Some Notes On Methods Of Financing Basic Incomes

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Introduction

The replacement of the current benefit system is long overdue. A Basic Income (BI), an idea that has been advocated for several centuries, could be the centrepiece of such a replacement. But advocacy for a BI has rarely extended to the practical requirements of funding such a change. Before I comment on some of the systems that have been proposed I emphasise the need to consider both taxes and benefits at the same time so that the one does not negate the other.

Earlier Work

Some earlier work outlines some principles to keep in mind. "A Tax System for New Zealand's Future" is a very lucid report by a 2010 Tax Working Group (TWG). It is available at http://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/pdf/tax-report-website.pdf

The paper should be read in its entirety but the following quotes (though out of context) are relevant to any proposed method of funding a Basic Income:

> *There is a major hole in the tax base concerning the taxation of capital.*
>
> *Many people face a disincentive to work because the abatement of Working for Families tax credits creates very high effective marginal tax rates.*
>
> *The approach of taxing those tax bases that are least likely to be subject to significant behavioural change from the imposition of a tax ('inelastic' bases) is also a sound principle to adopt.*
>
> *The company, top personal and trust tax rates should be aligned to improve the system's integrity.*
>
> *The majority of the TWG support detailed consideration of taxing returns from capital invested in residential rental properties on the basis of a deemed notional return calculated using a risk-free rate.*
>
> *Most members of the TWG support the introduction of a low-rate land tax as a means of funding other tax rate reductions.*
>
> *There should be a comprehensive review of welfare policy and how it interacts with the tax system, with an objective being to reduce high effective marginal tax rates.*
>
> *A land tax would be expected to cause an initial fall in the value of land by up to the net present value of the expected future land tax liabilities.*
>
> *The introduction of a land tax would be expected to reduce net foreign borrowing.*
>
> *The equity impacts of a land tax are also unclear. Firstly, it taxes only one component of wealth, and therefore mainly impacts those people and organisations holding their wealth in*

that form.

The TWG considers that, like the tax system, the existing social welfare system is in need of major review.

(The discussion of land tax on pages 50 and 51 is also valuable.)

Systems of Finance

Since the TWG's report in 2010, the increase in inequality creating social disturbance, a concentration of wealth and power in fewer hands, and depression of economic growth have become a major concern around the world. One of the objectives of any method of financing BIs should be the redistribution of wealth, not just the redistribution of income.

An Asset Tax and revised Income Tax (ATARIT)

This system is detailed in papers on my website at perce.harpham.nz, particularly “Simplifying our Benefit System”. Also a paper dealing with frequently asked questions, such as "Why not tax all wealth" and "Why not deduct mortgages from property values for Asset Tax purposes ".

Independently I have arrived at much the same conclusions as the TWG. There are also some similarities to the Morgan system, as described below.

Briefly, I have proposed different levels of BI for children, teenagers, adults and super-annuitants. However, the same system is applied to all. The BIs are tax free, and they are financed by a Uniform Income Tax (UIT) applied to every dollar earned, plus an Asset Tax.

Initially the Asset Tax would be applied to property, including land. Using standard depreciation schedules it could be extended to cars, boats, aeroplanes etc. All property owners would pay the Asset Tax. This would apply whether the property was owned by an individual, a group, a company or a trust. The Asset Tax on property could be readily collected by adding to local body rates, as is done with Regional Council levies.

The same Income Tax rate would apply to all. There are many virtues of having one flat tax regardless of income, and I have assumed this for calculation purposes. But the Income Tax rate could be increased by 1% every $50,000, from, say, $200,000. These increasing rates applied in such small steps and applied to the entire income would avoid the"discounts" enjoyed by those on lower incomes being enjoyed by those on higher incomes. A top limit at $1,000,000 or some other figure could be set for the increases otherwise a very high income could result in the whole income, or even more than the whole income, being taken in tax.

The full benefit of the BI is experienced by those with no income and no property. However, at some level of income and assets the BI is completely offset by the Uniform Income Tax and the Asset Tax.

A useful feature of the combined Asset Tax and Income tax system is that these can be set so that the benefit is not so quickly clawed back from those with low income but significant assets. In fairness, and for operational simplicity, the same BI would be paid to all adults and super-annuitants regardless of whether they have property or not. Note that this would assist those without property to acquire it, and it would compensate for probable rent increases as landlords respond to the Asset Tax. Note also that non-residents would pay the Asset Tax but would not get a BI.

Superannuation is a case in point. Here the Superannuitants are already effectively getting a form of BI. The difference would be that on becoming tax free with a uniform income tax those with no income other than the BI would benefit by the amount of tax currently charged on the Superannuation payment. Those with additional income and/or assets would have their BI being clawed back progressively as they had higher income and asset levels.

