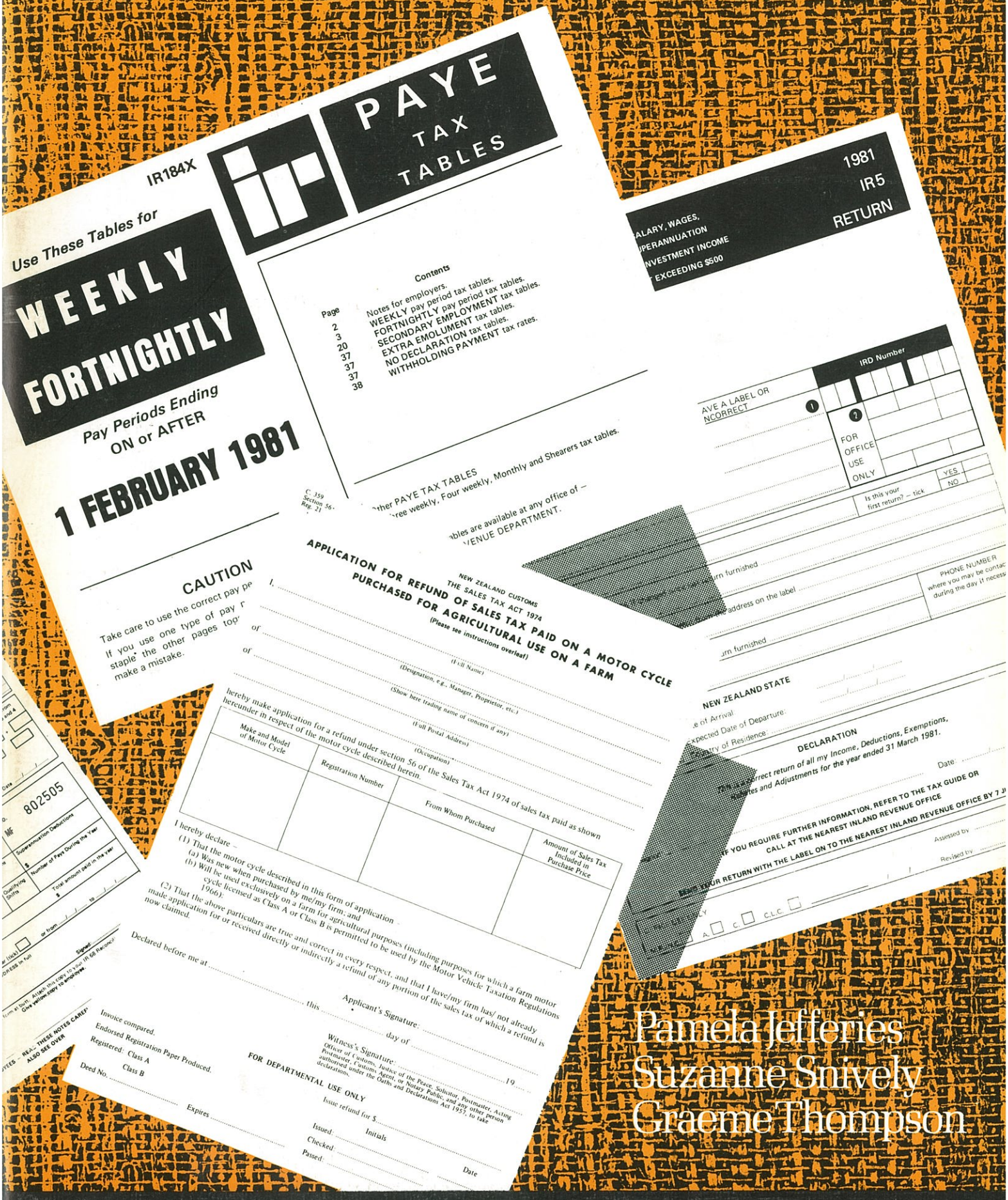
TAXING ISSUES



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TAXING ISSUES

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FOREWORD

In *An Agenda for Tax Reform* (June 1981) the Planning Council set out its proposals for a comprehensive but expeditious review of the New Zealand tax system which would lay the foundations for major reform beginning in 1982. The Council's agenda was based on research and consultations undertaken by a group convened by Pamela Jefferies, one of its members. *Taxing Issues* is a revised version of a background brief prepared at the time; it now includes the results of more recent analysis and discussion. It complements the report already published by the Council, although the views expressed are the authors' own.

The paper deals with some of the more basic issues in taxation reform, such as taxpayers' perceptions, the economic and social effects of taxation, the characteristics of a good system, and the defects in our own tax structure. Wider public understanding of these issues will, the Council believes, assist the process of change towards a better and more generally acceptable tax system. We see the report, therefore, as a contribution to the debate which will inevitably continue as the options for reform are discussed, evaluated, and implemented.

Frank Holmes,
Chairman.

Acknowledgments

We would like to express our gratitude to the many knowledgeable people who participated in our lively consultations about *Taxing Issues*. Thanks especially to those who read and commented on our earlier drafts and helped to clarify our thinking about the issues.

Thanks also to members of the Planning Council and secretariat who have put considerable effort into this publication, in particular Margaret Bell, Sue Hiles, and Geof Mortlock.

Finally, the views expressed in the paper are our own and should not be attributed to the Planning Council.

Illustrations by Isabel Lowe.

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GLOSSARY

apparent tax incidence—The point where a tax is legally assessed. Also called legal or statutory incidence. For example, the apparent incidence of the personal income tax is personal income.

average tax rate—Total tax paid as a proportion of income.

direct taxes—Taxes on income and wealth. So-called because these taxes have obvious direct effects on individuals and enterprises (their apparent incidence is similar to their effective incidence) but they may also have large indirect or hidden effects.

effective tax incidence—Who really pays a tax through adjustments to economic behaviour after the tax is legally assessed.

efficiency—Allocating economic resources so that optimal output is achieved.

equity—Standards of fairness; usually assessed in terms of income distribution.

excess burden—Distortion caused by taxation so that the most efficient patterns of production and consumption are not achieved.

fiscal drag—The effect of inflation on a progressive tax rate structure; because the proportion of tax grows as additional income is earned, fiscal drag has ensured that more tax is collected from personal income tax each year without the need to change tax rates.

incidence of a tax—Who pays the tax. See apparent and effective incidence.

indexation—Linking the tax structure to movements in prices. This is one way of avoiding fiscal drag.

indirect taxes—Taxes on goods and services. So-called because of the common belief that these taxes are shifted and therefore their most important effects are not apparent, but hidden. However, these taxes also have direct effects.

marginal tax rate—Proportion of tax paid on the last $1 of additional earnings. Different marginal rates apply at different levels of income.

neutral tax system—A system which does not distort existing social or economic behaviour.

progressive tax rate structure—Tax schedule where marginal tax rates become higher as income rises. In addition, average tax increases with income.

proportional tax structure—Tax schedule which taxes all incomes at the same average tax rates.

rebates—Subsidies provided through the tax system by refunding tax.

regressive tax rate structure—A structure where average tax rates fall as income rises.

taxation—Levies imposed by Governments which divert resources from chiefly private sector activities to the public sector for such things as electricity, education, health care, postal services, social welfare services, and other public goods and services.

tax capitalisation—When a tax concession is built into the capital value of a good.

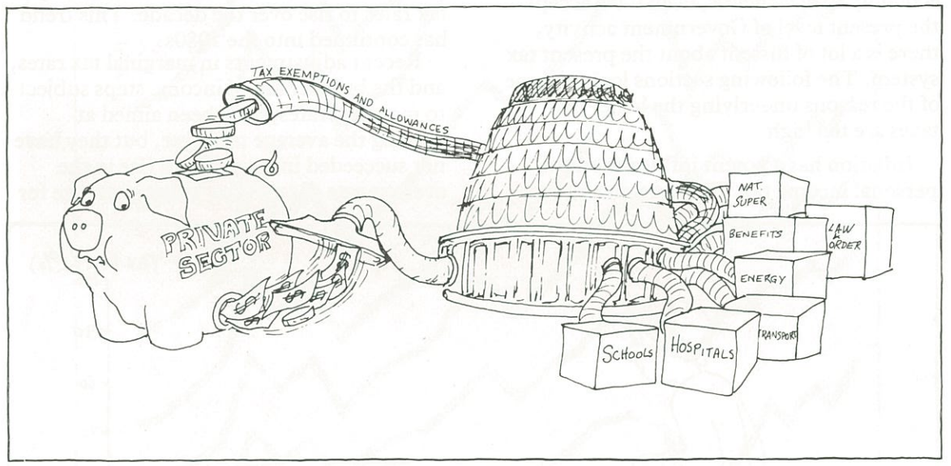
tax expenditure—Subsidies provided through reductions in tax liability, or through tax credits, e.g., export incentives.

INTRODUCTION

An inequitable and inefficient tax system is not just a source of aggravation to taxpayers, it is likely to limit social and economic progress. This paper explores some of the arguments about what is wrong with taxation in New Zealand, and discusses the scope for change.

Taxation provides the chief source of revenue for the Government. It diverts resources from what would otherwise be chiefly private-sector activities to the Government, for providing such things as electricity, education, health care, postal services, social welfare services, and other public goods and services. The tax system is made up of different types of taxes assessed on various income sources and expenditures.

Although the term "tax" usually refers to levies imposed by Governments, there are other forms of exaction that could be described as taxes. For instance, there are fees and charges collected to finance Government expenditures. Also, a portion of the trading receipts from Government enterprises are remitted to the public purse. Further, the Government may deliberately choose to finance part of its expenditure by borrowing. When this entails compulsory investment in Government securities by certain entities such as life insurance companies and finance companies, it may be considered to be a form of taxation.



TAXPAYERS' PERCEPTIONS

Many people who believe that taxes are too high, think that the simplest way to reform the tax system would be to reduce taxes. To say that taxes are too high, however, involves subjective judgments. For some, taxes seen too high a proportion of their earnings. For others, taxes seem too high for the quality and quantity of Government-provided goods and services. Some people believe their taxes are too high compared with what they would pay in other countries. And some people believe that their taxes are too high compared with others that they know of with similar incomes but who are better able to avoid or evade taxes.

A taxpayer's point of view about taxation cannot be divorced from a view about central government and its role in the economy. Nevertheless, even if we accept the present level of Government activity, there is a lot of dissent about the present tax system. The following sections look at some of the reasons underlying the belief that taxes are too high.

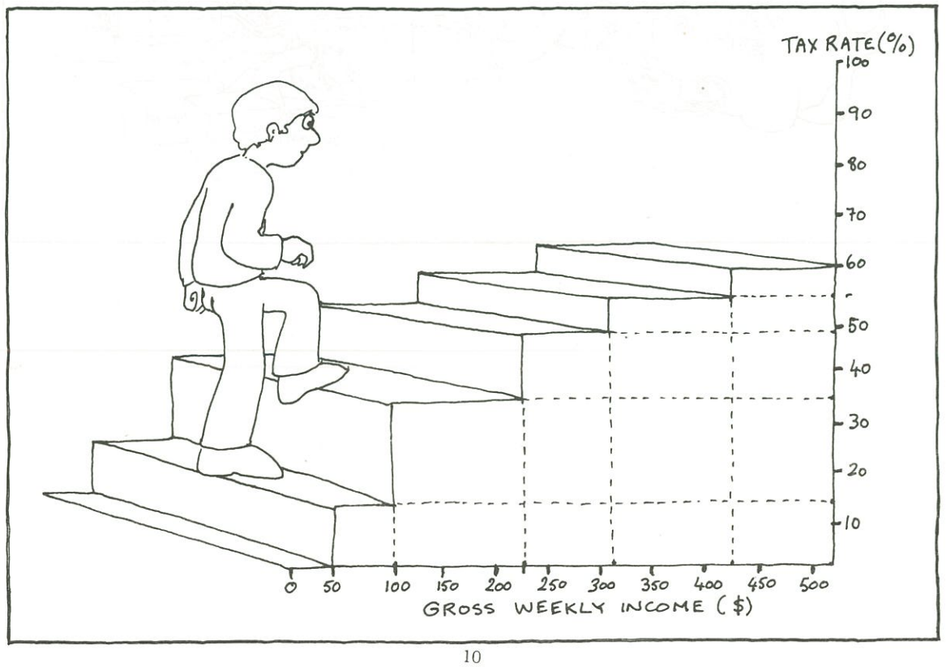
Inflation has a potent influence on the personal income tax. The personal income

Inflation and the Personal Income Tax

tax structure is progressive; in other words, the proportion of tax grows as additional income is earned. Fiscal drag, the effect of inflation on a progressive tax rate structure, has ensured that more tax is collected from personal income tax each year without the need to change tax rates.

