NEW ZEALAND PUBLIC FINANCE

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Contents

Editorial

Welcome to the second 2016 edition of the of New Zealand Public Finance newsletter. It has been an interesting and fast paced five months since our last newsletter; with a lot of hot topics surfacing in the global economy, from the Brexit vote fall-out in the UK and Europe to the diverse policy platforms of Hilary Clinton and Donald Trump in the up-coming US elections.

In this issue, we have a compelling mix of articles and research contributions from our public finance friends and synopses of recent Events and Conferences that have generated fiscal policy discussions.

This issue's Public Finance People profile gives us an opportunity to welcome Dr Peer Skov to New Zealand shores. Peer has recently embarked on a lecturing role at the School of Economics at Auckland University of Technology and is looking forward to being part of the New Zealand Public Finance environment. Peer's Research Report on The Power of Large Datasets gives us an insight into some of this recent work. We also get a snapshot of recent research on 'The Size and Shape of the State in New Zealand' by the Chair and Derek Gill, principal economist at NZIER.

Planning for the next joint CPF/Government Economics Network, *Public Finance Debates* series is now underway; with the first one due to kick off in October. Possible debate topics are outlined in the Future Events section of the issue and we welcome your suggestions on potential speaker candidates. We also showcase some public finance news from around the world and highlight the latest Working Papers uploaded to our series on the New Zealand Public Finance website.

Last but not least I would like to introduce myself; Fiona Taylor, the newly appointed Administrator to the Chair in Public Finance and co-editor to the newsletter. I am enjoying the diversity of the role and working alongside Norman and the wider CPF community. It also feels a bit like being back at home, after graduating from both a Commerce and a Bachelor of Arts degree from Victoria University in 2002.

Fiona Taylor
Editor, NZPF Newsletter

Norman Gemmell
Chair in Public Finance, VUW

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Public Finance People

Dr Peer Ebbesen Skov

A brief profile of contributors to public finance in New Zealand.

After completing undergraduate and Masters degrees (2005-2009) at The University of Copenhagen, I received my PhD from the University in 2014. Since then I have spent the last two years as a post-doctoral research fellow, also at the University of Copenhagen. In July 2016 I take another small step down the academic road, in combination with a significant geographical jump, when I begin as a lecturer at the School of Economics at Auckland University of Technology. I'm excited to get back in front of the students and also, hopefully, to become an integral part of New Zealand's public finance environment in the years to come.

My primary research interest is the interaction between public policy and taxpayer behaviour. My research draws insights from the modern Public Economics literature and I approach my research projects from an applied point of view, using large scale administrative register data, often in combination with survey evidence. In most of my papers, I use state-of-the-art empirical methods to draw causal inference (e.g. regression discontinuity, the bunching estimator, and difference-in-difference type analyses of policy reforms) with the research aim of a better understanding of the mechanics behind taxpayer responses and thereby, facilitating effective public policy. More specifically, my current and completed research projects include studies on tax evasion and enforcement, tax avoidance, and the elasticity of tax bases.

As a very recent addition to the New Zealand academic world I am grateful for the opportunity to introduce myself. I hope to do so by way of presenting some key findings from one of my research projects but also by highlighting one aspect of my research approach - the use of administrative register data (or to use the buzz phrase: ***BIG DATA***). In a short research report below, I give an example of one of the many benefits of access to administrative registers data.

Research Report

The Power of Large Datasets

Dr Peer Ebbesen Skov

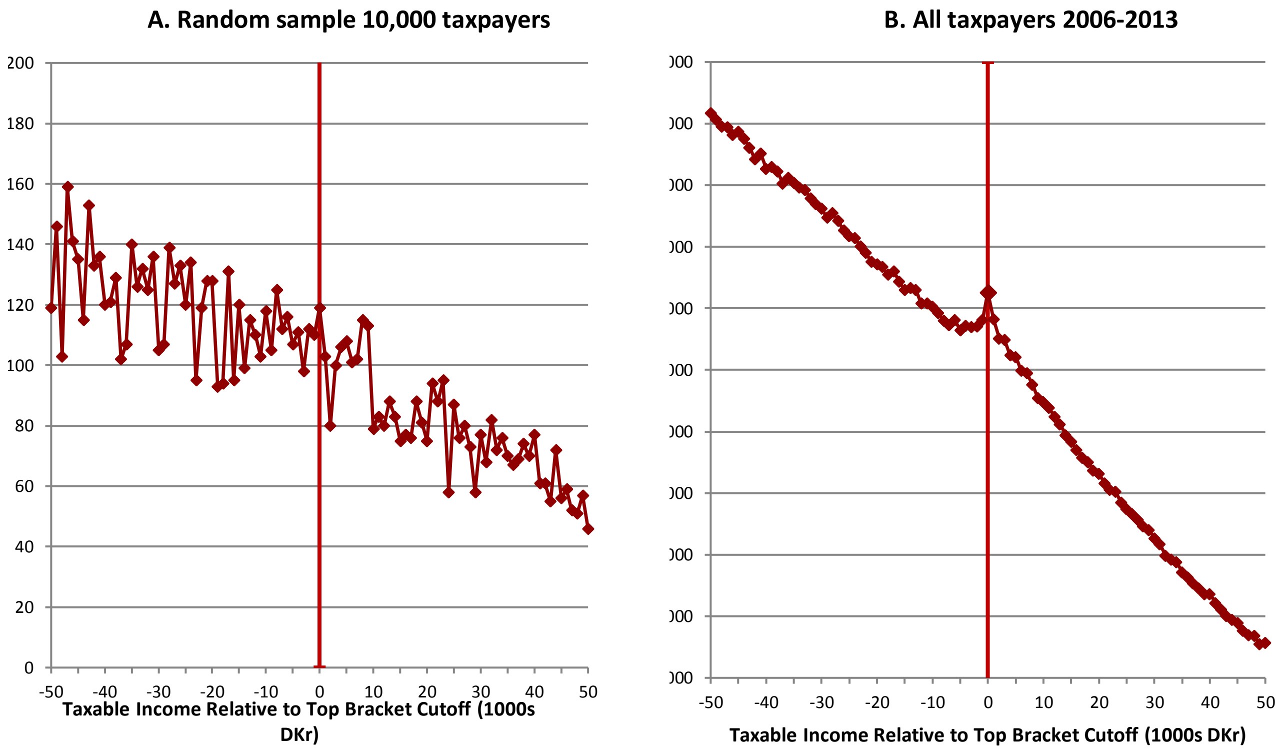
Large panel datasets of individual taxpayers are increasingly regarded as ‘best practice’ when undertaking research into how taxpayers respond to changes in tax policies. Below I give an example of one of the many benefits of access to administrative registers data. This comes from my research into how Danish taxpayers respond to the Danish income tax system.

Figure 1 panels A-B show histograms of all Danish taxpayers (standard wage earners) from 2006-2013 by their distance in Danish Krone (DKK) to the top tax bracket limit. Each point on the figure represents a bin with width of DKK1,000 (≈NZD215). That is, the point at 0 on the X-axis shows the number of taxpayers with taxable income in the range of ±DKK500 to the top tax bracket threshold and the point -10(+10) shows taxpayers in the range of DKK9,500-1,0000 below (above) the threshold, and so forth. Panel A includes a random sample of 10,000 taxpayers. Panel A shows that, not surprisingly, the number of individuals is declining as income increases but the panel doesn’t suggest that any further systematic behaviour is at play. Panel B includes all taxpayers (approximately 5 million) and the figure now reveals a clear buildup of taxpayers around the top tax bracket limit. The tax rate kink at the bracket limit elicits a behavioural response by taxpayers. In fact the tax schedule in combination with very large (full population) data sets can be used to estimate the elasticity of taxable income, see Saez (2010).[1] However, as Figure 1 reveals, the approach is not likely to be meaningful without access to very large data sets.

