthy.

This is against the trend in other countries – a recent OECD report<sup>2</sup> shows a clear trend to reduce personal tax by reducing rates and/or increasing income thresholds. Some countries have reduced tax rates at all income levels while others have reduced rates for low and middle-income earners. Some have also introduced family-related benefits delivered through the tax system.

## NZ tax – rising faster than other countries

NZ is one of the few OECD countries where wage and salary earners faced higher average tax rates in 2002 than in 2000, as shown in the table below.

<sup>1</sup> According to Statistics NZ's *New Zealand Income Survey*, average weekly incomes have risen from \$425 per week in the June 1998 quarter to \$554 per week in the June 2004 quarter, an increase of 30.3%

<sup>2</sup> *Tax Policy: Recent Trends and Reforms in OECD Countries*, OECD, Nov 2003

### ✓ Average tax rates for employees 2000 and 2002<sup>3</sup>

Country	2000	2002	Change
Australia	22.8	23.6	+0.8
Spain	18.5	19.2	+0.7
<b>New Zealand</b>	<b>19.5</b>	<b>20.0</b>	<b>+0.5</b>
Switzerland	21.3	21.5	+0.2
Japan	16.2	16.2	0.0
France	26.8	26.5	-0.3
United Kingdom	23.6	23.3	-0.3
Italy	28.5	28.1	-0.4
Norway	29.2	28.8	-0.4
Korea	9.2	8.7	-0.5
Germany	42.0	41.2	-0.8
Canada	26.6	25.7	-0.9
Denmark	44.1	43.1	-1.0
United States	25.5	24.3	-1.2
Finland	33.6	31.7	-1.9
Sweden	32.9	30.4	-2.5
Ireland	20.3	16.4	-3.9
Netherlands	36.2	28.7	-7.5
<b>OECD Average</b>	<b>25.6</b>	<b>24.7</b>	<b>-0.9</b>
<b>EU 15 Average</b>	<b>29.2</b>	<b>27.6</b>	<b>-1.6</b>

Source: OECD

A recent update of this research shows that NZ's average tax rate crept up further in 2003, with the average tax rate for a married couple with two children on the average income rising from 18.8% in 2002 to 20.4% in 2003.

At 39% NZ's top rate of personal income tax is not excessively high by OECD standards – in 2002 the OECD average top rate was 43.6%, with only five countries having lower top rates than NZ. But the top rate is only half the equation. Just as important are the income thresholds the rates apply to. NZ's top personal rate kicks in at the fairly low level of \$60,000.

### ✓ Company tax

NZ's company tax rate has been 33% since 1989 when the Lange-Douglas Labour Government cut it from 48%. Despite this large reduction in the company tax rate, the revenue from company tax increased dramatically, an effect that has been dubbed the 'tax cut paradox'. The increase in tax revenue came about partly because tax concessions and avoidance opportunities were also removed, but also because the economy grew, stimulated by the tax cut.

**THE TAX CUT PARADOX IN 1989 THE COMPANY TAX RATE WAS CUT – FROM 48% DOWN TO 33%. THE EXPECTED OUTCOME WAS THAT TAX REVENUES WOULD FALL. BUT REVENUES INCREASED DRAMATICALLY INSTEAD, BECAUSE THE ECONOMY GREW FASTER, STIMULATED BY THE TAX CUT.**

<sup>3</sup> Single person, no children at the average income level



During the March 1987 year, company tax revenue was \$1.67b. In the March 1989 year, company tax revenue rose to \$2.4b – an outstanding increase.

In the decade before 1988, net revenue from company taxes averaged almost \$1b a year (\$0.953b for the 1979-88 annual average), while in the decade after; it was three times as much (\$2.871b for the 1989-98 annual average).

The benefits from this reduction still continue – the share of revenue from company tax has grown from 8% to over 16% since 1991. Research<sup>4</sup> indicates cutting the company tax rate is more likely to increase tax revenue because business activity, employment and investment are all stimulated.

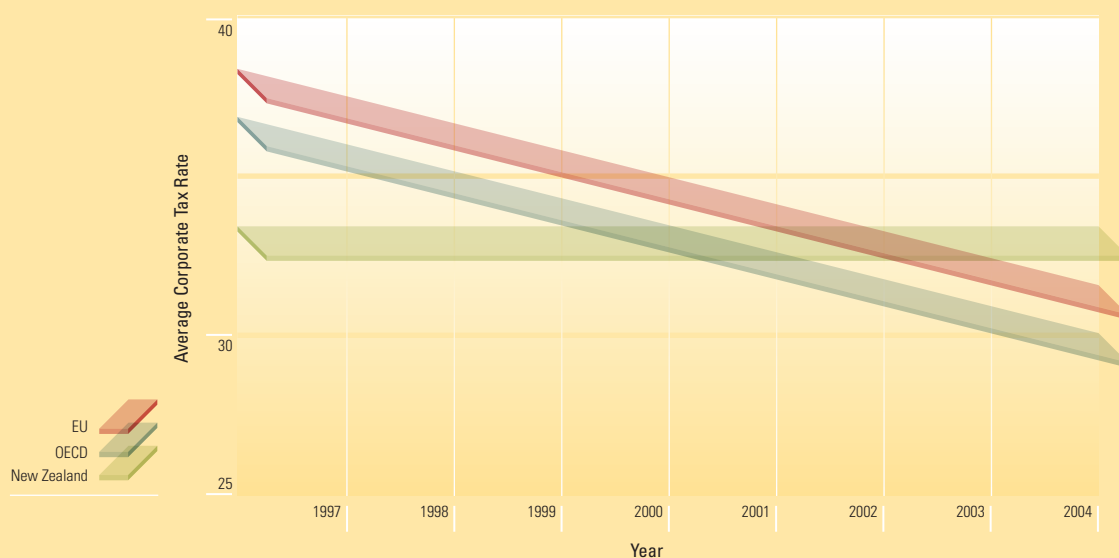
#### Company tax a withholding tax

The operation of imputation credits – where a company pays tax on behalf of its shareholders and provides them with imputation credits for the same amount – means company tax is largely a withholding tax. Reducing the company tax rate should therefore increase the revenue collected from personal income tax, with the only 'leakage' being for those situations where imputation credits are not being utilised (e.g., non-resident shareholders, state owned enterprises, managed investment funds, etc).

