Critique of the Deliberations and Report[1] of the Victoria University Tax Working Group.

by Keith Rankin, 04 May 2010

Abstract:

The Victoria University Tax Working Group (TWG) – a 2009 collective of (mainly) academics and accountants with a shared interest in taxation policy issues – published a report in January 2010 that, by then, was widely understood to become the blueprint for New Zealand tax reform in 2010 and the 2010s. Its mandate was to suggest changes to the structure of taxation within the constraint of fiscal neutrality.

The TWG formed conclusions, derived from the application of a set of core principles plus economic research, that equity (fairness), efficiency and economic growth could be enhanced by adopting a relatively ungraduated set of tax rates with minimal exemptions, with additional revenue coming from broadening the tax base to better incorporate property income. A preference for lower direct tax rates, seen as necessary for achieving higher economic growth, would require higher taxes on consumption.

The Report is a victim of tension between its principles – which point to simplicity and alignment of company, trust and top personal rates, but not necessarily to low rates of taxation – and a belief that low taxes *per se* are better for achieving the goals of higher growth and improved global competitiveness. This focus leaves the report light on addressing the equity and affordability issues most relevant to most New Zealanders, who are on low and middle incomes.

Introduction: The Political Context

From small beginnings in 2009, a group of mainly economists and tax accountants followed up a conference at Wellington's Victoria University to form the VUW Tax Working Group (TWG).[2] The government soon took an interest, to the extent that by the end of the year, the findings of the TWG would represent the principal input into ongoing taxation policy. Thus, the deliberations of the TWG came to be political as well as academic. The raised status of the TWG was not a problem for its members, who had already determined that their proposals should be politically realistic. The government decided that the TWG's proposals, so long as they were fiscally neutral (ie zero-sum), would become the basis for tax reforms that the government was looking to implement from October 2010. As members of the working group were not being paid for their contributions, a degree of actual implementation of the group's recommendations would represent a return on their investment.[3]

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[1] *A Tax System for New Zealand's Future*, Report of the Victoria University of Wellington's Tax Working Group, 20 January 2010 (http://www.victoria.ac.nz/sacl/cagtr/pdf/tax-report-website.pdf)

[2] http://www.victoria.ac.nz/sacl/cagtr/twg/

[3] The background to the formation of the TWG was discussed by group member Geof Nightingale at a Unitec Industry Event on 27 April 2010.

The TWG were contributing to the gift economy – placing their gifts into the public domain for governments and citizens to use or not use as they wished – in full knowledge that the government was looking to utilise such gifts, so long as they conformed with a clearly communicated government specification. That gift economy,[4] which nicely complements the market economy, is an essential part of the mix of ingredients that makes nations prosperous and civilised. Economic growth is enhanced by an enriched public domain, possibly more than it is by lower taxes.

The political context in New Zealand in 2009 was highly unusual. New Zealand, in recession prior to the global economic crisis that took hold in September 2008, had a new National-led government which on the basis of an electoral commitment made in October 2008, legislated in December 2008 to cut personal tax rates in every year of its first term in office. Early in 2009, the government concluded, on the grounds that the global economic crisis, that even the modest second and third stages of these personal tax cuts were unaffordable. The main features of the 2008 legislation were commitments to bring the 20% tax rate down to 20%, and the 39% rate to 37%, by April 2011. Finance Minister Bill English revoked this legislation six months after it became law. In 2008 there had been widely circulated[5] arguments in favour of a top marginal rate of no more than 33 cents. National Party strategists, while clearly sympathetic to a bigger than legislated reduction in the top personal rate, recognised the political sensitivity of reducing taxes in such a way that would give almost all the gains to the high-income-earning minority.[6]

Consideration of a restoration of the cancelled tax cuts was never a part of the brief of the TWG. Certainly the cancelled tax cuts could have been made fiscally neutral without raising Goods and Services Tax (GST) above 12.5%, by removing the depreciation loading on investment properties (real estate),[7] by raising some other indirect taxes such as those on alcoholic beverages,[8] and, if that was not enough, by re-introducing death duties. Such a proposal would

[4] Heilbroner, Robert & William Milberg (1995) *The Crisis of Vision in Modern Economic Thought*, New York: Cambridge University Press.
[5] Media examples: "Balancing the Scales of Taxation", *Herald on Sunday* 13 April 2008; " Tax expert preaches case for reform during city visit", *Taranaki Daily News* 10 September 2008.
[6] While the argument for tax cuts was often framed in terms of a need to reduce average rates to be competitive with Australia, most actual policy suggestions focussed on the top marginal tax rate, a reduction of which would not affect the vast majority of taxpayers burdened by comparatively high average rates. Don Brash *et al* (2009) (*Answering the $64,000 question: Closing the income gap with Australia by 2025* http://www.2025taskforce.govt.nz/firstreport/index.htm) summarise the tone of this debate. (Executive Summary p.11, and Recommendations)
[7] Advocated by the TWG (2010 p.62).
[8] An acknowledged component of an effective solution to a major contemporary social problem, while also representing an inelastic tax base for revenue purposes; refer "Palmer Report" *Alcohol in Our Lives: Curbing the Harm* 27 April 2010 (http://www.lawcom.govt.nz/ProjectPressReleases.aspx?ProjectID=154).

have been more politically honest for the period 2008-11 of the present Parliament, leaving the more far-reaching components of the TWG's thinking to the discretion of future Parliaments.

