Meeting income redistribution aims: budget reform, not just tax reform

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I. TAXATION AND ECONOMIC GROWTH

In 1981 the Planning Council set up a committee to look into the need for tax reform. The committee suggested that a committee like the Task Force be appointed, to analyse the tax system and recommend options for changing it. One of the rationales given for reforming the tax system was to improve economic growth. The analysis of the tax system was, however, to be carried out as though the tax system could be isolated from the rest of the economy. No real effort was made to discover what particular tax measures would enhance growth. New Zealand's poor economic performance during the 1970s is evidence that an important opportunity for tax research was neglected. Between 1975 and 1980, we had the lowest rate of real economic growth of any other member of the 24-country Organisation for Economic Co-operation and Development (the OECD). Our average growth rate (measured in terms of real gross domestic product or GDP) was a measly 0.7% per year compared with 5.1% in Japan, 3.9% in the United States and 2.5% in Australia. Even the United Kingdom, which usually beats us to the bottom of the rankings, had higher growth at 1.6%.

It is not surprising that the most recent real GDP figures for calendar year 1981 are less depressing, since they are built on the base of low growth which prevailed during the late 1970s. New Zealand's growth for 1981 was 3.9%, the third highest rate for the OECD. This is in marked contrast to our average growth of 0.7% between 1975 and 1980. In the 10 years between 1970 and 1980, New Zealand ranked fourth from the bottom of OECD countries with average growth of 2.3% per year.

Buoyant growth in 1981 was markedly above the 1.2% rate of growth for the OECD as a whole. This growth contributed to improving business confidence, high profits and investment growth. Partly as a consequence, investment intentions remained firm into the first half of 1982 according to the New Zealand Institute of Economic Research Quarterly Survey of Business Opinion.

The test of government policy in the year from July 1982 will be whether it follows the OECD's advice to provide a climate where investment intentions are actually carried out. Given the wage freeze and the growing external deficit, internal demand for goods and services is likely to weaken in the second half of

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1982, a discouraging environment for firms to consider new investment. In such an environment, New Zealand's GDP growth for calendar year 1982 may not achieve the 1.0% forecast by the OECD.

Changes in the tax system can assist in generating some economic growth. For example, a reduction in income taxes would give consumers additional spending power, in this way supporting domestic demand and encouraging investment.

II. INCOME REDISTRIBUTION AND THE TAX SYSTEM

Despite the obvious problem of low economic growth, the Task Force chose not to concentrate on this problem. One problem which did receive considerable attention however, was the income distributional aspects of taxation. The Task Force's analysis showed that it was possible to switch from personal income taxes to taxes on goods and services while maintaining some progressivity (that is, taxing those on high incomes at a higher rate than those on low incomes). But again, the Task Force's brief was much too narrow. Its brief was to look at tax reform in isolation from the rest of the government's budget transactions.

Analysis of the income distributional aspects of taxation involves the determination of the incidence of different taxes. The incidence of a tax defines who pays it. The Task Force's view of tax incidence was misguided, and in fact, was a product of economic thinking in the 1950s, failing to reflect a number of significant changes in the methodology for assessing incidence which have taken place since then. Its approach was to get at something which is called "final incidence" in some of the outdated books on public finance. Final incidence implies that once a tax is assessed, it either "stays where it is put" (a personal income tax, for example, taxes the person) or shifts to a point from which the tax cannot be shifted further. Even if such a point exists, it is unlikely that any tax would be fully shifted in a year, the period of analysis considered by the Task Force. But also, taxes are part of an ever-changing economy and the microeconomic relationship implied by the concept of a tax being introduced and then making an immediate, one-time only impact, ignores the wealth of theory about the macroeconomic effects of taxes.

To be consistent with this theory, taxation is best seen as one part of government budget transactions (and the budget as part of economic transactions). It is necessary to examine not only the incidence of taxes, but also the incidence of other budget receipts (for example, receipts from government trading activities such as the Government Printer or through the sale of electricity) and of public expenditures. The nature and size of the budget deficit also has important effects on income distribution.

The omission of public expenditures in a discussion of the effects of taxation on the income distribution is tantamount to implicitly assuming that expenditures are distributed in a certain way and that changes in taxation have no influence on the size and nature of government spending. Ignoring budget receipts other than taxation and the amount of borrowing is tantamount to assuming that taxation provides the only means of financing expenditure, which clearly is not true.