### Company tax affects investment

It is also important to set the company rate so that it is internationally competitive – i.e. lower than in competing countries – to attract foreign investment and further maximise growth opportunities and tax revenues. Unfortunately NZ's company tax rate has remained the same since 1989, while other developed countries have reduced theirs. In 2000 Australia's company tax rate was cut from 34% to 30%. The figure below shows that since 1997 the average company tax rates for the OECD and the EU have fallen steadily and substantially, while NZ's has remained the same.

FIG 9. Average Corporate Tax Rates 1997 - 2004



Source: KPMG International Corporate Tax Rate Survey 2004

<sup>4</sup> Infometrics, for EMA (Northern) and Business NZ, 2001

The table below also shows NZ's current company tax rate in comparison with other countries, along with the top personal tax rate and difference.

### Company tax rate and top personal tax rate (2002)

Country	Company Tax Rate (%)	Top Personal Income Tax Rate (%)	Difference
Australia	30.0	48.5	-18.5
Canada	38.6	43.3	-5.7
Denmark	30.0	59.7	-29.7
Finland	29.0	53.8	-24.8
Germany	38.9	51.1	-12.2
Ireland	16.0	42.0	-26.0
Netherlands	34.5	52.0	-17.5
<b>New Zealand</b>	<b>33.0</b>	<b>39.0</b>	<b>-6.0</b>
Spain	35.0	48.0	-13.0
Sweden	28.0	55.5	-27.5
United Kingdom	30.0	40.0	-10.0
United States	45.2	45.2	0.0
<b>OECD Average</b>	<b>31.3</b>	<b>45.3</b>	<b>-13.4</b>
<b>EU 15 Average</b>	<b>31.9</b>	<b>48.9</b>	<b>-17.0</b>

Source: OECD

Countries now compete intensely for foreign investment, with investment analysis becoming increasingly sensitive to taxation. NZ, which has maintained its company tax rate at 33% for over 15 years, runs the risk of being left behind. NZ's company tax rate is now well above the average in the OECD, EU, Asia-Pacific, and Latin America.

It is true that focusing on the 'headline' company tax rate ignores issues such as NZ's lack of social security and payroll taxes and other advantages such as its generally efficient tax system. But the company rate is still important in determining a country's international competitiveness.

Until 2000 the company rate was aligned to the top rate of personal tax, but the increase of the top personal rate to 39% has brought a 6% gap between the two rates. An excessive gap between the company and the top personal rate can cause distortions and encourage avoidance.

### Other taxes in NZ

#### Goods and services tax

GST was introduced in 1986, broadening the tax base and raising additional revenue that enabled income tax rates to be lowered. It is widely regarded as being fairer than the previous regime, with less scope for avoidance and evasion. GST raised 22% of the total tax revenue in 2004, up from the 11% raised by sales taxes in the early 1980s.

#### Excise taxes and gaming duties

NZ applies excise taxes to tobacco, alcohol and petrol. The tax on petrol is a convenient way to fund roading and other transport infrastructure, although successive governments have taken the majority of the revenue raised from petrol tax for non-transport purposes. NZ has four gaming taxes – totalisator duty, lottery duty, gaming machine duty, and casino duty. Revenue from gaming duties has been on the rise.

#### Customs duties, road user charges, vehicle licence fees

Until the early 1900s customs duties were a big revenue source. Their significance reduced during the 20th century as personal income tax became more widely levied. More recently, trade liberalisation has reduced the significance of customs duties still further. Revenue from road user charges and vehicle licence fees are dedicated to the National Land Transport Fund.

### Fringe benefit tax

FBT is not a big source of revenue, raising only \$400m in 2004. Its purpose is more to protect the personal income tax base by discouraging employers from paying their staff in non-taxable benefits (cars, car parking etc). FBT was introduced in the early 1980s in response to attempts to circumvent the 1982 wage price freeze.

### Estate and gift duties and taxes on property

Like FBT, estate and gift duties are also revenue protection devices, raising only \$2m in 2004. Rates (property taxes imposed by local government to fund their activities) are outside the scope of this PUBLICATRION paper. However, rates are a significant burden on property owners, currently raising around \$3b a year.

## ✍ Taxing and spending

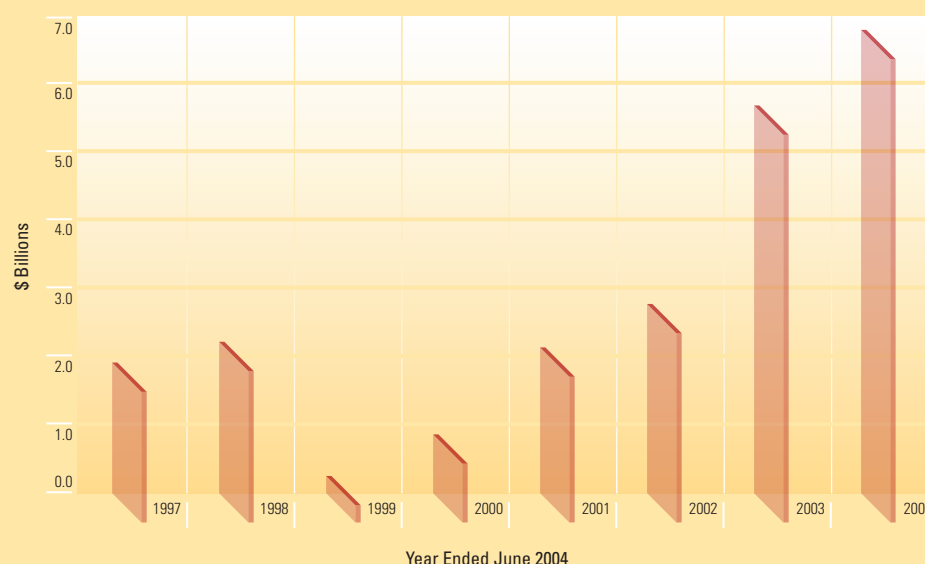
Fiscal management is the management of the economy by government taxing and spending policies. The outline of NZ's tax system above shows a current tendency to impose a relatively high level of taxes, led by relatively high levels of government spending.

