POLICY ADVICE DIVISION

Tax policy report: Personal tax rate reductions and an increase in the GST rate

Date:	15 February 2010	**Priority:**	High
Security Level:		**Report No:**	T2010/191 PAD2010/16

Action sought

	Action Sought	**Deadline**
Minister of Finance	**Agree** to recommendations	19 February 2010
Minister of Revenue	**Agree** to recommendations	19 February 2010

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**	
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15 February 2010

Minister of Finance
Minister of Revenue

Tax policy report: Personal tax rate reductions and an increase in the GST rate

Executive summary

New Zealand relies heavily on income taxes (i.e. personal tax and corporate tax) in order to fund government expenditure. These taxes may be particularly harmful for efficiency and growth. Taxes on consumption (such as GST) tend to be less harmful for growth. While GST is still effectively a tax on labour, it does not discourage savings like income taxes do because GST only taxes consumption. A switch from income tax towards GST can, therefore, boost incentives to save and encourage economic growth consistent with the government's economic strategy. Officials consider that there is merit in a shift in the tax mix to reduce personal tax rates and provide more tax revenue through GST, while reducing the tax revenues generated through income taxes. This was also the view of many members of the Tax Working Group (TWG).

Further, a particular concern with the current income tax structure identified by officials and the TWG is its lack of integrity as a result of the non-alignment of the company, trustee, portfolio investment entity and top personal marginal tax rates. This creates opportunities for tax planning and can result in a reduction in vertical equity. Officials and the TWG have noted that these integrity problems could be partially addressed if the top personal tax rate were aligned with the trustee tax rate (T2010/119, PAD2010/7 refers).

Subsequent to the final report of the TWG, Ministers are considering a range of measures that could form part of a tax reform package for Budget 2010. On 1 February 2010, Cabinet agreed that further advice be sought from officials on, among other things, potential changes to personal tax rates and increasing the rate of GST (Cabinet Minute (10) 3/2 refers). Further, the Prime Minister's Statement to Parliament on 9 February included a number of parameters that will guide the shape of the package.

Given the above Cabinet decision and statements of the Prime Minister, this report considers a number of matters with a view to further clarifying Ministers' preferences regarding key elements of the Budget tax package. This will allow officials to advance work on developing a tax package that reflects Ministerial preferences, is feasible, and is broadly revenue neutral. These matters include:

- reducing the top personal tax rate and whether to align it with the trustee tax rate at 33%;
- reducing other personal tax rates;
- whether to increase the GST rate in order to alter the tax mix between income tax and consumption tax and to assist in funding a reduction in personal tax rates;
- whether to provide other support for certain groups as a result of any increase in the GST rate;
- clarification of potential implementation dates; and
- other issues (e.g. consequential changes, administrative implications and costs).

The nature of any compensating measures as a result of GST changes will be considered in a subsequent report to Ministers.

Further, due to the number of key issues requiring resolution and the importance of the revenue-neutral constraint, developing the tax package is likely to be an iterative process. In particular, the requirement for the package to be self-funding requires the inclusion of a number of other base broadening measures. These other measures will be considered in subsequent reports to Ministers during the lead up to Budget 2010.

As this process develops, the nature and extent of feasible and affordable tax reforms will become clearer, allowing the final form of the package to take shape. Where Ministers' preferences are unable to be accommodated within the revenue neutral parameters agreed by Cabinet (Cabinet Minute (10) 3/2 refers), officials will provide advice on workable variations. Officials aim to report to Ministers with a final recommended Budget 2010 tax package in mid March 2010.

Recommended action

We recommend (subject to final decisions on a tax package for Budget 2010) that you:

(a) **Note** that the Prime Minister's Statement to Parliament of 9 February included these statements regarding GST and personal income tax rates:

(i) "We are not only looking at possible reductions to the top personal tax rate. That is where a lot of commentary has focused, but the Government has always been looking at the whole personal tax structure, across the board."

(ii) "The Government is also carefully considering a modest increase in the rate of GST, to no more than 15 percent."

(iii) “Therefore, if an increase [to GST] were to occur it would have to be accompanied by across-the-board reductions in personal taxes, as well as up-front increases in benefits, New Zealand Superannuation, and Working for Families payments.”

(iv) “No decisions have yet been made about raising GST and the Government has asked for more work to be done on this.”

Noted   Noted

(b) In relation to personal tax cuts, **direct** officials to develop, for consideration by Ministers, initial packages that reflect:

(i) the Prime Ministerial statements to the House noted in recommendation (a);

Agreed/Not Agreed   Agreed/Not Agreed

(ii) the alignment of the top personal tax rate and the tax rate applied to trustee income.

Agreed/Not Agreed   Agreed/Not Agreed

EITHER

Alignment of the trustee and top personal tax rates

(c) (i) If recommendation (b)(ii) is agreed, **agree** there is a preference for alignment of the top personal tax rate and the tax rate applied to trustee income at 33%.

Agreed/Not Agreed   Agreed/Not Agreed

AND

(c) (ii) **Note** that officials will only advise on alterations to the 33% preferred rate in recommendation (c)(i) if it is considered essential in order to form a broadly revenue neutral tax package.

Noted   Noted

OR

(d) If recommendation (c)(i) is not agreed, **agree** there is a preference that a range of rates at which the top personal tax rate and the tax rate applied to trustee income could be aligned be considered (including 33%).

Agreed/Not Agreed | Agreed/Not Agreed

Reducing lower personal tax rates and increasing the GST rate (in addition to alignment of the trustee and top personal tax rates)

(e) **Note** that if the tax package announced on Budget night is also to include further personal tax rate reductions in the current lower personal rates, an increase in the rate of GST will be required to fund such reductions.

Noted | Noted

(f) **Agree** there is a preference for the tax package announced on Budget night to also include reductions to the current lower personal tax rates.

Agreed/Not Agreed | Agreed/Not Agreed

(g) **Agree** there is a preference that a range of options be considered to reduce the three lowest personal tax rates.

Agreed/Not Agreed | Agreed/Not Agreed

(h) **Agree** that, if required, officials may also advise on changes to income tax thresholds in addition to cutting income tax rates.

Agreed/Not Agreed | Agreed/Not Agreed

(i) **Agree** there is a preference for the tax package announced on Budget night to include an increase in GST.

Agreed/Not Agreed | Agreed/Not Agreed

(j) **Agree** that there is a preference for any GST increase to be to 15%, and that initial packages not examine intermediate increases between 12.5% and 15%.

Agreed/Not Agreed | Agreed/Not Agreed

Implementation dates

EITHER

(k) **Agree** there is a preference that any reduction in personal tax rates and increase in the rate of GST be implemented on 1 October 2010.

Agreed/Not Agreed Agreed/Not Agreed

OR

(l) **Agree** there is a preference that any reduction in personal tax rates and increase in the rate of GST be implemented on 1 April 2011.

Agreed/Not Agreed Agreed/Not Agreed

OR

(m) **Agree** there is a preference that any reduction in personal tax rates and increase in the rate of GST be implemented on a range of dates (that is, some rates to be implemented on 1 October 2010 whilst others are implemented on 1 April 2011).

Agreed/Not Agreed Agreed/Not Agreed

GST support options

(n) **Note** that for most taxpayers, reducing the lower personal tax rates will, depending on circumstances and the make up of the final tax package, likely more than counter any negative effects from increased prices to goods and services as a result of an increase in GST.

