Accounting for Benefits

by Keith Rankin (Unitec), 8 September 2010

This essay highlights ways that the welfare system can be reformed through an improved national accounting framework, reflecting on equity concepts, public property rights, and financial stability.

Descriptive Paragraph:

One of the first tasks of national accounting is to divide national income into its private sector and public sector components. This primary task is currently performed in an implicit and unprincipled way, in particular with respect to the accounting of income tax. By applying the principle of horizontal equity to income taxation, it becomes apparent that tax concessions received by non-beneficiaries are most appropriately accounted for as benefits. Practical reform follows by granting these existing unconditional benefits to all, while at the same time reducing the size of present conditional transfers.

From the 1980s, task forces on welfare reform have generally begun with the premise that welfare states create a form of moral hazard called "dependency"; an incentive to rely on the providence of others without contributing much in return. The solution to such a misaligned incentive must therefore be a rearrangement of incentives, with the introduction of punitive counter-incentives, to deal with this "sin". Despite increasingly stringent conditions governing entitlement to welfare benefits, the problem of dependency seems not to wane. So, by this reasoning, additional counter-incentives are always required. The whole exercise of welfare reform is very normative from the outset.

An overlay to the moral hazard assumption has been the assumption that the purpose of a country's economy is to maximise GDP (gross domestic product), and that this should be achieved through high growth rates – with a special 'contestual' mercantilist[1] emphasis on higher growth rates than other countries – and that a growth of labour inputs should be a central part of this growth project.

An alternative approach is to deny the place of sin and contest in macroeconomics, and instead to premise our income claims on the basic principles of equity and property rights.

Some basic principles are these:

- People are born free.
- People have both public and private property rights, and obligations.
- People have a right to draw income (claims on present output) from both public and private sources.
- Horizontal equity means all persons within a polity have identical public rights.
- Vertical equity means that persons with greater private incomes have some public obligation to provide some support for those who in practice are only able to draw on minimal private incomes.

[1] Mercantilist economics essentially has two components. Crude mercantilism is a zero-sum game, which is won by achieving persistent balance of payments' current account surpluses; or, to put it another way, to persistently accumulate financial claims over other countries. 'Sophisticated' mercantilism, is essentially a growth contest, like an Olympic marathon (or a horse race) but with no defined end. The aim of economic activity, for a country, is to hold or to improve your country's position. In this framework, a generous welfare system is seen as a kind of macroeconomic deadweight, much like a weight handicap imposed on participants in many horse races.

Another basic principle, an identity because it is true by definition, is that when total output of a certain value (aggregate product) is produced, then the sum of claims on that output (aggregate income) has the same value. It means that income tax is equivalent to an output tax.

A system of welfare benefits is widely understood to mean a set of transfer payments[2] made by a government agency other than the tax-collecting agency. In New Zealand that agency is called Work and Income New Zealand (WINZ); the tax collecting agency is called the Inland Revenue Department (IRD).

In reality welfare benefits are a combination of rights-based and needs based payments paid to private individuals or households from public funds.[3] Here, rights-based (horizontal equity) payments I call <u>dividends</u>, and needs-based (vertical equity) payments I call <u>transfers</u>. An explicit example of a dividend-type benefit is New Zealand Superannuation. A third kind of benefit, <u>subsidies</u>, are effectively forms of transfers. Implicit subsidies arise when persons or companies are able to pay less tax than their public obligation suggests that they should.

Identifying all benefits is made difficult because many of them are paid, in New Zealand, not by WINZ but by the IRD, and because many of those are implicit. Thus, depending on individual politicians' or writers' normative stances, some or all benefits paid by the IRD may be excluded from taxes, making it look as if taxes are lower than they really are, and making it look as though tax liabilities are skewed in favour of the poor. A particularly egregious example is the denial that "Working for Families"' Family Tax Credits are welfare benefits.

Benefits paid by the IRD come in at least seven categories:

1. general tax avoidance (ie benefits able to be claimed through rearrangement of one's affairs)
2. subsidised company tax
3. non-taxation of owner-occupier housing rents
4. depreciation subsidies
5. Working for Families family of "tax credits" (includes "in-work tax credits").
6. Independent Earner Tax Credit
7. concessions on a person's first $70,000 of annual income

Only categories 5 and 6 are explicit payments.

While all such credits, subsidies, concessions, allowances, rebates and exemptions should be treated for analysis as benefits,[4] my focus here is on the final category. To note, first, I believe that all hidden subsidies should be phased out, and replaced, if warranted, by explicit benefits.[5] Appropriate reform of national accounting would facilitate that.

