INCOME MAINTENANCE AND TAXATION

SOME OPTIONS FOR REFORM

A REPORT PREPARED FOR
THE NEW ZEALAND PLANNING COUNCIL

by

Paul Bevin
Avery Jack
John Jensen

The views expressed in this report
do not necessarily represent the views of
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PREFACE

In August 1977 the New Zealand Planning Council established a Working Group on Income Maintenance to study the topic prior to the preparation of the Council's planning document to be published in March 1978. The Working Group was set up because of concern expressed about the cost of income maintenance programmes which include the social security scheme, the national superannuation scheme and the accident compensation scheme. The difficulty in raising the revenue to finance these programmes was recognised as was the problem of reducing government expenditure in terms of GNP.

It quickly became evident to the working group that the two issues to which it was addressing itself - financing income maintenance programmes and ensuring income adequacy for all groups - could not sensibly be viewed independently of the tax system and that changes in taxation could substantially affect the nature and extent of the problems. The report therefore examines options for tax restructuring, measures to assist families, and ways in which the income maintenance programmes might be rationalised.

The report was presented in November 1977 and all figures used were those current at that date.

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Notwithstanding the assistance received by the authors, the report is their work and they accept responsibility for it. It does not represent the official views of the New Zealand Planning Council nor of the organisations by which the authors are employed.

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I INTRODUCTION

1 Purpose

This report addresses three issues :

i The economic implications and consequences of raising sufficient revenue to finance the rising cost of income maintenance programmes.

ii The failure of tax and transfer systems* to provide a common minimum level of support (relative to family and household circumstances) for households dependent on social security benefits and households dependent on full-time market incomes.

iii The inconsistent treatment of various types of transfer recipient under the three schemes of social security, national superannuation and accident compensation, together with certain other specific issues of social security policy.

2 Inter-relation Between Income Maintenance and Tax Issues

a Financing Expenditure on Income Maintenance Transfers

In recent years total Government spending has increased in relation to gross national product. The trends are shown in Table 1. In 1977/78, total Government spending is estimated to be about 37.2 percent in terms of GNP.

This is about average for the four years 1975-78 and compares with an average of 30.1 percent in the preceding five year period. Increased expenditure on income maintenance transfers has been a significant but not the only contributing factor to the growth in total Government expenditure. In 1977/78 expenditure on monetary benefits is estimated to be about 9.6 percent in terms of GNP which is 2-4 percentage points higher than during the previous 15 years.

* In this report the word "transfer" (or "transfer payment") is used as a general term for any benefit or pension payment which is funded from general taxation. This usage follows that of economists.

TABLE 1 : GOVERNMENT SPENDING IN TERMS OF GNP

	Total Government Spending (1)	Goods and Services (2)	Monetary Benefits (3)
	% GNP	% GNP	% GNP
1968	31.2	16.6	6.5
1970	30.5	16.1	6.2
1972	28.9	16.7	5.7
1974	30.5	15.8	6.9
1976	40.1	19.8	7.7
1978	37.2	18.6	9.6

Notes:

(1) Source : Budget Table 2

(2) Includes both current and capital expenditure

(3) Including family benefit capitalisation

The increases in income maintenance transfers are attributable to several factors. Following the report of the Royal Commission on Social Security in 1972, standard social security benefit rates were increased after having declined in real terms for some years. Family benefit rates were doubled at that time in conjunction with the abolition of personal income tax exemptions for children. Further, the coverage of the social security system* was broadened by the introduction of the statutory domestic purposes benefit. Benefit rates have not increased in real terms since 1972. More recently the additional benefit for limited income and assets has been introduced and there has been a limited extension of sickness benefit to women.

A major contributor to the increased expenditure has been the introduction of national superannuation which reduced the qualifying age for pensions without an income-test from 65 to 60 years. Gross benefit rates have been raised but some of the increase in expenditure is returned to the Government in tax. By 1980/81, the first full year of implementation of national superannuation, gross expenditure on income maintenance transfers will be a considerably higher proportion of GNP than at present.

* Outside the social security system there has also been a large increase in accident compensation payments as a result of the new contributory scheme.

Population projections during the next 20 years show that the proportion of people actively engageable (i.e. aged 16-59) will increase relative to the proportion over 60. At the same time there will be a fairly rapid decline in the proportion of under 16 year olds. Soon after the turn of the century, however, the proportion of over 60s is projected to rise relative to the working age population. The decline in the proportion of younger people is expected to continue. These trends suggest that after full implementation of national superannuation (in the fiscal year 1979-80) transfers to the aged will initially become steadily less costly until the year 2000, after which they will become steadily more expensive.

The major source of extra revenue to finance recent rises in expenditure has been increased taxes on personal incomes from 10.6 percent in relation to GNP in 1967/68 (after a period of stability in the 1960s) to 20 percent in 1977/78 (see Table 2). The percentage of personal income taxes to GNP has risen faster than total Government spending resulting in a reduction in the relative shares of other forms of taxation. During the period 1968 to 1978 taxes on personal income have risen from 43.3 percent of total tax revenue to 61.1 percent. Although part of this increase is attributable to the changed tax treatment of pensions for the aged and the switch from tax exemptions for children to family benefit payments, there has, nevertheless, been a substantial real increase in the burden of personal income taxes.

TABLE 2 : TAXES ON PERSONAL INCOME *

	Percent of GNP	Percent of Total Tax Revenue	Tax Rates for married persons on average ordinary time wage	
			Average Rate	Marginal Rate
1968	10.6	43.3	11.8	22.5
1970	11.1	45.1	12.2	24.5
1972	13.3	50.4	15.5	28.4
1974	15.1	54.5	16.7	30.6
1976	17.2	58.9	18.0	33.5
1978	20.0	61.1	23.2	45.5

* Excluding company taxes

During a period of sustained economic growth, increases in Government expenditure on goods and services in relation to GNP can be absorbed and still leave an increase in real incomes in the private sector. When economic growth is zero or negative however, as in recent years, continued increases in the relative share of public expenditure on goods and services can only occur at the expense of reductions in private real disposable incomes. If increases in transfers are superimposed on this situation, there must inevitably be greater reductions in the real private disposible incomes of the working population. (It should be pointed out that although the total

level of income maintenance transfers has increased in terms of GNP, the net transfer to families with dependent children has been significanly eroded in real terms). In these circumstances, the working population naturally shows more resistance to further increases in taxes. This raises the question of whether we can afford the present and projected levels of income maintenance transfers in relation to GNP.

Table 3 shows social welfare expenditure related to the main categories of benefit.

TABLE 3 : PERCENTAGE OF TOTAL COST OF SOCIAL SECURITY BENEFITS BY BENEFIT TYPE

Benefit Type	1974/5 (1)	1975/6 (1)	1976/7 (1)	1977/8 (2)
	%	%	%	%
Superannuation & Age	59	62	64	71
Family	25	21	17	12
Domestic Purposes	5	6	9	8
Widows	5	4	4	3
Sickness & Invalids	5	5	5	4
Unemployment	1	1	1	1
Other	1	-	-	-
	100 (3)	100 (3)	100	100 (3)

Notes: (1) Source : Annual Reports of Department of Social Welfare

(2) Source : Estimates of Expenditure

(3) Columns do not total 100 owing to effect of rounding

Over the period to which the table relates, retirement benefits, domestic purposes benefit and family benefit together account for approximately 90 percent of expenditure. With the full implementation of national superannuation this percentage is expected to rise. As emerges from discussion below, reducing the level of income maintenance transfers may well be unacceptable. In broad terms, the options for making significant reductions are:

i. to reduce rates generally;

ii. to reduce the rate of national superannuation (which will be somewhat above social security rates when the scheme is fully

implemented);

iii. to restrict eligibility for national superannuation, family benefit or domestic purposes benefit (these benefits being the only ones involving sufficiently high levels of expenditure to be able to produce substantial reductions in total expenditure).

The first of these - general reduction in rates - could produce substantial savings but few would argue that current rates are excessive in providing for the social objectives underlying social security. A direct reduction of sufficient magnitude to alleviate current concerns about the level of transfers is obviously not practicable. The only possibility would be to increase benefits more slowly than increases in the consumers price index. This would increase hardship amongst those dependent on transfers, and it is doubtful whether it would be acceptable to policy makers or New Zealanders generally.

The second possibility, that of reducing the cost of national superannuation is considered later. Account needs to be taken of the fact (noted by the OECD) that increased expenditure resulting from an increase in the rate of benefit does not provide the same constraints on economic growth as increased expenditure on, say, health and education, which use up resources which might otherwise have been used for production. However, when the increased expenditure results from a lowering of the retirement age, it is likely to be accompanied by a loss of production.

The only way of making a substantial saving in expenditure on national superannuation would be to raise the eligibility age above 60 years. This is not likely to be acceptable in the near future.

The third option, reducing eligibility for certain social security benefits, also offers little practical prospect of substantial savings. The increased coverage of social security came about from recognition that there were groups who had as good a claim for assistance as others already covered. A major reduction in the number of persons eligible for social security assistance could be achieved only by measures likely to be viewed as arbitrary or capricious.

There seems little prospect, therefore, of achieving a significant reduction in the projected level of growth of social security transfers relative to GNP in the short or medium term without a substantial depletion of our social security system.

If, in fact, built in commitments for an increased share of expenditure on income maintenance transfers exceed what is feasible given medium term growth prospects and, if the prospects for expenditure restrictions in other areas (such as health and education) are equally bleak, attention must focus on the capacity of the present tax structure to finance that expenditure. Of the possible alternatives a further increase in personal income taxes does not appear to be an option. Indeed there is widespread pressure for some reduction in rates of personal income tax.

b Need to ensure income adequacy

A major concern in recent years has been the inconsistency in after tax and benefit income between those dependent on the market and those dependent on social security for their main income.

These inconsistencies have largely arisen because of the comparatively high level of earnings a beneficiary may have before becoming ineligible for some benefit payment. A married beneficiary with a dependent child does not become ineligible as a result of the income test until earnings exceed $117 per week, which currently is only just below the average wage. Beneficiaries are eligible for significant levels of supplementation at incomes above the lower award rates. For example, the current award wage for a storeman or a builders labourer is $94 per week gross*. If the worker is supporting a wife and two children, one under 5 years of age, he will have a net weekly income of $90 as he is required to pay tax of $4. The situation of this family may be compared with that of a solo parent with two children (one under five) who is in receipt of a domestic purposes benefit. When such a beneficiary has $94 gross per week in other income, the weekly amount received from benefit is $15. The solo parent family (with one less member than in the earners family above) would have a net income of $103. Thus her family receives a net supplementation (after tax and benefit) of $9. Both households would, in addition, receive $6 a week family benefit.

A further problem is that although both tax and benefit structures have in recent years attempted to make adjustments for family composition these measures have not fully succeeded in making adequate allowance for low income and large families. This has been highlighted by work on income equivalences which has been carried out by the study group. The equivalent incomes of family households of different composition may be defined as the incomes they require respectively to achieve the same standard of living. Appendix I provides a fuller account of this concept and gives a provisional set of equivalences. These indicate that, to achieve the same standard of living as a married couple with some specified level of net income, a couple with one child would require about 27 percent more income, a couple with two children would require about 53 percent more income, and a single person would require about 60 percent of the net income of the couple. On the basis of these income equivalences, it is possible to calculate the net incomes required by families of various sizes to reach the same standard of living as, say, a married couple, whose total net weekly income is the standard benefit rate of $69. The amounts are shown in Table 4.

* All award and benefit amounts have been rounded downwards to the nearest dollar.

TABLE 4 : NET INCOME REQUIRED BY FAMILIES OF VARIOUS SIZES TO ACHIEVE THE SAME STANDARD OF LIVING AS A MARRIED COUPLE ON BENEFIT

Family Size	Net Income Required ($ per week)	Family Size	Net Income Required ($ per week)
Two parents +		One parent +	
1 child	87	1 child	63
2 children	105	2 children	83
3 children	122	3 children	101
4 children	138	4 children	117
5 children	153	5 children	134

In a previous example it was noted that a family of 2 adults and 2 children supported by a single wage at the award rate for a storeman or builders labourer would have a net income of $90 plus $6 family benefit. The above table suggests that this is less than such a family requires to reach the same standard of living as a married couple on benefit. That is, the family dependent on the market income has a lower level of support in relation to its requirements than the beneficiary couple.

The figures in the table suggest that this will happen for a significant number of larger households, as incomes required to achieve the standard of living of the beneficiary couple exceed the average male wage (plus family benefit) when there are more than four children in a two parent family.

The income equivalences have been applied to income distributions of households of different sizes. The analysis required assumptions which make the results somewhat imprecise but they suggest that the proportion of families dependent on market incomes achieving a lower standard of living than a beneficiary couple increases as number of children increases and is substantial (in excess of 20 percent) for families with three children or more (see Appendix I).

It would seem desirable that, on the basis of income equivalences, a set of income "floors" should be established which will ensure a common basic but adequate standard of living for families of different composition. In suggesting that the "floor" incomes should correspond to income equivalences it is recognised that this probably would not be practicable across the complete range of family sizes. For example, it might be regarded as necessary to limit the size of family beyond which the income floor would not increase. A theoretical defence of such a restriction could be made on the basis that children are desired and are a source of satisfaction to parents, so that having a large family could be regarded as implying a willingness to accept a lower standard of living. Another consideration is that the income floors deriving from the equivalences are amounts required on average to ensure the

common standard. They do not take account of the assistance to some low income families provided, for example, through state housing.

The same set of income floors should apply consistently to the tax and transfer systems. This implies a constraint on the tax system such that for family households dependent on market incomes, the combined effect of tax and relevant transfers (such as family benefit) should not leave any household below the floor, which would also be the level of support provided by social security benefits. (It is assumed here that in a family dependent on market earnings the principal earner is working full time. Provisions to ensure the floor was reached would not apply to those who had opted out of the economic system, in the same way as unemployment benefit is not available to those unwilling to accept suitable work.)

Failure to ensure a common minimum standard is not only inequitable, it is likely to lead to decreased acceptance of the tax system by earners who perceive themselves contributing tax for the support of beneficiaries who achieve a higher standard of living than they themselves do. It is also likely to cause such earners to become unsympathetic to social security objectives.

The introduction of tax concessions for young families, where it is usual for one adult to be at home, has undoubtedly eased the problem for this group. The concessions have some undesirable features, however, and do not protect larger families which have higher costs and where there may still be constraints on the capacity of the mother to work after the youngest child has reached school age. It seems probable that such families make up the largest single group of persons not able to achieve a basic but adequate standard of living.

It is clear that the economic situation of families is considerably affected by the taxation provisions which apply to them, so that any general treatment of this issue must recognise the inter-play between taxation and transfer provisions intended to ensure income adequacy.

c. Income maintenance issues

The other concerns of this paper, which relate to the reconciliation of current income maintenance schemes and certain other income maintenance issues are not likely to be closely affected by tax changes. Thus discussion of them is left to a later section of the paper.

3 Strategy of this Report

The above considerations suggest that two of the major problems with which this paper is concerned (financing income maintenance transfers and ensuring income adequacy for all groups) cannot sensibly be viewed independently of the tax system and that changes in taxation could substantially affect the nature and extent of the problems.

These are only two of a number of issues which would need to be taken into account in any tax restructuring. More fundamental from an economic point of view is the need to reduce marginal rates and progressivity* in the lower and middle income range and to otherwise provide incentives to greater productivity.

The strategy which is followed in this report is to examine initially the options for a general tax restructuring. The objectives of the restructuring, as well as enhancing productivity, include the harmonisation of the tax and transfer systems.

Options are then put forward for measures specificially intended to assist families dependent on market incomes, in the context of what would be required after the likely ameliorative effects of the tax measures.

Finally, options are put forward for rationalising the current income maintenance transfer schemes.

* The progressivity of a tax scale is the extent to which the rate of taxation (i.e. the proportion of income paid in tax) increases as level of income increases. The current New Zealand tax scale is an example of a fairly progressive scale. A scale in which tax was a constant proportion of income would have no progressivity. A regressive scale would be one in which the rate of taxation decreased as income increased.

II TAX RESTRUCTURING

1 Preamble

There are serious deficiencies in New Zealand's tax system which can largely be attributed to the impact of inflation on a direct income tax structure which is steeply progressive in the lower-middle income range where the great bulk of taxpayers are concentrated. Successive governments have used the extra tax revenue resulting from 'fiscal drag'* to finance increased public expenditure, including transfers to special groups, rather than to finance direct tax reductions.

The present income tax structure is inefficient in an economic sense because high average and marginal tax rates on incomes probably produce disincentives to work and to increase earning capacity through investment and the acquisition of skills. It also encourages tax evasion and avoidance. Such inefficiency is not consistent with national efforts to raise productivity. The present tax structure also fails to achieve a socially desirable degree of income redistribution because it taxes many low income families too heavily and because it concentrates the main redistributive burden on the lower to middle income earner relative to higher income taxpayers and secondary earners in households. While the tax scale is progressive for single persons and married couples with only one income, a household can actually lower its average tax rate if the wife has some income. Expansion of tax evasion and avoidance also reduces the equity of the whole tax system.

2 Scope for Tax Reform

Increased economic growth would, of course, increase the scope for increasing private disposable incomes by reducing direct taxes. Otherwise, the lowering of direct tax rates for the majority of taxpayers in the average income range and assistance to families in particular, simply involves a redistribution of the national income to these groups from other groups. The extent to which various groups bear the burden of redistribution will depend on the method by which a direct tax restructuring is financed.** In evaluating options the redistributional effects need to be clearly identified.

* When incomes increase but tax scales remain unchanged, income earners are put into higher tax brackets and pay a higher proportion of their incomes in tax. The phenomenon by which tax revenue is increased as a result of this process is known as 'fiscal drag'. It results in a progressively higher proportion of national income being collected as tax revenue.

** It depends on the way in which different taxes and expenditures are shifted from one group to another - e.g. company taxes may be passed from shareholders to consumers in prices; income tax may be passed from tax avoiders to tax payers.

a Reduced growth in public expenditure

The scope for slowing down increases in public expenditure in the near future is limited. A high proportion of expenditure is either automatically or usually linked to price increases, i.e. social welfare benefits and salary and wage payments. The cost of public debt is rising even faster than prices. Tight controls are already being applied in the areas of capital works and other operating expenditure. Significant curbs in nominal expenditure growth imply real reductions in public expenditure which are likely to be unacceptable. To the extent that real increases in public expenditure can be avoided, the scope for tax reduction will be improved.

b Increased government deficit

Depending on the prevailing economic conditions the Government may want to contemplate some fiscal stimulus to the economy. If so, a reduction in direct taxation should be one of the preferred methods of increasing the deficit. The Government recently acted in this way with a mini-budget containing a 5 percent tax cut from 1 February 1978. This is estimated to reduce tax revenue by over $200 million in the March year 1978/79. While this may provide a short term solution, it is unlikely that the Government would be prepared to contemplate a permanent increase in the deficit.

3 Indirect Taxes

The major indirect taxes in New Zealand are expenditure taxes imposed on a selective basis with many goods excluded, for example consumption goods regarded as necessities, exports and used goods. The large range of exempted goods is partly an historical development, but is sometimes claimed to result in the indirect expenditure taxes being progressive with respect to household incomes, i.e. in lower income groups paying a smaller percentage of their income in indirect expenditure taxes. In fact it is likely that New Zealand's indirect expenditure taxes are regressive although they may be less so that otherwise as a result of the selectivity.

A ten percent increase in the present indirect taxes would generate in excess of $100 million in 1978/79. Its impact would be highly selective, however, and would magnify the price differences between taxed and non-taxed products. A review would be required of the present sales tax base and probably, the substitutions of new more general tax base e.g. a single stage (retail or wholesale) sales tax or a value added tax.

Personal consumption in 1977 is estimated in excess of $7.5 billion. A broad-based indirect expenditure tax would therefore yield up to $75 million (depending on the income elasticity of consumption) at a 1 percent tax rate. This would increase domestic prices. Exclusion or zero-taxing of basic goods such as food and housing would reduce the yield and the initial inflationary impact. It would also be less regressive.

Such a shift in tax incidence would be likely to be regressive. It would therefore need to be carefully balanced with more progressive adjustments to our income tax and transfer systems. Benefit levels and tax thresholds may have to be raised to compensate for the regressive effects.

Two further points are noted. Firstly, there is good reason to expect that a move to indirect tax would result in an increase in savings. Secondly, while such a move would increase prices, the inflationary impact could be mitigated if the accompanying direct tax reduction resulted in more moderate wage demands or stimulated additional output.

While presenting many difficulties a shift to a new broad-based indirect expenditure tax offers considerable scope for achieving a more efficient and equitable tax distribution.

The respective merits of these types of indirect expenditure tax have been well canvassed. What is needed is a decision by the Government as to whether it is prepared to contemplate such a tax and, if so, a thorough investigation of the indirect tax options should be undertaken.

4 Income Tax Base

Income is widely used as the basis for direct taxation because it is a reasonable representation of an individual's command over economic resources and therefore his 'ability to pay'. In practice income is measured as the sum of receipts from various sources within a given period.

The New Zealand income tax base excludes income from some sources. The main reasons for the exclusions are measurement difficulties, the notion that some income is of a 'capital' nature, the acceptance that some income is neither consumed nor saved (e.g. costs of employment and running a business) and to provide incentives for various purposes.

Before identifying some of the major income sources which currently escape taxation it is necessary to make two important qualifications.

Firstly, some items are excluded for well-considered reasons. There may be formidable practical obstacles to bringing them into the tax net or conflicting economic policy implications which are judged to outweigh the advantage to be gained. Secondly, inclusion of these items in the tax base may have important effects on the distribution of the tax burden and these would need to be borne in mind in determining the overall rate structure.

Notwithstanding these qualifications, a widening of the tax base should be considered. To the extent that the tax base can in practice be expanded, the scope for lowering direct tax rates is increased. The following is a summary of some of the main items which could be brought into the tax net.

a Fringe benefits

Fringe benefits or tax-free allowances paid to employees in addition to salary and wages, are a major area of tax avoidance. To some extent they are a by-product of high tax rates and their exclusion represents a major inequity in the present tax structure. Estimates are subject to a wide

margin of error, but if the amount escaping tax assessment was 5 percent of salary and wage incomes in 1978-79 it would be about $500 million*. At current tax rates this would represent over $200 million additional tax. The administrative problems of defining fringe benefits as distinct from reimbursement of expenses, are formidable. Employers would be required to make a declaration of all allowances payable. Taxation of fringe benefits would need to be comprehensive to prevent circumvention by switching to alternative tax-free benefits.

b Unearned income

Under a progressive tax system based on the individual, a family or household can reduce its tax by diverting income from sources other than employment to the individual with a lower incremental tax rate. Earned income cannot be split in this way because it is clearly associated with the individual earner. In New Zealand where the tax scale is steeply progressive, the advantage which can be gained is substantial. There is no doubt that this feature has contributed to the large number of women returning investment income, and the formation of family trusts. Equally there is no doubt that the amount of income effectively escaping tax in this way is substantial. In other OECD countries the investment income of the family is almost invariably aggregated whether the taxation of earned income is based on the individual or the family. The alternative solutions are:

i compulsory aggregation of unearned income;

ii tax concessions for earned income or penalty on unearned income;

iii reduction in the potential tax gain from income splitting.