Fiscal management techniques have changed in recent years. From the mid 1990s until 2002 government spending was managed by use of a spending-to-GDP ratio (spending had to be kept below 35% of GDP, with three-year new spending limits). After 2002 this approach was changed to a debt-to-GDP ratio (spending has to be kept at a level that produced a level of gross debt no higher than 20% of GDP over the longer-term). This more recent approach is less effective in constraining government spending, as the OECD has noted<sup>5</sup>. Recent experience has shown that the spending-to-GDP ratio can rise even while the debt-to-GDP ratio has fallen.

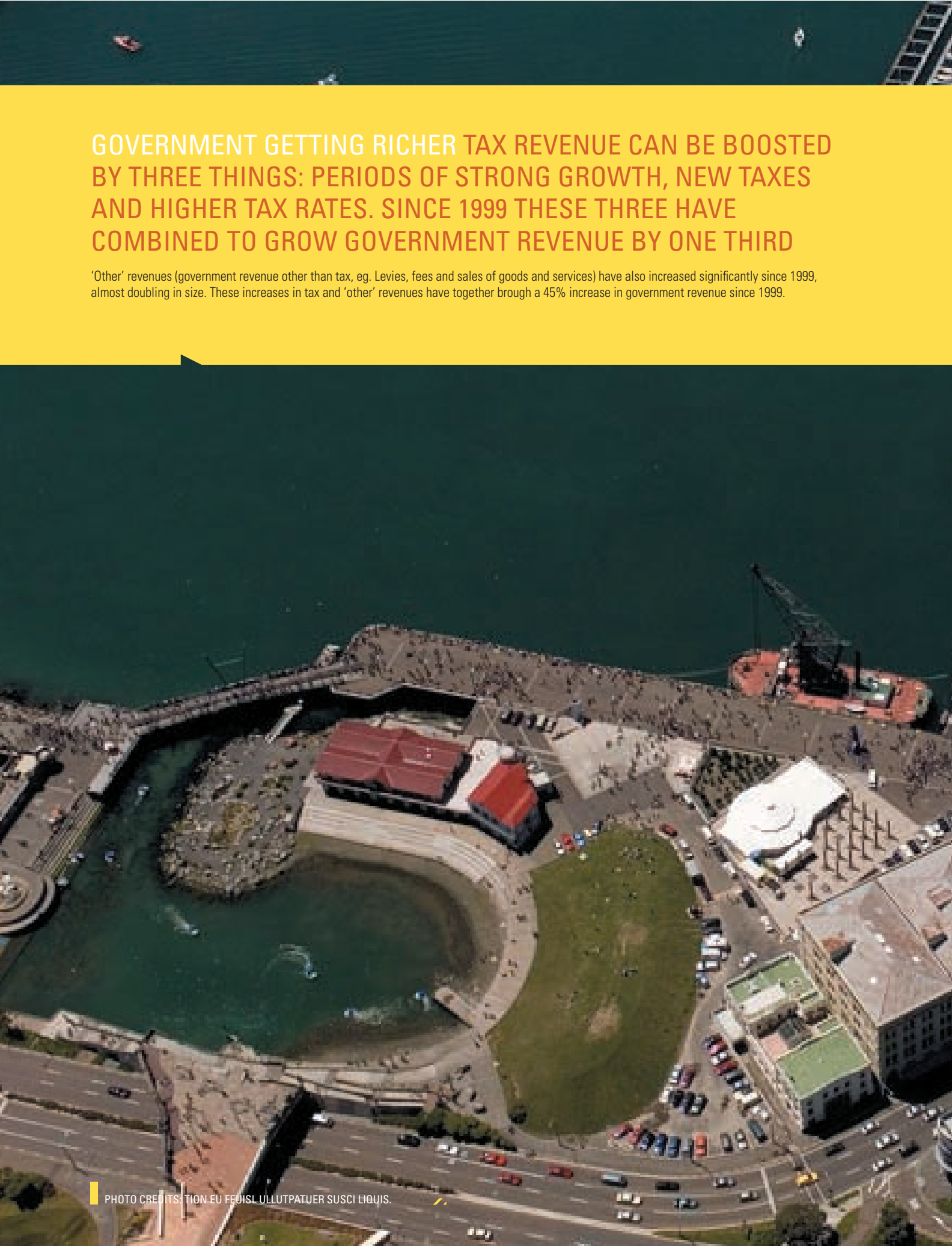
The Government's fiscal priority has been to increase spending (preparing to deliver a forecast 82% increase in spending between 2000 and 2009) and providing more targeted assistance through the tax system. Business NZ's view is that a better priority would be to constrain government spending in order to lower tax rates, to better stimulate economic growth.

The graph below shows the operating balance using the Government's preferred measure of fiscal stewardship, OBERAC. It shows the operating balance (revenue less expenses plus surpluses from state-owned enterprises and Crown entities) excluding revaluation and accounting policy changes, and indicates the strong surplus levels since 1999.

