BACKGROUNDER 24: TAX CUTS DON'T MAKE SENSE

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In a recent newsletter Don Brash, National's finance spokesman, expounds on taxation.

"The reality is that almost all New Zealanders have been hit by increased taxes since this government came to power in 1999," Brash writes, before proposing a $2billion tax package—cutting company taxes and the top marginal rate. Brash believes that the tax system already protects low-income families, and that tax cuts would give incentives for New Zealanders to "grow their business, invest, take entrepreneurial risks and so on". The pay off, writes Brash, would be increased economic growth "say 0.5% a year."

Brash quotes selective examples leaving the reader with the impression that the overall tax take has increased. In fact, it has fallen in relative terms. Between 1996 and 1999 the tax take averaged 32.4% of GDP, dropping to 31.6% of GDP in 2000-2002. Spending has fallen further, as successive governments have not adequately adjusted assistance for low income families as prices have increased.

As a result in New Zealand, a society that has long believed in a fair go for all, children are increasingly dying in hospitals from diseases of poverty. Many more will be crippled by such diseases and be incapable of working. An even larger number will suffer from chronic illness. Many children will go hungry, have their schooling disrupted and live in stressful homes. These children are not getting a chance to develop and contribute to society.

In 1988, according to the Ministry of Social Development, 12.5% of children lived in families with income after housing costs are deducted falling below the poverty line—defined as 60% of the median. In 1998 the comparable figure was 27.5% —an extraordinary increase in poverty in just 10 years. Between 1998 and 2001 the number of children living in families with income below the poverty line increased further—to 29.1%.

This increase in poverty has been accompanied by a dramatic increase in third-world diseases. The third most common admission to Auckland Starship and South Auckland's Kidz First hospitals is cellulitis, a disease linked to overcrowding and poverty which can lead to limb amputations and death. As a contrast, in Australian hospitals, children with cellulitis don't even rate among the top 20 admissions.

If we wish to live in a society where all children are valued then a more progressive tax system is needed, combined with strategies to ensure that families living in poverty receive more income. Many families find themselves in a poverty trap. Extra income means less child support and other welfare assistance as well as higher tax payments. The result can be extremely high effective marginal tax rates – well over 70%. The present tax/benefit system leaves many families with inadequate support. The first question that Don Brash needs to address is how the tax system might ensure that all families have enough to live on.

A universal child benefit set at a high level would make a huge difference to poor families and mean the effective marginal tax rates would be lower creating extra incentives for work. In the United Kingdom where the government's strategy is to reduce poverty, a universal child benefit exists – the equivalent of $ NZ 8 a week for the first child.

Don Brash argues that his strategy of tax cuts delivers growth—"say 0.5% a year" for his $2 billion worth of tax cuts. He believes that the "benefits to all, whether low income or high, would be substantial very quickly." Brash must have plucked out of thin air his figure of 0.5% a year increase in the GDP growth rate, which he claims would result from decreasing the top

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marginal tax rate and the company tax. He is in any case being overly modest when he suggests that it is a "relatively small amount". The 0.5 % increase in GDP growth rate that he predicts is dramatic.

A recent comprehensive review of the empirical evidence on taxation and growth by Gareth Myles finds that "although there are some disagreements, the picture that emerges is that the effect of taxation [on growth], if there is any at all, is relatively minor...As far as policy is concerned the conclusion is reassuring since it removes the need to be overly concerned about growth effects when tax reforms are being planned" In other words, governments who plan more progressive taxation aren't undoing their economies.

If Brash is interested in generating growth then it would seem sensible to examine the known robust links. He could start by reading Jonathon Temple's recent survey, in which Temple writes "there are significant correlations between growth and investment.... the social return to increased R&D spending is high" and that "government spending on infrastructure is beneficial [to growth rates]." Temple concludes that "somewhat unusually for growth literature, studies have tended to concur in finding a negative effect of high inequality on subsequent growth." Inequality has increased dramatically in New Zealand over the last fifteen years. Cutting tax rates for the rich as Brash wants to do would only widen the gap further and could have the opposite effect from what he is ostensibly aiming for.

Given the weight of evidence cited above Brash must be proposing cutting the tax rates for other reasons. In fact he gives the impression that it's just not fair that rich people should pay more tax. It's a position fair-minded New Zealanders should find deeply disturbing.

(Sources: Gareth Myles, "Taxation and Growth, in the Journal of Fiscal Studies , 2000, vol. 21, p141; Jonathon Temple, "The New Growth Evidence", in Journal of Economic Literature, 1999, Vol 37 p. 112)