A restructuring of the personal tax scale along the lines of the various options described later in this report would have the effect of achieving the third alternative.

c Rental value of owner-occupied housing

A person occupying a house which he or she owns could be considered to derive from it a notional income in the form of the consumption of the services provided by the house. The notional income would be taken to be equivalent to the gross market rental value of the house less the costs of depreciation, maintenance, rates, insurances and mortgage interest. Logically, this net rental value should be included in the income tax base. Its exclusion is inequitable as between owners and renters and distorts consumer housing choices. The rental value of owner-occupied housing is estimated in 1978-79 as $430 million before deduction of local authority rates which are estimated at about $130 million.

* Mr. L. Ross, former Chairman of the Taxation Review Committee which reported in 1967 recently suggested a figure of 10 percent, which would represent about $1000 million.

There are, however, substantial arguments for omitting rental value. Firstly, there is a strong social tradition of home ownership in New Zealand. Secondly, taxing an imputed income poses severe problems of tax administration and compliance because there is no cash flow from which tax could be met. Thirdly, there are also practical difficulties in estimating the imputed rental value. Any move to tax rental value would require an education programme in view of the general lack of public understanding of the concept.

If rental value of owner-occupied housing is not included in the tax base no deductions should be allowed for mortgage interest or property taxes (rates). The present tax rebate for rates is intended to relieve the burden on ratepayers but it thus places them at some advantage over those who rent their homes.

d Retirement pensions and endowment insurance

At present, income contributed to a life insurance plan is not taxed. Neither are the proceeds of a maturing policy. The income which accrues during the life of the policy is taxed at a concessional rate (life insurance companies are taxed at 30 percent on allocated bonuses). Income contributed to an approved superannuation scheme is also tax exempt. If the emerging benefits are in the form of a pension they are taxed, but lump sum benefits are virtually untaxed. The earnings of a superannuation fund are not taxed unless the fund is backed by a life insurance company. This treatment discriminates among forms of saving and investment, encourages a concentration of wealth in pension funds and life insurance schemes and reduces the available tax base.

An argument for exclusion from the income tax base of superannuation and life insurance contributions is the inducement to make private provisions for retirement. However, a retirement benefit financed from tax revenue is universally provided and although there should be no discouragement to people making further provision on their own behalf through supplementary contributory pensions it is questionable whether these should be subsidised.

Major changes in the taxation of retirement pensions and life insurance would, of course, require a lengthy transition period or compensation in view of the long run contractual commitments.

Other complex issues also impinge on the role of life offices and superannuation funds in New Zealand's capital market. At the very least a general review of the present position is desirable.

e Capital gains

Another area in which income tax has been said to be ineffective is in the treatment of capital gains. In principle it is inequitable to exclude from the tax base capital gains which in economic terms represent an increase in net worth.

It is inequitable between two people whose net worth increases by the same amount, one from earnings and one from capital; it is also inequitable insofar as capital gains are more common in higher income groups. In practice, provisions for the taxation of capital gains would need to ensure that only real increases in net worth were taxed, otherwise the impact of inflation could result in nominal gains being taxed when real losses had been incurred. This applies equally, however, to the taxation of interest and dividend income from investment in financial assets. Account would need to be taken of the fact that New Zealand has a moderate level of taxes on net worth and property in the form of local authority rates and estate duties. The main sources of capital gains in New Zealand are land and shares. Land gains would be relatively simple to tax but there would be pressures to exempt gains on farms and owner-occupied houses, which would severely erode the tax base. If company and shareholder taxation were integrated as discussed subsequently, it would be necessary to exclude the portion of capital gains on shares which is attributable to retained earnings.

Estimates of the amount of capital gains are subject to a wide margin of error and likely to fluctuate from year to year. Based on overseas experience the amount would possibly be about $100 million. For practical reasons only realised gains could be taxed. Realised losses would also be deductible. In the present conditions of low growth and high inflation it is possible that real capital losses could exceed capital gains. The administrative approximations involved in calculating real capital gains are considerable but should not be over-stated in view of the distortions which arise from not taxing capital gains at all.

f Interest and dividend concessions

A substantial amount of revenue is foregone by the exclusion of interest receipts up to a general level of $100 and the exclusion of additional interest from specified sources. The purpose of the general interest exemption was originally to avoid the need for large numbers of salary and wage earners to furnish returns and pay small amounts of provisional tax. The PAYE system has now developed to a stage where many taxpayers furnish returns to obtain refunds and the abolition of the concession would be unlikely to increase the number of returns significantly. In the past the interest concession was also justified on the basis of bolstering net returns from savings in institutions whose interest rates were artificially held at low levels by Government policy. Now that the Government has moved to a more liberal interest rate policy the need for the concession is reduced.

5 Other Taxation Issues

Two further matters related to the tax base question are raised here although they would not contribute to an expansion of the tax base.

a Company taxation

Although companies have a distinct legal entity they do not, in themselves, consume economic resources or have a standard of living as persons do. Company profits accrue to shareholders and are therefore included in the tax base. In New Zealand companies are taxed under the classical system of unrelieved taxation at both company and shareholder level. The combined effective rate of dividend tax is up to 78 percent whereas retained profits are taxed at the company rate of 45 percent only. The individual is not taxed on the value of retained profits contributing to an increased capital value of his shares, whether or not the gains are realised.

The tax treatment of company income results in several major distortions :

i it raises the overall rate of tax on capital investment income and thus discourages savings and investment;

ii it disadvantages investment in equities (shares) relative to other forms of investment;

iii it raises the comparative cost to the company of equity finance thus encouraging debt finance;

iv it discourages distribution of dividends thus avoiding the market for capital allocation and restricting the spread of shareholding;

v it favours smaller privately controlled companies whose owners are able to avoid double taxation of dividends and realise capital gains on retained profits.

To the extent that company tax is, in practice, shifted to consumers in higher prices these distortions are reduced but there is still ample evidence that they occur.

In New Zealand, the need for direct measures to stimulate investment in companies is a matter of contention. Company taxes in relation to GNP have declined significantly, partly as a result of selective incentives for exports and investment. However, measures to improve the flow of capital and to remove the discrimination against equities as opposed to other financial assets are considered desirable. While the introduction of specified preference shares has been beneficial, more comprehensive integration of company and personal income taxes should be considered.

In this way, company profits could effectively be taxed at the rates applying to individual shareholders. Integration could be achieved by either a dual rate of company tax whereby distributed profits are taxed at a lower rate than undistributed profits, or an imputation system whereby a credit is granted to the shareholder for the company tax attributable to the dividends.

Inflation accounting adjustments to calculated business profits may be desirable in terms of reallocating taxes among businesses with different levels of capital intensity and debt finance, but the justification for a lowering of the quantum of company taxes for this reason must be weighed against the justification for excluding inflationary gains from other forms of income.

Changes in company taxation would have wide-rainging implications for foreign and domestic capital flows and income redistribution. This is a very complex and controversial subject, however, and the full implications of possible changes would need to be explored. It would not involve an extension of the income tax base so much as rationalisation. Changes could be achieved with minimal budgetary loss if the effective tax rate on retained profits were increased while that on dividends reduced.

b Direct expenditure tax

As an alternative to direct income taxes there are strong conceptual grounds for a direct expenditure tax, i.e. a tax on income less savings.

The advantages of this approach are:

i Equity: An expenditure tax does not discriminate against persons who save. If two individuals have the same earnings potential at the start of their lives an income tax would penalise the one who saved more and thereby increased his income. An expenditure tax would not discriminate in this way because savings would not be taxed.

ii Simplicity: An expenditure tax would avoid the difficult measurement problems of depreciation allowances (because all business outlays, capital or current, are deductible) inflation adjustment (because all expenditure is in current dollars) and undistributed company profits (because all savings are deducted).

iii Efficiency: While both expenditure and income taxes distort the choice between market (i.e. money transactions) and non-market activities (e.g. barter, home-gardening), only an income tax distorts the choice between present and future consumption. An income tax penalises savings by taxing them twice - when they are earned and when interest is earned. A switch from an income tax to an expenditure tax yielding the same revenue would tend to increase national savings and investment and thereby raise future output.

A direct expenditure tax could be made progressive by applying a progressive tax scale. The rates are likely to be higher than under a comprehensive income tax because the base is smaller. It would also be desirable to link it with a form of wealth tax (or expanded estate and gift tax), to prevent undue wealth accumulation.

III PERSONAL INCOME TAX RESTRUCTURING

Once the income tax base is established it is necessary to consider how it will be taxed. This is a function of the unit of tax assessment and the distribution of tax burdens among those units.

1 Unit of Tax Assessment

There is a choice between the individual and the family as the basic unit upon which tax is assessed. The arguments in favour of family assessment are:

i families with equal incomes pay equal taxes;

ii families typically share and make joint decisions about the use of their resources and supply of their labour;

iii family filing averts the need to allocate property rights or to trace intra-family transfers;

The arguments in favour of individual assessment are :

i tax liability of two individuals does not change when they marry;

ii the absence of discrimination against secondary workers so that there is no disincentive to wives working;

iii the administrative ease of identifying individuals whereas differing degrees of formality in marriage can cause difficulty in defining a family unit.

The trend in most OECD countries is to move away from family towards individual taxation. In New Zealand there is strong social and political opposition to family taxation, and the individual will probably remain the basic tax unit. (Appendix II discusses the issue of joint taxation.)

Notwithstanding the advantages of retaining the individual as the unit upon which tax is assessed, the family comprising parents and dependent children remains the primary social and economic unit of New Zealand's society. The relative hardship suffered by many families is a major problem. Family circumstances alter taxable capacity in several ways, the main ones being:

i The number of children or other dependents alters the household's total consumption requirements and therefore the minimum income required to maintain a given material standard of living.

ii There are costs of child or dependent care which may be explicit in the case of a working solo parent or two-income household or implicit in the case of a parent at home.*

iii Under a progressive tax schedule the number of incomes in a household alters the overall incidence of tax.

iv A two earner family is likely to incur higher costs than a one earner family.

The tax structure, although based on the individual, can allow to a greater or lesser extent for these family factors. Means of doing so are discussed subsequently. In this report it is assumed that the individual will remain the unit for taxation.

2 Personal Income Tax Scale

As outlined previously, the effect of rising nominal incomes on a static, steeply progressive tax scale has increased rates of taxation, especially on the average income taxpayer. As stated earlier, there are good reasons why the steep progression on the middle income range should be reduced by lowering marginal and average tax rates in this range. By 1978/79 it is estimated that the average ordinary time wage will have risen to over $7,000 and the lowest award wage for adults to at least $5,000. The majority of the principal income earners in households will be deriving incomes in the range $5,000-$11,000 per year. This income range is the primary target area for tax reductions.

Table 5 shows the estimated income and tax position in 1978/79 under the present tax scale of this middle income group compared with the lower and higher income groups :

TABLE 5 : TAX PAID ACCORDING TO INCOME RANGE

Income Range $	Percentage of taxpayers in range	Percentage of taxable incomes in range	Percentage of tax paid by taxpayers in range
0-5,000	46	16	8
5,000-11,000	39	44	40
11,000 and over	15	40	52

* Currently, this is usually the mother although it may not necessarily be so. Future references to wives at home are used for ease of understanding although equal considerations apply to fathers at home.

The table shows that the middle income group pays five times as much tax as the lower income group although it has less than three times the taxable income and a smaller proportion of taxpayers. The middle income range contains most of the principal income earners in households (See Figure 3 Appendix IV).

The group of individual taxpayers returning incomes below $5000 a year comprises mainly part-time or part-year income earners, most of whom would not be primary income earners in households. The remainder of the lower income group are firstly, single national superannuitants with no or little extra income, and secondly, young persons in their early employment years including many undergoing training of some sort, e.g. nurses, teachers, bank officers. (Appendix III gives an estimated breakdown of the taxpayers returning less than $6,500 in 1978/79). There would be justification in redistributing income away from low income supplementary earners toward full-time middle income principal earners in households. Most of the tax options considered below have this effect.

As well as redistributing some of the tax burden away from average income earners to supplementary income earners in households, reduction in the overall rate of direct taxation is desirable. For the purposes of considering possible tax scale options an overall tax cut of $300 million is assumed. In 1978-79 the present income tax scale is expected to yield about $3800 million before deducting family rebates (wife, single income family and young family rebate). This represents an average tax rate on estimated taxable income (after deduction of present exemptions) of 31.4 percent. The 5 percent tax cut will reduce revenue by $200 million and result in an average tax rate of 29.7 percent. A further $100 million would give an average tax rate of 28.9 percent. This compares with about 24.8 percent in 1976-77.

There are numerous possible marginal rate scales which would achieve the objectives outlined above. Some broad options are detailed in Appendix IV and compared with the present scale. Table 6 shows the marginal tax rates for these options. It also shows the average tax rate for a single person without dependants.

The central features of the alternative scales are :

i Universal tax threshold :

This is the income below which no tax is payable. Appendix V discusses the present personal rebate which provides a universal tax threshold to all individual taxpayers at an income of $775 a year. It concludes that it is an expensive way of protecting low-income households, unduly reducing taxation on the low-income group of taxpayers which comprises mainly part timers and part year workers who do not provide the principal source of a household's income. It also produces extra administrative work. In order to redistribute from this group to the average income group it would be possible to abolish the personal rebate. Among the options Scale 1 retains the personal rebate. All others dispense with it.

An important group who would be disadvantaged by a tax scale with no personal rebate would be national superannuitants receiving a single rate of benefit and with no other income. If necessary, this group could have their net income preserved in several ways. A special tax rebate for pensioners has been used in the past and could be re-introduced to offset any extra tax payable. The rebate could be reduced as other income increased. For each dollar per week of such a rebate the estimated cost is about $15 million. Another alternative would be to introduce the new tax scale concurrently with the shift to 80 percent of the average wage so that there was no fall in the net pension. The gain from the shift would be correspondingly reduced. Other measures concerning superannuitants are considered later in this report.

ii Initial marginal tax rate :

Scales 2-5 have varying initial tax rates ranging from 29 percent for a proportional tax * (Scale 2) down to 16 percent (Scale 5). A higher initial rate increases the redistribution from lower income groups to higher income groups. It also increases the income level below which tax is increased and above which tax is reduced (the breakeven point). For instance, a proportional tax of 29 percent would increase tax on all incomes up to $8,000. Scale 3 features a 25 percent rate on all incomes up to $10,000 a year with a breakeven point of $6,400 a year. Scale 4 has an initial rate of 20 percent on incomes up to $3,000 a year and the breakeven point is $5,400. Scale 5 taxes income up to $3,000 a year at 16 percent. It almost breaks even at $3,000 a year and then again at $6,000 a year with average tax rate increases of up to 1.5 percent between these income levels.

* A proportional tax applies a constant rate of tax to all income.

TABLE 6 : MARGINAL TAX RATES FOR FIVE TAX SCALE OPTIONS

Income In Range	Present Scale		Scale 1		Scale 2		Scale 3		Scale 4		Scale 5	
	Marginal Rate	Average Rate*	Marginal Rate	Average Rate*	Marginal Rate	Average Rate*	Marginal Rate	Average Rate*	Marginal Rate	Average Rate*	Marginal Rate	Average Rate*
$	%	%	%	%	%	%	%	%	%	%	%	%
0-775**	0	0	0	0	29	29	25	25	20	20	16	16
775-1,999	20.0	12	20.0	12	29	29	25	25	20	20	16	16
2,000-2,449	21.0	14	21.0	14	29	29	25	25	20	20	16	16
2,500-2,999	23.5	16	23.5	16	29	29	25	25	20	20	16	16
3,000-3,499	26.0	17	26.0	17	29	29	25	25	23	20	32	18
3,500-3,999	28.5	19	27.0	18	29	29	25	25	23	21	32	20
4,000-4,499	31.0	20	27.0	19	29	29	25	25	26	21	32	21
4,500-4,999	33.5	21	30.0	20	29	29	25	25	26	22	32	22
5,000-5,499	36.5	23	30.0	21	29	29	25	25	29	22	32	23
5,500-5,999	39.5	24	33.0	22	29	29	25	25	29	23	32	24
6,000-6,499	42.5	26	33.0	23	29	29	25	25	32	24	32	25
6,500-7,999	45.5	29	36.0	25	29	29	25	25	32	25	32	26
8,000-9,999	48.0	33	40.0	28	29	29	25	25	35	27	32	27
10,000-11,999	49.0	36	45.0	31	29	29	35	27	39	29	45	30
12,000-13,999	50.0	38	50.0	34	29	29	45	29	43	31	45	32
14,000-15,999	51.0	39	51.0	36	29	29	50	32	47	33	45	34
16,000-17,999	52.0	41	52.0	38	29	29	50	34	51	35	55	36
18,000-19,999	54.0	42	54.0	39	29	20	54	36	55	37	55	38
20,000-21,999	57.0	43	57.0	41	29	29	57	38	60	39	55	40
22,000 & over	60.0	-	60.0	-	29	29	60	-	60	-	60	-

* The figures for average rates show tax as a percent of income when income is at the highes point of the range. They are average tax rates for a single person. ** $775 is the income up to which no tax is payable due to the present personal rebate.

iii Tax reduction in average income range :

4

Scales with higher initial rates achieve a greater tax reduction at higher income levels but have higher breakeven points. Because the proportion of full-time workers increases as income increases a breakeven point which is too high would disadvantage many low-income full-timers. In 1978-79 there would be a large number of these with incomes less than $6,500. There would be very few principal earners in households with young children below this income level, however. (Refer Appendix III). Of Scales 3, 4 and 5, Scale 3 achieves the largest rate reductions in the income range above $7,800. Scale 4 has the largest rate reductions on incomes from $5,400 to $7,800. Scale 5 achieves smaller reductions but, conversely, produces smaller tax increases at incomes below $5,000.

iv Shape of marginal tax scale :

Scale 3 features a flat rate of tax on incomes up to $10,000 with fairly sharp increases thereafter. It tends to concentrate the tax gains in the target income range. Scale 4 has a flat rate up to $3,000 with more moderate and even progression in income brackets above this point. The tax redistribution is more spread. Scale 5 has a lower rate up to $3,000, a higher flat rate on all income from $3,000-$10,000, and large income brackets and rate increases above this level. The result is to bunch the tax redistribution so that the biggest gains occur at the upper end of each income bracket. A smooth progression in the increase in marginal tax rates is a desirable feature of a tax scale. It ensures that as nominal incomes rise the resulting rate of increase in average tax rates is either constant for all incomes or rising for higher incomes. A scale with wide income brackets and sharp marginal rate increases tends to increase average tax rates faster at some income levels than at others. Some taxpayers are thus more disadvantaged by inflation than others.

v Maximum marginal tax rate :

All Scales except 2 and 4 have a maximum rate of 60 percent on income over $22,000 a year. Scale 2 has a maximum rate of 29 percent and Scale 4 taxes income in excess of $20,000 at 60 percent.

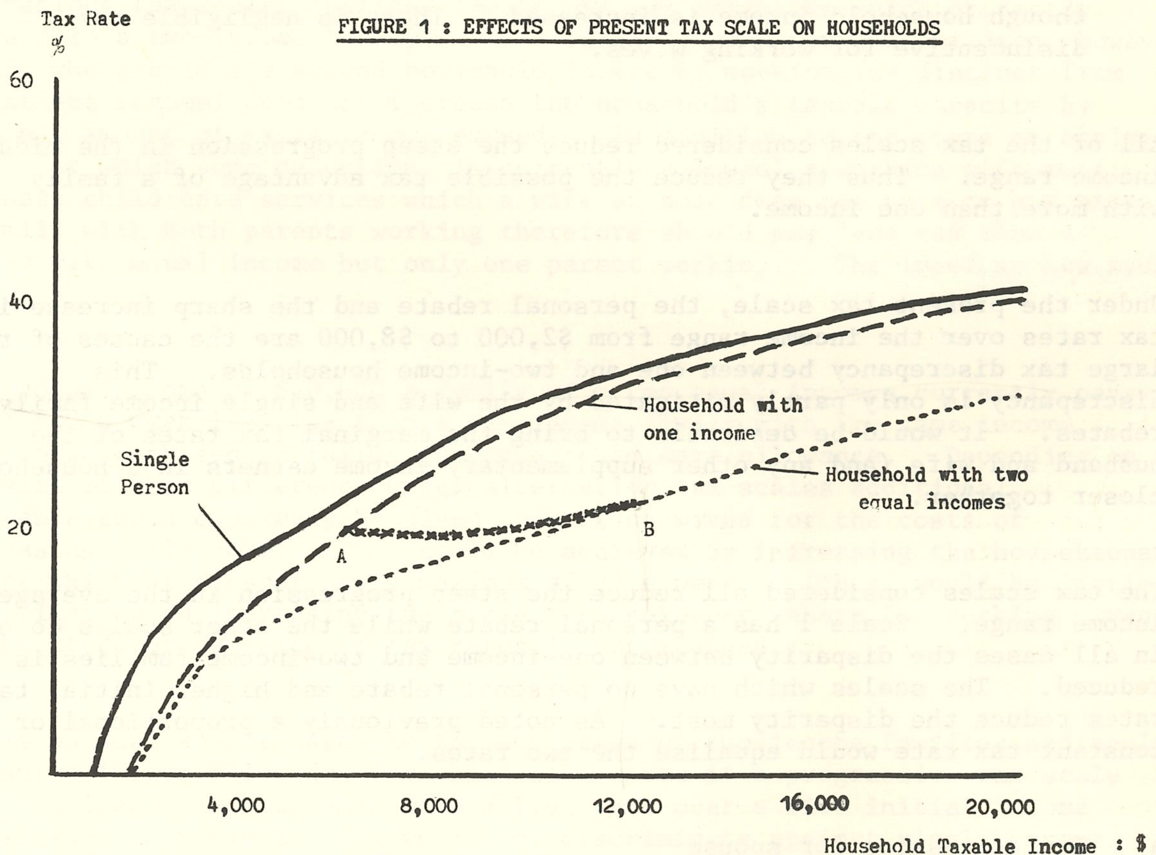
Estimates of costs of the alternative tax options are shown in Appendix VI.

3 <u>Households with more than One Income</u>

An objective of individual taxation is neutrality toward marriage, that is, the tax liability of two people should not change if they marry. An objective of family or joint taxation is to apply equal tax to families, or couples, with the same total income. The two objectives are incompatible under a tax structure where the marginal rate is progressive because the latter objective requires an increase in the income of either husband or wife to be taxed at the marginal rate for their joint income, while the former requires that the tax rate applying to one should not be affected by the income of the other. The two objectives are only compatible under a proportional tax

rate where every individual and household would pay the same rate of tax.

New Zealand's income tax system is virtually neutral to marriage and does not tax equal-income families equally. Because individuals are subjected to a progressive tax scale, a household in which the husband and wife have equal incomes pays a lower average rate of tax than a household where the same total income is earned by one person. Figure 1 shows this effect of the present tax scale. A couple with two incomes of $6,000 each for example, pays an average tax rate of 24 percent whereas a couple with only one income of $12,000 pays about 34 percent in tax.



The majority of households with two incomes lie somewhere between the two lower lines of the graph depending on the relative proportions each adult contributes to total household income.

The graph also displays other characteristic features of an individual based progressive tax system.

i A married couple pays less tax than a single person at all levels of income although the relative advantage diminishes as income rises.

ii Apart from a very limited income range over which the wife rebate reduces, the tax system is neutral towards marriage - two individuals with equal incomes pay the same tax whether married or not. (The proximity of the two lower curves in the income range $1,500-$3,500 is the effect of the wife rebate which reduces as the wife's income increases.)

iii The line AB shows the average tax rate on household income as the wife's income increases from $0 to $6,000 per annum, given that the husband's income remains at $6,000. It indicates that a wife going out to work can reduce the household's average tax rate even though household income is increased. There is negligible tax disincentive for working wives.