The seventh kind of benefit is the largest, and least understood as a benefit. Benefits paid by IRD as tax concessions are better understood as dividends than as transfers or subsidies. To understand the

[2] ie public-to-private gifts; pejoratively known as "handouts"

[3] "Public funds" means public claims on aggregate product. The aggregate product of a single nation is GDP (gross domestic product).

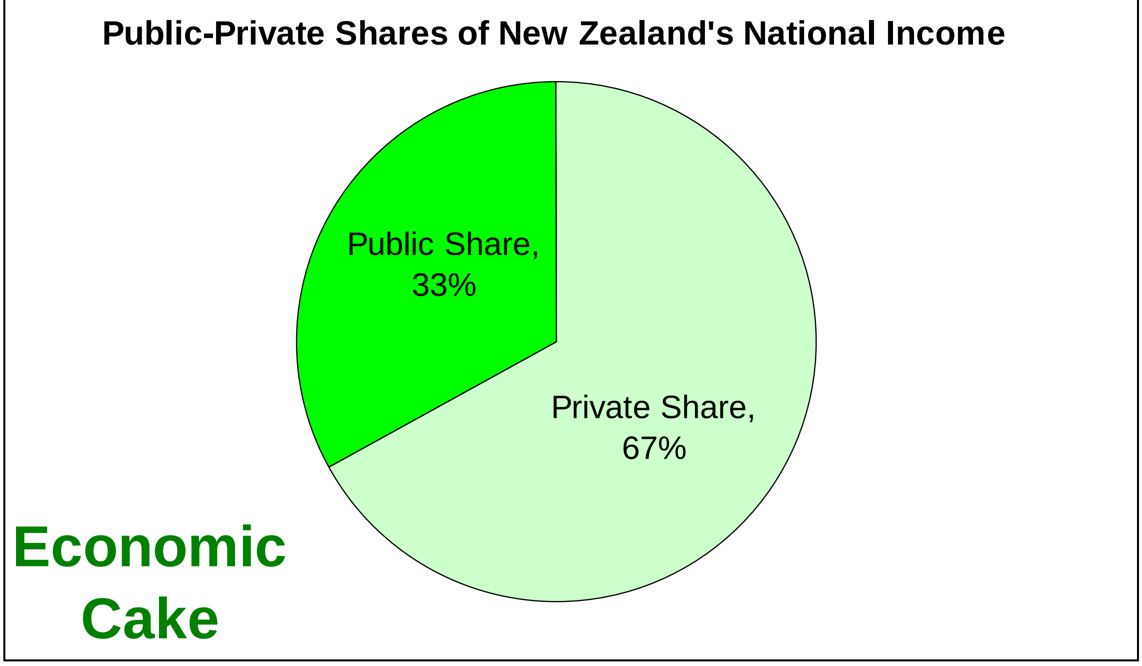
[4] Administration issues are different from accounting issues. I have argued (ref Scoop, Unitec) that one agency (eg IRD) should administer individual payments (taxes and dividends) based on the principles of horizontal equity, while another agency (eg WINZ) should administer transfers to households based upon vertical equity principles.

[5] Explicit subsidies such as those paid to general practitioner doctors and rest homes are warranted and are paid through the Ministry of Health (MoH). Another possible subsidy that has been suggested – on certain healthy foods, set equivalent to the GST (goods and services tax) on those foods – should also be paid by the MoH and does not interest us here. This paper claims there is no role for those hidden subsidies that are accounted for as tax exemptions.

matter properly, we need to determine a country's ***underlying rate of income tax***. In New Zealand this is easy; one rate – 33% – stands out over all others. For many other countries, with much more complex tax regimes, and with federal government structures, this is much harder to assess.

For New Zealand the underlying national rate of income tax will be, from October 2010 in line with the 20 May 2010 Budget, the top personal tax rate (which is also the "trust rate"). In New Zealand, the underlying rate will be 33% (ie 33 cents in the dollar).[6] What this means is that income – claims on New Zealand's annual output – in New Zealand is, in reality, taxed at 33%. This 33% of GDP is collectable as a public property right; the public claim on distributable output.[7] In practice it means that each employee (and shareholder profits) have their gross income taxed (at source) at 33%. Workers who receive 80% of their gross income as net income are in fact receiving a benefit from public funds equal to 13% of their before-tax income. All income recipients in reality receive a mix of privately and publicly sourced income.

