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Introduction

Income and wealth inequality is a growing concern globally. It has always been heralded as a potent threat to social justice and living standards for the disadvantaged. More recently, research has suggested that it also marks poor outcomes for economies as a whole. Policymakers should certainly be concerned about both effects. Expansion of the state's redistributive policies is risky and involves certain trade-offs. If structured wisely, such policies can mitigate the pernicious effects of inequality without markedly disincentivising beneficial economic activity.

The Inequality Problem

The late twentieth century saw a long-term rise in economic inequality which is now at a thirty-year high in most OECD countries.[1] New Zealand has seen the sharpest rise out of all OECD countries in that period. The wealthiest 20% of the population receive about 40% of after-tax income. The bottom 20% receive just 8%.[2] The wealth of the wealthy is growing disproportionately quickly, while that of deprived populations is barely growing, or in some instances, even decreasing when considering increasing costs of housing.

Focusing on the extremes of the income distribution overseas reveals particularly alarming trends. In 2014 Oxfam reported that the five richest families in the United Kingdom were wealthier than the poorest 20% of the entire population.[3] In the United States in 2009, the average CEO made 185 times more than the average production worker; compared to 24 times in 1965.[4] The recent OECD report indicates that New Zealand may be moving in this direction.

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[1] OECD (2014) "Focus on Inequality and Growth - December 2014". Retrieved from http://www.oecd.org/els/soc/Focus-Inequality-and-Growth-2014.pdf.
[2] Ministry of Social Development (2014) "Household incomes in New Zealand: Trends in indicators of inequality and hardship 1982 to 2013 – July 2014".
[3] Oxfam (2014) "A Tale of Two Britons: Inequality in the UK – March 2014".
[4] Economic Policy Institute (2011) "More compensation heading to the very top: Ratio of average CEO total direct compensation to average production worker compensation, 1965-2009 – May 2011".

There are a number of acute social harms that come from income inequality.

First, it undercuts social mobility which is a key feature of an egalitarian society. This trend has been well-documented in the United States, where half of an individual's income can be predicted from what their parents earned.[5] This has oppressive outcomes at the extremes of the income distribution. A study has found that people in the top 20% who drop out of high school are about as likely to stay in that bracket as people in the poorest 20% who have college degrees are to remain in the poorest bracket.[6] This distortion of meritocracy is a symptom of inequality which undermines the goals of publicly-funded education. Indeed, increasing inequality in OECD countries has led to lower educational outcomes for those from low socioeconomic backgrounds, but has not affected outcomes for those of middle and higher backgrounds.[7] The Treasury identified social mobility and the ability to participate as important factors of equity; a consideration in the Living Standards Framework.

Income inequality also marks poor economic outcomes for individuals and countries. The OECD estimates the in the period from 1990-2010 New Zealand lost ten percentage points off growth due to rising inequality.[8] It marks a waste of human potential when large proportions of the population are locked out of skilled jobs when they lack the means to upskill. Growing inequality is not a necessary consequence of economic growth; rather it can constrain growth by hindering human capital accumulation. This indicates that the effects of inequality on individuals, and on states, are inseparable.

Lastly, in the modern political economy, economic inequality can lead to inequality of political influence. Economic and political power tend to be linked such that the wealthy are able to

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[5] A. Krueger (2012) "The Rise and Consequences of Inequality in the United States – January 2012".
[6] R. Reeves and I. Sawhill (2014). *Equality of Opportunity: Definitions, Trends and Interventions.* Conference paper presented to the Federal Reserve Bank of Boston, October 2014.
[7] F. Cingano (2014) "Trends in Income Inequality and its Effect on Economic Growth". *OECD Social, Employment and Migration Working Papers No. 163*.
[8] OECD (2014), see above at 1.

exert disproportionate political influence.[9] This can facilitate rent-seeking by corporations, and for wealthy individuals, tax breaks and exemptions that are regressive and unhelpful for deprived populations. Not only do these influences perpetuate inequality, they promote policies that weaken economic competition and effective taxation.