All of the tax scales considered reduce the steep progression in the middle income range. Thus they reduce the possible tax advantage of a family with more than one income.

Married

Under the present tax scale, the personal rebate and the sharp increase in tax rates over the income range from $2,000 to $8,000 are the causes of the large tax discrepancy between one and two-income households. This discrepancy is only partly mitigated by the wife and single income family rebates. It would be desirable to bring the marginal tax rates of the husband and wife (and any other supplementary income earners in a household) closer together.

The tax scales considered all reduce the steep progression in the average income range. Scale 1 has a personal rebate while the other scales do not. In all cases the disparity between one-income and two-income families is reduced. The scales which have no personal rebate and higher initial tax rates reduce the disparity most. As noted previously a proportional or constant tax rate would equalise the two rates.

a Tax concession for spouse

One rationale for a spouse concession such as the wife rebate is that two people require more income to achieve a standard of living equivalent to that of a single person and there is a presumption that the spouse is dependent. The equivalence scales (see Appendix I) suggest a ratio of about 1.7 times as much income. The present wife rebate clearly does not reflect this ratio. Moreover, as more married women enter the work force the presumption that a wife is dependent in households with no children is questionable. If there were no wife rebate for couples without dependents, the tax structure would be completely neutral to marriage. (It would have a logical corollary in the extension of benefit coverage for married women - this is discussed in a later section.) The abolition of the tax rebate for wives without dependents would save an estimated $15-20 million.

There is another reason for the spouse concession, however. Under a progressive tax scale which incorporates a universal tax threshold such as the personal rebate, there is a tax advantage from income-splitting. This encourages investment in the wife's name, thus diverting unearned income to the wife who has a lower income and a lower marginal tax rate. The present wife rebate overcomes this problem to some degree because it reduces as the wife's income increases, thus raising her effective marginal tax rate. It would be desirable to incorporate a reducing spouse concession if a tax scale were adopted which retained a personal rebate. If there were no personal rebate this reason for a spouse concession is less important.

b Working wives

The various tax scales outlined reduce the tax advantage which presently accrues to a two-income family. In a family with dependent children, however, a wife who provides a second household income by working (as distinct from investment income) does not increase the household's taxable capacity by the full amount of extra income earned. In addition to the costs of employment (for which some deduction is currently allowed) a working wife must purchase child care services which a wife at home does not have to purchase. A family with both parents working therefore should pay less tax than a family with equal income but only one parent working. The issue is how much less.

At a total income of $10,000 a family with two equal incomes currently pays about $20 a week less tax than a one-income family with the same income. This would represent a fairly generous child care allowance. Depending on the size of this difference under alternative tax scales additional allowance could equitably be given to working wives for the costs of purchasing child care. This could be achieved by increasing the housekeeper rebate which at present has a maximum of $3 a week. (There would be little justification in increasing the present housekeeper rebate for working wives if the steep progression in tax rates is not reduced.)

Single parents do not have the tax advantage of two-income families and could warrant a larger allowance for child care costs if a progressive tax scale were retained. A tax scale with a flat rate over a wide initial income range (such as Scale 2 or 3) would not discriminate against single parents in this respect.

4 Indexation

Much of the present problem with New Zealand's tax structure has resulted from the impact of rising nominal incomes on a personal tax scale which has not been adequately adjusted to reflect this. This has two important consequences. Firstly, it allows Governments to increase public expenditure without the need to increase explicit tax rates. Thus the community at large may be less aware of the link between the cost of additional public services and higher rates of taxation. Many commentators have suggested that this has been a contributing factor to large increases in public expenditure in relation to GNP both in New Zealand and overseas. Secondly, since marginal tax rates rise more steeply in some income ranges than in others,

inflation shifts the tax burden, typically to the disadvantage of low income taxpayers and families.

Consideration should be given to indexing the personal tax structure, say to the rate of domestic price increases. Full and automatic indexation is probably impracticable because it would imply a fiscal discipline which is unrealistic given present and foreseeable methods of controlling government expenditure and given the proportion of expenditure which is, itself, effectively indexed. However, partial indexation might be feasible. At the least, if a major restructuring is undertaken, there should be a greater willingness in the future to make periodic adjustments to offset the effect of rising nominal incomes on a fixed progressive tax scale.

IV PROVISIONS FOR FAMILIES DEPENDENT ON MARKET INCOMES

The application of income equivalences to household income distribution suggests that a significant proportion of families* dependent on market incomes achieve a lower level of support, relative to their needs, than many households supported through benefits. For families primarily dependent on an income maintenance scheme, any particular level of support can be ensured by appropriate determination of the benefit rate and abatement provisions, but market incomes are not generally responsive to household composition. Wage rates do not reflect the family circumstances of the wage earner.

It seems likely that families dependent on low market incomes constitute the numerically largest single group of persons experiencing difficulty in maintaining a minimum adequate standard of living. Difficulties arise for two principle reasons. The first is the additional consumption generated by children in the family. (The income equivalences set out in Appendix I demonstrate the effect of this.) The second is the requirement for child care which is usually met by the withdrawal of one parent from market employment with the consequent lowering of household income. In those circumstances where both parents continue to earn, child care must be purchased, with consequent reduction in net income for them also. Thus the presence of dependent children has both cost and income effects on households.

In considering measures to assist families two objectives may be distinguished - one is to ensure that the effect of tax and transfers on households with children is equitable in relation to households without children at all income levels and the other is to ensure a basic but adequate minimum income for all families. The former objective acknowledges that at all levels of income children create extra costs and accepts that those bearing the costs should receive some relief. However, the relevance of this objective decreases with higher incomes and it cannot be seen as having priority over the second objective referred to.

The most straightforward method of providing for the first objective is through universal measures, such as family benefits, which are applied equally to all households with children. Although they are administratively simple they require a high level of transfers which in turn can restrict the scope for removing the disincentive effects of high marginal tax rates.

Universal measures also contribute toward the second objective of ensuring an adequate "floor" of income. However, selective measures permit this objective to be realised with a lower level of transfers because they result in concentration where need is greatest.

* Throughout this section "family" means a household comprising a couple, or single person, and at least one dependent child.

Selective measures which can be applied either through the tax or income maintenance systems, require potential recipients to provide information on the factors which determine their entitlement. There seems to be a greater readiness amongst people to divulge financial information for tax purposes than for benefit purposes. Where selective measures require potential recipients to apply, some will not do so, in which case the measure will not achieve complete coverage.

Inability of families to achieve a minimum adequate standard of living depends upon the level of income and the number of children. One or both of these can be used as criteria for allocating resources. Using only one, or giving one less emphasis than the other,could result either in some low income small families failing to reach an adequate level or in some large families remaining at an excessive disadvantage. It could be argued that having a low income is a less voluntary position than having a large family and that the former group therefore should receive priority, but the full implications, including those for wage levels,have to be considered in choosing the most appropriate measures for providing for families.

1 Family Tax Concessions

Much of the difficulty experienced by families may be attributed to the high level of direct taxation which reduces net incomes. Assistance through the raising of tax thresholds for households and lowering average tax rates would alleviate much of the problem. It could not supplement deficient gross incomes, however, and there would be a need for further income supplements in some instances.

There are a number of ways in which taxation of household income can be approximated while retaining the individual as the tax unit. (Optional joint taxation is discussed in Appendix II). It would be possible to construct a system of tax rebates* which would be allowed to a principal income earner in a household. The rebates would have to be large enough to protect a household in which his was the only income. Adjustments would be required if there was additional household income. He would be required to declare his wife's income and the composition of his household. The objective would be to ensure that a household with one income earner paid no tax unless its gross income was higher than the established minimum level for the particular family composition. Adjustments could be made if the household income exceeded the minimum levels, either because the husband had higher earnings or because the wife was working.

In order to determine the size of total tax rebates required for various types of household it is possible to use the family equivalence scales which have been developed. (See Appendix I.) It should be emphasised that the minimum income level is essentially an arbitrary judgement and that the family equivalence ratios are only one way of quantifying the relationships between families of different size. By way of illustration the married rate of social welfare benefit is taken to be the minimum income level for a two-adult household and equivalent incomes calculated for other household types.

* Tax rebates are the favoured method of tax relief. They are also most easily integrated with a tax credit system of income supplements which is discussed later.

Table 7 shows the minimum income levels and total tax rebates required for each different tax scale and compares this with the present position.

It can be seen that a married couple with two children would need a net income of $105 to achieve the same standard of living as a married couple receiving the present social welfare benefit of about $69 a week. Under tax Scale 3 the husband would pay $26 a week at this income and would therefore require a tax rebate of this amount to ensure his income was not taxed below the minimum. If he were currently receiving a family benefit of $6 a week his required rebate would be only $20.

TABLE 7 : ALLOWANCES REQUIRED TO GIVE FAMILIES EQUIVALENT INCOME TO MARRIED BENEFIT

$ per week (1)

Tax Code	Required Minimum Income	Allowances Required Under Alternative Tax Scales (3)					Present Scale (2)	Existing Allowances (3)(4) Youngest Child Aged		
		Option 1	Option 2	Option 3	Option 4	Option 5		Under 5	6-10	11-16
S1	63	10	18	16	13	11	10	16	7	3
S2	83	16	24	21	18	17	15	19	10	6
S3	101	21	29	25	22	23	21	22	13	9
M1	87	17	25	22	19	19	16	19	10	6
M2	105	22	30	26	24	24	22	22	13	9
M3	122	28	35	31	29	30	29	25	16	12
Tax Rebate : Per Household										
S		5	13	12	8	5	4	13	4	0
M		12	20	18	14	13	10	16	7	3
Per Dependent (3)		5	5	4	5	6	6	3	3	3

(1) All amounts are rounded to the nearest whole dollar.

(2) Allowances which would be required under the present scale after allowance for 5 percent tax cut from 1 February 1978.

(3) The allowance per dependent may be given as a tax rebate or as a family benefit payment. In the right-hand segment of the table the existing family benefit is included in the total together with the rebates for young families, single income families and wife rebate.

(4) The personal rebate is excluded as it is treated as part of the personal tax scale rather than a family tax concession.

Family benefit has been built into the table because it is an integral part of the net income of households. Although the family benefit is discussed subsequently under alternative measures to assist families it should be noted that to introduce tax rebates for each child would be to return to a similar position to that which existed prior to the McCarthy Commission report in 1972, where extra PAYE tax codes were required to allow for family size. The Commission recommended that the then existing tax exemption be converted and combined with the family benefit. The equivalence ratios used in this report to quantify the relative income requirements of families with dependents suggest that some assistance is required on a per child basis. The various tax scales considered suggest different levels of per child tax rebate as well as different levels of household rebate (as shown in the lower section of the table). For example tax scale 5 would suggest an initial rebate for a married couple with dependents of $13 a week and a per child supplement of $6 a week. Tax scale 3, on the other hand, suggests a household rebate of $18 a week for a married couple and a per child supplement of $4 a week.

Interestingly, the application of these particular family equivalence ratios to the present tax scale would suggest that the tax thresholds for families with a child under 5 and less than three children are higher than they need to be. On the other hand, the tax thresholds for families with older children or three or more children do not appear to be high enough. (However, many families with younger children have very high housing costs and may therefore not be as well off as the equivalences suggest).

Appendix VI to this report contains some approximate costs of the various tax options and the family rebates appropriate to each tax scale to ensure that family equivalences are achieved.

Having determined the total level of tax rebates required for each household type for a given individual tax scale, the structure of the rebates could take several forms. The form would depend on the way in which household income was to be approximated. The tax concessions allowed to principal earners could be restricted closely to those families with low total household incomes which would also reduce the total cost. The use of tax rebates to compensate for the cost of child care by a non-working spouse has the disadvantage of increasing the income of the earner but giving no direct reward to the carer.

Appendix VII contains a diagramatic presentation of the following forms of tax rebate and family income supplement measures.

a <u>Increased marginal tax rate on wife's income</u> (Fig 5 Appendix VII)

A higher marginal tax rate on the spouse's income can be achieved by having a single income family rebate and reducing it as the wife's income increases. Because it provides an adjustment directly related to the wife's income this method is the best approximation of joint taxation. (It may not be appropriate to single parent families with high incomes, however.) The present wife and single income family rebates are examples of this form of concession.

The scope for effectively increasing the marginal tax on a wife's additional earnings depends on the personal tax scale - a high initial tax rate over a wide income range (e.g. Scale 3) would provide less scope than a scale where the wife was entitled to a personal rebate (Scale 1). If the total effective rate were too high housewives might be discouraged from working, which would increase the cost of any such tax concession to families. One effect of this device is that, while the effective marginal tax rate on the wife is increased, the extra tax is payable by the husband. Thus it could be seen as a compulsory transfer to the wife in addition to the after-tax income she earns. From a pracitcal point of view the requirement to estimate wife's income for PAYE tax purposes complicates tax administration. Mis-coding due to incorrect estimates can give rise to extra end-of-year adjustments.

There is an anomaly which could arise under this form of rebate. A husband whose gross income was below the minimum required to support his family and whose wife was forced to work to supplement the household income, could have his rebate (and hence his net income) reduced. It would be necessary to ensure that the wife's income did not disqualify the principal earner from obtaining the tax concession if total household income was below the minimum.

An increased marginal tax rate on the wife's income has other implications which were considered in Section III on the relationship between one and two income households.

b Restriction by family type

As a proxy for the secondary income, a presumption could be made that families of a certain size or with young children are more likely to have little or no secondary income because the wife has responsibilities of child care. An implication of this is that in families where there are fewer or older children the single parent or married mother can, and may be expected to, supplement the household income by working. The corollary of this is that the single parent or married mother should also qualify for unemployment benefit if work is not available. Although the issue is more clear-cut for single parents (who can qualify for a social security benefit) the presumption has a close link with child care policy.

If the rebates restricted to families with a child under a certain age are fairly generous, there is a problem that a household's net income can be reduced quite sharply once that age is reached. For instance at the end of the year during which the child of a taxpayer currently receiving the young family rebate turns 5, tax is increased by $9 a week.

Because a rebate of this type does not take explicit account of any secondary income it is possible that a household could be receiving well above the minimum income yet still receiving the full tax concession. The growing trend for wives to work, including many who have young children, makes the age of the youngest child less reliable as an indicator of household income. Its main advantage is that it severely restricts the coverage and thus the cost of the rebate. Families with a child under 5 years of age represent about 42 percent of all families with dependent children.

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c Increased marginal tax rate on husband's income (Fig 5 Appendix VII)

This could be achieved either by reducing the tax rebate as the principal earner's income increased, or by tying the rebate to a higher marginal rate scale. In either case the effect would be that at higher income levels the value of the concession would be partly or wholly eliminated. The rationale for this approach is that at higher income levels there is no longer a minimum income support requirement and it becomes less relevant to maintain equity among households of different composition. Although the principal earner qualifying for a tax rebate would have a higher marginal tax rate than a person who does not qualify, his average tax rate would always be lower.

It would need to be ensured that the extra marginal rate, when added to the basic personal tax rate, was not too high. The present young family rebate reduces at a rate of ten percent on incomes between $7,800 ($150 p.w.) and $12,480 ($240 p.w.). At an income of $8,000 the combined marginal tax rate is 58 percent which compares with 57 percent at an income of $20,000. Obviously, tax scales with lower marginal rates are more amenable to this type of adjustment.

The main deficiency of this form of rebate is that it takes no account of the wife's supplementary household income. It is appropriate for a single parent household, however.

The foregoing discussion suggests that no one method for approximating household taxation under an individual tax system is entirely free of problems. (Some further implications of the tax effects on households with more than one income were discussed in Section III). In practice an amalgam of various options as at present is probably most suitable. Some examples of possible rebates in relation to the various tax scales are given in Appendix VIII.

Since it is desirable to incorporate family tax rebates in PAYE tax deduction tables it is preferable that the number of tax codes be kept to a minimum and the risk of incorrect coding minimised.

2 Family Benefit (Figure 3 Appendix VII)

An income supplement, such as family benefit, paid as a fixed amount per child recognises that children involve additional costs and therefore lower the material standard of living of the household at any income level. Payment to all families regardless of income preserves equity at all income levels between households with children and those without children but does not guarantee a minimum standard of living unless the rate per child is very high. That would involve a large transfer payment to many families who have less need.

As well as being administratively simple the family benefit is paid directly to the mother or parent at home. It is very amenable to adjustment to reflect the different levels of income required to support children of different ages. For instance, it would be possible to graduate the benefit with the age of the child.

Applying the income equivalences to the income distribution of families suggests that the families most commonly experiencing difficulty are those with large numbers of children. An overall increase in family benefit would help large families but assistance could be given more selectively by increasing the rate of benefit in relation to the number of children in a family or by making benefit payable only for families with more than a stipulated number of children. Such measures may not be acceptable and would need to take account of any population policy which New Zealand might develop.

The additional cost arising from any increases in family benefit could be limited by tapering off the benefit at higher income levels. In principle, this could be achieved either by income-testing or by taxation of the benefit. However income testing is ruled out because of the large number (470,000) of benefits in force.

Taxation of the benefit would be administratively complicated. Taxing in the hands of the mother would not be very effective in reducing wastage because, for many families, the husband's income will be the main household income. Taxation in the hands of the father would be more effective but raises many complications in relation to intra-family transfers such as maintenance payments.

A per-child tax rebate would have the same effect as a family benefit for those whose incomes were sufficiently high for their tax liability to exceed the rebate. Those whose incomes were below this level would receive less assistance from a rebate, however.

3 Income Supplement for Low Income Families (Figure 4 Appendix VII)

This approach consists of "topping up" the incomes of households which are below the minimum needed to provide a basic but adequate standard of living. The cost effectiveness of the approach is dependent on :

i the guaranteed income level (which in some applications of the approach may be below the income needed to provide the basic but adequate standard of living);

ii the rate at which supplementation reduces as income increases;

iii the threshold at which no net tax is paid or supplementation received.

Decisions about two of these variables automatically determine the remaining one.

An income supplement approach would bring household incomes up to a guaranteed minimum but it has some problems. For every extra dollar of income earned by the household the supplement would be reduced by a dollar. As this would leave the household no better off it would be a strong

disincentive to be self-supporting. The disincentive would be lessened if the supplement were to be reduced by (say) only 50 cents for each extra dollar of earnings, but then some households would be 'topped up' to a level above the guaranteed minimum. While this problem could be overcome by reducing the guaranteed minimum income, some families would then have insufficient income.

In practice families below the minimum level are likely to be concentrated only just below. A system with a low guaranteed income and a moderate rate of supplement withdrawal would probably be most appropriate as it would not discourage families from becoming self-sufficient by working harder/longer.

An income supplement scheme for low income families could be administered through either the benefit or the tax system. The benefit system is geared to household income-testing, but families would have to apply, lowering the probable take-up rate and hence its effectiveness. An income supplement scheme administered through the tax system is referred to as a tax-credit scheme.* Some practical difficulties arise from the fact that an individual-based tax system is not readily amenable to administering supplements on the basis of household income unless a system of joint taxation is used.

4 Young Family Allowance (Figure 4 Appendix VII)

The withdrawal of one parent from the workforce to care for children is a major cause of lower income in families. Changes in taxation alone cannot alleviate this problem which results from a major loss of household income. To the extent that mothers of younger children become more willing to take up employment the problem of income loss may become of shorter duration in the life cycle. However if home care continues to be the preferred form of child care it is possible that the state will eventually accept an increasing share of the burden of child raising costs by providing a substitute income for the mother at home.

Because of the large number of households with young children the amount of income which could be transferred to them on a universal basis would be small in relation to the income loss of each household. However a beginning could be made with some small selective provision such as an allowance payable to households with pre-school children where there was an earner and a non-working spouse. This would result in the costs of children being shared among all taxpayers rather than falling entirely on families. It would be selective to some extent because one-income families tend to have lower incomes than two-income families. It would be necessary to reduce the allowance if the wife went out to work. This could be achieved by applying a special tax code to her income or reducing the allowance payable. (However, if the total effective tax rate on the wife's additional earnings was too high it may be a disincentive to work, especially as she would also be required to pay for child care.) The allowance could also be made more selective by restricting it to households where the husband's income was below a certain level.

* Such a scheme is similar in concept to a negative income tax which is discussed in Section V.

5 Non-financial Assistance to Families

Housing is a major cost to most families with dependent children. New Zealand's housing policy has been largely geared towards home ownership. For those families who buy houses the period of heaviest repayments is usually over the few years immediately following purchase. The birth of children during this period not only increases the family's costs, but in cases where the wife had been working it usually results in the loss of her income. This combination of circumstances (i.e. a high fixed level of housing repayments, increased family costs and reduced family income) can cause financial difficulties even when the husband's income is above average. Difficulties arising in this way could be alleviated by variable mortgage schemes which provided for a lower level of repayments over the period when a family had only one income. An advantage of this form of financial relief is that, in the long term, it has no financial cost to the state. This is in contrast with (say) providing tax concessions for mortgage interest or subsidising artificially low interest rates on housing loans. More extensive provision of subsidised public rental housing would be of assistance to families who are not buying their own homes.

Families could also be assisted by measures such as free milk in schools and subsidies on certain goods and services commonly utilised by families. Examples of these include baby equipment, children's clothes and shoes, children's use of public transport and perhaps public transport generally. While the last of these would not be very selective, benefiting others as well as families with dependents, it could assist in energy conservation by encouraging wider use of public rather than private means of transportation.

Although suggestions in this report aim to make it possible for all children to be cared for by a parent at home there is clearly a need for child care facilities, especially care for school age children outside of normal school hours and terms. The development of high standard child care services is crucial to the effectiveness of policies designed to rationalise assistance to families and make it possible for families to improve their financial position through the market. It is desirable that Government should facilitate the availability of a range of child care services through better utilisation of existing resources, such as schools, and by encouraging the development of other facilities.

V REALLOCATION OF INCOME MAINTENANCE EXPENDITURE

1 Preamble

a Level of expenditure

It has been noted earlier that the level of expenditure on income maintenance transfers has been rising. Given the economic conditions which prevail at present and are forecast as likely to prevail in the immediate future, it would be unrealistic to propose changes in income maintenance programmes which would require substantial additional expenditure. The present task is to improve the effectiveness and fairness of the income maintenance system while as far as possible "holding the line" in terms of expenditure. While some of the following proposals would increase the costs of the particular programmes to which they relate, the proposals as a whole should be seen as a reallocation of resources to provide a more equitable distribution among the groups dependent on income maintenance transfers.

b Feasibility of establishing a common basis for tax and income maintenance systems

Some commentators have proposed that the criteria by which tax is levied on those with incomes above appropriate thresholds could also provide the basis for supplementing the incomes of those below the thresholds and that on this basis the tax and income maintenance transfer systems could be brought together within a single system. This is most commonly known as a negative income tax approach, because in appropriate cases it involves a transfer from the government to the individual, instead of the other way round as with ordinary income tax.

The conceptual simplicity of this approach has great appeal. Its proponents point out its advantages in the harmonisation of tax and transfers whereby those who earn above a minimum set income would pay tax and those whose income falls below that level would be brought up to a point near it. It seems a logical extension of the tax system and treats all persons through the same administration whether they be payers or recipients. However, there are major problems, particularly in the conflict between the present use of the individual as a unit for tax purposes and the necessity of using the household for income maintenance purposes. From an administrative viewpoint machinery would also have to be established by which payments could be made to persons who had no employer and by which emergency payments could be made. Further, eligibility for receipt of a transfer should be based on criteria other than merely the lack of income. The conclusion of the Royal Commission in 1972 that a negative income tax system "is too inflexible and insensitive to income maintenance problems to be acceptable in New Zealand" still seems valid. More flexibility can be achieved through a co-ordinated approach to the separate tax and transfer systems and that is what is proposed here.

