# GROWING OUT OF IT: FIVE POLICIES TO ENCOURAGE GROWTH AND CONQUER DEBT

## Introduction

In recent months, the Government has borrowed significantly on taxpayers' behalf and more borrowing is expected in the years to come. The result: net debt will peak at 56.3% of GDP in 2025/26 – up significantly from 19% of GDP in 2019 pre-crisis – putting serious pressure on our ability to respond to a future recession or natural disaster.

There are two ways to approach that problem: spend less and therefore reduce the size of deficits in coming years or increase the rate of economic growth and therefore reduce the relative size of debt as a share of the economy. Both matter – the relative size of debt as a share of the economy is the most important factor for determining whether debt is sustainable for Government and taxpayers.

While we always support cutting wasteful spending, this paper will focus specifically on a tax and economic relief strategy to increase the rate of economic growth in coming years. We propose using the $14 billion from the Government's $50 billion COVID-19 Response and Recovery Fund (CRRF) which is forecast to be spent over the next four years, but which has not yet been allocated.

In our view, most of this $14 billion should be front loaded to accelerate the economic recovery and deliver labour market relief. Front loading tax relief will increase debt as a share of the economy in the short term but will be deficit-neutral over the next four years as the spending is already priced in for the forecast period.

While some will argue the $14 billion earmarked by the CRRF should go unspent, we believe it is very unlikely that the Government will take that option given the fragility of the economy. The Minister of Finance has repeated many times that he is unwilling to enact austerity: leaving money on the table simply will not be an option with this Government.

Given that, the conversation needs to be focused on how to allocate the $14 billion remaining in the CRRF. We believe the trade-off in taxpayers' minds should be weighing up pro-growth tax relief vs. politicians and bureaucrats picking winners. The first option is better whichever way you examine it: leaving more money in the pockets of taxpayers rather than having politicians allocate on taxpayers' behalf will almost certainly result in more efficient allocation of resources and growth.

Our package has two components: direct tax relief and elimination of indirect regulatory taxes.

On direct tax relief, we propose both temporary and permanent tax relief.

Firstly, we propose a reduction in GST from 15% to 10% for 12 months to encourage consumers to bring forward any planned future spending and increase the purchasing power of households.

Secondly, we propose modest and permanent tax relief on income earners: reducing the 33% marginal tax rate on income above $70,000 to 31% and reducing the 30% marginal tax rate on income over $48,000 to 27.5%. Letting households and employers keep more of their income will drive spending and investment – accelerating our economic recovery and ensuring debt as a share of the economy falls.

We also propose relief from two regulatory taxes. Many regulations function like taxes – they cost businesses and employees money and distort economic behaviour – but they don't raise any revenue for the Government.

Firstly we propose implementing a 15-month trial period provision, where businesses can easily let go of any staff they hire between October 2020 and December 2021 during that period, in order to encourage employment. This would essentially be an extension of the 90-day trial period provisions.

A paper by the New Zealand Taxpayers' Union Incorporated, released on 17 September 2020.
www.taxpayers.org.nz

Secondly, we propose increasing the threshold for foreign investment to be approved by the Overseas Investment Office from $100 million to $500 million until the end of 2022, in order to encourage foreign direct investment which will employ New Zealanders and kickstart economic growth.

Obviously relief from each of those regulatory taxes will cost the Government very little (or even save money) and have no impact on our national debt levels.

The net impact of the package will be to accelerate economic growth and reduce the relative burden of forecast debt on the Government's books and taxpayers.

## Summary of Proposals

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|---|---|
| Cut GST from 15% to 10% for the next 12 months | $7.36b |
| Permanently cut the $70,000-threshold rate from 33% to 30% | $4.08b |
| Permanently cut the $48,000-threshold from 30% to 27% | $2.58b |
| 15-month hiring trial periods from October 2020 to end of 2021 | $0.00 |
| Increase the $100 million overseas investment threshold to $500 million | $0.00 |
| **Total[1]** | **$14.02b** |

1 The GST cut cost estimate is taken from a previous Taxpayers' Union paper available at www.taxpayers.org.nz/gst_cut | Other cost estimates are based on Treasury's revenue effect estimates for changes in the tax base available at https://bit.ly/2E8tgTk | Our calculations assume no change in economic behaviour, which is conservative. In reality these tax changes are likely to encourage economic growth and increase the size of the tax base, limiting the estimated revenue impact.