As exemplified in Figure 1 sometimes the behavioural responses we hope to study will not be well captured by population representative survey samples. Based on my experience a survey sample of 10,000 individuals is perceived as a large survey dataset yet panel A in Figure 1 reveals that for bunching estimation of the ETI it is not even close to sufficient.

[1] I’m not aware of a project estimating the elasticity of taxable income using the New Zealand full population tax records and bracket limits. Maybe that is potential project for the future.

Figure 1: Income Distributions around the Top Tax Cutoff for Wage Earners



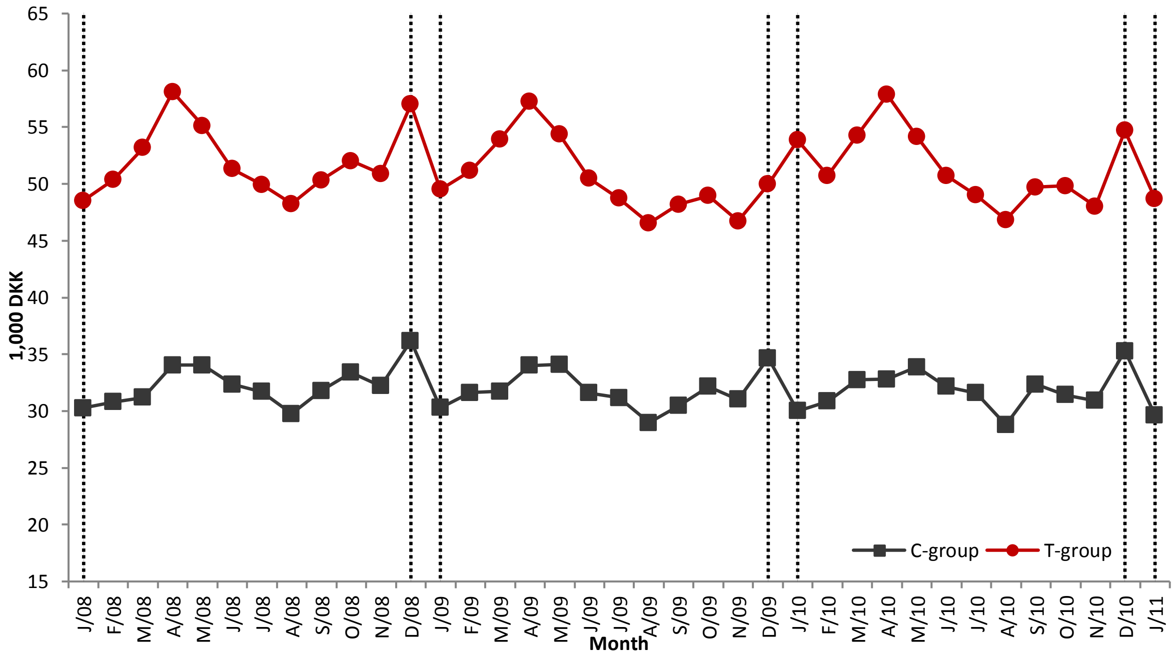
If the behavioural responses we hope to study can't be captured even in a large survey dataset do they really matter?

In one of my research projects I, along with co-authors Claus Thustrup Kreiner and Søren Leth-Petersen study intertemporal income shifting on the eve of the Danish 2010 tax reform.[2] Intertemporal shifting of wage income takes place when income earned in one tax year is paid out in another tax year in order to reduce the tax payment. The Danish 2010 tax reform reduced the top marginal tax rate from 63% to 57% affecting the after-tax income for 25% of all employees. The 2010 tax reform was passed in parliament in May 2009 taking effect from the coming tax year starting in January 2010. The distance between the announcement and the implementation of the tax reform provided the taxpayers with roughly 6 months to plan their income shifting activities. Examples could include postponing wage payments from November and December into January or postponing any end-of-the-year bonuses. As tax liability is triggered at the time of payment any such income shifting would reduce the tax payment.[3]

[2] See Kreiner et al. (2014) and Kreiner et al. (2015) for more details.
[3] Income shifting requires cooperation between the employee and the employer, but the Danish tax law provides a window of up to 6 months between the work taking place and the wage payment (the standard contract includes monthly wage payments) which makes it possible to shift income across tax years while still complying with the tax law. In other words income shifting is an example of tax avoidance rather than tax evasion.

Figure 2 shows the average monthly wage earnings for a treatment group (taxpayers with an incentive to shift income) and the control group (taxpayers with no incentive to shift income). The figure shows clear cyclical tendencies in wage earnings around Christmas and New Year where average earnings increase for both the T- and C-group from November to December and then decline from December to January. This pattern is observed around New Year in 2009 and again in 2011. It is also observed for the C-group around New Year 2010 (the reform year) but not for the T-group. Instead the T-group reveals a pattern where earnings increase, by a slower than normal rate, from November to December and then increase again from December to January. That is, the T-group behaves in line with expectations and shifts income from 2009 to 2010 to avoid the higher pre-reform marginal tax rates. Interestingly the response is strong enough to be visible even for summary measures of average earnings as Figure 1.

Figure 2: Wages for taxpayers with shifting incentive (T-group) vs. no incentive (C-group)



In the paper we find, perhaps surprisingly based on Figure 2, that only roughly 3% of the taxpayers shift income, however, they shift substantial amounts. Furthermore we document that this intertemporal income shifting introduces a sizable bias in standard DD estimates of the ETI. In fact, we show that removing the shifting component of the estimate reduces our elasticity estimate to zero for all earnings levels. So despite being few in numbers, the behaviour of the income shifting taxpayers is very important.

The project uses the possibility to link tax records with other socio-economic characteristics, firm characteristics etc. to further explore the nature behind income shifting. However, one large advantage of survey data compared to administrative registers is the possibility to tailor project-specific questions on, for example, knowledge and understanding of the relevant (tax) incentives. This is important as most tax systems provide a myriad of tax incentives and not all margins are equally well understood by all taxpayers. We use survey data to show that a substantial fraction of the taxpayers weren't aware of the advantage and legality of shifting income, suggesting that a lack of awareness is at least part of the explanation of the low fraction of taxpayers engaging in income shifting.

The access to Danish administrative register data has also allowed me to work on a number of contemporary aspects of tax design relevant for most advanced tax systems. As an example the New Zealand government's 2015 green paper, Making Tax Simpler, includes the suggestion to pre-populate tax returns with charity donations, a policy Denmark adopted in 2008; for more details see Gillitzer and Skov (2013).[4]

In the coming years I hope to explore the possibilities for research projects using the New Zealand integrated data infrastructure (IDI). I firmly believe access to administrative register data enables researchers to better target specific policy questions and provide more convincing answers, and I think there is a lot of potential in the setup provided by Statistics New Zealand. However, I also see the current public finance literature is moving beyond register data and starting to provide new and fascinating research results from a collaboration between the tax authorities and different groups of researchers, see e.g. Hallsworth et al. (2014) and Kleven et al. (2011). I'd be excited to see something similar come out of New Zealand.

Literature:

Gillitzer, Christian and Peer Ebbesen Skov. 2013. Evidence on Unclaimed Charitable Contributions from the Introduction of Third-Party Information Reporting in Denmark. *EPRU Working Paper Series* 2013-04,

Hallsworth, Michael, John List, Robert Metcalfe, and Ivo Vlaev. 2014. The Behavioralist As Tax Collector: Using Natural Field Experiments to Enhance Tax Compliance. *NBER Working Paper*, No. 20007

Kleven, Henrik J., Martin B. Knudsen, Claus T. Kreiner, Søren Pedersen, and Emmanuel Saez. 2011. Unwilling or Unable to Cheat? Evidence from a Tax Audit Experiment in Denmark. *Econometrica* 79: 651-692.