Noted Noted

(o) **Note** that, with respect to the impact of a GST increase on beneficiaries, superannuitants, and Working for Families recipients, most main benefits and transfers are indexed annually on 1 April (although the Family Tax Credit is only indexed on 1 April if a CPI threshold is breached) for changes in prices, and will therefore increase automatically as a result of an increase in GST. A few benefits (e.g. the accommodation supplement and some hardship assistances) do not adjust automatically, however.

Noted Noted

(p) **Note** that if the rate of GST is to increase on 1 October 2010, there would be potentially significant fiscal and administration costs of bringing forward support to beneficiaries, superannuitants and Working for Families recipients to this date in order to provide immediate relief.

Noted Noted

(q) **Agree** there is a preference that if the rate of GST is to increase on 1 October 2010, immediate support for certain groups should also be given, for example by bringing forward the date that benefits and transfers increase to 1 October 2010.

Agreed/Not Agreed Agreed/Not Agreed

(r) **Note** if Ministers agree that any increase in GST on 1 October be accompanied by immediate support, officials will report back separately to Ministers with further detailed advice on this issue by Monday 1 March.

Noted Noted

(s) **Note** that officials will advise on variations to the preference in recommendation (p) above if necessary to form a broadly revenue neutral tax package.

Noted Noted

Tax credits

(t) **Agree** that, if reductions to personal taxes are agreed, the transitional circumstances tax credit be removed.

Agreed/Not Agreed Agreed/Not Agreed

(u) **Note** that when the independent earner tax credit was originally considered, it was estimated that its fiscal cost would be approximately $275 million per year.

Noted Noted

(v) **Agree** that the removal of the independent earner tax credit not be considered as part of the final tax package.

Agreed/Not Agreed Agreed/Not Agreed

(w) **Note** that if Ministers do not agree with recommendation (v), officials will report back separately with further detailed advice on this issue.

Noted Noted

Consequential changes required

(x) **Agree** in principle for the tax package announced on Budget night to include, depending on the final measures chosen, various consequential amendments to the Income Tax Act, the Goods and Services Tax Act, and the Tax Administration Act as a result of any changes in personal tax or GST rates (as noted in appendix 1of this report).

Agreed/Not Agreed Agreed/Not Agreed

(y) **Note** that any changes in personal tax or GST rates will have significant administration implications for Inland Revenue and other parties, in particular in respect of communications with taxpayers about the changes (especially regarding any change in GST).

Noted Noted

Bill Moran
for Secretary to the Treasury

David Carrigan
Policy Manager, Policy
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Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. Following the final report of the final report of the Victoria University Tax Working Group (TWG), Ministers are considering a range of initiatives that could form part of a tax reform package for Budget 2010 (Cabinet minute (10) 3/2 refers).

2. You have asked officials to report to you on a number of the initiatives that could form part of a tax reform package. This report considers:

- reducing the top personal tax rate;
- reducing the other lower personal tax rates;
- increasing the GST rate in order to fund reducing personal tax rates;
- potential implementation dates;
- support for certain groups for increasing the GST rate;
- potential packages for inclusion in a tax reform package for Budget 2010; and
- other issues (further policy issues, consequential changes, administrative implications and costs, legislative process and consultation).

3. Whilst we have outlined the integrity, growth, efficiency and competitiveness effects of reducing personal tax rates and increasing GST, the overall effects (including distributional effects) of any broader tax package will also need to be considered once the tax package is finalised.

4. In order to have a tax reform package for Budget 2010 that is broadly revenue neutral (consistent with the Government's fiscal strategy), measures with a revenue-positive input will also be required. These other measures will be considered in subsequent reports to Ministers during the lead up to Budget 2010 or, in the case of a potential rise in the GST rate, elsewhere in this report.

Reducing the top personal tax rate

Background

5. Personal income tax in New Zealand is currently levied using a progressive rate structure from 12.5% up to 38%. Personal income taxes raised $28.5 billion in 2009, 53% of the total tax take.

6. The current rates and thresholds are as follows:

Income bracket	Tax rate
$0–$14,000	12.5%
$14,001–$48,000	21%
$48,001–$70,000	33%
Over $70,001	38%

7. The Working for Families programme, where monetary benefits are abated as income rises, can lead to higher effective marginal tax rates, in particular at middle income levels.

8. This section of the report outlines the issues relevant to reducing the top personal tax rate.

Issues when considering the case for reducing the top personal tax rate of 38%

Growth and efficiency

9. International evidence suggests that personal taxes tend to be the most harmful to growth.[1] They may be particularly harmful in New Zealand because of our highly mobile labour force (discussed further below).

10. The TWG noted that a major efficiency concern with the current structure of the New Zealand tax system is the impact that personal taxes have on productivity and GDP growth. The New Zealand tax take from personal income taxes as a percentage of GDP is high relative to comparable OECD countries. It is, however, worth recognising that New Zealand does not have payroll or social policy taxes that exist in some other countries. These taxes affect labour supply decisions in ways which are similar to personal income taxes.

11. New Zealand's top personal tax rate of 38% is not especially high by OECD standards. Nevertheless, the TWG noted that this top personal tax rate gives rise to adverse efficiency costs because it distorts people's behaviour compared to their preferred choices when there is no tax – namely, by influencing the number of hours worked, decisions on whether to undertake jobs, methods of savings, and choices over investment and tax avoidance.

12. High personal average and marginal tax rates are likely to affect decisions on how long and how productively people work. They may also affect the level of private savings through their effects on after-tax returns. Because not all forms of saving are taxed neutrally (e.g. equity investment in owner-occupied housing is tax favoured), reductions in tax rates are likely to reduce savings biases through reducing tax distortions.

13. Tax progressivity can reduce incentives for individuals to invest in human capital (i.e. develop skills). The OECD has indicated that there are sizeable adverse effects of progressive income tax scales which go over and above the effects on human capital accumulation. The OECD also reports top marginal tax rates tend to have a negative relationship with the level of total factor productivity in an economy, perhaps through discouraging entrepreneurship.[2] This effect may be mitigated in New Zealand at present because of the ease with which higher wealth individuals can shelter income in trusts. But this clearly raises integrity and fairness concerns.

14. Taxpayers are using trusts, companies and other savings vehicles to shelter income from higher personal tax rates. As a result investment may be diverted into more costly entities which can adversely impact on productivity and growth.

[1] Johansson, A., Heady, C., Arnold, J., Brys, B., Vartia, L. (2008), *Taxes and Economic Growth*, OECD Working Paper 620.
[2] Johansson et al (2008), op cit.

15. Reducing personal income tax rates, in conjunction with other base broadening measures, would enhance the broad-base low-rate tax framework in New Zealand and is, in officials' view, an important part of any tax reform package that seeks to shift the current tax system away from bases that are considered more damaging to efficiency and growth.

Global competitiveness

16. New Zealand has a highly mobile and sought after labour force that can migrate to Australia (in particular) with relative ease. As well as affecting decisions on work participation within New Zealand, high personal tax rates can also affect the decision of taxpayers, in particular highly skilled workers, to stay in New Zealand or work abroad.