# The Case for Economic Relief

## GST relief

GST is an extremely efficient tax and far more progressive than many of its critics argue. For those reasons alone, we should aim to maintain the 15% rate of GST over the long-run and target other more distortionary taxes for structural relief.

However, for the purposes of accelerating economic growth out of a recession, temporarily cutting the rate of GST could be extremely effective. It applies a short-term discount to consumption, which encourages consumers to bring forward expenditure to take advantage of the relief. It also applies a discount to many goods and services we buy every day – an average family's $230 trip[2] to the supermarket each week would save $10. For many families, those savings will immediately go into new purchases.

Both of those effects would put upward pressure on consumer spending which in turn would put upward pressure on economic growth and employment.

While competitive pressures would ensure consumers receive a majority of the GST cut in the form of lower prices, it may also benefit precarious businesses struggling with wage bills and weak sales if they keep some of the tax relief. Reducing the number of businesses which fall over in the coming months would help to constrain unemployment – keeping consumer demand elevated and limiting welfare payments and debt.

A range of studies have been conducted on the effectiveness of cutting taxes like GST overseas. These studies show that in the right circumstances, cutting taxes like GST can be an effective tool to bring forward and increase economic growth.

Blundell (2009)[3] examines the cut of VAT (equivalent of GST) in the United Kingdom which was implemented in late 2008 during the Global Financial Crisis. He argues that consumers experienced 75% of the benefit of the tax relief and responded by increasing their demand for goods.

Crucially the paper finds that it's important for the subsequent increase in tax to be timed to coincide with economic growth taking off again – this is one major reason why we support a full 12 months of a lower rate of GST. A shorter period might be cheaper, but if economic growth has not yet returned the policy may be less effective.

Crossley et al. (2014)[4] find that the UK's 2008 VAT caused a significant shift in purchases from the period after the VAT cut towards the period when VAT was cut – so the relief from VAT was effective in bringing spending forward.

## Income tax relief

Compared to many other countries, we tax modest incomes at comparatively high rates. All income earned over $48,000 is taxed at 30% and all income earned over $70,000 is taxed at 33%.

In contrast, a median income earner from New Zealand in the UK would pay a 20% marginal tax rate on income up to $94,000 NZD, 22% in the United States up to $134,000 NZD, and 20.5% in Canada up to $114,000 NZD. Middle-income earners in New Zealand are simply over-taxed on their labour compared to all our major economic rivals.

Relief from income tax would have a couple of effects. Firstly, income earners would keep more of what they earn each week, much of which would be spent at local businesses, supporting growth and employment. Secondly, letting earners keep more of what they earn would encourage more economic activity on the margin, driving employment and investment.

The Tax Working Group chose to reject income tax relief in 2019, but came to the following conclusion on the evidence for income tax relief[5]:

> *"[Changes] to the tax rate can affect the incentives to accumulate financial and physical and human capital. The weight of evidence suggests that income taxes affect behaviour in ways that reduce investment in skills, risk taking, and the accumulation of capital. These influences reduce productivity and growth."*

2 Stats NZ data suggests an average household spends $234 a week on food as of 2019 https://www.stats.govt.nz/information-releases/household-expenditure-statistics-year-ended-june-2019

3 Blundell, R. (2009). Assessing the temporary VAT cut policy in the UK. Fiscal studies, 30(1), 31-38.

4 Crossley, T. F., Low, H. W., & Sleeman, C. (2014). Using a temporary indirect tax cut as a fiscal stimulus: evidence from the UK (No. W14/16). IFS Working Papers.

5 Position Paper prepared for the Tax Working Group Session 21 https://taxworkinggroup.govt.nz/sites/default/files/2019-08/twg-bg-4024866-personal-tax-rates-and-thresholds.pdf

The Group also noted that:

> *"[Decreasing] marginal tax rates, including the top marginal tax rate, is likely to have the greatest impact on incentives at the margin for most saving and investment decisions by New Zealand households. Decreasing the rate for these individuals would also improve returns to skill accumulation and employment."*

Income tax relief would also de-politicise fiscal stimulus. If the Government chooses instead to spend remaining funds from the CRRF, politicians or officials will inherently be required to pick specific companies and sectors to benefit. By providing income tax relief, the benefit of economic stimulus is spread more broadly and fairly.