FIG 4. Operating Balance Excluding Revaluation And Accounting Policy Changes ('Oberac') 1997–2004



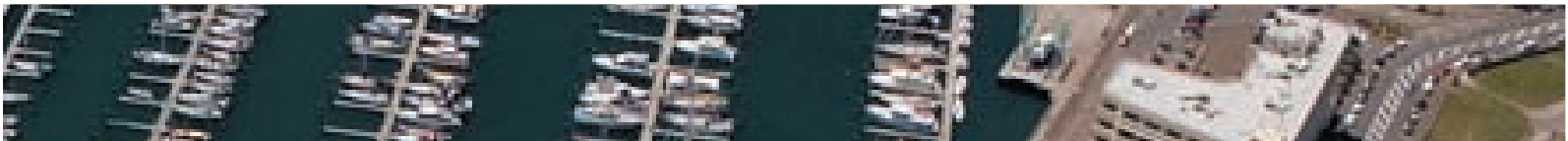
<sup>5</sup> OECD *Economic Survey of New Zealand*, December 2003.

An aerial photograph of a coastal city. In the foreground, a large stadium with a red roof and a green field is visible. To the right of the stadium is a large parking lot filled with cars. Further right, there are several buildings, including a large white one with a circular roof. In the background, a large shipyard with a crane is situated on a hillside overlooking the water. Several boats are visible in the harbor.

## GOVERNMENT GETTING RICHER TAX REVENUE CAN BE BOOSTED BY THREE THINGS: PERIODS OF STRONG GROWTH, NEW TAXES AND HIGHER TAX RATES. SINCE 1999 THESE THREE HAVE COMBINED TO GROW GOVERNMENT REVENUE BY ONE THIRD

'Other' revenues (government revenue other than tax, eg. Levies, fees and sales of goods and services) have also increased significantly since 1999, almost doubling in size. These increases in tax and 'other' revenues have together brought a 45% increase in government revenue since 1999.

PHOTO CREDITS: TION EU FEJISL ULLUTPATUER SUSCI LIQJIS.



## "EVERYONE'S BUSINESS WOULD BENEFIT FROM LOWER TAX"

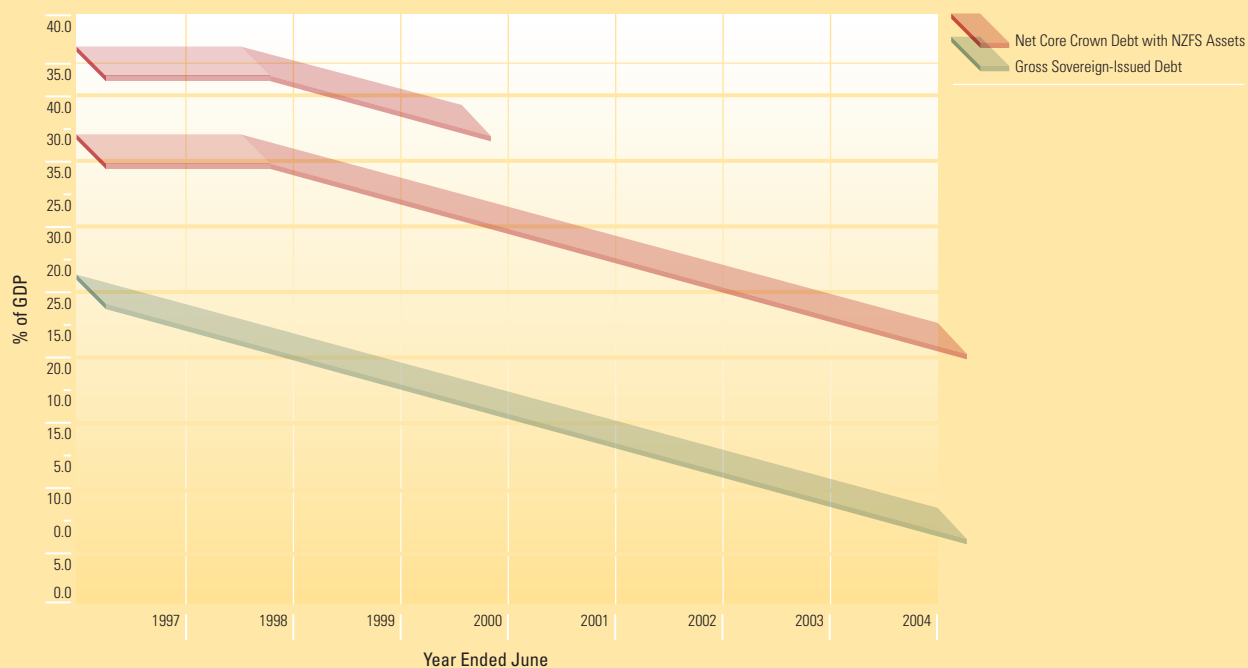


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An important element of fiscal management is to reduce debt. The Government aims to reduce gross sovereign-issued debt as a proportion of GDP, 'reaching 20% of GDP by 2015'. On recent trends this target is likely to be achieved much earlier than 2015. The graph below shows the progress of reducing the percentages of GDP for both gross-sovereign debt and net debt (excluding Superannuation Fund assets).