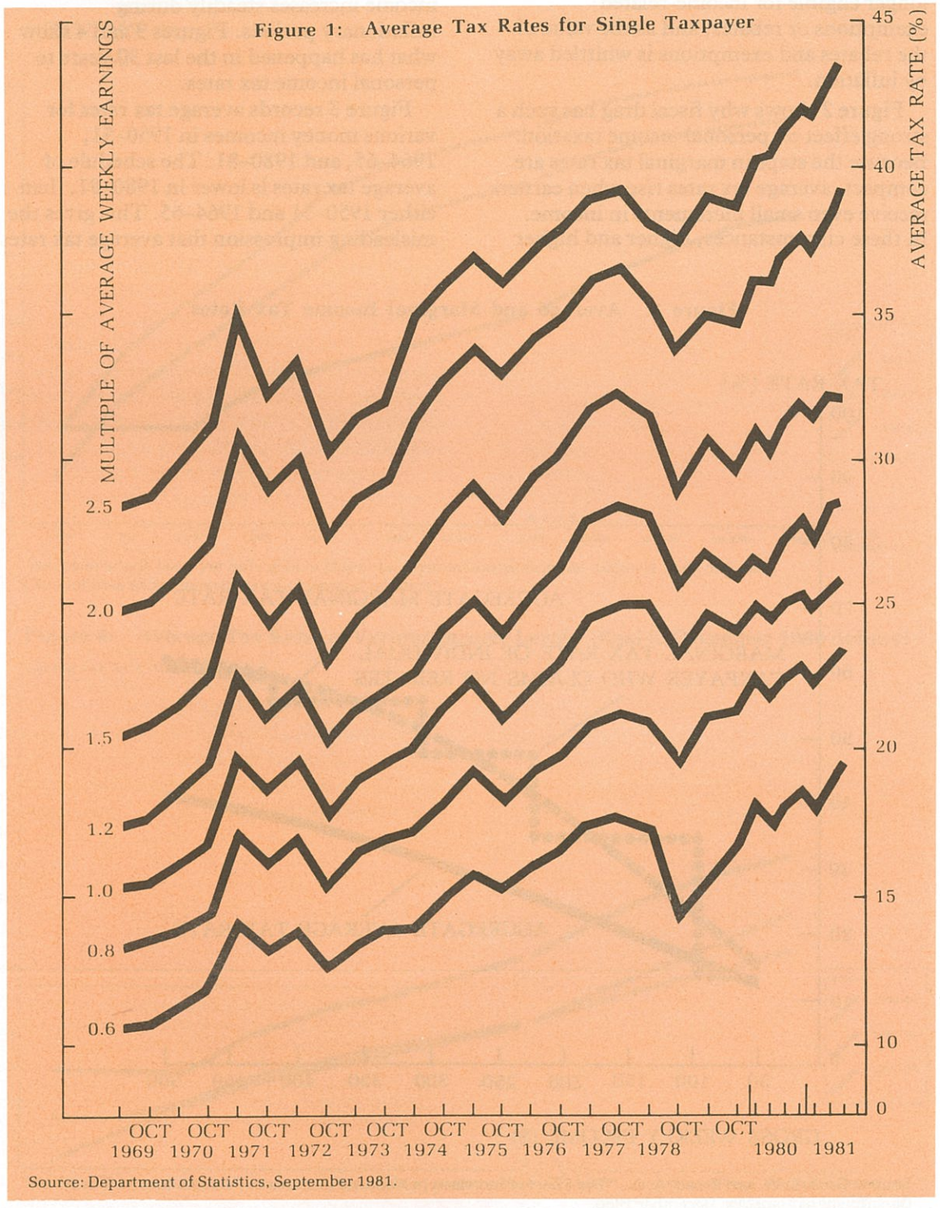
Taxes have risen in relation to just about everybody's earnings in recent years. The rapidity of the rise in average tax rates in relation to rises in earnings can be seen from figure 1 prepared by the Department of Statistics. It shows changes in average tax rates for single income earners with no rebates or exemptions on their money incomes. Clearly the trend was for average tax rates to rise over the decade. This trend has continued into the 1980s.

Recent adjustments in marginal tax rates, and the broadening of income steps subject to marginal rates, have been aimed at helping the average taxpayer, but they have not succeeded in stemming a rise in the average rate of tax. The average tax rate for



average earners rose faster than for those with higher incomes during the 1970s. The average tax rate for the average single income earner rose from over 15 percent in October 1969 to over 25 percent in August 1981 making the rate of tax paid 66 percent more in 1981 than in 1969. The average tax rate for single income earners on 1.5 times the average wage rose from around 20 percent to nearly 33 percent, an increase of 65 percent. The average rate for those on 2.5 times the average wage was 33 percent more in August 1981 than in 1969.

Figure 1: Average Tax Rates for Single Taxpayer



Source: Department of Statistics, September 1981.

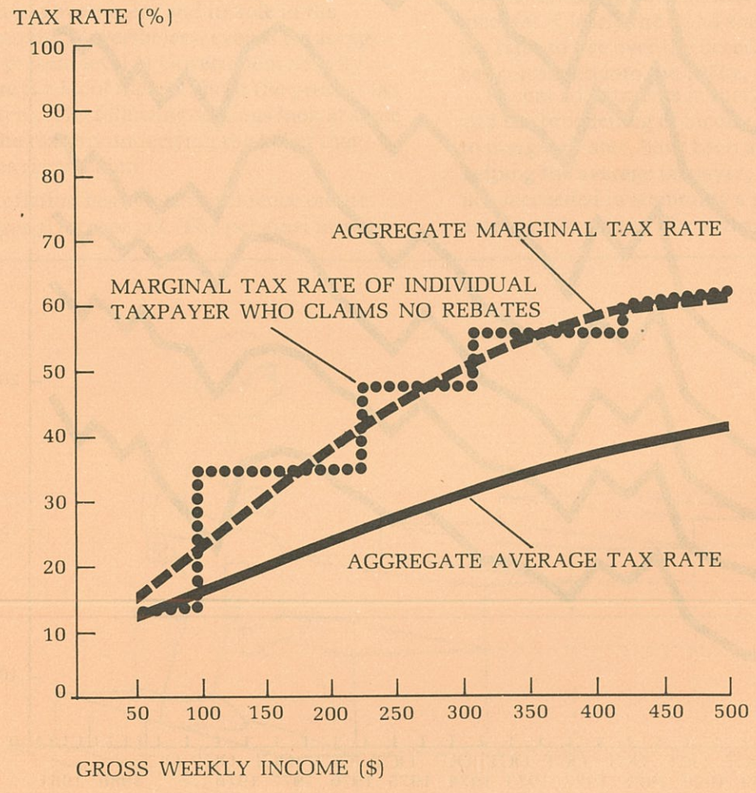
Figure 1 understates the rise in average tax rates for those taxpayers who have increased their incomes because they were promoted or otherwise improved their work status.

Rebates and exemptions reduce average tax rates. But the average tax rate rises rapidly at the point where taxpayers are no longer eligible for income-related exemptions or rebates, and as the value of the rebates and exemptions is whittled away by inflation.

Figure 2 shows why fiscal drag has such a strong effect on personal income taxation. Because the steps in marginal tax rates are compact, average tax rates rise when earners receive even small increments in income. In these circumstances, higher and higher levels of pre-tax money income are required to maintain after-tax purchasing power. When tax steps are fixed in money-income terms, someone whose income has theoretically risen just enough to maintain purchasing power, still pays a greater proportion of that income in tax. Thus Inland Revenue's share of total personal income increases steadily during inflationary periods. Figures 3 and 4 show what has happened in the last 30 years to personal income tax rates.

Figure 3 records average tax rates for various money incomes in 1950–51, 1964–65, and 1980–81. The schedule of average tax rates is lower in 1980–81, than either 1950–51 and 1964–65. This gives the misleading impression that average tax rates

Figure 2: Average and Marginal Income Tax Rates

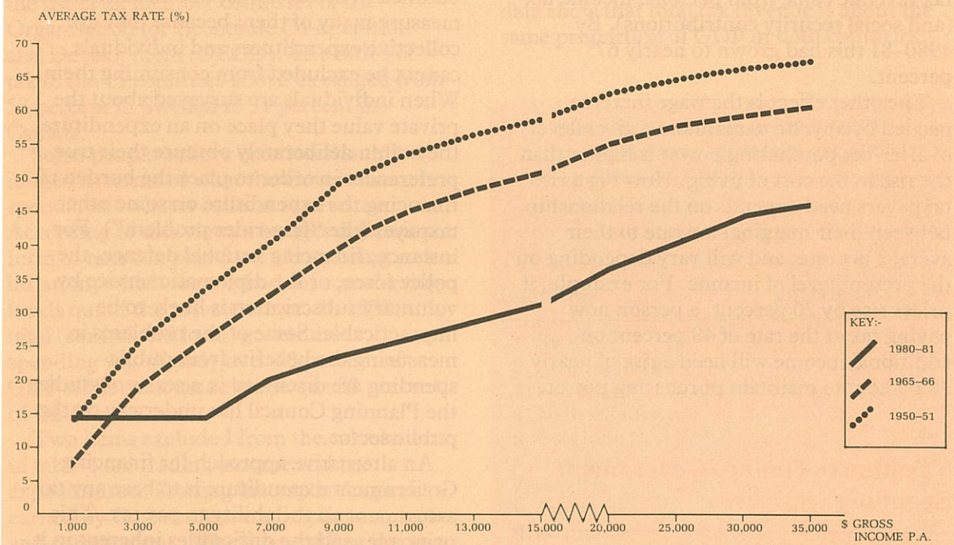


Source: Cook, L. W. and Broad, A. A., "The Effect of Increases in Nominal Incomes in Personal Income Tax Rates," Department of Statistics, December 1980.

for most earners have fallen in the last 30 years.

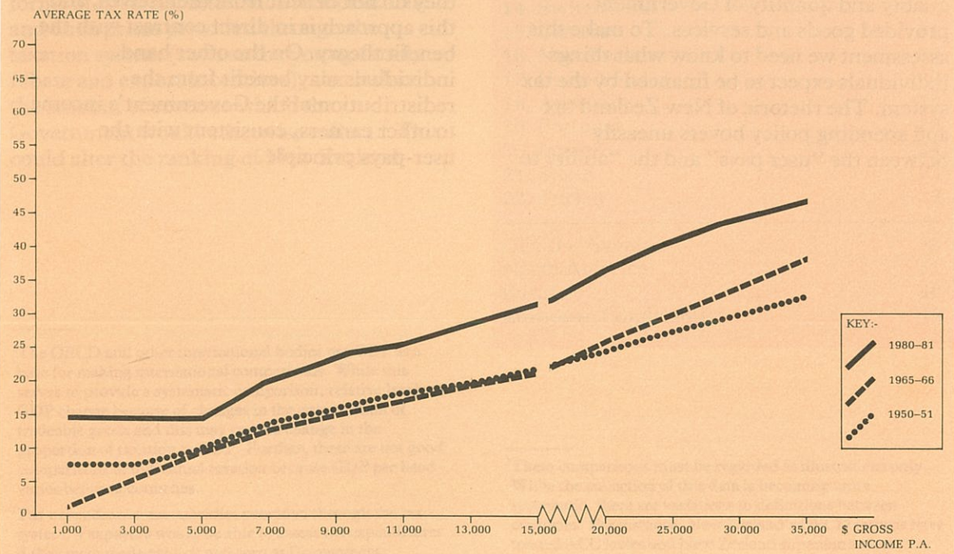
The picture changes markedly if incomes are adjusted for inflation (see figure 4). In terms of purchasing power, average tax rates were much higher in 1980–81 than in 1950–51 and 1964–65. Although Governments have frequently changed the marginal rates of taxation since 1950–51, these changes have not reduced average tax rates in real terms.

Figure 3: Average Tax Rates at Various Income Levels[1] (Nominal)



[1] Assumes single taxpayer only able to claim the personal exemption (for 1950–51 and 1965–66 also includes social security tax and general rebates).

Figure 4: Average Tax Rates at Various Income Levels[1] (Real in December 1980 dollars)



[1] Incomes adjusted for inflation, same assumptions as in graph for nominal incomes.

Two effects of inflation on the personal income tax structure are noticeable. One is that fiscal drag has caused a substantial shift in the balance of taxation towards personal income taxes, away from other taxes such as customs duties, the company income tax, and gift and estate duties. In 1949–50, around 38 percent of central government's tax revenue came from personal income tax (and social security contributions). By 1980–81 this had grown to nearly 67 percent.

The other effect is the wage increase needed by anyone to maintain a given level of after-tax purchasing power is higher than the rise in the cost of living. How big a rise taxpayers need depends on the relationship between their marginal tax rate to their average tax rate, and will vary depending on the present level of income. For example, if prices rise by 20 percent, a person now paying tax at the rate of 48 percent on additional income will need a rise of nearly 38 percent to maintain purchasing power.

Taxation to Finance Government Spending

While it is easy to see that taxes have risen faster than earnings, it is not so easy to judge whether taxes are too high for the quality and quantity of Government-provided goods and services. To make this assessment we need to know what things individuals expect to be financed by the tax system. The rhetoric of New Zealand tax and spending policy hovers uneasily between the "user pays" and the "ability to pay" principles without any clear philosophy.

The user-pays principle says that the amount of tax paid by an individual should be directly related to the benefit derived from public expenditure. This is also known as the "benefit theory" of taxation. The benefits of public spending may be outlined in broad terms, but it is difficult to measure many of them because they are collective expenditures and individuals cannot be excluded from consuming them. When individuals are surveyed about the private value they place on an expenditure, they often deliberately obscure their true preferences in order to place the burden of financing the expenditure on some other taxpayer (the "free-rider problem"). For instance, financing national defence, the police force, or the diplomatic service by voluntary subscription is likely to be impracticable. Some of the problems in measuring the benefits from public spending are discussed in a series of studies the Planning Council has underway on the public sector.

An alternative approach for financing Government expenditure is to base any tax assessment on the ability to pay tax. This principle, and the difficulties inherent in it, are discussed more fully on pages 29 and 30. People with greater ability to pay may end up financing public expenditures which they do not benefit from themselves, and this approach is in direct contrast with the benefit theory. On the other hand, individuals may benefit from the redistribution of the Government's income to other earners, consistent with the user-pays principle.

New Zealand Taxation and Other Countries

New Zealanders are not highly taxed compared with other countries. Table 1 shows that our total tax revenue was about 30 percent of gross domestic product (GDP)[1] in 1978. This placed us sixteenth on the list of 22 member countries of the Organisation for Economic Co-operation and Development (OECD). The ratios of tax in the 15 countries above us ranged from 53 percent in Sweden to 31 percent in Canada.

Some people believe taxation should be judged in terms of what the Government spends, not what it collects in revenue. According to this view, a budget deficit is a form of taxation paid for by borrowing and inflation, which are methods of transferring funds out of the private sector. In 1978, total (central and local) government spending was slightly over 40 percent of GDP while total tax revenue was 30 percent of GDP.

Two items excluded from the calculations in table 1 are trading income and tax expenditures. Trading income is the profit earned by Government trading departments and corporations. When net trading income is included, Government revenue here reached $5,495 million in 1978 or just under 38 percent of GDP. Tax expenditures, forms of financial assistance to individuals and enterprises provided through the taxation system (such as the young-family rebate and export incentives), also reduce the amount of revenue which the Government would otherwise collect.[2] This could alter the ranking of New Zealand compared with other countries that first collect the total in tax and then distribute benefits (to young families, exporters, and so on) through their social welfare or other Government departments.

For many New Zealanders, the belief that we are more heavily taxed is based on a comparison with the level of personal taxation in Australia. Yet the latest OECD data show that total tax revenue is about the same proportion of GDP in both countries.