An earlier section, on assistance for low income families, included an option of income supplements paid through the tax system. That option is an application of the negative tax approach. However, because it is limited to households with a full-time earner, and does not seek to subsume the benefit system, it is not subject to the particular administrative difficulties described in the preceeding paragraph, although it does have its own difficulties, noted in the earlier section.

c Use of income equivalences in setting benefit rates

There has been some discussion earlier in this paper about income equivalences - the differing amounts of income required by households of different composition in order to achieve a set standard of living. For income tested beneficiaries it would seem sensible that the amounts of benefit received by households of different composition should be such as to ensure a common basic but adequate standard of living. To achieve this it would be necessary for the amounts received in benefit to be in the same relation to one another as the corresponding income equivalences, although some relaxation of this requirement would probably be appropriate in relation to very large families. (The reasons for this qualification were discussed in the section "Need to ensure income adequacy" page 13). The application of the equivalences to social security benefits would increase the rates of benefit for households with more than one dependent child relative to those for childless households. The appropriate relativities could be achieved either by increasing the rates for households with more than one child, or by giving other households less than the full cost of living adjustment.

d The unit of support

The basic unit of support adopted in the income maintenance system is the family household. The two current exceptions are the accident compensation scheme and the entitlement of a working wife to sickness benefit for a limited period; in each case assistance is provided to the individual without regard to the earnings of the spouse.

There is developing pressure from the community for entitlement to income maintenance to be put on an individual basis. The growing rejection by women of enforced economic dependence upon their husbands together with a developing individualist emphasis in our social values may eventually cause income maintenance systems to shift to a basis of individual entitlement. Indeed a first step has been made in this direction by the recent extension of sickness benefit to working wives for a limited period. The ultimate outcome of a move to individual entitlement would be for all income maintenance provisions to apply in the same way to married as to single persons and for those out of the workforce caring for dependents to be supported on the same basis as solo parents.

Developments in this direction would increase expenditure and in terms of the objective of relieving hardship would decrease the efficiency of the income maintenance system by channelling funds to households which would not qualify on the basis of a household income test because of the earnings of a spouse. The provision of support to all non-working child carers on an individual

basis would be especially expensive.

Thus while a move to individual entitlement of married persons may be a valid long term objective, it is not feasible in the short term. Under present circumstances when it is not economically possible to significantly expand the scope of the income maintenance system, further development towards individual entitlement should not progress at the expense of the primary objective of the relief of need.

e Support of married women

Income maintenance programmes provide for the support of the non-working wives of beneficiaries by treating them as dependents of their husbands. Support is provided whether or not the wives are engaged in caring for children. It is considered that this is now less in accord with social norms and that women without dependent children should be presumed to be potentially capable of self-support, with certain exceptions, such as those who have been out of the workforce in excess of, say, 20 years. There would not then be general justification for paying a married rate of benefit to a man with a non-working wife when she is not caring for children. It would not be reasonable to expect a couple to change their way of life for only a short period of dependence on an income maintenance benefit so the married rate would probably need to be paid for a period long enough to cover most short term contingencies and to give time for adjustment in life style to be made.

If such a principle were adopted it is suggested that a man qualifying for an income tested benefit might receive only half the married rate for his particular household size. This could be subject to either :

i a household income test (which would take account of the spouse's income); or

ii an income test applying only to the individual.

Married women would be subject to the same provisions, so the change would remove current differences in the provisions for men and women. The former option would not result in an increase in expenditure and would ensure a minimum level of support for the family household, thus meeting the primary objective of relief of need. However, it would be somewhat restrictive and might be objected to on the basis that it would make one spouse dependent on the other. The latter option would accept the principle of individual entitlement to benefit and is related to moves for the independence of women. It would increase expenditure.

f Married and single rates of benefit

At present the rate of benefit provided to a married couple is 83 percent of the amount which two single persons would receive. The rationale for a couple receiving less than twice as much as a single person is that in living together they can be presumed to achieve economies of scale.

In practice, marital status is not a very good indication of whether a person is living alone or with others. Many single persons live with others (e.g. a young person sharing a flat with others, elderly persons living in their children's households) and it can be assumed that they generally enjoy the same economies of scale as married persons living together.

It is worth considering whether it might be sensible to set a basic individual rate which assumes a group-living arrangement and to make provision for those who in fact are living alone through the introduction of a "living alone supplement", which would be provided on the basis of a declaration by the beneficiary about his living situation. It would be necessary to define specifically the types of living arrangements which would be regarded as living alone (so that the status of those in boarding houses, in semi-detached baches without cooking facilities, etc. is made explicit) but an initial examination suggests the problems would not be insuperable.

Obviously such a change would need to be introduced in such a way that no one was made worse off in absolute terms. It would probably be best to combine it with a cost of living adjustment of rates, with the result that less than the full adjustment would be received by beneficiaries on a single rate of benefit who did not qualify for the "living alone supplement".

g Abatement of benefit

Much public attention has been focused on anomalies and work disincentives resulting from current provisions for the abatement of income-tested benefits. It can be shown, for example, that at certain levels of income a beneficiary can actually suffer financially by increasing his/her earnings. This is said to result in beneficiaries being unable to improve their financial position by working and to lead therefore to dependence on benefit payments rather than to independence. However, the likelihood of such anomalies arising and the extent to which providing work incentives is an issue of practical importance differ according to the type of benefit. For example, sickness benefit is provided on the basis of medical certification of the recipient's unfitness for work, so providing a work incentive is not in general a relevant concern. By contrast, the circumstances of some solo parents would not prevent them from working and in such cases the current abatement provisions undoubtedly act as a powerful disincentive. It is considered that to ignore these differences and try to provide a general treatment of abatement issues would not be useful. Although this can be seen as introducing inconsistency into a previously uniform scheme, the view is held that it is more important that provisions for each class of benefit should be internally consistent rather than consistent with benefits provided for different purposes. Accordingly, the matter is dealt with separately for each type of benefit in the sections which follow.

2 Specific Suggestions for Adjustments to Income Maintenance Schemes

There are four broad categories of person who depend in whole or in part on income maintenance transfer payments : solo parents and others who care for dependents; the sick and disabled; the unemployed; and old people. As each category has its own characteristics and needs, it is appropriate that income maintenance programmes for them be considered separately. There is also a brief discussion of the need for discretionary provisions in the income maintenance system generally.

a Benefits for solo parents and those who care for other dependents

New Zealand's child care policy favours the family as the basis for child care and benefit provisions have been developed which give solo parents a viable choice of remaining out of the workforce in order to care for their children. As a result of social changes which have occurred over recent years, benefit expenditure for support of solo parents has risen steeply.

The present benefit schemes distinguish between widows and other solo parents but in both cases they provide a full rate of benefit as long as there is a dependent child. Given the developing social acceptability of women with children being in the workforce, current eligibility could be considered as too broad. While it would seem appropriate that a solo parent with a young child should have the option of devoting herself/himself entirely to its care, there is much less justification for providing full support to one with a child of, say, 15 years. It might be considered that at some point between these extremes the solo parent should become at least partly self-supporting if suitable work is available.

Provisions for widows in fact go beyond the objective of providing support for those caring for children and extend into providing for the widow herself under certain conditions. For example, widows benefit is payable to widows whose children are no longer dependent and also to widows over the age of 50 who have never had a child. Men are not eligible for such support though they are eligible for domestic purposes benefit. Thus widows benefit provisions reflect societal expectations that married women will normally be out of the workforce and entirely supported by their husbands with this supporting role becoming the responsibility of the state if the husband dies.

It is questionable whether it is still appropriate to pay widows benefit to younger widows who have no dependent children and indeed whether widows with dependent children should be treated differently from other solo parents, including widowers.

A feature of present benefits covering solo parents which has attracted public criticism is the schedule of abatement of benefit on the basis of the beneficiary's other income. At present the combined effect of abatement of benefit and income tax means that virtually no advantage is obtained from an increase in weekly earnings over a wide income range. For solo parents not in a position to take full-time employment at a relatively high rate of pay,

the abatement schedule provides a strong disincentive to work for more than a few hours a week.

There are two basic options for tackling this problem :

i changing the abatement provision (perhaps with an accompanying change in the benefit rate);

ii reducing the benefit rate, or eliminating eligibility for benefit, for those who can reasonably be expected to be partly or wholly self-supporting.

Conceptually, the first option is attractive but presents practical difficulties. An abatement schedule which, when tax is taken into account, would give even a modest retention rate for earnings would result in benefit supplementation of earnings up to a high income level. For example, for solo parents with a child under five, a retention rate of 45 percent or higher would result in the benefit providing supplementation at <u>all</u> levels of earnings, no matter how high.

For a retention rate of 40 percent (which in any case would probably be regarded by many solo parents as providing little incentive to increase earnings) supplementation would continue until earnings reached about $13,000 per annum.

These calculations do not allow for any income to be exempt from abatement provisions; to do so would further increase the income level up to which supplementation through benefit would continue. (There are sound administrative reasons for continuing to have an exemption, as it avoids the need to adjust the benefits of the large number of beneficiaries who are not working but who have small amounts of income from interest on savings, etc.)

If benefits provided supplementation of earnings up to such a high level it would have two undesirable effects. Firstly, it would put solo parents in a favoured position compared with two-parent families dependent on market incomes. Not only would this be inequitable but it could also reduce the willingness of earners to accept as fair the contribution they make through taxes to the income maintenance system. Secondly, it would make eligible for supplementation many solo parents who at present do not receive benefit and who manage satisfactorily on their own resources.

The second option is not subject to these objections but is open to others. It would be seen by some as harsh and as representing a backward move in our welfare provisions. On the other hand it is consistent with the principle that the fundamental purpose of income-tested benefits is to provide for those who are prevented by incapacity or circumstances from supporting themselves. It would recognise that some solo parents presently on benefit could partially or wholly provide for themselves while still continuing to enjoy their parental roles and without jeopardy to the quality of the care their children would receive.

On the basis of the foregoing considerations benefit provisions for solo parents along the following lines would seem reasonable. There would be two classes of benefit :

Class A : For solo parents whose youngest child was below some specified age (e.g. 7 years)

A full benefit would be paid. There would be no abatement of benefit for income up to a modest level - the equivalent of one day's work at the average wage, say. For income above that level the benefit would abate sharply, because the principle reason for the benefit is to enable a solo parent to care for her/his own child. Those who work long hours thus erode the basis of their eligibility. Persons who wished to work longer hours than provided for by the abatement provisions could opt for a Class B benefit (below).

Class B : For solo parents whose youngest child was older than the limit for a Class A benefit but was below some higher specified age (e.g. 14 years).

Such parents would be considered to be 50 percent employable unless they had more than two children of this age or unless one of the children was handicapped, in which case the parent could continue to receive a Class A benefit. Class B benefit would be paid at 50 percent of the full benefit rate and would not be abated until total income exceeded the amount which could be achieved by a Class A beneficiary. If the parent was registered as unemployed, full benefit could be paid. Eligibility for this benefit would cease when the youngest child reached the upper age limit. Solo parents becoming thus ineligible could receive unemployment benefit if they could not find work. There would need to be recognition of exceptional circumstances which would permit an extended period of support through benefit, (for example having been out of the workforce for many years).

Single persons caring for disabled adults could also be eligible for a Class A benefit. Eligibility would require medical certification of disability and the need for full-time care.

It is worth considering whether this provision might not be extended to provide for the care of a disabled adult by a married person whose spouse is working. (Probably the most common instance of such an arrangement would be a married women caring for her own or her husband's elderly parents). While this would extend the provision for the care of disabled adults beyond those for the care of dependent children it would be consistent with the widespread acceptance of the social and economic desirability of non-institutional care for the old and disabled. If the measure led to a reduction in the number of such people in institutional care it could produce a net financial saving.

b The sick and disabled

More inequities presently exist among this group of people than among any other group of beneficiaries, persons with virtually identical physical conditions being in different financial circumstances depending upon whether their condition arose through an accident, through war service or through an illness.

Accident victims receive payments related to their previous earnings, ex-servicemen receive payments regardless of their ability to earn and the sick receive income tested flat rate payments. In the year ended 31 March 1977 $39.6 million was paid out by the Accident Compensation Commission in earnings related benefits, $66.6 million was spent on war pensions and $47.5 million was the cost of sickness and invalids benefits.

Broadly, the main approaches to reconciling the provisions for accident victims and the sick are to shift the sickness provisions closer to those for accident victims; to shift the accident provisions closer to those for the sick; or to develop some combination of the two schemes.

It must be recognised, however, that accident compensation provisions were a total package which included the elimination of civil law remedies whereby compensation could be awarded by the courts. It would be extremely undesirable to return to the previous situation of some compensation being based on litigation. This puts a constraint on the extent to which the second approach above can be pursued.

It would be possible to incorporate all the sick and disabled into one compensation scheme similar to the present accident and war pensions schemes, paying earnings related benefits for periods out of the workforce and continuing grants for long term disabilities which do not necessarily result in economic loss. This would compensate people, as far as it is financially possible, for the effects of their disability. The costs of such a scheme are difficult to calculate but would doubtless be high for it would bring in an unknown number of people in addition to those who currently qualify for benefits. Such a scheme would be more concerned with compensation as an objective than with the meeting of need and would result in considerable leakage to those persons with otherwise adequate incomes.

However, if for economic reasons it is not possible to extend the accident scheme to other incapacitated persons, it would seem appropriate to consider other ways of reducing the disparities between the different groups of sick and disabled people. Some options are :

i Social security sickness and invalids benefits could continue to be paid at a flat rate but the income test could be removed and the benefit made available regardless of the sex or marital status of the applicant. The main advantages of this would be that the long term disabled would not be discouraged from engaging in such employment as was open to them, and that married people who were sick would not be disqualified because of the income of their spouses.

ii All the sick and disabled could be incorporated into one social security category similar to the present sickness benefit scheme. Eligibility would commence one week after the onset of the condition and it would depend on regular medical certification and an income test. It would not be affected by sex or marital status. Benefits would be paid at a flat rate. This would ensure that need was satisfactorily met and it would be less costly than the present three systems. However it would contain no element of compensation either for loss of fitness or for actual economic loss so it would probably not be popular.

iii A new scheme could be devised which would incorporate elements of both the social security and the accident compensation approaches and which would apply to all sick and disabled people regardless of their sex, their marital status, or the origin of their condition. Essential features of this would be :

- A short stand-down, or no-payment period (of one week, say) with discretion to cover this period under certain conditions.

- A benefit, beginning from the end of the stand-down period which would for an initial period be earnings related. This would tide the beneficiary over a limited period off work without an undue drop in income, and would give him an opportunity to adjust to a more modest standard of living if he was going to be out of the workforce for a long period. If earnings related benefits were paid for three months, approximately two thirds of the sick would be covered for the full period they were off work. One third would be fully covered if earnings related benefit were paid for one month. There could be an upper limit for earnings relationship at say 1½ times or twice the average wage.

- After the period of earnings related benefit a flat rate benefit would be paid.

- The long term disabled could qualify for additional assistance in forms such as a lump sum paid to those suffering total or partial permanent disability, or a lump sum payment (similar to a Christmas bonus) to those who had been continuously on flat rate benefit for the previous year.

- Because most benefits would be short term and beneficiaries would have other income during the year, it would be appropriate to tax the benefit.

- Certification of incapacity for work would constitute eligibility for the benefit and a person who chose to work would thereby negate the grounds of his eligibility although special provisions could apply in cases of long term or permanent incapacity.

- A person could be deemed to be say, 50 percent incapacitated and could receive 50 percent of the benefit, being expected to supplement this from earnings. If no suitable work was available he could be paid at the full rate.

- For administrative purposes it would be necessary to exempt a small amount of income, but unless a person was certified by his doctor as only partially incapacitated and was receiving a reduced benefit on that account, income from earnings would cause the benefit to be abated. In practice it is expected that few people would be affected by such a provision.

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- Some provision could be made for medical care expenses of those in receipt of benefit. These would subsume the current accident compensation provisions for medical costs.

- Increases in costs would arise from the extension of earnings related benefits to those whose incapacity arose for reasons other than accident. Cost increases would depend upon the period and the level of earnings relationship chosen. Savings would come from a reduction in the period that accident victims could remain on earnings related benefits, from reducing the privileges in relation to medical care and by unifying the administration of all benefits for the sick and disabled. Funding could continue to be from a combination of levies and general tax revenue.

Option (iii), which shifts both accident compensation and sickness provisions to a common intermediate position, is considered the most satisfactory option in principle. However, this option would constitute an extension of the social security system on a basis not related to need *per se* and would require a substantial increase in expenditure.

A change in this direction is desirable in the long term. Indeed, as one aspect of the general move towards individual entitlements it is probably inevitable. However, as has been noted previously, in the short term the primary objective should be relief of those currently in need. Changes of the type proposed above should not be carried out at the expense of this objective.

c The unemployed

The involuntarily unemployed suffer as much dislocation of their personal and financial circumstances as do those who are prevented from working through sickness so benefits should be paid on a basis which reflects the same objectives of income maintenance as for sickness and disability. While inevitably there will be some who will attempt to abuse unemployment provisions there is considerable experience in applying administrative safeguards such as testing willingness to work.

It would be possible to develop unemployment provisions along the lines of option (iii) for the sick and disabled (above) whereby after a stand-down period an unemployed person receives an earnings related benefit for a certain time and subsequently a flat rate of benefit. The benefit could be income tested and subject to tax and would be payable to any persons who became unemployed after a stipulated period of full time employment. Special provision would have to be made for school leavers. As in the case of an income related sickness scheme, this development would increase expenditure and should have lower priority than changes directed at the relief of need.

Although not strictly an income maintenance issue, there is a need to develop programmes aimed at encouraging constructive use of the unemployed person's large amount of uncommitted time. These would involve the education services for vocational training programmes, the social services for utilising the

unemployed as volunteers, and the recreation services for the development of leisure activities. While under some circumstances payment of benefit could be conditional upon the beneficiary undertaking vocational training it would not be appropriate to make it conditional upon his undertaking voluntary social service work or participating in recreational activities.

d Old people

The definition of "old age" is itself difficult because aging occurs differently among people and is affected by a variety of factors including the person's earlier life style and health. For planning purposes 65 has usually been accepted internationally as being most appropriate although some European countries adopt an older age and some developing countries a younger age. In New Zealand the age of retirement has generally been considered to be 65 but the introduction of national superannuation is likely to lead to an acceptance of the age of 60. Life expectancy at age 60 in New Zealand is 16 years for men and 20 years for women.

8

Most societies willingly accept the responsibility to support their older members, and New Zealand took its first statutory steps in this direction at the end of last century. The support initiated at that stage was based on the principle that income maintenance would be provided where financial need was proved. This has continued to be one principle of the income maintenance system. But from the gradual introduction of a universal retirement pension in 1938 another principle emerged in relation to the aged - that of presumed rather than tested financial need. It had the implicit assumption that beyond a certain age people were unlikely to be able to be self-supporting and should therefore qualify for income maintenance without the necessity for individual assessments. Now a third principle has taken precedence, that of the pension being a right of all older citizens in recognition of the contribution that they have made to society.

Options for the payment of pensions to old people can be considered in the light of these principles and related social and economic policies, including the possibility of restricting the growth of expenditure on such pensions, which already absorbs 71 percent of total spending on social welfare benefits. Questions tend to revolve around five issues in particular : firstly, the age from which the retirement benefit should be paid to old people; secondly, the rate of payment; thirdly, whether payments should be universal (i.e. not subject to an income test); fourthly, the effect of the benefit provisions on participation in the workforce; fifthly the level of expenditure.

The shift from the previous benefit provisions for the aged to the present national superannuation scheme gives rise to two problems. Firstly, it has produced a substantial increase in income maintenance transfers at a time when the overall level of transfers is becoming more difficult to sustain. Secondly, the lowering of the eligibility age for universal provision from 65 years to 60 could hasten the recent trend towards an earlier average age of retirement. This is not only because it eliminates the income test for those in the 60-64 age group who wish to retire, but also because it may encourage more businesses to adopt age 60 as the usual (and in some cases compulsory) retirement age for employees. While there may be a tendency

for some presently retired persons in the 60-64 age group to return to the workforce as a result of the removal of the income test for that group, it is difficult to know whether this will outweigh changes in the opposite direction. The net effect could be a reduction in labour force participation and thus a loss of productivity unless concerted attempts are made to encourage older people to remain in work by providing suitable job opportunities, especially for part-time employment.

The consideration here of possible adjustments to the national superannuation scheme does not include the reintroduction of a contributory funded scheme partly because the ground has been well traversed in recent years and little could be added in this report. It is also important to recognise the necessity for stability in schemes for retirement provisions, so that citizens can with confidence make long range plans for their old age. Thus a generally conservative stance should be taken in considering possible modifications to schemes for retirement pensions.

It is recognised that there would be great difficulties in changing the national superannuation scheme, but in view of its very high cost it is important to consider the possibilities for doing so. A reasonable constraint would be that no one should be made worse off if he is already retired and has no source of income other than national superannuation. The following are some options :

i It would be possible to increase the age of universal eligibility for national superannuation while retaining other aspects of the scheme. People between the age of 60 and any higher universal eligibility age would receive national superannuation subject to an income test. Such a scheme could provide a saving in expenditure.

ii The qualifying age for national superannuation could be raised to 65 years and persons under that age unable to be employed would qualify for sickness or unemployment benefit. This would reflect the desirability - consistent with other policy for the aged - of people continuing to be actively engaged for as long as possible. It would also be consistent with an economic policy geared to maximum productivity, although it might conflict with a policy of giving preference for employment to young persons in times of high unemployment. A social cost may be experienced if persons compulsorily retired were unable to find other work and their pride and dignity suffered as a result of their being classified as unemployed. Such a scheme would reduce expenditure on national superannuation.

iii An income test could be introduced for national superannuation. This would reduce expenditure by ensuring that only those in financial need received payments but it would be a return to the principle of meeting only proven need and would have no element of there being a right to a benefit solely on account of old age.

iv The rate of national superannuation could be reduced to the usual social security basic but adequate level.* This would be consistent with other income maintenance policies which are designed to relieve need but would not reflect the principle of reward for past contributions to society. However, a change could not be made precipitately as it could reduce the income of some persons whose only income is national superannuation. Gradual modifications could only be made by not fully adjusting rates in relation to wage increases. Expenditure would be lower than for the present scheme.

v Two rates of national superannuation could be paid, one being at a higher rate but based on an income test. This would meet the principle of adequately relieving tested need and also meet the principle of paying a pension as of right. It would reduce the leakage to those with adequate other income and enable savings to be made on overall costs.

e <u>Discretionary payments</u>

It is desirable that a benefit structure should confer rights to income maintenance in certain contingencies; that these rights should be explicit in law; that they should be widely known and easily understood by citizens; that they should be such as to maintain not only the well-being but also the dignity of the recipients. However, in addition to these statutory benefits it is also desirable that provision be made for discretionary payments to meet extraordinary circumstances whether they relate to additional need or to unusual conditions. It is unlikely that any system of benefits could be developed which would cover every possible contingency and it is thus necessary to incorporate such an additional discretionary element.