Kreiner, Claus Thustrup, Søren Leth-Petersen, and Peer Ebbesen Skov (2014). Year-End Tax Planning of Top Management: Evidence from High-Frequency Payroll Data. *American Economic Review*, vol. 104(5), pp. 154-158, Papers & Proceedings.

Kreiner, Claus Thustrup, Søren Leth-Petersen, and Peer Ebbesen Skov (2015). Tax Reforms and Intertemporal Shifting of Wage Income: Evidence from Danish Monthly Payroll Records, Forthcoming *American Economic Journal: Economic Policy*.

Saez, Emmanuel (2010). Do Taxpayers Bunch at Kink Points? *American Economic Journal: Economic Policy* 2(3), 180-212.

[4] I'll provide no spoiler but the introduction of third-party reported charity deductions was very effective and the reporting changes were (at least to me) surprising.

Event Report

Guarding the Public Purse: Fiscal Policy Frameworks to Support a Modern Economy. A Report on a Panel Discussion.

Norman Gemmell and Martin Fukac[5]

Introduction

This year's New Zealand Association of Economists (NZAE) annual conference, held at Auckland University of Technology at the end of June, included a panel discussion session on 'fiscal frameworks' organised by the New Zealand Treasury and chaired by Norman Gemmell, Chair in Public Finance at Victoria University of Wellington.

Three invited contributors were chosen for their mixture of conceptual and applied knowledge of fiscal policy in both research and policy advice contexts. These were: Tim Ng (Director of the Economic System Directorate at The Treasury), John McDermott (Assistant Governor and Head of Economics at the Reserve Bank of New Zealand), and David Fielding (Professor of Economics at the University of Otago).

Fiscal policy is an essential tool of all governments seeking to influence economic outcomes; though its role has been hotly debated since at least the Great Depression of the 1930s, through the post-World War II 'Keynesian' approaches, the Lucas critique of the 1980s, to the more recent post-Global Financial Crisis (GFC) 'reassessment'. This panel discussion was not about the specifics of fiscal policy however. Rather it sought the speakers' and audience's views on what kinds of frameworks, within which fiscal policy is conducted, should be followed in a modern, open economy. Should this framework involve specified 'rules'; should governments' fiscal policies be constrained by requiring adherence to specific fiscal targets such as debt/GDP ratios? Should these rules tie particular instruments to specific targets such as limiting public borrowing to the financing of public investment?

Within that context the panellists were asked to consider a number of questions. What should a fiscal policy framework that supports a modern economy look like? What is its position within the wider macroeconomic policy mix? How can the fiscal framework support national living standards? And did the panellists views on the general role of fiscal policy change following the GFC?

What emerged was an interesting mixture of shared views and differences.

Views from a Treasury Director

Opening the discussion, Tim Ng argued that any fiscal framework has to deliver on three key objectives: long-run sustainability, short-to-medium term macro stability, and appropriate fiscal

[5] Principal Adviser, Macroeconomic Policy, The Treasury.

structures (choices among forms of taxation and spending). Fiscal sustainability, he suggested, is the foundation on which everything else rests. Once you have that, you have the flexibility to start to think about other objectives such as contributions to macroeconomic stability (e.g. by not being forced into austerity in a sharp downturn), or supporting growth with different mixes across and within tax and spending. The general quality of the institutional environment (transparency, checks and balances through the government financial management process, rule of law, etc.) to promote fiscal sustainability deserves emphasis as much as the more specific 'rules' governing fiscal policy (such as the existence or not of fiscal rules).

Tim suggested that these objectives are even more important with increased globalisation, which puts a premium on domestic macroeconomic policy frameworks being credible and enduring. But while the fiscal framework should usefully limit governments' discretion with respect to delivering sustainability and stability, with respect to fiscal structure governments "should be less constrained by the framework as [they] generally have different views/values across these".

On the question of whether his views had changed following the GFC, Tim responded that "the core is unchanged, but the calibration of the different quantitative markers of sustainability, stability and structure have probably shifted as there is more awareness of the need to be prepared for possibly large fiscal stimulus (due to the much more widespread incidence and duration of 'Zero Lower Bound' issues than most people had anticipated pre-GFC).

Views from a Reserve Bank Economist

John McDermott argued, perhaps surprisingly and certainly controversially, that now is a good time to re-emphasise the stabilising role of fiscal policy via higher public debt and for fiscal frameworks to allow greater fiscal intervention. Fiscal policy, he suggested, is more powerful under current economic conditions because it can avoid the potential for 'financial excesses' from greater use of monetary policy when interest rates are low, while such conditions provide the ideal opportunity to expand debt-funded public investment. John therefore called for 'shovel-ready public investment' that governments should have ready for economic downturns which would provide an especially effective, and relatively low cost, counter-cyclical tool.

On the adoption of specific fiscal rules, John McDermott was sceptical, arguing that even the perceived 'tight' monetary policy rules around inflation targeting have some flexibility associated with what he termed an 'incomplete contract' between the government and the central bank. However, fiscal rules would require even more flexibility in part due to the multiple outcomes or objectives associated with different legitimate government preferences over tax and spending choices, and because "fiscal rules are unlikely to be politically neutral". In addition, he argued, "unlike price stability, numerical fiscal targets (e.g. debts ceilings of 60% of GDP) are arbitrary".

Finally, recognising that the Reserve Bank's remit ensures that it will adapt to whatever fiscal plan the government announces, John called for effective coordination of monetary and fiscal policies and especially effective communication, suggesting that "if financial markets see a credible plan for reducing debt, they are more likely to look through a short term deterioration".

A View from Academia

David Fielding began by reminding the audience of the International Monetary Fund's (IMF) immediate post-GFC advice on fiscal policy. Namely:

"The financial nature of the crisis weakens the traditional monetary transmission mechanism… The Managing Director of the IMF has called for a sizable fiscal response at the global level. Its precise magnitude should depend on the extent of the expected decline in private sector demand", and "Spending programs … can be (re)started quickly … Target tax cuts or transfers towards those consumers who are most likely to be credit constrained. Measures along these lines include the greater provision of unemployment benefits, increases in earned income tax credits, and the expansion of safety nets in countries where such nets are limited." (Fiscal Policy for the Crisis, IMF, December 2008).

Nevertheless, the post-GFC re-evaluation of the role of fiscal policy has tended to view fiscal deficits as ineffective until a major recession, such as the GFC, hits and where monetary policy becomes ineffective. Thereafter fiscal stimuli take over. David, on the other hand, argued for a more graduated approach in which the fiscal framework allows fiscal deficits to be used progressively as the economy begins to head into recessionary territory. Should we be 'heading back to the 1960s' he wondered?

Turning specifically to New Zealand however, David argued that recent evidence on how fiscal policy 'works' here suggests that (unlike in several other developed countries) a fiscal stimulus in New Zealand appears to crowd out private investment, and reduce GDP. He attributes this to the especially integrated nature of the New Zealand and Australian economies which causes investment in New Zealand to fall when governments spend more, partly in response to a rise in New Zealand's real exchange rate with its main trading partner. That is, trans-Tasman real investment and finance respond quickly to changing price signals when government intervenes.

If correct, these results present a particular challenge for fiscal policy in New Zealand, suggesting that a framework that encourages greater use of the fiscal stabilisation role in an economic downturn could be counter-productive, as the private sector responds by cutting back, our exchange rate appreciates and overall GDP falls in the short-run, rather than rises!

So What Do We Conclude?