Table 1: Tax Revenue 1978: OECD countries[3] (as percentage of GDP)

Countries	Total Tax Revenue (includes local government tax)
1. Sweden	53
2. Luxembourg	50
3. Norway	47
4. Netherlands	47
5. Belgium	44
6. Denmark	44
7. Austria	41
8. France	40
9. Germany	38
10. Finland	37
11. United Kingdom	34
12. Ireland	33
13. Italy	33
14. Switzerland	31
15. Canada	31
16. New Zealand	30
17. United States	30
18. Australia	29
19. Portugal	26
20. Japan	24
21. Spain	23
22. Turkey	23
OECD—Average	36
North America	31
Europe	38
European Community	40

[1] The OECD and other international bodies use GDP as a base for making international comparisons. While this serves to provide a systematic comparison, relative levels of GDP change because of changes in the composition of tradeable goods and this may cause a change in the proportion of taxation to GDP. Further, these are not good comparisons of individual taxation because GDP per head varies between countries.

[2] Tax expenditures are subsidies provided through the tax system. Taxpayers would be able to assess tax expenditures if they were made explicit and seen as Government expenditures, which is what they really are.

[3] These comparisons must be regarded as illustrations only. While the collection of this data is becoming more systematic, there are variations in definitions between countries. For instance, New Zealand's OECD returns have treated ACC levies and New Zealand superannuation contributions differently in different years.

Table 2: Central Government Taxation in Australia and New Zealand Compared 1980–81

	Australia	New Zealand
	percent	
Income Tax		
Taxes on personal income	54	66
Taxes on corporate income	14	9
Total Income Tax	68	75
Taxes on goods and services		
Sales tax	6	11
Excises, customs duties, and other duties ...	24	12
Other taxes (payroll taxes, taxes on property) ...	2	2
	100	100

Source: Australian and New Zealand Budget statements 1981.

Table 2 shows, however, that the two tax structures are different. Australia collects a significantly smaller proportion of revenue from income taxes. This permits marginal personal income tax rates to be lower and to spread over a wider range of personal income than here. But Australia is able to get a larger proportion of its revenue from taxes on goods and services than New Zealand, and its resource-based taxes may possibly be shifted to foreign buyers of the resources.

A final note. Any international comparisons must extend to assessing the benefits from Government spending. Perceptions about these too will influence how people accept the tax system.

Anomalies Create Dissatisfaction

Perhaps the greatest source of dissatisfaction with the present tax system stems from a widespread feeling that it is unfair that others are in a better position to dodge paying taxes when their share of the tax burden becomes too great.

Evasion and avoidance are often discussed in the same breath. But there is a sharp distinction between tax avoidance which is legal (even though it may also lead to inequities and inefficiencies), and tax evasion which is purely and simply a criminal offence.

It is widely perceived that tax avoidance is becoming more common. Research is required to show the extent of avoidance and to identify the determinants of a change in the amount of avoidance. High marginal tax rates are a common subject of complaint about the tax system, but it is not clear that these, on their own, lead to avoidance. It might be that New Zealanders want wider earning differentials; in other words, equity is perceived as rewarding some types of work more than others. Tax avoidance may come about (and loopholes in the tax law may have been intentionally designed) so that post-tax rewards are wider than those which are the outcome through the wage-bargaining process.

Income and income tax data of course cannot show just how much tax avoidance and tax evasion goes on. Since taxpayers are not required to list all their non-taxable earnings it is difficult to assess the extent of earnings which escape tax. It is possible, however, to illustrate some instances where those with greater ability to pay will pay less tax.

Non-taxable income earnings

There is an apparent trend for employers to give some employees (usually those with seniority, executive status, or bargaining power) allowances and other benefits which are supposedly non-taxable, rather than wage and salary increases which are. So, people earning similar incomes may pay different rates of tax depending on what proportion of income they can derive in non-taxable allowances.

Table 3 is based on three actual cases. It shows the tax paid by a skilled tradesman on $288 a week ($15,000 a year), and by a salaried manager and salaried employee both on $25,000 a year. The skilled tradesman and the salaried manager have similar average tax rates at quite different levels of remuneration, and despite large differences in their marginal tax rates. The salaried manager and salaried employee have different average tax rates and similar marginal tax rates because their gross incomes differ while the taxable component of their earnings is the same.

Company cars are the main tax-free allowance that firms offer their employees. Although employees often do not have the same degree of freedom in using the vehicle as if they owned it, they benefit substantially from a company car. The company also benefits. But although both the employee and the company benefit fom the provision of a vehicle they both also benefit from that vehicle being tax-free. If the company was assessed tax on the vehicle, or if it raised the taxable salary of the employee to cover the price of a vehicle, its costs would be greater and its profits less. As far as the employee is concerned, most companies are unlikely to pay $12,500 more to a person on $25,000 (to give them an extra $5,000 after marginal tax at 60 percent) to make it possible to purchase a vehicle privately but they would perhaps provide an additional $5,000 gross in salary.

Table 3 is a plausible demonstration of the effects of income exemptions and tax allowances. The allowances are valued at

Table 3: Comparing the Value of Tax-free Allowances (Calculated for March Year 1981)

	Skilled Tradesman	Salaried Manager	Salaried Employee
	$	$	$
A. Annual wage/salary	15,000	25,000	25,000
Less Deduction: life insurance	1,000	1,000	1,000
standard ...	52	52	52
Taxable income	13,948	23,948	23,948
B. Tax assessed	3,930	9,271	9,271
C. *Less* Rebates			
School fees/donations ...	100	175	175
Overtime rebate	20	–	–
D. Tax liability	3,810	9,096	9,096
E. Tax-free allowances:[1]			
Entertainment ($200 net) ...	–	360	–
Home telephone ($144 net) ...	–	1,000	–
Car (annual rate $5,000 net)[2] ...	–	12,500	–
Tea money ($2 per day when overtime)	100	–	–
Tool money ($5 per week) ...	500	–	–
Petrol allowance ($5 per week)	500	–	–
Total Allowances	1,100	13,860	–
F. Total Gross Income (A + E) ...	16,100	38,860	25,000
Total Tax (D)	3,810	9,096	9,096
Average tax rate	23.7%	23.4%	36.4%
Marginal tax rate	48.0%	60.0%	60.0%

[1]Equivalent gross income derived as follows: $\frac{\text{Non-taxed (net) allowance}}{1 - \text{marginal tax rate}}$ e.g. for car $\frac{\$5{,}000}{0.4} = \$12{,}500$

[2]Assumes firm leases car at a cost of $4,200 a year, and pays $800 towards petrol.

the cost to the company. In some cases, this may overstate the additional worth in income terms to employees, because if they had to finance these tax-free benefits out of their own pockets, they might settle for a cheaper car or whatever. Further research is required to find out how representative this illustration is, and whether tax-free benefits are widespread. It is this unknown element which makes taxpayers suspicious of the tax system and imagine that they are disadvantaged compared with others.

Anomalies in the taxation of enterprises

Instances where those with greater ability to pay sometimes pay less tax are not restricted to salary and wage taxpayers. Self-employed individuals, farmers, and businesses face different treatment under the tax law.

A number of income tax concessions provide special treatment for particular taxpayers.[1] Some of these are export incentives; farm development expenditure; the livestock incentive scheme; investment allowances for farmers and fisheries; first year depreciation allowance for farmers, fisheries, tourist establishments, manufacturers and transport operators; regional investment allowances; investment allowances for high priority new plant; and machinery investment allowances.

There are also concessions related to other taxes. Farmers qualify for sales tax exemption. Fisheries may receive sales tax refunds. Manufacturers, transport operators, and businesses may qualify for sales tax refunds on high priority activities. They may also be exempt from sales tax on machinery for export production if they are classified as an industry of national importance, an essential public service, or if they are involved in energy conservation. Farmers are exempt from land tax. While these concessions are aimed at maximising the Government's particular economic objectives, more study is required to see if the desired aims are met. If they are, taxpayers not directly eligible for such concessions may benefit indirectly from a higher living standard.

Table 4 illustrates how two companies producing an identical product with equal sales and profitability pay different amounts of tax because of regional investment incentives. Both invest $500,000 in new plant in the year under study but one company is located in Wellington, the other in Dunedin. The difference in tax payable on identical manufacturing operations is $45,000. The Wellington company pays 57 percent more than the Dunedin company.

Many taxpayers have difficulty understanding investment incentives which vary according to location, export performance, plant utilisation, participation in industry study, high priority status, and the nature of investment.

Another anomaly is created by the industry study programme. This programme is aimed at encouraging companies to restructure and produce more efficiently. Two companies with different products but the same domestic content,

Table 4: The Effects of Regional Investment Allowances

	Wellington Company	Dunedin Company
	$	$
Gross income	1,000,000	1,000,000
Less Manufacturing costs (excluding depreciation)	600,000	600,000
Depreciation	125,000	125,000
Investment allowance (on $500,000 in new plant)	–	100,000
Net taxable income	275,000	175,000
Tax payable	123,750	78,750

[1]These concessions are related to the tax system and may be more precisely called tax expenditures. There are also concessions provided as subsidies outside the tax system which have the same effect of providing an income benefit to the recipient.

the same effective rate of protection, the same location, the same export performance, the same profitability, and the same turnover will pay different tax when one company's product has been through an industry study. Table 5 provides an example of the effect of the investment allowance paid under the programme. Both firms invest $500,000 in new plant but the firm that has been through an industry study pays 267 percent less tax than the other company.

The examples in table 5 show how much tax liability can diverge despite tax units making identical economic contributions. As with export incentive concessions, the Government has decided that the location and restructuring of industry warrants fiscal concessions. These examples do not challenge the socio-economic fairness of these concessions, but they do demonstrate how perceived anomalies occur.

Problems of the taxation period

Individuals and unincorporated enterprises with incomes that fluctuate from year to year pay more tax than those whose income is stable, or to put it in tax jargon "they are disadvantaged by period inequity". This results from having a progressive tax rate structure based on an annual assessment. It affects a number of enterprises, such as farming, where output or sales can vary from year to year.

Table 6 illustrates how two taxpayers, who over 2 years receive the same taxable income, pay different amounts of tax because one of them has a fluctuating income.

Although over 2 years, taxpayers A and B have the same taxable income, taxpayer B pays $2,951 ($11,821 minus $8,870) more tax because in year 2 a portion of income is taxed at the higher marginal rate of 60 percent. The highest marginal rate for A is taxed at 48 percent.

This is another reason why some taxpayers think they are worse off than others. Some classes of taxpayers subject to period inequity have the option of determining the amount of income to be derived in any year. For example, farmers can determine in any year whether gross profits will be channelled into development.

Table 5: How Industry Study Allowances Influence Taxation

	Company Outside Industry Study	Company Completed Industry Study
	$	$
Gross income	1,000,000	1,000,000
Less Manufacturing costs (excluding depreciation)	600,000	600,000
Depreciation	125,000	125,000
Investment allowance (at 40 percent)	–	200,000
Net taxable income	275,000	75,000

Table 6: Period Inequity

	Year 1	Year 2	Total	Average Tax Rate
	$	$	$	percent
Taxpayer A				
Taxable income	15,000	15,000	30,000	
Tax	4,435	4,435	8,870	29.6
Taxpayer B				
Taxable income	5,000	25,000	30,000	
Tax	725	11,096	11,821	39.4

Based on tax rates at April 1981—ignores exemptions and rebates.

More information is needed to assess if many are disadvantaged by period inequity or if this disadvantage is compensated by other factors.

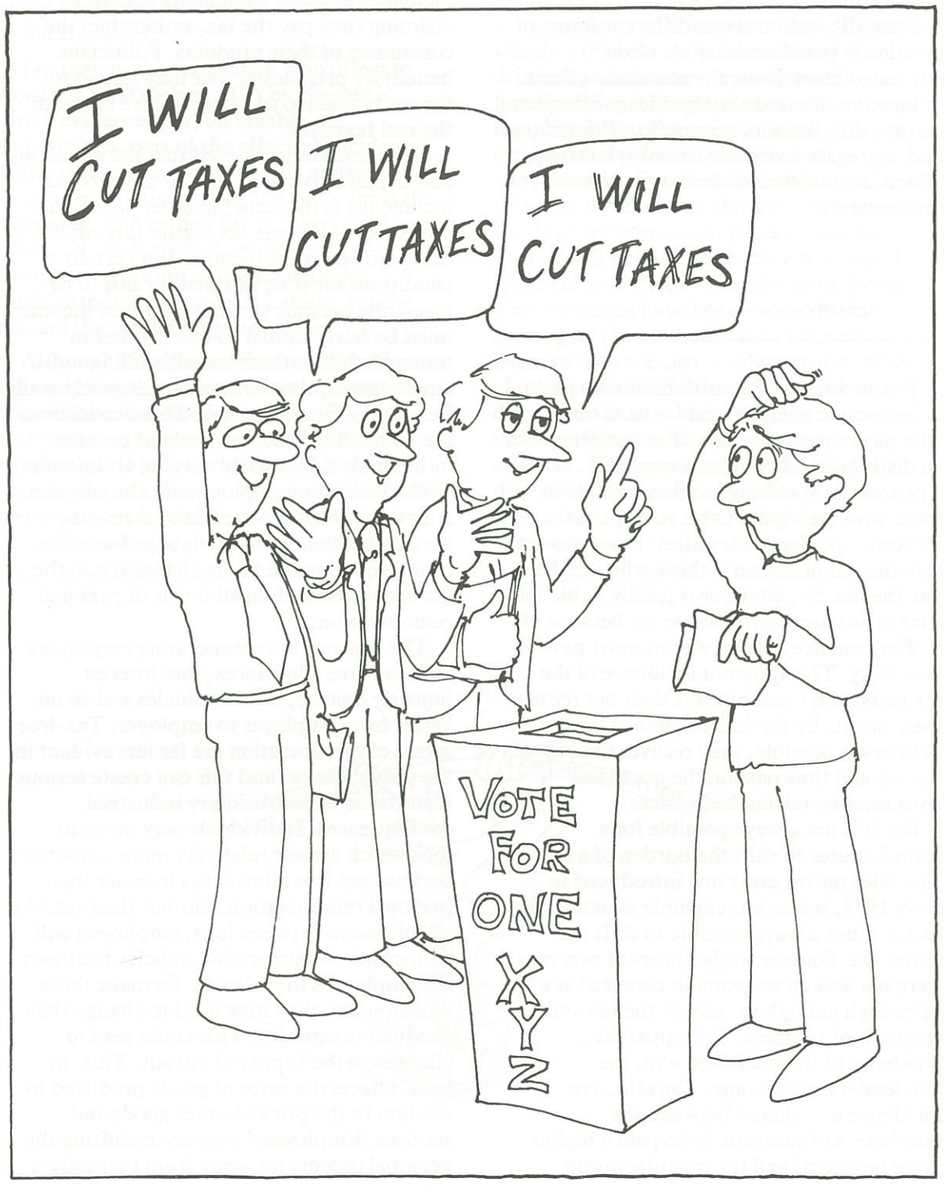
The tax system is unacceptable

The current system of taxation seems unacceptable to just about everybody. This section has outlined some reasons why people think the tax system is in disarray: perhaps because taxes are a high proportion of earnings; or because taxes seem high compared with taxation overseas; or because people no longer find the quantity, quality, and mix of public spending acceptable; or because of a feeling that others have ways of escaping tax which are not available to a particular taxpayer. Further research is needed to show whether this dissatisfaction is justified, and what changes to the tax system would make it more satisfactory.

