Welfare reform: Changing the way we account for taxes and benefits *Keith Rankin*

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Introduction

The issue of welfare reform is made difficult because of the boundaries we traditionally (yet implicitly) place between the tax system and the benefit system. To most economists, benefits are transfers, and transfers are equivalent to negative taxes. The key insight here is to turn this proposition on its head, to suggest that tax concessions are really benefits and should therefore be accounted for as such. Somewhat disconcertingly for many people, this means that almost all of us receive some income that can best be understood as benefits.

Benefits in New Zealand are not only paid by WINZ, and arguably the most important benefit-paying agency is the IRD (Inland Revenue Department). "If it walks like a duck, and quacks like a duck, then it probably is a duck". Benefits paid by the IRD include:

a. "Tax Breaks"
b. Working for Families family of "tax credits"
c. Independent Earner Tax Credit
d. Concessions on a person's first $70,000 of annual income
e. Subsidised company tax

By the very nature of graduated income tax scales, whereby the first dollars earned are taxed at concessionary rates, then all taxpayers receive some tax concessions. Therefore it can accurately be claimed that all taxpayers are beneficiaries. Given that almost all adult non-taxpayers are also beneficiaries – receiving benefits in such forms as Family Tax Credits, New Zealand Superannuation, and Accommodation Supplements as well as traditional benefits such as the Invalids Benefit – then it is not unreasonable to claim that "we are all beneficiaries now".

From this "we are all beneficiaries now" perspective, the issue becomes one of equity. Horizontal Equity is a *rights-based* perspective, whereas negative equity is a *needs-based* perspective. Both principles apply to a sound benefit system.

Benefits paid (or justified) under horizontal equity principles cannot be classed as transfers. Rather, they are *dividends*. One shareholder in a business firm receives the same income share as another shareholder on the basis of the principle of treating equals equally.

Some Basic Principles

– **Private and Public Income Rights**
- People are born free, into societies.
- People have both private and public ownership rights, and obligations; ie people have both private and public equity.
- **People have a right to income from both public and private sources.**

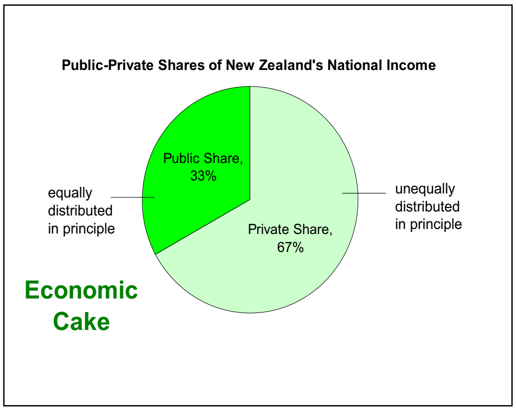
– **Equity Principles**
- **Horizontal Equity** – treating equals equally – means all persons within a society have **identical public rights and obligations**.
  – *note, though: minors may have their rights defined differently*
- **Vertical Equity** – treating unequals unequally – means that persons without special needs have some obligation to concede a portion of their public income rights in favour of those who in practice are not able to draw on sufficient private incomes to meet their special circumstances.

Children (minors) have the same rights as adults, but those rights need not be expressed in the same ways as for adults. Thus an equal income entitlement that would be paid to adults in monetary form might be paid to children as additional social expenditure on their behalf, including expenditure on their education.

Benefits paid or justified under vertical equity principles are *transfers*, and are conditional, by their very nature, on the needs of the recipients. Needs may include the inability to secure a private income due to circumstances such as unemployment, disability or the requirement to care for others. Or it may include a shared belief that older persons should be exempt from the requirement to gain a private income through work. Or a recognition that child-raising and housing requirements create additional needs.

The approach taken here is that taxation is based, in principle, on horizontal equity, with the individual rather than the household as the basic taxable entity. Benefits (dividends or transfers) may be payable on grounds of either horizontal or vertical equity. All instances of vertical equity – treating unequals unequally – shall be accountable on the benefit side of the ledger. Thus, for example, a tax concession negotiated with a movie production company would be accountable as a subsidy (a form of transfer benefit) rather than as a reduced tax liability.

The only kind of income tax that conforms with horizontal equity is a proportional or "flat" tax. The benchmark underlying flat rate of tax in New Zealand, since 1988, is 33 cents per dollar (33 per cent) of national income: from 1988-2000 the top personal rate, trust rate and company rate were 33 per cent. The 39 per cent rate introduced in 2000 was a surcharge then applied only to the highest 5 per cent of individual incomes; however, trust and personal rates realign at 33 per cent from 1 Oct 2010.[1]



The accounting reform suggested here would mean that all individuals pay exactly 33 per cent of their income as income tax, with the difference accounted for as a benefit. Such a benefit, which is lower for lower income recipients, as it stands, cannot be justified on vertical equity grounds. Nevertheless, despite being horizontally inequitable, it is much closer to being a dividend than a transfer.