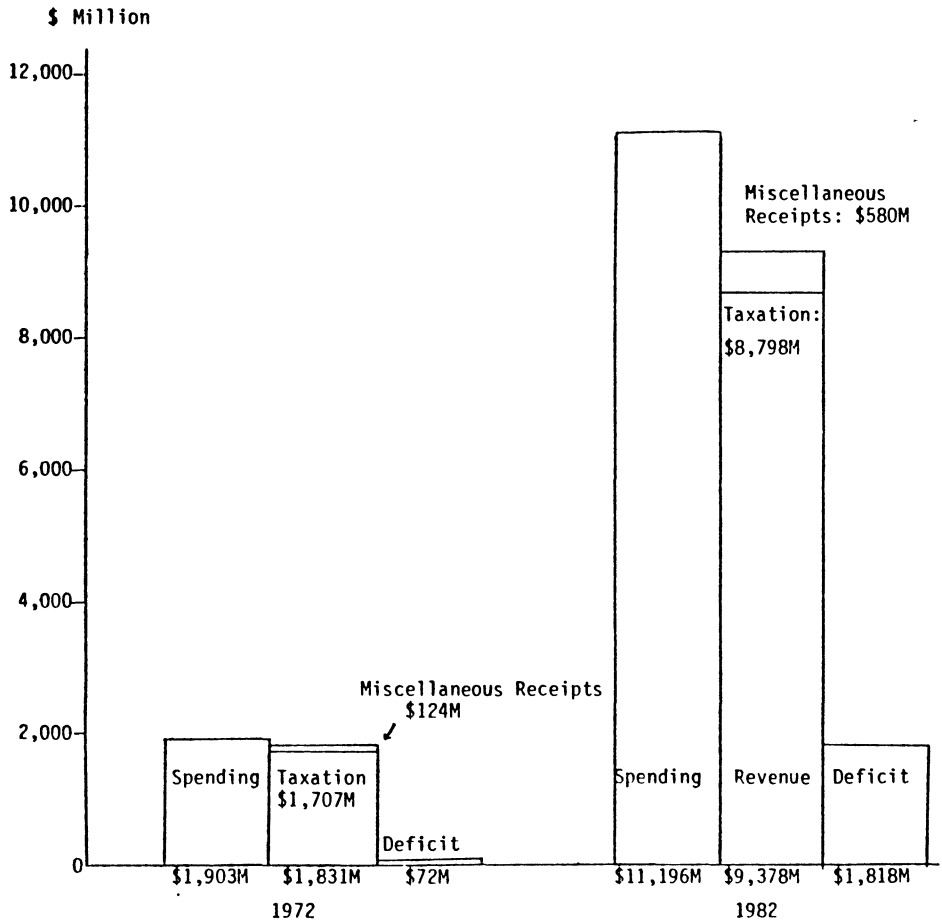
Taxes and other forms of government levies are not simply a way of reducing the income of the taxpayer. They are the means by which command over resources is transferred from the private sector to the public sector in order to provide those goods and services that satisfy wants which are not satisfied by the private sector. Or, to put it more bluntly, taxes exist to provide public expenditure. The government's budget exists to allocate resources in a different manner from the private market place, to help stabilise economic activity and to achieve income distributional aims. Thus, comprehensive tax reform depends on knowledge of the incidence of the entire budget, not just about tax incidence.

III. TAX REFORM WAS A PRETENCE

In setting up the Task Force the government made a pretence of being interested in tax reform. But in fact, the government was not so much interested in tax reform as it was in *not* making any tax reduction. The reason is that the government was already spending substantially more than it earned. Chart I compares the levels of spending, taxation, other receipts and the deficit in 1972 and

Chart I

GOVERNMENT BUDGET TRANSACTIONS



1982. Compared to 1972, when the deficit before borrowing was 72 million dollars or just over 1% of gross domestic product, the deficit in 1982 was 1,818 million dollars, an estimated 6.3% of gross domestic product.

Between 1972 and 1982, tax receipts grew by 415%. Yet while tax receipts were nearly 90% of expenditure in 1972, by 1982 they were less than 79% of expenditure. The deficit in 1982 totalled 1,818 million dollars, only 13 million dollars less than the total of 1,831 million dollars collected in revenue in 1972.

With such a large gap between what the government spends and its income, tax reductions were out of the question. Instead, the Task Force thought about tax reform in terms of a balance sheet. Like the Taxation Review Committee in 1967, the Task Force concluded that personal tax revenue had grown more rapidly than tax revenue from other sources (see Chart II) which must mean personal income taxes are too high. The recommendation was to reduce the rate at which income taxes are assessed and to make up the short-fall in tax revenue by taxing something else, for example, by broadening the base of the wholesale level sales tax.