These direct, noticeable effects of taxation are only the visible part of the iceberg. The next section discusses some of the hidden or less obvious effects of taxation.

THE EFFECTS OF TAXATION

We all are affected by taxes and this shapes our preferences about the kinds of tax and the amounts of tax we would like to pay. The problem is how to account for preferences in any decisions taken to change the tax system. As is obvious from the present tax debate, public preferences are not easy to take into account when it comes to designing a tax system. Taxpayers do not vote directly for tax measures, but for



parliamentary representatives who form a Government which takes decisions about tax measures.

Preferences are not formed in a vacuum but reflect our current (often limited) knowledge about the effects of taxes—how high they are, what they pay for, and who else pays them. Since much of this information cannot be known exactly, taxation is a field full of potholes for the unwary.

Some discussion about different forms of taxation is based on what are often out-dated ideas about the economic effects of taxation. Taxes have significant effects on income distribution, economic efficiency, and aggregate economic activity, but these effects are not always obvious or generally understood.

Tax Incidence

The incidence of a tax defines who pays it. Economic analysis enables us to observe who pays a particular tax. Tax incidence can be distinguished in at least two ways. Apparent or statutory incidence refers to those who are legally liable to pay the tax. Effective incidence identifies those who are actually out of pocket—those who in effect pay the tax. So, whoever is legally liable for a tax is not necessarily worse off because of it. For instance, the breweries must pay beer duty. The apparent incidence of the tax rests with them but this does not reduce their profits by the full amount of the tax. Whenever possible, they recover the cost of the tax and thus pass on the tax to the consumer by raising beer prices.

But it is not always possible for a manufacturer to shift the burden of a tax. The sales tax on caravans, introduced in early 1979, is a recent example which shows that it is not always possible to shift the entire tax. Some manufacturers of caravans were not able to sell enough caravans at a price high enough to recover the tax and went out of business. The apparent incidence of the tax rested with the wholesalers of caravans. The effective incidence was shared between the purchasers of caravans (who paid a higher price for them) and the manufacturers (whose margins fell as the demand for caravans reduced).

In such cases, who really pays the tax depends on how production changes and how the prices of other goods change in relation to one another. Those with an interest at stake (such as merchants and politicians) benefit from taxpayers' confusion about the difference between the apparent incidence and the effective incidence of a tax. Merchants benefit by claiming they pay the tax, rather than the consumers of their products. Politicians benefit by pretending that they intend for the tax burden to rest everywhere but with the real taxpayer.

It is commonly believed that the apparent and the effective incidence of the personal income tax is the same; in other words that the personal income tax is paid directly by those who earn the income. But certain conditions must be fulfilled for this to be true—the persons earning the taxed income must be fairly similar to one another in terms of ability; there must be full employment; the tax must be assessed on all forms of personal income. These conditions are not fulfilled in New Zealand because individuals have widely varying abilities and skills; there is unemployment; the common Australia – New Zealand labour market means that the size of the labour force can change in response to tax changes; and the tax is not assessed on all forms of personal remuneration.

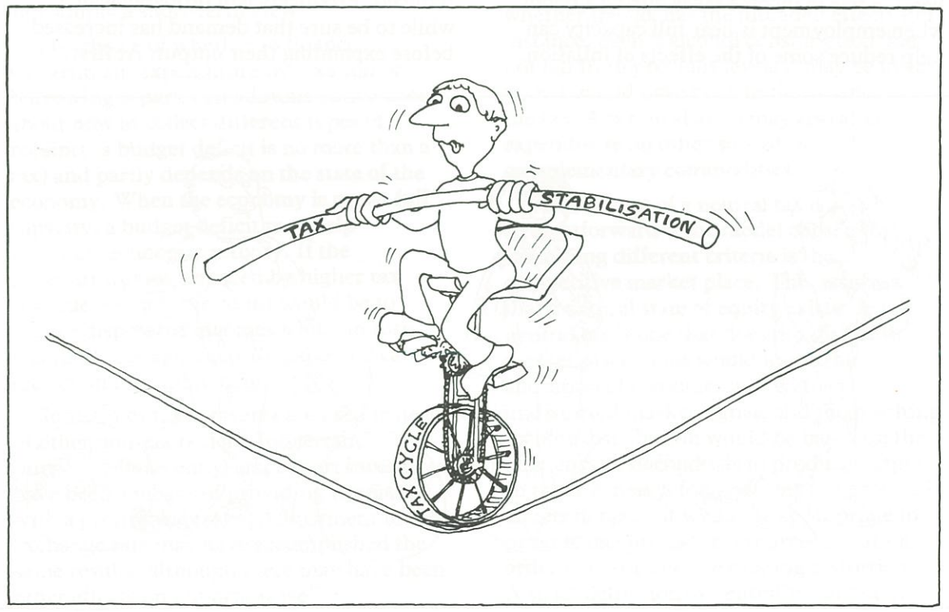
The practice of remunerating employees with tax-free allowances, low-interest housing finance, motor vehicles and so on, varies from employer to employer. Tax-free forms of remuneration are far less evident in the public sector, and this can create serious distortions with subsidiary industrial consequences. Individuals may move to jobs which appear relatively more attractive because tax-free allowances increase their personal remuneration, but not their tax. As people move between jobs, employers will adjust their remuneration policies to attract the employees they desire. To make these adjustments, they may need to change their productive capacity. This could lead to changes in the supply of output. This, in turn, affects the price of goods produced in relation to the price of other goods and services. Employees' success in shifting the personal income tax away from themselves to the consumers of higher-priced goods and services is reflected in the increased prices of goods and services.

The personal income tax can also be shifted from the employee to the employer. Higher marginal tax rates require increases in remuneration more than the rate of increase in the cost of living for living standards to remain the same. If earners are able to obtain rises greater than the cost of living, they are shifting part of their tax on to the employer.

For instance, a tradesman who offers to work for $100 cash or $135 by cheque is direct evidence that, on taxable transactions, part of the effective incidence of the personal income tax falls on the employer (in this case the householder is the employer) rather than the employee. Of course, if the householder agrees to pay cash, he is working in league with the tradesman in evading legal liability for the tax and the public revenue suffers.

Although "incidence" is a useful notion for analysing the general effects of taxation, it cannot be identified precisely. To establish the precise incidence of a tax we would need to know what would have happened in its absence. There are likely to be certain consequences if the tax did not exist. For example, a loss of revenue may result in a reduction in public expenditure. Hence, a better method to explore tax incidence would specify either what other tax would have been imposed, or which item of public expenditure would have been reduced, or how the Government would have met its borrowing requirements to offset the tax. This can become complicated.

Most economists agree that the apparent incidence of a tax is generally irrelevant to who pays it. It is of little practical difference whether the beer duty is levied on beer drinkers, wholesalers, manufacturers, or hoteliers. So, it is sensible to impose the legal liability at the point at which the tax can be collected most cheaply and conveniently. Further, the harder it is for a taxpayer to substitute things for the taxed goods or their means of production, the greater will be the equivalence between the apparent and effective incidence of the tax. The breweries have been successful in passing on the beer duty to consumers because they are also involved in a number of other activities such as producing soft drinks and beer substitutes. The caravan industry found it harder to cope with the sales tax. Firms, unable to sell caravans at the taxed price and also unable to adapt their plant to some other activities, went out of business.



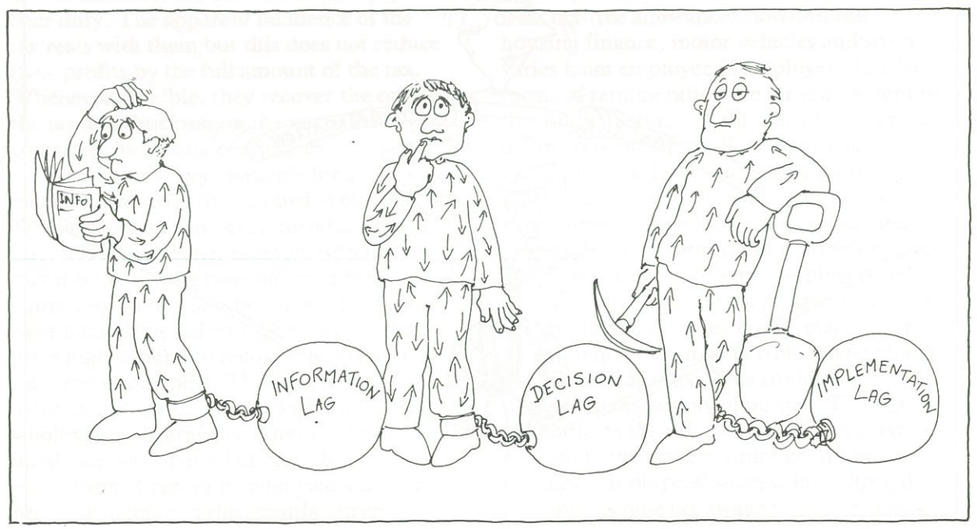
Sometimes the short-term effects as a result of changes in apparent incidence are important. If personal income taxes were reduced but company taxes were increased by the same amount to compensate, then the week after this change took place workers would be better off. But gradually they would become worse off, depending on how much companies then raised prices or reduced remuneration payments to cover their higher tax. These short-term responses could have important macro-economic effects; the shock effect of a tax change can sometimes be all that is needed to stimulate economic activity or depress it.

Macro-economic Effects of Taxation

In the 1930s, economist John Maynard Keynes developed the idea of using fiscal policy to control fluctuations in aggregate demand. Policy, based on changes in Government expenditure and taxation, can smooth out fluctuations in the business cycle. In other words, fiscal policy can help stabilise the economy. For instance, if all other things stay the same and there is some unemployment, a cut in income tax during a recession could lead to more employment and stabilise business activity. On the other hand, a rise in income taxes during a boom when employment is near full capacity can help reduce some of the effects of inflation.

But policymakers have found that using fiscal measures to influence the economy is complicated by many factors such as conflicts between economic and political short-term objectives, difficulties in measuring and timing the effects of different fiscal policies, and problems in distinguishing automatic effects (which are innately part of the economy) from the effects of discretionary policies.

There are three main time lags: an information lag, a decision-making lag, and an implementation lag. Since there are inevitable delays in collecting statistics, it may be some time before policy-makers are aware of a particular problem and once it has been identified, more time may elapse while data are collected to help solve it. Then there is another lag while Parliament, or some other decision-taking body, debates the policy option. Once a decision is taken, there are still lags. For example, if the Government decides to reduce income tax it might have to wait to introduce legislation because of the lead time required to print PAYE tables and inform the public. Major changes may require an April 1 starting date since the personal income tax year begins then. Even when the new legislation is in effect, individuals will take time to adjust their spending patterns. When they begin to spend more, the stock in the shops will be reduced. Producers will probably wait a while to be sure that demand has increased before expanding their output. At first,



more goods will be produced by those working overtime until firms are convinced that it is worth expanding their labour force permanently.

In the past Government budget policies too often have been short-term and *ad hoc*, and shifts in policies have been too wide and too sharp. This has led to uncertainty rather than to more stabilised economic activity. At least initially, instability has delayed adjustment to our overseas deficit, and encouraged rather than dampened inflation. Perhaps it has diverted attention from the pursuit of a more rational, phased adjustment to our external trade difficulties. A well-balanced package of measures designed to achieve a clearly defined set of objectives over the medium term would create more certainty.

A further problem with the short time framework of fiscal policy is that businesses do not trust any long-term pledge by the Government, including tax measures. They make investment plans in an uncertain environment. This must inhibit the speed at which new measures will bite. This applies to tax policy. The effects of tax policies on economic output and on the balance of payments can be large, and certainly greater than the initial change in taxation. For these reasons, it is necessary to take a medium-term view of taxation policy and not simply a short-term view.

The choice of whether to finance Government expenditure by taxation or borrowing is partly an administrative choice about how to collect different types of receipts (a budget deficit is no more than a tax) and partly depends on the state of the economy. When the economy is not at full capacity, a budget deficit may help stimulate economic activity. If the expenditure was financed by higher tax revenue instead, the result would be to reduce disposable incomes which in turn would reduce aggregate demand and cause a reduction in employment.

Sometimes tax measures are used instead of other non-tax policies for certain purposes. In recent years, export incentives have been a means of providing exporters with a profitable return. Adjustment to the exchange rate may have accomplished the same results, although there may have been other effects on imports as well.

Neutrality

The Government often manipulates the tax system, or a specific tax, to encourage what are considered to be desirable things and to discourage undesirable ones. While in clearly defined cases there may be good reasons for putting a tax to this use, there is much to be said for encouraging neutrality. A neutral tax system seeks to raise revenue in ways that avoid distortionary effects.

There are two arguments favouring a neutral tax system and the acceptance of these rests mainly on political judgment. The most common argument is the one mentioned above, that the tax system should influence the behaviour of taxpayers as little as possible. An even more basic argument favouring neutrality is that the effects of taxation are not generally obvious, as the discussion of the distinction between apparent and effective incidence shows. Since the effects of taxation are very often not what they seem, a tax system based on a series of unsystematic and *ad hoc* measures, as ours is, ends up a jumbled mass which lacks a consistent rationale and a coherent structure. When a tax is designed for a specific purpose (such as a tax on alcohol designed with the intention to discourage alcohol consumption) so many things result from the tax that it is difficult to know whether the tax has the intended effect. For instance, even if alcohol consumption does not fall from previous levels it may be lower than it would have been in the absence of the tax. A tax on alcohol may also affect expenditure on other substitute and complementary commodities.