<u>Figure 1</u>:[8] Shares of New Zealand's GDP based on Horizontal Equity Principle



Once we account for our tax using the underlying tax rate, it's easy to see that taxes payable at a 33% flat rate conform – as they should – with the principle of horizontal equity. Further, by the nature of the dividend concept, all benefits of dividend form should also conform with this principle (as private company dividends do). Currently these personal benefits that I have uncovered do not conform with this most basic of principles; further they never have, because income taxation was originally based on low income exemptions. A low-income tax exemption is an implicit benefit.

[6] Strictly speaking it is 35%, adding in the 2% employee ACC levy. I am avoiding this in my examples because of complications arising from the exemption of the ACC levy on high employee earnings.

[7] Consider two small firms. Firm A has 1 fulltime employee earning $100,000 per year. Firm B has 2 part-time employees, each earning $50,000. Otherwise the two firms are identical. Under current implicit accounting conventions the income tax generated by Firm A will be greater than that generated by Firm B. Under the proposed national accounting convention, both firms will generate $33,000 of public revenue (and therefore $67,000 of private income).

[8] The public share of disposable funds is in fact greater than this; this is only the share arising from direct taxation. The principle other sources of public revenue are value-added taxes on expenditure – GST (Goods and Services Tax in New Zealand) – and dividends paid by publicly-owned enterprises such as Meridian Energy, Television New Zealand, and Air New Zealand. These contributions do generally follow the principle of horizontal equity, in that GST is charged at a flat rate without exemptions, and publicly-owned commercial enterprises pay dividends on the same basis as privately-owned commercial enterprises.

Table 1 shows both a simple historical example and the October 2010 New Zealand tax scale. When income tax was first introduced in New Zealand the underlying rate – top personal rate and company rate – was 5% ("shilling in the pound").[9] There was an exemption for the first £300 of annual income. There was also a concessionary rate of 2.5% ("sixpence in the pound").

The result is that persons earning £300 had no tax liability because the tax incurred at the underlying rate was balanced by an equal benefit of £15. Persons earning £1,000 remitted £17.50 because the tax incurred (£50) at the underlying rate was offset by a concession (ie benefit) of £32.50. Close inspection shows that the £32.50 benefit (nearly $6,000 in today's money) was built in to the tax scale, and can appropriately be interpreted as a public dividend. The inequity arises from the full or partial withholding of this benefit to persons earning less than £1,000.

Table 1: (a) NZ Income Tax 1892 — annual values

income £	nominal tax rates	income £	deduction £	underlying tax rate	tax £	benefit £
0		0	0.00	5.0%	0	0.00
to 300	0.0%	300	0.00	5.0%	15	15.00
to 1,000	2.5%	1,000	17.50	5.0%	50	32.50
to 2,000	5.0%	2,000	67.50	5.0%	100	32.50
to 4,000	5.0%	4,000	167.50	5.0%	200	32.50

(b) NZ Income Tax 1892 (values in $2010 dollars)

income $ 2010	nominal tax rates	income $ 2010	deduction $ 2010	underlying tax rate	tax $ 2010	benefit $ 2010
0		0	0.00	5.0%	0	0.00
to 52,500	0.0%	52,500	0.00	5.0%	2,625	2,625.00
to 175,000	2.5%	175,000	3,062.50	5.0%	8,750	5,687.50
to 350,000	5.0%	350,000	11,812.50	5.0%	17,500	5,687.50
to 700,000	5.0%	700,000	29,312.50	5.0%	35,000	5,687.50

(c) NZ Income Tax October 2010

income $ 2010	nominal tax rates	income $ 2010	deduction $ 2010	underlying tax rate	tax $ 2010	benefit $ 2010
0		0	0.00	33.0%	0	0
to 14,000	10.5%	300	1,470.00	33.0%	4,620	3,150
to 48,000	17.5%	1,000	7,420.00	33.0%	15,840	8,420
to 70,000	30.0%	2,000	14,020.00	33.0%	23,100	9,080
to 700,000	33.0%	4,000	221,920.00	33.0%	231,000	9,080

It turns out that, in New Zealand, only persons earning $70,000 or more will (from October 2010) receive their full public dividend. The amount of that dividend will be $9,080 per year. Table 2 shows the lesser benefits currently paid as tax concessions to persons earning $78,000 or less (ie $1,500 per week or less).[10]

[9] P. Goldsmith (2008), *We Won, You Lost, Eat That*, David Ling, p.80.
[10] shaded table cells indicate application of horizontal equity principles

Table 2 --- Examples of individual tax-payers with different levels of gross earnings :

