

# **Macroeconomic Effects of Fiscal Policy**

## Introduction

As described in the macroeconomic overview paper, fiscal policy concerns the impact on the level and pattern of economic activity of government expenditure and the financing of that expenditure, in particular the gap between aggregate revenue and expenditure. The macroeconomic importance of fiscal policy arises from the power of the government to substantially alter spending patterns in the economy by changing the composition and level of its spending programmes and its taxes. Frequent changes in fiscal policy can severely disrupt business investment and employment plans and reduce public sector efficiency. Chronic imbalances between government expenditure and revenue, to the extent of borrowing to finance current consumption, penalises future generations and can seriously destabilise and disrupt the economy by generating spiralling debt burdens, undermining monetary control and, as described in the exchange rate paper, raising the real exchange rate at the expense of our international competitiveness.

This paper conveys two key messages:

- a fiscal policy has been overused and ineffective in anything other than the very short run as an instrument of macroeconomic manipulation ("stabilisation") in recent years;
- b the current imbalance between expenditure and revenue is much too large -the deficit must be reduced substantially if the problems arising from the serious imbalances in the economy are to be effectively addressed.

The paper discusses the macroeconomic effects of policies to reduce the deficit, addressing possible concerns about adverse effects, at least in the short run, on output and employment.

## Fiscal Policy as an Instrument of Macroeconomic Stabilisation

In general, government expenditure can be expected to affect the configuration of an economy. In part this arises because of the scale of government fiscal activities as described in the fiscal outlook paper. Both current and capital expenditures directly consume resources which, as a

result, cause shifts in the expenditure and production patterns of the private sector. Government transfer payments alter household and business disposable incomes, shifting resources from one section of the economy to another and thereby creating the potential for changes in expenditure patterns. The provision of goods and services by the government will mean reduced private provision to the extent that public provision meets private requirements adequately. Similarly, government tax decisions will often alter the relative returns to various activities or the prices of various goods and services. This too will lead to resource shifts.

The powers of governments are such that fiscal policy has been seen by many as giving governments the duty to influence the profile over time of economic activity in the sense that adjustments to government expenditure and revenue may be made, not because of their inherent desirability in terms of the pursuit of efficiency, effectiveness and equity objectives, but because of their effects on the overall level of activity in the economy. It has frequently been argued that, for example, by increasing its expenditure or reducing its revenue in the face of an economic downturn, the government can boost aggregate demand and thereby draw forth greater output and employment, at least in the short term. More recent thinking and experience has tended to emphasise that, when account is taken both of the way in which people anticipate and react to government interventions and of the degree of crowding out of private expenditure as a result of government expenditure and financing decisions, even the short-term effects on output and employment may be weaker than was earlier thought. Furthermore, in the longer-term the effects of a sustained fiscal expansion may be highly unfavourable.

### *Recent International and Domestic experiences with Fiscal Deficits*

Table 1 attached demonstrates that countries with high and growing fiscal deficits have not avoided stagflation and unemployment, and Table 2 shows that the New Zealand experience of the last decade must raise serious questions about the effectiveness of fiscal policy as an instrument to influence output and employment in a predictable manner. The second table shows that while an increase in the deficit may produce some **short-term** increase in activity, particularly if accompanied by monetary growth, the ability of fiscal expansion to maintain increased output has been limited, and that the maintenance of high fiscal deficits has not been able to prevent rising unemployment. The link between a fiscal stimulus and output and employment has been weak for a number of reasons:

- a to transform an increase in demand into a sustained increase in output requires a fall in the real wage rate in relation to productivity in order for employers to find it profitable to increase production. Frequently

in recent years, however, domestically generated increases in demand have led to increases in product prices, quickly followed by increases in labour and other factor prices. In good part the increase in demand has been met from stocks and imports rather than increased output. This has been particularly so in times of slack monetary conditions;

- b the extent to which fiscal policy can smooth out the peaks and troughs in economic activity has also been undermined by the effect of fiscal activity on the balance of payments. Recent economic upswings have seen import volumes grow by considerably more than domestic output. For instance, in the 1981/82 upturn import volumes grew by 10.3 percent against real GDP growth of 4.4 percent. The deterioration in the balance of payments that follows such import growth has normally produced a monetary tightening and a slowing in the rate of increase of domestic activity;
- c to produce an increase in output and employment from a fiscal stimulus requires an expectation that the higher demand is sustainable. In New Zealand's recent history, the stimulation of domestic demand has not always been accompanied by improved terms of trade or other real support, so that producers have been reluctant to respond to what they perceived to be transitory increases in demand by increasing output or hiring extra staff. This was the case in the expansion of 1981/82 when the terms of trade rose only marginally. As a result, despite having 4.4 percent real GDP growth in that year, employment rose by only 1.5 percent. The extra output was generated by making greater use of existing staff and plant with extra shifts and more overtime, and by running down stocks. This reaction probably reflects widespread awareness of the instability of fiscal policy, with large swings in the degree of stimulus making the increases in demand even more transitory. For example, in 1976/77 the deficit was 3.6 percent of GDP whereas it had been 8.6 in 1975/76. In 1979/80 the deficit dropped to 4.9 percent of GDP after having been 8.3 percent the previous year. Such swings create a great deal of uncertainty. As an example, it has become apparent in talks with manufacturers during the last six months that they are more likely to increase permanent employment in response to increased demand when that demand is export rather than domestically based;
- d the impact of an expansion in the fiscal deficit can also be reduced if the deficit leads to either increased inflation or higher interest rates:
  - i if the government chooses to finance its increased deficit by selling public debt outside the financial sector, nominal and real interest rates will rise. While this is essential to the achievement of lower inflation, the risk is that the higher interest rates will lead to a decline in interest sensitive private expenditures (especially investment). This tends to offset any

initial impact on aggregate demand and create the temptation to increase the fiscal deficit even further to stimulate activity. The extent to which this occurs is dependent on the relative sizes of the impact on economic activity of higher deficits and higher interest rates respectively. The interest rate effect is likely to be heightened if there is the perception that the government has no effective policies to reduce the deficit and a widespread expectation, therefore, that future deficits will also be large;

- ii the expansion of a deficit to promote economic activity also runs the risk of fuelling excessive monetary expansion if sufficient debt is not sold to reduce liquidity in the financial system. For instance, in 1978/79, when the deficit expanded rapidly, real private sector credit (deflated by the change in the CPI) grew by 13.2 percent. During the 1981/82 upturn, real private sector credit grew by 12.3 percent. In the last year, inadequate, funding of the deficit has led to 11.6 percent real growth in private sector credit. Growth rates of this magnitude inevitably exacerbate inflationary pressures. In these circumstances, the chance of increased demand being met by price rather than output responses is heightened, and pressure on the balance of payments, the export sector and ultimately the exchange rate is increased.

As a consequence of the sort of experiences described above for New Zealand, and also international experience as illustrated in Table 1, increasing attention is being paid to two further factors as being crucial in determining the impact of fiscal policy:

- a individuals' expectations about how a given policy change will affect their incomes, both now and in the future, will influence the way people adjust their expenditures in response to that policy change. For instance, if people see a tax cut now as meaning higher taxes in the future, they may not adjust their expenditure at all, thereby reducing (or negating) the effects of the fiscal expansion;
- b the extent to which increased government activity displaces (crowds out) private activity. There is good reason to believe that, by competing for real resources (such as skilled **labour**) and raising their price, by shifting expenditure patterns and, depending on how the deficit is financed, by financial crowding out (through the government absorbing greater proportions of the total supply of investable funds), any government move to increase the deficit to stimulate activity may in the long run have a considerably negative impact on economic performance.

Furthermore, even if fiscal policy does have some influence on the level of aggregate demand in the short run, it has become increasingly apparent that governments should be wary about using it as an instrument for stabilisation for several reasons:

- a as stated above, the degree to which the government is able to influence the level of economic activity depends on the expenditure/savings decisions of the private sector which, in turn, depend on its expectations about how a given government action will affect not just its current incomes but future incomes as well. Individuals will react differently to different actions, and even differently at different times to the same action. Economic managers know too little about the likely reactions of individuals to be confident of the magnitude of the effects their intervention will have, or even that such intervention will be **stabilising**;
- b for the Government to use fiscal action to stabilise the economy, it must be constantly aware of the precise position on the business cycle that the economy is in and the length of time needed before any policy change has an effect so as to time its policy change correctly. In practice, it is difficult to predict precisely when a downturn or upturn will occur, it takes further time to decide on and implement the appropriate policy response, and a further variable amount of time for that policy response to have an effect. Consequently, government attempts at smoothing may end up being pro-cyclical rather than counter-cyclical, and hence **destabilising**;
- c if the Government implements a fiscal policy change which does alter the level of economic activity, it inevitably also alters the allocation of resources in the economy. This reallocation may well be in a way that reduces efficiency and total welfare in the long run. As a result, before acting, the Government should satisfy itself that the benefits of a policy change will outweigh the costs. Given the lack of certainty about the degree of benefit to be gained from an active use of fiscal policy for macroeconomic purposes, this criterion can seldom be met.

The weight of evidence suggests that fiscal policy has been overused as an instrument of stabilisation in recent years.

#### — The Expenditure/Revenue *Imbalance*

This section discusses why the Government should be seriously concerned about the persistent imbalance between expenditure and revenue, and why it is desirable urgently to implement a programme of deficit reduction.

The imbalance between government expenditure and revenue can be measured in a variety of ways. The conventional measure, the amount to be financed before borrowing as published annually in Table No.2 of the Budget, is useful for its intended purpose of accounting for the changes in public debt and public account investments which result from expenditure and revenue levels, but it is not the most appropriate statistic for discussing the macroeconomic implications of expenditure imbalances. In particular, the Budget Table No.2 deficit statistic is not particularly useful for indicating the monetary effects of the Government's overall activities because it excludes the activities of the Reserve Bank. For example, the monetary effects of an increase in public account lending to the Rural Bank are identical to the monetary effects of increased Reserve Bank lending to the Meat Board, yet the Budget Table No.2 deficit is affected by the former transaction but not the latter. For monetary policy purposes, what matters is the potentially destabilising influence of injections of liquidity into the financial system from the combined public account and Reserve Bank spending and lending activities. Table 3 attached shows for comparative purposes the Budget Table No.2 deficit (i.e. amount to be financed by borrowing) compared with the combined Reserve Bank and public account borrowing requirement for the years 1975/76 to 1983/84. It can be seen that the combined borrowing requirement is generally, but not invariably, higher than the Budget Table No.2 requirement, with the differences being particularly marked in 1977/78 and 1982/83 when large increases in Reserve Bank lending occurred. The larger the combined borrowing requirement, the more active the public debt sales programme necessary to achieve monetary control and the greater the risk of disruption to interest-sensitive expenditures in the economy and the real exchange rate.

#### *— Borrowing to Finance Consumption*

In addition, Budget Table No.2 data are not compiled in a way which reveals the extent to which public account borrowing is going to finance current rather than capital expenditures; neither does it reveal the extent to which some of the borrowing merely results from the public account acting as a financial intermediary, applying the borrowings to on-lending programmes to trading departments such as NZED and to lending agencies such as the Housing Corporation and the Rural Bank. The Budget Table No.2 deficit, for example, can be reduced simply by allowing such entities to issue their own debt directly, yet the effect would not be to alter one iota the degree to which the Government as a whole was saving or dis-saving in its transactions with the rest of the community.

The best available data for discussing the macroeconomic issues raised in the previous paragraph are presented in Table 4 attached. The data are closely related to the Budget Table 2 data in terms of coverage, but

they provide an economic classification which allows government expenditure to be split into current expenditures, capital expenditures and lending activities. These data are prepared by the Treasury for publication by the International Monetary Fund in its annual "Government Finance Statistics Yearbook". A paper relating these data to the Budget Table No.2 data is available.

The following draws out some conclusions from this classification:

- a line 2 of Table 4 attached shows the deficit or surplus on the Government's current transactions (current expenditure less current revenue). Until 1977/78, the Government generally ran a surplus on its current account which meant that it made a positive contribution to financing its own capital formation, and indeed to total savings in the economy. From 1978/79, however, the Government has been running deficits on its current account, and since 1979/80 increasingly bigger deficits so that it has had to call on savings elsewhere, both domestically and overseas, to cover its entire net capital spending and a portion of its current expenditure;
- b line one of Table 4 shows the public account's annual net capital expenditure. This has been relatively constant in relation to GDP. It should be noted, however, that this statistic excludes a lot of central government capital formation financed by public account lending to agencies such as NZED, NZPO, Petrocorp, Air New Zealand etc. This means that the degree to which central government has been calling on the savings of other sectors in order to finance its own current and capital expenditure activities has been appreciably higher than is indicated in the attached table. Unfortunately no official data are available for central government as a whole on a comparable basis, but the NZIER has estimated that in 1982/83 net borrowing to finance central government capital formation and the excess of current expenditure over revenue amounted to 7.9 percent of GDP, appreciably higher than the 5.2 percent figure (2.0+3.2) for the public account alone;
- c adding the current account deficit to capital spending gives line three in Table 4, the public account's net borrowing requirement which measures its net recourse to cash from other sectors to finance its expenditures on goods, services and transfers net of taxes. This figure excludes from government expenditure the total of government lending minus repayments in each year, and most accurately reflects the demands on foreign and domestic savings necessary to finance the public account's capital spending and deficit in current transactions. Table 5, line five, attached shows that the percentage of non-public account savings that the net borrowing requirement represents has followed a continual upward trend in recent years and reached a peak of 36.1 percent in 1983/84.

