

Top After-Tax Incomes

The purpose of this article is to present some data on top after-tax incomes in New Zealand. Thus it is a companion to the preceding article in this *Policy Quarterly*, ‘Distribution of pre-tax top personal incomes’, which looked at before-tax incomes. That article found that there had been little change after 1981 in the market (before-tax) income shares of those on top incomes. This article reports that, nevertheless, those on top incomes had dramatic increases in their after-tax incomes and shares of total after-tax income in the late 1980s and early 1990s. Since there was no change in pre-tax market income shares, these increases were due to changes in relative tax rates.

Note that this article traverses the personal income distribution, not the household distribution, which may involve more than one person and children (Perry, 2014). As such, it parallels the work of Alvaredo et al. (2013), which Thomas Piketty uses in his *Capital in the Twenty-first Century* (2014).

The article also explores the political and social consequences of the increased share.

Data sources

The primary data source is provided by Inland Revenue (IRD), which derives the personal income (before and after

tax) distribution from a sample of actual returns. As such, it covers only income reported for tax purposes. It therefore excludes income that is not taxed (such as capital gains and pension income in some years) or is attributed to other entities (such as trusts and private companies). Residents for tax purposes report all income, but those who are deemed non-residents report only their New Zealand incomes.

The IRD provides a consistent series back to the 1980/81 (March tax) year. Data for earlier years can be derived from Department of Statistics publications *Incomes and Income Tax* (various years). However, before the 1970/71 year social security tax was not included in the database because it was levied separately. Thus this analysis only goes back to the 1970/71 year, when social security tax was abolished. The year refers to the year of the return, not the year in which the income was generated, which is often a year earlier.

For various reasons – such as those on lower incomes not having to file returns – IRD returns may not cover all income recipients. This does not affect those on top incomes, but totals in the database do not cover total income. Instead, the share of the income of the top is compared with household disposable income as reported in the national accounts. (Note that this has the effect of treating benefits and the

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like as negative income taxes.) Data is reported below for the top 0.1%, 1% and 10% of all adults (those aged over 15). This avoids the omission at the bottom of the IRD database. In the 2012 year the three groups represented about 3,500, 35,000 and 350,000 people respectively. Further details of the database and the method are reported in the preceding article.

Results

The overall results are shown in Figure 1.¹ Essentially, the pattern is that after-tax income shares are stable for the three groups over time, except that the shares lifted markedly between the late 1980s and early 1990s. (In summary, each group's graph shows two plateaus with a sharp scarp between them.)

It is possible to tell a more refined story within the two outer periods, but for our purposes the dramatic change is the lift between 1987 and 1993.² It is summarised in Table 1.

The table may be interpreted as follows, illustrating the pattern with the top 0.1% column. In the period before 1987 the top 0.1% had 0.62% of total household disposable income (which meant their average income was 6.2 times the adult average). After 1991 their share averaged 1.68% (so their incomes averaged 16.8 times the adult average). This represented a relative increase in their income of 169%. Thus, the share in the later period was more than two-and-a-half times what it had been in the earlier period, but not three times. The absolute gain amounted to \$1.43bn in 2011/12, equivalent to \$6 a week per New Zealander (including children).

The gains to those below the top 0.1% are proportionally smaller, but larger in absolute terms because more people are involved. Although the boost to the top 10% (including the 0.1%) is only 25%, the absolute gain is \$7.4bn, the equivalent of about \$32 per week per New Zealander. Summing the additional income over the last 20 years (and ignoring interest and inflation), the top 0.1% had an extra \$19.8bn, the top 1% had an extra \$46.8bn and the top 10% had an extra \$98.7bn more disposable income than at the old tax rates. The top 10% includes