17. By one estimate, around 17% of skilled New Zealanders now live abroad, the third highest percentage in the OECD after Ireland and Luxembourg.[3] Any further deterioration in emigration levels may cause problems for New Zealand in maintaining its tax base, enhancing its skills and knowledge bases (and therefore its productivity potential), and more generally, maintaining or improving our living standards.

18. The TWG noted that if we compare our tax rates with those of Australia, our tax rates tend to be high at lower incomes rather than at higher incomes. But a reason for being particularly concerned about higher marginal tax rates is that it is the highest skilled individuals who tend to be the most mobile. Reducing higher marginal tax rates would increase the incentives for highly skilled New Zealanders to remain in New Zealand and for highly skilled non-residents to move to New Zealand.

19. Not only is this likely to have a direct positive effect on productivity and growth, it is also likely to increase the sustainability of the tax system given the high proportion of taxes paid by those on higher incomes. The top decile of households pay 46 percent of gross tax or 76 percent of net tax after Working for Families, New Zealand Superannuation and other transfers.

Integrity

20. A key policy consideration is the relationship between the top personal tax rate, the rate of tax applying to trustee income, the company tax rate, and the top rate applying to portfolio investment entities (PIEs). This issue is considered in detail in the policy report entitled *'Tax system integrity and the alignment of tax rates'* (T2010/119; PAD2010/7). Issues in respect of the PIE rate will be further considered in a subsequent policy report.

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[3] *A profile of immigrant populations in the 21st Century*: Data from OECD countries, OECD, 2008.

21. In its report, the TWG concluded that "The company, top personal and trust tax rates should be aligned to improve the system's integrity. If at any time this is no longer feasible due, for example, to global pressure causing the company tax rate to reduce, at the very least the trustee rate, top personal tax rate and top rate for portfolio investment entities and other widely held savings vehicles need to be aligned, accompanied by the introduction of suitable fiscal integrity measures."

22. The TWG report is a useful starting point for considering a reduction of the top personal tax rate and the desirability of aligning it with the rate of tax applying to trustee income.

23. A key concern with the current tax system is that taxpayers are able to structure their affairs to avoid higher statutory or effective marginal tax rates on personal income, creating integrity, efficiency and equity concerns. This can arise from:

- the differences between the top personal rate and the rate of tax applying to undistributed income of a trust (trustee income);
- the differences between the top personal rate and the company rate; and
- the taxable income measure used for Working for Families purposes (discussion of this issue will be included in a future report to Ministers).

24. This non-alignment of tax rates can give rise to two types of benefit – deferral benefits and permanent benefits:

- Deferral benefits generally arise from the difference between the company tax rate (30%) and the top personal tax rate (38%). These benefits arise from the time company income is generated until dividends from that income are paid out of company income.
- Permanent benefits generally arise from the difference between the rate of tax applying to trustee income (33%) and the top personal tax rate (38%). This is also an issue with the top PIE rate of 30%, and will be considered in a subsequent report. Permanent benefits arise because the taxes on trustee income and PIEs are final taxes.

25. There is strong evidence to suggest that taxpayers who would otherwise be facing the top personal tax rate are using trusts, companies and other savings vehicles to shelter income from higher personal tax rates, thus avoiding the full application of the intended progressivity of the tax system and undermining its integrity and efficiency. This raises concerns about the fairness of some taxpayers escaping higher personal tax rates and others, such as salary and wage earners, being unable to do so.

26. Officials consider that it is the permanent benefits being offered by the non-alignment of the tax rate applying to trustee income and the top personal tax rate that is causing most integrity pressure, and that this should therefore be a focus of any tax rate changes. This would suggest either returning the top personal tax rate to 33%, or alternatively increasing the tax rate applying to trustee income so that the top personal tax rate is aligned with that rate.

By how much could the top personal tax rate be reduced?

27. The extent of any decrease in the top personal rate needs to be considered in the context of the rates of tax that are to apply to trustee income, companies and PIEs. The costs associated with any given rate will be crucial in determining the feasibility of alignment.

28. Aligning the top personal tax rate with the existing rate applying to trustee income would result in a reduction in the top personal tax rate from 38% to 33%. This is officials' preferred recommendation, and the rate we have assumed for the following initial estimation of revenue impacts. While this would not involve as extensive cuts to the top personal rate as would be consistent with the government's 30%, 30%, 30% medium term objective, it would substantially reduce current integrity concerns. It would also be consistent with enhancing growth and productivity.

29. Alternatively, it would be possible to increase the tax rate applying to trustee income and aligning the top personal tax rate with that new rate. A disadvantage of aligning the rates at a point above 33% is that an increase in the rate applying to trustee income would negatively affect existing trusts that do not immediately distribute a large proportion of their income to beneficiaries of the trust. Significantly, it would also widen the existing gap between the rate applying to trustee income and the company tax rate (as well as the top PIE rate), running contrary to greater rate alignment between tax types (this would be further exacerbated if international pressures create the need for New Zealand to cut its company tax rate). To the extent that pushing up the trustee rate reduces incentives to save and discourages entrepreneurship, it could also have a negative impact on productivity and growth.

Revenue impact

30. The estimated impact on the operating balance from decreasing the top personal tax rate to 33% is as follows:

$ million	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Personal tax	0	-470	-775	-910	-1,005
FBT[4]	0	-30	-65	-65	-70
Net	**0**	**-500**	**-840**	**-975**	**-1,075**

31. These figures exclude any effect from clawback – where higher spending as a result of tax cuts flows through to other tax revenues (largely GST). To the extent that personal tax cuts are funded through other tax types (e.g. property tax changes) that affect people's disposable incomes, only the net effect will result in clawback. Assuming no change in the GST or company tax rates, this clawback factor is estimated at 15.5% (i.e. the net cost reduces by that amount). If coupled with an increase in the GST rate to 15%, this clawback factor becomes 17.3%.

[4] The Fringe Benefit Tax (FBT) revenue reduction occurs as a consequential impact to the personal tax rate reduction.

Reducing the other lower personal tax rates

32. In addition to decreasing the top personal tax rate, cuts to the lower personal tax rates could be introduced to ensure that lower income earners also benefit from a tax rate cut. Many of the growth and efficiency arguments outlined above for reducing the top personal tax rates would also apply to any reductions in the other lower personal tax rates.

33. Reducing the top personal tax rate in isolation would result in a less progressive personal tax rate structure. However, by reducing the lower personal tax rates as well, so that the tax cuts are across the board, a more progressive new tax system would be created that would be fairer for more taxpayers.

34. It should be noted that it can be fiscally costly to reduce lower personal tax rate cuts because, within the current tax structure, any reductions would benefit high income earners as well as the lower income earners that they are targeted at.

By how much could the lower personal tax rates be reduced?

35. The extent of any decrease in the lower personal rates would depend to a very large extent by the degree to which assistance is to be given, where it is to be targeted, and the associated costs.

36. Adjusting the threshold levels at which any rate changes apply could also be considered. However, we note that, from an administrative standpoint, it is much simpler to keep existing thresholds. Moreover, the integrity concerns that have arisen with the nonalignment of the trustee and top personal marginal tax rate would not be addressed effectively through threshold changes.

Revenue impact

37. In order to make significant reductions to lower personal tax rates within a broadly neutral tax reform package it will be necessary to also consider other measures that have a significant revenue-positive input.