### — *Extent of Overseas Borrowing to Finance the Deficit*

The degree to which monetary policy has been insufficiently active to avoid recourse to balance of payments deficits in order to fund the public sector savings gap is indicated in Table 6. This table shows the degree to which the combined borrowing requirements of the public account and the Reserve Bank were financed by net borrowing overseas rather than internally since 1975/76. What is noteworthy is the heavy reliance on external financing in some years. A greater reliance on domestic financing would have reduced domestic cost pressures at the risk of crowding out more private investment. If neither outcome was desired, then the only solution would have been to reduce the fiscal deficit.

### — *Cyclical Influences on the Deficit*

Another indicator of the magnitude of the deficit problem is the breakdown of the deficit into its cyclical and structural components. In times of economic recession, the government's deficit will tend to rise as expenditure rises on 'unemployment benefits and tax revenue falls due to reduced employment and real activity. The increase in the deficit arising from these factors is the cyclical component of the deficit. To the extent that a cyclical deficit is justified in a downturn as a temporary phenomenon which does not require corrective action, the corollary is that on the upswing of the economic cycle (such as **currently**) the government should run a cyclical surplus so as to achieve a desirable long-run average financing requirement. By separating out the cyclical component of the deficit, it is possible to produce an estimate of the structural deficit—that part of the deficit that will not disappear without deliberate changes to expenditure and revenue patterns.

Table 7 provides some estimates of the cyclical and structural deficits prepared on this basis for the years 1977/78 to 1983/84. For example, if real GDP had only grown at its 0.6 percent trend value in 1983/84 (instead of the actual 2.1 percent **growth** rate), the methodology suggests the deficit would have been even larger at 9.6 percent of GDP. The calculations summarised in the table indicate that the effects of fluctuations in economic activity on the deficit are relatively small (i.e. never more than 1.5 percent of GDP) so that the major portion of the **large** deficits experienced in recent years is structural. This implies that only a structural change in the economy which substantially raises the real growth path is likely to reduce the deficit markedly in the absence of discretionary policy changes.

### Dangers of Fiscal Imbalance

As discussed earlier, Tables 1 and 2 attached showing the experience of both New Zealand and other large fiscal deficit countries **over** time suggest

that expansionary fiscal policies, far from having prevented low growth, may well have been a contributory factor to poor economic performance. There are a number of reasons why we need to be particularly concerned about the fiscal imbalances outlined above:

- a Table 5 shows that the net borrowing requirement of the Government is potentially absorbing a steadily increasing proportion of total national savings, and Table 4 shows that the increase is due to a rising excess of current expenditure over current revenue. The move from surplus to deficit on current account by the Government has been offset only to a degree by a rise in private savings, and overseas savings have been relied upon to a greater extent than in the past to finance domestic capital formation. The danger is that the competition for savings between the private and public sectors could push up interest rates and reduce investment at the expense of future welfare. In this context there is cause for concern that, during the period since 1978/79 when the public account has been continuously in deficit on current account, the national ratio of gross fixed investment to GDP has averaged only 21 percent, fractionally below the long-run average of 21.5 percent despite the influence of the major project investments;
- b one danger, clearly shown by the New Zealand experience, of an active fiscal policy is that increases in expenditure or reductions in revenue to combat recession may never be completely reversed in times of economic expansion. During the last fifteen years government expenditure and revenue and the deficit have ratcheted upwards. This has resulted in an increasing command by the Government over the nation's resources. To the extent that the Government has not always used the extra resources it has gained command over in the most cost-effective manner, or invested in areas with satisfactory rates of return, total welfare has been reduced;
- c continued fiscal deficits risk an escalating spiral of debt, interest payments and deficits. Table 8 attached sets out statistics on the stock of public debt and interest on public debt for the last 13 financial years. The figures demonstrate the rapidity with which the Government's interest bill has grown in recent years, thereby reinforcing the underlying growth in government expenditure. In addition, to the extent that a balance of payments deterioration occurs due to either increased government expenditure leading directly to increased imports, or inadequate domestic funding of the fiscal deficit leading to monetary expansion, the potential exists for ever-increasing external debt and related interest payments;
- d the threat to monetary control that a large fiscal deficit poses can be exemplified by the experience of the last year when, because of concerns about nominal interest rates, insufficient debt was sold to

negate the effects of the injection from the fiscal deficit. As a consequence, both real M3 and private sector credit grew rapidly in the last half of 1983/84. This has increased the likelihood of an increase in the rate of inflation with the removal of the price freeze. The destabilising effect of this will be felt most, under a pegged exchange rate regime, in those sectors of the economy exposed to international competition. The substantial imbalance on the external current account suggests that our real exchange rate (that is New Zealand's cost structure relative to that of our trading partners) is too high and that, as a result, our exposed sectors suffer inadequate returns. To lower our real exchange rate we need a lengthy period during which costs in our exposed sectors are reduced relative to selling prices. To achieve this would require monetary discipline. Because of the risks that fiscal deficits imply for monetary control, this will require fiscal discipline as well.

All of these factors suggest that past fiscal management may have done considerable damage to the growth prospects of the New Zealand economy.

## Summary

The conclusions to be drawn from the discussion so far are that:

- a fiscal policy is likely to have some effect on output in the short run but the effect is not likely to be stable, strong or readily predictable and, in the longer run, a sustained fiscal expansion is likely to destabilise the economy;
- b because of the uncertainties about the way the economy responds to fiscal stimulus and the efficiency costs that may be involved in fiscal intervention, it is not appropriate to use fiscal policy to actively smooth fluctuations in the economy except, perhaps, in the case of exceptional cyclical disturbances. This does not exclude allowing cyclical factors to alter the fiscal position in an automatic manner but the potential value, even of this flexibility, is limited if the underlying fiscal position is destabilising;
- c by several measures, there is a severe fiscal imbalance in New Zealand;
- d this fiscal imbalance is posing **serious problems** for monetary policy in particular, and for the performance of the economy as a whole.

## The Macroeconomic Effects of Contracting the Deficit

Traditionally, it would have been presumed that policies to reduce the fiscal deficit would have a contractionary effect on the economy, at least

in the short-term. This at least is a frequent justification by some governments for their failure to exercise fiscal responsibility. However, against this presumption the following points must be weighed:

- a continuing fiscal deficits are likely themselves to be contractionary to the extent that interest rates are driven up in order to finance them in a non-inflationary manner. To the extent that they are financed in an inflationary manner, the contractionary effect is forced on the economy either because of a deteriorating external situation or because sooner or later the government is forced to act to reduce inflation;
- b just as an expansionary fiscal policy is not now thought to have a stable, predictable or strong short-run impact on output and employment, neither need a contractionary fiscal policy. To the extent that fiscal cuts are made in areas in which considerable wastage was occurring or where policy objectives could be more efficiently achieved by other instruments (e.g. the exchange rate), and to the extent that the cuts took place in a planned, coherent and understandable manner which generated confidence in the private sector to plan future investment and employment decisions, the effects will certainly be beneficial in the medium term and need not be substantially adverse in the short term. It is important that the programme of fiscal reform be undertaken in a phased manner which concentrates on the consistent pursuit of efficiency and equity objectives, so as to minimise the risks of policy reversals with all the undesirable side-effects on private sector decisions which such uncertainties about policy intentions arouse.

### Targets for the Deficit

What then can be said about the appropriate size of the fiscal deficit in the medium term? The following criteria should be kept in mind when assessing the appropriateness of the size of the fiscal deficit:

- a on average the cyclical deficit should be zero; that is cyclical deficits in times of recession should be balanced by surpluses in times of growth;
- b as a general rule, the Government should aim to finance out of current revenue all current expenditures including replacement of capital. It would also be reasonable to require government trading activities to price their services (allowing for reimbursement from the public account of any subsidy element) so as to cover fully the real component of interest charges plus a normal profit element and provision for economic depreciation. Thus, in the longer term, the Government would aim to finance all current and recurring capital expenditures out of current revenue. Borrowing would then be confined to:

- i funding increases in the Government's capital stocks, the benefits of which will accrue to future generations who can, therefore, reasonably be expected to share in meeting the costs involved;
- ii on-lending activities, either to the private sector or to fund increases in the capital stock of government trading activities.

To quantify this accurately would require inflation-adjusted accounts for all government activities. These are not available. In present circumstances, when public account capital formation is being held fairly steadily in relation to GDP, a reasonable approximation would be a Budget Table No.2 deficit sufficient to cover on-lending activities as defined in (ii) above. In the present fiscal year, this would imply a deficit of less than 2 percent of GDP.

It would not be desirable to reduce the fiscal deficit as rapidly as that target implies, given, the disruptive effect it would have on both the public sector and the economy with the risk of future policy reversals. Nevertheless, in the short-term, it is highly desirable that the fiscal deficit be reduced as quickly as possible in order to reduce the pressures on interest rates, monetary policy and the real exchange rate. A more appropriate deficit level will not be attained without policy changes. There is no conclusive basis for determining in a precise way an appropriate deficit target for 1984/85 and 1985/86 for all the reasons discussed above. The sort of deficit reduction achieved between 1975/76 and 1976/77 (from 8.6 percent of GDP to 3.6 percent) would probably be too drastic, although in that case it was done at a time when the external terms of trade had dropped sharply whereas, at present, circumstances are more propitious. However, taking into account the need to take the pressure off monetary policy and reduce the balance of payments deficit, very significant reductions in the deficit to GDP ratio are required. A target of a reduction in relation to GDP of at least 2 percent per annum for the next 3 years would seem to be the minimum necessary to establish a credible programme of fiscal adjustment.

## Conclusion

Because the Government has the power to substantially alter spending patterns in the economy by changing the composition and level of its spending programmes and its taxes, fiscal policy has been used extensively as a macroeconomic policy instrument. The fact that changes in fiscal policy can severely disrupt business investment and employment plans and reduce public sector efficiency suggests that excessive reliance has been placed on fiscal policy as an instrument of macroeconomic management in recent years.

As shown by the New Zealand experience, chronic imbalances between government expenditure and revenue can seriously disrupt and destabilise the economy by generating spiralling debt burdens, undermining monetary control and raising the real exchange rate at the expense of international competitiveness. This suggests that action must be taken to reduce the substantial fiscal imbalances that exist in New Zealand. International experience in small, trade dependent economies in particular, confirms that the supportive effects of fiscal policy on economic activity are of dubious strength and limited duration, especially when deficits are high. To enable fiscal policy to regain any effectiveness as a cyclically stabilising influence, a return to a position much closer to budget balance is required.

The medium term objective should probably be a deficit of less than 2 percent of GDP. The speed and method by which this is achieved should be determined by rationally co-ordinated moves on both expenditure and revenue policies, which ensure that the efficiency of both is improved.

TABLE 1  
COMPARATIVE PERFORMANCE OF OECD AND MEMBER COUNTRIES WITH HIGH FISCAL DEFICITS

	General Government Deficit as % of GDP/GNP			Unemployment as % of Labour Force			Inflation Rate			Current Account Deficit (-) as % of GDP/GNP			Growth of real GDP/GNP		
	1978 1982	1982	1983	1978 1982	1982	1983	1978 1982	1982	1983	1978 1982	1982	1983	1978 1982	1982	1983
Netherlands	-4.5	-7.4	-6.6	6.2	10.0	14.2	5.5	6.0	2.8	+0.3	2.7	2.1	.8	-1.6	+1.0
Belgium	-9.3	-11.0	-11.1	10.0	13.1	14.0	6.4	8.7	7.7	-3.1 <sup>1</sup>	-3.6 <sup>1</sup>	-1.4 <sup>1</sup>	2.2	1.1	.5
Denmark	-4.3	-9.5	-7.8	7.8	9.7	10.6	10.7	10.1	6.9	-3.7	-4.1	-2.8	2.0	3.1	2.5
Ireland . .	-14.5 <sup>3</sup>	-16.6 <sup>3</sup>	-13.4 <sup>3</sup>	7.7	10.7	14.1	15.3	17.1	10.5	-9.3	-8.4	-3.8	3.9	1.2	1.0
Italy . .	-10.4	-12.7	-11.8	7.9	9.1	9.7	16.5	16.6	14.6	-0.5	-1.6	-0.4	2.8	-0.3	-1.2
Sweden	-3.8	-6.2	-5.0	2.4	3.1	3.5	10.3	8.6	8.9	-2.4	-3.6	-3.1	1.8	+0.2	2.3
New Zealand <sup>4</sup>	-6.4 <sup>3</sup>	-6.2 <sup>3</sup>	-5.5 <sup>3</sup>	3.3	5.3	5.5	14.9	16.1	7.4	-4.0	-5.6	-6.3	1.9	-0.2	+2.0
OECD . .	-2.7 <sup>2</sup>	-4.1 <sup>2</sup>	-4.3 <sup>2</sup>	6.2	8.4	8.9	9.8	7.8	5.3	-0.4	-0.4	-0.3	2.4	-0.5	+2.4

<sup>1</sup> Belgium/Luxembourg.