Figure 1: Shares of top income in disposable income

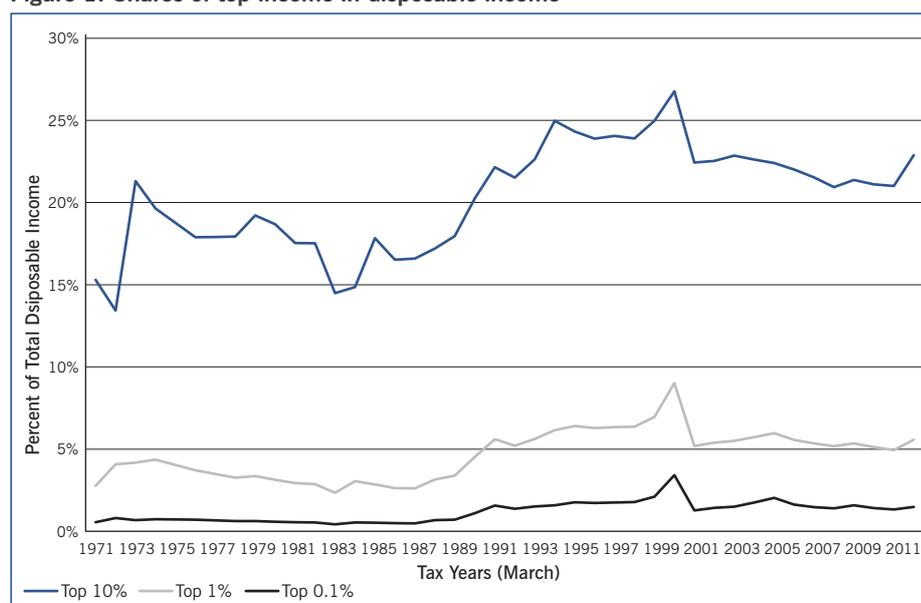


Table 1: Shares of top income groups in household disposable income

	Top 0.1%	Top 1%	Top 10%
1970/71–1986/87	0.62%	3.4%	18.4%
1991/92–2011/12	1.68%	5.9%	22.9%
Increase	169%	78%	25%
Absolute gain 2011/12	\$1,430m	\$3,620m	\$7,420m

the top 1% with their greater gains. The proportional increase in the share of those in the top 2–10% is 13% (or about half of that for the top decile as a whole). The big gains are to the top 1%, who got about as much as the remaining nine-tenths of the top decile.

The impact of taxation

Since, as observed in the earlier article, there have been no dramatic changes in the distribution of pre-tax market incomes, the change in disposable income shares reflects reductions in the relative incidence of taxation. There were two main ways in which this happened.

The flattening of income tax rates

Before 1987 effective marginal tax rates on top incomes averaged over 50% (the official rates were as high as 66%), but after 1991 the rates were below 40%: they were 33% in the 1990s and after 2009; they were 39% in between.³

Imputation of corporate taxation

Until 1989 it was said that corporate

dividends were 'double taxed'. Corporations paid tax on their profits, and their dividends paid from the tax-paid profits were treated as taxable income of the shareholder. To illustrate, suppose the tax rate is 50% and all the after-tax company profit was remitted in dividends. The calculation would appear something like this:

Company profit before tax	= \$100
Less tax on profit at 50%	= \$ 50
Company profit before tax	= \$ 50
Dividend	= \$ 50
Less tax on dividend at 50%	= \$ 25

Thus, the shareholder would only receive 25% of the original company profit.

From 1989 there has been a dividend imputation system in which a shareholder receiving a dividend from a company is entitled to an 'imputation credit', which represents tax paid by the company and is offset against the shareholder's income tax liability. The previous tabulation becomes:

Company profit before tax	= \$100
Less tax on profit at 50%	= \$ 50
Company profit before tax	= \$ 50
Dividend	= \$ 50
Imputed tax on profit	= \$ 50
Total income reported to IRD (sum of previous two lines)	= \$100
Tax calculated on reported income at 50%	= \$ 50
Less tax already paid by company	= \$ 50
Additional tax to pay	= \$ 0
Net difference between before and after the introduction of imputation of corporate dividends:	
Gain	= \$ 25

about 20% in the early 1980s to 24–25% more recently) (Perry, 2014). All of the significant shift occurred in the late 1980s and early 1990s, and was attributed to the reduction of income tax rates.

This article reports on the personal rather than the household distribution. There is not a simple relation between the two: households may have more than one income recipient, and may contain other adults and children. Even so, the share of the personal distribution of the top 10% increased 25%, suggesting a similar increase to household incomes despite the results being drawn from quite different databases. (That the change occurs at

economic growth but that the effect was offset by less successful measures (which?). However, the promise of growth would also predict that, following the tax reductions, the market (pre-tax) share of those on top incomes would increase. It didn't (see the preceding article). This is puzzling. One might have expected that the additional disposable income would have led to greater savings, and that the consequent return on the investment would have boosted the incomes of those at the top even further.

Among the possible explanations are:

- there was greater investment but it was offshore and does not appear in the growth data (nor in the tax base if the beneficiaries switched their status to non-resident for tax purposes);
- the increased income is not reported for tax purposes because it has disappeared into capital gains, private companies and trusts, for instance;
- some of the investment would be in housing (more below);
- the rich have been getting a poor return on their investment (possible);
- their savings rate has not been very high (discussed below as patterns of consumption).

There is an additional important caveat. Top income tax rates were falling in many other parts of the rich world. For a variety of reasons – the most important being the international mobility of highly skilled labour and big investors – it is impossible today to isolate the New Zealand tax system from the rest of the world and maintain high tax rates here out of line with relevant competitors; economic insulation is not what it was once.

Social and political consequences

Critical changes in social and political behaviour are associated with, and almost certainly (in part) a consequence of, the shift in the after-tax distribution. However, some of the phenomena reported below may have been incipiently developing before the tax reductions of the Rogernomics period.

At issue is what those on top incomes did with their additional income (i.e. the \$1.4bn a year for the top 0.1%; \$7.4bn

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Thus, the shareholder pays no additional tax on dividends in this example and corporation tax becomes, in effect, a withholding tax for shareholders' dividends.⁴ So shareholders pay less tax under an imputation system. The two effects explain the marked fall in tax rates on top incomes in the late 1980s and early 1990s. Despite there being no marked change in the before-tax shares of those at the top, there was a dramatic change in their after-tax shares.