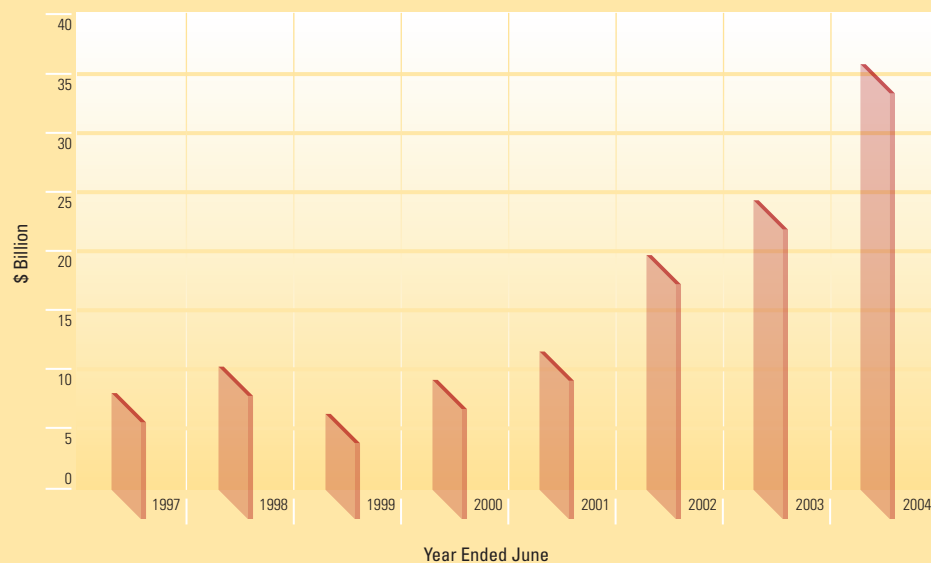
**Fig 5. Net Core Crown Debt And Gross Sovereign-issued Debt 1997–2004 (% Of Gdp)**



Source: KPMG International Corporate Tax Rate Survey 2004

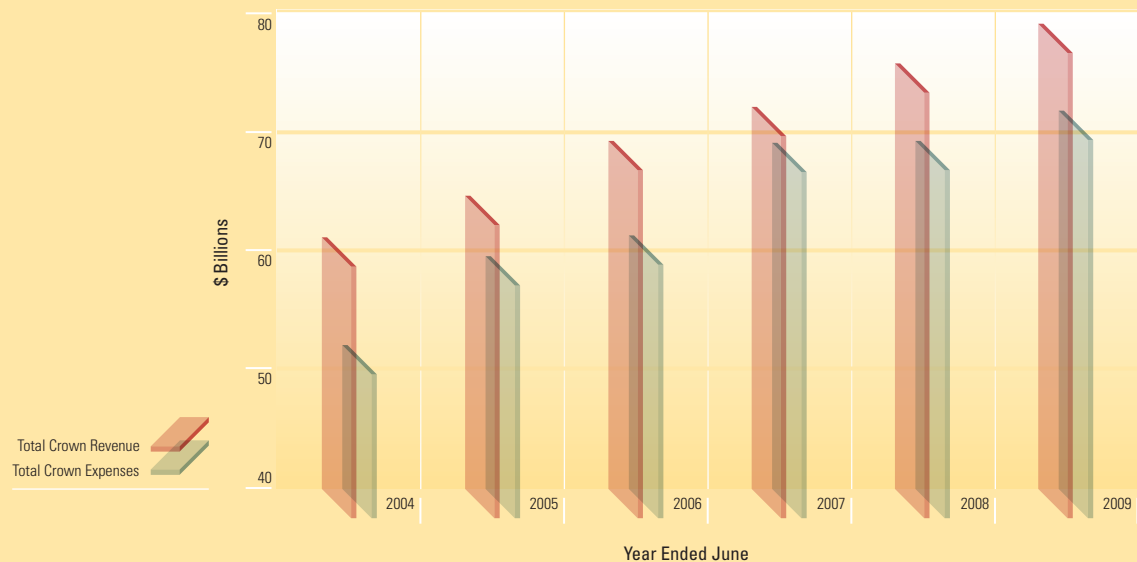
Another indicator of fiscal strength is Crown net worth (assets less liabilities). The table below shows the strengthening of the Crown's net worth, especially in the last three years.

**FIG 6. Net Worth 1997–2004 (\$ Billion)**



The next graph shows Treasury's forecast for growth in government revenue and expenditure to 2009. It shows revenue increasing slightly as a percentage of GDP and expenditure increasing at a higher rate, but with operating surpluses of around 3% of GDP.

**FIG 7. Forecast Total Crown Revenue And Expenses 2004–09**



The Government's budget policy statement 2005 says higher than expected tax revenue will enable higher spending beyond what was signalled in the 2004 Budget. The Government now intends to increase new operating spending in 2005/2006 from \$1.8b to \$2.1b.

### More government spending or a tax cut?

Successive fiscal updates show tax revenue running ahead of forecast and higher than expected surpluses. The past two years have seen surpluses of over 4% of GDP and although OBERAC does not necessarily equate to the amount of money available for increased spending or for tax cuts, it is a good indicator of the strength of the Government's finances.

The Finance Minister says there is little room to cut taxes, but projections show that total Crown expenditure will be 82% higher in 2008/9 than in 1999/2000 and could be even higher given new spending decisions made in future budgets<sup>6</sup>. The key question is whether such a large increase in spending is more or less responsible than tax cuts.

### What's the responsible thing to do?

A phased programme of tax cuts implemented over time would be affordable and sustainable providing spending growth was contained at a more modest level. This need not involve spending cuts, although there are undoubtedly areas of spending that are of low value and should be critically examined.

The debate should not be about whether the fiscal position would allow for tax cuts or spending increases – to date it has comfortably allowed large spending increases and is forecast to continue doing so. The issue is more about whether we should have a bigger government and a bigger tax burden or a smaller government with a smaller tax burden.

## Is our tax policy attractive to investors?

Size of government and tax policy can be critical for attracting or repelling international investment. How does NZ compare with other places? The table below shows tax revenue as a percentage of GDP for a number of developed nations.

	Tax revenue as % of GDP
Sweden	50.6
Finland	45.9
France	44.2
Norway	43.1
Italy	41.1
Netherlands	39.3
Germany	36.2
UK	35.9
Spain	35.6
<b>New Zealand</b>	<b>34.9</b>
Canada	33.5
Australia	31.5
Switzerland	31.3
Ireland	28.0
Korea	28.0
US	26.4
Japan	25.8
<b>OECD Average</b>	<b>36.3</b>
<b>OECD EU 15</b>	<b>40.5</b>

Source: OECD, 2002

This shows NZ's tax burden as below the OECD average, however the OECD average is heavily influenced by European and Scandinavian countries, most of which have very large governments. Excluding these countries gives a clearer picture, putting NZ at the top of the table, with a relatively high tax burden – in fact in 2002 NZ overtook Canada as the non-European/Scandinavian OECD country with the highest percentage of tax revenue to GDP. This is important considering that Asia-Pacific countries are our major competitors for investment.