38. Of the available options that are feasible for inclusion in Budget 2010, increasing the GST rate (as considered by the TWG) is the only one that is likely to be able to provide the significant revenue required to fund widespread reductions in income tax rates.

39. The following figures give rough estimates[5] for the cost in 2011/12 of decreasing each personal tax rate by 1%:

Income bracket	Cost of 1% change ($m)
$0–$14,000 (current rate 12.5%)	400
$14,001–$48,000 (current rate 21%)	510
$48,001–$70,000 (current rate 33%)	140
Over $70,001 (current rate 38%)	170

Increasing the GST rate

Background

40. As we have noted, a change to the rate of GST could be considered as part of a broader package of tax reform. Therefore, any increase in the rate should be seen as a revenue-positive input that is available for inclusion if changes to other areas of the tax system are desired. Consequently, while it is important to identify the efficiency and equity effects of raising the GST rate, they are only one component of the growth, efficiency and equity effects of the overall package.

Role of GST

41. GST is predominantly a tax on domestic, final consumption. The legal incidence of GST is designed to fall on domestic consumers and non-resident visitors to New Zealand. The tax is not designed to fall on businesses or non-resident consumers. This is achieved by allowing businesses a deduction for any GST that they have paid in producing their goods or services, and by zero-rating exports of goods and services.

Issues when considering the case for increasing the GST rate

Growth and efficiency

42. The TWG noted that using GST to fund cuts to personal tax rates is likely to have benefits from a growth and efficiency perspective. A number of studies have found that a GST tends to be less harmful to growth than company and personal income taxes.[6] In New Zealand, a shift in the direction of GST is likely to be particularly efficient because of our broad GST base and limited exemptions. This is likely to limit distortions to consumption choices. Our GST also has a low cost of collection and has a relatively low level of non-compliance. This is likely to make GST a particularly efficient tax in New Zealand.

[5] Excludes interaction with NZS and benefits, and consequential impacts on other tax types.
[6] See, for example, Johansson et al (2008), op cit.

43. Both a GST and an income tax will affect labour supply decisions through affecting the amount of goods and services that can be purchased by an individual in recompense for an additional hour of work. However income taxes can be particularly distorting through their effects on savings decisions (i.e., how much is saved and how savings takes place). By encouraging savings, a switch towards GST can boost GNP and support a more sustainable longer term tax base.

44. To the extent that GST is paid by overseas visitors (estimated at 5% of private sector GST revenues) a switch towards GST allows more revenue to be raised from non-residents than through the income tax system provided, of course, it does not change visitors' decisions about coming to New Zealand or unduly influence the amount that they spend while here.

45. Increasing the GST rate would provide scope for funding at least a part of the tax reform without significantly changing existing frameworks for administration and compliance.

Equity implications

46. The TWG noted that these efficiency and administrative advantages need to be considered alongside the impact on equity and fairness.

47. A common concern raised with increases to GST is that those on lower incomes on average pay a higher percentage of their disposable income in GST than higher income households – in other words that GST is regressive. Analysis of the Household Economic Survey (HES) expenditure data from 2006-07, for example, shows that lower income households pay on average a higher amount of GST as a proportion of annual income than higher income deciles.[7]

48. However, as the TWG noted, the impact of this difference should not be overstated. Economic literature suggests that the percentage of disposable income paid in GST is largely accounted for by the difference in savings and dis-savings across income levels. Many of these differences arise from different spending and savings habits over the life cycle of an individual. A young couple, for example, may spend more than they earn by borrowing and then gradually move into a net savings position over time and run down those savings in retirement. Given that people spend income over time and will tend to base their current spending decisions on not only their current income but also their expected life-time income, lifetime income may be a better measure of ability to pay. Moreover, actual spending may be a better proxy for lifetime income than annual income. In this context, GST as a proportion of expenditure is found to be roughly proportional across all income levels over time rather than being regressive. Analysis of the HES data confirms this to be the case in New Zealand too.

[7] However, higher income decile households pay more GST in absolute terms with around a third of GST being paid by the top two deciles.

49. Nevertheless, even if the impact of GST is less regressive, or flat, on a lifetime basis, it still may pose real difficulties for households at a point in their lifecycle where GST payments are high. Based on past experience, this could prove controversial with particular groups. As noted above, assuming that a GST increase would be part of an overall package, the overall equity effects of the package and the degree to which it provided adequate support for such factors, would need to be considered.

50. However, the effect of an increase in GST on the progressivity of the tax system is complex. Raising the rate of GST increases the tax on existing wealth because past accumulated savings would now face a higher tax rate when spent. As wealth is highly concentrated, this effect generally increases the progressivity of the tax system. At the same time, this can hit older age groups who have accumulated savings from past income but now have limited income-earning ability.

51. An increase in GST must also be analysed in combination with the offsetting changes to the personal income tax rate. It should also be noted that the GST increase can improve fairness by raising taxes on higher income individuals who are currently avoiding the top personal tax rate.

52. If the top marginal tax rate is to be reduced to 33 percent to align it with the trustee tax rate concerns will be raised that income tax cuts will tend to be targeted at those who are better off.

53. However, it should be noted that many higher income individuals are currently escaping the top marginal tax rate through sheltering their income in trusts and other entities. The tax cut would not benefit these individuals, and an increase in the rate of GST provides additional tax on them. For these individuals, the combined package therefore increases their taxes paid. The increased GST on such taxpayers helps to finance cuts in lower marginal tax rates, and so provides a way of supporting the progressivity of the tax system while restoring integrity.

Macroeconomic effects

54. Both the introduction of GST in 1986, and the 1989 rate increase, produced one-off price level increases.[8] Increasing the GST rate by 2.5%, to 15%, could increase the Consumers Price Index (CPI) by up to 2.22% (115%/112.5% - 1 = 2.22%) if the price of all goods were impacted, including those not directly subjected to GST,[9] and services were subject to GST and there is full pass-through to consumers of the higher tax. By comparison, Statistics New Zealand (SNZ) recently estimated that increasing the GST rate to 15% would increase the CPI by 2%. The SNZ estimate assumes no change to the price of items not subject to GST (primarily financial services and residential rents), showing that changing this assumption makes about 0.2% to the estimated movement in overall prices (SNZ assume that retailers would pass through the full effect of the tax increase to prices on items subject to GST).

[8] Prior to the introduction of GST in 1986, retail sales increased 8% in the quarter preceding the introduction; and dropped 13% in the following quarter. The introduction of GST was seen to boost the price level, with an impact of between 5.7% and 7%. In 1989, the impact of the 2.5% increase in GST was estimated to have resulted in a one-off increase in the price level of 2.3%.

[9] There may be flow on effects to the prices of goods and services not subject to GST. For example, prices of some financial services, even though not subject to GST, could be impacted as financial institutions would face higher input costs.

55. Price increases may be less than these estimates if retailers absorb some of the GST increase in their margins. The 2.22% estimate is consistent with the experience in 1989 where the estimated[10] impact of the increase in GST from 10% to 12.5% was a one-off inflationary increase of 2.3%. Therefore in its distributional analysis of tax packages Treasury assumes increasing GST from 12.5% to 15% would have a one-off price effect of 2.22%. Though actual price movements cannot be predicted with precision, this estimate is more likely to be too high than too low, so using 2.22% to calculate compensating tax and transfer payment changes is more likely to slightly over-compensate than under-compensate affected groups.