The contributions from these three speakers perhaps sum up nicely why there is on-going debate about the role of fiscal policy in New Zealand. On the one-hand, Treasury, as the custodian of the nation's fiscal prudence and sustainability is justifiably concerned to ensure that the short-run stabilisation role of fiscal policy does not render its long-run debt target an ever-receding objective. On the other hand, John McDermott is perhaps understandably more focused on coordination between fiscal and monetary policy as the Reserve Bank seeks to encourage mutually enhancing, rather than inhibiting, actions from the two policy tools. But if David Fielding's New Zealand evidence is taken seriously in the policy space, the best that might be expected from fiscal policy here is that it seeks to avoid being pro-cyclical when monetary policy is trying to stabilise the economy. Given its controversial policy implications, this New Zealand-specific evidence seems especially worthy of further investigation to confirm its robustness.

An issue to arise from John McDermott's call for more 'shovel-ready investment' while interest rates remain low, is whether this argument might also support a case for a framework which targets a debt service to GDP ratio, rather than (or as well as) a debt to GDP ratio. This recognises that the risks of high debt levels for governments, as for households, depend more on their ability to service the debt, than the value of the debt itself.

Finally, under questioning the panellists did find at least one clear point of agreement: that New Zealand's relatively tight fiscal targets such as the 20% net debt/GDP ratio, and its history of political commitment to those targets, probably did contribute to New Zealand having much more fiscal space than many of its OECD contemporaries when the GFC hit in 2008. In this sense New Zealand's fiscal framework has produced a 'double dividend' – commitment to a relatively strict long-term fiscal 'rule' seems to have proved its worth when short-run stabilisation (including debt expansion) was required during the GFC. Several past and current Finance Ministers can take some credit for this considerable political and economic achievement.

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Conference Report

Public Finance Papers at the New Zealand Association of Economists Annual Conference, AUT, June 29th to July 1st, 2016

Norman Gemmell

As usual, the NZAE conference attracted a number of presenters whose papers had a public finance theme. These included papers specifically on tax, on fiscal policy and on social services, for example. As a quick guide to their content, we report paper *Abstracts* below where these were made available.

Nazila Alinaghi, ***Taxes and economic growth in OECD countries: a meta-regression analysis***

Abstract

The impact of fiscal policy, particularly tax policy, on economic performance has been a centre of attention for decades now. Despite a large body of research on the topic, no consensus exits within the academic community and the empirical evidence has so far been mixed. Considering 713 comparable estimates of growth effect of taxation in OECD countries derived from 42 studies, this study aims to answer the following questions by applying meta-analysis regression (MRA): (Q1) What is the overall, mean effect of taxes on economic growth? (Q2) Are some taxes (e.g., personal income, corporate income) more distortionary than others (e.g., value-added tax)? (Q3) Is there empirical evidence to support the conventional wisdom that "distortionary taxes" used to fund "unproductive expenditures" are especially harmful for economic growth? (Q4) What are the factors causing researchers to encounter different or even contradictory results? My results suggest that there is no statistical evidence of overall adverse tax-growth effect. However, some taxes seem more distortionary than others. Finally, 36 different aspects of study design have been codified to explain heterogeneity observed in the existing literature.

Dhritidyuti Bose, Renee Philip and Richard Sullivan ***Returning to surplus: New Zealand's recent fiscal consolidation experience***

Abstract

New Zealand's fiscal outlook deteriorated following the Global Financial Crisis, and in late 2008 fiscal projections showed net government debt in New Zealand increasing from 5% of GDP to around 40% within 10 years, mostly reflecting permanently lower expectations for future tax revenue. The structural deficit peaked at 4% of GDP in 2011. These circumstances were compounded by the significant costs associated with the Canterbury earthquakes in 2010 and 2011. In 2011, the Government set an ambitious target to return the Budget to surplus by 2014/15, and began a period of fiscal consolidation. A surplus has recently been achieved, and net debt is now expected to peak just above 25% of GDP. The surplus was predominantly achieved by slowing the growth rate of nominal spending so that expenses-to-GDP declined. While there has been some adjustment to policy parameters on the spending side, most of the consolidation has been achieved through efficiency savings and reprioritisation. New Zealand's fiscal framework – a combination of fixed nominal baselines for

most expenditure alongside comprehensive top-down constraints on new spending through the Budget – provided effective tools for controlling expense growth. Nevertheless, the return to surplus is only the first step in fiscal consolidation and challenges remain to ensure these surpluses are sustained, and to rebuild the fiscal buffers that existed prior to 2009.

Sina Ahmadzadeh Mashinchi, Basil Sharp, and Stephen Poletti, ***Environmental tax reform (ETR) and New Zealand economic performance: modelling with E3ME***

Abstract

This paper analyses the potential environmental and macroeconomic impacts of environmental tax reform (ETR) in New Zealand using the E3ME model, a global macroeconometric model that links the world's economies to their energy systems and associated emissions. A number of different scenarios including a baseline are constructed to investigate the performance of the NZ ETS and other complementary mitigation policies over the commitment period (2021-2030). In the light of the model results, it is notable that the higher carbon prices especially in the early years would be necessary to achieve the ambitious GHG emissions target in New Zealand. The results also suggest that a combined NZ ETS and carbon tax approach with revenue recycling could lead to significant economic benefits. Therefore, a double dividend effect could be achievable, if New Zealand's government recycles the revenues from carbon taxes efficiently.

Anthony Anyanwu, Christopher Gan, and Baiding Hu, ***Government domestic debt, private sector credit, and crowding out effect in oil-dependent countries***

Abstract

In oil-dependent countries, banks are more liquid, better capitalized, and more profitable. However, bank credit is relatively low as a percentage of GDP. The low level has been blamed, amongst other reasons, on governments' reliance on the banking sector to finance fiscal deficits. The effect of government borrowing operates directly (real crowding out), or indirectly through rising interest rates (financial crowding out). This study examines the crowding out effect of government domestic borrowing using a panel data model for 28 oil-dependent countries over the period 1990-2012. We estimate the model, using both fixed effects and generalised method of moments estimators, and find that a one percent increase in government borrowing from domestic banks significantly decreases the private sector credit by 0.22 percent and the lending rate by 3 basis points albeit insignificantly. This finding suggests that government domestic borrowing has resulted in the shrinking of private credit.

Niki Lomax, Simon McLoughlin, and Ben Udy, ***The New Zealand fiscal management approach***

Abstract

The Fiscal Management Approach (FMA) is the core tool, or the 'rules of the game', for ensuring that the government's decisions are consistent with their fiscal strategy. It constitutes a flexible set of rules applied to the day-to-day operations of government to inform decision-making. This includes the setting of allowances for new spending (and/or revenue reductions), setting constraints on between-Budget spending, and allowing automatic stabilisers to work over the economic cycle. In recent years, the FMA has contributed to the achievement of the return to surplus target in 2014/15 and net government debt that is low relative to most developed nations. The FMA has evolved and been improved since it was first introduced.

The purpose of this paper is to capture the FMA as it stands, and provide some examples of how it is applied in practice. Further, we review how effective the FMA has been and reflect on some of the challenges presented by the current approach and any opportunities for further improvement.

Keith Rankin, ***Flat tax in New Zealand: unemployment and social security taxes 1930-70***

Abstract (Ed: 'Introduction' from Rankin's paper)

With the concept of a Universal Basic Income (UBI) being mooted this year as an important reform that can facilitate our adaption to a flexible work-world characterised by short-term contracts, inequality and automation, it becomes instructive to investigate historical precedents. In particular, unconditional income (including negative income tax) solutions are linked – at least in economists' minds – to a flatter (if not flat, ie proportional) income tax structure.

