

NZCPR Weekly

By Dr. Muriel Newman
8 July 2007



The New Zealand Centre for Political Research

Struggle Street

While we were away in Europe for two weeks, we did see New Zealand featuring in the news – but no, it wasn't about the America's Cup. It was about the Reserve Bank's unprecedented foray into the currency markets! But more on that later...

The most sobering aspect of our trip was the realisation that New Zealand's standard of living is more like Poland, than Holland, Denmark, Sweden, Germany, Singapore, and many other countries. And that's despite Poland being shackled by the vestiges of socialism and organised crime.

The troubling question is how can this be, when we have so much going for us? What has forced so many families to live in Struggle Street when our economy continues to deliver to the government record tax surpluses?

The answer is that our economy is like one very poorly tuned automobile (a fiat 500 comes to mind) - no matter how hard you put your foot on the accelerator, the car will never do more than cough and splutter its way along the autobahn. So it is with our economy – all of our combined effort will never flow into standard of living increases, until the economy is managed for growth rather than spending.

At the top of the faults list has to be our tax rates. Most New Zealanders now understand that they would be better off if the government didn't have so much of their money in its pocket. That's why the promise of tax cuts in the 2005 budget – through raising tax thresholds - was so important:

“We have decided to raise the thresholds by a uniform 2% each year. Compounded over three years this produces an increase of 6.12%. In April 2008, the income threshold for 15% tax will rise from income up to \$9,500, to income of \$10,081. The 21% threshold will rise from income up to \$38,000, to \$40,324. The 33% threshold will rise from income up to \$60,000 to \$63,672. And the 39% rate will cut in at \$63,673 instead of at \$60,001 now. (Michael Cullen in the 2005 budget speech, see www.nzcpr.com)

However, in a shocking revelation, Cabinet papers posted on Treasury's website last week now reveal that on April 15th – over a month before the 2007 Budget – the tax cuts were secretly rescinded:

“Our increased spending in Budget 2007 has not been costless. I may need to make some adjustments to future Budgets. These are likely to be: that we do not adjust tax thresholds in the medium term thereby retaining fiscal drag and potentially

allowing tax to GDP ratios to rise slightly. Accordingly, this paper seeks Cabinet's agreement to rescind our previous decision to adjust income tax thresholds on a three-yearly basis.” (To view Cabinet Paper on Budget 2007, see www.nzcpr.com)

The deception over this is a blow to every hard-working New Zealander. In Europe flat taxes are common and consumption taxes reach 25%. The question is whether there would be public support for increasing GST and lowering income tax? In my mind New Zealand's goal should be to introduce a simple flat tax covering personal, company and consumption tax, set at 19%. This was the rate proposed by Hoover Institute Senior Fellows back in 1981 for the USA and is the rate that is driving economic growth in Slovakia. (To view the Hoover Institute “Where the flat tax goes from here”, see www.nzcpr.com)

Slovakia's flat tax, introduced in 2004, has generated a growth rate of over 8% p.a. and with it a dramatic improvement in living standards. A fascinating Harvard Business School discussion “All Eyes on Slovakia's Flat Tax”, published in April and featured as this week's NZCPR guest commentary, explains:

“Economists and business leaders alike are talking about flat taxes in many countries. As Western European countries lose ground vis-à-vis countries in Eastern Europe endowed with low tax rates, low salaries, and skilled labor, governments will increasingly look for ways to reform their tax and labor systems in order to attract business—or simply stop businesses from delocalizing. The direct effect of the Slovak flat tax can be seen in Europe, where neighboring Austria has lowered its corporate tax rate from 34 percent to 25 percent. This has been perceived by many as a clear sign that the Slovak reforms have been attractive to foreign investors. In response to broader initiatives, Germany has recently decided to reduce its corporate tax rate from 39 percent to below 30 percent in an effort to make the country attractive for investors. Similarly, voters in Finland decided to oust the ruling Social Democrats in favor of parties promoting tax cuts in response to the attraction of neighboring Estonia's flat tax. Most recently, the United Kingdom reduced its corporate tax rate from 30 percent to 28 percent and its income tax rate from 22 percent to 20 percent in an attempt to simplify the tax system”. (To read the full article see www.nzcpr.com.)

The Czech Republic, which has lowered personal tax rates but unlike many of its Eastern European neighbours, has not adopted a flat tax, remains paralysed by its government. As

the Economist points out:

“The June 2006 election to the lower house resulted in a hung parliament, with centre-left and centre-right parties each winning 100 seats. On January 19th 2007 the Czech Republic finally confirmed a government, about seven months after holding the general election. However, the three-party coalition, comprising the Civic Democratic Party, the Christian Democratic Union-Czechoslovak People's Party and the Green Party, still lacks an absolute majority in parliament, and will struggle to push deep structural reforms through parliament”. (To read more see www.nzcp.com.)

This sounds uncannily like New Zealand, where the sort of courageous reforms needed to introduce say, a flat tax, appears to be almost out of the question under MMP as parties seem to be increasingly losing their identities and morphing into each other. (If you still haven't voted in the MMP poll at the top of the www.nzcp.com homepage, please do so!!!)

So while a flat tax and a prosperous economy might be a distant dream at this stage, we presently face extremely serious problems on the home-front as the collateral damage from having the highest rates of interest in the Western World and a dollar at record levels, bite deep, killing off business and crucifying exporters. The reason, of course, is that New Zealand Government Stock offers a high rate of risk-free return to overseas investors who can borrow money far more cheaply at home. There is no better example of this than Japan where investors can borrow at a rate of less than 2% and invest here to achieve 7-8%. With that sort of easy-money incentive it is not hard to see why there has been a strong inflow of Japanese currency buying Kiwi dollars and in the process creating unprecedented demand for our currency.

While our interest rates remain high, it is logical to predict that the Kiwi will remain in strong demand, and the dabbling by the Reserve Bank in the currency markets is not likely to change that. Instead, surely the focus should be on

what is driving such excessively high interest rates.

We have been repeatedly told by socialist politicians that “speculators” driving the booming housing sector are the culprits. The fact that these so-called ‘evil’ speculators are mum and dad homeowners who have sought to trade up to a better house or invest in a rental property for retirement purposes, is by-the-by. And the fact that demand for housing was driven by the sudden influx of tens of thousands of immigrants a few years ago when the government got their immigration numbers wrong, is conveniently forgotten. Also conveniently glossed over is the inflationary effect of year-on-year record levels of government spending.

In an article published in the Dominion Post on Monday, “Reserve Bank needs sharper focus”, Infometrics economist Brent Oliver reveals that changes to the Reserve Bank's policy targets, made by Labour when they first came to office, are responsible for exacerbating the situation resulting in “interest rates and the currency being higher now than they would otherwise have been”. (See www.nzcp.com to read the article.)

But there is another issue. In contrast to the rest of the world, New Zealand's Consumer Price Index, which is used by the Reserve Bank as the trigger for raising interest rates, includes a heavy weighting of housing costs. Some countries do not include housing costs at all, while many other countries use an imputed rental approach. The conclusion to an international analysis of Housing Costs in the CPI by the Reserve Bank is that “there is a strong case for moving over to an implicit rental approach to bring New Zealand's principal inflation measure into line with internationally accepted standards” (see www.nzcp.com to view).

Maybe if we did that, mum and dad homeowners would no longer cop the blame for CPI increases.

The poll this week asks: Do you support the introduction of a 19% flat tax in New Zealand?

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