So much for the political environment of taxation policy from late 2008. It should be noted, however, that the TWG had some politics of its own. When reading the report, it turns out that the New Zealand tax system appears not nearly as broken as the headlines – including some of the TWG's own headlines[9] – would have us believe. The TWG aspires that New Zealand should have a "world class tax system", which appears to mean an ideal system (in the sense of Plato[10]) rather than an emulation of another country that has already achieved "world class" status. Hence the aspiration is for New Zealand to lead other nations towards this ideal – with always an anxious glance over the shoulder that Australia (with its comprehensive Henry Report[11] only released in May 2010) might be our major rival in this matter, as in many others. By the TWG's criteria I would grade the present system B+ (well above average). It needs to be overhauled, allegedly, not because a B-graded tax system is broken, but because a B+ is not an A+.

Three Critical Concerns Identified

The TWG commenced their January 2010 report with a summary listing three "critical concerns" and thirteen policy recommendations. The body of the report employs a number of principles of that underpin good tax policy within the tradition of neoclassical economics, plus two general principles of fairness (horizontal and vertical equity). There are four main areas that a critique of the economic aspects of the TWG report may focus on: the identification of the critical concerns; the extent to which the recommendations address the concerns; the extent to which the recommendations are informed by the principles cited; and the appropriateness of the principles themselves.

The first stated concern is that the tax structure is over-reliant on personal and company income taxes, while capital is in practice undertaxed, especially with respect to real estate income and capital gains. High effective marginal tax rates on labour are seen as a major influence on labour supply which in turn is presented as a key ingredient of economic growth. It's the effect of taxes on economic growth that matters most when setting tax policy, according to those who share this concern about work incentive.

[9] "The status quo is not a viable option" (TWG 2010, p.59)
[10] *Plato's idealism*: http://www.crossref-it.info/articles/207/Plato's-idealism.
[11] *Australia's future tax system; Report to the Treasurer* (December 2009; released 2 May 2010).

The second concern focuses on "coherence, integrity and fairness". A multiplicity of tax rates encourage people to arrange their economic lives and their savings in such a way that taxes play too great a role. The principle of horizontal equity is breeched. If different arrangements incur essentially the same taxes, then people will arrange their affairs in accordance with other more appropriate criteria. Of particular concern here are differences in PAYE marginal rates compared to trust rates and company rates.

The third concern focuses on the sustainability of the future tax base, with an emphasis on the risks of losing workers to Australia, the risks associated with an aging population, and risks associated with rising public debt and hence a rising commitment of tax revenues towards debt-servicing. It turns out from the remainder of the report that the need for tax rates competitive with other countries – especially Australia – is seen as central to the first concern, economic growth. The narrative of the report shifts from competitiveness issues relating to labour in the report's critical concerns to competitiveness issues relating to company tax in its recommendations.

Thirteen Policy Recommendations of the TWG Report

The first three recommendations relate to company tax and international competitiveness, an issue not explicitly identified within the critical concerns discussed above. This is curious, given that promotion of 'exports' or the 'tradable sector' is not mentioned once in the report. As other countries subject to "global pressure" race to cut their corporate tax rates, so, the report appears to argue, we must race too, even if it turns out to be a race towards its logical conclusion: zero tax. Economic studies that show growth benefits arising from lower company taxes are necessarily national in focus. They do not show the growth losses to countries B to Z that arise when country A cuts its company tax. Nor do they show the losses to countries A to Y when Z responds to A by reducing its corporate tax rate. Gains to each can eventually become losses to all.

The fourth recommendation addresses the concern about the misalignment of company, trust and top personal rates as well as noting the iniquities of high taxes on labour. Thus the argument is both for a flattening of personal tax scales and lowering of rates. The recommended changes to personal taxation however do nothing to address the average tax burden faced by the substantial majority of workers. GST, which the TWG argue should increase (recommendations 10 and 11), is in reality as much of a tax on workers as is direct personal taxation. All direct taxes – taxes at source such as income taxes and company taxes – are taxes on production. Countries which utilise more public inputs as a source of higher productivity should have higher rates of tax at source. Otherwise low company taxes are really (in part) subsidised profits. Further, taxes at source that are set too low – due to competitive pressure – are as much a threat to efficiency as taxes that are set too high.