The practical reconceptualisation and reform of income tax and benefits that I would argue for is indeed a proportional income tax, initially set at 33 percent, coupled with a minimum publicly-sourced personal credit set initially at $175 per week ($9,080 per year).1 Such a 'basic income flat tax' schema adapts easily to New Zealand's present tax and benefits levels, and will be affordable in the near future if not already. It would allow many people – especially young people – on benefits, student allowances or low wages to bypass the Work and Income bureaucracy and get on with their lives, leaving Work and Income to focus on addressing specific needs and deprivation, and allowing sole parents to benefit directly from Child Support agreements or impositions.

In this paper I investigate the flat (sometimes 'flattish') income tax that existed, under various names, between 1930 and 1970.

John Creedy and Norman Gemmell, ***Allowing for income effects in estimates of the elasticity of taxable income***

Abstract

This paper examines two problems in the estimation of the elasticity of taxable income. The first arises from the need to deal with endogeneity arising from the fact that the marginal tax rate and taxable income are jointly determined in a multi-tax structure. The approach taken in many empirical studies has been to use instrumental variable estimation. In contrast, the approach proposed in the present paper is to use ordinary least squares using proxy variables. It is shown that more robust, plausible results can be obtained using this approach. Secondly, the paper considers a potential role for income effects. One approach previously adopted has involved the addition of a term involving the proportional change in the net-of-tax average rate in addition to the change in the marginal net-of-tax rate. It is shown that the derivation of this specification, starting from the Slutsky equation, involves an invalid assumption (that virtual income can be neglected) at a crucial step. Nevertheless, for the New Zealand case, correction for this assumption leads to empirical results which also support the finding that income effects are negligible and statistically insignificant. In addition, the simpler specification can be derived more easily from a direct utility function. Following Kleven and Schultz (2014), income effects are also examined by introducing a term involving the proportional change in virtual income. Estimates reported here show a very small negative, but significant, coefficient on this variable when a proxy based on the expected tax rate is used, but a negligible and insignificant coefficient when a proxy based on an unchanged taxable income is used.

Other papers:

Other presentations on a public finance theme delivered at the conference included:

Matthew Bell, Tugrul Vehbi and Ben Udy, ***Estimating the future real rate of return on New Zealand 10-year government bonds.***

Dave Heatley and Geoff Lewis, ***The economics of social services.***

Sean Kimpson***, Smith, Mill and Say on taxation.***

Udayan Mukherjee and Oscar Parkin, ***The design of fiscal targets: insights from the literature for New Zealand***

Matt Nolan, ***Tax-transfer policies and income inequality: New Zealand in 1995-2013.***

Patrick Nolan and Grant Scobie, ***Public sector productivity and quality changes.***

Tim Ng, John McDermott and David Fielding, ***Guarding the Public Purse: Fiscal Policy Frameworks to support a modern economy***. A Panel Discussion chaired by Norman Gemmell. (See separate report in this Newsletter issue).

Research Report

The Size and Shape of the State in New Zealand

Norman Gemmell and Derek Gill

Across many countries economists often debate the normative issue of how large or small the government's share of an economy should be. Unfortunately, the arguments can all too readily generate more heat than light, at least in part because of limited available data (or because it is ignored), or because the protagonists are unclear about which particular measure(s) of the public sector they have in mind.

This is also the case in New Zealand where discussion often proceeds from the premise that the major economic reforms of the late 1980s and early 1990s succeeded in reducing the size of government in New Zealand. To provide better data for such debates, and to chart the progress of the public sector over a longer time span, we decided to collect, and make publicly available, data on the size of New Zealand's public sector. The project has so far collected data on a variety of public sector measures, or 'lenses' through which government size may be viewed. This includes bringing pre-existing but disparate data series together in one place[6], updating previously constructed series to the latest available year (usually 2014 or 2015), and commissioning new data - such as for marginal income tax rates (weighted averages across taxpayers) for recent years, from Inland Revenue.

The lenses we focus on relate to the government's various roles in the economy: as state spender and taxer; as producer, consumer and investor; as employer, as asset owner and debt holder. An important lens which we omit through lack of suitable data is 'government as regulator'. Each of those dimensions, or metrics, of government can change in quite different ways over time. For example, growth in the social benefit system in the form of transfers will add to public expenditure but not to public consumption, investment or GDP. Tax credits can either be measured as a deduction from tax revenues or as an expenditure item (New Zealand's family tax credits administered by Inland Revenue are deducted from tax revenues).

In a recent Victoria University of Wellington, *Working Paper in Public Finance*, we report on each of the above lenses in some detail, and a forthcoming *Policy Quarterly* article summarises our key charts and arguments. Below, we illustrate some of the data trends, and the role of government actions during and after the 1980s reforms using three charts.

Starting with the state's role as through taxation, Figure 1 reports evidence for marginal rates of income tax over the period 1962 to 2013 (taken from a longer series going back to the beginning of the 20th century). The figure shows an income-weighted average of the marginal income tax rates (AMTRs) faced by all taxpayers. It is often claimed that one of the main contributors to the 1980s tax reforms was the reduction of the top marginal tax rate (MTR), the move to fewer MTRs and the introduction of GST. Figures 1 highlights the effect of the tax reforms introduced in the 1986 budget in reducing average marginal tax rates.

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[6] Actually *two* places: the data can be found at www.data1850.nz and the New Zealand Public Finance website, www.nzpublicfinance.com .

Figure 1 (Weighted Average) Marginal Rates of Income Tax, 1962-2013

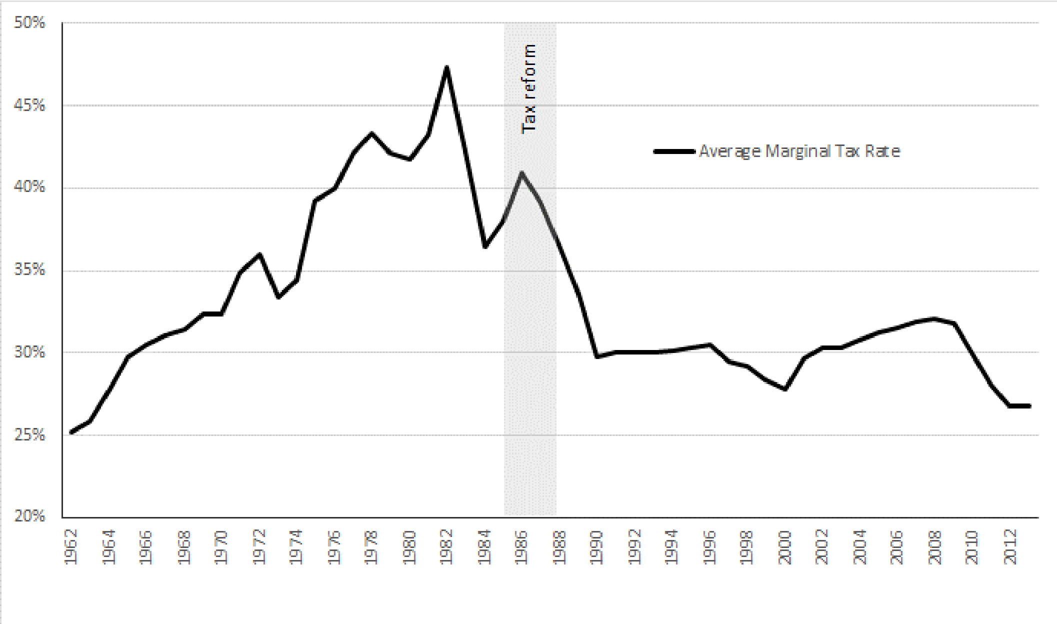
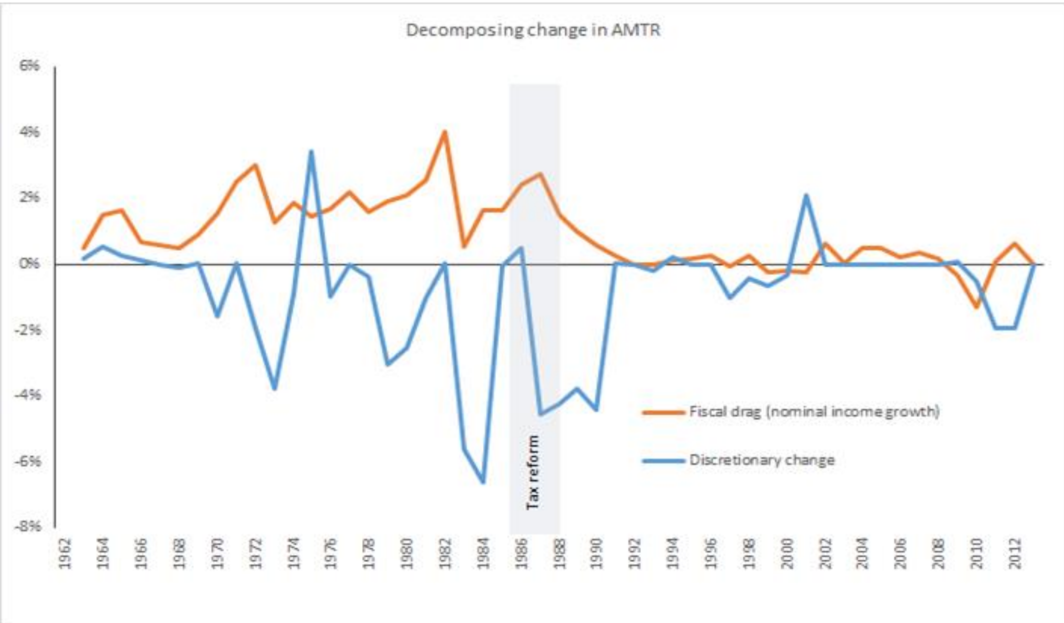