Such a scheme should also apply to members of the workforce experiencing unusual hardship.

* It should be noted that the present rate of national superannuation provides only a modest income when viewed in the light of a two income family becoming the norm. Where a husband and wife have each been on the average wage their income in retirement will be only 40% of that which they previously received. Attitudes to present rates may therefore change as women increasingly remain in the workforce in middle age.

VI CONCLUDING COMMENT

This report was prompted by concern at the rising level of expenditure on income maintenance schemes and the fact that the increase in expenditure has been financed largely from direct taxation with the burden falling heavily on the average income earner. A further concern has been that some families dependent on market incomes have not been able to achieve even the basic standard of living of those in receipt of benefits, which in turn has resulted in decreased acceptance of social security objectives in general among earners. It is likely too, that high tax rates have led to a greater avoidance and evasion of tax; to some people being disinclined to work harder or longer; and, among the more mobile, tax rates may have been a factor in the decision to emigrate.

Thus, high average and marginal rates of income tax have contributed to some of the alienation and disincentive currently being experienced in New Zealand. Tax reforms are therefore seen as being necessary for social as well as economic reasons.

If public expenditure in terms of GNP, including expenditure on income maintenance schemes, cannot be restricted, it is clear that reductions in the burden of income tax in the average income range cannot be made without raising revenue from some other source. Therefore, as well as putting forward options for restructuring personal income tax scales, the report suggests a thorough investigation of indirect tax options and discusses some possibilities for widening the tax base.

A fundamental consideration in exploring possibilities for restructuring the tax system, as well as in the design of income maintenance programmes, is ensuring that all households have an income high enough to achieve a basic but adequate standard of living. A table of income equivalences has been developed to provide some guidelines for this. The report gives particular attention to possible ways of assisting large families, low income families and single income families through both the tax and the benefit structures.

In a discussion of income maintenance schemes, possibilities are explored for the reallocation of available resources among the various categories of recipients so as to minimise the inconsistent treatment received under different schemes, and some issues which arise in developing income maintenance programmes are examined.

The report attempts to highlight some of the choices available to policy-makers and the issues underlying those choices. It has shown that there are possibilities for restructuring the tax and income maintenance systems so as to achieve greater equity between different groups of New Zealanders.

APPENDIX I

INCOME EQUIVALENCES

To compare the financial well-being of households of different composition it is necessary to take into account not only net household incomes but also the demands on income arising from the composition of households. Income equivalence scales provide a means of making such comparisons. Equivalence scales are intended to establish the relative net income needed so that families of different composition can achieve an equal standard of living.

Several equivalence scales have been developed in overseas countries, with households being distinguished in terms of a variety of considerations, including number of adults, costs to adults associated with working, whether adults are retired, number of children and ages of children. For an equivalence scale to be credible, the minimum distinction which needs to be made between households is in terms of number of adults and number of children.

A supporting paper by J. Jensen, Minimum Income Levels and Income Equivalence Scales, provides a brief review of methods of deriving income scales and proposes a set of equivalences which might provisionally be applied to New Zealand. The equivalences are set out in Table 1.

TABLE 1 : Provisional Income Equivalences for Households Distinguished by Number of Adults and Number of Children (Taking a household of two adults as a standard, with a value of 1)

Number of Adults	Number of Children						
	0	1	2	3	4	5	6
1	0.60	0.92	1.20	1.46	1.70	1.94	2.16
2	1.00	1.27	1.53	1.77	2.00	2.22	2.43
3	1.35	1.60	1.84	2.06	2.28	2.49	2.70
4	1.67	1.90	2.12	2.34	2.55	2.75	2.95
5	1.96	2.19	2.40	2.61	2.81	3.01	3.20

The table indicates that to achieve the same standard of living as a household comprising two adults, a household of two adults and one child requires 1.27 times as much income; a household of two adults and four children requires twice as much income; a household of a single adult (without children) requires 0.60 times as much income, and so on.

If minimum incomes set for families of different composition are intended to ensure a common basic but adequate standard of living, then they should bear the same relation to one another as the income equivalences. However, it may be neither practicable nor desirable to precisely realise this requirement. For example, it may be necessary to limit the size of family beyond which the minimum income would not be further elevated. This could be

supported on the basis that, in general, children are desired by and bring satisfaction to their parents so that having a large family could be regarded as implying a willingness to accept a lower standard of living than that adopted as the basic but adequate level.

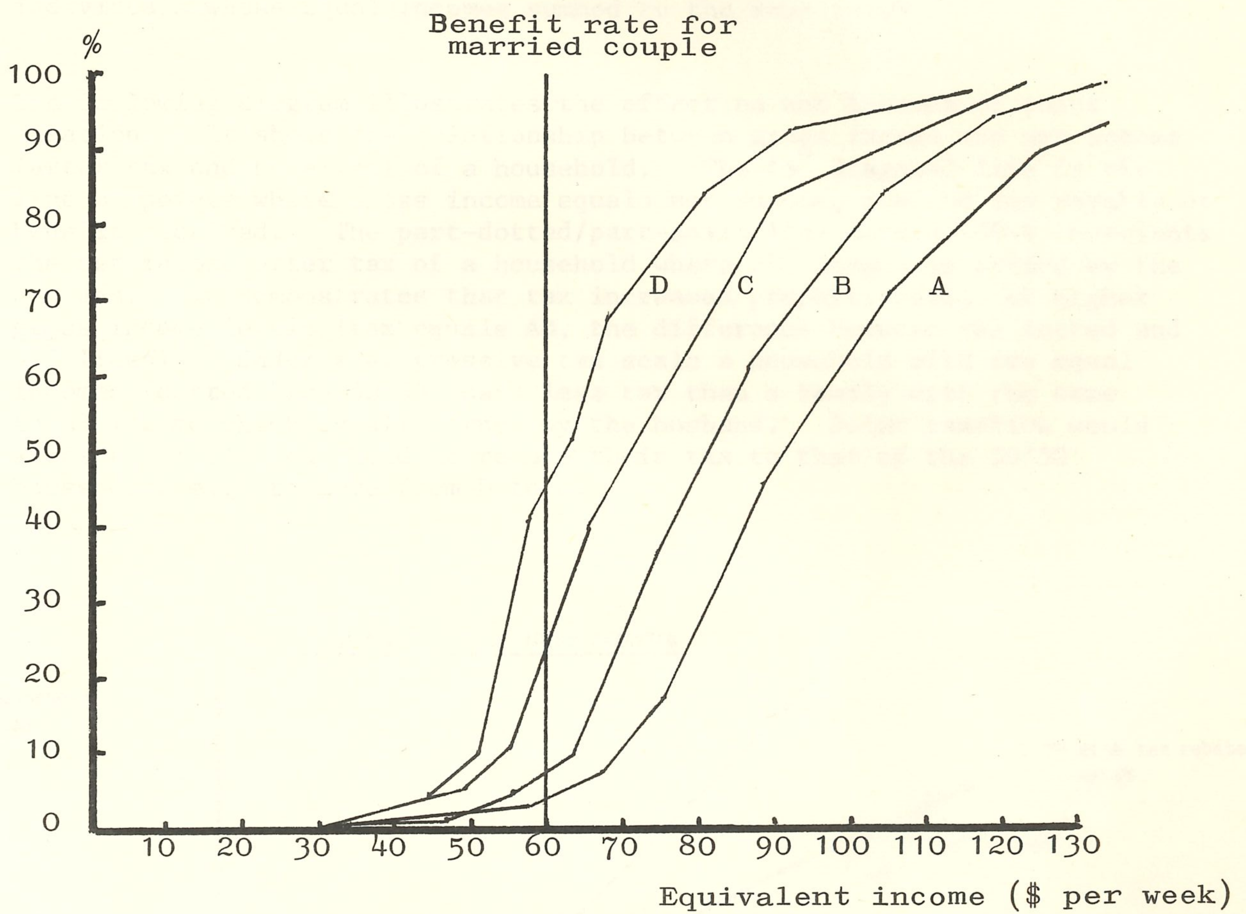
The income equivalences given above have been applied to data on household incomes obtained by the Department of Statistics in its Household Sample Survey. The results are problematical because of assumptions which have had to be made to convert the gross income data provided by the survey to disposable income. Nevertheless the picture they present is probably correct in its outlines.

The equivalent income distributions of families with varying numbers of children are shown in Figure 1. They are for the period March 1976 to March 1977. The horizontal axis is in equivalent dollars, with a married couple with no children again being taken as the standard.

In October 1976, the middle of the period to which the figures relate, the rate of benefit for a married couple was $60.36 so those families with equivalent incomes above this amount can be regarded as being comparatively better off in terms of income than married couple beneficiaries.

The distributions indicate that as family size increases, the proportion of families below a particular equivalent income level also increases. A significant proportion of families with three or more children are below the reference level defined by a married couple on benefit. Specifically 3 percent of families with one child and 7 percent of families with two children are below this level compared with 22 percent of three child families and 42 percent of families with four or more children.

Figure 1 : Households BELOW specified equivalent income by family size (March 1976 to March 1977 estimated from Department Statistics Household Sample Survey.)



A - Couples with one child.
B - Couples with two children.
C - Couples with three children .
D - Couples with four children.

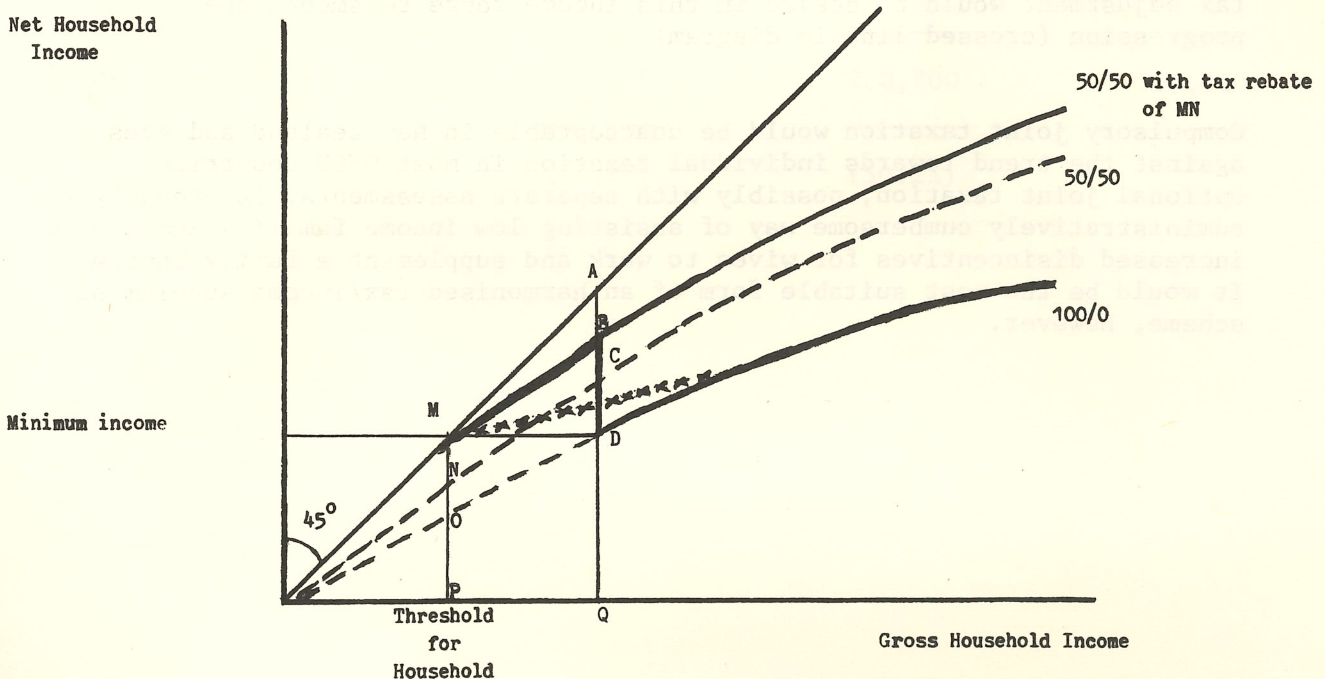
APPENDIX II

JOINT TAXATION

Optional joint taxation would achieve the best approximation of household taxation. Tax could be calculated in either of two ways. Husband and wife could average their incomes, calculate the single rate of tax on each half and multiply by two. A couple with only one income would add zero as the second income. Alternatively, the two incomes could be aggregated and taxed on a separate tax schedule. In either case the effect would be to lower the household's average tax rate to that of two individuals whose equal incomes summed to the same total.

The following diagram illustrates the effect on net incomes of joint taxation. It shows the relationship between gross income and net income (after tax and benefits) of a household. The 45° diagonal line is the line of points where gross income equals net income, i.e. no tax payable or benefit received. The part-dotted/part-solid line marked 100/0 represents the net income after tax of a household where all income is earned by the husband. It demonstrates that tax increases proportionately at higher gross income levels (tax equals AD, the difference between the dotted and 45° lines). Under a progressive tax scale a household with two equal incomes (dotted line 50/50) pays less tax than a family with the same total income which is all earned by the husband. Joint taxation would allow the 100/0 household to reduce their tax to that of the 50/50 household, e.g. to move from D to C.

FIGURE 1 : EFFECT OF JOINT TAXATION



Joint taxation across-the-board would result in equal taxation of equal income families. It would therefore be equitable to allow two-income families a deduction for the costs of child care which would not normally be incurred by a single-income family.

Tax rebates based on the number of adults and dependents would be used to set the tax threshold for the household. For example, if the minimum household income was M, a tax rebate of MN would raise net incomes by the distance MN at all levels above income P.

Joint taxation would not necessarily mean joint assessment. Separate returns could be filed and separate assessments or refunds issued. The two parties would have to agree, however, as the lower income individual would have his individual tax increased by joint assessment. Optional joint assessment would be complicated for PAYE purposes because of the requirement to estimate spouse's income as is done at present with the wife rebate.

The option could be restricted to families below a certain income level. Since the majority of low income families are dependent on a single income this may not have great advantages over individual taxation. It would, however, reduce the risk of supplementing a principal earner's income when the wife was also working. There are some low income families where the wife is forced to work to supplement an otherwise inadequate household income. In these circumstances joint taxation would increase her marginal tax rate thus raising the disincentive to work and reliance on state concessions.

Restriction of the option to a certain income level (say Q) would require a decision about the position of single income families below the minimum who would, by joint assessment, move above the threshold (from D to B). A tax adjustment would be needed in this income range to smooth the progression (crossed line in diagram).

Compulsory joint taxation would be unacceptable in New Zealand and goes against the trend towards individual taxation in most OECD countries. Optional joint taxation, possibly with separate assessments, is probably an administratively cumbersome way of assisting low income families and implies increased disincentives for wives to work and supplement a family income. It would be the most suitable form of an harmonised tax/income supplement scheme, however.

LOWER INCOME TAXPAYERS

TABLE 1 : OCCUPATIONS OF WAGE AND SALARY EARNERS WITH INCOMES UNDER $6,500 IN 1978/79

Occupation	No. of Returns Full Year Full Time	Part Year/ Part Time	Total
Students	-	51,300	51,300
Housewives	-	37,600	37,600
Superannuitants	10,700	7,600	18,300
Construction workers	21,800	26,100	47,900
Farming	11,500	6,800	18,300
Retail/wholesale	28,100	25,500	53,600
Manufacturing	42,400	24,900	67,300
Community services	63,000	42,000	104,900
Office workers	80,800	38,900	119,800
TOTAL	258,300	260,700	519,000
	(49.8%)	(50.2%)	

TABLE 2 : INCOME DISTRIBUTION OF WAGE AND SALARY EARNERS WITH INCOMES UNDER $6,500 IN 1978/79

Approx. Income Range 1978/79	OCCUPATION					
	Students	Housewives	Superannuitants	Other: Full Time	Other: Part Year/Time	Total
$						
0 - 1,300	32,400	21,100	4,300	4,000	58,400	120,200
1,300 - 2,600	13,400	9,000	7,300	20,300	46,900	96,900
2,600 - 3,900	4,000	4,400	2,100	47,300	31,200	89,000
3,900 - 5,200	1,500	1,500	3,300	70,500	19,700	96,500
5,200 - 6,500	600	1,200	1,500	106,100	14,800	124,200
TOTAL	51,900	37,200	18,500	248,200	171,000	526,800

Notes : (i) Difference between totals in this table and in Table 1 are due to rounding errors.

(ii) As this estimation was based on a sample of 1976/77 tax returns and national superannuation was introduced from February 1977, the number of superannuitants returning less than $6,500 would be substantially greater than the number shown here.

(iii) Less than one percent of taxpayers returning less than $6,500 would claim the young family rebate for a child under five years of age.

TAX OPTIONS

The present marginal tax scale, including the personal rebate of $155 a year, is shown in Figure 4 (line of large dots). The effect of the personal rebate is that no tax is payable on the first $775 of an individual's income. It can be seen that the rates are steeply progressive in the income range $2,000 to $6,500 and then flatten out rapidly. Progression increases again on income between $18,000 and $22,000.

The uneven progression in the tax scale has resulted in the fiscal drag effects (i.e. the growing proportion of tax being taken as a person's income increases) being borne largely by the middle income group. Figure 1 shows the uneven impact of fiscal drag under the present tax scale. The percentage shown on the vertical scale can be interpreted as that proportion of a rise in income that is removed by fiscal drag, e.g. a fiscal drag of 20 percent means that a rise of ten percent in nominal income results in a rise of eight percent in after tax income (ten less 20 percent of ten). Figure 1 shows that for a single person the degree of fiscal drag peaks at 26.8 percent at an income of $6,000 then falls away to 20.7 percent at $16,000. It then rises again steeply to 29.3 percent at $22,000. It also shows that at any income level the drag effect is more marked for an M code taxpayer. Taxpayers qualifying for family rebates have a higher degree of fiscal drag because the rebates effectively increase the progression in the tax structure by increasing the level of income not subject to tax.

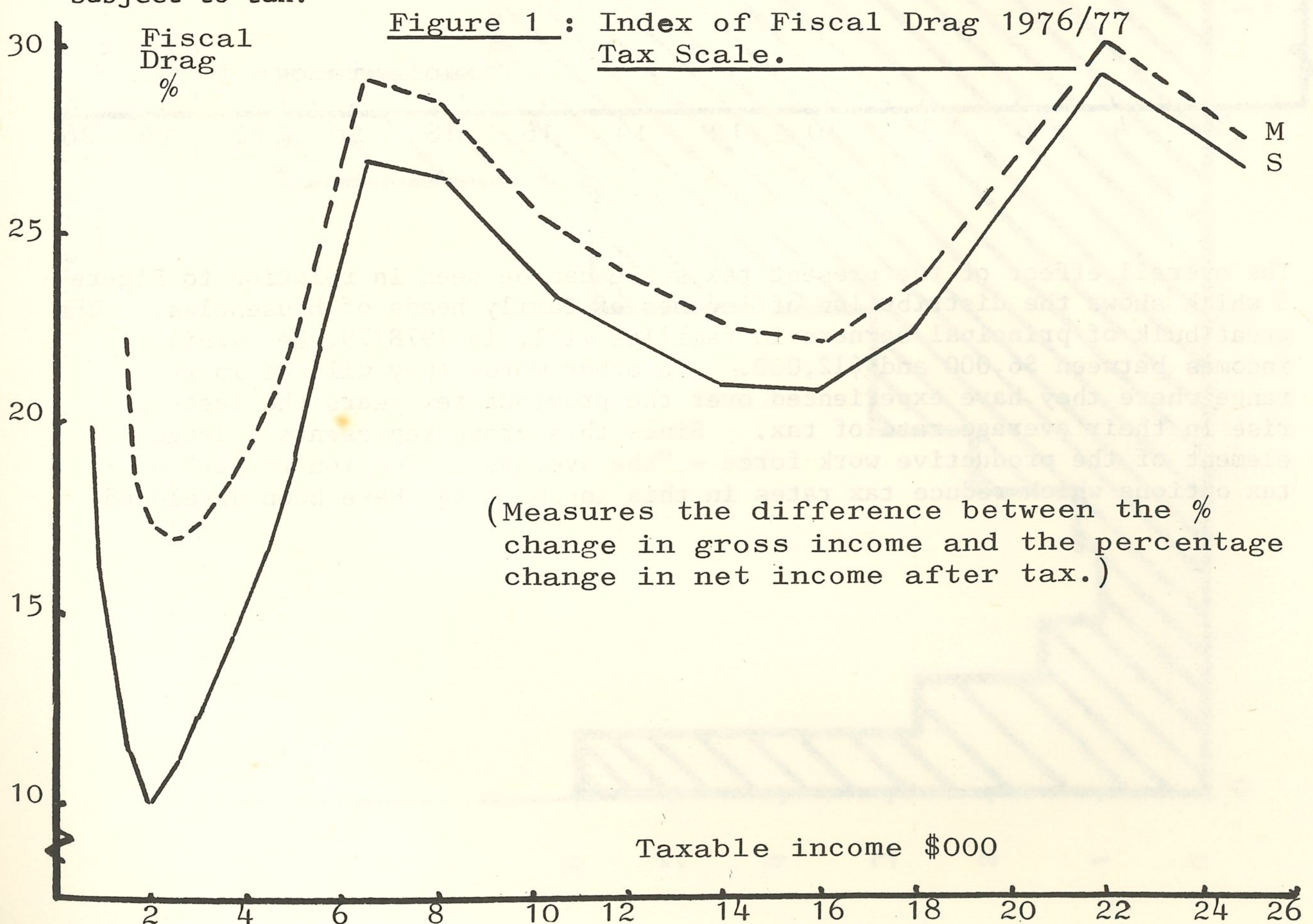
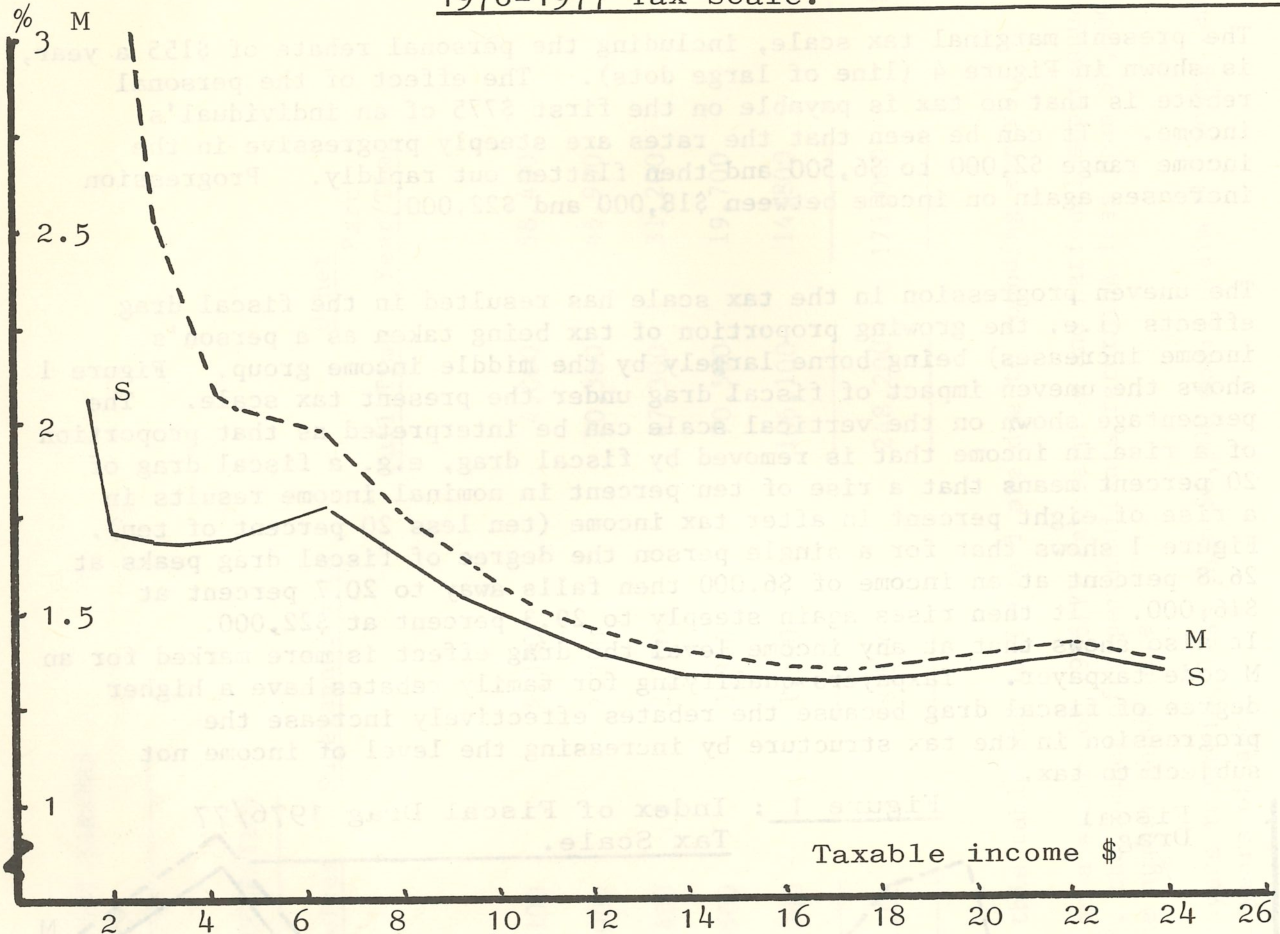


Figure 1 : Index of Fiscal Drag 1976/77 Tax Scale.