Gross Wage or Salary		Public-Sourced Income (Personal Benefit)			Private-Sourced Income (33% tax rate)			Net Income before ACC deduction		
$pw	$ annual	$pw	$ annual	%	$pw	$ annual	%	$pw	$ annual	%
100	5,200	22.50	1,170	22.5%	67.00	3,484	67.0%	89.50	4,654	89.5%
200	10,400	45.00	2,340	22.5%	134.00	6,968	67.0%	179.00	9,308	89.5%
300	15,600	65.35	3,398	21.8%	201.00	10,452	67.0%	266.35	13,850	88.8%
400	20,800	80.85	4,204	20.2%	268.00	13,936	67.0%	348.85	18,140	87.2%
500	26,000	106.35	5,530	21.3%	335.00	17,420	67.0%	441.35	22,950	88.3%
600	31,200	121.85	6,336	20.3%	402.00	20,904	67.0%	523.85	27,240	87.3%
700	36,400	137.35	7,142	19.6%	469.00	24,388	67.0%	606.35	31,530	86.6%
800	41,600	152.85	7,948	19.1%	536.00	27,872	67.0%	688.85	35,820	86.1%
900	46,800	161.35	8,390	17.9%	603.00	31,356	67.0%	764.35	39,746	84.9%
1,000	52,000	164.23	8,540	16.4%	670.00	34,840	67.0%	834.23	43,380	83.4%
1,100	57,200	167.23	8,696	15.2%	737.00	38,324	67.0%	904.23	47,020	82.2%
1,200	62,400	170.23	8,852	14.2%	804.00	41,808	67.0%	974.23	50,660	81.2%
1,300	67,600	173.23	9,008	13.3%	871.00	45,292	67.0%	1,044.23	54,300	80.3%
1,400	72,800	174.62	9,080	12.5%	938.00	48,776	67.0%	1,112.62	57,856	79.5%
1,500	78,000	174.62	9,080	11.6%	1,005.00	52,260	67.0%	1,179.62	61,340	78.6%

Most persons receiving very low wages currently receive more than $9,080 in explicit and implicit benefits.[11] Explicit benefits come as main benefits (such as unemployment benefit), accommodation supplements, or family and other tax credits. These benefits are conditional transfers, and understood as "someone else's money".

The essence of national accounting reform is that implicit personal benefits become public dividends known technically as "refundable tax credits". Thus, every adult in principle receives at least $9,080 from the public revenue pool. Adults currently receiving more than $9,080 from the public revenue pool should have their first $9,080 accounted for as a dividend benefit (a public equity right, reflecting horizontal equity) with only the excess accounted for as a transfer benefit (reflecting vertical equity).[12]

To immediately pay all adults from public funds using these numbers would be easily branded as "unaffordable". However, the most important part of welfare reform at present is to acknowledge that higher earners receive higher benefits (by virtue of their higher earnings) than most lower earners, and that this outcome is contrary to the most basic of equity principles.

To implement an immediate and practical reform based on an underlying principled accounting framework could involve reducing the $9,080 benefit paid to all higher recipients (to say $7,500), and paying that $7,500 as a true dividend benefit. Transfer payments would be reduced from present levels, with the aim of ensuring that no low earner receives less from public funds than they do at present.

An alternative approach would be to regard Table 2 as a policy target, committing to a transition period which would progressively raise benefits payable to those who do not currently receive the

[11] For non-earning parents, this will most commonly take the form of Family Tax Credits and Accommodation Supplements.

[12] The question arises that children might have the same public property rights as adults. This issue is tangential to the purpose of this discussion, but can be resolved through the allocation of children's dividends into a collective education fund.

full public equity dividend in lieu of future tax reductions. In the process, vertical equity transfer benefits could be reduced (but never eliminated), as increasing proportions of aggregate benefits are accounted for as dividends rather than as transfers. Table 3 shows the outcome, exclusive of transfers and ACC levies, at the end of the transition period.

Table 3 --- Examples once reform is completed :

