Tax Principles – A Need for Public Debate

Keith Rankin, Unitec, 15 February 2010

One of our problems in policy debate about many issues – taxation is but one – is the lack of reference to the principles that can give structure to our opinions. In the absence of principles, opinions about policy matters such as tax tend to reflect immediate self-interest. Few advocate tax changes that make themselves worse off whether in absolute terms or relative to others. Many advocate tax cuts that make themselves relatively better off.

I will suggest here some very basic "fiscal" principles about how taxes and benefits might be understood, and invite critical responses to these suggestions.

First a definition: taxation is the revenue of the "crown" that is gathered by way of levy. (The crown gains additional revenue by partly or fully owning businesses such as TVNZ and Air New Zealand.) Tax revenue should be understood as a portion of the economic output of a country (a share of GDP in today's terminology), and not simply as a pile of money. Benefits are the flip-side of taxation; they are the disbursement of the crown's revenue. (Welfare benefits are a faction of the total public benefit made possible by taxation.)

Before we can go further we have to unpack this concept of "crown" or "sovereign". For much of human history, control over some territorial domain was exerted by a warlord through military control. That person might be called a prince, king, or even an emperor, and his sovereign power would typically pass, dynastically, to his descendents.

Taxes were initially little more than protection money paid to the warlord monarch to keep him from hurting his subjects in other ways. A fiscal contract would emerge whereby the benefits would not be entirely appropriated for the use of the king and his family and his army. Roads might be built. Laws against theft and murder would be enforced. People soon recognised that they might be better off under a monarchy – despite taxes – than they would be in an anarchy.

Thus the fiscal contact between the people and the sovereign came to be; a balance between output appropriated in the form of taxes, and benefits gained in the form of public services and subsidies.

The term "public domain" was used widely in European political writing in the 16th to 18th centuries. In effect, the sovereign drew revenue from the use of resources in his public domain. A wise sovereign would reinvest some of his revenue in ways that would expand the public domain, resulting in economic growth.

Two changes of thought took place in Europe in the years from about 1750 to 1850. Monarchies in practice had become very corrupt, with taxation representing substantial transfers of wealth from the relatively poor to the rich.

The new intellectual developments provided the clash of principles that came to inform 20th century fiscal policy, and its accompanying accounting systems. The first was the transition to democracy; the second was the rise of classical economics.

With the advent of democracy (completed in 1893 in New Zealand, later in most other territories), the "crown" became the people. Thus the fiscal contract came to be between the people and the people. In this context, it means that individuals pay a share of their incomes to the collective, and that the collective (still called the "crown") confers equal benefits upon its constituent people.

Translated into numbers, and using the current trust tax rate of 33% as an example, 33% of GDP represents gross income taxation: income levied on the people by the people for the people. If we add revenues from other taxes (eg GST, ACC) and profits of crown-owned companies, we are looking at a share of GDP close to 45% ($83 billion in 2009) that is crown revenue for the public benefit.

Dividing that by 3.3 million eligible voters gives a democratic dividend of about $25,000 per adult New Zealander (or – alternatively – $20,000 per man, woman and child). This $25,000 is itself split between public investment, services and cash benefits. As the public domain expands over time, so should the democratic dividend.

Almost everyone receives a cash benefit in democratic countries. For the most part benefits are paid as "non-refundable tax credits" – essentially tax concessions on the first dollars (the first $48,000 in New Zealand) of an individual's income. For some, cash benefits include one or more welfare benefits.

The second intellectual revolution that took place 200 years ago – that of classical economics – leads a number of us (and probably a disproportionate share of economists) to a different view of the fiscal relationship between the crown and the people.

In its extreme form, this classical view is that all property (and hence all income) is essentially private (ie subject to exclusive ownership), and that taxes by their very nature are kleptocratic rather than democratic. In this view the sovereign, now called "the state", has no innate property rights; all taxes distort the allocation of resources. The public policy challenge, for these thinkers, was to minimise taxes, and to choose the least inefficient taxes.

Most of us hold ideas about taxes that are an uneasy mixture of the democratic contract view and the classical economics view. We need to freely discuss these differences, giving each of us opportunities to change or clarify our opinions by reflecting on the underlying principles.

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