<sup>2</sup> Total of 17 countries.

<sup>3</sup> Central Government only for Ireland; public account (table 2 basis) for New Zealand for closest March year.

<sup>4</sup> Closest March year, except the inflation rate which is on an annual basis. External balance is balance of payments data which is not strictly comparable to the SNA basis used for the other countries.

SOURCE: OECD Secretariat—Economic Outlook, July 1984.

**TABLE 2**  
**MONETARY AND FISCAL STIMULUS 1972-1983**

<i>Year Ended March</i>	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
Real GDP Growth (%) <sup>3</sup> .. .. .	2.5	4.4	7.2	4.0	1.7	0.1	-2.7	0	2.7	0.7	4.4	-0.2	2.0
Budget Deficit % GDP (%) .. .. .	1.1	2.6	2.6	3.9	8.6	3.6	4.5	8.3	4.9	6.2	6.2	5.5	8.7
Annual Increase in Private Sector Credit Deflated by the CPI (%) <sup>2</sup> ..	0.0	13.1	25.1	-1.9	-2.4	13.6	-0.5	13.2	2.5	4.5	12.3	-7.5	11.6
Growth in Real Disposable Household Incomes (%) <sup>3</sup> .. .. .	7.6	11.0	4.5	-4.5	3.8	-1.7	-4.3	4.5	-4.3	-1.8	1.1	-4.2	0.1
Change in Real Private Consumption (%) <sup>3</sup> .. .. .	0.4	7.4	8.7	4.3	-0.5	-3.0	-3.0	1.3	-0.3	0.7	2.1	-1.2	1.8
Change in Total Employment (000) <sup>2</sup>	12	39	50	21	8	14	-3	13	17	-3	21	-10	+13
Annual Rate of Inflation (%) <sup>2</sup> .. .. .	8.5	6.0	10.3	13.2	17.2	13.7	14.7	10.4	18.4	15.2	15.8	12.6	3.5
Change in Import Volumes (%) <sup>1</sup> .. .. .	2.7	5.7	31.8	2.6	-18.7	4.8	-12.6	11.6	5.3	-2.5	10.3	-8.5	10.7
Terms of Trade (1957 = 100) .. .. .	93	113	112	78	72	79	78	86	82	76	77	74	74

<sup>1</sup> June year on June year

<sup>2</sup> Point to point (March quarter) except for employment which is at 31 March

<sup>3</sup> Year on Year

TABLE 3  
 COMPARISON OF PUBLIC ACCOUNT AND CONSOLIDATED  
 GOVERNMENT AND RESERVE BANK BORROWING  
 REQUIREMENT

	<i>Public Account Deficit \$m</i>	<i>Consolidated Borrowing Requirement \$m</i>	<i>Public Account Deficit % of GDP</i>	<i>Consolidated Borrowing Requirement % of GDP</i>
1975/76	1001.7	1126.9	8.6	9.7
1976/77	506.1	474.0	3.6	3.4
1977/78 . . .	694.4	1308.6	4.5	8.5
1978/79 . . .	1445.9	1440.2	8.3	8.2
1979/80 . . .	1026.9	1190.2	4.9	5.6
1980/81 . . .	1524.9	1485.1	6.2	6.1
1981/82 . . .	1818.3	2254.1	6.2	7.7
1982/83 . . .	1766.9	3024.8	5.5	9.4
1983/84 . . .	2984.0	2817.3	8.7'	8.2'

• Based on Treasury Estimates of GDP for 1983/84

TABLE 4  
RELATIONSHIP BETWEEN FISCAL DEFICITS AND GOVERNMENT CAPITAL  
EXPENDITURE, CURRENT ACCOUNT BALANCE AND NET BORROWING/LENDING REQUIREMENTS

IMF Classification of Public Account  
Years Ended March  
% of GDP

	73/74	74/75	75/76	76/77	77/78	78/79	79/80	80/81	81/82	82/83	83/84	84/85	85/86
Net Capital <sup>1</sup> Expenditure	2.9	3.7	3.1	2.6	2.6	2.5	2.0	2.0	2.0	2.0	2.1	2.3	N.A
<i>Financed by:</i>													
Current Acct Surplus(+) <sup>2</sup>	3.0	3.8	-0.1	2.6	2.1	-1.8	-0.4	-1.8	-2.6	-3.2	-4.8	-3.1	N.A
Net Borrowing (+)/Net Lending (-) ..	-0.2	-0.2	3.2	-0.1	0.5	4.3	2.4	3.8	4.5	5.2	6.9	5.4	5.0
Total Financing ..	2.9	3.7	3.1	2.6	2.6	2.5	2.0	2.0	2.0	2.0	2.1	2.3	NA
<i>Relationship to Overall Fiscal Deficit</i>													
Lending minus Repayments <sup>3</sup> ..	2.6	4.3	7.1	4.4	4.6	4.3	2.9	2.5	2.7	2.2	2.4	1.7	2.1
Overall Deficit (+) <sup>4</sup> ..	2.4	4.1	10.2	4.4	5.1	8.6	5.3	6.3	7.2	7.4	9.4	7.2	7.1

Source: Government Finance Statistics Yearbook, 1982 (IMF Classification) and Treasury projections

Notes: (Totals may not add exactly due to rounding differences)

<sup>1</sup> Includes gross fixed capital formation, net land purchases and capital transfers.

<sup>2</sup> Current revenue less current expenditure, including interest.

<sup>3</sup> Those elements of net lending which are classified as government expenditure.

<sup>4</sup> IMF classification basis. It indicates the residual borrowing requirement. It is calculated as net borrowing plus lending minus repayments.

<sup>5</sup> Based on Treasury estimated or projected GDP

**TABLE 5**  
**PUBLIC ACCOUNT NET BORROWING/LENDING AS A PERCENTAGE OF NON-PUBLIC SAVINGS**  
**\$ Million**

	71/72	72/73	73/74	74/75	75/76	76/77	77/78	78/79	79/80	80/81	81/82	82/83	83/84	84/85*
Non-public Account Savings ..	929	1341	1573	1164	1688	2177	1891	2727	3683	4043	5558	5694	6598	6714
Public Acct Current Acct Surplus (+)/Deficit (-) <sup>1</sup> ..	281	149	280	388	-11	372	322	-320	-91	-438	-750	-1037	-1658	-1134
TOTAL SAVINGS <sup>2</sup> .. ..	1210	1490	1853	1552	1677	2549	2213	2407	3592	3605	4808	4657	4940	5580
Public Acct Net Borrowing (+)/Net Lending (-) <sup>1</sup> ..	-87	85	-18	-18	370	-7	79	753	512	925	1322	1673	2384	1957
Net Borrowing (+)/ Net Lending (-) as % of Non-Public Account Savings (%) .. ..	-9.4	6.3	-1.1	-1.5	21.9	-0.3	4.2	27.6	13.9	22.9	23.8	29.4	36.1	29.1

\* Provisional

Source

<sup>1</sup> Government Finance Statistics Yearbook, 1982 (IMF Classification)

<sup>2</sup> Monthly Abstract of Statistics

TABLE 6

SOURCE OF FINANCE FOR COMBINED RESERVE BANK/  
PUBLIC ACCOUNT BORROWING REQUIREMENT

	Total Borrowing Requirements \$m	External Borrowing \$m	External/ Total Borrowing as % of GDP	Total Borrowing as % of GDP	External Borrowing as % of GDP
1975/76	1126.9	560.4	49.7	9.7	4.8
1976/77	474.0	325.7	68.7	3.4	2.3
1977/78	1308.6	214.5	16.4	8.5	1.4
1978/79	1440.2	504.3	35.0	8.2	2.9
1979/80	1190.2	408.2	34.3	5.6	1.9
1980/81	1485.1	723.3	48.7	6.1	3.0
1981/82	2254.1	1373.1	60.9	7.7	4.7
1982/83	3024.8	389.2	12.9	9.4	1.2
1983/84	2817.3	934.7	33.1	8.7*	2.8'

\* Based on Treasury estimates of GDP for 1983/84

TABLE 7  
STRUCTURAL AND CYCLICAL COMPONENTS OF THE FISCAL  
DEFICITS

Budget Table 2 Basis As a Percentage of GDP

Year Ended	Actual Fiscal Deficit <sup>1</sup>	Estimated Structural Deficit <sup>2</sup>	Estimated Cyclical Component <sup>3</sup>
1 9 7 8	4.5	3.1	1.4
1979..	8.3	9.4	-1.1
1980..	4.9	5.0	-0.1
1 9 8 1	6.2	5.9	0.3
1982..	6.2	7.6	-1.4
1983..	5.5	5.1	0.4
1984..	8.7	9.6	-0.9
1985..	6.5	7.3	-0.8

1 Budget Table 2, basis.

2 Column (!)-Column (3).

3 Calculated on the basis of estimates of how much higher or lower income taxes, indirect taxes and unemployment benefits would have been if GDP had been at its trend value in each year rather than its actual value. In years of cyclical upturns for example, GDP would be above trend and unemployment benefits would be reduced and tax revenues increased relative to the trend case. The cyclical effect (column 3) would then be to reduce the actual fiscal deficit below its structural (or trend) level. Trend GDP is calculated in each year from the 0.6 percent per annum average compounded growth rate in real GDP during the 1978-1983 period.

TABLE 8  
PUBLIC DEBT AND INTEREST ON PUBLIC DEBT STATISTICS  
\$ million

Year Ended March	(1) Net Govt Expend	(2) Interest on Public Debt	(3) Net Expend Excl Interest	(4) Total Receipts	(5) =(3)-(4) Deficit Excl Interest	(6) =(2)+(5) Deficit Before Borrowing	(7) Change in Public Debt	(8) Closing Public Debt	(9) Gross Domestic Product
1972	1862	167	1695	1790	-95	72	180	3187	6874
1973	2219	185	2034	2013	21	206	316	3503	7901
1974	2633	200	2433	2392	41	242	231	3735	9199
1975	3410	221	3190	3020	170	390	465	4200	10177
1976	4386	270	4116	3384	732	1002	1358	5558	11669
1977	4504	367	4137	3998	139	506	731	6289	14105
1978	5669	465	5204	4974	230	694	1195	7484	15424
1979	6949	590	6259	5403	856	1446	1336	8820	17510
1980	7587	758	6829	6560	269	1027	1526	10346	21092
1981	9133	891	8242	7609	633	1525	1271	11617	24461
1982	11196	1203	9993	9378	615	1818	2764	14381	29296
1983	12673	1476	11917	10906	291	1767	4352	18733	32240
1984*	14250	2042	12208	11266	948	2984	3146	21879	34313
Cumulative 1972-84	665%	1123%	620%	529%	4850	13679	18871	586%	399%

\* Preliminary

**Note:** Differences between columns (6) and (7) will reflect in part both adjustments due to exchange rate changes and to Reserve Bank lending and asset purchase operations. For example in 1982/83 the public debt increased by \$4352 million in comparison with a fiscal deficit of \$1767 million. The discrepancy largely reflects the 8 March 1983 devaluation, and also in part, large purchases of public sector securities by the financial system in the last half of the 1982/83 fiscal year on account of a sharp increase in Reserve Bank lending and a net cash injection from overseas exchange transactions.

## *Chapter Eight*

# **Fiscal Policy : Expenditure and Revenue Principles**

The government has a significant influence on the way in which the economic system meets the constantly changing needs and wants of the community. This arises from the legal and regulatory environment within which individual market participants operate, and from direct government intervention through public provision of certain goods and services and the reallocation of resources among different activities and individuals in the community. The government's fiscal activities are one form of such interventions and include both expenditure programmes and the means by which revenue is raised to finance these expenditures. The primary objective of these fiscal activities is to raise the community's welfare by raising general levels of incomes and altering the distribution of incomes or the consumption of particular goods and services.

Fiscal interventions based on appropriate criteria have the potential to increase the efficiency of the economy by affecting the use of resources between or within the public and private sectors in a way which raises the overall returns and the level of income to the community as a whole. It is also possible for government policies to achieve better social outcomes through tax policies and direct transfer payments which redistribute incomes between individuals and family groups, or by government social expenditure programmes designed to improve the pattern of consumption of particular goods and services.

In assessing existing or proposed government expenditures, it is important to recognise that the resources appropriated by the Government to finance its expenditures are not available to satisfy the community's desires for various goods and services in other areas. This is directly reflected in rising tax burdens-the mechanism by which those resources are transferred. To the extent that these resources may yield higher social returns in alternative uses, government expenditure impairs economic performance and may lower community welfare. It is also important to recognise that actions to reduce the scope and magnitude of inequalities in the community may entail efficiency costs, by weakening the incentives the market provides individuals to undertake productive and otherwise profitable activities. In addition there may be considerable direct costs involved in administering government programmes. Similarly beneficiaries may incur costs in complying with requirements to obtain assistance.