56. Past experience also indicates that households' expenditure on durable goods was brought forward. For the 1989 increase, for example, expenditure on durable goods in the quarter immediately prior to the increase was around 10% higher than would normally have been expected, but then quickly adjusted downwards in the following quarter, and resumed its long-term trend thereafter.

57. Since it is envisaged that the additional GST revenue is being raised to fund wider tax cuts (as in 1986 when GST was introduced), and would therefore represent a change in the tax mix, the impact on GDP is dependent on the overall package rather than any individual component. The effect on GDP is also dependent on the ability and willingness of consumers to advance expenditures prior to the date of the GST increase (this may not be readily achievable if there are credit constraints). The combined package of GST and income tax changes will likely result in stronger overall activity in the long run, a lower share of consumption, increased savings, and a more balanced economy.

By how much should the rate be increased?

58. The extent of any increase in the GST rate is governed by how much additional revenue is required and the costs associated with addressing the equity and integrity concerns for any given rate.

59. The TWG specifically used the rate of 15%, which would mean a moderate 2.5% increase. The Prime Minister's recent statement to Parliament also referred to the Government considering a modest increase in the rate of GST, to no more than 15%. We have therefore used that rate in this report.

60. Apart from the equity issues discussed above which we have assumed will be addressed as part of the final package, an increase in the GST may have implications for revenue integrity. A higher GST rate could increase incentives to avoid GST through switching away from goods subject to GST. It would also increase risks with respect to GST refunds and fraud. These risks are discussed more fully below. However, in the event of a moderate rise in the GST rate, these risks are considered to be manageable.

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[10] Subsequently estimated by academics.

Revenue impact

61. GST is paid by both the private and public sector. Given that the GST paid by public sector organisations is funded as part of Budget baselines, this has been excluded from any consideration about revenue gains. Within the private sector, GST is paid by businesses (who, if registered, are refunded for the input costs), domestic consumers, and non-residents who consume in New Zealand. Currently, around $12 billion in net GST is collected per annum from the private sector.

62. The additional revenue from increasing the rate to 15% is estimated to be the following, provided there is no behavioural change on the part of consumers:[11]

$ million	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
GST revenue	0	1,795	2,515	2,635	2,740

63. Note, however, some behavioural change is likely, which would reduce the additional revenue. Behavioural change could include a substitution toward non-GST expenditure, a decrease in total expenditure, or an increase in avoidance behaviour.

64. Officials do not anticipate significant substitution towards non-GST expenditure given the broad-base nature of GST and the fact that non-GST items such as financial services are not generally readily substitutable. There may, however, be some reduction in or switching of expenditure depending on how sensitive demand is to the price of individual goods or services. In addition there would be an increased incentive to obtain goods outside of New Zealand.

65. We do not anticipate a material increase in avoidance behaviour. We note, however, that a risk for most GST/VAT systems is that of phoenix-type fraud under which the purchasing entity will claim a refund from a transaction but the supplier fails to make the corresponding GST payment. While an increased rate could to some degree exacerbate this issue, the government discussion document released in November 2009, *GST: Accounting for Land and other High Value Assets* contains possible measures to address this concern.

66. The overall composition of the tax package will have an impact on aggregate expenditure – tax cuts and any support should, however, provide a counter stimulus.

[11] These estimates do not take the cost of any support into account.

Other GST issues

Altering the GST base

67. The TWG considered whether support could be provided through exempting certain basic necessities from GST. Narrowing the GST base would, however, substantially reduce the efficiency of the tax and increase compliance and administration costs, while having limited impact on equality. It would also have a large fiscal cost. The TWG considered that GST should continue to have a broad base and that no exemptions should be given.

68. For example, removing food from the base makes almost no difference to the distribution of the tax across income levels, but loses 20% of GST revenue. This fall in revenue would then need to be recovered by higher rates of GST, or by increasing other taxes. Also, in addition to the obvious ongoing compliance and administration costs of removing GST from food, the government would need to decide what foods were meritorious of exemption given that there would be many differing views on this. Based on experiences in other jurisdictions this is undesirable.

69. The TWG also considered the feasibility of extending the GST base by applying GST to financial services and to imputed rents of owner-occupiers and to housing rents more generally.

70. While, in principle, there are good reasons for bringing financial services more fully into the GST base, this would require identifying the margins charged by financial intermediaries which has proved to be an intractable problem not only for New Zealand, but internationally.

71. With respect to buildings, the choice is between taxing the building stock at the time it is constructed (and subsequently altered) or on the flow of rents that it produces. Irrespective of which approach is used, the effective overall revenue should be broadly the same except that a GST levied on rents would be a tax on both land and buildings whereas a tax on new construction is a tax on buildings only. Charging GST on the imputed rents of owner-occupiers is considered not to be practical. Doing so would involve significant valuation and cashflow issues that would need to be addressed and the registration of all owner-occupiers would present formidable administration and compliance costs. Further, this would also require consideration of bringing rental housing into the GST base. Accordingly, New Zealand has chosen to tax the building stock on simplicity grounds and we do not propose to change that approach.

Potential implementation dates

72. Personal tax cuts could be provided to salary and wage earners and superannuitants from 1 October 2010. Other taxpayers would receive their tax cut after filing their tax return at the end of their 2010/11 income year. While these timeframes are tight, officials believe they are achievable given past experience. Similarly, officials consider that a GST rate increase could also be implemented as early as 1 October 2010.

73. The impact on pre-invoicing and consumption patterns arising from an increase in GST would be reduced if the time span between the announcement and introduction date were kept to a minimum. However, some pre-announcement seems desirable to give taxpayers time to make systems changes and re-price their goods and services. An announcement in May and implementation on 1 October 2010 should provide adequate time for this.

Options available for implementation dates

74. There are three main options available to Ministers in considering when any reduction in personal taxes and any increase in the GST rate could be implemented:

- all personal tax and GST rate changes included in a tax reform package could be implemented on 1 October 2010; or
- all personal tax and GST rate changes included in a tax reform package could be implemented on 1 April 2011; or
- a range of implementation dates could apply depending on the measure involved (that is, some rates could be implemented on 1 October 2010 whilst others are implemented on 1 April 2011).

75. We note that if a GST rate increase is made on 1 October 2010, there may be further support issues to consider for certain groups.

Support for certain groups for increasing the GST rate

76. For most taxpayers, reducing the lower personal tax rates will, depending on circumstances and the make up of the final tax package, likely more than counter any negative effects from increased prices to goods and services as a result of an increase in GST.

77. There are, however, specific issues that arise in providing immediate support to certain groups who could be particularly affected by an increase in GST.

Support for particular groups

78. The TWG recommended that any equity concerns associated with increasing the rate of GST be addressed through the existing mechanisms in place to support lower income earners, superannuitants and beneficiaries, and those who may not receive the benefit of any tax changes.

79. There are a number of automatic mechanisms that adjust existing benefits, superannuation, and Working for Families (WfF) payments for price changes (see Table 1). Most benefits and transfers are indexed for inflation annually on 1 April (or alternatively when a CPI threshold is breached in the case of the Family Tax Credit) for changes in prices, and will therefore increase automatically as a result of an increase in GST. There are questions, however, about the extent to which this mechanism provides adequate support to cover cost increases, and whether it is timely enough. In addition, a few benefits (for example, the accommodation supplement and some hardship assistances), do not adjust automatically.