Figure 2 measures the same effect from the point of view of the percentage increase in tax, rather than in net income, which results from a rise in gross income.

<u>Figure 2</u> : Tax Elasticity-Percentage change in tax for a given percentage change in taxable income: <u>1976-1977 Tax Scale.</u>



The overall effect of the present tax scale can be seen in relation to Figure 3 which shows the distribution of incomes of family heads of households. The great bulk of principal earners in families will, in 1978/79, be earning incomes between $6,000 and $12,000. In other words they will be in the range where they have experienced over the previous few years the fastest rise in their average rate of tax. Since this group represents a large element of the productive work force - "the average production worker" - tax options which reduce tax rates in this income range have been developed.

Figure 3: 1978/79 Distribution of Incomes of Heads of Households (Of one complete family only households, estimated from 1976 provisional census results : number of households = 550,360 .)

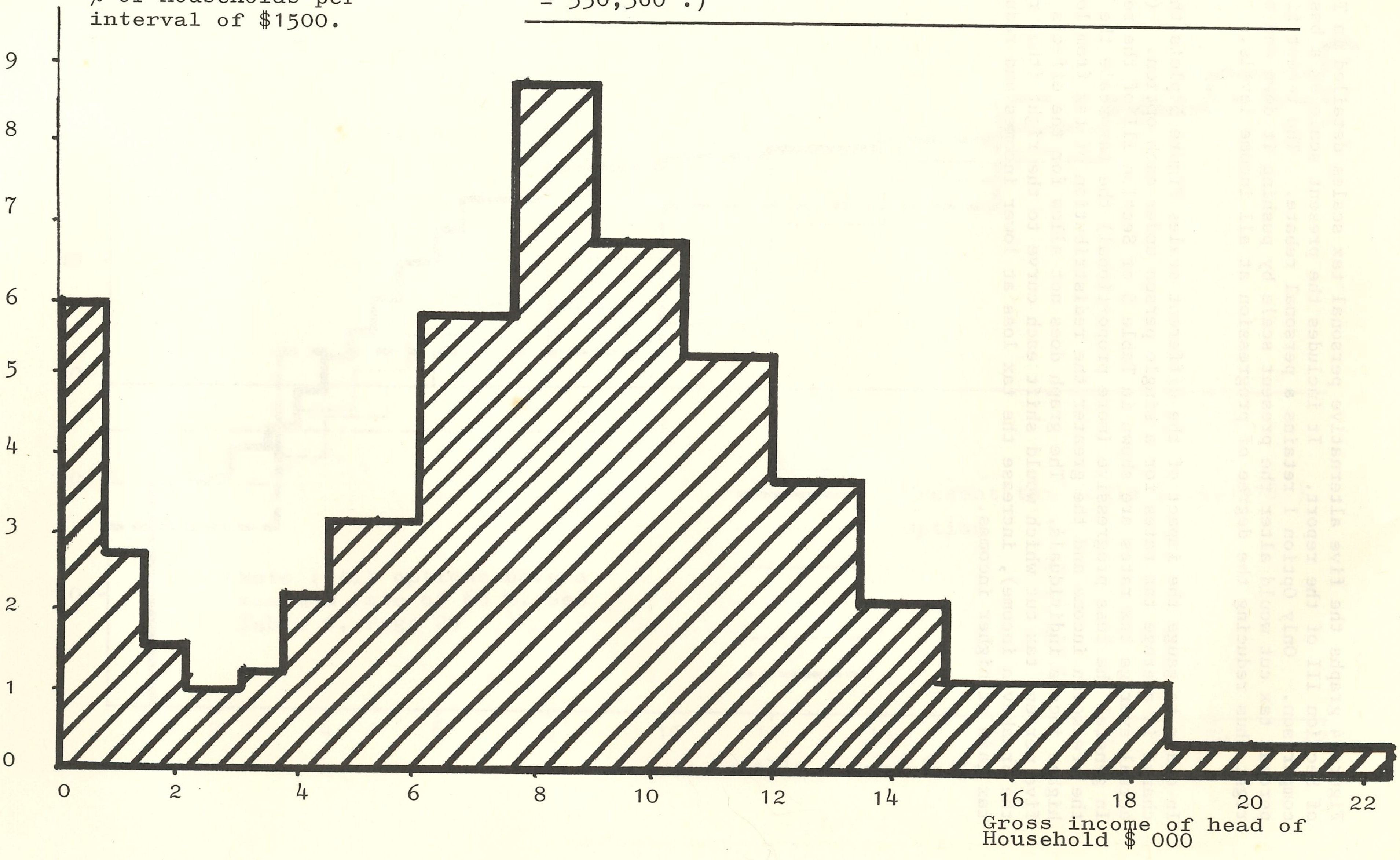


Figure 4 graphs the five alternative personal tax scales detailed in Table 5 of Section III of the report. It includes the present scale as a basis of comparison. Only Option 1 retains a personal rebate. The recent five percent tax cut would alter the present scale by pushing it down and to the right thus reducing the degree of progression at all income levels.

In order to gauge the impact of the different scales Figure 5 plots the change in average tax rates for a single person under each option. (The actual average tax rates are shown in Table 5 of Section III of the report). In general the less progressive (more proportional) the tax scale the higher the breakeven income and the greater the redistribution of tax from lower to higher income individuals. The graph does not allow for the effects of the five percent tax cut which would shift each curve to the right (thus raising the breakeven income), increase the tax loss at lower incomes and reduce the tax gain at higher incomes.

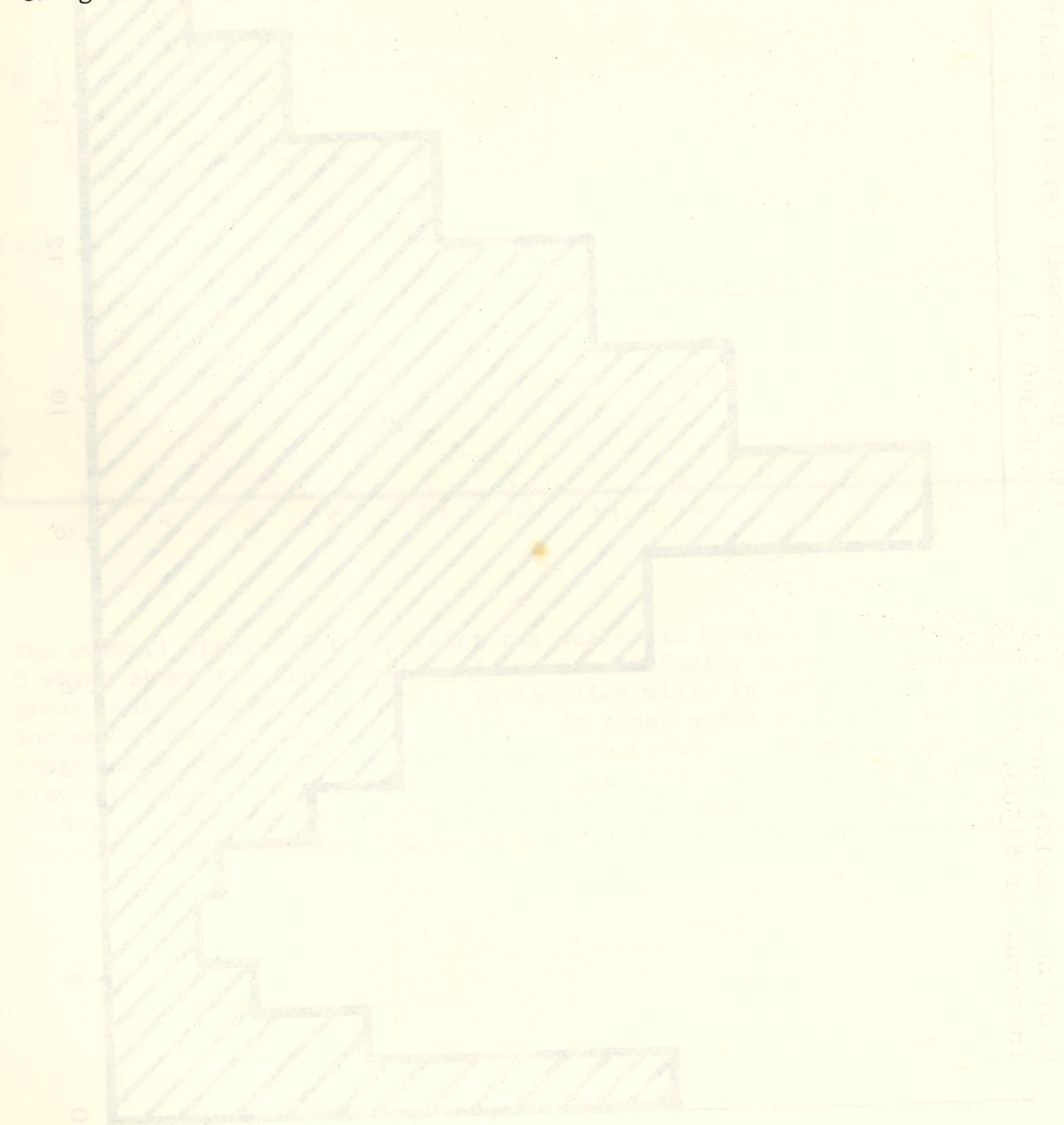
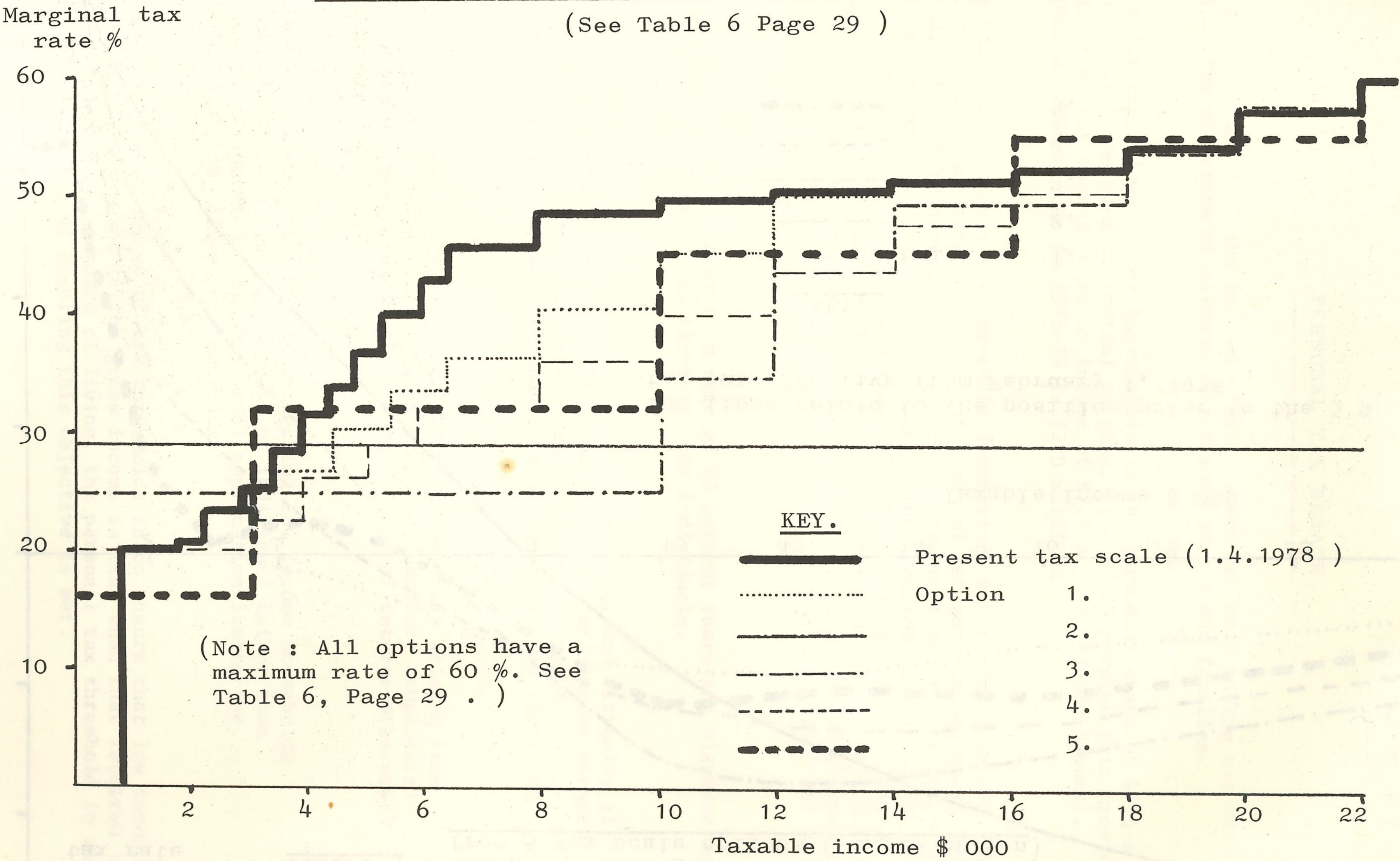


Figure 4 : Marginal Tax Rates for five tax scale options.

(See Table 6 Page 29)



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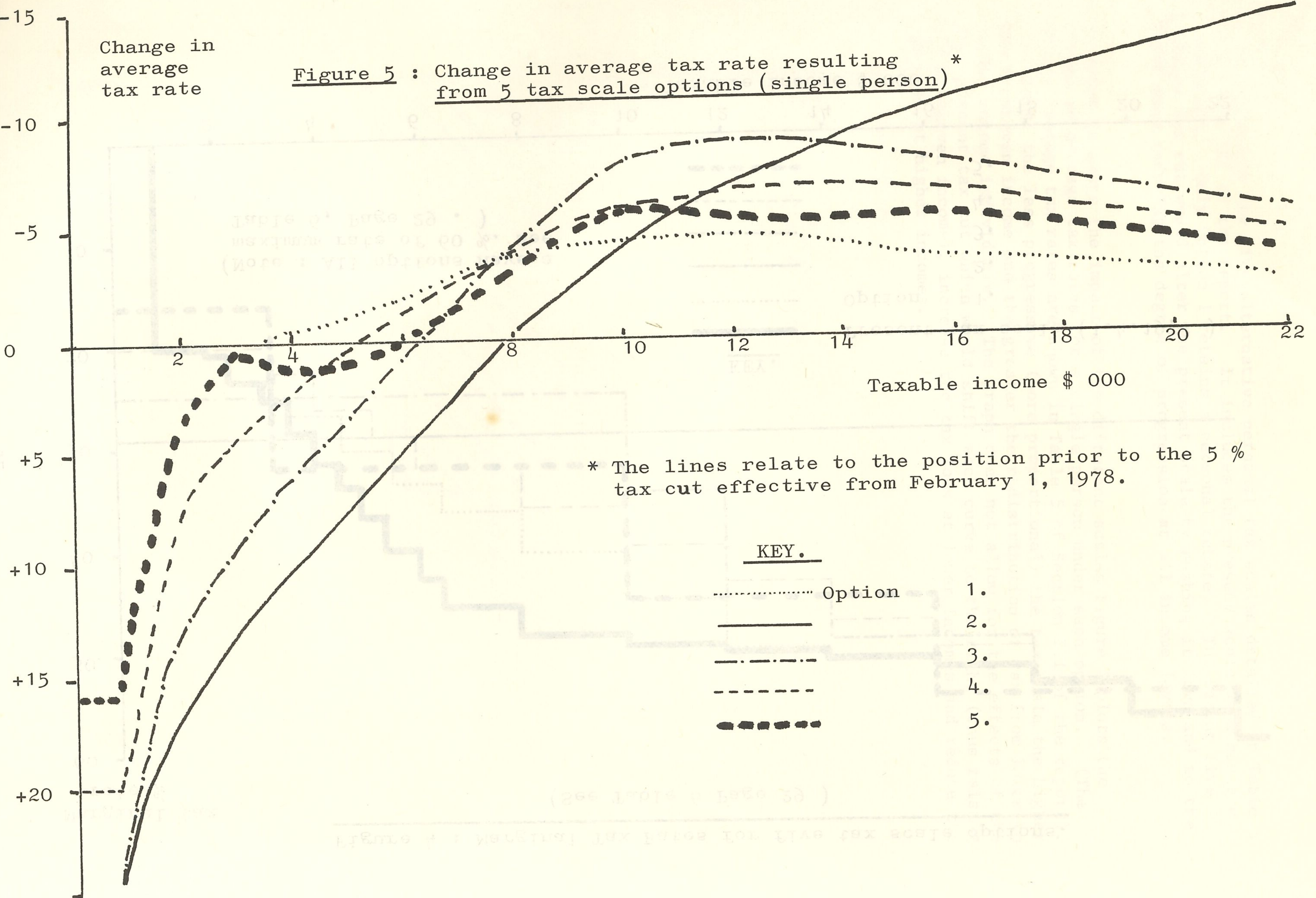

Figure 5 : Change in average tax rate resulting from 5 tax scale options (single person) *

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APPENDIX V

PERSONAL TAX REBATE

The overall impact of the tax structure depends not only on the tax scale but also on the structure of allowances for individuals and families.

The major tax allowance for individuals is the personal rebate of $155 a year. Combined with the present initial marginal rate of 20 percent this provides a universal tax threshold at an income of $775 a year ($14.90 a week). The estimated revenue loss in 1978-79 is $270 million.

Originally the personal tax threshold (exemption) was designed to avoid the need for low income taxpayers to furnish annual returns and pay small amounts of tax. With PAYE deductions at source for the vast majority of taxpayers this reason now has little significance. The need for salary and wage earners to furnish returns now arises only where they qualify for tax concessions not built into PAYE tax tables or where they change status or have fluctuating incomes during the year. (There is a statutory exemption from furnishing returns for those whose income is less than $2600 and is entirely taxed at source.)

Given a tax scale with a minimum rate of 20 percent there are disadvantages in retaining a universal tax threshold for individuals.

i The bulk of taxpayers in the lower income range, and virtually all those returning less than $775 a year are secondary income earners supplementing another primary source of household income. At present this group pays an unduly small proportion of the total tax burden.

ii It is a major reason for terminal tax adjustments arising from part-year earnings (e.g. by students) and therefore complicates tax administration by increasing the number of returns otherwise required.

iii It is an ineffective way of protecting low income households because it is allowed in respect of individual rather than household income and its universal application limits the amount of tax rebate per individual.

If the fundamental purpose of tax thresholds is to ensure that low income households are not taxed if the gross income is less than that required to maintain the minimum standard of living, the personal tax threshold is not a cost-effective way of ensuring this objective is met.

When the one income family with two adults plus children was the norm it was reasonable to suggest that minimum wage levels reflected the requirement to support a non-working spouse. With the advent of equal pay and the rising labour force participation of married women this is far less true. Minimum wages are now more likely to reflect individual rather than family support requirements. It is probably also reasonable to suggest that tax rates affect gross wage levels because trade unions are anxious to maintain net income levels as well as gross factor rewards. In these circumstances a personal tax threshold to protect low income individuals may not be an essential tax requirement. Clearly, the present threshold of $775 does not of itself ensure a minimum living standard for one person. Instead this objective is, by and large, achieved for full-time workers through minimum wage requirements.

Because all taxpayers qualify for the personal rebate, its abolition would raise average tax rates at all income levels, but most markedly at the lower income level. The income level at which an individual would be unaffected by the abolition of the rebate (i.e. neither better nor worse off) would depend on any associated changes in tax rates. Obviously, the higher the initial tax rate the higher the breakeven point.

APPENDIX VI

ESTIMATED COSTS OF ALTERNATIVE TAX OPTIONS

Table 1 gives an indication of the range of costs of alternative tax scales in comparison with the present scale prior to the 5 percent tax reduction announced in the October 1977 mini-Budget. The family rebates appropriate to each tax scale as set out in Section III of the report are also costed. The rebates are calculated to ensure that no tax is payable on incomes less than the equivalent of the married rate of social security benefit. The equivalent income is as determined by the study group according to the method outlined in Appendix I.

For the purposes of this costing it is assumed that the amount per child is paid as a family benefit rather than as a tax rebate. Because per child tax rebates would not be received by families with incomes below the tax threshold they would cost less than equivalent family benefit payments. To the extent that family tax concessions are restricted in coverage - by the methods outlined in Section III of this report the cost of various options would also be reduced.

The first column of the table shows the estimated revenue from the present tax scale and the estimated cost of existing family benefit and family tax rebates. The second column shows the estimated cost of additonal family assistance measures to achieve the equivalent income objective if no change were made to the present tax scale. Columns headed Options 1 to 5 show the same position for the various tax scales developed.