Thus, while private markets cannot satisfy perfectly all the needs of the community, there are limitations to what governments can do to improve

the situation. In pursuing its economic or social objectives it is important that the government carefully weighs the alternatives. For economic activities it is necessary to determine whether fiscal interventions are the most effective instrument for altering market outcomes. Assessments should also be made as to whether government activities improve on the market outcome and whether the benefits outweigh the attendant costs. For social activities this process requires a clear identification of objectives (which can be expressed in terms of income distribution or of levels of consumption by target groups) and an assessment as to how these objectives can be achieved at lowest cost, both in terms of total resources consumed by the programmes and their effect on the efficiency of resource use elsewhere. For example, it may be better in certain circumstances to improve equity through tax or income-transfer arrangements, rather than through direct public provision of goods.

The way in which the government raises revenue to finance its expenditure also influences economic and social outcomes in the community. The tax rates involved in meeting revenue targets inevitably affect choices among economic activities, including the incentives to work, save and invest. Taxes can involve significant administrative and compliance costs. The taxation system should therefore be designed to minimise these costs for the economy overall.

Taxes also affect the distribution of disposable incomes in the community. For this reason it is important to consider the interaction of taxation and expenditure policies in assessing the overall impact of the government's fiscal actions on equity. Whether directed at equity or efficiency, the combination of expenditure and revenue measures chosen should be based on their relative cost-effectiveness in achieving their goals.

## Expenditure

Like many other OECD countries, government expenditure in New Zealand has been characterised by persistent real growth since World War II. As a proportion of GDP, expenditure has risen from around 28 percent in the early 1970s to an estimated current level of over 41 percent. The upward movement in this ratio has been particularly significant in recent financial years. A notable feature of this trend in government expenditure as a proportion of GDP has been a "ratchet" mechanism whereby increases in spending in election years have not been fully reversed in subsequent years.

The trend in public sector growth and its impact on tax burdens has encountered increasing resistance in New Zealand as in other OECD countries. In part this has been reflected in widening deficits. The rise in oil prices and large falls in the terms of trade which occurred in the

early 1970s, and the stagflation that has characterised the western economies in the later part of this period, have had major influences upon economic performance and policy. In this tougher environment, the size of the public sector has come under closer scrutiny, and is increasingly mentioned as an independent factor contributing to weaker economic and social performance. There is concern with the size of sustained public indebtedness and the growth of quasi-government activities; resources absorbed by the government are perceived as “crowding out” private consumption and investment; and the limitations of the scope for government action to achieve specified objectives, or to improve upon market outcomes, are frequently noted.

Against this background it is not at all surprising that people want better value for money as their tax burden rises. Where a dollar spent returns less than a dollar of benefits to the taxpayer there is likely to be increasing conflict between spending and funding decisions. But where those spending decisions are subjected to and meet the appropriate test of their value as outlined above, taxpayers can have more confidence that their welfare is increased by the public sector activity.

On the basis of the principles outlined above, there are a number of key areas where **government** expenditure in New Zealand does not pass the “value for money” test. Burdensome levels of assistance to industry and agriculture, poor targetting of social policies, and inefficiencies with which resources are used and managed in the public sector are all features of the present fiscal system which allow scope for substantial savings to be made while enhancing the attainment of general economic and social objectives. The ways in which this might be achieved are outlined below, and further detail is provided in the briefing papers dealing with each of these areas.

#### *a Assistance to Industry*

The form and level of industry assistance have a significant impact on the Government’s fiscal position. For example, in the last financial year the Government provided about \$2 billion in assistance to industry and agriculture via **SMPs**, lump sum payments, subsidised loans, underpriced government goods and services and tax incentives.

The allocation of expenditure in this area has been closely linked to our inward-looking attitude to economic development, which has inhibited our ability to adapt to changing external conditions. By sheltering so much of our industry and service sectors from competition, we have fermented very strong doubts in the community about the ability of commercial interests to achieve desirable social and economic outcomes. This has led to calls to support industries in periods of economic downturn, and to the introduction of measures which are rarely rolled back in better conditions.

A direct consequence of protection, regulation and subsidies which shelter some activities has been the increasing fiscal assistance needed to support competitive export and import competing industries so as to prevent resources being drawn away from these sectors towards the sheltered sectors.

The Government's fiscal position is worsened because assistance is delivered to agriculture and other exporting sectors via the fiscal system, rather than by greater reliance on more appropriate policies which would preserve the competitiveness of these sectors. Distorted prices leading to inefficient resource allocation are the result, and the importance of government assistance to industry incomes and profits leads to the diversion of resources to non-productive lobbying activities.

There is currently scope for large fiscal savings to be made in the industry assistance area. Direct fiscal subsidies in 1983/84 included \$350 million in SMPs for meat and wool, about \$300 million through the Export Performance Taxation Incentive, and about \$46 million on other export assistance schemes. Reforms on the import protection front together with a more active use of exchange rate management would reduce the need for fiscally provided support to exporting and efficient import competing industries by creating a more uniform level of assistance across the economy and increasing the competitiveness of the internationally traded goods sector.

## *b Social Policies*

Welfare expenditures have grown by 90 percent in real terms since 1970/71 and in 1983/84 accounted for over \$8 billion or 56 percent of total public expenditure. This growth in welfare spending partly reflects the previously held belief, shared in many countries, that some kind of government programme or action could be designed to deal with many social problems. However, accompanying this spending growth has been an increasing recognition that much of this spending has failed to fulfil its objectives, explicitly or implicitly, directed at achieving greater equality. Part of this failure can be attributed to a less than precise definition of the objectives of social policies, but a major part is due to deficiencies in targetting policies to those they are intended to help. Such policies must not only meet their objectives but do so at minimum cost—a cost which is less than the value placed upon the benefits of the policies.

Examples of poorly targetted social policies include many subsidy schemes in areas such as housing, education and medical care, where much assistance is delivered to everyone regardless of need. Subsidies in these areas alone, together with the family benefit, could produce fiscal savings in the order of \$500 million a year by better targetting assistance to those in need.

Clearer definition of objectives and improved targetting in the social welfare area would enable substantial fiscal savings to be realised while at the same time achieving a more equitable distribution of incomes.

### *c Pricing and Performance in the Public Sector*

The Government has a major impact on economic and social performance through the pricing policies and performance of its trading activities. Given the volume of resources they absorb (about 12 percent of GDP) and the impact of their pricing policies on resource decisions elsewhere in the economy, such trading activities have important implications for the efficiency and general performance of the economy.

Pricing of the public sector's output below the resource costs involved is inevitably reflected in net expenditure. In effect it represents a subsidy from the taxpayer to consumers of the goods or services. For instance the difference between the current price of electricity and coal and their respective costs of supply are estimated to imply effective subsidies in the order of \$800 million and \$80 million respectively. (These figures are indicative only and do not take account of the consumer response to the implementation of higher prices.)

Underpricing public sector goods and services contributes to pressures for increased expenditure by raising the demand for public outputs. Where public output competes with or substitutes for private sector production, failure to charge the full costs incurred may also prevent or inhibit the development of private sector activities.

On the other hand, holding down these prices for "social" reasons would seem to be a sure recipe for widening inequalities. Subsidies of this type are delivered to all users, irrespective of need, and could be targetted more effectively by other instruments such as through the tax or transfer system.

Poor performance by government enterprises and trading activities is reflected in the amount of resources they must absorb in delivering their output. Low rates of return on the resources they employ amount to an additional burden on net expenditure arising either from the profits which taxpayers forgo on their equity or below market returns to the debt (e.g. supplied through the Loans Account).

Two major factors contribute to these problems:

- - the lack of clear objectives for government trading enterprises; and
- the environment in which they operate.

The confusion between non-commercial and commercial objectives leads to a lack of any clear basis for assessing the performance of such activities.

Moreover the enterprise itself often becomes involved with identifying target groups, and delivering assistance. This removes important equity and industry assistance decisions from the direct control and scrutiny of the Government.

Existing control and monitoring mechanisms, together with the advantages and protection provided to enable “social” objectives to be met, create an environment where performance is difficult to measure and the incentives and pressures to manage resources are seriously attenuated. These mechanisms also tend to limit the ability or reduce the incentives for management to achieve a more satisfactory performance.

As pointed out in the section on State Owned Enterprises, the solution to these problems lies in removing the non-commercial functions of these activities and replacing them with explicit measures which target assistance to those it is intended to help. This would then enable them to operate in a more competitive and flexible environment where performance can be measured against established commercial objectives.

Questions of the efficiency of resource use extend beyond state trading activities to the whole of the public sector. In this context the general management structure in the public sector assumes importance since, given its size, even minor general increases in efficiency may permit significant resource savings. Achieving these efficiency improvements requires a management system which is given clear objectives set by the Government, and appropriate incentives to encourage efficient performance. A review of the State pay fixing system could also provide the means whereby incentives for productivity improvements are enhanced and resource savings are realised.

#### *d Other Areas of Expenditure*

This section of the paper has only examined three broad areas of expenditure—industry assistance, social services, and public sector efficiency—where large fiscal savings can be made without sacrificing, and indeed in many cases enhancing, the Government’s other objectives. However, the general principles described in this paper can be applied to all areas of government spending. In addition, to the extent that expenditure savings enable reductions in the size of the fiscal deficit to be made, expenditure to meet future debt interest payments will be reduced. Currently the annual cost of public debt interest stands at over \$2 billion. Such action would, in itself, curb the growth of what has been the fastest expanding area of government expenditure in recent years.

### **Revenue**

While government expenditure has continued to grow steadily over recent years, revenue has increased more slowly. The result has been a widening

deficit. This has not avoided the efficiency costs implicit in a rising tax burden, but simply channelled the costs through other mechanisms such as rising inflation, high real interest rates and costly controls designed to suppress these consequences. In any event the debt required to finance these deficits implies higher future tax burdens to meet the resulting interest payments-the tax problem is simply deferred.

Although government revenue as a proportion of GDP (at around 33 percent) is comparable to many other OECD countries, New Zealand's tax system is characterised by its heavy reliance on direct taxation as a revenue source. In 1983/84 direct taxation provided around 72 percent of total tax revenue, significantly higher than for the vast majority of OECD countries. Moreover, direct taxation is concentrated heavily on personal income tax which contributes about 65 percent of total tax revenue-much higher than the OECD average which in 1980 was around 33 percent. These characteristics have produced a tax structure which falls well short of the criteria relating to efficiency and equity against which the system can be evaluated.

A more detailed analysis of the New Zealand tax system is set out in the paper dealing with tax policy. The following discussion points to major weaknesses in the tax system and suggests broad directions for change.

#### a *Direct Taxation*

The high proportion of the tax burden borne by personal taxpayers, together with a wide range of personal tax concessions and other exemptions on significant sources of income (e.g. fringe benefits and capital profits), have a serious adverse impact on economic efficiency. The resulting narrow tax base means that both average and marginal tax rates are high for many categories of income subject to tax. This creates strong incentives for taxpayers to convert income from highly taxed to untaxed or less taxed sources, and to move from taxable market activities to untaxed non-market activities, reducing the general efficiency of resource use, and discouraging productive effort and risk taking. The lack of comprehensiveness in the personal tax base also reduces the ability of the system to effectively achieve a more equitable distribution of the tax burden, particularly since the scope for earning untaxed income is generally greater for those on higher incomes. Moreover, while the resulting complexity of the system imposes costs on most taxpayers, it is likely that it more heavily penalises lower income taxpayers. A move to a more comprehensive definition of income for taxpayers, which also included welfare benefits, would offer significant gains in terms of the efficiency of the system, and enable a better interface between taxes and social expenditures in achieving equity objectives.

The other area of direct taxation is business tax. Major weaknesses in the definition of taxable business income arise from the exclusion of capital profits, deductibility of nominal interest on debt (but no deduction for the cost of equity), the failure to adjust the tax base for inflation, and a number of expenditure and industry specific concessions. The interaction of these features with high rates of inflation in recent years has produced a system which distorts returns among activities and types of capital asset and biases decisions regarding investment and financing, yet produces a relatively small amount of revenue. Moreover, the individuals to whom the business income accrues generally face (implicit) rates of taxation which diverge significantly from the appropriate personal tax rates.

There are clearly significant gains to be obtained from reforming business tax. Options for reform in this area which are currently under examination are outlined in the chapter on Tax Policy.

### *b Indirect Taxes*

The major sources of indirect taxation are the wholesale sales tax and customs and excise duties. Currently the wholesale tax applies to only one third of the private consumption base. As discussed in the chapter on Tax Policy, significant gains in terms of both efficiency and equity could be achieved by extending the indirect tax base and moving to a more uniform rate structure. However, to increase indirect tax revenue significantly would require the inclusion of services within the tax base, including the value of services added from the present wholesale taxable value to the retail level. This would inevitably require a change in the way the tax is levied. Such a move offers the prospect of a significant improvement in the efficiency of the tax system overall by permitting the high personal income tax rates to be reduced.

