

The role of taxation in an economy economics essay



The first part of this report provides a brief overview of the role of tax within a country's macro economic environment. Taxation can be collected from a number of sources diagrammatically shown in the circular flow of income figure. Governments make use of taxation as a tool to generate revenue, discourage undesirable behavior, reduce inequality, distribute resources and to protect local industries.

The report reflects on the current NZ taxing system and identifies current bottlenecks/flaws. The major of these being the corporate-, trust- and personal tax rates not being aligned which creates unwanted economic behavior. It then moves onto the soon to be implemented changes in an attempt to address these issues. Briefly the personal- and trust tax rates will be aligned with the corporate rate slightly fixed under these. Various base broadening policies will be implemented to finance the reduction in these rates.

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1. Introduction: The role of taxation in an Economy?

Tax can be defined as “ a compulsory contribution to state revenue, levied by the government on personal income and business profits or added to the cost of some goods, services, and transactions. ” (Electronic Concise Oxford English Dictionary, 2010). Tax regimes vary from country to country but are an integral part of most governments in industrialized countries (Carnell, 2010).

There are two broad classification of tax, these are (A Tax system for New Zealand's Future, 2010):-

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Revenue Tax: – raise revenue for government spending.

Corrective Tax: -these have specific purposes such as promoting or discouraging certain behavior.

Below is the depiction of circular flow of income and the points where taxation is collected.

Overseas Sector

Producer

Investment

BANKS

Government

Spending

Taxation

Net Export

Savings

Consumer

Spending

HOUSEHOLDS

GOVERNMENT SECTOR

FIRMS

Taxation

Transfers

Factor

Income

Disposable

Income

FIGURE 1: CIRCULAR FLOW OF INCOME HIGHLIGHTING THE TAX POINTS

Source: Faculty of Business Studies, 2010

Taxation has a key role in a modern economy. Listed below are the ways in which governments can use taxation in a modern economy:-

Revenue generation: – Taxation is used by the government to raise revenues for its operations, infrastructure, welfare, education defense (Carnell, 2010).

Behavior Discouragement: – Also referred to as social engineering, the purpose of this is to discourage people from antisocial behavior and is often done heavily taxing the commodity there by increasing its price (Carnell, 2010).

Reducing Inequality: – Tax money is used to serve the weaker sections of the society through the welfare programs (Carnell, 2010).

Resource Redistribution: – Can be used to transfer resources form one section of society to another section of the society (Carnell, 2010).

Protecting local Industry: – Local industries are normally protected by the government through the use of heavy import tariffs. This makes the imported goods more expensive then the local goods and thereby encouraging the production of local goods (Carnell, 2010).

2. NZ's current tax base system

“ The Tax Base is the set of economic activities and assets that are taxed” (AfDB, 2010). The things and activities which are taxed in an economy vary among countries. Some countries have adopted a narrow tax base while others have favored the broad tax base.

New Zealand's tax system has adopted a broad – base – low – rate approach to its taxation policy. This approach took shape in the late 1980's where a goods and services tax (GST) were introduced. This broadened the taxed base reducing the New Zealand government's dependence on a growth inhibiting form of tax generation such as heavily taxing exporting goods and services (A Tax system for New Zealand's Future, 2010). The current New Zealand tax base is made up of the following taxes (Hooper, K., Somerfield, J., Ritchie, K. & Greenheld, J., 1998) :

Income Tax

Fringe Benefit Tax

Specified superannuation contributions withholding tax

Goods and Services Tax (GST)

Estate Duty

Gift Duty

Stamp Duty

Approved Issuer Levy

Accident Compensation Levies

Land Tax

Excises

Totalisator Duty, Lottery duty and gaming duty

Road User Charges

Some key changes to the above mentioned tax base are discussed in more detail below.

Throughout the 1990's the top personal income-, company- and trust tax rates were more aligned for economic reasons which are discussed later in this report. During this time in an attempt to make the current system more equitable the above mentioned rates became unaligned. Prior to the National Party winning the 2008 New Zealand elections the above mentioned rates were sequentially fixed at 38%, 30% and 33% (TaxRates. cc, 2010).

Contributions from investors placed into different types of entities known as PIE's are currently taxed at a top rate of 30%. Kiwi Saver forms part of this as well.

Goods and Services Tax (GST) are currently set at 12.5% and is applied across the board without exceptions. This makes it one of the simplest forms of revenue generating tax to administer.

Currently New Zealand's tax system lacks a Capital Gains Tax (A Tax system for New Zealand's Future, 2010). Compared to Australia, New Zealand's tax system does not tax income generated from capital investments such as real estate, stocks and bonds. The lack of such a tax in New Zealand has some significant economic impacts. Amongst others it limits widening the tax base and also leads to an increase in demand for residential investment.

Currently a 20% depreciation loading on capital and land form part of the system. Additionally a 75% debt - to - asset ratio is applicable in New Zealand. These both limit the government's ability to successfully broaden the tax base.

3. Proposed tax base system October 2010

As mentioned in section 1, tax generates important revenue for the government and also serves as a mechanism to reduce unwanted activity. According to the TCG a comprehensive tax system is one that promotes equity and fairness, allow for sufficient growth and ensure and maintain its revenue integrity. It should also be easy to administer and cost effective to implement (A Tax system for New Zealand's Future, 2010).

The current system's personal income-, corporate- and tax rates are unaligned. Tax payers structure their affairs to funnel their income through that of companies and trusts. This leads to tax avoidance. This undermines the integrity of the current system seeing that not all tax payers are able to structure their affairs accordingly. To be implemented in October 2010, is the alignment of the top personal rate and trust rate at 33%. Together with this the company rate will be reduced from 30% to 28%. Currently New Zealand's company tax rate being fixed at 30% is higher than most OECD countries including that of Australia. The reduction from 30% – 28% makes New Zealand more attractive for foreign investment. The current imputation policy will however remain in place which ensures shareholders are not double taxed (A Tax system for New Zealand's Future, 2010).

In order to finance the above mentioned reduction in tax rates, a 2.5% increase in GST will be implemented across to board on all goods and services. Many view GST as a regressive form of tax being most harmful for the lower income earning groups. This is not entirely true seeing that higher earners spend more and thus gets taxed more severely. An up front after tax income adjustment could be a way to limit its regressive effect however will have a significant cost to New Zealand's government.

The only way for New Zealand to become less dependent on foreign borrowings and to restore its current account deficit is to improve New Zealand's per capita saving to consumption ratio. Depreciation will be removed especially from residential properties seeing that these forms of capital investment more often than not appreciates rather than depreciates in value. This will lead to broadening the tax base and also limit unfair tax

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advantages to property investors within New Zealand. In addition to the above the current 20% depreciation loading on commercial property and equipment will be removed. Companies need to review their current depreciation levels (TaxRates. cc, 2010).

New Zealand competes for capital and labor internationally. The quantity of New Zealand tertiary educated students and professionals moving across to Australia are of concern and the above is an attempt to address this. These high earners need to be employed within New Zealand to enhance productivity whilst remaining tax payer within the system.

4. Conclusion

For New Zealand to develop a functional taxing policy, the New Zealand governments need to build on its already established BBLR taxation system. In an attempt to lessen the dependence on corporate and income tax, which is most harmful for New Zealand to sustain economic growth, the above mentioned amendments to the current taxation policy will be implemented.