TABLE 1 : ESTIMATED REVENUE IN 1978/79 FROM ALTERNATIVE TAX AND FAMILY ASSISTANCE OPTIONS

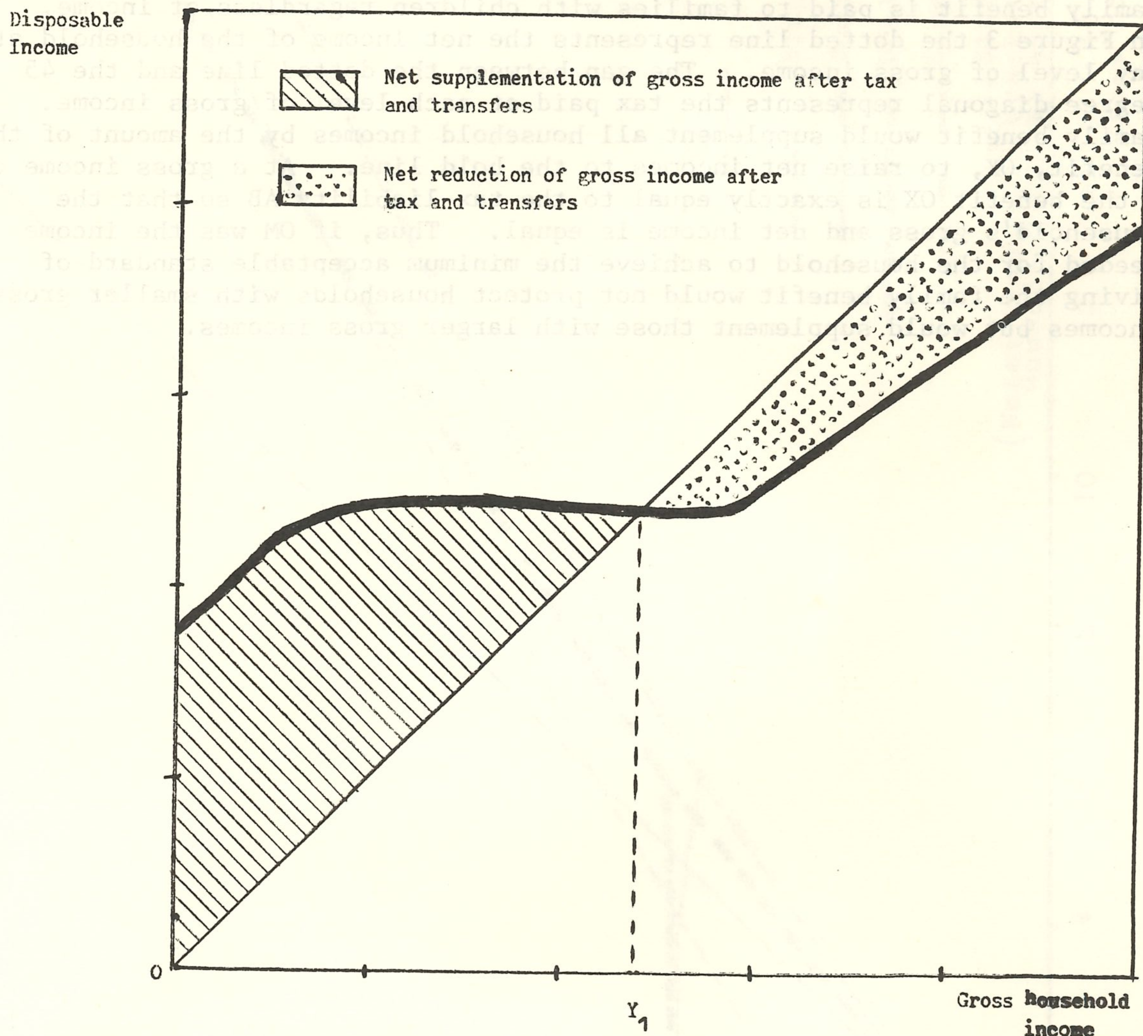
($ million)

TAX SCALES	Present Scale	Present Scale	Option 1	Option 2	Option 3	Option 4	Option 5
Revenue	4,070	4,070	3,480	3,515	3,505	3,480	3,495
Less personal rebate	270	270					
	3,800	3,800					
Less 5 percent tax cut	200	200					
	3,600	3,600	3,480	3,515	3,505	3,480	3,495
FAMILY ASSISTANCE							
Family Benefit	160	320	270	270	215	270	320
Family Rebates							
If allowed to all families with a child aged:							
either under 16 (470,000)	-	230	275	470	420	315	295
		or	or	or	or	or	or
or under 10 (300,000)	30	145	175	300	270	200	190
		or	or	or	or	or	or
or under 5 (200,000)	55	100	120	200	180	135	125
Wife rebate	60	-	-	-	-	-	-
Net Revenue if family rebates allowed in full to all families with a child under 16	3,295	3,050	2,935	2,775	2,870	2,895	2,880

A DIAGRAMMATIC PRESENTATION OF OPTIONS FOR ASSISTING FAMILIES

Graphs are presented in this Appendix to show the effect which various options would have on family income. As an introduction, a simple graph is presented (Figure 1) to explain the effect of taxes and transfers on household income. It demonstrates the relationship between gross incomes and disposable incomes.

Figure 1 : Explanatory Graph.



In Figure 1 the horizontal axis represents gross household income (most commonly earnings) before tax and transfers. The vertical axis represents net disposable household income after tax and transfers. The line through the origin (0) at 45 degrees to the axes defines the points where gross and net income are equal, i.e. no benefit is received or tax payable, or the benefit exactly equals any tax payable. The heavy line shows the relation between gross and disposable income for a household which, subject to an

income test, is eligible for a benefit. It shows that disposable income exceeds gross income until the point Y_1 of gross income because the benefit received exceeds the tax paid. From that point on disposable income is less than gross income because the tax paid exceeds any benefit received. Thus, at zero gross income the household receives a full benefit, but as gross income rises the benefit is diminished and tax increased. At some income above Y_1 benefit is zero.

Figure 2 uses this presentation to show the effect of the present tax and transfer system on households with no children.

Family Benefit

Family benefit is paid to families with children regardless of income. In Figure 3 the dotted line represents the net income of the household at any level of gross income. The gap between the dotted line and the 45 degree diagonal represents the tax paid at each level of gross income. A family benefit would supplement all household incomes by the amount of the benefit, OX, to raise net incomes to the bold line. At a gross income of Y the benefit OX is exactly equal to the tax liability AB so that the household's gross and net income is equal. Thus, if OM was the income needed for the household to achieve the minimum acceptable standard of living the family benefit would not protect households with smaller gross incomes but would supplement those with larger gross incomes.

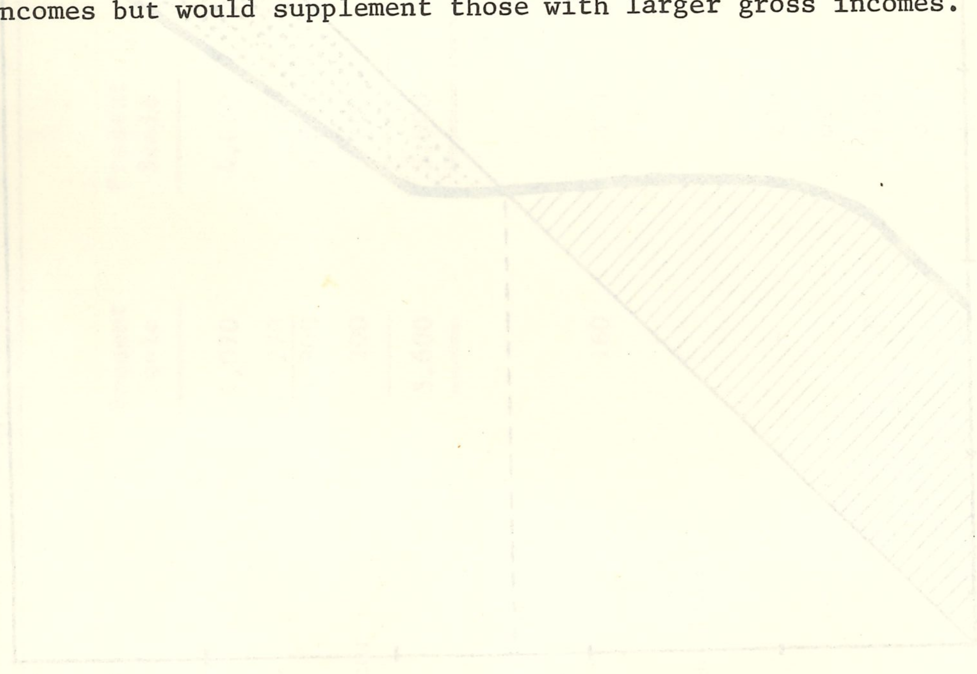


Figure 2: Effect of present tax/transfer system on households with no children.

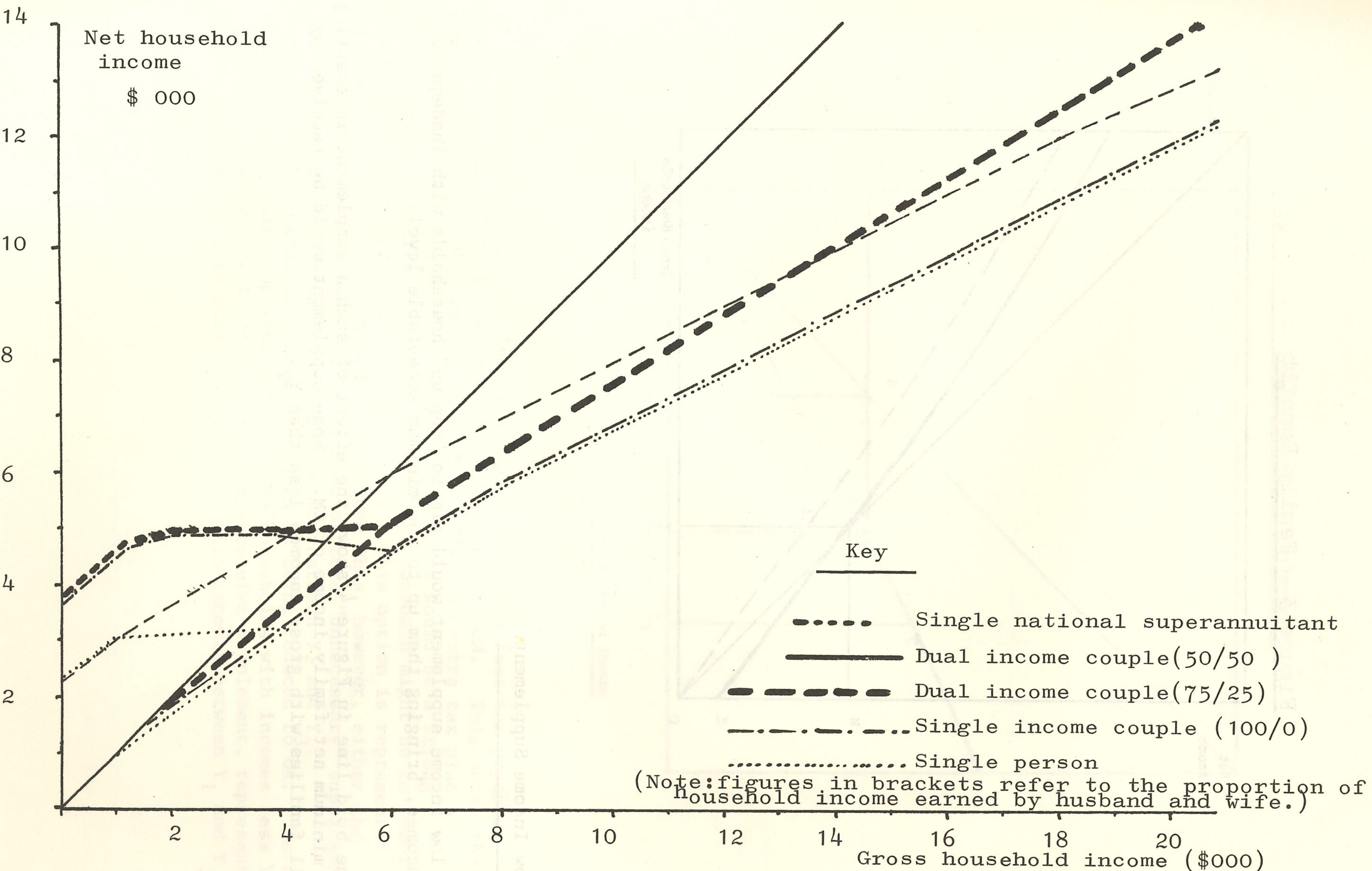
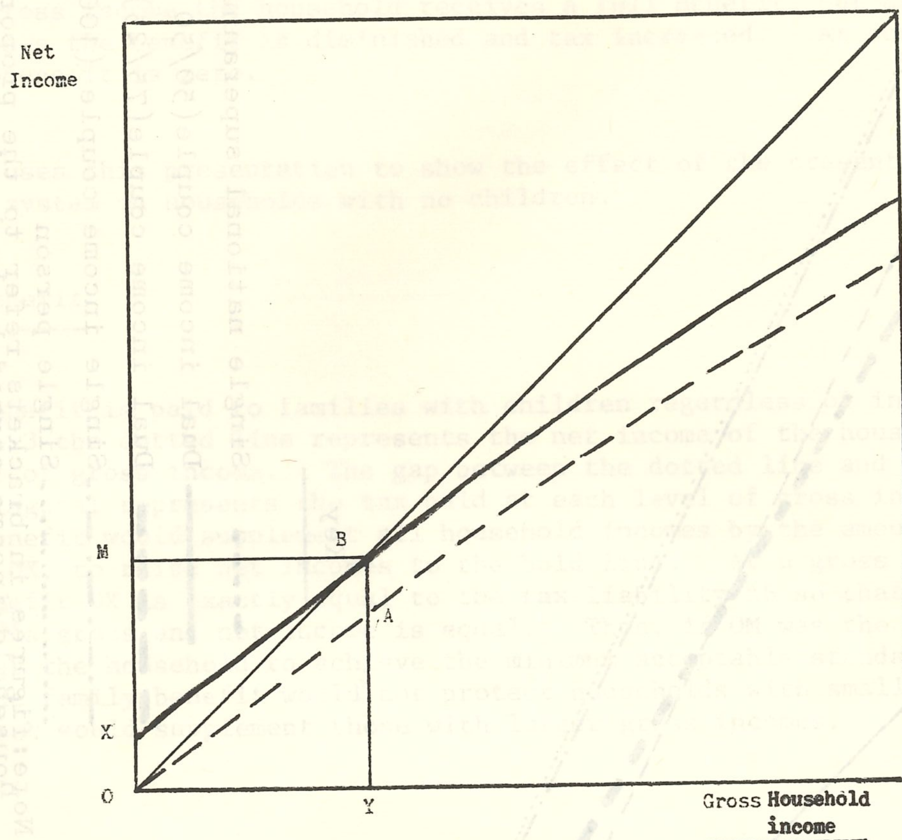


Figure 3 - Family Benefit

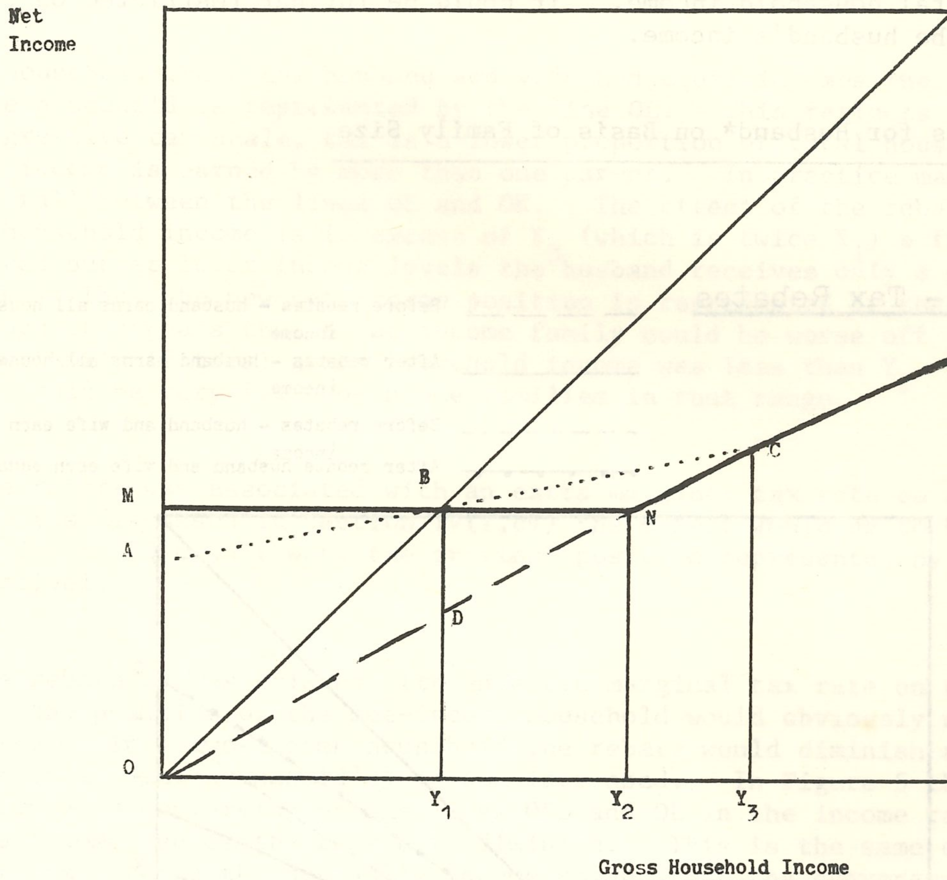


Low Income Supplement

A low income supplement would aim to "top up" households with inadequate incomes, bringing them up to the minimum acceptable level.

The bold line in Figure 4 shows the effect of such a supplement in ensuring a minimum net family income of OM. Some supplement would be received by all families with gross incomes less than Y_2.

Figure 4 - Low Income Supplement



At an income of Y_1 the supplement BD would exactly offset tax payable. For all incomes up to Y_2 the net income is equal to OM. This means that every extra dollar of earnings is exactly offset by extra tax plus a reduced supplement totalling a dollar. As this would be a strong disincentive to increase earnings, a modified approach might be to lower the rate at which the supplement cuts out. This option is represented by the dotted line AC. In order to achieve this, however, either the minimum guaranteed income must be reduced or some "unnecessary" supplement (BC) must be paid to households with incomes between Y_1 and Y_3.
In Figure 4 the guaranteed income is shown as being reduced to OA. As a result an inadequate supplement is paid to households with incomes less than Y_1, represented by the triangle AMB. An excessive supplement, represented by the triangle BCN, is paid to households with incomes between Y_1 and Y_3.

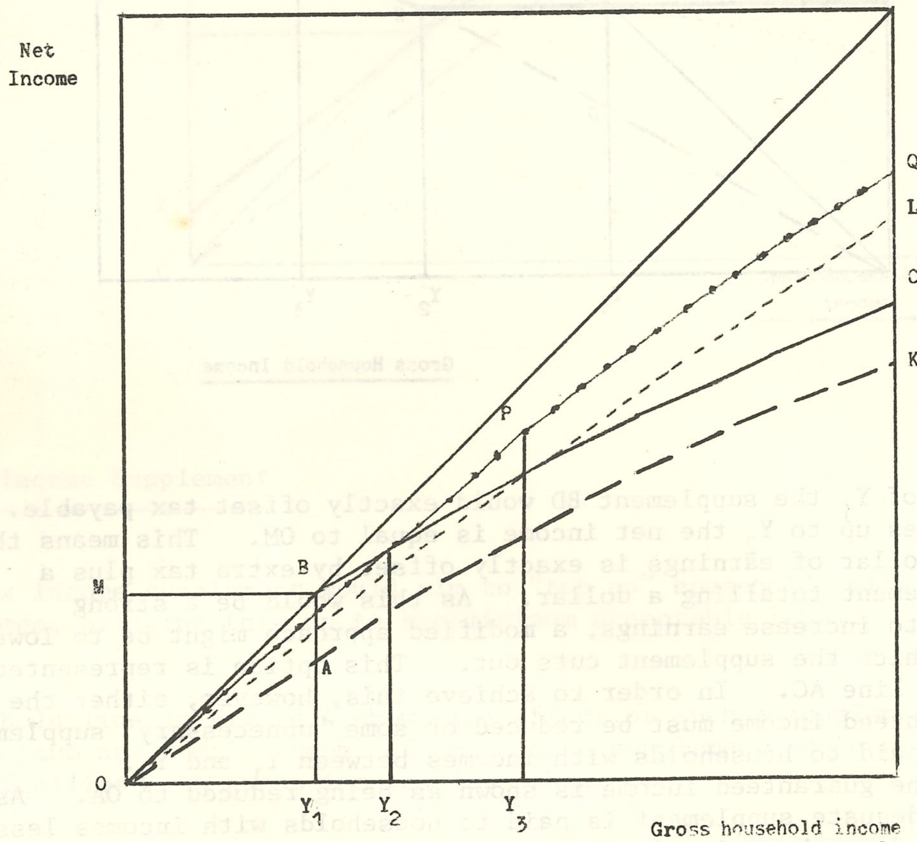
Young Family Allowance

The young family allowance is similar in effect to the low income supplement. The difference is that assistance is based on the income of the wife rather than on total household income. It could be further restricted on the basis of the husband's income.

Tax Rebates for Husband* on Basis of Family Size

Figure 5 - Tax Rebates

Before rebates - husband earns all household income
After rebates - husband earns all household income
Before rebates - husband and wife earn equal income
After rebate husband and wife earn equal income



* The rebate would apply to the income of the principal earner (i.e. the earner with the higher income). In practice the principal earner is usually the husband and is referred to as such for simplicity of exposition.

In Figure 5 the net income of a household where the husband earns all the income is depicted by the line OK. A flat tax rebate would supplement all incomes in excess of Y_1 by the rebate AB. Incomes less than Y_1 would be paying insufficient tax to gain the full rebate. Thus, the net income after rebate is represented by the line OBC.

In a household where the husband and wife had equal incomes the net income of the household is represented by the line OL. This reflects that under a progressive tax scale, tax is a lower proportion of total household income where income is earned by more than one parent. In practice many households would fall between the lines OL and OK. The effect of the rebate is that when household income is in excess of Y_3 (which is twice Y_1) a full rebate is received but at lower income levels the husband receives only a partial rebate. Thus the new net income position is represented by the line OPQ. Although it appears that a two income family could be worse off than a one income family if total gross household income was less than Y_2, in practice there would be very few two-income families in that range.

If the rebate was associated with an extra marginal tax rate on the husband's income (as discussed in Section IV(1,c)) the effect would be to bend the lines BC and PQ down toward the original position represented by OK and OL respectively.

If the rebate was associated with an extra marginal tax rate on the wife's income the position of the one-income household would obviously not be affected. In a two-income household the rebate would diminish as the wife's (and total household's) income increased. In Figure 5 this would be shown by a converging of the lines OPQ and OL in the income range as the wife's income causes the rebate to diminish. This is the same effect as a higher tax rate on the husband's income except that the convergence would occur in a lower income range.

APPENDIX VIII

FAMILY TAX REBATES : TWO EXAMPLES

This appendix shows average and marginal tax rates for the present tax scale and then, by way of comparison, gives two examples based on the tax options presented in the report. The examples combine alternative tax scales with rebates. Rates are given for both the principal earner of a household (referred to for convenience as the husband) and a supplementary earner (referred to as the wife).

Present tax scale* (Figures 1 and 2)

Figure 1 shows the present marginal tax scale for a husband (unbroken line X) with the extra marginal rate due to the abatement of the young family rebate (connected dashed line). Lines A,B and C are the average tax curves for the married person qualifying for the various existing family rebates. In particular line A is the average tax on married code (i.e. after the wife rebate is deducted). Line B shows the effect of the wife rebate and the single income family rebate. Line C shows the effect of these rebates together with the young family rebate.

Figure 2 shows the present tax position of the wife. The unbroken line, X, is the marginal tax curve. The connected dashed line shows the effect of the wife and single income family rebates diminishing at 30 cents in the dollar as the wife's income rises from $520 a year to $1,733 a year. Although this is related to the wife's income the extra tax is payable by the husband and, therefore, does not affect the wife's average tax rate which is shown as the line D.