The main criterion adopted for restructuring the personal income tax was that horizontal equity conditions be satisfied, that is, to reduce taxes in such a way as to ensure that those in similar situations were treated similarly. Questions of vertical equity in the tax system, usually interpreted to mean that those on higher incomes pay a larger proportion of their income in tax than those on low incomes, also interested the Task Force. However, it recommended that the rate at which personal income tax is assessed be increased for those on low incomes, claiming that many low-income earners supplement the income of another higher-earning household member.

IV. TASK FORCE ON THE INCIDENCE OF TAXATION

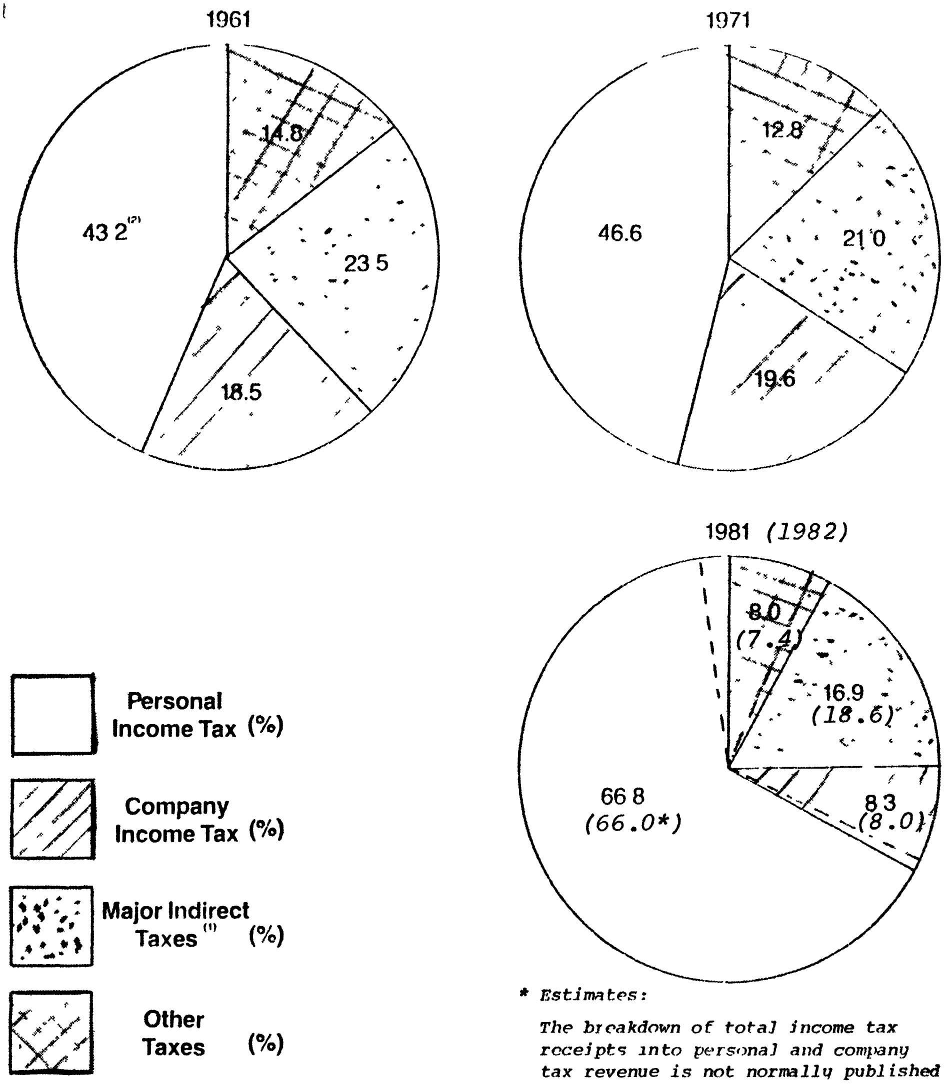
Tax legislation provides particular economic units with a statutory obligation to pay certain taxes. However, once the tax is assessed, economic units may react by changing their behaviour in some way. When the tax results in a change in household or personal income which is different from the change that results from the household meeting its statutory obligation, then the cost of the tax has been shifted.