Figure 2 Income Tax AMTR Components (changes), 1962-2013



It can be seen that while there was indeed a major drop in the AMTR in the early reform years, the process of decline started earlier – around 1982. The 1982 income tax cuts were introduced to support incomes during the 1982-84 wage and price freeze. Figure 2 then decomposes the change in the AMTR into two key components: changes in the AMTR associated with discrete changes in the tax structure (e.g. legislated changes to tax rates and thresholds) and changes due to nominal income growth, for a given tax structure (fiscal drag). Of course, these two components are not independent. Indeed, they are likely to be closely related, with governments often adjusting the tax structure in response to the growth of taxpayer incomes pushing them into higher tax brackets.

Figure 2 makes clear that, even prior to the 1986-88 period, there was substantial discretionary change in the income tax structure that contributed towards reduced AMTRs. Though the 1986-90 period is one of substantial reductions in AMTRs it is by no means the only one. The figure also illustrates the comparative 'calm' in the AMTR from 1990 onwards, with a very stable income tax regime except for the 2000-01 increase in the top rate to 39% and the substantial reductions arising from the 2010 Budget reforms (together with some GFC-related effects).

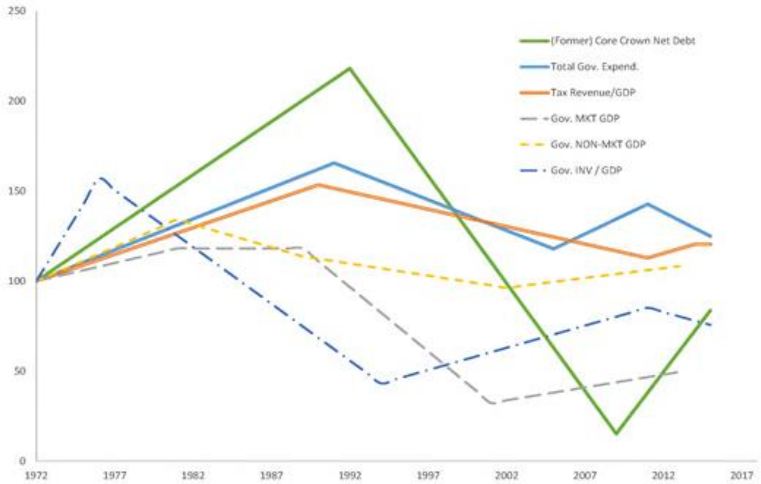
Finally, Figure 3 provides a stylised summary of the increases and decreases in various government size metrics or lenses over 1972-2015 (1972 is the first available year for several series). The figure is 'stylised' in the sense that we have selected the (approximate) years which represent turning points in each series and plotted straight lines between these for each lens shown. These include profiles for government debt, tax revenue, government market sector and non-market sector GDP, and the government investment/GDP ratio. A government consumption profile is omitted because it is almost flat throughout the period, peaking around 1982 and then fluctuating in the 15-20% of GDP range with no persistent upward or downward trends.

All the data series have been converted to indices based on 1972 = 100 so that the relative size of the movements in each indicator can be compared. Figure 3 tends to confirm that, while some government size metrics do reveal a clear change of direction around the time of the late 1980s reforms, for others there are various trend changes that occur at quite different times. The *extent* of the change in trend for different metrics is also very different. There is clear evidence that the state's role as a producer of market outputs has shrunk since the 1980s and also its role as employer. But for a range of other measures the state's role has changed relatively little. Changes in Crown debt reveal the largest relative rise and fall over the period to 2008; and, of course, the omitted government consumption is at the opposite extreme with no major trend or changes in trend.

Overall there is little sign in the data of the hollowing out or shrinking of the state, though some changes following the 1980s reforms have persisted. Instead, what we found in the data were some significant changes in the shape of the state. Looking at the government as a spender, some of the components have proved very volatile. For example, the introduction of New Zealand Superannuation led to a significant increase in government spending after 1976, which was wound back in the 1990s but it is now increasing again. The level of social welfare spending is still above the level in 1975 although well below the peak in the mid-1990s.

Our takeaway conclusions from examining the broader set of lenses is that whether the objective is to understand the impact of the late 1980s and early 1990s reforms or longer-term historical trends, the conclusion one reaches regarding trends, and changes in trends, in the government's economic size depends very much on which measure of government size is the focus. The analysis we have conducted to date has looked at the broad trends in the data. In the next phase of the work we will be using econometric techniques to unpack the relative roles of various factors suggested by the literature on the growth of government. The results of that work will be discussed in a future edition of this newsletter.

Figure 3 Stylised Changes in Different Government 'Lenses', 1972-2015



Derek Gill is a principal economist at NZIER and a research associate of the IPGS at Victoria University. Derek has worked all his career on public management and public finance issues, including as a researcher at Victoria University and the OECD, and as a leading practitioner at the New Zealand Treasury and the State Services Commission

Past Events

Personal Income Tax and Transfers Microsimulation Modelling Workshop

Date: 10th June 2016 **Venue**: New Zealand Treasury

This workshop, organised jointly by the Chair in Public Finance and The Treasury, explored recent work on tax-transfers microsimulation modelling by the NZ Treasury (NZT) and Melbourne Institute (MI). Around 40 people attended including guests from the Australian Treasury and the Australian National University. The workshop aimed to share tax modelling knowledge, establish closer ties between researchers in agencies and academia, and identify research areas for further development. More information including some of the powerpoint slide presentations listed below are available on request from Fiona.taylor@vuw.ac.nz or Penny.mok@treasury.govt.nz.

Programme Outline:

Time	Topic	Presenter
08.45 – 09.00	I. Introduction and Welcome	Tim Ng / Norman Gemmell
09.00 – 10.30	II. Non-behavioural microsimulation models	Chair: Norman Gemmell
	New Zealand Taxwell-A Model	Brett Stawinski (NZT)
	Australian MITTS Model	Guyonne Kalb (MI)

Objective: Descriptions of the 'tax calculator' models, analysis of outputs and use in policy advice.