NZ is also moving against the overall trend. For the 30 OECD countries where 2002 could be compared to 2000, most of them (20) recorded a fall in tax (as a percentage of GDP), nine recorded an increase (including NZ) and one recorded no change<sup>6</sup>.

These are important considerations for would-be investors in NZ. Analysis to inform any decision to invest in a foreign country will certainly take account of that country's tax burden. A high company tax rate will mean less company revenue and a high personal income rate will mean less disposable income for consumers – neither likely to attract international investment.

NZ should be attempting to make its business environment, notably the tax burden, more internationally competitive.

## Does size matter?

Is there a relationship between government size and economic growth? Conventional economic theory suggests that there should be, and that beyond a certain point government spending will have a negative impact on economic growth as it crowds out private sector activity and imposes costs on businesses and individuals. Three recent pieces of economic analysis are worth highlighting.

Gwartney, Holcombe and Lawson<sup>8</sup> make the case that government spending on core functions (e.g. infrastructure, human capital, protection of property rights) may enhance economic growth but spending outside those areas may harm it.

<sup>6</sup> Total Crown expenses were \$40.13b in 1999/2000. By 2008/09 they are forecast to reach \$73.02b



Winton Bates<sup>9</sup> argues that reducing spending to 30% of GDP could improve NZ's growth rate by half a per cent over ten years, and this size cut would not necessarily affect core government functions.

Arthur Grimes<sup>10</sup> reports on NZ's reliance more on direct than indirect taxes, and on unproductive spending – both likely to be negative for growth.

NZ's tax revenue as a proportion of GDP is rising at a time when most developed countries are reducing their tax burdens. Although NZ's government sector is not large by OECD standards, it is when compared to countries outside Europe – and these are our most important competitors.

## Business NZ perspective

Business NZ's analysis leads to the following recommendations for government taxation and spending:

- Cut government spending (including Super Fund) to less than 30% of GDP by 2010
- Cut net Crown debt (with Super Fund assets falling below –5%) by 2010
- Keep the broad base low rate approach
- Flatten personal tax rates
- Inflation-index income thresholds for personal tax rates
- Urgently cut the company tax rate to 30%, reducing over time to 20%

These recommendations could be achieved in a number ways; the methods described below are not necessarily Business NZ's preferred options, but are offered with the intention of stimulating debate on how we can achieve an internationally competitive tax system bringing stronger economic growth.

## Cut government spending below 30% of gdp by 2010

There is nothing new or radical about a 30% spending cap. The previous Government had this objective until 2000 when the incoming government lifted it to 35%. Achieving a 30% cap would not require a cut in nominal spending. Achieving the goal would be easier without having to make contributions to the Super Fund, however political consensus on the Fund has firmed, bringing the need to include Super Fund contributions in these calculations. The table below shows how a 30% spending target could be achieved by 2010. It would result in core Crown expenses of \$55.9b (including Super Fund contributions), \$8b higher for the current financial year. (The projection to 2009/10 is based on trends in Treasury December Economic and Fiscal Update (DEFU) 2004 forecasts.)

# "A FLAT TAX STIMULATES GROWTH AND ENDS UP BENEFITING EVERYBODY"



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<sup>7</sup> Tax Policy: Recent Trends and Reforms in OECD Countries, OECD (Nov 2003)

<sup>8</sup> The Scope of Government and the Wealth of Nations, James Gwartney, Randall Holcombe and Robert Lawson (1988)

<sup>9</sup> How Much Government? The Effects of High Government Spending on Economic Performance, Winton Bates, NZ Business Roundtable (July 2001)

<sup>10</sup> Economic Growth and the Size and Structure of Government: Implications for New Zealand, Arthur Grimes (July 2003)

## How a 30% spending target could be achieved

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Forecast spending (\$b)	47.9	50.3	53.4	56.9	60.0	63.2
Annual spending increase (%)	+10.1	+5.0	+6.2	+6.6	+5.4	+5.5
Forecast spending (% of GDP)	31.8	32.3	33.0	33.6	33.7	33.8
Spending to achieve 30% target by 2010 (\$b)	47.9	49.4	50.9	52.5	54.1	55.9
Annual spending increase (%)	+10.1	+3.1	+3.1	+3.1	+3.1	+3.1
Spending to achieve 30% target by 2010 (% of GDP)	31.8	31.7	31.5	31.0	30.4	29.9

The additional \$8b spending over five years would allow for around 3.1% annual growth in nominal spending, and aggregate annual spending would in effect grow at inflation of 2% and population growth of 1%. Although this would leave little room for additional discretionary spending, the restraint would encourage the Government to ensure better value for money in its spending decisions. Achieving a 30% spending goal by 2010 would result in cumulative savings of \$21b over five years. These savings would be the prime way in which the rest of Business NZ's tax and fiscal proposals could be achieved.

## Cut net crown debt by 2010

It is debatable whether a gross debt target is an appropriate measure for constraining government spending. A net debt target (taking into account superannuation fund assets) would be a better reflection of the fiscal position when looking forward. A change to a net debt target would mean that under current Treasury forecasts, net debt would be forecast to fall below 0% of GDP by 2008 and would fall further over time as super fund assets continued to build. So a target of -5% by 2010 would provide an easily achievable objective on the current Treasury forecast for 2010 (-4.8%).