The concept of a neutral tax is straightforward if the model chosen for examining different criteria is the competitive market place. This assumes that a natural state of equity exists. A neutral tax is one that does not distort the market place. This would lead to an allocation of resources guided by undistorted market signals and the resulting income distribution would be based on the efficiency of individuals to produce output. In other contexts for analysing the economic effects of taxes, it would be appropriate to provide incentives for resource allocation in order to neutralise the existing distortions. A strict definition of neutrality cannot be

easily applied in the real world because the market place is distorted by institutions, such as governments, with a non-competitive share of market power. Systematic analysis is required to discover the effects of a policy because it will not be satisfactory to merely apply the criteria of neutrality.

It is often asserted that a tax, or tax system, should be neutral in respect of the legal status of marriage or child rearing, or for a free choice between earning income or a capital gain. Many would argue that the present tax system is not even neutral according to these criteria.

Tax Capitalisation

Like taxes, tax concessions may affect the prices of goods on which they are assessed. They can have a long-term influence when capital goods and financial assets are involved. Tax capitalisation exists when a tax concession is built into the capital value of these goods. The main beneficiaries of tax capitalisation are those who hold an asset at the date when a tax concession on it is introduced. Subsequent holders of the asset would lose if the concessions were discontinued. In effect, they have bought the right to the concession from the former holders, and would have part of their savings invested in the capitalised value of the tax concessions. They would be disadvantaged if this tax advantage were eliminated. Not only would they be worse off by virtue of their having to pay extra tax, they would be additionally worse off because the asset they hold is likely to fetch much less on resale.

Tax capitalisation traps policy-makers. Since selectively taxing assets influences the prices of assets and does not benefit later owners of assets, it could be argued that it would be better if the concession had never been given in the first place. Once given, to withdraw it could cause hardship. One way around this problem is to let inflation gradually reduce the value of the concession in purchasing power terms.

There are numerous examples of capitalised taxes in the New Zealand tax structure. Life insurance is one of the most important. Last year New Zealanders were able to put about $160 million into insurance investments which would otherwise have been tax revenue. The usual argument favouring tax exemption for insurance is that it enables the Government to subsidise the cost of insurance and so encourages insurance investments. To some extent, this is what actually happens—as is evidenced by the many taxpayers who buy insurance up to the total tax-free level of $800 on subsidised schemes and $1000 on unsubsidised ones. In the long-run, however, this subsidy may have been built into the price of insurance which probably costs more than it would if it were not exempt from tax. During the recent recession many insurance companies have been under financial strain and would probably have been disadvantaged if the exemption had been removed. But some of their loss of profitability might be caused by the tax concession. Because the cost of insurance has been protected by the tax advantage, those in the insurance business have not been able to pick up warning signals (as their clients react to changes in the price of insurance) and may have made poor investment decisions as a result. On the other hand, tax advantages may have enabled insurance companies to take greater investment risks which are required to offset their low return on compulsory investments in Government securities.

Other examples of tax capitalisation are the first home mortgage rebate, interest exemptions on building society investments, and tax relief given on agricultural land. Exemption for the land tax, which offers substantial financial relief, is intended to assist working farmers. But the capitalisation of such concessions makes the price of land ridiculously high compared with the return it can yield. This creates special difficulties for many farmers who wish to purchase their first farm.

The Excess Burden of Taxation

Any tax diverts resources from the taxpayers to the Government and leaves them worse off by that amount. There is also a less obvious cost which economists can identify. This is the effect of taxation distorting behaviour so that the most efficient patterns of production and consumption are not achieved. This is called the "excess burden" of taxation.

Suppose John Smith earns $6 per hour and his employer is willing to let him work as many hours as he desires at that rate. If a 25 percent flat-rate tax were assessed on this income, then John Smith's take home pay would be reduced to $4.50 an hour. Given this rate of pay, he chooses to work 40 hours per week, thus paying $60 in tax each week. For a little more than $4.50 per hour, he might be willing to work more than 40 hours. If he could get $6 an hour clear, John would happily stay after work one or two evenings a week. Then he would benefit from the extra pay and his employer would benefit from the extra output. And if the $60 paid in tax were levied not as income tax but as a set weekly contribution to public revenue, which he was obliged to pay regardless of how many hours he worked in a week, then his net earnings from overtime would be $6 an hour and he would decide to do it.

If John had the opportunity to do so, he would pay a lump sum tax and then work several more hours per week, making a contribution to increased economic output. But the personal income tax structure, scaled at increasing marginal rates, makes this opportunity unattractive. The problem arises because the tax depends on how much John chooses to work and how much time he chooses for leisure. The more he works, the more he earns. The more he earns, the more he pays in tax. This discourages him from working for more money because the monetary gain is not enough to compenstate for the leisure time he loses. This implies that the loss in output imposed by the tax is greater than the value of tax collected. The idea that income taxes have undesirable effects on output is formally defined as "excess burden" by economists.

Excess burden effects are not restricted to personal income taxes; they are rife throughout the entire tax system. For example, if a Split Enz record could make a

profit at $6 and provide $1 tax revenue at $7, but because of sales tax sells at $10 (a price which discourages buyers who would willingly pay $7) then there is an excess burden. At $7, production costs would be more than covered. If there were more buyers at $7 than there were at $10, it is possible that the Government would receive more revenue as well. Because of the tax, these things do not happen. There is a disincentive effect to buy recordings and this imposes an "excess burden" or welfare loss of the same kind as the personal income tax example discussed above.

Tax and Social Welfare

Taxes have two effects on individual welfare. There is an income effect, which reduces a taxpayer's net income because part of it is compulsorily transferred to the Government. There is also the excess burden effect, which reflects additional output losses arising from the way a tax is levied. The total social and economic welfare is the sum of the two.

Although the disincentive effects of taxes reduce welfare because of their excess burden on individuals, it does not necessarily follow that reducing taxes would increase the hours of work taxpayers put in. Taxes have an income effect (they alter the real incomes of taxpayers). They also have substitution effects (the taxpayer substitutes leisure for work). In the example above, the excess burden of John Smith's tax could be eliminated by transforming the 25 percent income tax to a fixed tax of $60 per week. The income effect of the tax could be eliminated by abolishing the fixed tax of $60 per week. But then the worker might decide he could achieve the same standard of living ($180) by working 30 hours, rather than 40 hours per week.

CHARACTERISTICS OF A GOOD TAX SYSTEM

Although there has been much complaint about taxation in New Zealand, and there have been a number of proposals for change, little of the debate has concerned the characteristics of the tax system as a whole. It is therefore difficult to judge what would be generally acceptable in terms of structure and purposes. To get to grips with this problem we turn in this section to some of the traditional methods of assessing a good tax system.

A tax system may be composed of one or several taxes. Individual taxes may be known to have certain effects, but the nature of the tax system depends on the way in which these particular effects interact with those of other taxes.

A good tax is fair in terms of taxpayer's ability to pay it. It is simple and certain so that two taxpayers in similar circumstances pay the same amount of tax. It is convenient for the taxpayer to pay, and is inexpensive to collect.

Individual taxes combine into a tax system. The design of a tax system should be tested to see that:

- It is composed of good taxes;
- It burdens everyone fairly;
- It stimulates an efficient allocation of resources;
- It has a neutral effect on economic, political, and social behaviour;
- It meets the Government's intended aims;
- It is acceptable.

The "ability to pay" principle implies that people with more of what is taxed (be it income or wealth or whatever) should pay more of the tax. This principle is interpreted in quite different ways in practice. On the one hand, some say that the ability to pay increases with additions to income and the tax structure should be progressive. On the other hand, some say that the ability to pay principle is reflected by a proportional tax structure where the absolute amount of tax increases with income but the average tax rate stays the same.

There is a catch. Since the currency of taxation is cash, ability to pay is defined in terms of taxable cash income, not unrealised wealth or non-cash allowances. As taxation becomes more onerous, the existing system encourages a change to non-taxable non-cash income and the accumulation of non-assessable capital reserves. It is often argued that taxpayers on higher incomes have more ability to avoid tax in this way, so that the intent of the ability to pay principle is violated.

In a tax system, "equity" is related to the "distributional consequences"—the fairness of the tax system. A commonly held view is that the tax system should redistribute income because taxpayers are unhappy about the distribution of income produced by the operation of the market-place. How far the tax system succeeds depends on the combined effects of the individual taxes in the system. For instance, a progressive income tax (which takes a larger proportion of higher incomes) could offset a regressive tax (a tax which rises as incomes fall), resulting in a tax system which taxes most households at a proportional rate.

"Economic efficiency" measures whether resources are allocated to their best use. The efficiency of the tax system is not the same as an "administratively efficient" tax, which is a convenient and inexpensive tax to collect. Free-market supporters argue that the market is the best means of allocating resources to the best use. An efficient tax system would not interfere with the market mechanism and this would also be a neutral tax system. Supporters of Government intervention would argue that certain activities use resources more efficiently than others and an efficient tax system encourages them.

Regardless of whether a free-market or interventionist stance is taken, an efficient tax system is likely to channel resources towards the particular sectors of the economy which are productive and away

from sectors which are not productive. Yet equity usually demands the opposite flow; so that resources are taken from the "haves" (who were rewarded for being productive) and distributed among the "have-nots" (whose income is smaller because they are less productive). The problem is to design a tax system that makes the best trade-off between equity and efficiency.

As far as the Government is concerned, taxation has four functions:

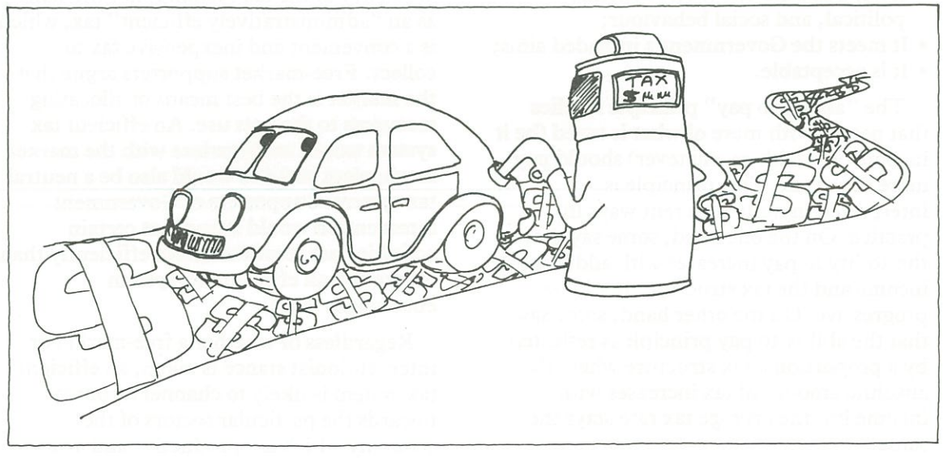
- To provide the bulk of revenue to finance necessary Government expenditure.
- To act as an instrument to achieve Government's economic stabilisation aims.
- To provide a means for redistributing income.
- To act as an instrument by which the Government can alter signals in the market place for various purposes. (For example, export incentives or foreign exchange taxes are intended to improve the balance of payments.)

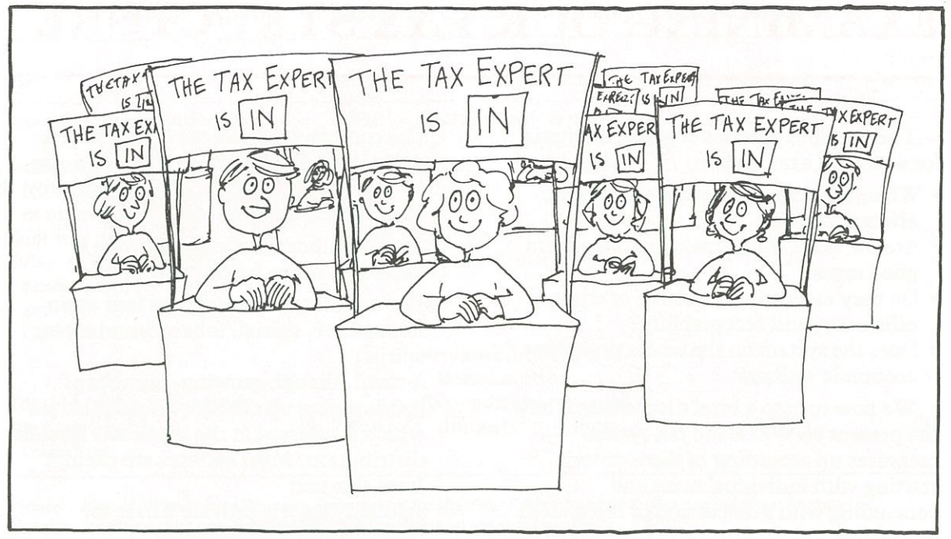
While it is possible for the tax system to achieve all four functions, no one tax can fulfil them all at once. In fact, it is better that the Government design individual measures with only one specific aim. This has the advantage of making Government intentions explicit so that taxpayers can readily assess whether objectives have been achieved. Further, when a measure has only one aim, policy makers are provided with a clear guideline for fine tuning a tax measure when it goes off course.

Problems arise when taxes are expected to achieve inconsistent aims. For instance, it has been claimed that a tax on petrol will reduce petrol consumption. Yet the tax has been the chief source of increased revenue for highways development and local authority road improvements (which may encourage road usage). If the real intention of the tax is to reduce consumption, it must raise the price of motor spirits to such an extent that people use less petrol. Then the increase in revenue from the tax is less than it would be if the petrol price stayed the same.

There has been a tendency to overload the tax system with measures that have conflicting aims—sometimes at the expense of raising revenue, stabilising the economy or redistributing income. For instance, export incentives are tax measures designed to benefit exporters. But these have reduced the amount of revenue collected from company income tax. They may not redistribute income in the preferred way since many companies benefit by paying no tax or even receiving tax credits. Even worse, tax concessions may not be fulfilling their intended aim to direct resources if they are bonuses to businesses for behaviour they would undertake anyway. Also, a properly valued exchange rate might be a better means of encouraging exports than export incentives.