The essence of the TWG Report is that, through reductions of top tax rates and changes in the balance between income taxation and GST, most of those in the top income bracket will gain while other workers and beneficiaries should not lose. Given that this is a zero-sum exercise, the proposed losers are those, mainly in the top income bracket – certainly in the top wealth bracket – who are currently avoiding their appropriate obligations. Most of these people identified can be classed as "property investors", who, and despite experiencing reductions in tax rates, the TWG believe should become the net losers by paying taxes that they do not currently pay. This process is called "base-broadening" (recommendations five to nine).

One of the most important aspects of the first "critical concern" – high effective marginal tax rates on labour – is only addressed as recommendation twelve. The essence of this concern is the impact of benefit abatement rates – with Working for Families tax credits singled out as the main culprit. The report 'kicks for touch', on this issue, however. One or two directions for reform are sounded out – for example the re-introduction of a universal family benefit which will not abate and therefore will not contribute to high effective marginal tax rates. The general inference here, however, is that – given the zero-sum mathematical constraint of the TWG exercise – lower income workers could expect reduced benefit entitlements as the flipside of reduced effective marginal tax rates. The mathematics of the exercise – once welfare reform is factored in – suggest that there must be overall losers other than landlords; and that lower income workers and beneficiaries will be among those losers. Indeed, in addition to the impact of reduced personal taxes, higher GST, some reductions in benefit entitlements, the matter of increased housing rents (Report 2010 p.16) paid by low income recipients looms large.

Options for increased effective taxation of the property sector include comprehensive (or non-comprehensive) capital gains tax (CGT), a general land tax, and a property tax calculated on a supposed "risk-free rate of return", suggested in examples to be 4% of a property's unmortgaged capital value. Capital gains and such other taxes may not address the main reasons for property speculation. Countries with CGTs also experienced property-market mayhem in the 2000s' decade; indeed greater than the speculative excesses seen in New Zealand. The tax regime is less significant than other forces at work in this sector.

Arguably there is a saturation of markets for non-positional goods in all developed economies. Markets for traditional consumer goods and services are not able to grow much under present global income distributions. If we wish to invest in economic growth by making more food, manufactures, and consumer services, it first requires mechanisms to deliver more purchasing power to the world's poor – including our own poor. That will make such industries sufficiently profitable to encourage financial institutions to invest more in them, and invest less in housing. The recommendations of the TWG, on the other hand, will, *ceteris paribus*, increase inequality and therefore increase demand, relatively, for positional goods such as housing, meaning that the profitability of supplying non-positional goods will remain low.

If we end up with houses continuing to be highly priced relative to median incomes, but without past expectations of capital gain, then housing rents can be expected to rise, and there maybe little that the government can do other than raise accommodation subsidies. Further, prospective first home buyers, generally not in the top income brackets, weighed down by the burdens of higher rents, higher GST and debt, and trapped by low after-tax incomes and effective marginal tax rates that include student loan repayments, will ensure that demand for rental housing stays strong.

Land and property taxes hurt those with real assets but little income, such as retired persons. Substantial exemptions would need to be applied; or alternatively property tax liabilities could be capitalised until death, as the report notes (p.51). The TWG, however, emphasises the efficiency costs of exemptions wherever they arise. Exemptions cause people to modify behaviour to avoid paying tax. The TWG accept the political reality that only a subset[12] of homes will be liable for any new taxes on property ownership that might eventuate in the future.

Death duties were discussed briefly by the TWG[13], but largely discounted on the grounds, ironically, of mobility. Potentially, death duties meet the stated criteria of an inelastic tax base, fairness, and efficiency with respect to incentives. People, it appears however, go to as much trouble to avoid taxes after they die than they do when living. Many people with substantial

[12] Geof Nightingale confirms in a personal communication that, should capital gains exemptions to owner-occupiers be applied, on grounds of equity such exemptions should be extended to persons who rent out the one home they own while living themselves in a rented home. See also my "Tax reform? Watch for the broken glass", *NZ Herald* 22 January 2010.

[13] Confirmed by Geof Nightingale at the Unitec Industry Event, 27 April 2010.

property interests would choose to die in Queensland rather than in New Zealand. (This has wide implications for economic theory, because it is clear that people save in their working lives for reasons other than to spend their savings in later life. Many people, apparently, aspire to sell more than they buy – to earn more than they spend – throughout their lives; a reality that can only occur if other people do the opposite.) So capitalisation of property taxes into death duties may create as many problems as a raft of exemptions to property taxes would.[14] Some forms of avoidance of death liabilities of course may be beneficial to economic growth; for example expenditure rather than asset hoarding, and philanthropy.