11.00 – 12.30	III. Behavioural microsimulation models	Chair: Norman Gemmell
	New Zealand Taxwell-B Model	Hemant Passi (NZT)
	Australian MITTS Model	Guyonne Kalb (MI) & Nicolas Hérault (MI)

Objective: Descriptions of models' behavioural dimensions, analysis of outputs, simulations of actual policy change, and implications for policy advice.

	Developing Behavioural Modelling	Chair: John Creedy
1.30 – 2.15	IV. Measuring labour supply responses: NZ/Australia Comparison	Penny Mok (NZT)
2.15 – 3.00	V. Introducing welfare change metrics in tax-transfer models	Nicolas Hérault (MI)

Objective: Assessing sensitivity of conclusions and policy advice to key model assumptions and alternative evaluation metrics

3.30 – 4.30 VI. Future modelling directions for Australia & New Zealand

Roundtable discussion on further development opportunities for MITTS and Taxwell in light of the day's presentations and discussions. Planning for future workshops on international benchmarking of tax-transfer models.

Roundtable on The Size and Shape of the State

Date: 21st June 2016 **Venue**: Productivity Commission

Norman Gemmell presented some initial results from a joint project with Derek Gill of NZIER on the size and shape of the New Zealand state over the last century or so, to an invited audience of guests with experience and interest in this area. The research is gathering data on various 'lenses' through which the state sector in New Zealand may be measured, with a key focus being whether and how the size of the state shrank (temporarily or sustainably?) after the major 1980s reforms. A lively discussion followed with several knowledgeable contributors including Ruth Richardson who shared her experience as finance minister during key points of this episode.

A set of slides from Norman and Derek's presentation is available here, and more details of the project are reported elsewhere in this Newsletter.

Special thanks are due to Patrick Nolan of the Productivity Commission for organising the roundtable event, the NZIER Public Good Fund for sponsoring this research, and Loc Nguyen for excellent research assistance.

You can find the NZIER's larger interactive database, including public finance-related data series produced by this project, at www.data1850.com.

Future Events

Public Finance Debates, 2016

Planning for the next joint CPF/Government Economics Network, *Public Finance Debates* series is underway. We expect to have three this year in October, November and, of course, a Christmas debate in December. As last year, the debates will be held at the Ministry of Business Innovation and Employment premises on Stout Street. Further details will be forthcoming over the next few months, so watch out for the email alerts, and announcements at www.nzpublicfinance.com. At this stage possible debate topics look likely to be the following.

OCTOBER
"Big data in policy advice: big opportunity or big risk?"
In the absence of detailed knowledge of individuals' circumstances, the traditional approach to policy targeting has often been to target the policy as widely to ensure that all those who might be eligible are reached. But now 'big data' is providing unique opportunities to identify individual characteristics, so radically improving our ability to target those most in need. But what are the risks? Some might argue that while big data can provide a more detailed picture of targeted individuals, it focuses policy on the symptoms, not the causes, of their condition.

NOVEMBER
"The Future of work: New Zealand needs a four day working week"
New Zealanders work hard. Not only do we have high rates of labour participation but our hours of work are relatively high too. Conversely our labour productivity (the output per hour worked) is poor. But does it have to be this way? Does New Zealand need to introduce a four day working week to give our labour productivity a boost? And are new technologies going to deliver on the promise of an improved work-life balance?

DECEMBER [Christmas Debate]
A sugar tax in New Zealand would help avoid some of the consequences of Christmas excesses
A sugar-tax high is hitting the news! The UK introduced a tax on sugary drinks in its 2016 Budget and other countries seems to be lining up. But will it deal with the alleged obesity problem among children and adults? What about other good or bad side-effects of a sugar tax, and is regulation a better way to go? Should all edible Christmas goodies aim to be sugar-free in New Zealand?

As we look to line up possible debate speakers (proposers, opponents and chairs/commentators), suggestions and offers are always welcome! Please get in touch with either Patrick Nolan or Norman Gemmell.
Patrick.nolan@productivity.govt.nz
Norman.gemmell@vuw.ac.nz

Recent Public Finance News

New Zealand

- 2 February 2016, How would you spend a half-billion dollars on arts, culture and heritage?, NZIER
- 3 May 2016, Tax Bill to improve, strengthen tax rules, The Scoop Independent News
- 9 May 2016, The state of the state New Zealand 2016: Social investment for our future, NZIER
- 17 May 2016, Making superannuation affordable, Interest.co.nz
- 17 May 2016, First home buyer KiwiSaver withdrawals grow exponentially, Interest.co.nz
- 18 May 2016, Lifetime renters have to save bigger nest-eggs than homeowners, Stuff
- 29 June 2016, NZIER launches Data1850 website, NZIER
- 19 July 2016, Are today's young people super savers or splurging spenders?, The Treasury NZ
- 22 July 2016, Taxes don't build houses, The New Zealand Initiative
- 28 July 2016, Economist predicts Brexit like shift in attitudes towards housing, Stuff
- 29 July 2016, Capital gains tax, performance pay for teachers backed by Mainfreight chairman, The New Zealand Herald
- 31 July 2016, New provider will pay it forward for KiwiSavers, The New Zealand Herald
- 31 July 2016, Government raises KiwiSaver HomeStart caps, The Scoop Independent News

World

- 18 January 2016, The $100bn muddle of climate cash, Public Finance International
- 1 March 2016, Aid effectiveness: value during adversity, Public Finance International
- 8 March 2016, OECD countries confirm their drive to improve gender equality in public leadership, OECD
- 25 April 2016, What Would Happen If We Just Gave People Money?, FiveThirtyEight
- 18 May 2016, The truth about the google tax, The Sydney Morning Herald
- 16 June 2016, Regional inequalities worsening in many countries, OECD
- 17 June 2016, IMF Survey: Developing Economies' Untapped Revenues, IMF
- 23 June 2016, Mexico to Accelerate Path to Financial Inclusion, The World Bank
- 24 June 2016, A systematic approach to powering city growth and transforming public services, Public Finance International
- 29 June 2016, A look at Carbon Pricing and Competitiveness, The World Bank
- 9 July 2016, Bank of England poised to slash interest rates to shore up economy, The Telegraph
- 10 July 2016, What is the correct fiscal policy now we want Out? The Telegraph
- 11 July 2016, Economy stutters as Brexit fallout takes hold, The Telegraph
- 11 July 2016, Lowest-paid workers to receive smaller pay rises, says thinktank, The Guardian
- 10 July 2016, Halt sugar tax introductions, urges food and drink industry, The Guardian

- 19 July 2016, The big challenge on living standards is to boost incomes for those in work, Institute for Fiscal Studies
- 20 July 2016, Governments should use tax systems to drive inclusive growth agenda, OECD
- 22 July 2016, Taxes don't build houses, The New Zealand Initiative
- 27 July 2016, Cash transfers don't discourage working, says ODI, Public Finance International
- 27 July 2016, Let people take state pension early or they'll risk missing it, The Guardian
- 27 July 2016, Theresa May should think again about harmful green belt limits to help fix the housing crisis, The Telegraph

Public Finance Journals

1. FinanzArchiv
2. Fiscal Studies
3. International Tax and Public Finance
4. Journal of Public Economics
5. Journal of Public Economic Theory
6. National Tax Journal
7. Public Budgeting and Finance
8. Public Finance Review
9. Public Finance and Management
10. Tax Notes International

Public Finance Publications

Working Papers in Public Finance

This working paper series is published by the Chair in Public Finance, Victoria University of Wellington, in collaboration with researchers in New Zealand and overseas.