For example, take the case of the wholesale sales tax assessed on motor vehicles. The statutory obligation to pay the tax rests with the motor vehicle wholesaler. However, it could be argued that the new car buyers pay the tax by paying a higher price for the car. The extent to which the tax is passed on to the buyer depends on how responsive the demand for cars is to the price of cars.

Over the last twenty or so years, economists have gained a clearer understanding of the nature of tax incidence. Changes in relative prices may result in a different composition of products, a change in the pattern of buying and selling products, and in the end, these changes will reduce or increase household incomes. Nevertheless, there is a wide range of opinion about the precise incidence of taxes.

Chart II

TAX MIX: RELATIVE CONTRIBUTIONS OF CENTRAL GOVERNMENT TAXES
1961, 1971 & 1981
ESTIMATES FOR 1982



* *Estimates:*

The breakdown of total income tax receipts into personal and company tax revenue is not normally published until the Inland Revenue Annual Report is tabled in Parliament.

(1) Customs duty, sales tax, and beer duty.
(2) Includes Social Security Income Tax

Sources: Annual Budgets, Public Expenditure and its Financing (NZPC 12a).

Arguing that "ascertaining final incidence is an intractable problem"[1] the Task Force decided to adopt some arbitrary assumptions:

(a) The incidence of the personal income tax was assumed to rest with the individual from whose income the tax is deducted. The "burden" of the tax was assumed to be shared among the members of a household by way of reduced spending power to the extent that some members of the family may be financially dependent on others;

(b) Taxes on goods and services were assumed to be fully shifted from the wholesalers of these products (with the statutory obligation to pay the taxes) to the final consumers of these products.

The Committee took the view that it is the welfare and ability to pay tax of families and/or households that is the ultimate concern of policy evaluation. Individuals are not considered to be independent economic units (unless they lived on their own) because they probably shared consumption with other members of their household.

To show the way in which tax incidence varies within the population, members of the Task Force secretariat used the 1980/81 household sample survey and the 10% sample of the 1981 Census to classify households by size of household, number of dependent children and by range of household income. In addition, households consisting of just one or two adults were subdivided according to whether national superannuation is received.

Table 1 shows some characteristics of the 1,008,900 private households in New Zealand. Households have been classified by size of household (in terms of the number of occupants), and by the number of dependent children (decided by the number of children in the household eligible for the family benefit). Households consisting of just one or two adults have been subdivided according to whether national superannuation is received. Information about the average income of different household types is also recorded.

Table 1

NUMBER OF PRIVATE HOUSEHOLDS (IN THOUSANDS)[a]
BY HOUSEHOLD TYPE 1980-1981

	1 Adult		2 Adults		2 Adults			1 Adult		All	
	Nat. Sup.	Other	Nat. Sup.	Other	With Children One	Two	Three+	With C'dren	Other	Households	(%)
TOTAL	100.0	88.8	123.8	152.4	78.5	120.7	93.9	45.9	204.9	1008.9	(100)
(%)	(10)	(9)	(12)	(15)	(8)	(12)	(9)	(5)	(20)	(100)	
Average Income[b]	5,600	10,000	12,200	20,200	17,100	18,100	17,900	7,500	28,900	17,200	

[a] From 1981 Census of Population and Dwellings, 10% Sample File.
[b] From Household Survey 1979/80, estimates for 1980/81.
Source: Table 2.14, Report of Task Force on Tax Reform (Government Printer, Wellington, 1982) 28.

1 *Report of the Task Force on Tax Reform* (Government Printer, Wellington, 1982) 26.

The largest proportion of households fall into the residual household type — called "other". This group comprises those households with three or more adult occupants. About half of these "other" households also include children. The next most significant grouping is two adults without dependent children who make up 15% of total households. Households with two adults receiving national superannuation and two adults with two children each make up 12% of the household population. One-adult households with children make up 5% of the household population. Adding up all the household types with children, including half of "other" households, over 44% of households have dependent children.

Looking at Table 2, 20% of households earned under $8,000 in the March 1981 year. The minimum adult award wage was a little over $8,000. About 23% of households earned the minimum award wage or below at the time of the 1980/81 Census. One and two-adult national superannuitant households made up about half of these. Most other households in this low income category receive a large proportion of their income as social welfare benefits.