Addressing Inequality

Inequality is a systemic problem that stems from both a lack of government intervention in markets, and ineffective intervention where it does occur. The position that free markets will naturally tend towards equity over time is a tenuous one, as is the position that government intervention poses an inevitable trade-off between equality and efficiency.[10] Such an outcome is of course possible, but it can be minimised through approaches that are both robust, and properly-targeted to minimise harmful unintended effects. New Zealand policymakers should consider a smarter approach to taxation, redistribution, and social services that improve living standards and economic participation.

The first strategy is a more serious approach to redistributive taxation. OECD research observed that all OECD countries significantly reduced their top personal income tax rates significantly in recent decades.[11] New Zealand's current top marginal tax rate of 33% is dwarfed by the former rate of 60% which was scrapped during the reforms of the 1980s. Scandinavian countries have top tax rates of 60-70%, while the top rate in the United Kingdom is 45%. With ten OECD countries having increased their top marginal tax rates in 2013, it would be apt for New Zealand to consider doing the same. Alternatively, a capital gains tax

[9] See for example, J. Stiglitz (2012) "The Price of Inequality". Penguin UK.
[10] IMF (2014) "Redistribution, Inequality and Growth – February 2014". Retrieved from http://www.imf.org/external/pubs/ft/sdn/2014/sdn1402.pdf.
[11] OECD (2014) "Focus on Top Incomes and Taxation in OECD Countries: Was the crisis a game changer? - May 2014". Retrieved from http://www.oecd.org/els/soc/OECD2014-FocusOnTopIncomes.pdf.

may be particularly effective in addressing inequality given the increasing weight of capital income in the make-up of total income of the wealthy.[12]

Income and wealth inequality will not, however, be meaningfully addressed with a myopic focus on wage income. First, it is difficult to design income taxes that can not be avoided through legal means. In 2014 Inland Revenue reported that half of New Zealand's 200 wealthiest people were not paying the top tax rate. Second, a focus on income ignores the growing role of accumulated and inherited wealth, as opposed to income, in perpetuating inequality as Piketty argues.[13]

A direct response would be to tax wealth, in addition to personal and corporate income. This would provide a potent new source of tax revenue. Importantly, it would fill gaps in income taxation given that all kinds of assets can provide currently untaxable non-cash benefits to their owners. The tax can be applied to all forms of assets ranging from houses to complex financial instruments. Susan Guthrie of the Morgan Foundation suggests that such taxes would be relatively straightforward to calculate; the state can make reasonable assumptions about the non-cash "income" derived from assets. For example, in respect of owner-occupied houses, the state can make a simple assumption of the rental equivalent of that, and treat it as taxable income.

It may be seen as unusual or unprincipled to tax non-cash benefits from freehold owners of property. This position, however, relies on an arbitrary distinction between cash and non-cash income which is inconsistent with the purpose of redistributive taxation. Wealth provides in-kind benefits which deprived populations are excluded from, such as the equivalent of rent for owner-occupied houses.

[12] OECD (2014), see above at 11.
[13] T. Piketty (2014) "Capital in the Twenty-First Century". Harvard University Press.

Alternatively, rather than applying a broad wealth tax, the government can target specific forms of wealth. One option that has found favour with economists since Adam Smith is a Land Value Tax. Land Value Taxes target land which is disproportionately owned by the wealthy. Further, given that supply of land is fixed, taxes are unlikely to distort decision making. The Victoria University of Wellington Tax Working Group partially endorsed a land tax for its efficiency, while noting that it may create equity concerns by disproportionately affecting groups such as retirees and Maori authorities.[14] This is perhaps a reason to keep the tax at a low rate, and apply it alongside taxes on capital. This would be more in line with New Zealand's general "broad-base, low-rate" approach to taxation than a standalone tax on land value. Further, as the Tax Working Group suggests, there can be a value-per-hectare threshold below which no tax is levied. This would protect land-intensive activities like farming and make the tax more progressive.

Lastly, the Government can look into restoring inheritance and gift taxes. As Piketty warns, bequeathments are means through which wealth is accumulated across generations, worsening the problem of wealth inequality. Such taxes are unlikely to adversely distort economic decision making, as there is no clear benefit to exorbitant bequeathments across generations.