Finally, any tax system must be reasonably acceptable to most taxpayers. The system relies on taxpayer compliance to





fulfil its primary goals, Tax evasion and severe pressures on the Government to introduce more allowances and exemptions, or the multiplication of loopholes for taxpayers to avoid paying tax, would suggest that the system is becoming unacceptable. A proliferation of books and businesses dispensing advice on how to avoid tax is further evidence of this.

Dissatisfaction with tax could be part of a more general dissatisfaction with living standards. Recent economic conditions would have contributed to reductions in purchasing power and may have reduced living standards, even if there were no tax system. The tax system has added to the pain caused by these other economic forces. Because it is easy to measure the amount of tax siphoned off income, but it is not easy to identify the reasons for falls in living standards, taxation gets the blame.

Governments have tried to repair some of the damage to family living standards created by economic conditions, but the attempted redress has not soothed the taxation irritation. Decision-taking in the past few years had tended towards piecemeal changes. There have been some changes to the personal income tax scale, special rebates have been designed to assist low-income families, and several concessions have been introduced to help overcome structural weaknesses in our internal economy and widen our export and manufacturing base. Taxpayers have remained dissatisfied because the changes have not offset declines in purchasing power and because the changes have made the system appear more inequitable to many unable to benefit from the specific concessions.

EXAMINING OUR TAX STRUCTURE

The previous sections suggested criteria for assessing a tax system:

- What do we know about the economic effects of taxes?
- Are the taxes which make up the system good taxes?
- Do they meet with standards of equity, efficiency, and acceptability?
- Does the system on the whole promote economic welfare?

We now turn to a brief discussion of how the present New Zealand tax system measures up according to these criteria, starting with individual taxes and concluding with a discussion of the system as a whole.

The Tax Base

Taxes are assessed on a wide variety of sources and uses of income. The sources and uses which are subject to tax are called the tax base. Table 7 shows that the tax base has shifted in the last 20 years, and a greater proportion is now collected from the personal income tax.

Nearly 75 percent of tax revenue is collected from the income tax which has two main bases:

- The personal income tax base which is made up largely of wage and salary income, as well as self-employed, farming, partnership, and sole-trading earnings: this base is reduced by tax-free allowances, exemptions, and other deductions.
- The company income tax base which is derived from company profits. The size of the base is reduced considerably by the concessions outlined on page 32.

The remainder of the tax revenue is collected from the following bases:

- The excise tax base includes four main items: beer, spirits, tobacco, and motor spirits;
- A small, though growing, number of goods makes up the base of our sales tax which is assessed at the wholesale level of distribution. Most services are exempt from this tax;
- Selected imports provide a base for customs and import duties;
- Wealth and gifts provide a base for estate and gift duties. Exemptions and avoidance narrow this base substantially;
- Property, usually valued at its unimproved value, is the base of the property rates assessment;
- A number of activities are liable for a "permission-to-use" tax; for example, some road use is taxed by road-user charges.

Most activities carried on by charities, and non-profit organisations (such as the Rugby Union, churches, and co-operatives) are legally exempt from taxation or pay it at a special rate. The legal exemption of certain activities from tax reduces the tax base.

One criticism made about the base underlying the present tax system is that it is too narrow, and another, that different

Table 7: The Changing Pattern of Central Government Taxation

	1960	1965	1970	1975	1980
			(percent)		
Personal income tax[1] ...	41	42	46	59	64
Company income tax ...	18	23	20	15	10
Estate and gift duty	5	3	2	2	1
Taxes on goods and services ...	36	32	32	24	25
Total	100	100	100	100	100

[1] Includes social security tax in 1960 and 1965.

Source: *The Budget*, for selected years and Annual Reports of the Inland Revenue Department.

Table 8: Approximate Effective Central Government Tax Rates 1980–81

Tax	$ million	Base[3]	$ million	Tax as % of base
Income tax, individuals ...	4,710[1]	Compensation of employees	13,480	35
Income tax, including individuals and companies	5,299[2]	Total private income ...	22,095	24
Customs duty	349[2]	Imports	7,380	5
Sales, excises and other taxes on goods and services (excluding Customs duty) ...	1,352[2]	Private Consumption ...	14,720	9
		Private and Public Consumption ...	18,700	7
Total taxation including tax on wealth transfers	7,051[2]	Expenditure on gross domestic product ...	23,970	29

[1] Source: *Report of the Inland Revenue Department for the Year Ended 31 March 1981*. Includes net income tax individuals, non-resident withholding tax, and absentee income tax.

[2] Source: *The Budget 1981*.

[3] Source: NZIER Estimates *Quarterly Predictions*, June 1981.

parts of the tax base are taxed at different effective rates. Table 8 shows how much the tax base is dominated by taxes on income. This suggests that average and marginal tax rates on personal incomes could be reduced if a broader base were taxed or if the burden of taxation was shifted to other bases. While the total amount of tax collected would remain at about the same level, the distribution of the tax would be different. If the new distribution were more acceptable to taxpayers, it could lead to increased productivity and growth, and an eventual fall in tax as a proportion of GDP.

Evasion and avoidance

Tax evasion and tax avoidance narrow the tax base. For example, there is much anecdotal evidence that some people deliberately secure jobs on a cash payment basis and do not declare this part of their income. These tax evaders are being abetted by people who are happy to accept services at less than normal prices in return for paying cash and asking no questions. Most bartering of goods and services is a legal way of avoiding tax, but it also reduces the tax base.

Tax evasion and tax avoidance are not limited to personal income taxation. Sales tax liability is also avoided through businesses reorganising their operations. Manufacturers are increasingly selling either to retailers or directly to the public, cutting out the wholesaler. This process does not preclude collection of the wholesale sales tax, but it does make the basis for calculating the amount of tax less certain. Another way to reduce the apparent tax base is to charge separately for packaging and promotional costs.

Personal income provides the main base of the present tax system. The taxpayer tends, therefore, to be taxed on a higher level of earning the income than on spending it. Since most taxpayers earn income taxed at source, their only means of avoiding tax is to increase their leisure. A switch of the tax base so that a greater proportion of taxation is collected from goods and services could give the taxpayer a greater choice between spending and saving. In an economy such as ours which could benefit from additional investment, encouragement to save could provide a useful investment resource.

New Zealand tax practice has defined the tax base such that income earnings are generally subject to tax while capital earnings are not. This causes individuals and companies with that option to spend considerable energy identifying new sources of capital gain rather than increasing their

income. Perpetuation of the distinction between capital and income is responsible for a large part of tax litigation. At present two areas stand out:

- Endeavours by corporate entities to set up reserve accounts for shareholders from share premium accounts.
- The myriad of deduction cases which are fought—usually over whether a deduction is of an income or capital nature.

The non-taxation of capital gains encourages considerable speculation in property and other assets thought likely to gain in capital value. Taxing income and not capital may also encourage developments which use capital-intensive, rather than labour-intensive, methods because the tax increases the cost of labour in relation to capital. Also, the tax system encourages investment in real capital assets rather than financial assets because it allows capital asset holders to be protected while those with financial assets have the value of their asset eroded by inflation.

A decision to change the tax base will depend on whether it is possible to define and value income sources and uses so that any taxes assessed meet ability to pay criteria and are fair, convenient, and inexpensive to collect. Equity and efficiency arguments favour some widening of the base.

The Income Tax Act 1976

Treatment under this Act can differ quite markedly for wage and salary earners, self-employed individuals, partnerships, farmers, low-income families, and companies. The average rates of tax paid by businesses vary depending on whether they are incorporated and depending on whether the business operates a farm, a fishing boat, a forest, a factory, or something else for which it receives a tax concession.

Wage and salary earners

Tax collected on wages and salaries generally is pay-as-you-earn and scores highly on two counts in terms of the characteristics of a good tax. PAYE is both an effective and a convenient way to collect revenue. But because the tax is now complicated by rebates, exemptions, and exceptions to the law, it is becoming more and more costly to collect. Although the tax is still convenient in the sense that the employers of salary and wage earners use PAYE tables, the requirements (to be introduced in the 1982 tax year) that allowances be listed on the IR12 form, and that taxpayers be classified according to family status, is making source deduction less convenient for employers.

Taxpayers' preferences about ability-to-pay criteria are unclear. The "personal income tax", as the tax on wages and salaries is commonly called, can reflect ability-to-pay criteria through its graduated scale and marginal tax rates or by a proportional (flat) tax. Some taxpayers believe that the ability-to-pay criteria are violated no matter which definition is applied because those on higher incomes have more opportunities to avoid tax, though there are no comprehensive data to support this belief. There is plenty of evidence though, that as tax rates have risen, more rebates and exemptions have been added so that the system has become less certain and simple to administer, and those with equal incomes and circumstances are no longer treated equally.

It is difficult to assess whether the personal income tax adequately meets standards of equity because the available data describing the personal income tax are out of date and inappropriate. The latest statistics are for 1977–78. Table 9 illustrates that about 70 percent of New Zealand taxpayers were grouped around the middle income brackets. Although effective tax rates rise with income, a large proportion of tax is paid by those on middle incomes. These effective tax rates are calculated by measuring the percentage of total income reported for inland revenue purposes which is paid in taxation. Tax-free allowances and capital gains are excluded. If they were included, the effective tax rates would be lower for some taxpayers.

Economists have different opinions about the incidence of the personal income tax. The mainstream view is that the personal income tax lives up to its popular label as a

Table 9: Income Distribution and Taxation: Income of Persons by Amount of Total Income 1977–78[1]

Income	% of individual tax returns[2]	% of total income	% of total tax assessed	effective tax rates (%)
Under $2,000	15.7	2.4	0.5	5.5
$2,000–$5,999	38.0	24.6	16.1	16.5
$6,000–$9,999	31.9	39.7	37.3	23.7
$10,000–$13,999	10.0	18.5	22.4	30.5
$14,000 + ...	4.4	14.8	23.7	40.6
Total average tax rate				25.2
Total	100.0	100.0	100.0	

[1]These were the latest figures available in October 1981.

[2]Figures include returns furnished for losses and nil income.

Source: Department of Statistics, *Statistics of Incomes and Income Tax 1977–78.*

direct tax. That is, the tax is paid by the person legally liable; it is a tax which stays where it is put and is not shifted. In order to reach this conclusion, a number of restrictive assumptions are made. These probably do not apply in New Zealand (the reasons have been elaborated on page 22). To the extent that the personal income tax is shifted to the prices of goods and services, it is shifted away from those who were legally liable for the tax. Since low-income households tend to spend a larger proportion of their incomes on goods and services, this can bring a regressive element into an otherwise progressive income tax scale. This regressivity may be increased if these same households have less access to tax-free allowances and if they are outside the formal wage bargaining system.

The young family rebate and the low-income family rebate are intended to reduce average taxes for families whose taxable incomes are below a certain level. The removal of the personal rebate in 1978 was intended to bring about a fairer distribution of the tax burden between households on similar earnings. The overall aim of these recent policy measures was to make the income tax scale more progressive.

But not all of the 15 personal income tax rebates redistribute incomes from high incomes to low incomes. Sometimes a rebate is yet another way of reducing tax for those with the greatest ability to pay. Those on high incomes may be able to spend more money on school fees, mortgagee vendor interest, and charitable contributions which also qualify for tax rebates.

Self-employed and others

About 8 percent of tax returns are filed by individuals who receive mainly self-employment income rather than salary and wage income. These returns account for around 17 percent of total assessable personal income. The definition of assessable income for the self-employed (including partnerships, sole traders, and other situations where the individual runs an unincorporated enterprise) differs from the definition for wage and salary earners. There are greater opportunities for deducting expenses incurred while deriving an income. Self-employed taxpayers pay provisional tax twice a year on an estimate of their annual earnings, rather than monthly PAYE.

The Department of Statistics has not been able to record the exact number of self-employed earners over recent years because of delays caused by computerisation of tax returns. This means we cannot accurately compare the position of the self-employed with persons who are taxed mainly on salary and wage income. Table 10 reports the most up-to-date figures and must be regarded as indicative only of the numbers and total income of self-employed by source of total assessable income.

Table 10: Numbers and Total Income of Self-employed by Source of Total Assessable Income 1978–79[1]

Source of Total Income	Number of Returns	Total Income ($m)
Agriculture and livestock production:		
Dairy farming	26 000	214.5
Sheep farming	23 000	278.3
Other farming	17 200	151.4
Total Farming	66 200	644.2
Manufacturing	4 300	34.2
Construction	15 150	123.9
Wholesale and retail trade, and restaurants and hotels	14 200	120.0
Transport and storage	5 150	45.9
Business, community, social and personal services	21 200	338.9
All other industries	4 600	37.1
Total Self-Employed Persons	130 800	1,344.2

[1]Includes all forms of assessable income, but major earnings are self-employed income.

Source: *Income and Income Tax to 1979*, Department of Statistics.

Although the self-employed group is small, it is very important in terms of equity and the design of a better tax system. Clearly more detailed income and expenditure information is required before proposals for change can be made. The main difference between self-employed and wage and salary taxable income is the expenses of the self-employed which are exempt from tax. Analysis is required to see if the tax law treats these two groups similarly. It seems likely that rebates intended to play a redistributive role have a different effect on the self-employed than on wage and salary earners.

Companies

Companies have many advantages (including limiting liability) which makes them peculiarly suitable for modern forms of economic activity. They are able to undertake investment, at less personal risk for the shareholders, and they have more power than several unaligned individuals. The effect of taxation on company activity and growth is therefore of major significance in any review of the structure of taxation.

Table 11 records the latest Department of Statistics information about company returns. It shows about 80 percent of company tax is paid by about 3 percent of companies, but this is misleading because the data are collected in terms of assessable, rather than total income. Although this table suggests that the big companies pay a major proportion of company tax, it does not show that some of our largest companies

Table 11: Distribution of Company Incomes and Tax Payments 1977–78[1]

Income status of companies[2]	Companies filing returns	Assessable company income	Company tax paid
	(percent)		
Incomes of less than $2000	64.4	0.8	0.9
$2000–$19,999	24.6	7.3	7.3
$20,000–$99,999	7.5	14.3	14.3
$100,000–$999,999	3.1	34.1	34.5
$1,000,000 +	0.3	43.5	43.0

[1] These were the most up-to-date figures available in October 1981.

[2] This table covers only those companies with assessable income.

Source: *Monthly Abstract of Statistics*, January 1981, Appendix 1.

pay no tax at all. Companies that pay little tax would record low amounts of assessable income and would appear in the lower income brackets, even if they were large in terms of turnover or assets.