The last line in the table above shows that achieving a 30% spending cap by 2010 would free up to \$21b over five years. This amount would then be available for tax cuts and debt reduction. Net debt (including super fund assets) to -5% by 2010 could be achieved by using this amount. Conversely, based on current Treasury projections to 2010, increasing the net debt figure by 0.2 percentage points would cost approximately \$67.8m per year, cumulatively costing \$339m by 2009/2010.

## Keep the broad base low rate approach

Business NZ is committed to continued support for the broad base low rate approach. Achieving it involves showing both the Government and the wider public how this could be achieved. This publication is one such step Business NZ is taking.

## Flatten personal tax rates

Just like the net debt objective, the cumulative savings of \$21b in the table above would also provide the funding for tax cuts. The table below shows the amounts available for tax cuts over the next four years if 80% of the \$21b went towards tax cuts (assuming taxes would be cut as the savings are made).

## How to achieve funding for tax cuts

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Savings from moving to 30% spending target by 2009 (\$b)	—	0.9	2.4	4.4	5.9	7.4
Amount applied to tax cuts at 80% of savings (\$b)	—	0.7	1.9	3.5	4.7	5.9

To assist in such calculations, the Treasury produces a ready reckoner tool, which shows the costs for each change in various tax rates<sup>11</sup>, as outlined in the two tables below.

### Ready reckoner: cost of a 1% cut in tax rate

Personal income tax rate	Estimated cost of a 1% cut
39%	\$120m
33%	\$100m
21%	\$320m
15%	\$175m
Company tax rate (33%)	\$195m

### Ready reckoner: cost of a \$1,000 increase in income thresholds

Income threshold	Estimated cost of a \$1,000 increase
\$60,000	\$15m
\$38,000	\$95m
\$9,500	\$40m

Lower personal tax rates could be achieved by simply dividing the amount available for tax cuts. If the three personal income tax rates were reduced by 1-4% for four years, by 2010 these could be reduced to two rates (15% for income up to \$47,300 and 25% for income over that threshold). The cost of over four years would be \$4,100m or 19.5% of the savings possible with a 30% government spending cap.

These ready reckoners are included in order to give an idea of the sums involved for tax cut purposes. They do not take into account the tax cut paradox and are based on the erroneous assumption (in Business NZ's view) that tax cuts are always a cost. The tax cut paradox, see page X, demonstrates the impetus gained by the economy resulting from a tax cut, which leads to higher, not lower tax revenues.

### Inflation-index income thresholds

Adjusting income thresholds for inflation could be achieved by adjusting the thresholds to take into account 6 years of inflation. This would cost around \$715m, again taken from the \$21b savings. The following years would see each personal income bracket increase by 2%, which by 2010 would cost an additional \$460m, giving a total cumulative cost of \$1,175m by 2010.

### Urgently cut company tax to 30%, reducing over time to 20%

Reducing the company tax rate by 1-3% for every year for four years would drop the company tax rate from 33% to 25% by 2010, and align the company tax rate with the top personal tax rate, and would cost, cumulatively, \$1,560m. Again, this would be met from savings from the 30% spending cap by 2010, although as company tax is only a withholding tax the impact on total tax revenue may be less. And more importantly, the tax cut paradox would in any case be more likely bring an increase in revenue rather than a cost.

## "LOWER TAX WOULD LET US REINVEST IN PEOPLE AND MACHINERY"



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<sup>11</sup> See [www.treasury.govt.nz/readyreckoner/reckoner.asp](http://www.treasury.govt.nz/readyreckoner/reckoner.asp). This is a static model that does not allow for second-round macroeconomic effects. It is updated annually and is designed for estimating small changes in tax rates and thresholds. Its results should therefore be treated with some caution.

## Pulling it all together

The last table below shows how the revenue and expenditure related to Business NZ's tax and fiscal policy objectives could be achieved. Taking into account the extra revenue offset by the extra expenses of the net debt objective, cuts in the company and personal tax rates and personal tax threshold adjustments, there would still be approximately \$1,613m in surplus which could be used for further tax or debt reduction.

## Business NZ perspective on tax and expenditure:

### HOW IT CAN BE ACHIEVED

Current position/thresholds	2005/06	2006/07	2007/08	2008/09	2009/2010	End position/ thresholds
<b>Extra revenue</b>						
Saving over current forecast	\$900m	\$2,400m	\$4,400m	\$5,900m	\$7,400m	
Overall cumulative revenue	\$900m	\$3,300m	\$7,700m	\$13,600m	\$21,000m	Total cumulative revenue \$21b
<b>Extra expenditure</b>						
Net debt of -5% by 2010						
<b>Total Cost</b>	\$67.8m	\$67.8m	\$67.8m	\$67.8m	\$67.8m	Total cumulative cost \$339m
<b>Personal income tax threshold adjustments</b>						
Top bracket (\$60,000)	increase 13% to \$67,800	increase 2% to \$69,156	increase 2% to \$70,539	increase 2% to \$71,950	increase 2% to \$73,389	
Middle bracket (\$38,000)	increase 15% to \$43,700	increase 2% to \$44,574	increase 2% to \$45,465	increase 2% to \$46,375	increase 2% to \$47,303	Top personal tax bracket: \$47,300
Low bracket (\$9,500)	increase 15% to \$10,900	increase 2% to \$11,118	increase 2% to \$11,340	increase 2% to \$11,567	increase 2% to \$11,798	
<b>Total cost</b> (income tax threshold adjustments)	\$715m	\$115m	\$115m	\$115m	\$115m	Total cumulative cost: \$1,175m
<b>Personal income tax rate adjustments</b>						
Top rate (39%)	cut 2% cost: \$240m	cut 4% cost: \$480m	cut 4% cost: \$480m	cut 4% cost: \$480m	cut 4% cost: \$480m	top personal tax rate (25%)
Upper-middle rate (33%)		cut 1%	cut 2%	cut 1%	cut 1%	bottom personal rate (15%)
Lower-middle rate (21%)		cut 1.5% cost: \$480m	cut 1.5% cost: \$480m	cut 1.5% cost: \$480m	cut 1.5% cost: \$480m	
<b>Total cost</b> (tax rate adjustments)		\$820m	\$1,160m	\$1,060m	\$1,060m	Total cumulative cost \$4,100m
<b>Company rate adjustments</b>						
Company rate (33%)		cut 1% to 32%	cut 3% to 29%	cut 2% to 27%	cut 2% to 25%	Company Tax Rate (25%)
<b>Total cost</b> (tax rate adjustments)		\$195m	\$585m	\$390m	\$390m	Total cumulative cost: \$1,560m
Overall annual cost	\$782.8m	\$1,197.8m	\$1,927.8m	\$1,632.8m	\$1,632.8m	
Overall cumulative cost	\$782.8m	\$1,980.6m	\$3,908.4m	\$5,541.2m	\$7,174m	Overall cumulative cost: \$19,387m
<b>Total revenue less total expenditure</b>						Surplus: \$1,613m