*NZPF Research associates in **bold***

WP01/2016

Creedy, J. 'The Optimal Threshold for GST on Imported Goods'.

This paper examines the determination of the optimal threshold value for Goods and Services Tax (GST) for imported units arising from internet orders. The concept of an optimal threshold is wider than simply the maximisation of revenue net of administrative costs. At the optimal threshold, the marginal cost of funds from GST is equated to the ratio of the marginal value of public funds to their marginal social value, reflecting the value judgements of a decision maker. The marginal cost of funds allows both for compliance costs and the marginal excess burden arising from a small increase in the threshold. Illustrative numerical values are reported, showing the sensitivity to administrative costs, the demand elasticity and, importantly, value judgements.

WP02/2016

Gemmell, N., Kneller, R., McGowan, D., Sanz, I. and Sanz-Sanz, J. F. 'Corporate Taxation and Productivity Catch-Up: Evidence from European Firms'.

This paper explores whether higher corporate tax rates reduce the speed with which small firms converge to the productivity frontier by lowering the after-tax returns to productivity-enhancing investments. Using data for 11 European countries we find evidence that their productivity catch-up is slower the higher are statutory corporate tax rates. In contrast, we find large firms are instead affected by effective marginal rates. Using the reduced form model of productivity convergence due to Griffith et al. (2009) our results are robust to a host of robustness checks and a natural experiment that exploits the 2001 German tax reforms.

WP03/2016

Creedy, J., **Gemmell, N**. and Teng, J. 'The Elasticity of Taxable Income: Allowing for Endogeneity and Income Effects'.

This paper examines two problems in the estimation of the elasticity of taxable income. The first arises from the need to deal with endogeneity arising from the fact that the marginal tax rate and taxable income are jointly determined in a multi-tax structure. The approach taken in many empirical studies has been to use instrumental variable estimation. In contrast, the approach proposed in the present paper is to use ordinary least squares using proxy variables. It is shown that more robust, plausible results can be obtained using this approach. Secondly, the paper considers a potential role for income effects. One approach previously adopted has involved the addition of a term involving the proportional change in the net-of-tax average rate in addition to the change in the marginal net-of-tax rate. It is shown that the derivation of this specification, starting from the Slutsky equation, involves an invalid assumption (that virtual income can be neglected) at a crucial step. Nevertheless, for the New Zealand case, correction for this assumption leads to empirical results which also support the finding that income effects are negligible and statistically insignificant. In addition, the simpler specification can be derived more easily from a direct utility function. Following Kleven and Schultz (2014), income effects are also examined by introducing a term involving the proportional change in virtual income. Estimates reported here show a very small negative, but significant, coefficient on this variable when a proxy based on the expected tax rate is used, but a negligible and insignificant coefficient when a proxy based on an unchanged taxable income is used

WP04/2016

Gemmell, N., Gill, D. and Nguyen, L. 'The Changing Size of the State in New Zealand, 1900-2015'.

This paper presents some evidence on the size and scope of the government sector in New Zealand over several decades, and in some cases since around the beginning of the 20th century. It uses various 'lenses' or metrics by which to measure changes in government size including its role as spender and taxer; as producer, consumer and investor; as employer (public employment share); and as steward (macro-fiscal manager). With the exception of employment, all measures presented are relative to GDP. These data reveal that both the relative size of government, and changes over time, depend importantly on which aspects of government are the focus of interest. As a result, assessing how far the major reforms to government in the late 1980s were associated with reductions in the size of the state appears to depend on which particular lens is used. There is clear evidence that the state's role as a producer of market outputs has shrunk since the late 1980s and also its role as employer.But for a range of other measures the state's relative role has stayed the same. The overall Crown Balance Sheet shows the greatest variation with a rapid deterioration until 1991/2 and then strengthening remarkably thereafter. The overall size of state's role as producer of non-market outputs has been remarkably stable since the 1980s.

WP05/2016

Creedy, J. and **Gemmell, N**. 'Types of Income Mobility: Insights from TIM Curves'.

Jenkins and Lambert (1997) demonstrated that a number of measures of poverty could be combined and compared using the "Three Is of Poverty" (TIP) curve; the 'three Is' being the incidence, intensity and inequality of poverty. This paper takes the insights from the TIP curve and applies them to measures of income mobility, proposing a "Three Is of Mobility" or TIM curve. The analysis is then applied to the concept of poverty persistence. Illustrations are provided using income data from random samples of New Zealand income taxpayers over the period 1998 to 2010.

Institutions Working on Public Finance Research or Policy

New Zealand

Centre for Accounting, Governance & Taxation Research (CAGTR)
Victoria University of Wellington
The CAGTR was established within the School of Accounting and Commercial Law to advance and apply knowledge germane to the accounting and legal professions, commerce and industry and the public sector.

Retirement Policy & Research Centre (RPRC)
The University of Auckland
"The Retirement Policy and Research Centre (RPRC) is an academically focused centre specialising in the economic issues of demographic change."

Chair in Public Finance (CPF)
Victoria University of Wellington
The Chair in Public Finance (CPF) is a joint venture between Victoria University and four sponsoring institutions with an interest in public finance The Treasury, the Inland Revenue Department, PricewaterhouseCoopers, and the Ministry of Social Development. The Chair conducts research and organises events to increase awareness and discussion around public finance issues.

World

Tax and Transfer Policy Institute
Canberra, Australia
"The Tax and Transfer Policy Institute (TTPI) carries out research on tax and transfer policy, law and implementation for public benefit in Australia."

CESifo Group Munich
Munich, Germany
Centre for Economic Studies, the ifo Institute and the Munich Society for the Promotion of Economic Research in Germany.

Institute for Fiscal Studies
London, UK
The Institute for Fiscal Studies aims to promote effective economic and social policies by better understanding how policies affect individuals, families, businesses and the government's finances.

London School of Economics Public Economics Programme (PEP)
London, UK
The PEP's activities include "theoretical and empirical work on the economics of taxation, the provision of public goods, social insurance and the economics of income distribution.

Oxford University Centre for Business Taxation
Oxford, UK
"The Oxford University Centre for Business Taxation is an independent research centre which aims to promote effective policies for the taxation of business."

University of Exeter, Tax Administration Research Centre
Exeter, UK
"The Tax Administration Research Centre undertakes research on tax administration in order to strengthen the theoretical and empirical understanding of tax operations and policies. The Centre is operated in partnership by the University of Exeter and the Institute for Fiscal Studies."

Office of Tax Policy Research
Michigan, USA
The Office of Tax Policy Research (OTPR) is a research office at the Stephen M. Ross School of Business at the University of Michigan. OTPR supports and disseminates academic research on all aspects of the tax system, with the goal of informing discussion about the future course of policy.

OECD Centre for Tax Policy and Administration
Paris, France
The Centre for Tax Policy and Administration (CTPA) is the focal point for the OECD's work on all taxation issues, both international and domestic.

Congressional Budget Office
Washington, DC, USA
The Congressional Budget Office (CBO) has produced independent analyses of budgetary and economic issues to support the Congressional budget process. The agency is strictly nonpartisan and conducts objective, impartial analysis.

National Institute of Public Finance and Policy
New Delhi, India
The National Institute of Public Finance and Policy (NIPFP) is a centre for research in public economics and policies. The institute undertakes research, policy advocacy and capacity building in areas related to public economics.

Centre for Public Finance Research
Washington, DC, USA
The Center for Public Finance Research (CPFR) offers research and education in public budgeting and finance, public financial management, public economics, and benefit-cost analysis at the local, regional, national, and international levels.

National Institute of Economic and Social Research
London, UK
"NIESR aims to promote, through quantitative and qualitative research, a deeper understanding of the interaction of economic and social forces that affect people's lives, and the ways in which policies can improve them".

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