* The data given for the present tax scale is for the situation prior to the introduction of the five percent tax cut effective from 1 February 1978.

FIGURE 1 : HUSBAND'S INCOME : PRESENT TAX SCALE WITH PRESENT REBATES

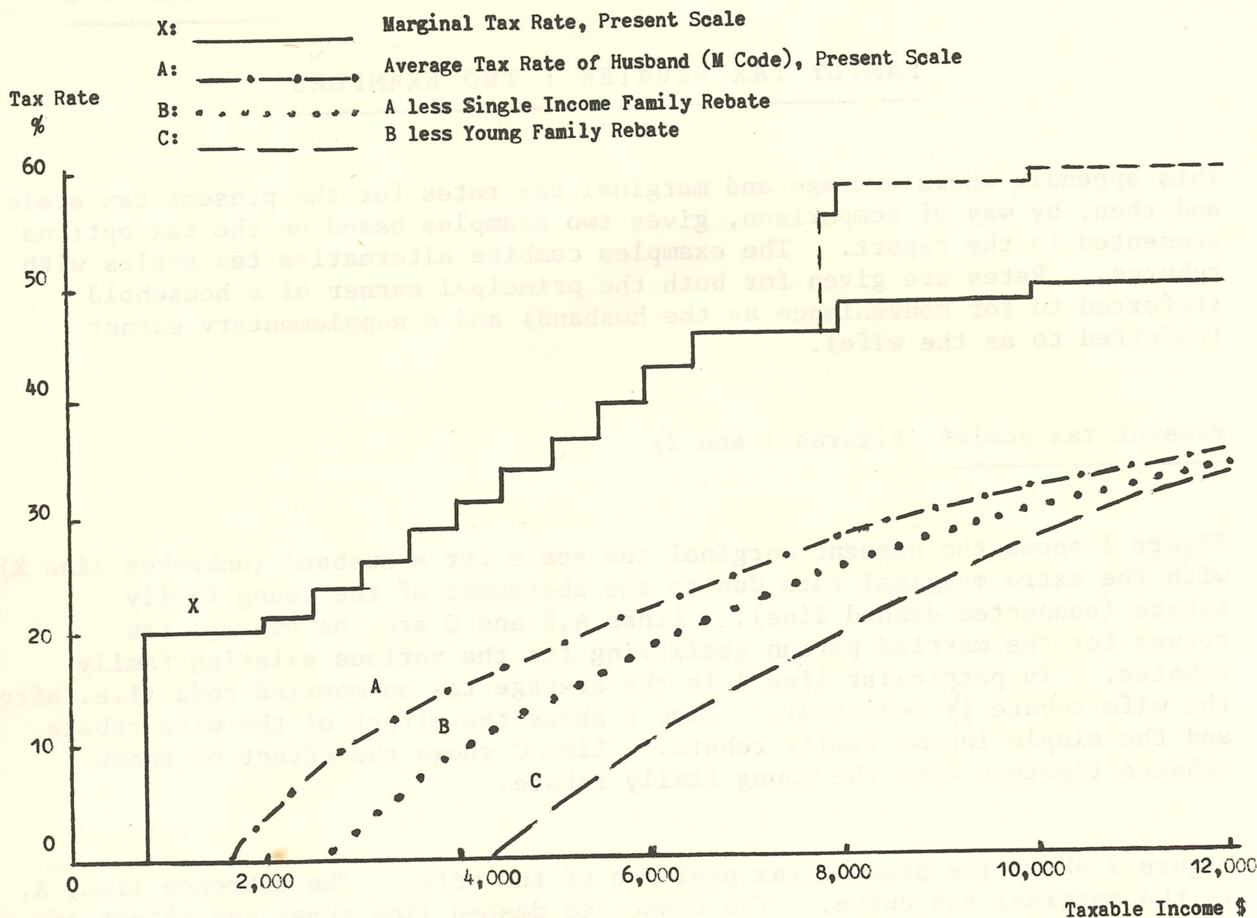
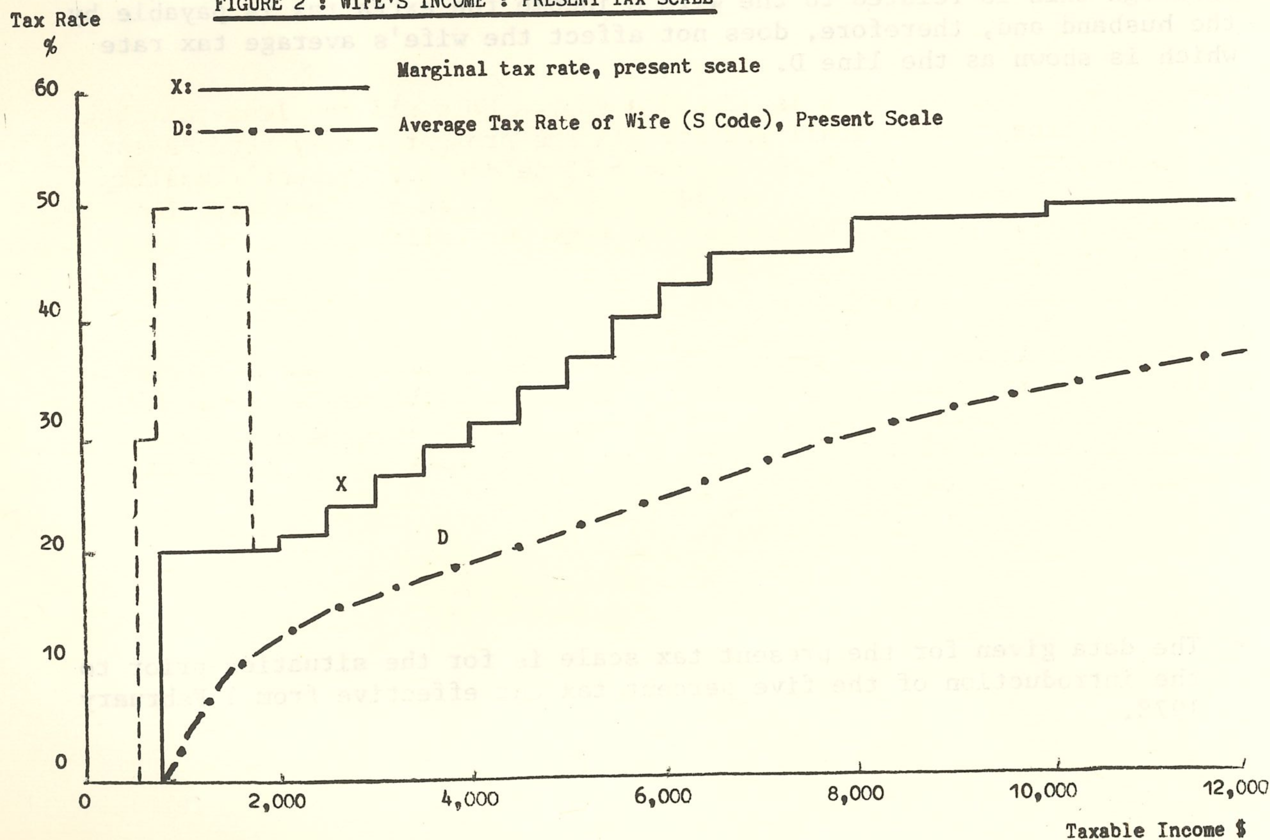


FIGURE 2 : WIFE'S INCOME : PRESENT TAX SCALE



Example 1 (Figures 3 and 4)

Tax scale 3 applies. A tax rebate of $18 a week is allowed to the husband. The husband's marginal tax rate is increased by ten percent on income between $3,600 and $10,000. A family benefit or tax rebate per child of $4 a week is also allowed, but the effect of this is not shown on the figures below. Figure 3 gives the marginal and average tax rates for the husband. To provide a basis for comparison, the figure also reproduces from Figure 1 the average tax rates under the present scale, given the various rebates. The husband's tax threshold is $3,702. Figure 4 gives the marginal and average tax rates for the wife, with the average rate under the present scale shown for comparison.

The husband would pay less tax than at present except if he qualified for all the present family rebates and his income was less than $7,800 a year. If he did not qualify for the present young family rebate he would pay less tax at all incomes. The household would also receive an extra $1 per week per child.

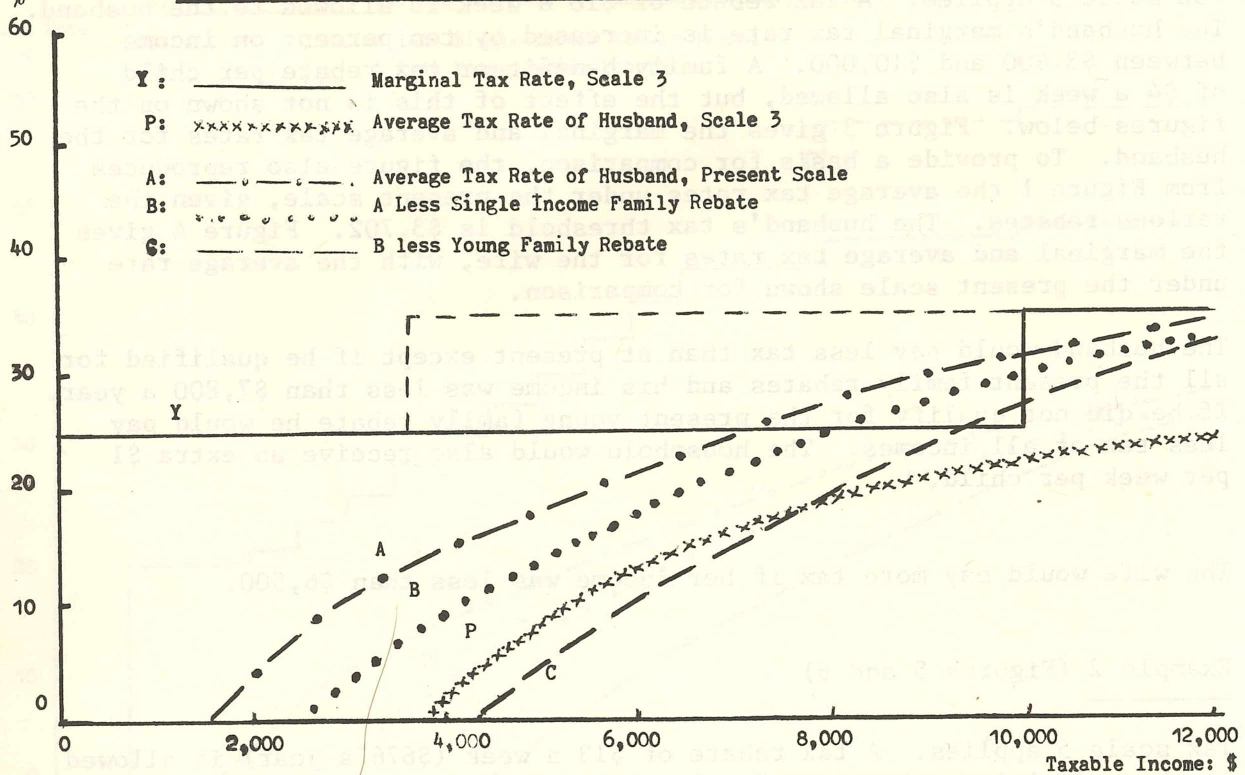
The wife would pay more tax if her income was less than $6,500.

Example 2 (Figures 5 and 6)

Tax scale 5 applies. A tax rebate of $13 a week ($676 a year) is allowed to the principle earner in a family with dependents. His marginal tax rate is increased by eight percent on income between $3,000 and $10,000. $8 of the total rebate is diminished by 16 cents per dollar of the wife's income in excess of $400 a year. A family benefit or per child tax rebate of $6 a week is also allowed but the effect of this is not shown on the Figures 5 and 6 below.

The husband's tax threshold is $3,490 a year. He would pay less tax than at present except if he qualified for all the present family rebates and his income was less than $9,600 a year. If he did not presently qualify for the young family rebate he would pay less tax at all incomes. The household would also gain an extra $3 a week per child because of the increase in family benefit.

If the wife's income exceeded $3,000 a year the husband's tax rebate would be reduced to $5 a week ($260 a year). The wife would pay more tax if her income was between $1 and $3,000 a year, fractionally more if her income was between $3,000 and $6,000 a year, and less tax if her income exceeded $6,000 a year.


Tax Rate
%
FIGURE 3 : HUSBAND'S INCOME, TAX OPTION 3 WITH REBATE
Y : Marginal Tax Rate, Scale 3
P: Average Tax Rate of Husband, Scale 3
A: Average Tax Rate of Husband, Present Scale
B: A Less Single Income Family Rebate
C: B less Young Family Rebate
60
50
40
30
20
10
0
Y
A
B
P
C
0
2,000
4,000
6,000
8,000
10,000
12,000
Taxable Income: $

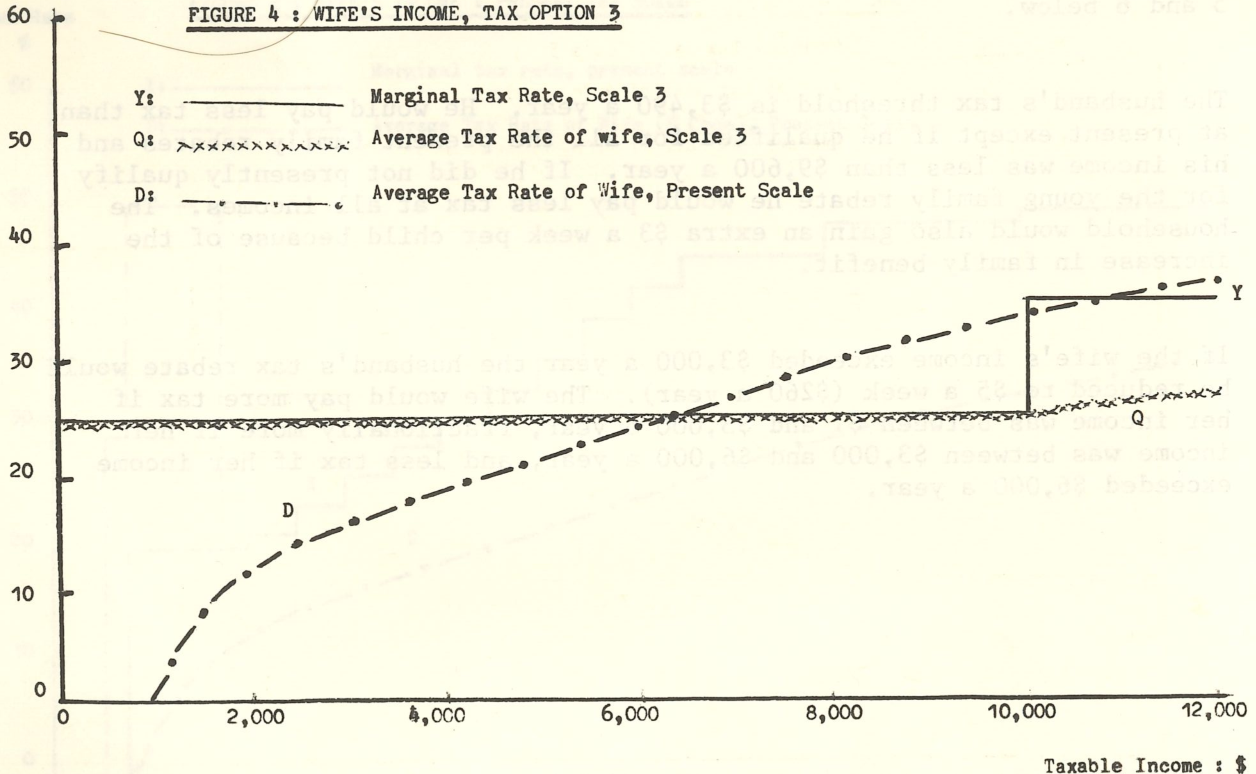

Tax Rate
%
FIGURE 4 : WIFE'S INCOME, TAX OPTION 3
Y: Marginal Tax Rate, Scale 3
Q: Average Tax Rate of wife, Scale 3
D: Average Tax Rate of Wife, Present Scale
60
50
40
30
20
10
0
Y
Q
D
0
2,000
4,000
6,000
8,000
10,000
12,000
Taxable Income : $

FIGURE 5 : HUSBAND'S INCOME, TAX OPTION 5 WITH REBATE

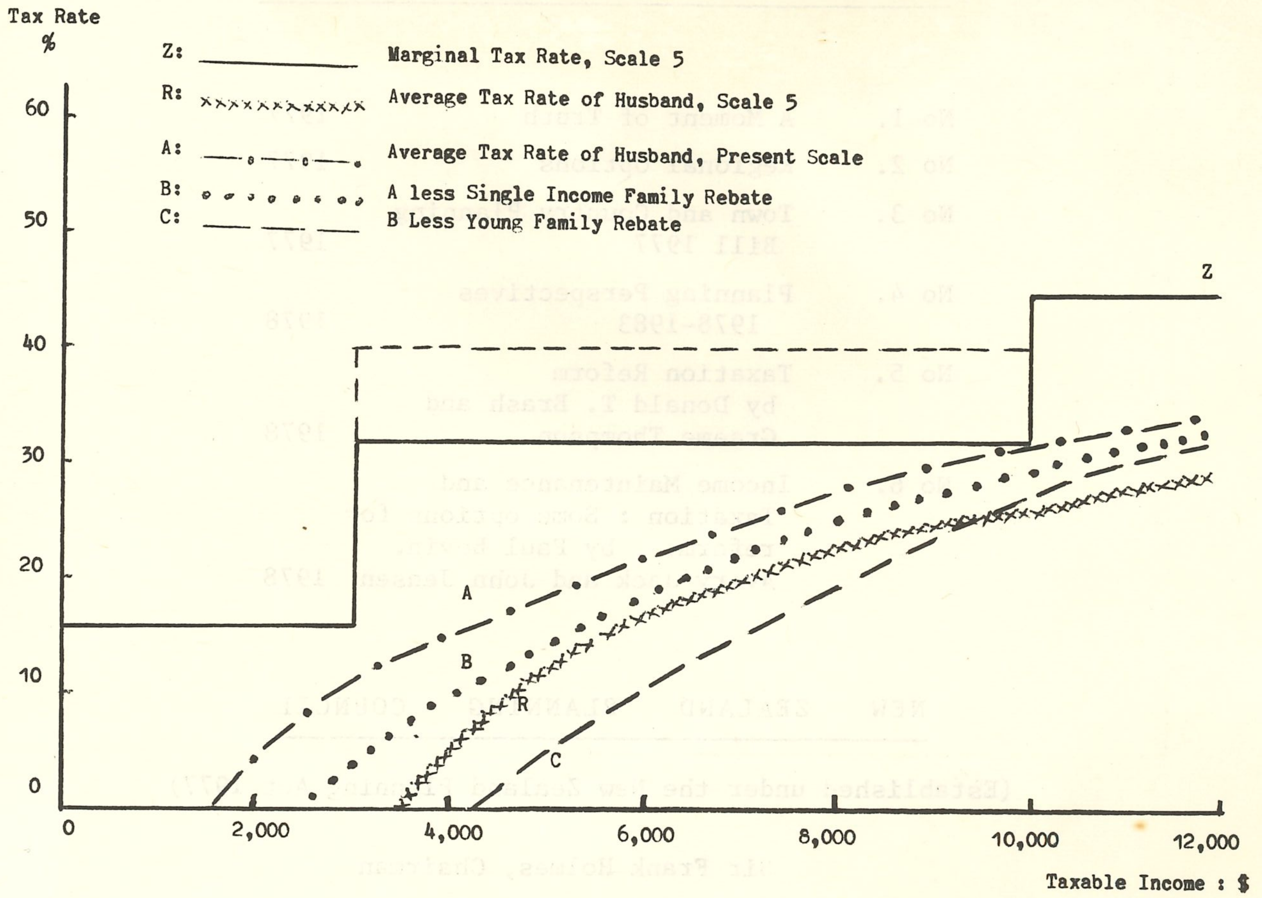
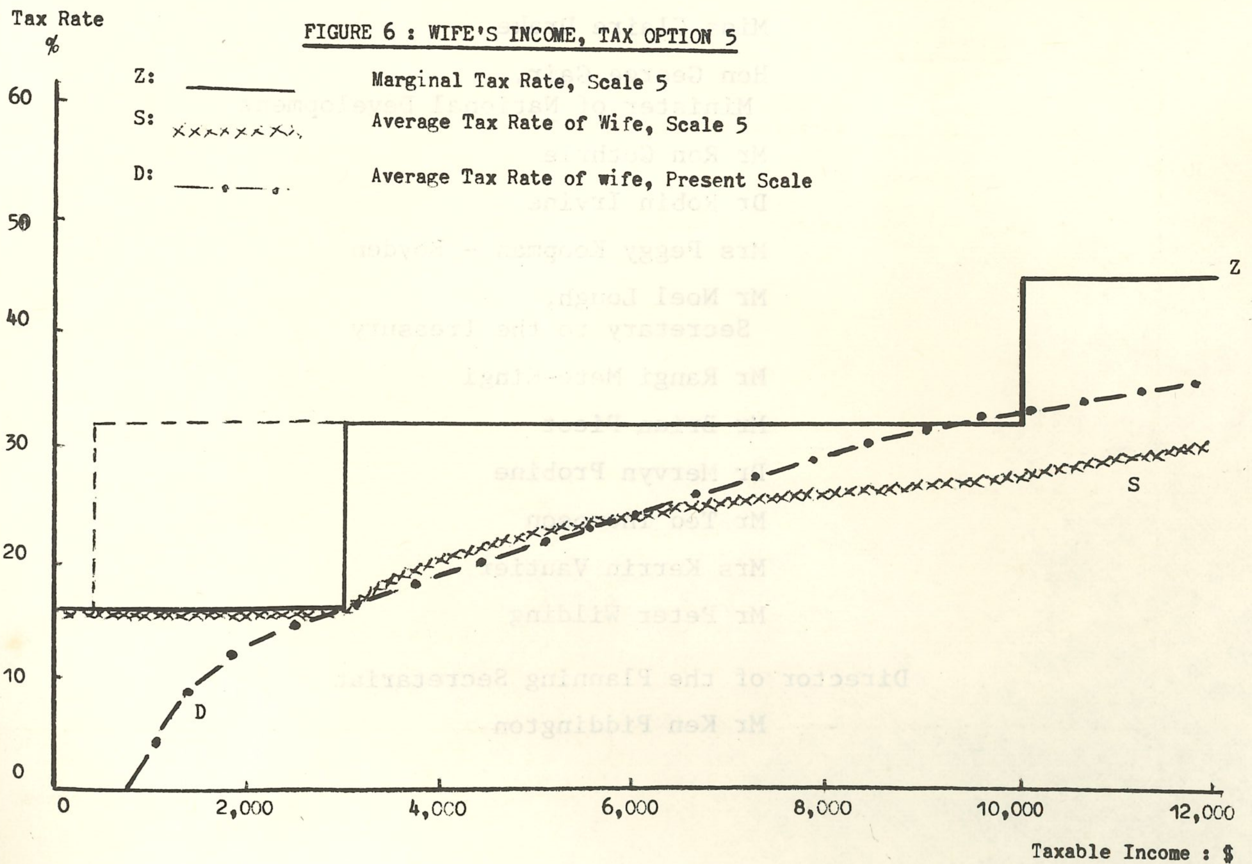


FIGURE 6 : WIFE'S INCOME, TAX OPTION 5



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