## Employment trial periods through 2021

According to Treasury's latest economic forecasts, unemployment is not expected to peak until March 2022 – a reflection of the uncertainty and malaise which is likely to impact the business environment for at least the next 18 months.

From a commercial perspective, many businesses will be reluctant to hire new staff if those staff can't easily be let go in the event of weak sales or poor business conditions. Businesses worried about taking on large wage obligations may then simply choose to hire fewer staff – contributing to the weak labour market.

To give businesses confidence to hire, we propose introducing a temporary 15-month freedom-to-hire-and-fire period, wherein businesses can let staff go as if they were on a 90-day trial. This option would only exist staff hired in that timeframe – not those already employed. This would give businesses the confidence to take employment risks – with any fixed obligations to only begin once the economy is expected to have entered recovery.

After the previous National Government introduced 90-day trials in 2009, NZIER examined the policy and found that the trial periods improved hiring[6]. They noted that the policy had a "small but positive" impact on SME hiring "during a time when the labour market overall was shedding workers due to the recession." NZIER found that hiring by SMEs who benefitted from the policy was almost 6 percentage points higher than expected. Given we now face conditions similar to 2009 (a severe recession with a very weak labour market) the evidence indicates that hiring trial periods may be effective in stimulating employment growth.

6 NZIER's analysis is available at https://nzier.org.nz/static/media/filer_public/ef/af/efaf0bf9-fadb-4bbd-b032-fe00195f3d33/nzier_insight_25_-_90-day_trial_final.pdf

## Lift overseas investment thresholds

Overseas investment has been a significant factor for economic growth in New Zealand. We are a small country so rely heavily on the investments foreign companies and individuals choose to make here.

As Treasury noted in its 2019 consultation document[7] on amending the Overseas Investment Act:

> *"Overseas investment ... supports our businesses to invest by bridging the gap that currently exists between New Zealand's savings and investment needs. It enables new firms to be established and existing firms to expand and become more productive."*

To support our economic recovery, we support lifting the threshold at which foreign investment needs to be approved from $100 million to $500 million until the end of 2022. This would encourage investment by allowing a greater proportion investments without the requirement to seek formal approval.

There is evidence that legislative barriers to foreign investment can have negative economic impacts. Mistura and Roulet (2019)[8] find the degree of restriction on foreign investment negatively impacts foreign-direct investment in both manufacturing and service sectors.

There's also evidence that foreign investment can be good for economic growth and incomes in the country receiving the investment. Fabling and Sanderson (2014)[9] find that foreign investors in New Zealand "tend to target high-performing ... companies" and that companies acquired by foreign investors "exhibit higher growth in average wages and output, relative to similar domestic firms".

7 Treasury's consultation document can be found at https://www.treasury.govt.nz/sites/default/files/2019-04/overseas-investment-reform-consultation.pdf
8 Mistura, F. and C. Roulet (2019), "The determinants of ForeignDirect Investment: Do statutory restrictions matter?", OECD Working Papers on International Investment, 2019/01, OECD Publishing, Paris.
9 Fabling, R., & Sanderson, L. (2014). Foreign acquisition and the performance of New Zealand firms. New Zealand Economic Papers, 48(1), 1-20.

# Conclusion

When net debt reaches 56.3% of GDP in the 2025/26 financial year, we will be significantly less able to respond to a financial crisis or natural disaster. Reducing the relative size of that debt burden is therefore not just an economic imperative but the only way to maintain the flexibility to respond to crises fast and hard.

With significant amounts of money earmarked in future years for the Government's continued response to COVID-19, we argue that the prudent way to limit the impact of debt is to focus that pool of money at pro-growth tax relief coupled with affordable elimination of regulatory taxes which constrain hiring and investment.

Putting aside impacts on our relative debt, we would all benefit from stronger economic conditions. This package would accelerate employment growth and relieve pressure on small businesses facing thin margins and falling sales; business confidence would rise and investors would face greater certainty.