Customs duties are a further source of indirect tax revenue, although they differ from sales tax in that they discriminate between domestically produced and imported commodities. Together with import licensing, input subsidies and export incentives, they directly affect the allocation of resources among different activities. While tariff rates in New Zealand are high by international standards, revenue from this source has been small. This is a consequence of the typically low rates on industrial inputs (the bulk of imports) and the use of licensing as the primary form of protection for domestic manufacturers of final goods. As outlined in the chapter on Regulation and Industry Assistance, moves toward tariff-based protection and lower, more uniform tariff rates will improve resource allocation. It will also provide the potential for greater revenue from this source in the short to medium term, although this area should not be thought of as an important longer run revenue source.

### *c Tax Expenditures*

As outlined above, a range of special forms of assistance, in both the personal and business areas, is provided through taxation concessions. The annual fiscal cost of these “tax expenditures” is estimated at around \$1.5 billion. In many cases these expenditures distort resource use and contribute to inequities in the tax structure. In other cases their objectives could more cost-effectively be achieved by other means. A significant step towards facilitating the thorough scrutiny and evaluation of concessions against equity and efficiency criteria would be made by identifying and publishing a descriptive list of these expenditures and their estimated cost. Reviews of tax expenditures undertaken by Treasury indicate a number of concessions which could be eliminated or reduced in accordance with the criteria outlined earlier.

To summarise, there is much room for increasing the revenue potential of the existing tax system consistent with improving community welfare. More thorough-going reforms in the direct and business tax areas offer the prospect of a significant improvement in the tax system overall.

### Conclusion

The incompatibility of many features of fiscal policy with efficient resource allocation in both the public and private sector is a major factor in explaining the country’s relatively poor recent economic performance. To the extent that fiscal policy is aimed at reducing this incompatibility, the Government can both increase the level and improve the distribution of national income.

## *Chapter Nine*

# **Expenditure Planning and Control**

### Introduction

The Chapter “Fiscal Policy: Expenditure and Revenue Principles” sets out the criteria against which to assess public spending and revenue activity. The assessment of fiscal activity is, however, itself a Government activity which is not costless. The objective of expenditure planning and control is to achieve a pattern of government activity consistent with equity and efficiency goals, at least cost in terms of monitoring performance, assessing new proposals and reviewing existing policy. It must also be consistent with the Government’s fiscal goals and its other macro-economic objectives.

In order to meet these objectives, changes to the existing expenditure planning and control mechanisms are required. If expenditure control were costless, all government expenditure could be subjected annually to review and assessed against appropriate economic and social criteria. However, for the large bulk of government spending this would be impractical and far too costly. For these spending areas, an expenditure management process is required which provides a formal mechanism to evaluate and review new and existing policy on the basis of a list of priorities. This would include policy areas which are not currently subject to any formal review procedure, such as tax expenditures. The general environment and mechanisms which might facilitate this process are outlined in the Chapter “Practice and Organisation of Economic Management and Consultative Procedures in Government”.

Outside this on-going review procedure, costs of monitoring performance and controlling expenditure can be reduced by setting a framework in which there are incentives to achieve government-set objectives so that monitoring responsibilities are delegated down through the public sector. Measures designed to move government owned enterprises on to a more commercial footing (see the “Government Owned Enterprises” section of the brief) are motivated by this desire to generate the incentives to achieve broader government objectives, thus reducing the need for external monitoring. Methods of creating these incentives within government departments are discussed in the “Managing the Public Service” section of “The Public Sector” Chapter.

Nevertheless the implementation of government policies inevitably requires delegation of detailed spending and resource decisions to departments and individuals who may not understand or share the

objectives involved and where detailed monitoring and control to ensure decisions are consistent with broad criteria is extremely costly. In this environment some form of **centralised** expenditure control procedure will be necessary to ensure efficient use of public sector resources in cases where, for example, it may be difficult to ensure that decision makers take into account directly the cost of raising funds employed.

Thus an expenditure management system should have two main features:

- a ensure that wherever possible detailed review procedures test spending against efficiency and equity criteria;
- b given the limitations in the capacity to undertake detailed reviews, ensure that general control measures have been established to constrain the level of spending in areas outside the detailed review process.

## **Review Procedures**

With regard to the first of these points, some issues will automatically lend themselves to review because of their size. Such issues, which will usually be few in number, can and should be subject to assessment against efficiency and equity criteria. However, some more formal mechanism to establish the review agenda would seem desirable if maximum efficiency gains are to be realised. This would enable the Government to establish priorities among the issues it wishes to review. To determine eligibility for specific review and analysis, it would be possible to pose a series of questions in respect of both new and existing expenditure programmes. For example:

- a is it necessary for the Government to **carry** out this activity, e.g., is it necessary for the taxpayer, through the Post Office, to finance all future developments in the rapidly expanding telecommunications sector when the private sector itself is willing to finance some of this investment?
- b what are the objectives of the activity and what are the policy options to achieve these objectives? For example should industry assistance be delivered via the fiscal system?
- c in the case of new policy will the Government receive value for money spent? For existing policy, is the Government currently getting value for money? In project specific policies does the project meet the 10 percent rate of return criteria; in the social welfare area is the assistance well targetted?

d what is the priority of the activity in relation to other policy objectives in related areas?

Any policy which did not stand up well to such queries could be expected to be reviewed, subject to the constraints and bottlenecks in the review process itself. The latter should not be under-estimated. Only a few issues can be tackled at any one time. The time constraints imposed on senior Ministers and officials limit the number of in-depth reviews it is possible to conduct in any year. In addition the issues invariably take longer to review than anticipated. Evaluating options, consultation with affected parties and preparation of legislation is time-consuming and demanding. Furthermore, public understanding of the issues is more likely to result in a sustainable decision being reached. Hence time spent in securing greater public involvement (with a constituency for change) is usually well worthwhile.

### **General Control Measures**

As noted previously, all spending decisions cannot be monitored by control departments against efficiency and equity criteria, so **centralised** control procedures must be developed to cope with the residual large areas of government spending.

In Treasury's view current arrangements could be improved in two ways. (Existing arrangements, together with comments on their shortcomings are detailed in Appendix I.) First, the control on the aggregate level of expenditure could be reinforced by disaggregation into a few smaller expenditure groups ("envelopes" in the Canadian parlance) centered upon major government objectives e.g., social policy, industry assistance, infrastructure, administration. Secondly, the current mix of input controls could be replaced with simpler cash planning levels. Such a control mechanism would have the advantage of enabling the Government to first determine how much it wants to spend and then to decide on the distribution of funds to various expenditure groups. In addition, entrusting managers with full responsibility to manage within a cash limit will encourage better management which, as managerial experience grows, should yield improved efficiency in the public sector generally. Of course, for indexed expenditures and other open ended expenditure items such as national superannuation, cash planning levels would be inappropriate. Expenditure items of this type would require separate review periodically.

The determination of broad cash planning levels for three years out within broad groupings would provide a perspective within which Ministers and departments could assess spending priorities and encourage trade-offs to be made, thus providing a greater incentive to bring spending decisions into conformity with efficiency and equity criteria.

## **An Improved Expenditure Control Procedure**

Based on the foregoing comments, the following elements could form the basis of a revised expenditure control process:

- a Ministers should submit forecasts of existing policy for three years ahead on the basis of broad criteria agreed to by Cabinet;
- b Treasury should aggregate these forecasts and convert them to nominal prices. This data together with a revenue projection would provide a view of the fiscal situation for three years out;
- c a committee of senior Ministers should review the fiscal projections and in broad terms decide on:
  - i the major policy areas that it wishes to examine e.g. agricultural assistance, export incentives, pricing policies of the trading agencies;
  - ii the overall objectives for expenditure, revenue and the deficit against the background of other economic objectives;
  - iii the general **shape and** level of the three year cash planning levels for major non-indexed expenditure;
- d two parallel processes could then follow:
  - i the review of the major policy areas;
  - ii the implementation of the agreed cash planning levels for the financial year immediately following;

The reviews could be carried out in various ways depending on their size and area eg:

- by a Committee of Senior Ministers;
- by an envelope Committee e.g., one dealing with Industry Assistance;
- by “bilaterals” (cf Australia) where the Minister of Finance discusses policy issues and expenditure levels with the relevant spending Minister.

## **Publication Of the Government’s Fiscal Policy, Including Cash Planning Levels**

A further development could involve the publication of the Government’s fiscal policy including cash planning levels. This can only happen after the full implications of all the decisions required have been considered by the Government. If it is not done on this basis, it will inevitably prove

difficult to meet published numbers. Publication would be the final stage of a relatively long and complex process. In the first instance the Government would need to determine in broad terms its desired fiscal stance, not only for the year ahead but also for the following two years. From this point, the Government can initiate detailed reviews of expenditure together with analysis of revenue options. Appropriate cash planning levels must also be determined. To enable this process to be successful, some changes to existing expenditure planning procedures will be required: not only will the process be interactive but it will be essential to ensure that the necessary time is available.

Treasury sees publication as helpful in demonstrating the fiscal constraints within which the Government is operating and thus of assistance in modifying expenditure demands. In addition, publication provides signals to the community (business and individuals) of the broad directions of fiscal policy and priorities and allows **them** to plan ahead with more confidence. At one level, publication could involve the release of expenditure and revenue projections and at the other, a commitment to a particular expenditure/deficit target. Without an integrated and public approach to expenditure, and a political commitment, a Government will find it difficult to resist **sectoral** pressures,' which when dealt with in isolation incrementally lead to the type of expenditure growth that has occurred over the last ten years.

## **Summary and Conclusions**

The level and mix of Government expenditure should be determined in relation to:

- a the efficiency and equity of major Government programmes and activities;
- b the medium term fiscal outlook and other economic objectives.

The expenditure control procedures outlined in this paper would assist the Government in meeting these twin objectives.

It is important to re-emphasise however that without a strong political commitment to control expenditure, together with a willingness to take hard and unpalatable decisions, and to meet published objectives no expenditure control system will in itself constrain expenditure. On the other hand, where such a will is evident, the institutional arrangements will be inevitably of lesser importance.

## **Existing Budget Cycle Arrangements**

Departmental budgetary allocations represent the culmination of four budget cycle steps. These are:

- Step 1: In August/September of each year, three year forecasts of expenditure are prepared by departments on the basis of constant prices and existing policy. The reasonableness of the forecasts is assessed by officials who report to the Minister of Finance on the forecast levels of expenditure for the next three years. Year 1 of the forecasts is translated into financial planning levels, which provide the basis for initial Estimates preparation.
- Step 2: The New and Existing Policy Review in the early part of the calendar year involves Ministers submitting their new policy proposals together with compensatory savings to fund these new policies to the Cabinet Committee on Expenditure for consideration.
- Step 3: Assistance to the housing and agricultural sectors is reviewed, at which time funding for the Housing Corporation and Rural Bank is determined. Other packages have included assistance to employment and funding for Vote: Energy.
- Step 4: An Estimates review is carried out by the Treasury, (in March, April, May) with final approval to gross and net departmental expenditure being obtained from the Minister of Finance in the context of the Budget.

## **Expenditure Control Instruments**

Within the budget cycle process, various expenditure control instruments of an across-the-board nature have been used to restrain Government expenditure. These include the requirement for compensatory savings to fund new expenditures (New and Existing Policy Review), the use of staff ceiling controls, holding or, in some years, reducing capital works levels, and providing less than full price compensation for non-personnel operating expenditure. In addition, reviews such as the 1981/82 3 percent savings exercise have been undertaken. On the whole, the policy instruments noted above have merely influenced Government expenditure at the discretionary margin.

## Shortcomings of the current system

The shortcomings of the current system can be attributed to a number of factors:

- *inadequate time and resources* are allowed for the analysis and evaluation of alternative expenditure policies;
- the formal review process suffers from an *inadequate coverage*: expenditure options should not be considered in isolation from alternative approaches e.g. tax expenditures;
- *inadequate analysis of proposals*: all too often objectives are poorly specified and few alternatives are identified;
- *inadequate ranking of review priorities*: the annual new and existing policy reviews have seen an inordinate amount of time and effort devoted to small proposals involving less than one percent of total government expenditure;
- an unrealistic focus *on the short term*: as a general rule only minor savings can be achieved in the short term: spending Ministers and departmental managers can achieve considerably greater savings if they are given both the time and the incentive to make adjustments with a longer term impact;
- *an undue weight on across the board measures* such as the sinking lid on staff numbers and less than full compensation for inflation which, it can be argued, are counterproductive in their effects on management practices.

## *Chapter Ten*

# **Tax Policy**

### A OVERVIEW

#### **Introduction**

The New Zealand tax system is unsatisfactory in many respects. Its principal faults are:

- a it is not delivering sufficient revenue;
- b many of its features are contrary to any reasonable efficiency and equity criteria.

Rectification of these defects will require significant structural changes.

The considerable public dissatisfaction with our present tax system stems from concerns about the aggregate level of tax (which really reflect the heavy reliance on personal income tax rather than the total tax burden), individuals' perceptions of the fairness of their relative burden, and the complexity and uncertainty of the present scheme. In recent years numerous ad hoc amendments have been made to plug specific loopholes. The loopholes have often reflected more fundamental deficiencies in the tax base itself. Complexity and uncertainty have increased as special provisions to reward certain activities or penalise others have been added to the tax system. The effects of these provisions are often uncertain. Even where such measures achieve their original intention, they may outlive the conditions which prompted them. Much wasteful private sector effort can be devoted to devising ways around complex tax law.