The introduction of new low-rate taxes on wealth is the most desirable solution. The Tax Working Group warned the New Zealand's personal and corporate income tax rates are already high. In the context of increasing mobility and competition with Australia, raising these taxes is likely to encourage the movement of labour and capital. The Treasury recognises access to human, financial and physical capital as being important determinants of living standards – redistributive taxation should avoid pernicious effects on living standards.[15] Further, relatively

[14] Victoria University of Wellington Tax Working Group (2010) "A Tax System For New Zealand's Future – Report of the Victoria University of Wellington Tax Working Group – January 2010".
[15] New Zealand Treasury (2013). Living Standards Framework: links between corners and capitals. Retrieved from http://www.treasury.govt.nz/abouttreasury/higherlivingstandards/hls-capitals-and-points.pdf.

high personal income tax rates create incentives and opportunities for avoidance – as evidenced by the aforementioned IRD report.

The Tax Working Group's suggestion of broadening the base of taxation will be more effective. In particular, a capital gains tax, and wealth taxes would reduce inequality because wealth is distributed progressively. Further, a broad-based approach that targets wealth reduces opportunities for avoidance.

Strengthening progressive taxation is inequality-reducing in itself; however the equally important second choice for the government is whether to use the extra revenue to expand public services, or to simply lower the tax burden on lower incomes.

Contrary to the orthodox neoliberal objection, a strong social safety net can support employment and productivity. Provision of public services that improve quality of life can also make it easier for people to be employed. For example, the public provision or subsidy of childcare services can make it more easy and desirable for people to move into employment. Similarly, services like cheap public transportation and continuing education can reduce the cost of entering the workforce for those who otherwise would not be adequately remunerated. The notion that generous public services are incompatible with high employment is unfounded; Denmark, Norway and Sweden have among the highest employment rates in the world due in part to generous employment subsidies and public services.[16]

Similarly, access to higher education is a key factor in social mobility. Extra public revenue may be invested in tertiary education and vocational training that is means-tested rather than universal.

[16] H. Kleven (2014). How Can Scandinavians Tax So Much? *Journal of Economic Perspectives*, 28(4): 77-98.

Lastly, the government may choose to reduce the tax burden on those at the lower end of the income distribution rather than increasing spending. These losses of revenue can be offset by new, base-broadening taxes. For example, reducing the tax rate applied to low levels of income, or increasing the threshold of non-taxable income, would be a form of redistribution that increases the net income of deprived population. This is a benefit in itself that avoids the risks carried by public services which may not be targeted or implemented in perfect alignment with their intentions.

In assessing the options, it is important to examine the likely trade-offs in relation to the goals of public policy.

The broadening of the tax base, with a particular focus on wealth taxes, has the potential to greatly improve living standards across a range of metrics identified by the Treasury. First, it is highly likely to improve equity, which is about "building the capabilities and opportunities of individuals to participate in society in a way that they value".[17] Second, it has the potential to increase economic growth by enhancing social mobility and access to higher education, and therefore greater use of human capital in the economy. In the long term it may also aid growth indirectly through the aforementioned political benefits of preventing bad regulation and policy.

Conversely, there are risks that are particularly likely to occur if new taxes are poorly targeted and implemented, or not set at the optimal rates. New taxes will almost inevitably affect the decisions of those affected. For example, capital gains taxes may have "lock-in effects" on those who own property, and it is possible that on the margins they may deter risk-taking

[17] New Zealand Treasury (2013). Living Standards: A Short Guide to 'Increasing Equity'. Retrieved from http://www.treasury.govt.nz/abouttreasury/higherlivingstandards/hls-ag-equity-jan13.pdf

behaviour. Such possibly distortions are highly unlikely to markedly affect living standards, nor would they outweigh the potential improvements provided by reducing inequality.

Conclusion

The rise of wealth inequality should be of concern to policymakers. The government needs to directly address inequality through comprehensive, redistributive taxation that targets the kinds of wealth that are distributed progressively. The new revenue should be used to provide of public services that improve social mobility and opportunities of economic participation. This will improve living standards for New Zealanders across a range of metrics. Most importantly, it would improve equity and economic growth by allowing the realisation of human potential.

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