2007 'Liberal Thinking' Essay Competition

Winner's Essay: Cameron Loughlin

Question 3

"What effect does taxation have on the people and/or the economy in New Zealand?"

'The claim that cutting taxes leads to higher economic growth is simply not true.'
Hon Dr Michael Cullen, Minister of Finance

'…an economy hampered by restrictive tax rates will never produce enough revenue to balance the budget, just as it will never produce enough jobs or enough profits.'
U.S. President John F Kennedy 1962

Taxation within New Zealand has a major effect on all aspects of the economy, whether it be personal expenditure, supply of labour, or the willingness of companies to invest. Out of all the proposals the most viable solution seems to be a flat rate of tax for all New Zealanders to increase market efficiency. This provokes the ethical argument of equality vs. efficiency, and the further debate of the equity of such policies. I hope to also contest these objections, as well cover the disadvantages of a nominal progressive taxation system.

The progressive taxation system that New Zealand uses to gather income tax (P.A.Y.E.), is supposed to increase the equality of New Zealanders, by allowing the government to tax high income earners at a greater rate (a higher marginal tax rate), and then re-allocating this generated revenue as welfare to low income earners in the form of benefit schemes. This is an interesting policy. The Labour Government, so vocal in not discriminating on the basis of race, creed, or socio-economics, can blatantly punish our most productive members of society by penalising them for being successful.

This is an important point as there is a high economic cost in taxing the most productive individuals within New Zealand. They are highly responsive to changes in the tax rate, and if forced to pay higher proportions of income as taxation they will simply reduce their productivity.

The New Zealand tax system has similar disincentives for mothers or single parents who wish to move into the labour market. In many instances the opportunity cost of gaining employment outweighs the financial benefit of wages. The rate of taxation in these circumstances is known as the 'Effective Marginal Tax Rate'[i], or EMTR. The EMTR takes into account not only the marginal tax rate that the new worker pays on their wages (i.e. 19.5 cents in the dollar), but looks also at the cost of what the new worker;

i) has to pay,

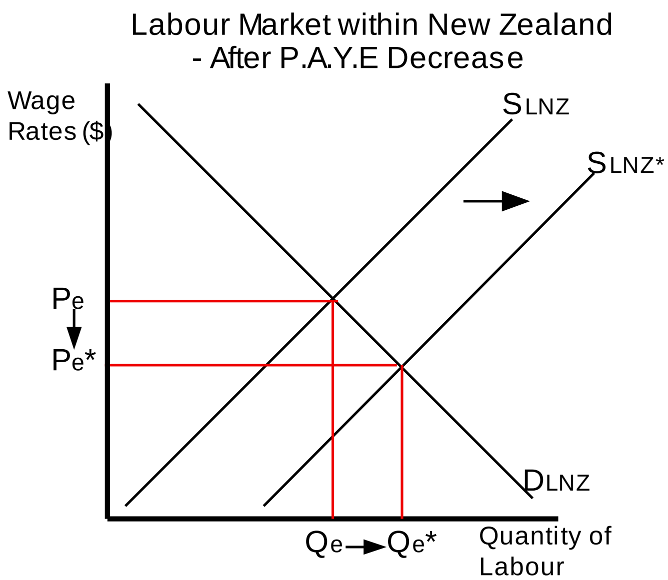
ii) has given up to in order to become a productive member of the labour force.

The EMTR of a single parent entering the labour force is harsh. Not only is their new wage penalised with P.A.Y.E., they now also face diminishing benefit compensation as they overcome their thresholds. There is decreased eligibility for Housing New Zealand assistance, Working for Families rebates and Family Assistance payments. For a mother, moving from the Domestic Purposes Benefit to part time work (of $20,000p.a.) the EMTR is 91 cents in the dollar.

The lack of incentives for single parents (or even couples) to enter the labour market means that many will withhold their supply of labour, as it may push them over their benefit or taxation threshold and actually make them worse off. A common example is a worker turning down a pay increase from $58 000 to $63 000 because the five thousand dollar increase is actually outweighed by moving into a 39c tax bracket, as well as removing Working for Families eligibility, which results in a loss to the worker.

Such a mindset within the economy is dangerous, as it provokes workers to decrease their efficiency (by working less hours, turning down promotions) in order to ensure their EMTR is not compromised.

When this occurs, the economy experiences a deadweight loss (DWL), as many people will not enter the market because government intervention (taxation) does not make it profitable. The DWL of tax has been estimated at $1.20 per $1 raised, which indicated that if in 2006 taxation revenue was $52b, $4.2b of potential wealth has been lost[ii]. The long-term result is that there will always be a reluctance of workers to enter the market. Economically there is no allocative efficiency, and therefore the New Zealand economy will never be able to operate at its full capacity as there are idle workers.



If New Zealand had a lower income tax rate, there would be many more incentives for workers to either enter the market, or to increase to their potential as a greater proportion of wages is transferred into disposable income. This would cause the supply for labour on the NZ market to increase, which would result in less pressure on wage rates.

As the supply of labour continues to increase (shift right), the nominal amount spent on wages by firms decreases, as there is less demand for wages to increased due to the relative ‘surplus’ of labour. This results in firms having lower costs of production, which allows businesses to start increasing their expenditure in areas other than wages, e.g., research & development, capital expenditure, or by purchasing new technology. To the aggregate economy, this results in an increase in productivity, further increases in circular flow and investment, which ultimately results in RGDP increasing.

The Wall Street Journal states that since the United States’ overall tax cuts in early 2003, 5.3 million new jobs have been added to the economy. However, the total proportion of national income captured by the richest 1%, 5% and 10% of Americans is lower now than in the past decade[iii].

Meanwhile, company tax within New Zealand has the exact some effect on prospective investors, as the corporate tax rate in New Zealand proves to be consistently above the OECD average[iv]. A company tax rate higher than that of fellow trading nations creates incentives to stream profits to countries with lower tax rates[v]. For New Zealand to achieve profitable investment from firms, these tax rates too must be cut.

Over all, the high taxation of individuals and entities within New Zealand has many negative externalities on the economy and the taxed persons themselves. Whether or not the current tax policy increases equality at the detriment of productive workers is an ethical debate, but one which seems justified concentrating on the information I have presented within.

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[i] RENNIE, Phil; ‘Why tax cuts are good for growth’, The Centre for Independent Studies, Issue Analysis 75, October 2006

[ii] RENNIE, Phil – quotes BATES, Winston & Treasury Dept. figures in ‘Why tax cuts are good for growth’ where (52,000,000,000/1.20=4,222,222,222)

[iii] DU PONT, Pete; ‘Tax Cuts are good for Everyone…’, The Opinion Journal – Wall Street Journal, Tuesday, July 25th, 2006.

[iv] http;//www.treasury.govt.nz

[v] RENNIE, Phil; ‘Why tax cuts are good for growth’, The Centre for Independent Studies, Issue Analysis 75, October 2006