This chapter examines the criteria for evaluating a tax system and relates them to the major features of New Zealand's current tax regime. It then identifies those aspects which we consider to be in most urgent need of reform.

#### **Attributes of a Good Tax Regime**

The purpose of any tax regime is to raise revenue. The level of revenue will itself be dictated by the level of government expenditure and the size of the Budget deficit that the Government is prepared to accept. Any particular tax regime must be evaluated, first of all, in the light of how well it meets the revenue requirement.

However, taxes also create wedges between prices paid and received for goods and services, and between the costs of and incomes to factors of production. These two wedges can alter relative prices and so the allocation of resources, resulting in efficiency losses and reduced total welfare. A second aim should, therefore, be to raise the required revenue in a way which minimises distortions to relative prices. Pursuit of particular allocative or distributional objectives should be effected through specific tax measures only if they are clearly the most efficient instrument.

The application of these general objectives can be broken down into the following criteria for the evaluation of tax options:

- a economic efficiency;
- b equity;
- c simplicity and certainty;
- d international compatibility.

These criteria will often conflict, resulting in compromises in the design of tax systems. In addition, feasibility of transition must be considered in relation to options involving significant structural changes.

#### a *Economic Efficiency*

Any tax system which raises revenue will obviously have an effect on the incomes of those who bear the burden of that tax. This “income effect” is often contrasted with the “substitution effect”. Where different rates of tax are levied on substitutable activities, this will encourage excess activity in the lightly taxed area and too little activity in the highly taxed area. It is generally preferable that substitutable goods or activities be taxed at the same rates so that individuals can freely choose how to act without artificial influence from the tax system. This maximises efficiency and total welfare. At present, for example, investment options with a diverse spread of pre-tax rates of return may all yield the same after-tax rate of return. This encourages investment to flow to uneconomic areas and lowers national income.

#### b *Equity*

Two separate notions of equity may be distinguished. First, there is the principle that all individuals receiving the same level of income, regardless of source or form, should pay the same amount of tax. This is commonly referred to as horizontal equity and implies that all individuals on the same income also face the same marginal tax rate. Horizontal equity is fully consistent with economic efficiency.

Secondly, there is the principle that those on higher incomes have greater ability to pay tax and as such should be taxed more heavily. This is commonly referred to as vertical equity. Considerations of vertical equity suggest that those on high incomes should pay higher *amounts* of tax, but do not necessarily provide a justification for marginal tax rates increasing with income. This refinement of the vertical equity principle depends upon the notion that an additional dollar of income is worth less to a relatively high income person than to a person on a lower income.

Unless a tax system is horizontally equitable, it cannot be vertically equitable. If the tax liability for those on a given level of income can vary with the source or form of the income, it will be impossible to ensure that those on high incomes pay more tax than those on low incomes. Similarly, a tax system which is not horizontally equitable will also generate economic inefficiencies of the type referred to in (a) above. There will, however, be some clash between efficiency and vertical equity if application of the latter takes the form of marginal (and average) tax rates rising with income. A good tax system will minimise such clashes.

### *c Simplicity and Certainty*

The costs to the Government of administering the tax system and to taxpayers of compliance with it are economic losses to the community as a whole. A good tax system will minimise such losses. This is most readily achieved by a tax system which is as simple as possible. To maximise efficiency, the participants in an economic transaction should be able to determine in advance, and with certainty, the precise tax liability created by that transaction. Perhaps the most common request made by the private sector is for the tax system to be made simpler and more certain.

### *d International Compatibility*

In addition to evaluating whether a tax system would be sensible if applied to New Zealand in isolation from the rest of the world, any evaluation should examine international compatibility. The tax system may, for instance, provide unintentional incentives to transfer capital from one country to another. Reform options may require renegotiation of double tax agreements with other countries. This may be particularly difficult if forms of tax unique to New Zealand are contemplated. The generally accepted principle is that income is taxed in the country of origin and goods and services are taxed in the country of destination.

## The Present Tax System

In 1983/84 total tax receipts comprised the following components:

	\$m	%
Personal tax	6707	64.3
Company tax	703	6.7
M i s c e l l a n e o u s	<u>43</u>	<u>0.4</u>
Total income tax	7453	71.4
Other direct tax	<u>69</u>	0.7
Total direct tax	7522	72.1
Indirect (including highways) tax	2909	27.9
Total Tax	10431	100.0

The most pressing problem with the present tax system is the narrowness of its base. The present wholesale sales tax applies to only approximately one-third of private consumption (by value). The income tax base has been eroded by numerous special exemptions, and capital gains and fringe benefits are largely untaxed. Even within the present income base, different forms of income may be differently taxed. The capital or wealth tax base is extremely fragmented.

A narrow base has adverse effects on both equity and efficiency. The lack of tax on certain activities is distortionary and results in lower rates of tax on individuals involved in such areas. In addition, for a given revenue requirement, the rate of tax which others must pay on activities included in the tax base is raised. Even if it is considered that the present level of tax revenue is adequate, a high priority should be placed on extending the base, lowering rates, and achieving a uniform rate structure for comparable incomes and substitutable expenditures. If fiscal priorities require a higher level of tax than is currently levied, the case for extending the base becomes compelling. It is doubtful whether the present tax base is sufficiently robust to produce substantially higher amounts of revenue.

Determining an appropriate balance between forms of tax (direct and indirect) involves a consideration of:

- a the efficiency and compliance effects of each form of tax for the rates and bases to be considered;
- b the likely distributional effects of the resultant allocation of the tax burden. In this regard the personal income tax system is more flexible in terms of distributing the tax burden than an indirect tax system.

The present income tax base is nominal income. There are difficulties in extending a nominal income tax base in a way which will be seen to be fair. For example, taxing capital gains at the same rates as current income appears inequitable when the gain is purely due to inflation. There are two main alternative direct tax bases:

- a a real income tax;
- b a direct expenditure tax.

Both of these alternative bases have strong theoretical advantages. The arguments for and against a transition to such taxes have been well canvassed overseas. To our knowledge, however, neither is in current use in any country, although some of their features are quite commonly approximated by ad hoc provisions. Further work would be required before we could advise on the practicability of these options.

The second major problem is the high average and marginal rates applying in both the income and the sales tax systems. This in part reflects the narrowness of the bases but is probably largely due to attempts over many years to pursue often ill-defined equity objectives.

The third major problem is the plethora of departures from the basic system which permeates all our major taxes. Again these generally reflect attempts to pursue specific efficiency or equity objectives. Often the tax system has been chosen for this purpose, not because it was the most efficient instrument available, but because the costs were less visible than under the alternatives.

Finally, the system of collecting tax from provisional taxpayers (both companies and individuals) has serious destabilising effects on the financial system.

The following sections discuss each of the major taxes in turn, followed by a brief consideration of tax expenditures.

## B PERSONAL TAXATION

From a distributional viewpoint personal taxes have an advantage over indirect and company taxes in that they can more readily reflect individual circumstances. Broadly speaking, three main bases may be used for personal direct taxation : income, expenditure and wealth.

### The Personal Income Tax Base

By international standards, personal income tax represents a relatively high proportion of both central government revenue and GDP in New Zealand. In terms of economic efficiency, equity and, to a lesser extent, simplicity, there are a number of major flaws in our present personal income tax system. The bulk of these result from, or are related to, the narrowness of the personal income tax base and this in turn is due to the failure to tax such gains as fringe benefits and capital profits, and to the wide range of tax concessions available to individuals.

The narrowness of the tax base provides a substantial incentive for taxpayers to convert income from taxed to untaxed or less-taxed sources. This diversion reduces the overall efficiency of the economy by shifting resources from activities which have the highest economic rate of return to those with the highest after-tax rate of return. In the case of labour, resources may shift to untaxed non-market activities, including leisure. There is a widely held view in New Zealand that the present personal income tax system discourages productive effort and risk-taking.

The distortions due to a less than comprehensive tax base are in fact part of a vicious circle whereby a narrower tax base requires higher tax rates on taxed income. This increases the incentive to avoid and evade tax, which in turn increases the tax rate required on taxed income, and so on. A widening of the tax base could conceivably establish a virtuous circle with reinforcing effects operating in the opposite direction.

If income is not defined comprehensively, horizontal and vertical inequities arise which reduce the effectiveness of personal tax as a social instrument. Under our current tax system, income is too narrowly defined to act as an accurate gauge of ability to pay. Horizontal inequities exist because individuals with the same total income and personal circumstances pay different amounts of income tax. Vertical inequities arise because the scope for earning untaxed or less-taxed income is generally greater for those on higher incomes. This problem is exacerbated since information costs relative to gains from avoiding tax are probably much higher for low-income groups. One result of these inequities is that the personal tax system is widely perceived to be unfair and socially divisive. This is of concern, given that the successful functioning of any tax system relies on the taxpaying population being generally willing and compliant.

To a certain extent the current narrowness of the personal income tax base also increases the complexity of the tax system because of the need to account for the numerous personal tax rebates and exemptions. While moves to tax fringe benefits and capital gains, for instance, would appear to add to the overall complexity and cost of the tax system, this has to be weighed against the complexity of the various specific measures that have been taken to plug the worst loopholes.

As a first step towards broadening the income tax base, immediate attention should focus on the practicalities of introducing taxes on fringe benefits and capital gains. There is also a need to examine the validity of all tax expenditures as proposed in Section E.

Possible alternative bases for personal taxation are discussed below.

## **The Personal Tax Unit**

The tax unit is the mechanism for specifying the extent to which, if at all, individuals' incomes are to be aggregated for the purpose of assessing their respective tax liability. Apart from the period 1939-1962, New Zealand's personal tax system has been based upon the individual unit, with the family rebate being the only component of the current system which takes account of family income.

The tax unit chosen should reflect the varying weights placed upon the frequently conflicting objectives set for a personal tax system with income as its base. For example, there may be on the one hand a desire to maintain the progressivity of income tax and, at the same time, achieve an equitable relationship between the tax positions of different households-single persons, one-and two-income couples, and families with and without dependants. On the other hand, there may be the wish to avoid discriminating against working women who are not the principal income earner, a major consideration behind the change in New Zealand to an individual-based tax system. Furthermore, family-or household-based tax systems will achieve the equity advantage claimed for them only if the tax base is redefined to **recognise** either the imputed income of a non-working spouse or the additional costs incurred by two-income families. Finally, adoption of a tax unit other than the individual would greatly complicate the tax system, particularly the **PAYE** component.

We can see no strong argument for moving away from the individual tax unit in New Zealand.

## **The Tax Rate Scale**

The first consideration in the design of any personal income tax scale is the amount of revenue it must yield. For a given distribution of assessable income, this revenue goal determines the overall average tax rate. How progressive or otherwise the personal income tax rate scale should be depends on the relative weights given to economic efficiency and horizontal equity on the one hand, and vertical equity on the other. Such decisions also need to have regard to the degree of progressivity inherent in the fiscal system as a whole (including the distribution of benefits from government-provided services and transfer payments).

The advantages of progressive tax scales are often greatly exaggerated, especially in New Zealand with its very compressed taxable income distribution. Ninety percent of taxpayers have incomes below 1.6 times average weekly earnings (i.e. \$25,000 per annum). A steeply progressive scale, therefore, risks adverse incentive effects (both economic and tax compliance) for limited distributional gains. A relatively flat scale on a

comprehensive base is likely to be both more efficient and more equitable than a steeply progressive scale on the present base. Finally, we would stress the need, in designing tax scales, to have regard to the dynamic effects--the effect over time, as incomes change, on tax liabilities--rather than the "before and after" effect.

For any particular revenue goal and income base, the degree of progressivity and fiscal drag in the tax system depends heavily on the initial tax rate chosen. A low initial rate is a cost-inefficient means of providing tax relief to those on low incomes. Only those on higher incomes are sure to gain the full benefit of such a policy. For instance, the bottom step of the present tax scale (\$0-6000) encompasses 39 percent of all taxable income. Each 1 percentage point reduction in the marginal tax rate for that step reduces revenue by \$88 million. The full benefit of such a move would go to 95 percent of taxpayers. Tax rebates targetted at specific classes of taxpayer are a more cost-effective means of achieving the same objective, albeit at the cost of additional complications. Direct transfer payments may be even more efficient.

### **The Interface Between the Tax and Welfare Systems**

Income taxes are able to take explicit account of the prevailing concepts of social justice, either by adjusting tax burdens by some measure of ability to pay or by actively seeking to redistribute income according to some other criteria. If the latter approach is taken, there is a need to redesign the present income tax system and give explicit attention to the interface between the tax and social welfare systems in order to gauge the nature and extent of any overall redistribution. Even if redistributive objectives are not explicitly present in the design of the tax system, there is still a need to be aware that the tax system constitutes one side of the redistributive process.