I envisage the BI for all Superannuitants being roughly the same as the present single rate and being increased with the Consumer Price Index as at present. The web page referred to above also has several papers and a spreadsheet which allows the user to input various BIs and Income Tax Rates . The Asset Tax rate needed to finance the BIs is then derived. From this the effects are shown for people with different income and asset levels. Careful choice of the variables should result in over 70% of people being better off. Inequality would be reduced.

Negative Income Tax.

The great virtue of this system (which was first proposed by Milton Friedman) is its name. It has a nice ring to it which might appeal to everyone until some found that they would be paying much more than before in order to finance it.

There are variations but essentially a level of income is chosen and below that income the difference between the actual income and the target is "taxed" at, say, MINUS 50%. Above the target income the rates of positive income tax would be higher to pay for the negative figure.

The setting of the minimum income level and the negative tax rate are crucial. If one wants to have those with no income receive $10,000 per year then at minus 50% the required target income level is $20,000. So the person recieves $20,000 times 0.50. At minus 20% the required minimum income is $50,000. and at minus 100% it is only $10,000. Financing the system requires those above the target income to pay for the system while those below the target benefit from it and make no contribution to the financing. So the temptation is to set the negative tax at 100%. This is then the perfect "poverty trap" for those receiving the benefit – every time they earn a dollar they lose a dollar.

Friedman did not propose different BIs for different ages. This could be done of course. But if only income is considered as a means of financing the BIs the rates become so high that they could well be counter productive. In fact some,such as Brian Easton, have claimed that BIs are totally impractical because they have assumed that BIs would be financed only from income tax. (E.g.see http://www.pundit.co.nz/content/what-is-the-problem-with-a-universal-minimum-income)

Nor did Friedman propose to do anything to reduce accumulated wealth. This could be brought into the net by assigning an imputed income to assets and adding this to the actual income. And people would soon realise that they were paying a disguised addition to their local body rates. But by this means the negative income tax system would become close to the ATARIT System discussed above. Although the latter has some additional features which give greater flexibility for taxation and political purposes.

Land Taxes

These have been advocated for many years. Land is a convenient proxy for total wealth and gives a broad base on which to base a tax. It is particularly suited to the present need to have a tax aimed at redistributing wealth so as to improve equality.

However, every argument I have seen in favour of Land Taxes (i.e. based on what is known in local body rating as "Unimproved Value") applies with even greater force to an ATARIT using "Improved Value"). The inclusion of homes and buildings greatly broadens the base for taxation purposes and is arguably a better proxy for total wealth.

(An interesting 2009 paper has as its main purpose consideration of a combined land/property tax as a means of reducing other taxes rather than to distinguish between land and property taxes.
The paper is by Andrew Coleman & Arthur Grimes - Motu Working Paper 09-14 at page 5, of 72, and says:
The allocative efficiency properties of a land tax do not automatically flow through to a property (capital value) tax since improvements (e.g. buildings, walls, drainage, etc) are subject to tax under a property tax system, whereas they are not taxed under a land tax. Thus the supply of improvements is affected by a property tax, resulting in distorted resource allocation (McLeod et al, 2001; p.31).

Similar assertions are made by others and seem to me to be mistaken in the modern era of land development where mountains are shifted, roads and services are provided, waterways are altered, provisions are made for schools and shopping centres etc by land developers. These "unimproved value" improvements would be subject to a land tax just as improvements in a property would be with a tax on the improved value as in the Asset Tax.)

A land tax could lead to gross inequities such as an aged person in an old home having to pay the same land tax as the total from the many apartment dwellers in the building next door.

The Morgan System

The “Big Kahuna” book (BK) by Gareth Morgan and Susan Guthrie was a tour de force. It gave a superb historical account of how our tax and benefit systems have been tinkered into a complex mess. The BK also advocates considering the combined effects of the tax and benefit systems at the same time.

The BK proposed one level of BI for adults and Superannuitants. The BK's BI proposals could easily be modified to provide different BIs for different ages, including recognising the fact that Superannuation is already far above the likely BI level for those below 65. Cutting Superannuitants back to a uniform adult rate does not appeal to me as fair or politically possible. The case for a higher rate for Superannuitants is that they have less opportunity to earn. And getting old is expensive – medical bills, restricted mobility requiring personal help, reduced energy for self help and do-it-yourself, personal frailty, heating bills etc.

So far as financing of the BIs is concerned the BK focussed primarily on companies rather than on the net effect for individuals. None-the-less for the particular case of individuals who own their own home without a mortgage the effect could be effectively the same as in the ATARIT System.

The Morgan System for financing is with a “Comprehensive Capital Tax” (CCT). This appears to be very much what was considered by the TWG. It is well explained in BK on pages 176 and following, with more detail on pages 194 to 199.

A required "minimum return" is calculated as a percentage of "non-current assets" . Interest expenses are deducted from this minimum return and the normal income tax rate is applied to the result to give the CCT which has to be paid. If the CCT is greater than the Earnings Before Interest and Taxes (EBIT) the balance can be carried forward for credit against future CCT when the business is more profitable. Normal Income tax is paid on EBIT above the required minimum.