Table 1:
High-level summary of adjustments of benefits and other financial assistance for changes in prices

Type of benefit	Main rate	Income limits	Abatement Thresholds	Legislated
Annual adjustment to main rate (1April)				
Main benefits (includes unemployment benefits, invalids benefits, DPB, Widows benefit)	CPI Adjusted	N/A	Not adjusted	No*
Student Allowances	CPI Adjusted	N/A	CPI	No*
Orphans benefit, unsupported child's benefit and foster care allowance board rate	CPI Adjusted	N/A	N/A	No*
Disability assistance (disability allowance, blind subsidy, special disability allowance, child disability allowance)	CPI Adjusted	CPI adjusted, where relevant	N/A	No
Childcare assistance (including Child Care Subsidy; out of school care subsidy)	CPI Adjusted	When cumulative CPI reaches 5%	N/A	Income limits only**
Assistance into work/training	Mixed – some assistance CPI adjusted, some not	Where applicable, usually CPI adjusted	N/A	No
War Pensions	CPI adjusted	N/A	N/A	No
NZS	CPI adjusted, within 66% to 72.5% average wage	N/A	N/A	Yes
Adjustment to main rate when threshold is reached				
Family Tax Credit (Working For Families)	CPI adjusted when cumulative CPI increase of 5%	N/A	CPI adjusted when cumulative CPI increase of 5%	Yes

Type of benefit	Main rate	Income limits	Abatement Thresholds	Legislated
No adjustment to main rate				
In-Work tax credit (working for families)	Subject to periodic statutory review	N/A	No automatic increase. Annual review required	Yes
Parental Tax Credit (working for families)	Subject to periodic statutory review	N/A	No automatic increase. Annual review required	Yes
Accommodation supplement	No adjustment to maximum rates. Payment rates reduce when benefit or FTC rates increase.	Formula for non-beneficiaries	Flow-on for non-beneficiaries	No
Accommodation benefit	No adjustment to maximum rates	Eligibility based on student allowance receipt	N/A	No
Participation Allowance, Transition to Work Grant	No	CPI Adjusted	No	No
Hardship assistance	Mixture of non-adjustment, flow on, and some that are adjusted	Where applicable, CPI adjusted	N/A	No

**Under Future Focus proposals, this assistance will be subject to legislated CPI adjustment from 1 April 2011.*
*** The Future Focus proposes to remove legislation and adjustment of CCA income thresholds.*

80. Depending on the timing of a GST increase, these adjustments may not be immediate, which could cause hardship to some lower-income households. In particular, adjustments to reflect the price impact of a 1 October 2010 GST increase would not occur until at least 1 April 2011 (and possibly not until April 2012 in the case of the Family Tax Credit).

81. Therefore, if an increase is made to the rate of GST on 1 October 2010, the appropriate support given in such circumstances must be considered. There are a number of options in this regard:

- let the automatic update mechanisms apply from 1 April 2011 (or possibly only bring forward indexation of the Family Tax Credit to 1 April 2011); or
- provide immediate support from 1 October 2010; or
- provide immediate support only for recipients not otherwise fully compensated by personal income tax reductions.

82. A key consideration in the development of any support package is the extent to which it is acceptable to have any individuals who receive less total income after the provision of support, and whether it is acceptable to have individuals who do not receive the full value of the support. In addition, consideration will need to be given to the flow-on effects that occur within the tax and benefit system, for example the impact that adjustments to main benefits have on second-tier benefits. Given the complex inter-relationships that exist within the system, officials need time to analyse who the potential losers will be as a result of different tax packages, in order to advise the Government on a suitable support package.

83. Officials will report back to Ministers with further detailed advice on a support package, by Monday 1 March, should Ministers agree to a GST increase from 1 October 2010.

84. It should also be noted that, at this stage, it is proposed that key parts of the "Future Focus" package would be implemented from 4 October 2010, with legislation in the House from March 2010. Included in the package is a proposal to legislate for CPI adjustments of main benefits. Further advice about the interactions between Future Focus and any tax package will also be provided in the report on 1 March.

Potential package for inclusion in a tax reform package for Budget 2010

85. The degree and nature of personal tax reductions will critically depend on the final shape of a Budget tax package within the revenue-neutral constraint. While there are many permutations that could be considered, we have briefly analysed the scenario below as an initial starting point. This scenario involves reductions in all personal income tax rates (including alignment of the trustee and top personal tax rates) and an increase in the GST rate (with immediate compensation) from 1 October 2010. Any changes required to thresholds could be modelled at a later time.

Income bracket	Existing tax rate	Potential new tax rate
\$0–\$14,000	12.5%	10.5%
\$14,001–\$48,000	21%	17.5%
\$48,001–\$70,000	33%	30%
Over \$70,001	38%	33%
GST	12.5%	15%

86. It is assumed that compensation for superannuitants, beneficiaries and Working for Families recipients occurs immediately (from 1 October 2010) for the estimated 2.22% inflation impact.

87. The estimated fiscal cost of this package of rate changes is as follows:

$ million	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Personal tax	0	-2,435	-3,645	-3,980	-4,180
Gross NZS	0	-130	-175	-185	-190
Gross Benefits	0	0	0	5	5
WFF	0	-50	-70	-75	-70
ESCT	0	-40	-75	-75	-80
FBT	0	-40	-85	-85	-90
GST	0	1,795	2,515	2,635	2,740
Net	**0**	**-900**	**-1,535**	**-1,760**	**-1,865**

88. These figures take account of the additional expenses on New Zealand Superannuation, core benefits, and Working for Families tax credits.[12] The cost of consequential impacts on Fringe Benefit Tax (FBT) and Employer Superannuation Contribution Tax revenues are also included.[13]

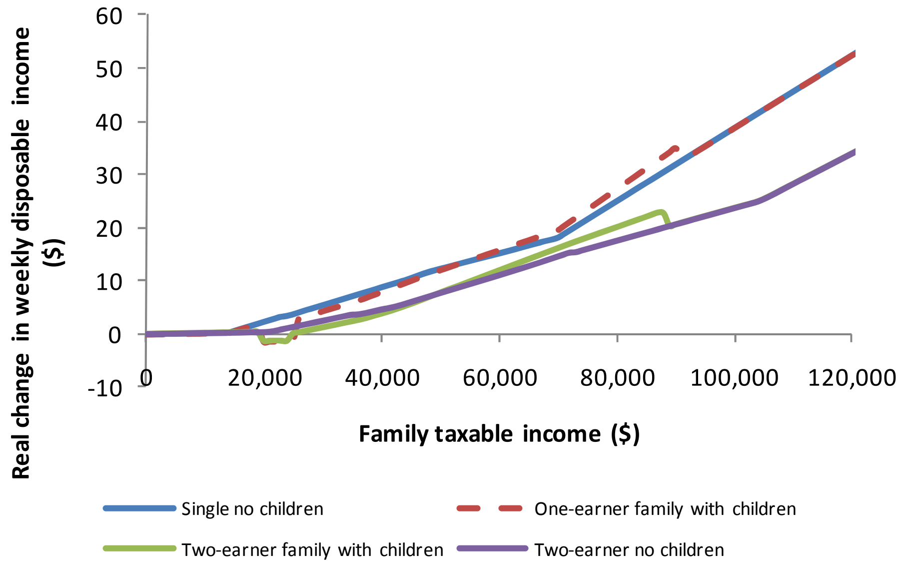
89. Without a GST increase, the cost would reduce by the following (since NZS and benefit expenses would not be affected by a price shock):