The company tax for proprietory companies provides shareholder-employees with an opportunity to derive an income from salary, dividends, or interest (taxed at a marginal rate up to 60 percent) and income from the company (taxed at a flat rate of 45 percent). This enables the small businessman taxpayer to gain interim benefits from the lower rate of tax on the company's share of income, as well as being able to split the company income between family, shareholders, and different classes of income for the maximum tax benefit.

In its present form the company tax does not measure up well in terms of the characteristics of a good tax. Some of those companies with greater ability to pay the tax also have the resources to take advantage of opportunities to invest in tax losses or to divert into areas where tax advantages lie. This means that the tax is not certain and similar companies pay dissimilar amounts of tax.

Before the 1977–78 tax year, the companies were taxed on a progressive scale. This was intended to help small businesses, but in practice it encouraged some of the larger enterprises to form small companies as a way of avoiding tax. Under the present system, New Zealand companies pay a flat rate of 45 percent on their profits and non-resident companies pay 50 percent. A large number of concessions and incentives exist, some of which are paid to companies as tax rebates (negative company income tax). Because of these concessions, the average tax for most companies is below 45 percent. In March many companies have to borrow money to meet tax commitments; this suggests the tax is not convenient. Finally, the tax would be costlier to collect if it were efficiently enforced because company accounts would require more thorough scrutiny by the Inland Revenue Department.

Under the present provisions, some forms of dividend income derived by individuals are liable to ordinary income tax, but dividend income derived by companies is not. A common complaint is that individuals are double taxed on dividends; the dividends are taxed both as company income before distribution, and then as personal income. A number of means exist to avoid this "double taxation", including specific preference shares and payments of dividends to companies rather than individuals, although when the companies at some stage declare dividends they will be taxed as personal income.

Tax revenue collected from dividends is not high because nearly two-thirds of all the dividends distributed are tax free. It would not be costly to abolish the tax on dividends. Abolishing it, however, would narrow the tax base.

Economists are more divided about the effective incidence of company taxes than they are about the incidence of personal income taxes. There is a deep gap between theory and practice. The weight of economic thinking favours the view that the company income tax is paid out of profits. (This view is based on the restrictive assumptions that there is perfect competition, that all markets act to maximise profits, and that capital stock is fixed.) Businesses, however, maintain that they never pay the tax out of profits but pass it on as a cost when they are pricing their goods.

We do not need to worry too much about not having conclusive evidence about the effective incidence of the company tax, because the conclusions about the distribution of the company tax payments by households are not especially sensitive to different incidence assumptions. Whether it is assumed that the company tax is paid out of profits or shifted on to prices, or something in between, the average amount of tax "paid" by households (either as shareholders or consumers of products priced to include the company tax) appears to be progressive. The part of the tax shifted on to prices is likely to burden those on low incomes to about the same extent as those on high incomes, and since high income households tend to own more shares, the tax on dividends has a progressive effect.

Taxes On Wealth

There is no capital gains tax or personal wealth tax in New Zealand. In recent years the effect of tax policy has been to reduce

existing taxes on wealth. The 1978 Budget claimed that "a review of medium-sized estates shows that a high proportion are the estates of farmers and that as a result of land price escalation, inadequate provision has been made for estate duties. As a result it has been necessary to raise substantial sums, and the repayment has severely curtailed the farming effort over subsequent years." In the light of this, the exemption level for all estates on which duty is payable was to be increased from $25,000 to $250,000 in stages over 4 years. In the 1980 Budget, the Government decided (because rising prices had eroded the real value of the exemption) to act more quickly and on 1 April 1981 the exemption moved straight to $250,000.

Estate duty contributed 13.5 percent of total Government revenue in 1913, and even by 1935 it still made up almost 10 percent of taxation. It has declined since. The estate duty has not been a major source of tax revenue in recent years. It contributes around $50 million a year—less than 1 percent of total tax revenue. Because of this, it was possible to increase the exemption level without a great loss in revenue. It may have the undesired effect, however, of raising estate prices since the presence of the tax may have dampened prices before.

Gift duties and land tax are also intended to tax wealth. Gifts valued at less than $15,000 in any one year are exempt from tax and a progressive scale applies to larger gifts. But, of course, by making gifts over a period of years gift duties may be avoided. Land tax is assessed on non-agricultural land valued in excess of $175,000.

Although the estate and gift duties have some design flaws, recent measures to reduce these taxes are open to question. First, those receiving wealth without saving to accumulate it are often well-placed to pay tax. Further, not taxing the gains from wealth while taxing the gains from income may result in a capitalisation of the tax advantage. This may be a cause of escalation of capital prices in the first place, and may encourage accumulation of capital rather than investment in productive capacity. On the other hand, most wealth in New Zealand may be in the form of housing and it may be considered acceptable for governments to encourage this form of accumulation.

Information on wealth in New Zealand is limited. The data for wealth taxes are one of the few sources of wealth data available. Now that the exemption level of the estates duty assessment has been increased, these data are even more limited.

Because the rate structures of estate and gift duties are progressive, and the exemptions for these taxes and the land tax are set to ensure the average wealth owner does not pay them, the burden of these taxes varies with wealth. Since there is a high correlation between wealth and income, then these taxes would also burden those on high incomes more than those on low incomes. Estate and gift duties were originally intended to contribute to greater distributive equity by helping to close a tax avoidance loophole—income tax could not be avoided forever by accumulating wealth since the wealth would be taxed when it was transferred as a gift or at death. Under present legislation it is not difficult to rearrange one's affairs to avoid these taxes. This and the fact there is no taxation of capital gains, allows those with wealth to accumulate more.

This trend to reduce taxes on wealth seems to have come about because the value of wealth has risen not fallen, and so the tax became quite high. Advocates for reducing the tax have claimed that this is only a nominal rise in value resulting from inflation, and there has been no real increase in the value of the assets. Nevertheless, given the protection offered by the Matrimonial Property Act, estate and gift duty is now paid out only on inherited wealth. If the view is taken that inherited wealth is less meritorious than earned income and the savings therefrom, then if anything, the estate and gift duties should be raised. This becomes more of an issue as family size diminishes.

Taxes on Goods and Services

Taxes on goods and services include the wholesale sales tax, excises, customs and import duties, service taxes, and regulatory (permission-to-use) taxes. These taxes are generally known as indirect taxes. Figure 5 illustrates the relative amounts collected from them.

The present sales tax is assessed on the wholesale stage of distribution, usually at an *ad valorem* rate varying from 10 percent to 60 percent. It did serve, when introduced in 1933, as an efficient and useful method of collecting revenue. In recent years, however, events have overtaken the tax and severely reduced its effectiveness as a source of revenue.

When implemented in 1933, the wholesale sales tax base was fairly broad until the early 1970s by which time the number of goods exempt from the tax had increased progressively. Although in the mid-1970s more and more goods were again added to the base, it is still very narrow. Less than 25 percent of private consumption expenditure is taxed. In general, taxed goods are selected by policy makers because they are considered to be "luxuries" or discretionary expenditures not having educational, health, or lifesaving uses. This selection, of course, involves a value judgment since tastes differ. Also, this selection is not always a means of making the tax less regressive since low income households often devote a larger proportion of their expenditures to these items than high-income households.

Goods purchased directly by private consumers make up 60 percent of the sales tax base. Motor vehicles provide a large (though reducing) proportion of this. The other 40 percent of the sales tax base

Figure 5: Taxation of Goods and Services: 1980–81:

Revenue $(m)		Proportion of taxes on goods and services (percent)
776	Sales tax	46
349	Customs and duties on imports, spirits, tobacco	20
261	Motor spirits duty	15
68	Road-user charges	4
64	Beer duty	4
47	Vehicle registration	3
46	Lottery duty	3
90	Other: *	5
1,701	Total	100

*Includes energy resources tax, international departure tax, duties on cheques and instruments.

comprises business inputs such as plant and machinery components, vehicles and parts, computers, and raw materials.

The instability of the wholesale sales tax revenue base has arisen for two main reasons. Changing business practices have resulted in the manufacturing, wholesale, and retail stages of production being integrated and this had made it difficult to assess the wholesale price for sales tax purposes. In addition, there has been growing pressure from individual firms for tax exemptions and refunds mainly because of the multiplicity of exemptions and refunds already available for particular uses or users of taxable goods. As the tax base is narrowed, higher rates must be charged on the taxable goods (if same level of tax revenue is maintained) and this increases the pressure for them to be made exempt. Imposition of a sales tax on a broader base would enable a lower rate of tax to be imposed to produce the same amount of revenue.

During the 1970s attempts were made to raise more indirect tax revenue. Policies to widen the sales tax base (to tax goods such as alcohol, tobacco, home appliances, ice cream, boats, caravans, and household cleaners, to name only a few) have brought about a marked growth in sales tax revenue. Between March 1978 and March 1981, sales tax revenue rose by over 100 percent: by comparison income tax revenue rose just over 50 percent.

Other sources of indirect tax revenue introduced in recent years have not proven to be efficient taxes; in other words they are not effective in producing more revenue. Also, they are inconvenient. During the five years to 1980, a number of indirect taxes have come and gone. Mileage tax and heavy duty traffic fees were replaced by the road-user charges. The foreign fishing vessel tax and foreign travel tax came and went. Other new taxes have included the international departure tax, the domestic air travel tax, and the energy resources levy.

One potential source of indirect tax is services such as taxes on sporting events, dining out, accommodation, transportation, and others. The production and distribution process for goods and services are similar in many ways and the non-taxation of services may produce anomalies.

The effective incidence of different taxes on goods and services varies, but we can get an idea of the major effects by looking at the wholesale sales tax. If the wholesale sales tax were assessed on *all* goods and services, the mainstream economic view would regard it as entirely shifted to prices. Since low income households spend a larger proportion of their incomes on goods and services than high income households, the tax is likely to be regressive (to burden those on low incomes more than those on high incomes).

Our wholesale sales tax, however, is assessed on a selected array of goods with the stated intention of avoiding some of the regressive effects of the tax. Even so, some of these goods, while considered to be luxuries, are purchased by those on low incomes and the tax is regressive. Further, in considering the effects of a selective sales tax, the position of consumers of the taxed product must be compared with that of consumers of the tax-free product. It is highly likely that the consumers of the untaxed product will bear some of the burden of the tax initially assessed on the taxed product because the rise in price of the taxed product will shift consumer demand to the untaxed product and raise its price until the supply of the untaxed product also increases.

But even if the wholesale sales tax is assumed to burden only the consumers of taxed goods, it is probably a regressive tax in New Zealand. An analysis of patterns of expenditure recorded in the Household Sample Survey suggests that low income households consume a higher proportion of "taxed luxuries" than those on higher incomes. Judgments about what should and should not be taxed are unavoidably value laden and perhaps are made more with an eye to collecting revenue than to questions of equity.

For example, excise duties are assessed on a narrower range of goods than the sales tax, and they are assessed on goods (such as cigarettes and alcohol) for which demand is not responsive to price rises. Excise taxes appear to take a larger proportion of income from low income households than from higher incomes households. This suggests they are even more regressive than sales taxes. If it is thought appropriate to levy such taxes, the income tax and social security system can be adjusted to increase the incomes of low-income households in compensation.

The Tax System as a Whole

As the preceding discussion shows, our tax system does not measure up according to a number of criteria. Many of the individual taxes in our system do not meet the criteria of good taxes; they do not measure up according to equity, certainty, convenience, and economy of collection. While the personal income tax is an efficient means of collecting revenue from salary and wage earners, the extent to which its high rates are no longer acceptable to them, and the avoidance and evasion carried on by other sectors of the community, provide evidence that this tax does not meet standards of equity, is unfair, and is uncertain. The present company income tax does not even have the virtue of being an efficient source of revenue to commend it, and wealth taxes are also declining in importance as sources of revenue. Some recently introduced taxes on goods and services have been efficient sources of revenue, but there seems to be limited scope for raising further revenue from such sources.

In the tax system, the inadequacies of some of the individual taxes do not seem to be balanced by the strengths of others. The system seems to be a drain on economic activities and is rife with excess burdens which discourage both workers and entrepreneurs from striving to increase production. Therefore, the tax system as a whole does not encourage economic efficiency.

Neither does the system meet with standards of equity—usually expressed as taking a higher proportion of income in tax from those on high incomes than from those on low incomes. Available evidence suggests that it does not tax high–income households at a higher rate than low income households[1]. The tax system as a whole may be proportional instead, taking about the same percentage of each household's income. While the personal income tax and company tax may have a slightly progressive effect on household incomes, any progressive effects of these taxes are probably offset by the regressivity of taxes on goods and services. Thus, it appears that the tax system as a whole is not progressive, but proportional, taxing most households at about the same flat rate regardless of their income.

[1]Of course, even if the tax system did result in those on high incomes paying tax at a higher rate than those on low incomes, it might not change the distribution of income. Redistribution can only be judged in the context of *both* the tax structure and the patterns of expenditure.

OTHER ISSUES IN TAXATION

The Tax Unit

In recent years, personal income tax in New Zealand has been based on individual incomes. This is consistent with the recent trend for members of the OECD to tax personal incomes on some form of individual unit. In 1974 there were 11 member countries with individual taxpayer units, 10 with joint husband and wife taxation, and only three with family taxation. There has been a trend towards individual taxation, particularly for earned income, and optional individual taxation opportunities have also increased. By 1977, individual taxation was allowable in 17 OECD countries and compulsory in 13. This trend away from compulsory joint or family taxation has been induced by the desire on the part of female earners to be taxed as individuals and the desire to provide incentives to work for married women by enabling them to pay tax in the lower tax brackets, rather than at the high marginal tax rates if their income was seen as additional to another earner's.

This growing emphasis on the individual as the basis for taxation does not mean, of course, that our taxation system does not pay regard to family matters. There are allowances for various dependants and numerous rebates in the tax system, applying not only to the taxpayers' expenditure on himself, but also to that made on behalf of family members. The tax system treats the mother of dependent children without market incomes as being a dependant of her husband. This approach may have been appropriate when most wives did not earn, or earned much less than their husbands. Then the husband would have submitted a joint tax return combining their incomes in order to calculate tax liability. Additional tax liability from any of the wife's earnings was usually offset by an allowance, either a deduction or a wife rebate.