Any substantial move towards a comprehensive definition of income for tax purposes would include bringing welfare benefits into the tax net. Provided the appropriate adjustments were made to the gross benefit levels, this would improve the equity and targeting of some welfare benefits, particularly in respect of people with a mixture of market and benefit incomes. Movement towards a more unified redistributive system could range from the introduction of additional, specifically targetted rebates through to a negative income tax system. Under the latter, much existing welfare support could be delivered through the tax system on the basis of need, formulated to take account of family composition, incomes and other relevant factors. However, the possible application of such a scheme in New Zealand has yet to be studied so that its likely costs and benefits cannot now be adequately assessed.

The present family rebate is perhaps as far as it is useful to go in terms of precise targeting of tax measures with an income support objective. Any more tightly targeted measures of this kind may well be handled more efficiently by the social welfare system.

## **Alternative Bases for Personal Taxation**

Two alternative bases exist for the taxation of individuals:

### *a Personal Direct Expenditure*

The major alternative to a personal income tax is a direct expenditure tax. While no developed western democracy has adopted a direct expenditure tax, the case for adopting this base to replace income tax, either totally or partially, has frequently been made since the middle of last century. The main but superficial argument for such a shift is that an expenditure tax taxes what the taxpayer “takes from society” instead of what the taxpayer “contributes to society” by way of production and earnings.

Another way of looking at this difference is that expenditure taxation taxes consumption expenditure more or less as it happens, while income taxation taxes both savings and the income return on savings. Both taxes, if comprehensive, would result in the same lifetime tax liability for each individual. The time profile of tax payments would, however, be different.

Any consideration given to moving towards a direct expenditure tax would need to weigh the advantages claimed for such a tax against possible administrative difficulties. These are expected to be considerable, not the least being international compatibility.

### *b Personal Wealth*

The only wealth-based taxes imposed in New Zealand are land tax and estate and gift duties. While at one time these taxes accounted for the majority of direct tax revenue, their importance has declined to such an extent that they are now insignificant revenue earners. Taxation of wealth can be justified on grounds of ability to pay and its use to redistribute wealth in ways deemed desirable by society. Any evaluation of the need for wealth taxes in New Zealand should follow an investigation into the present distribution of wealth and the direction in which that distribution is moving.

## **Conclusion**

The narrowness of the current personal income tax base provides a substantial incentive for taxpayers to shift resources away from those activities with the highest economic rate of return towards less-taxed areas. It also underlies the most glaring inequities in the current system. Consequently, the most urgently required changes to the personal income tax system involve measures to broaden the tax base. This would involve taxation of fringe benefits and capital gains, and removal of those tax expenditures available to individuals which either have no valid allocative or distributive justification or could be delivered more efficiently through some other part of the fiscal system.

## **C BUSINESS TAX**

### **Introduction**

The base of the present business tax system is generally historical cost profits. Broadly, taxable income is defined as net operating income, plus the increase in the nominal value of stocks, less depreciation based on the historical cost of assets, less nominal interest payments. There are, however, important exceptions where capital expenditure is also deductible as it is incurred, such as in farming, mining and (effectively) forestry. The immediate write-off of capital expenditure is a characteristic of an expenditure or cash flow tax. Taxable income, defined as above, is taxed under the personal tax system in the case of unincorporated businesses but, in the case of companies, at both the company tax rate and shareholders' marginal tax rates when profits are distributed as dividends (the "classical" system of company taxation).

### **Problems**

The major problems with the present business tax system are directly related to the definition of taxable income:

- a capital profits are generally excluded from the tax base, necessitating complex rules to distinguish between capital and current receipts and conflicting with the objective of taxing all forms of income equally;
- b dividends are not deductible, whereas the interest on debt is. The advantage of debt finance is increased during periods of high inflation since the inflation component of nominal interest rates is deductible. The non-deductibility of dividends at the corporate level results in dividends being taxed twice. The total tax burden on income derived through a corporate entity thus depends on the proportion of company income distributed and on shareholders' marginal tax rates. The

overtaxation of dividends may, however, be partly offset by the undertaxation of retained profits and associated capital gains on shares. The extent of so-called double taxation is also reduced by the ability of many companies to pay dividends tax-free from capital profits and, in the case of small private companies, by disbursing all company profits as salaries or as interest payments to employee-shareholders;

- c the tax base is not adjusted for inflation. Taxable profits are based on the historical cost value of stocks, fixed assets and debt. Historical cost accounting for stocks and depreciation on fixed assets increases tax liabilities during inflation, but tax liabilities are reduced by ignoring the inflation-induced gains from declining real levels of debt. The overall effect of inflation thus depends significantly on a firm's debt/equity ratio. The effect of inflation on the real value of depreciation varies with asset life, so that inflation distorts relative returns on assets;
- d expenditure-and industry-specific tax concessions, incentives and exemptions alter relative pre-and post-tax rates of return and distort investment choices. For example, investment allowances discriminate arbitrarily between different types of asset and encourage the employment of capital rather than **labour**. Other notable examples are the capital write-off provisions in farming, mining and forestry, and the concessionary taxation of life insurance.

The present business tax system is thus neither equitable nor efficient. It discriminates between different types of business Organisation, financial structure, investment and sources of income, and lacks any adjustment for inflation, In terms of equity, all forms of income should be taxed at the rates appropriate to the individual recipients of the income. To **achieve** efficiency, the tax system should be neutral with respect to business decisions, such as investment choices or method of finance.

### **Options for Reform**

There are two major options for reform of the company tax base and one major option (and a number of lesser options) for integrating the company and personal tax systems. The options regarding the base are a real profits base or an expenditure (cash-flow or flow-of-funds) base.

The object of a **real profits tax** would be to make real taxable income independent of general price inflation, but not independent of relative price changes. For example, an increase in the price of a capital asset relative to the general price level represents a real capital gain and would be taxed under a comprehensive real income tax. The main adjustments required in moving to a real income base relate to stocks, asset prices

and net monetary liabilities. For example, real interest, rather than nominal interest payments would be deductible. This would greatly reduce but not eliminate the advantages of debt over equity. There are considerable practical difficulties in fully adjusting the income base for inflation, and it is not clear whether partial adjustments will improve or impair the tax system. Problems concerning the different taxation of corporate and unincorporated income, and of corporate distributions and retentions would also remain under a real profits base in the absence of other changes to company/shareholder taxation.

A conceptually simpler solution is to move toward an *expenditure base*. Under this approach, the tax base would be equal to total receipts from the sale of all real goods and services less total purchases of all real goods and services (though other types of expenditure base are possible). The present profits tax could be transformed into an expenditure tax by allowing an immediate deduction for capital expenditure and by disallowing the deduction for interest payments. The main advantages of an expenditure tax are that it is neutral with respect to investment decisions, financing decisions and distribution policies. It also avoids the need to determine true economic depreciation and to separate capital and current expenditure; and it is automatically indexed for inflation. If, however, unincorporated and corporate businesses are to be taxed in the same way, an expenditure-based business tax should ideally be combined with a personal expenditure tax. The feasibility of an expenditure base for business tax would thus depend on the desirability and feasibility of either an expenditure-based personal tax system or of designing a suitable interface between the two systems.

The major option for reforming *company/shareholder taxation* is to fully integrate the company and personal tax systems. In essence, this means that the entire income of a company would be attributed to its shareholders for tax purposes. If company income tax continued to exist, it would only be as a withholding device. A fully integrated tax system would be neutral between alternative sources of finance, between corporate and non-corporate business activities, and between investment in equities and other types of financial asset. These objectives are not fully achieved by the various forms of dividend relief such as imputation or split-rate systems. The main arguments against full integration relate to its administrative feasibility, upon which no consensus has emerged. One administratively feasible scheme would, however, be a combination of a flat-rate personal income tax and a company tax at the same rate, with dividends being tax-deductible to companies (or equivalently, tax-free in the hands of individuals).

As noted above, one of the problems of the present business tax system is that significant sectors of the economy, namely farming and forestry, cannot readily be taxed under the standard income tax base. This problem

arises in part because of the practical difficulty of distinguishing between capital and current expenditure. This difficulty does not arise under an expenditure tax, since both current and capital expenditure are immediately deductible. There are clear advantages in terms of both equity and efficiency in moving towards a tax system which is capable of uniform treatment of all business.

Further analysis of the problems of the present tax system, however, needs to precede consideration of major reforms. This is the objective of a current work programme in Treasury and the Inland Revenue Department. More detailed consideration will then be given to the options outlined above to identify where further work is warranted. One practical issue is that almost any conceivable reform of the business tax system would deliver less revenue than the present system (leaving aside the question of tax expenditures). In a medium-term fiscal reform context, this should not be an inhibiting factor.

## D INDIRECT TAX

### **Introduction**

Indirect taxes refer to taxes which individuals pay indirectly, generally by taxing in some manner a form of consumption. A number of alternative methods exist for indirectly taxing consumption, the principal ones being: singlestage taxes on goods and services at either wholesale or final sale point, and multi-stage turnover or value added taxes.

The main criteria for evaluating an indirect tax system are that:

- a a high and sustainable yield of revenue should be available at moderate administrative and compliance costs on a base which will grow with inflation; and
- b the type of tax system selected should not distort relative prices or discriminate between production techniques or paths through the distribution system and should, insofar as possible, attach a tax content to final prices which is a uniform percentage of those prices.

In addition to these criteria, a change in the incidence of taxation, particularly if it involves a shift from direct taxation to indirect, will have redistributive consequences. These also need to be taken into account.

### **Current Indirect Tax Regime**

Indirect tax revenue, excluding highways tax (which should be regarded as a user charge), has been slowly rising as a percentage of total tax revenues in recent years: 20.2 percent in 1974/75, 22.5 percent in 1979/80,

25.6 percent in 1983/84. The main indirect tax component, at close to 50 percent of total indirect tax, is sales tax, with customs and excise duties accounting for about 23 percent, beer duty 7 percent, and motor spirits duty 8 percent. Current indirect taxes are generally taxes on consumption activities with two noteworthy exceptions: customs duties, which are levied on imports and should be viewed in a context of overall assistance to industry; and instrument duties, which are taxes on the transfer of certain types of capital asset.

The present *wholesale sales tax* (WST) is a single-stage tax, levied on some 9000 wholesalers across a range of goods. Numerous exemptions and multiple rates of tax are involved. Services remain largely untaxed. The main difficulties with the WST are:

- a inherent difficulties which include: price cascades (the effect of taxed inputs adding to the cost of the subsequently taxed outputs, as shown in Table 1); incentives to vertical integration; valuation problems (the difficulty of determining a sale price when no transaction physically takes place, *or* of establishing all the costs to be included in the taxable price); reduced cash flow for downstream traders; difficulties of taxing services and remitting tax on exports; and
- b introduced difficulties which include: multiple tax rates (goods are taxed at 0, 10, 20, 30, 37.5, 40, 50 and 60 percent rates of tax on a relatively arbitrary basis); use and user-based exemptions; identification and determination problems (stemming from arbitrary boundaries between sometimes similar goods and from the multiple rate structure).

Thus, as it currently operates, the WST has serious economic deficiencies, although some of these are not necessary features of this form of tax.

An analysis undertaken for the Task Force on Tax Reform, using 1979/80 data, shows that, despite the efforts of successive governments to bias the incidence on indirect tax towards “luxury” goods, indirect taxes as a proportion of household consumption varied remarkably little with income.

## **Options for Reform**

### **a *Extended Wholesale Sales Tax***

Of the potential areas for raising increased tax revenue, the indirect tax base appears to offer the greatest scope at a lower cost in terms of losses in economic efficiency. There is considerable potential to widen the tax base, as currently only about one-third of personal consumption is subject to tax, even without extension of the tax net to services or retail value

added. The wholesale sales tax currently taxes only some \$6970 million of a potential base of \$18830 million (in 1982/83 terms). Many items currently exempted from the tax are arbitrary, and large areas remain totally untaxed. The main exempt areas are:

	Untaxed Base Excluding Business Inputs \$ million
F o o d s t u f f s	2430
F u e l s	420
Building products	140
Paper products	300
Textiles and fabrics	440
Clothing	680
Footwear	160
Furniture	230

An extension of the tax base and removal of exemptions would impose taxes on many inputs to businesses, the output of which will also be taxed. This multiple taxation of goods will lead to losses in efficiency due to tax and price cascades unless some form of tax remission on business inputs is provided, either by:

- a defining in legislation eligible 'aids to manufacture' which qualify for tax exemption; or
- b introducing a credit offset mechanism whereby taxpayers can offset tax on inputs against tax on their outputs.

In conjunction with moves to widen the base, rationalisation of the number of tax rates currently applied would further ensure that distortions are reduced and efficiency gains are made. Revenue estimates are presented in Table 2. The widening of the base, and exemption of business inputs, would contribute significantly to efficiency but would offer limited revenue gains for the same average rate of tax, around 20 percent.

### b *Further Extensions*

Two major areas exist which are currently largely untaxed and which cannot be taxed under a wholesale sales tax. These are services (tax base of the order of \$5000 million) and the value added by retailers (\$6000 million).

Services could be taxed by a separate stand alone tax, which of administrative necessity would need to be limited to specified major services. This option could be implemented relatively quickly, but should be seen as a forerunner to a more comprehensive change.