### The Business NZ team

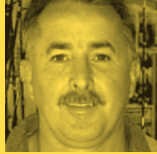
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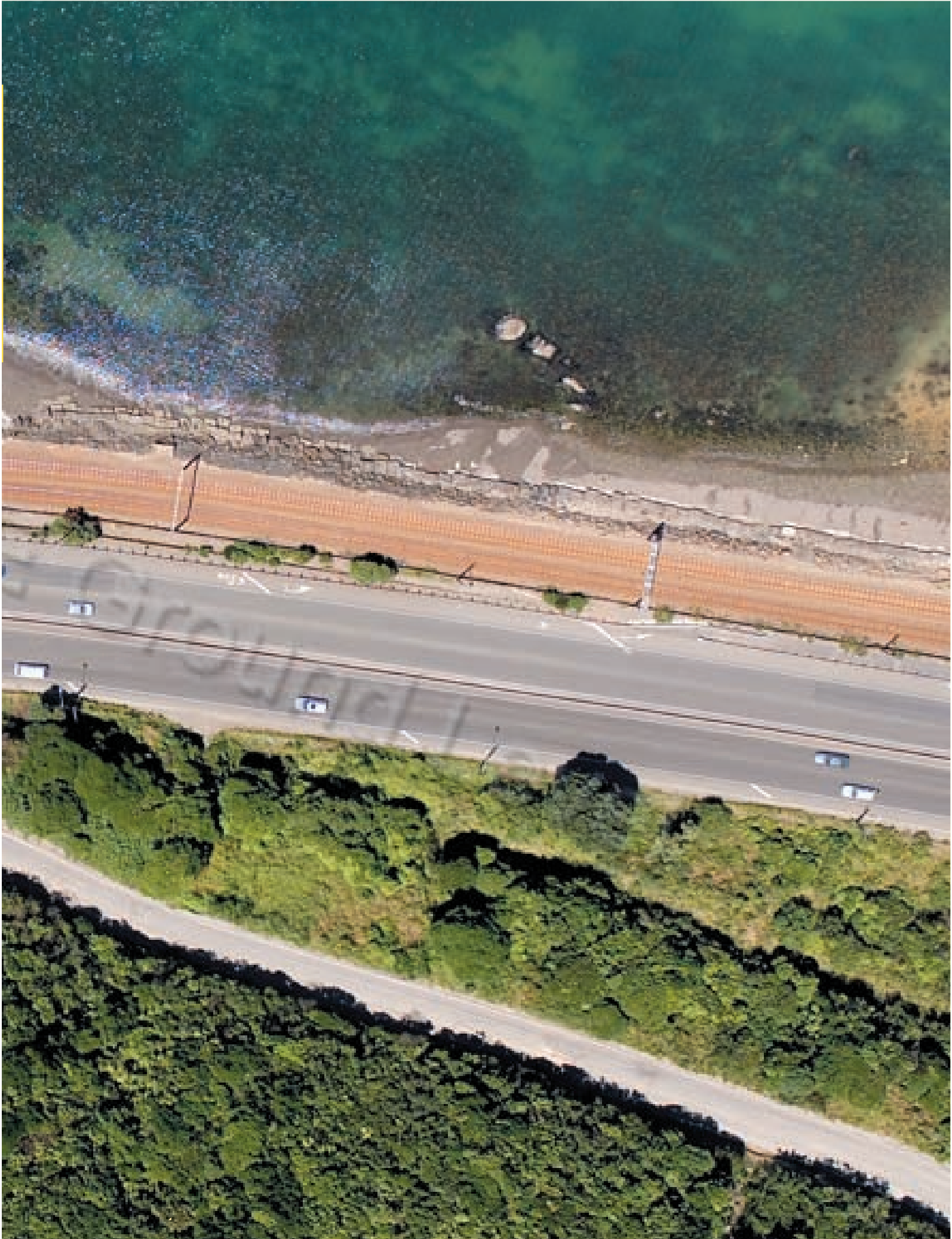
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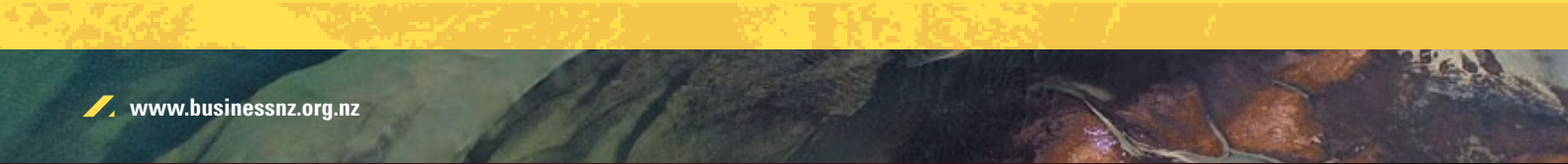


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