Were the tax reductions fair?

Economists rarely have much expertise in judging fairness. We therefore avoid making this judgement, merely observing that in the late 1980s and early 1990s there was a considerable shift in the after-tax income distribution towards the rich. This is not a new observation. The shift was first measured two decades ago, but it was observed via the household adjusted disposable income distribution. That measure is based on a sample survey of households and cannot assess changes at the top with any precision. It found that over the last decades there has been a 20–25% increase in the income share of the top 10% of households (from

about the same time is less surprising.)

While this cross-check is useful (and comforting), the important finding from this research is that those at the very top experienced far greater income increases than is evident in the household income distribution with its necessarily coarser groupings.

Was there an impact on economic growth from the redistribution?

The sort of tax redistribution observed here is sometimes justified in various ways, such as that it provides the investing class with more income to save and invest and increases the rewards for risk-taking and innovation by the entrepreneurial class. Two decades after the changes, there is little evidence that this happened in New Zealand (although there are caveats). Most fundamentally, there is no evidence that as a result of the policy changes made in the late 1980s and early 1990s New Zealand's economic growth rate increased, as was promised by the advocates. Once the Rogernomics recession was over in 1995 the economy grew at the same rate as it had before the measures were introduced.

Now it could be argued that the tax reductions on the rich accelerated

a year for the top 10%). Undoubtedly some was invested, although the previous section suggested that there is little evidence of a return on this additional investment in the available data. But certainly some of the billions would have been not saved but consumed.

The difficulty here is that the research evidence suggests that above some threshold – well below the amount those on top incomes experience – additional consumption does not add to happiness or well-being. There are exceptions, such as better access to health care. And there is evidence to the effect that experiences are more highly valued than consumption of goods (scuba diving is valued more than the scuba equipment itself, if you are that way inclined). While consumption may not enhance well-being, however, much income can be a source of social status, and there is a need by the wealthy to demonstrate how rich they are. (There would be no annual rich list were there not, even if its coverage and estimates are erratic.) This gives rise to conspicuous consumption: the acquiring of luxury goods and services to publicly display economic power (income and wealth).

Conspicuous consumption takes many forms, including the purchase for public display of assets such as housing and cars far in excess of reasonable requirements. (Such purchases may be described as investments, but they give no market return.) It may involve the hosting of expensive, publicly-observed events – such as lavish parties – while attention in the gossip columns, if not always welcome, also displays wealth. Hagiographies are commissioned; auto-hagiographies are ghosted. Probably titles – reinstated in part by pressure from the rich – are not directly bought, but there

is no doubt that there is an association between them and wealth. (Those that are awarded by merit enhance the less-merited awards.)

Traditionally the New Zealand rich have contributed to the public wealth by anonymous donations (although there was a convention that less anonymity was appropriate in donations after death). It is difficult to judge whether such donations are more common today – probably, given the greater income share of the rich – but today there is little anonymity, which makes the donors' status all the more conspicuous. (Note that the choices they make may shape activity in particular directions: acceptable art and writing is likely to be abstract rather than to depict political and social issues.)

Some of the surplus of the rich is used to defend their social positions. New Zealand's largest think tank (currently the New Zealand Initiative) is funded generously by millionaires. Donations influence political parties. Meanwhile, alternative views are discouraged in various ways, including limiting the role of the government as a contributor to the public good. Given that the evidence of increasing economic inequality is two decades old, it is extraordinary that widespread public debate is less than two years old. Perhaps even more importantly, the public debate tends to be confined to options that not only justify the rich's success but also ignore alternative possible developments.

It may be either conspicuous consumption or political defence or both, but a feature of today's political landscape is that three minor parties are overtly funded by millionaires. While money influences the public perception of the beauty, charm and intelligence

of the wealthy, it is well to remember that commercial acumen (and luck) are not necessarily associated with aesthetic sensibility, political insight, and intellectual aptitude (or even the ability to form a coherent sentence). Fortunately, the rich rarely make claims of sporting prowess (except in yachting). An obsequiousness by the guardians of public taste (who are often rewarded by the generosity of, and favours from, the rich) results in the wealthy's non-commercial attributes being exaggerated.

Conclusion

New Zealand is a different society today from that of the early 1980s. In part this is the result of social and technical change and changing external relations in a globalised world. But some features of the change can be explicitly attributed to the rise in the relative incomes and wealth of the rich resulting from the changes in economic redistribution and tax policy in the late 1980s and early 1990s. This article contributes to quantifying the magnitude of these changes and tracing their implications.

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- 1 Pareto coefficients are not reported as they were in the preceding article. Estimates proved unstable, indicative that the after-tax distribution was not particularly Pareto distributed. If the before-tax distribution was, the after tax-distribution would be only if the tax regime was exactly proportional.
 - 2 For instance, the rise in the top marginal tax in 2000/01 depresses levels slightly.
 - 3 The story is complicated by the removal of tax exemptions at various times and the imposition of the New Zealand Superannuation surcharge.
 - 4 It was rare for a company to pay tax at the full corporation tax rate because of various rebates and exemptions.

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