Taxation of retail value added, however, would require a change in the form of tax to a *final sales tax* (FST) or a *value added tax* (VAT). These options would also facilitate the taxing of services on a comprehensive basis. An FST (often misnamed a retail sales tax) taxes all final sales to consumers. A value added tax taxes all stages of production and distribution on the difference between input and output prices. Both an FST and a VAT have essentially the same base and properties from the point of view of economic efficiency, trade promotion and enforcement. There are slight advantages for VAT from an economic stabilisation viewpoint, but this must be weighed against greater complexity. Both systems would involve some 100,000 taxpayers. (This number compares with some 150,000 employers who collect PAYE deductions on behalf of the Inland Revenue Department.) Commencement costs would be similar, and introduction would take two to three years. Operating costs are higher under a VAT. A VAT, however, appears able to sustain rates of 15 percent or more, while rates above 10 percent applied under an FST appear prone to evasion. Given that change away from a WST system would be based primarily on a case for higher revenue requirements, a VAT is likely to be the most viable long-term option. Potential revenue estimates are presented in Table 2.

### *c Transition Paths*

An extension of the WST base and a rationalisation of the rate structure are feasible short-term moves which would significantly improve the efficiency of the indirect tax system. A single tax rate would be preferable, possibly with a special rate applied to those goods, such as tobacco and alcoholic products, which impose costs to society as a whole. Extension of the base should be accompanied by moves to exempt business inputs from tax. This process would involve a doubling of the current number of taxpayers and would require up to a year to implement.

Beyond this extension of the WST base, several paths exist. An extension of the tax base to include services could be made, either as a step to further reform or in its own right.

Any extension to an FST or a VAT would require at least a further two years, but will be required to raise significant extra amounts of tax revenue in the long run. The costs of transition also suggest that it should not be attempted unless significant revenue increases are deemed necessary.

### **Inflationary Effects**

The substitution of one indirect tax system for another on an equal yield basis can be expected to alter relative prices (such as between formerly taxed and non-taxed goods) but would be unlikely to influence the general level of prices. A higher yielding system, on the other hand, will

undoubtedly raise the general price level. Whether this is a **once-and-for-all** increase or an inflation-initiating increase will depend on the fiscal and monetary stance adopted by the Government in the period during and after the introduction of the tax, and whether it is compensated to some degree by a change in direct taxation. Overseas experience bears this out. To the extent that tax cascades and margin on tax effects are eliminated by either a final sales tax or a VAT, significant gains in revenue (up to 30 percent) can be made for no CPI effect.

### Incidence of a Broadly Based Sales Tax

Sales taxes are widely believed to be inherently regressive, i.e. that those on lowest incomes pay proportionately more tax. In practice, broad-based consumption taxes have not proved to be as regressive as the conventional wisdom would suggest. Indeed, the available evidence suggests that such taxes have turned out to be generally progressive, particularly over the lower and middle income ranges, or at worst slightly regressive. The reasons for this appear to be:

- a in practice it is not possible to tax all items of household consumption; and
- b most countries have adopted rate structures deliberately designed to ameliorate any inherent regressivity. In this regard, almost all OECD countries have reduced rates on basic foodstuffs.

TABLE 1  
EFFECT ON REVENUE OF MARGIN-ON-TAX CASCADE

			<i>Wholesale Tax</i>	<i>Final Tax of Same Total Yield (\$ million)</i>	<i>Final Tax Giving Same Final Price as Wholesale Tax</i>
Wholesale value	..	..	100	100	100
Wholesale tax (20 percent)	..	..	20		—
Price to retailer	..	..	<u>120</u>	i i i	<u>100</u>
Retail margin (30 percent) <sup>1</sup>	..	..	36	30	30
Retail price			<u>156</u>	<u>130</u>	<u>130</u>
Retail tax			—	<u>20(C)</u>	<u>26(D)</u>
Final selling price			<u>156(A)</u>	150(B)	<u>156</u>

**Notes:**

1 Cascade: 
$$\frac{(A)-(B)}{(B)} = \frac{156-150}{150} = 4 \text{ percent}$$
= price reduction for same revenue

2 Extra revenue for same final selling price and CPI effect: 
$$\frac{(D)-(C)}{(C)} = \frac{26-20}{20} = 30 \text{ percent}$$

TABLE 2  
POTENTIAL TAX REVENUES 1982/83

	<i>Tax Payable at:</i>		
	10%	15%	20%
	( <i>\$ million</i> )		
Wholesale sales tax:			
— Gross base \$10,150 million' .. .. .	1015	1520	2030
— Gross base less food, clothing and shelter ..	660	990	1310
Value added tax:			
— Gross base \$21,100 million .. .. .	2110	3165	4220
— Gross base less food, clothing and shelter (a) ..	1592	2388	3183
— Gross base less medical welfare and education (b) .. .. .	2080	3120	4160
— Gross base less (a) and (b) .. .. .	1 5 6 0	2340	3120

• **Business inputs excluded**

These figures represent the total potential tax collections under various options and can be compared with the **1982/83** WST collections of \$1212 million, derived from a taxable base of \$6970 million taxed at an average rate of about 18 percent.

**E TAX EXPENDITURES**

Tax expenditures are used to describe any deviations from the 'generally accepted' tax structure. Over the years a complex patchwork of special assistance has been built up by means of a wide variety of concessions in all the major taxes, summing to an annual fiscal cost of some \$1500 million. Describing an item as a tax expenditure does not necessarily indicate that the item represents a departure from an equitable tax system, but rather that its objectives could also be pursued through other means. The issue revolves around finding the most effective means of delivering assistance to the chosen target area. Frequently the tax system is a very poor method of targeting assistance, assuming that the assistance is justified in the first place. Very often the tax system has been chosen as the vehicle for no better reasons than that the costs are less visible and are not charges to particular votes.

A significant move to assist in identifying the most effective means of delivering assistance would involve making tax expenditures more visible. A first step towards this would be publishing a descriptive list in, say, the Budget, with cost estimates also shown where available. (It should be noted that, unlike direct expenditures, it is not possible to account precisely for tax expenditures.) A second step would be to allocate tax expenditures, where possible, to particular departmental Votes. This would facilitate annual reviews of tax expenditures which would otherwise not be subject to the same scrutiny accorded conventional expenditure policies.

A list of income tax expenditures is set out in the appendix.

## APPENDIX

### INCOME TAX EXPENDITURES-FUNCTION/DESCRIPTION

#### **Foreign Relations**

##### *— Defence*

- Gratuity paid under the Defence Act; exemption
- Deferred pay from active service overseas; exemption
- Earnings of servicemen in operational areas; exemption

#### **Development of Industry**

##### *— All Industry*

- Visiting experts; rebate
- Plant and machinery and certain buildings; accelerated first year depreciation ,
- Plant, machinery and equipment used for scientific research; accelerated depreciation
- Capital expenditure on pollution prevention; deduction
- Dividends on specified preference shares; deduction
- Notional interest on loans to employees under share purchase scheme; deduction
- Certain donations by companies; deduction
- Non-resident companies' income from special development projects; rebate
- Investment allowance-industrial development plan; deduction
- Suspensory loans-concessional treatment
- Scientific research expenditure; **deduction**

##### *— Agriculture, Fishing and Forestry*

- Farm vendor finance settlement scheme; interest exemption
- Special farm or fishing vessel ownership account; rebate. Ordinary farm or fishing vessel ownership account; exemption
- Certain capital expenditure on fishing boats; accelerated depreciation
- Tractor safety frames; accelerated depreciation
- Farming and agriculture investment allowance; deduction
- Land development **expenditure**; deduction

APPENDIX—*continued*

- Aquaculture development expenditure; deduction
- Income equalisation: agriculture, fishing, forestry; income spreading and tax deferral
- Deposits by forestry companies of income from thinning; income spreading
- Nil and standard values of livestock; deduction and income spreading
- Primary producer co-operatives; deduction
- Dairy, milk marketing and pig marketing co-operative companies; partial exemption
- Tree planting expenditure; deduction
- Sale of timber from farms; income spreading
- Compensation in connection with outbreak of scrapie; income spreading
- Excess income derived on sale of substantial amount of livestock where extremely low values or nil values have been adopted; income spreading
- Excess income on sale of livestock where farmers forced to quit farm because of fire, flood or other adverse event; income spreading
- Excess income on sale of sharemilking or lessee farmer's herd where further farm purchased; income spreading
- Expenditure incurred in purchase of fertiliser and lime; income spreading
- First year depreciation of farming plant and machinery and certain farm buildings
- Income of veterinary clubs, herd improvement societies; exemption
- Alternative values on gift of livestock to child

— *Mining and Petroleum Exploration*

- Exploration and development expenditure by mining companies; deduction
- **Income** from loans made by holding company to mining company; deduction
- Exploration and development expenditure by resident mining operators; deduction. Offset of losses allowed

APPENDIX-continued

- Exploration and development expenditure by non-resident mining companies; deduction
- Exploration and development expenditure by petroleum mining companies; deduction
- Concessions for non-resident petroleum mining companies paralleling those for resident operators

— *Other Industries*

- Taxi safety devices; accelerated depreciation
- Residual value and demolition costs of export slaughterhouses and packing houses; accelerated depreciation
- Scientific research bodies; exemption
- Advance deduction for film production expenditure
- Cook Islands development project income; exemption
- Standard value for brandy, wine and whisky; deduction and income spreading

— *Export Assistance*

- Export performance incentive for qualifying goods; tax credit
- Export performance incentive for qualifying services; tax credit
- Export performance incentive for qualifying overseas projects; tax credit
- Export performance incentive for qualifying tourism services; tax credit
- Export market development and tourist promotion expenditure; tax credit
- Export market development activities by self-employed; tax credit

Social Services

— *Social Welfare*

- Welfare benefits paid under Part 1 of the Social Security Act 1964 other than National Superannuation and unemployment benefit in certain cases; exemption
- Pensions or allowances paid under War Pensions Act 1954; exemption
- War pension total disablement; rebate
- Compensation for victims of Nazi persecution; exemption

## APPENDIX—*continued*

- Workers compensation and criminal injuries compensation; exemption
- Compensation for effects of thalidomide; exemption
- Income of disabled persons derived from activities undertaken in sheltered workshops; exemption
- Sickness or incapacity benefits paid by National Provident Fund, Friendly Societies, Credit Unions; exemption
- Sickness or accident benefits received by way of insurance payments or from trustee funds; exemption
- Cessation of employment payments and retiring allowances; substantial exemption
- Exemption of alimony

### — *Housing*

- First home mortgage interest; rebate
- Rates and **Chatham** Islands dues; rebate
- Special home ownership account; rebate. Ordinary home ownership account; exemption
- Additional depreciation allowance for newly constructed private rental housing; accelerated depreciation

## **Superannuation**

- Life, personal accident or sickness insurance and superannuation (personal); deduction

## **Charities**

- Charitable donations; rebate
- Donations by medical practitioners to New Zealand Medical Education Trust; deduction
- Income of charities; exemption

## **Recreation**

- Income of amateur sports bodies; exemption
- Income of racing associations or clubs; exemption
- Income of civic improvement bodies; exemption

### **Education**

- Scholarships and bursaries; exemption
- School fees; rebate

### **Government Savings Instruments**

- Interest from Post Office National Development Bonds and New Zealand Savings Certificates; exemption
- Inflation adjustment premium on inflation adjusted savings bonds; exemption
- Post Office Bonus Bond prizes; exemption

### **Personal Miscellaneous**

- Income of non-residents in country, including that of entertainers, personal services delivered by non-residents **and** interest on government stock which is payable out of New Zealand; exemptions
- Dividends derived by persons resident in the Cook Islands or Niue; exemption
- Interest received on post-war credits; exemption
- Racing stake winnings; exemption
- Retiring allowances to former Cook Islands or Western **Samoa public** servants; exemption
- Acquisition of land by Crown; income spreading;
- Sale of patent rights; income spreading
- Assignment of or grant of interest in copyright; income spreading
- Income of school children; rebate
- Value of board, lodging etc. of certain unmarried members of religious societies; exemption
- Interest and dividend income; exemption (partial)
- Family situation: dependent relative, principal income earner, family; rebates
- Housekeeper; rebate
- Petroleum mining dividend income; rebate

APPENDIX—*continued*

- Subscription to shares in mining companies or holding companies and petroleum mining companies; deduction
- Exclusion of gifts and bequests
- Exclusion of lump sum superannuation benefits
- Exemption of life insurance death benefits
- Exemption of salary of Governor General
- Exemption of Friendly Societies
- Exemption of fringe benefits
- Exemption of certain employer/employee reimbursing allowances
- Taxation of mutual associations
- Exclusion of imputed rent of owner occupied homes
- Exemption of income derived by trustee of certain superannuation funds
- Exemption of most capital gains
- Exemption of non-profit organisations (partial)

**Exemptions from Taxation Granted to Public Authorities and Quasi Government Boards and Foundations**

- All primary producer or marketing boards
- Milk treatment companies and corporations
- Most local authority or public authority income