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NEW ZEALAND CENTRE FOR POLITICAL RESEARCH

MOTIVATING A NATION

By Muriel Newman

Last year, the Human Rights Commission warned that the Electoral Finance Act would have “a chilling effect on the expression of public opinion during an election year”.

There is such a notable lack of debate about crucial public policy issues that you could be excused for not realising that we are already a quarter of the way through to the latest possible date for the 2008 election - Saturday 15 November.

That’s why Sir Roger Douglas’s entry into the debate about the future direction of the country has been so interesting. Sir Roger was the architect of New Zealand’s economic reform programme back in 1984, at a time when the country was on the verge of bankruptcy. These reforms included cutting taxes, floating the dollar, dismantling trade barriers, establishing a framework for stable monetary and fiscal policy, and overhauling the public service to dramatically increase productivity and ease the government out of commercial activities.

While both the political left - and sometimes even the right - think it beneficial to their electoral chances to hysterically demonise Sir Roger, the reality is that after initial opposition, his reform programme gained such widespread support across the country that Labour was re-elected in 1987 with an increased majority. Those who may doubt that simply need to ask if they would like to return to the pre-Douglas reform days.

In 2006 Sir Roger’s contribution was recognised when Deloitte/Management Magazine presented him with their Visionary Leader Award, stating that what was so extraordinary about Sir Roger was that his vision “transcended political parties”.

Sir Roger is this week’s NZCPR Guest Commentator. He believes that New Zealand again desperately needs an ambitious goal to pull us out of the doldrums.

“Given the disastrous position New Zealand finds itself in, what then has been the reaction of New Zealand’s main political parties – Labour, National, the Greens and NZ First? They’ve all retreated to a dangerous do-nothing approach. Given this collective reaction, it can be fairly said that there’s virtually no difference between these parties, except to some degree in the social policy area. None of them have a clear vision of where New Zealand stands and where they want to take it. None of them have a 10 - 20 year goal for New Zealand. None of them have a well thought-out plan to achieve that goal. None of them have the guts to do what’s right for New Zealand

“Until we form a clear and coherent view of our destination, it’s pointless to plague ourselves with questions about how to get there. We need an exciting goal to spark our

people into action. And it shouldn’t be a vague goal. It must be a smart goal – that is, one that’s specific, measurable, achievable, right for New Zealand and time-bound”.

Sir Roger goes on to explain what this goal should be.

“My suggested smart goal is that New Zealand should aim to beat Australia by 2020! In other words, by 2020, New Zealand would lead Australia in most of the important economic and social indicators, and be catching up fast in per capita income”. To read Sir Roger’s commentary and how he thinks we can achieve that goal, see www.nzcpr.com.

The latest TVNZ Colmar Brunton survey shows that consumer confidence is plummeting with 65 percent of voters now believing that the economy will be in a worse state in a year’s time. This negative sentiment is understandable. Driving it are concerns about the increase in interest rates, the downturn in the housing market, and rapidly rising prices. Key amongst those are skyrocketing petrol prices, which, on top of big increases in the price of milk, bread and cheese - and rising mortgages – are all putting real pressure on household budgets.

With the election looming, we need to know what the various political parties intend to do to turn the situation around.

Clearly tax cuts are going to be on the agenda – both Labour and National have promised as much. The question is whether they will be structured in such a way as to not only ease the burden on taxpayers, but give the economy the boost it needs.

People respond to incentives. Even those who know nothing off Adam Smith or Milton Friedman make cost benefit decisions. This is why consumers queue at mid-night ahead of a petrol price rise, mob retail outlets for the Boxing Day sales, or camp outside Ticketek to buy tickets to a popular event when they first go on sale.

And so it is with tax rates. When tax rates are seen to be “reasonable”, they encourage work, savings investment and entrepreneurial activity. But when they are seen to be “unreasonable”, they discourage productive behaviour and motivate the “black” economy. That’s why punitive progressive taxes targeting the “wealthy” are so damaging to an economy. Such “political” taxes discourage and penalise wealth creation, in spite of successful economies being built on wealth creation.