Gross Wage or Salary		Public-Sourced Income (Personal Benefit)			Private-Sourced Income (33% tax rate)			Net Income before ACC deduction		
$pw	$ annual	$pw	$ annual	%	$pw	$ annual	%	$pw	$ annual	%
0	0	174.62	9,080		0.00	0	67.0%	174.62	9,080	
100	5,200	174.62	9,080	174.6%	67.00	3,484	67.0%	241.62	12,564	241.6%
200	10,400	174.62	9,080	87.3%	134.00	6,968	67.0%	308.62	16,048	154.3%
300	15,600	174.62	9,080	58.2%	201.00	10,452	67.0%	375.62	19,532	125.2%
400	20,800	174.62	9,080	43.7%	268.00	13,936	67.0%	442.62	23,016	110.7%
500	26,000	174.62	9,080	34.9%	335.00	17,420	67.0%	509.62	26,500	101.9%
600	31,200	174.62	9,080	29.1%	402.00	20,904	67.0%	576.62	29,984	96.1%
700	36,400	174.62	9,080	24.9%	469.00	24,388	67.0%	643.62	33,468	91.9%
800	41,600	174.62	9,080	21.8%	536.00	27,872	67.0%	710.62	36,952	88.8%
900	46,800	174.62	9,080	19.4%	603.00	31,356	67.0%	777.62	40,436	86.4%
1,000	52,000	174.62	9,080	17.5%	670.00	34,840	67.0%	844.62	43,920	84.5%
1,100	57,200	174.62	9,080	15.9%	737.00	38,324	67.0%	911.62	47,404	82.9%
1,200	62,400	174.62	9,080	14.6%	804.00	41,808	67.0%	978.62	50,888	81.6%
1,300	67,600	174.62	9,080	13.4%	871.00	45,292	67.0%	1,045.62	54,372	80.4%
1,400	72,800	174.62	9,080	12.5%	938.00	48,776	67.0%	1,112.62	57,856	79.5%
1,500	78,000	174.62	9,080	11.6%	1,005.00	52,260	67.0%	1,179.62	61,340	78.6%

It makes no sense to pay large transfer benefits to those on low incomes as compensation for reduced dividend benefits. Company shareholders would not accept lower dividends because of lower income from other sources. Likewise citizens should receive the same publicly-sourced incomes (with provision for additional transfers to needy households) regardless of the size of their private incomes.

Sound, sustainable and equitable benefit reform is achieved by no longer withholding from the poor benefits presently paid unconditionally to high income earners.

There is one further and very important argument for the urgent implementation of benefit reforms that counter the post-1980 trends to increased inequality within developed economies.

If we imagine a country (or countries) that has a mercantilist strategy to indefinitely sell more than it buys, in the belief that this is a winning strategy in an economy conceived of as an endurance race. Such a country can be said to be a long-term saver. Its persistent saving strategy can only be sustained if some other country (or countries) acquiesce to a dis-saving strategy. For one country or group of countries to become an-ever larger creditor, others must become ever larger debtors. Global financial instability results.

This result follows if the parties are people rather than countries. And it becomes much more likely when market and/or political forces generate increasing inequality. The big earners cannot spend all that they earn. Even if they could the very rich would not spend much of their incomes on the mass-produced consumer goods and services that large fortunes were (and continue to be) made from. A global economy with high degrees of inequality can only be sustained if purchasing power is recycled through consumer debt. Economic sustainability comes at the price of financial instability.

Thus, a stable and relatively equal distribution of income acts to counter the forces that create financial instability. More income is spent from earnings than from borrowings.

Two important points will suffice us here. First, when those accumulating financial wealth (claims on future output) persist in a strategy of saving (non-spending, which means lending) find it harder to find willing and credible borrowers, the result is large quantities of unsold goods and services. Those creditors who follow a savings strategy to sell more than they buy find it ever harder to sell. "Depression economics" prevail. However, rather than abandon their creditor-surplus strategy, creditors may become more fearful and accentuate their strategy of buying less. Taken to its logical conclusion, such creditor behaviour becomes a "race to the bottom".

When a growth of debt-fuelled consumer spending ceases to be credible (ie when the distribution of income is so out of synch with the required distribution of expenditure), and when creditors continue or exacerbate their strategy of precautionary saving, the capitalist system can correct itself by delivering more income (rather than more debt) to those who will spend more because their unmet needs require them to spend more.[13] This is the second main point, that takes us back to welfare reform. Reform is urgently required so as to facilitate the much less unequal distribution of income that is a prerequisite of financial and economic stability.

By reforming the way we account for taxes and benefits, a more equal distribution of income can be achieved without increasing redistributive transfer payments. Rather, by no longer withholding dividend benefits (perhaps better called "equity benefits") from those on lower incomes, we can go some way to achieving this goal.

Further, distributing income from public funds equitably gives lower income households more choice over their private income arrangements. By having an unconditional public equity benefit, workers can refuse to accept low exploitative wages. More equal public incomes become the catalyst for more equal private incomes. And more equal private incomes are what capitalist economies need to save themselves from instability and unsustainability.

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[13] The problem can be characterised as "those who can spend more will not; those who will spend more can not". The problem is eased by increasing the income shares of those who will spend more but can not.