$ million	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Compensation	0	205	265	265	260

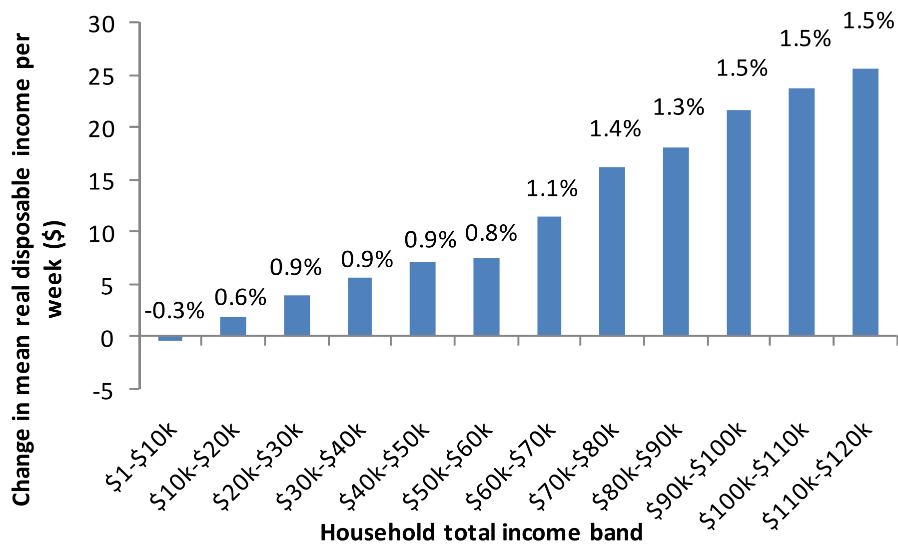
90. Further advice on these effects, other flow-on implications to welfare assistance (e.g. student allowance, accommodation supplement) and potential additional compensation mechanisms for particular vulnerable groups will be provided in a subsequent paper.

91. A high-level analysis of the equity implications of the above income tax/GST switch is shown below. The first graph is a mechanical calculation of the real change in disposable income on 1 October 2010 as a result of the income tax and GST change for three family types.[14] In this calculation, disposable income is given by taxable income less income tax less ACC earner levy plus WFF tax credits and the Independent Earner Tax Credit (IETC).

[12] As modelled using Treasury's Taxwell model – impacts on NZS and benefit expenses may be subject to refinement after comparison with Ministry of Social Development modelling.
[13] Figures based on Inland Revenue modelling.
[14] Families with children shown have two children under the age of 13; two-earner family has earnings split 1/3-2/3 between earners.



92. The bar chart below shows distributional analysis using Treasury's Taxwell micro-simulation model. The model uses Household Economic Survey (HES) data.[15] In contrast to the line chart above, the chart shows the change in households' disposable income,[16] across *total* income bands (as opposed to *taxable* income bands).



[15] Data from HES 2007/08 survey.
[16] No adjustment has been made for household sizes.

93. The percentage figures on these charts indicate the % change in real disposable income. It is apparent that the mean disposable income changes are lower in the bar chart than the line chart above. This results from a combination of effects:

- Households can be a mixture of families with and without children and of varying size.
- Total income bands include non-taxable income (e.g. private pensions).

94. The income tax reductions and compensation measures in this scenario are more than sufficient to offset the effect of the GST increase across nearly all income bands. The chart shows a slight reduction (33c per week) in mean real disposable income for households on less than $10,000 income – this can result from the likes of non-taxable income which obviously does not benefit from an income tax cut.

95. For specific individuals/households, the actual effect of a GST/income tax switch will be sensitive to actual price increases to non-GST and GST consumables, and the spending patterns of the particular unit. For the purpose of estimating impacts on disposable income, the analysis assumes that all disposable income is spent (since the real consumption value of any income saved falls similarly in value). In the analysis shown, the impact of income tax and GST changes are averaged over $10,000 income bands. Our analysis of expenditure patterns across these bands (using HES 06/07 data) indicates wide variances in the ratio of GST to total expenditure within each income band and little discernable change between income bands.

96. The extent to which various groups, particularly those on low-incomes, need to be compensated for a rise in GST depends on circumstances. For example, a low-income individual may be in a high-income family, who will gain from tax reductions in the upper tax rates. An analysis of individuals with taxable incomes less than $14,000 is provided in Appendix 2. Advice on the impact of tax changes on specific vulnerable groups will follow in a subsequent paper.

Other issues

Further policy issues

97. There are specific tax credits within the current tax system that Ministers may want to review as part of a tax package that includes across the board reductions in personal tax rates. In particular, changes to or removal of the transitional circumstances tax credit and the independent earner tax credit may be justified as part of the final tax package.

Transitional circumstances tax credit

98. The transitional circumstances tax credit is available to a full-time earner (a person engaging in at least 20 hours' of remunerative work per week) who does not have dependent children. The full year's maximum credit is $728. This abates at a rate of 20 cents for each dollar of net income in excess of $6,240. The credit therefore terminates when income reaches $9,880.

99. This credit was introduced in October 1986, at the same time as the introduction of GST in New Zealand, in order to compensate full time low wage taxpayers for the extra tax payable as a result of the introduction of GST.

100. Non indexation of its abatement threshold has, over time, meant that the credit's application no longer reflects its original policy intention – it no longer applies to the full time low wage taxpayers it was designed for. To illustrate this point, a full time taxpayer working at least 20 hours at the minimum wage for 48 weeks in the year will not qualify at all for the transitional circumstances tax credit because they would earn net income in excess of $10,000.

101. Instead, the credit is mostly claimed by taxpayers who do not work the full year. Although the quantum of the credit is apportioned when the claimant does not work the full year, taxpayers only working part of the year can still claim the credit. Examples of claimants will therefore include students who work during vacations. In excess of 41,000 taxpayers claimed nearly $8 million in transitional circumstances tax credits in 2008 (on average, $190 per claim).

102. The transitional circumstances tax credit is also a significant driver of refunds, and therefore personal tax summaries and income tax returns, which increases contacts and other administration costs for Inland Revenue.

103. Officials recommend that, if reductions are made to the lower personal tax rates, there is significant justification for removing the transitional circumstances tax credit from 1 April 2010. However, this matter could instead be reviewed at a later time.

Independent earner tax credit

104. The IETC was introduced in April 2009 and is a method whereby taxpayers earning lower incomes (those with incomes between $24,000 and $48,000) who do not receive benefits or transfers obtain targeted assistance to their income. The full year's maximum credit is $520 ($10 per week). This abates at a rate of 13 cents for each dollar of net income in excess of $44,000. The credit therefore terminates when income reaches $48,000.

105. As the IETC was only introduced in April 2009, it is not yet known how much IETC will actually be claimed. We note, however, that estimates made when the IETC was originally being considered put the fiscal cost at approximately $275 million per year (assuming full take-up).

106. As of September 2009 the uptake for IETC through the PAYE system was about 65% of eligible taxpayers (approximately 240,000 employees). It is expected that this number will increase

yet further, with many taxpayers electing to claim the credit as a lump sum at the end of the tax year.