With an increase in the number of mothers who work, it becomes harder to define the appropriate income unit at the base of our tax system. This involves a social judgment as to the role of those with children and with other dependants who do not work. Unless this problem is tackled systematically, inequities, anomalies, injustices, and inefficiencies will be generated by the tax system.

Rebates and allowances have made the New Zealand personal income tax into a kind of family system, but the system is not well designed to take account of differences in taxpayers' ability to pay because of family circumstances. One problem is that taxable income (which excludes wealth, capital gains, and human capital) is not a true reflection of ability-to-pay due to family circumstances and the stage in the life-cycle of the family unit. Tax allowances have been introduced to compensate for these problems, but further research is required to see if the intended recipients actually benefit from these and if the benefit is adequate. It has been argued in both the 1979 and 1980 Budgets that most low income earners are supplementary earners to a principal income earner, and it is therefore justifiable to raise bottom tier taxes by abolishing the personal rebate. This is a move to recognise some ill-defined unit other than the individual—possibly to the low–income earner's disadvantage.

Another problem which arises from a structure based on the individual unit with marginal tax rates is that families with only one member in full-time paid employment are disadvantaged compared with two-earner families who earn the same amount of taxable income. Table 12 compares two households, one with only one earner on $24,000 and the other with two earners. The two-income household pays nearly $3,188 less tax. If the chief income earner could transfer income to a spouse or other dependants, they would all pay lower marginal tax rates by filing individual returns and there would be substantial tax savings.

Table 12 may provide a false basis of comparison if the assumption is made that all those over 15 should be in paid employment if there are no dependants. In this case, the one-income household is in a

Table 12: Tax Rates for Two Households (at 31 March 1981)

	Household (Spouse not in paid employment)	Household (2 equal contributors)
	($)	($)
Head of household income...	24,000	12,000
Other household income ...	—	12,000
	24,000	24,000
Taxation:[1]		
For head of household ...	8,957.59	2,806.80
For other earner ...	—	2,806.80(3,190.21)[2]
	8,957.59	5,613.60(5,997.01)
Less spouse rebate ...	156.00	—
	8,801.59	5,613.60
	(%)	(%)
Average rate of tax ...	36.7	23.4
Marginal rate of tax ...	60.0	48.0

[1] Assumes each taxpayer claims for standard exemption of $52 for expenses and $1,000 for insurance.
[2] Situation where only one claims for life insurance.

materially different position from the two-income household. Whereas the second has exhausted its capacity to earn income, the household with a spouse not in paid employment has unused earning potential and it may be quite valid that the tax structure acknowledges this. Further, the household is likely to gain a benefit from the domestic services provided by the non-working spouse.

What this discussion of the tax unit shows is that there is no clear and precise specification of the objectives of the tax system. While the personal income tax structure provides graphic examples of this, taxation problems raised by family circumstances are not confined to personal income tax, but include all taxes, including those on goods and services and wealth.

Indexation

One way to reduce the effects of inflation on the tax system would be to build in adjustments for price changes; or in other words, to index the tax system.

Indexation would solve a number of problems. It would smooth out some of the effects of fiscal drag and maintain tax rates at the same levels in real terms. Indexation of the capital gains of financial assets would result in a more equitable income tax structure. Another argument favouring indexation is that it is a means of forcing upon the Government a more explicit regular review and control of its own expenditure.

Full indexation of the tax system could have its drawbacks. One drawback is that it insulates the economy from the useful messages that relative price changes bring as the mechanism for restructuring activity in light of changing economic conditions. Another drawback is that it limits the effectiveness of discretionary policy. Proper use of Government discretionary policy may play a stabilising role in economic management, not to mention the fact that Governments prefer that some discretion is left to them for political reasons. Nevertheless, indexation does not prevent discretionary changes in tax levels; it merely requires that they be explicit.

The problems caused by inflation are not confined to the effect of fiscal drag on the personal income tax, or to the rise in (real) income taken in taxation. Inflation poses difficulties in the definition of income itself. When prices are stable, an investor who may earn 5 percent on a $100 bank deposit is better off by the end of the year. He can prudently spend $5 while maintaining his capital and his ability to earn a similar sum

in future years. But when inflation runs to 15 percent, he is in a very different position: the $5 interest he receives is $10 short of the $15 he needs simply to stay as well off as he was when he deposited the money. Worse still his return may be further reduced because the income earned over an initial exemption will be taxed at a marginal rate applicable for additional income, and that could be as high as 60 percent.

This is not the end of the story. It is not simply capital gains but other forms of unearned income, such as interest on bank and building society deposits, which are overstated in inflationary times, despite the allowable exemptions built into the income tax structure. Here, indexation may be the way to design a more equitable income tax. Nevertheless, such indexation must be carefully conceived to avoid building in unwanted tax capitalisation in the long term.

International Perspective

Many New Zealand enterprises and individuals have trading and financial links with other countries. Because of these links, out tax system is influenced by, and affects, the pricing of goods in international and domestic markets. Also, migrant flows, especially between Australia and New Zealand, may be partially influenced by the perceived burden of personal income taxation here. Since Australia is our most important economic partner, a criterion for analysing our tax structure is: would a given tax structure in New Zealand lead to serious distortions in the movement of goods, capital, and persons?

Economic analysis suggests that New Zealand, as a small entity, generally has little power to shape international market conditions. As a result, it is difficult to burden foreigners with our taxes and it is highly likely that we are burdened by foreign taxes by paying higher prices for imports.

Our economic fortunes are heavily influenced by the terms-of-trade (the price of exports in terms of import prices) and foreign exchange fluctuations. The tax system provides a means of ameliorating some of the undesirable consequences of the international economy.

Double taxation agreements create administrative problems when designing a new tax system. For instance, if our system was changed to rely more heavily on expenditure-based taxes, such as a direct expenditure tax or a value-added tax, these agreements would have to be substantially revised.

ORCHESTRATING CHANGES TO THE TAX SYSTEM

There are many reasons for the widespread dissatisfaction with the tax system. An analysis of some of the economic effects of the tax system show it to be wanting according to the criteria of good taxes and efficiency, equity, and acceptability. All of these considerations indicate that there are good grounds for a comprehensive change to the tax system.

A number of options exist for making improvements. These include patching up the present system, using a broad overview to make sure the patching reflects a consistent set of objectives and is not piecemeal as in the past. It also includes the adoption of new taxes such as value-added taxes, a retail sales tax, a direct expenditure tax, a flow-of-funds company tax, a tax on capital gains, resource based taxes, factor taxes, foreign exchange taxes, and specific taxes.[1] Corporate taxation could be imputed to shareholders rather than collected from companies. The discussion in this document provides a basis for analysing and assessing these various tax options.

With so many people unhappy with the present system, the time is ripe for change. But data concerning the tax system are limited, often out-of-date, unreliable or incomplete. We have used the most up-to-date published information in our tables, yet several of them are for the 1978 financial year. The lack of data is a powerful impediment to major reform, and one central requirement, whatever the proposed directions of reform, must be to improve rapidly the information base which decision-makers will need. But this lack should not become the excuse for cautious policy.

There is great scope for making changes. Ours is not a large or complex economy; there is a stable democratic system; a wide range of administrative skills in the public sector; legal, accounting, and economic experience with taxation in the private sector; and an educated community of taxpayers. The technology (computers, business machines, and communication systems) required to revise the tax structure is already in place. Besides that, we have a tradition of innovating social and economic reforms.

[1]These alternatives are discussed in the appendix to *An Agenda for Tax Reform*.

What is Practicable?

Faced with a wide range of options and proposals for tax reform, policy makers are inevitably cautious because they have to take account of direct, short-term consequences as well as the longer-term objectives of policy. There is the immediate problem of maintaining an adequate flow of revenue. Existing tax arrangements have at least some degree of certainty, no matter how unsatisfactory they are in their economic and social effects. New tax proposals may offer large benefits but there is often considerable uncertainty as to their effectiveness at raising revenue, other effects, and their administrative feasibility. Lack of information and analysis compounds these uncertainties. Consequently, the inclination has been to equate the unfamiliar with the impractical, when it comes to specific proposals, and to concentrate attention on minor modifications to the *status quo*.

Tax structures can be changed in response to pressures exerted by particular interest groups, or they can be changed as part of a broader-based approach which takes into account the shape of the structure as a whole. The former piecemeal approach has characterised much of our taxation policy, as is evident in the range of concessions, exemptions, and other modifications to meet "special" circumstances.

Interest groups play a necessary and important part in any policy process, and especially in the formulation of taxation policy. Where their interests are tackled one at a time, however, it will be difficult to make much progress in improving the system. The emphasis is likely to be on detailed and minor objections and often minor financial costs. Only when an effort is made to look at the structure as a whole, or at major categories of taxation within it, can a reconciliation of different interests, and between short-term costs and longer-term benefits, be expected.

The test of practicability is whether a tax, or tax provision, can be operated reasonably cheaply and simply *and* be compatible with long-term objectives.

The starting point for any significant steps toward tax reform is a clear definition of what functions we want the tax system to perform. Some of these functions are set out on page 30. Within such a framework, individual tax measures may be taken with some confidence.

Where Do We go From Here?

The present tax system is apparently unacceptable to most taxpayers. This discussion paper has suggested that there are many other ways in which the system fails to measure up according to the characteristics of good taxation. It fails to meet both the equity and efficiency criteria which most people probably find acceptable, even if they do not use those concepts explicitly.

No tax system can fully meet everyone's expectations, and perhaps the best that can realistically be expected from a process of change is a system which many people will grumble about, but within which the great majority of people are willing to pay. Willingness to pay is only in part a function of the tax system itself. Taxation cannot really be viewed in isolation from other sources of revenue (borrowing here and overseas, and charging for public services) or the quantity, quality, and distribution of public expenditures at both central and local government levels. Even the most onerous tax might be acceptable if used to fund a desired public service. Hence tax reform should proceed with a close eye kept on the other elements of public finance.

Tax reform must also be pursued in the face of the data limitations mentioned above and the imperfect understanding of what the public really wants. For example, attitudes to what is fair and equitable are by no means clear. While it is frequently asserted that more equitable distribution of income is an essential component of reform, it may be that most people advocating this are thinking in terms of redistribution measures biting at a level somewhat above whatever each individually receives. Perhaps because of past economic pressures which have acted to narrow the range of incomes, tax measures seem to reflect the desire to provide a base to incomes but no strong egaliterian pressure. On the other hand, resentment is building up against some who pay no tax on parts of their income, or who can avoid or evade large amounts of tax.

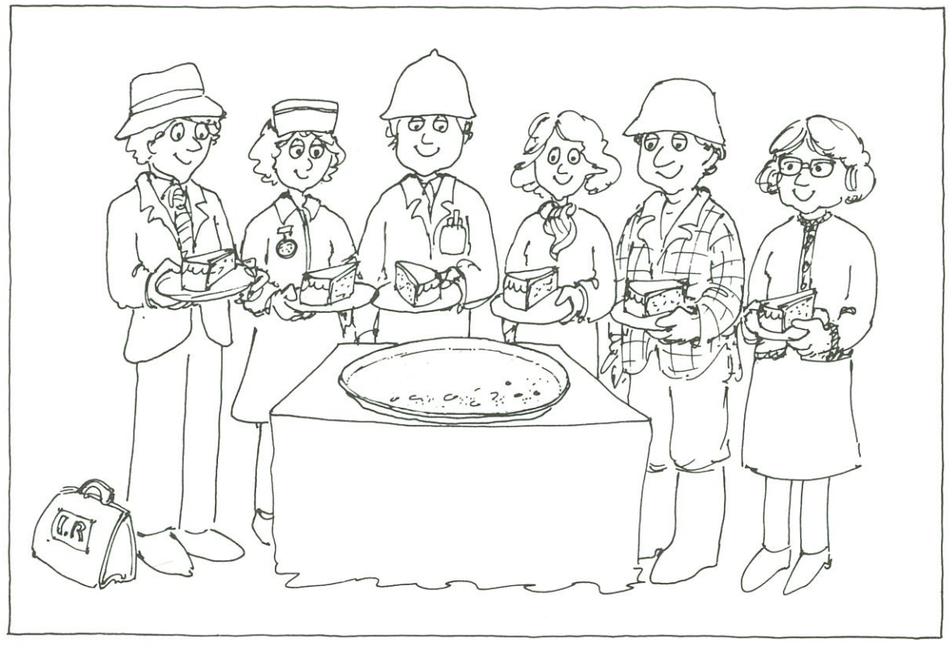
Distinguishing between the problem of too much tax (and too much public expenditure) and the problem of distribution of the tax burden is of critical importance. Options for change could be more sensibly discussed if there were a clearer indication of where taxpayers stand on this issue. For taxpayers, it is clearly important to know whether the aim is to shift the tax burden, or to increase the size of the tax take by introducing new forms of taxation.

Public education, on the effects of taxation and the major issues involved in reform, is badly needed. Wide and well-informed debate on taxation would assist those responsible for devising and implementing change.

It is evident from this paper there there is a considerable degree of uncertainty in our understanding of many crucial aspects of the present tax system. This should not prevent or delay substantial reforms which could quite radically improve the situation: reforms which will enhance productivity and encourage economic growth; which could result, through growth, in a reduction of the slice of the economic cake going to taxation while still providing enough revenue for the quantity and quality of public services we want; and which remove or reduce perceived inequities among taxpayers. The Task Force on Tax Reform was set up to consider some of these issues.

Whatever the results of this first step towards major reform, there will still be room for the consideration of further change. Although the possible directions of such change can be discerned from recent overseas investigations, which provide a wealth of useful information and a valuable stimulus to our own consideration of the options for change, much research and analysis is still needed on the specific New Zealand issues. We believe that there should be a continuing programme of research, adequately funded and making use of the resources available within the public service and in outside institutions, to provide a broad base for further, more fundamental taxation reform.

Taxation is not high in New Zealand, in relation to what we expect from the Government in free or subsidised form, and in benefits for individuals and enterprises. We have come however to rely heavily on personal income taxes, primarily on wage and salary earners. Many are no longer satisfied that they are getting good value for the tax they pay. The first priority for reform therefore involves the personal income tax, and the means by which costs and perceived benefits can be better matched. This will entail major changes in the structure of taxes on income, and probably also a considerably increased reliance on one or other form of expenditure tax.



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