Table 2

DISTRIBUTION OF PRIVATE HOUSEHOLDS BY INCOME RANGE

Household Income Range ($ p.a.)	All Households	(%)
Under $ 8,000	204.0	(20)
$ 8,000-$12,000	131.1	(13)
$12,000-$16,000	134.5	(13)
$16,000-$20,000	110.4	(11)
$20,000-$30,000	187.5	(19)
Over $30,000	103.4	(10)
Not Specified	138.1	(14)
TOTAL	1008.9	(100)
(%)	(100)	
Average Income	17,200	

Source: Table 2.14, Report of the Task Force on Tax Reform, supra, 28.

Table 3 shows the proportion of gross household income paid in personal income taxes by each household income group and by household type. There are three main components of tax liability:

(a) Basic income tax liability where no exemptions or rebates are allowed;

(b) The reduction in tax provided by exempting some income from taxation or allowing certain expenses to be deducted;

(c) The reduction in tax provided by the subtraction of rebates.

Figures in Table 3 are shown in aggregate and those for each group are averages. Multi-person households with two or more earners have lower tax liability compared with those where only one person earns all the income. The higher rates for two-adult households with children reflect the move out of

Table 3

INCOME TAX LIABILITY (% OF HOUSEHOLD INCOME) BY RANGE OF HOUSEHOLD INCOME AND HOUSEHOLD TYPE 1980-1981

Household Income Range ($ p.a.)	Household Type 1 Adult Nat. Sup.	1 Adult Other	2 Adults Nat. Sup.	2 Adults Other	2 Adults With Children	1 Adult With Children	Other	All Households
				(% of household income)				
Under $ 8,000	15	10	13	6	5	1	6	10
$ 8,000-$12,000	23	24	16	19	15	13	12	17
$12,000-$16,000	28	28	22	23	23	22	17	23
$16,000-$20,000	.	33	25	24	27	.	20	26
$20,000-$30,000	.	39	29	28	30	.	24	28
Over $30,000	.	.	40	38	40	.	30	34
TOTAL	20	26	23	28	28	10	27	26

Source: Table 2.15, Report of the Task Force on Tax Reform, supra, 30.

the workforce (or to reduced hours of work per week) of one spouse when there are children to be cared for in the household. The benefits of exemptions and other deductions are in proportion to income, increasing it by 1 to 2%. Those in the lowest income groups (under $8,000) are exceptions, claiming exemption benefits worth only 0.7% or less of their income.

Currently, tax rebates focus on providing assistance to families, and are targeted to supply the majority of aid to those with low incomes. Their major effect is to reduce markedly tax rates for low income households with children but to produce a much more severe progression in rates through the low to middle income ranges.

Overall, the personal income tax structure is progressive. As the last column of Table 3 shows, the percentage of income paid in tax increases on average with household income.

Table 4

TOTAL ALLOCATED INDIRECT TAXES[a] (% OF HOUSEHOLD INCOME) BY RANGE OF HOUSEHOLD INCOME AND HOUSEHOLD TYPE, 1980-81

Household Income Range ($ p.a.)	Household Type 1 Adult Nat. Sup.	1 Adult Other	2 Adults Nat. Sup.	2 Adults Other	2 Adults With Children	1 Adult With Children	Other	All Households
				(% of household income)				
Under $ 8,000	6.2	9.7	9.9	12.4	15.4	9.1	11.6	9.4
$ 8,000-$12,000	3.5	7.5	8.4	9.2	9.9	8.1	10.8	9.0
$12,000-$16,000	2.8	6.7	8.3	8.0	7.6	6.7	10.5	7.8
$16,000-$20,000	.	7.2	6.2	7.0	6.4	.	8.8	6.8
$20,000-$30,000	.	4.3	4.5	5.7	5.8	.	7.9	6.2
Over $30,000	.	.	4.0	4.8	4.1	.	6.8	5.8
TOTAL	5.3	7.4	7.1	6.3	6.6	8.6	7.5	6.9

[a] Wholesale sales tax, excise duty on alcohol and tobacco, domestic air travel tax, energy resources levy, motor fees, and motor spirits duty.

The other major component of taxation is indirect taxes. Table 4 shows indirect taxes as a percentage of household income.

Indirect taxes are assumed to be paid, via the cost of goods and services, out of disposable income (gross income less income taxes.) Since the income tax is generally an increasing proportion of gross income as incomes rises, disposable income forms a reducing proportion of gross income. Thus if all goods and services were taxed at the same rate, and all disposable income was spent, the indirect tax component would fall as a proportion of gross income as income rose. Table 4 shows the total indirect taxes which the Task Force secretariat chose to analyse (about all of the taxes on alcohol and tobacco but only 63% of wholesale sales tax on new cars and 50% of other taxes). The amount paid in indirect taxes tends to be a reducing proportion of household income as households rise through the income distribution. There is another effect at work also, namely, the ability to save some of a household's disposable income increases as income rises.