The principal equity principles discussed by the TWG are horizontal and vertical equity. Horizontal equity is treating equals equally, whereas vertical equity is treating unequals unequally. Principles of horizontal equity and efficiency both favour minimal differences in tax rates – so that different incomes and different investment choices are taxed at the same rate. Principles of vertical equity however give claim to a variety of tax concessions, transfers, exemptions and subsidies. The biggest challenge to policymakers lies in minimising the distortions arising from the application of vertical equity. TWG members acknowledge these issues, and (Nightingale[15]) generally favour the use of transfers to achieve low effective average tax rates, rather than tax exemptions and concessions as means to achieve this aspect of fairness. This appears contrary to the approach taken by Australia historically –accentuated by the more recent Australian Report (2009, released 2 May 2010) – which emphasises a significant non-taxable income bracket as a way to achieve low effective average tax rates.

A general underlying tension is that between the desire for tax scales to be as flat as can be achieved within the political constraints, while also having low tax rates. Based on the work of Melbourne economist John Creedy[16], and others, taxes on production by their very nature distort the economic growth process and the higher the rates of tax the lower the rate of growth, *ceteris paribus*. I have discounted this argument by noting that these studies are necessarily national rather than global in scope. Further, levying low taxes in a country which utilises many public inputs to achieve productivity gains is itself a false economy.

If we discount this questionable argument that equates low taxes *per se* with high economic growth, then we are able to consider a system of aligned and proportional taxes set at rates in the

[14] A solution might be to link the receipt of New Zealand Superannuation to a legal obligation to pay in New Zealand taxation liabilities, and any other death duties that might pertain.
[15] Unitec industry event
[16] Creedy, John (2009) *The Distortionary Costs of Taxation* (http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/5-the-distortionary-costs-of-taxation-johncreedy.pdf)

mid-high-30s (eg 34-38% range) – and offset by "social dividends" (noted as a possibility by TWG member John Shewan[17]) and other benefits that address specific vertical equity issues – rather than in the 25-30% range suggested in the TWG report. This finding I think can be reconciled with the general thrust of the TWG report, and is also in tune with the recommendations of the substantial Henry Report in Australia (which advocates a single marginal rate of income tax of 35% that will cover the vast majority of working taxpayers, coupled with a tax-free income band that is equivalent to a non-refundable tax credit of $8,750 payable in full – as a kind of social dividend – to all persons on the 35% marginal tax rate). With respect to company tax, there may be a vertical equity argument for granting some companies a concessionary tax rate of 25% or less; for example companies that face unfair competitive pressures from foreign suppliers.

The thirteenth recommendation of the TWG, though little commented upon, is an expression of political philosophy. "Government should introduce institutional arrangements to ensure there is a stronger focus on achieving and sustaining efficiency, fairness, coherence and integrity of the tax system when tax changes are proposed". This idea that tax reforms are "quasi-constitutional" (TWG Report p.57) suggests that political barriers should be put in place to guard against future changes to the tax system based on alternative or *ad hoc* principles. It seems to me that it is not our role, in 2010, to try to frustrate future tax working groups by placing limitations on the principals that they should be allowed to consider.[18] What we can do instead is to enunciate our basic principles as strongly as possible, so that people in the future will understand why we thought the way we thought, and did what we did.

There are principles of equity and efficiency that favour simple proportional taxation. There is no principle that states that lower rates of tax are necessarily more efficient than higher rates. The belief that low tax rates are better simply represents the conclusions of a selection of studies that are based on assumptions and methodologies that are contestable. Maintaining a healthy democracy is the main single institutional protection against capricious meddling in the tax system by future governments.

The government will have made its decisions about immediate and ongoing tax reform in its 20 May 2010 Budget, drawing substantially but not comprehensively from the TWG's deliberations, summarised in the TWG's 20 January 2010 Report. Whatever the government does, the

[17] Espiner, Colin (2008) "Taxation", *The Press* 5 April
[18] The TWG (p.61) itself notes that a "changed international context" between the 1980s and the 21st century is in itself reason to make substantial changes to a tax system that was, in its essence, created in the 1980s.

intellectual underpinnings remain important matters in their own right. Thus the parts of the TWG Report which will not be implemented continue to be an important part of the ongoing debate around taxation in New Zealand.

Conclusion

At its core, the TWG report is a victim of the tension between the equity and efficiency arguments for top-rate alignment between taxation of different entities, and the normative and competitiveness arguments for low top personal rates. The matter can be resolved by looking for alignment around rates of about 35% rather than 25%, and by if necessary applying tax concessions to companies that face excessive and unfair foreign competition.

By having aligned top rates in the 34-38% range, it becomes possible to have consistently lower average personal rates for workers on or below the average wage, for example through an initial zero-tax income bracket, a step that our rival Australia has consistently followed and appears likely to take much further. We have to address the problem of high average tax rates by taking our focus away from the New Zealand obsession with having a comparatively low top marginal rate of personal tax.

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