When Labour became the government in 1999, one of the first laws they passed (under urgency) was an increase in the top tax rate from 33 to 39 cents in the dollar. They promised that this tax hike would only affect the 5 percent of taxpayers who earned over \$60,000. Today 14 percent of taxpayers now pay the top rate of tax because Dr Cullen has conveniently

omitted to adjust the tax thresholds for wage inflation.

The effect on families is significant. While the average wage has risen 29.9 percent since 2001, the amount of tax paid on the average wage has increased by 43.7 percent. On top of that there has been a 20 percent increase in the Consumer Price Index. It's no wonder that household budgets are being squeezed by higher prices and higher taxation.

The Fraser Institute, a Canadian based think tank, has studied the impact of taxes on economic behaviour. They have found clear evidence that "high and increasing marginal taxes contribute to lower rates of economic growth, reduced rates of personal income growth, lower rates of capital formation, lower than expected aggregate labour supply, and reduced entrepreneurship. In short, high and increasing marginal tax rates reduce economic growth by creating strong disincentives to hard work, savings, investment, and entrepreneurship".

In particular they found that "a 5 percentage point rise in marginal tax rates would reduce the proportion of entrepreneurs who make new capital investment by 10.4 percent. Further, such a tax increase would lower average capital investment by 9.9 percent".

A lack of capital investment in business is a key factor in New Zealand's dismal productivity growth. In his paper "Why is Australia So Much Richer than New Zealand?" CIS's Phil Rennie found that for every hour of work Australians produce an extra 37 percent of output over New Zealanders, not because they work harder but because New Zealanders invest less in new tools and workplace technology. Labour's tax increases have clearly exacerbated this problem.

So looking ahead, what sorts of tax cuts can we expect?

Almost certainly Labour's tax cut package will retain its progressive nature in order to achieve their goal of redistribution (as one would expect given their underlying philosophy is to take from the "haves" and give to the "have nots"). That effect is to create a disincentive for income and wealth creation, while incentivising wealth consumers. In the long run this will result in a further decline in productivity and living standards.

National's tax cuts on the other hand are likely to be

larger and will probably follow the Government's 2001 Tax Review recommendations that the tax structure should be lower and flatter with business tax rates aligned to personal taxes.

But if we are really serious about beating Australia by 2020, shouldn't we be calling for more than tinkering?

Contrary to the political rhetoric promoted by Labour and its ally organisations, tax cuts that stimulate growth and productivity are not inflationary. There is countless research that shows this to be so. More than 20 jurisdictions are now using a flat tax as a proven instrument of sound fiscal policy to stimulate high levels of economic growth. Leading the flat tax charge is the island Jersey which introduced a flat tax of 20 percent in 1940. Hong Kong followed with 16 percent in 1947 and Guernsey with 20 percent in 1960. In 1994, the former communist country of Estonia was next to introduce a flat tax, followed by Latvia in 1995 and Lithuania in 1996. These three Baltic nations are now growing so fast they have become known as the "Baltic Tigers". This year the Czech Republic will introduce a flat tax of 15 percent and Bulgaria a flat tax of 10 percent. (More information on the remarkable transformation of Estonia can be found on the outstanding video "The Power of Choice" – available from www.nzcpr.com.)

Countries introducing flat taxes have something in common... they have been prepared to introduce bold policy changes - just like Sir Roger did for New Zealand in the 1980s. They have recognised that tinkering with marginal tax rates here and there is simply not enough to really motivate a nation.

The critical issue for New Zealand is whether our politicians have the intestinal fortitude and the intellectual foresight to be bold before the economic crisis hits. If not, the inevitable reforms will be delayed yet again, and our standard of living will continue to decline.

The poll this week asks: Do you think that beating Australia by 2020 is a worthwhile goal for New Zealand?

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