When total income tax liability is combined with total indirect tax liability, the Task Force found that the progressivity of the personal income tax (where average taxes increased with income) is moderated by the regressivity (where average taxes reduce as incomes increase) of indirect taxes. When the family benefit is taken into account as well, the effect is for taxes to rise as incomes rise.

The Task Force made the judgment that there is such a degree of progressivity in the entire tax system combined with the family benefit, that the marginal personal income tax scale could be flattened somewhat. Although the effect of changing the tax scale would be to make it less progressive, overall all taxes would still be an increasing proportion of income.

This analysis of the incidence of the present tax system led the Task Force to recommend that both average and marginal personal income tax rates be reduced for the great majority in the scale as it affects most members of the labour force also be reduced. They suggested a number of possible new marginal tax scales.

V. THE INCIDENCE OF EXPENDITURES

Obviously, the wholesale sales tax system would have to be substantially broadened if the government still wants to collect enough revenue from that source to offset any income tax reductions. However, with the present price/wage freeze, any additional taxes on goods and services will add to inflation. But another problem with the introduction of additional taxes on goods and services is that they will increase the regressivity of the tax system. The remedy to this problem according to the Task Force, is to increase the family benefit. Because it is a cash benefit, the family benefit is a logical extension of analysis of the tax system. It is little different from the young family rebate, which is fundamentally linked to the tax system. But it is by no means the only type of government expenditure (or other government non-tax transaction) which enhances the economic well-being of families. If we examine the budget expenditure tables, we see that social services expenditure is the largest item of net expenditure, making up around 27 to 28% of total expenditure. By far the biggest proportion of this is spending on national superannuation, which is included as pre-tax income for the purposes of the Task Force analysis. Also included in income are social welfare benefits.

If the distribution of social welfare expenditures were analysed for a given year, it would appear to be an expenditure which mainly benefits those on low incomes. The benefit is likely to be a larger proportion of private income than the amount paid in tax. As a result, national superannuitants would be net beneficiaries of government expenditures in a given year. But this points to another limitation of the Task Force analysis — that it is a snap-shot analysis of one year only and looks at current income, but not wealth. A life cycle approach and the inclusion of a measure of wealth could show that national superannuitants are relatively well-off (in general, of course). Either approach provides further grounds for increasing the marginal rate of tax on superannuitants.

The task of examining the incidence of other government expenditures is more difficult than for social welfare benefits, which as a form of transfer payment may be thought of as negative taxes. For example, we all benefit from having good foreign relations — partly because it brings us a better quality of life and a more tangible benefit is foreign trade. The valuation of those benefits is not straightforward. For those attending some form of educational institution, there are obvious direct benefits but again it is hard to say by exactly how much those on different incomes are advantaged by educational spending. But it is logical that most government expenditures benefit somebody. And just like an increase in taxes, a reduction in government spending reduces incomes. Incomes will be affected, either directly if the expenditure is for cash benefit, or indirectly, if the expenditure is for a less tangible benefit such as education or health.

Some sorts of expenditures, such as those for the Post Office, the Electricity Department or the National Roads Board, not only provide direct benefits to households, but also provide an infrastructure which, if efficiently managed, could enhance economic growth. And that brings this paper around full circle. The Task Force's narrow focus on income distributional issues was simply designed to justify increasing the proportion of tax paid by those earning low incomes, so that marignal taxes could be reduced without reducing the amount of tax revenue collected by the government. This sort of thinking reflects a view of the tax system which is static, not dynamic. It would be better to attempt to achieve redistribution goals by designing a tax system with the aim of generating more economic growth.

Initially, a tax system which enhances economic growth will have to be designed according to efficiency criteria; it will channel resources towards the particular sectors of the economy which are productive and away from those which are not productive. Income distributional objectives which demand the opposite flow, that is, resources are taken from the "haves" (who are rewarded for contributing to a sector of the economy which is producing output) and distributed among the "have-nots" (whose income is smaller because they are not working in a productive sector), can be met by the expenditure side of the budget. As more output is generated and economic growth is increased, the conflict between efficiency and income distributional aims will lessen. One of the associated benefits of more economic growth is that as real personal incomes grow, earners are more willing to be taxed for public programmes aimed at providing for those on low incomes.