A flat taxation rate of 33 per cent represents a 33 per cent share of gross domestic product that is claimed as public income,[2] leaving the remaining 67 per cent share as private income.

In the example below, we consider adults earning $0, $500, $1000, $1500 or $2000 per week before tax. The right hand column shows their present after-tax income, assuming no receipt of any kind of benefit other than statutory income tax concessions. The privately-sourced income column applies the horizontal equity principle (67% of gross earnings), meaning that the difference between privately-sourced income and current disposable after-tax income ("net income") is income sourced from the 33 per cent public claim on GDP.

We see that for higher income earners the annual public-sourced income comes to exactly $9080, and that for persons on an income close to average ($1000 per week) their public income component comes close to that $9080 figure.

[1] The average tax rate approaches 33%, asymptotically.

[2] There are additionally subsequent public revenue claims arising from indirect taxes (eg Goods and Services Tax) and profits from publicly-owned businesses. These other sources of public revenue already incorporate horizontal equity principles.

Personal Private & Public Income

- Private Income = 67% of Gross Earnings
  – *assuming a 33% underlying tax rate*
- Additional income received due to tax concessions, tax credits, WINZ benefits is drawn from the public share of the cake.

"Non-Beneficiary" Examples using October 2010 tax scales:

Gross Income		Public-Sourced Income		Private-Sourced Income		Net Income	
$pw	$ annual	$ annual	%	$ annual	%	$ annual	%
0	0	0		0		0	
500	26,000	5,530	21.3%	17,420	67.0%	22,950	88.3%
1,000	52,000	8,540	16.4%	34,840	67.0%	43,380	83.4%
1,500	78,000	9,080	11.6%	52,260	67.0%	61,340	78.6%
2,000	104,000	9,080	10.9%	69,680	67.0%	78,760	77.9%

We clearly see that present public-sourced income comes close to conforming to the requirements of a horizontal equity (dividend) benefit. We shall call this implicit individual benefit –currently $9080 per annum – a "public equity benefit" (PEB).

Currently, most persons earning less than the average fulltime wage (just under $1000 per week), qualify for some kind of vertical equity benefit, as do many earning more than that (eg abated Family Tax Credits, Accommodation Supplements on their mortgages).

So a substantial majority of New Zealand adults do presently receive at least $9080 of publicly sourced income. The policy challenge is: (i) to account for the first $9080 of all individuals' publicly sourced income as a Public Equity Benefit (payable as of right), and to only account for excess publicly-sourced income as needs-based transfer payments; and (ii) to ensure that all adults receive at least $9080[3] of publicly-sourced income.

Public Equity Benefit (PEB)

- All earners receive income from the public share of National Income
  - this benefit looks more like a *dividend* than a *transfer*
    - hence it can be understood as a **public equity benefit (PEB)**
  - low earners presently get a smaller PEB
    - present PEB conforms neither with horizontal nor vertical equity
    - company dividends never discriminate against the low paid
- We compensate most non-earners and low earners for their reduced PEBs by paying them substantial transfer benefits:
  eg WINZ Benefits (UB, DPB etc), Family Tax Credits, Accommodation Supplements

It is useful to account for any shortfalls in publicly-sourced income (eg, in the present context, situations where an adult New Zealander receives less than $9080 of publicly sourced income) as a tax surcharge. This means that we can presently account for the $9080 as an explicit Public Equity Benefit, and we can clearly see the policy challenge as one of eliminating "low income tax surcharges".

Reform Informed by Equity Principles

*Most adults currently receive total annual benefits of $9,080 or more.
*Account for the first $9,080 of WINZ benefits as a true Public Equity Benefit (horizontal equity).
*Account for the remainder as a transfer payment from public funds (vertical equity).
*For those whose total benefits are less than $9,080:
- account for the shortfall as a tax surcharge
- eliminate tax surcharges as public finances permit
- assess transfer payments on basis of household need

[3] A lesser figure could be adopted, but that would be interpreted as a tax increase by middle-high income earners. A more politic solution would be to focus any future 'tax cuts' on making the existing $9080 benefit into a truly universal dividend-style benefit.

How would this new accounting approach affect low income families?

First, it would allow such families to treat a greater share of their households' publicly-sourced incomes as rights-based dividend benefits (Public Equity Benefits), and a lesser share as transfers which maintain the stigma of being "hand-outs".