Endeavouring to assess the yield from this tax has led me to the view that this system is too complex, administratively cumbersome, open to avoidance - particularly by overseas companies who can manipulate interest charges- and fails the principle of Vertical Equity.

On page 177 of BK we have “This example highlights an important feature of the proposed tax regime. Capital that currently earns at least the required minimum return is unaffected by the policy (under current rules, EBIT of $8000 less interest of $2,000 would also generate $1,800 in total tax). Total tax paid is the same as it would be under today's rules (assuming a tax rate of 30%).”

So only the less profitable companies are impacted which means that they are the ones who have to pay more in order to generate the necessary finance for the BIs.

Also, the capital that is to be taxed is only the "non-current" asset base. Working capital is not included. So the brilliance of Fisher & Paykel would work against them. F& P invested in a multifunctional plant which meant that they could produce to order so quickly that they hardly needed to carry any stock. They spent more on technology and other "non-current" assets in the factory and cut their working capital requirements. This would raise their CCT under the proposal and would be a disincentive to such efficiency. Capital used in a business is capital whatever accounting name one gives it. If it were only the property subject to rates which attracted the extra tax then there would be no such disincentive.

This system would discourage start-ups and ventures like forestry companies (although any additional tax, including the ATARIT System, will do this to some extent). I think the concept of a BI has been confounded with a desire to see all capital earn a minimum return.

Quantitative Easing for People

This has been enthusiastically advocated by some desperate Europeans who point to what was done for banks in the GFC. I find it hard to believe that they are serious. It could not be more than a temporary feature and would be inflationary.

In most Quantitative Easing where the Reserve Bank buys bonds or other securities there is at least the prospect that the money advanced will be repaid in time. It is hard to see how this could happen if the money was paid out as a BI.

Sovereign Money or Positive Money

This is the idea of having Governments issue debt and profit from it instead of the banks doing this.

I have considerable sympathy with this view but do not believe that it can be done overtly by a small country like NZ. However, in the “good old days” Government owned the BNZ which had 45% of the banking market so we were some way down the desired track. We could go that way again. If the BIs were channelled through Kiwibank and it was properly capitalised much might be accomplished.

Part of the case for Positive Money stems from the peculiar exalted position of banks. If an ordinary company is unable to pay its debts (see section 287 and other parts of the Companies Act 1993) the directors are “trading while insolvent” and could be imprisoned. But banks are allowed to lend more money than they have (limited by the Bank Ratio). This is how they can offer customers 3% interest for their term deposits but lend it at only 5% with their margin between these two covering all their costs and providing good profits. If the Bank Ratio is 8 banks can lend 8 times as much as their capital and customers deposits. But an ordinary company or finance company would be considered insolvent if it had loaned more than they had. A finance company has to have a margin of 16% to be in the same sort of position.

This anomaly has been the case forever but many are coming to believe that it should not be so.

Emissions Pricing, Carbon Taxes & GST

These have considerable merit in their own rights. And the regressive effects could be compensated by increasing the BI. However on their own carbon taxes would not impact accumulated wealth or property prices.

Stamp Duty

Some years back New Zealand abolished stamp duty. I only remember it as being levied on cheques at a low rate per cheque, independent of the value of the cheque. In Australia all states have stamp duty on property sales and, in Victoria from July 2016, the rate for foreign buyers rose from the standard 3% to 7%. This would be a very easy tax to implement and collect.

In Australia the rate differs for primary or investment properties , first home buyers, state – NSW etc, land type etc. I believe it to be preferable to capital gains taxes. It is much easier to administer and harder to avoid. Suppose the stamp duty is fixed at 5% of the sale price. Then if someone makes a capital gain of 50% the stamp duty on it is 5% on the sale price which is twice the original price whereas a capital gains tax of 10% would gather the same amount. Tax gathered in each case would be the same. With no exemptions the tax base becomes much larger.

Capital Gains

Many people see a Capital Gains tax as a panacea. If it applies to all property sales with no exceptions for family homes or anything else it could provide useful tax income. But once exemptions are introduced for family homes or otherwise the tax base is eroded such that there may be little income from it. And like all closely targeted taxes or benefits there is then difficulty with administration, avoidance manoeuvres and misrepresentation.

A major difficulty is that, in fairness, capital losses must also be recognized. Interesting avoidance manoeuvres may be then be possible. For example the buying back of shares such as the

Commonwealth Bank of Australia buying back shares at $10 plus imputation credits (they call them Franking Credits) of $20 when the market price was $30. It all gets complicated but the after tax position was that for someone on a 20% tax rate they received $35.76 and someone on 48.5% $25.61 with no tax to pay.

A carefully constructed CGT may well produce considerable income but again, by itself, it does not do much to reduce inequality – especially as the wealthy tend to buy rather than to sell their properties.

For some years in the future it may also well be that capital losses are more common than capital gains.