Low Income Tax Surcharge

applied to person receiving no transfer benefits; eg caregiver not eligible for Family Tax Credits

Gross Income		Public-Sourced Income		Private-Sourced Income		Net Income	
$pw	$ annual	$ annual	%	$ annual	%	$ annual	%
0	0	0		0		0	
500	26,000	5,530	21.3%	17,420	67.0%	22,950	88.3%
1,000	52,000	8,540	16.4%	34,840	67.0%	43,380	83.4%
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for person on $1,000 pw, **annual tax surcharge**
= PEB ($9,080) – actual tax concession received ($8,540)
= **$540**

for person on $500 pw, **annual tax surcharge**
= PEB ($9,080) – actual tax concession received ($5,530)
= **$3,550**

Second the focus of future tax reform would be to ensure that Public Equity Benefits represented a bottom-line, a benefit that can never be lost. For example, changes in persons' hours of work, household composition, or partners' incomes will not affect this bottom-line benefit. Given that high income earners already receive this benefit unconditionally, the argument is compelling that it should be payable to all adult New Zealanders.

Following this approach, then the process of reforming the WINZ (vertical equity) system of transfer payments should be much less fraught, given that, with needs-based benefits being seen to form a relatively smaller share of total publicly sourced income, 'beneficiaries' (meaning people in receipt of transfer benefits) would be at risk of losing less than if their entire benefits are regarded as conditional transfers.

Low Income Families

- both parents should receive Public Equity Benefits
- Child Support, if applicable, is a private transfer
- additional support, where applied for and means-tested, payable as vertical equity transfers
  - transfers from public funds may be conditional on meeting some appropriate public obligations (not necessarily paid work)

Single Parent families

- parent more likely (than for 2-parent families) to require some support from public transfers

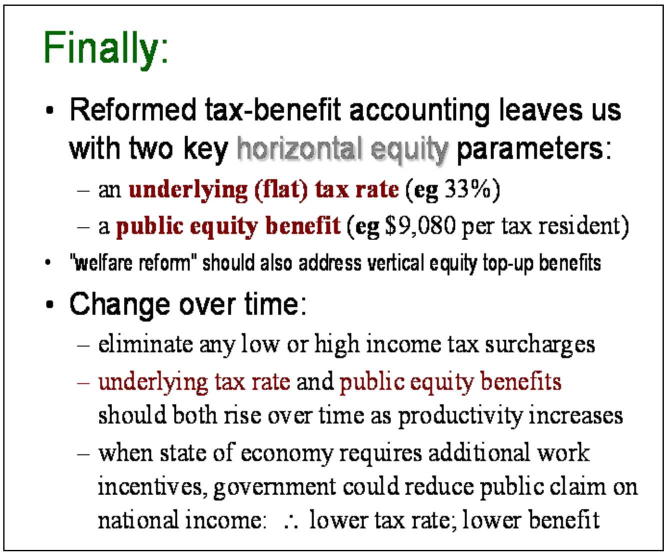
We account for our systems in order to understand them as clearly as possible. Good accounting systems will therefore open the door to appropriate changes to those systems. The principal argument here is that improved accounting enables us to make explicit a Public Equity Benefit (PEB) that is already there implicitly. Once PEBs are visible, we need to investigate and ideally remove any inequitable or inefficient anomalies that cohabit that benefit. Low income surtaxes are clearly inequitable. They are also inefficient. Families and individuals have incentives to modify their circumstances so as to avoid them.[4]

To maintain the integrity of all benefits they must be indexed over time, at least to the CPI (consumers' price index) as WINZ benefits are indexed today. Ideally, in growing economies, equity benefits at least should be indexed to some other indicator – for example nominal GNI (gross national income) per capita – to ensure that publicly sourced income grows at least as quickly as privately sourced income.

There are strong arguments that the principal drivers of productivity growth are collective inputs – such as social capital, education, infrastructure, good public policies. If these arguments are

[4] We see such avoidance today, as 'work avoidance' brought about by high 'effective marginal tax rates' as people become less eligible for transfer benefits.

valid, then it follows that, over time, the public claim over GDP should rise, progressively, above the 33 per cent share depicted here. This would indicate a need for gradual increases in the underlying flat tax rate, and increases in public equity benefits over and above those prescribed by any indexing system.



Conclusion

This reformed system of accounting for benefits leaves us with a tax-benefit system with two core horizontal equity parameters: an underlying flat rate of income tax (eg 33 per cent), and a public equity benefit (eg $9080 per annum). These parameters are of course set through the political process. One can imagine a right-wing government proposing a lower core tax rate, a reduced public equity benefit, and greater reliance on needs-based transfers. A left-wing government may be more inclined to raise the core tax rate, enabling increased spending on collective goods (such as health-care and education) and increased transfer payments. A centre government, while maintaining a strong commitment to collective goods' provision, might emphasise more the desirability of raising the level of the public equity benefit as a kind of growth dividend that benefits all equally.