107. The estimates of fiscal costs in this report have assumed that the IETC is to be retained. However, if across the board reductions are made to the lower personal tax rates, there may be a justification for removing the independent earner tax credit at the same time.

108. Officials note that if Ministers would like further work done on this issue as part of the final tax package, including revised distributional analysis on the effects on taxpayers of removing the IETC, officials would report back separately on this matter. Alternatively, this matter could instead be reviewed at a later time.

Consequential changes and administrative issues

109. A number of consequential amendments to the Income Tax Act, the Goods and Services Tax Act, and the Tax Administration Act will be required as a result of any changes in personal tax or GST rates.

110. An outline of the main likely changes is included in appendix 1 of this report. The final changes required will depend on the exact measures included in the final tax package.

111. Also included in appendix 1 are various administration implications and estimated associated costs to Inland Revenue.

Legislative process and consultation

112. Personal tax and GST rate changes could be enacted under urgency on Budget night. Pre-Budget consultation should not be required.

Appendix 1 – outline of consequential changes and administrative issues

A 1 October 2010 start date would require a different set of consequential changes to a 1 April 2011 start date. This appendix covers both these sets of possible changes.

The changes also have administrative implications for Inland Revenue and other parties, which differ significantly according to whether the start date is 1 October 2010 or 1 April 2011. Where applicable, this appendix highlights the administrative implications of each start date, and also outlines, where possible, high level initial estimates of the likely administration costs for Inland Revenue of any changes.

Main legislative and consequential changes

It is recommended that you agree to the following changes:

Changes as a result of personal tax rate reductions

Composite tax rates if 1 October 2010 chosen

If a 1 October 2010 start date is chosen for new personal tax rates it is recommended that composite personal tax rates be applied for the 2010/11 tax year. This is because income tax rates are applied to the entire tax year. If tax rate cuts are implemented part way through a tax year the existing annual rates need to be adjusted for the whole of that year – resulting in a composite rate for the year.

PAYE rates

The PAYE withholding rates applied by employers need to be adjusted downwards. This is the mechanism that delivers tax rate cuts to most individuals. We anticipate that the PAYE rate changes can be implemented smoothly from either 1 October 2010 or 1 April 2011. For both start dates the PAYE rates would be changed to the new proposed tax rates, rather than composite tax rates.

Resident withholding tax (RWT) on interest

Currently banks and other interest payers withhold RWT on interest that they pay to their customers. The rate that the bank applies depends on the rate that their customers elect with the bank. If an individual taxpayer elects a rate that is too low based on their income for the tax year and subsequently earns more than $200 of interest for the year, they must return the income and pay the additional tax.

Aligning the RWT rate on 1 October 2010 will be challenging for banks and other interest payers (approximately 16,000 in total), and delaying this until the start of the following income year (1 April 2011) is recommended.

Interest payers will have only just implemented recently enacted RWT changes by 1 April 2010, and there is therefore a risk that they will not be able to schedule in sufficient development time to enact a mid year change so soon after. This risk is magnified if the company tax rate does not align to one of the personal tax rates as interest payers will need to incorporate another RWT rate in their systems. It appears that some banks use the same third party contractor to update their systems, which may further limit their ability to respond by 1 October.

Therefore, if a 1 October 2010 start date is chosen for new personal tax rates we recommend that the current RWT rates on interest stay in place until 1 April 2011. This would result in banks withholding at too high a rate for the second half of the 2010/11 tax year for some individual taxpayers. This would in turn result in some additional filing from taxpayers (that would otherwise not file) in order to seek a refund.

Fringe benefit tax

Fringe benefit tax (FBT) taxes non-cash benefits provided to employees by an employer. Although the liability for FBT lies with the employer, it is economically a tax on employee remuneration and has been designed as such. Any changes to personal tax rates should therefore be reflected in changes to the main FBT rates.

Employers have the option of attributing fringe benefits to particular employees on different marginal tax rates at the end of the period. This provides a square-up mechanism to ensure that FBT paid reflects employees' marginal tax rates. It is recommended that the rates that apply for this square-up calculation should also be adjusted to reflect any reduction in tax rates. If a 1 October 2010 start date is chosen it will be necessary to use composite FBT rates for the transitional year.

Provisional tax

Changes to provisional tax rate rules for individual taxpayers could be implemented to deliver the immediate benefit of any tax cut package to self-employed individuals. Provisional tax provides a mechanism for non-salary and wage earners (e.g. sole traders) to pay their tax in instalments throughout the year with a square-up at the end of the year. People can calculate their provisional tax instalments by basing them on previous years' income tax liability plus an uplift factor.

A similar approach to reducing provisional tax instalments could also be implemented for provisional taxpayers that base their provisional tax payments on a ratio of their GST payments.

However, taxpayers already have the option to estimate their provisional tax payments downwards, which may mean an uplift change is less necessary (although there are use-of-money interest issues that need to be considered). Further, changing the uplift factor is more principled in situations in which there have been significant macroeconomic changes (such as the recent global economic and financial crisis). Finally, there may be a significant fiscal cost of providing this relief.

All these matters will be discussed further in a subsequent report discussing consequential changes that would be required as a result of any change in the company tax rate.

Child support implications

It should be noted that personal tax rate cuts will have child support implications. The living allowance (an amount of income not subject to child support obligations) for a liable parent in child support formulas is based on a gross (pre-tax) benefit. This amount will decrease to reflect the personal tax cuts, thereby increasing the amount of child support payable by the liable parent. This increase would, however, likely be more than offset by the tax cut.

Child support implications will take effect in the 2011/12 tax year if a 1 October 2010 start date is chosen, and in the 2012/13 tax year if a 1 April 2010 start date is chosen.

Māori authority tax rate (and certain other scheduler payments)

Currently the tax rate that applies to Māori authorities (and certain other scheduler payments) is 19.5%. In respect of the Māori authority tax rate, this rate was chosen as, at the time, it reflected the marginal tax rate of many of the beneficiaries of Māori authorities. Beneficiaries on higher marginal tax rates that receive Māori authority distributions must pay tax on the difference.

It is recommended that officials undertake further work to determine what the appropriate rates that apply to Māori authorities and certain other scheduler payments should be. This work will involve distributional analysis of the income levels of Māori authority beneficiaries. In the interim it is recommended that the 19.5% rate should remain unchanged.

Other consequential personal tax rate changes

The following minor mechanical changes to the Tax Acts as a consequence of a reduction in personal tax rates may also be required:

- Updating other tax thresholds and applicable rates that apply, including in respect of:
  - secondary tax codes;
  - extra pay amounts;
  - fund withdrawal tax;
  - specified superannuation contribution withholding tax (SSCWT);
  - ACC attendant care;
  - retirement scheme contribution tax (RSCT).
- Amending the child rebate to reflect any reduction in the lowest personal tax rate to preserve the rebate amount.

- Amending the transitional tax credit to preserve the amount of the credit.

Changes as a result of an increase in GST

Legislative changes

Various legislative mechanisms are already provided in the GST Act to facilitate the administration of a rate change. This means a limited number of few legislative amendments would be required. A limited number of references to the current rate would need to change.

The existing legislative mechanisms deal with GST returns that straddle the rate change-date and transactions that have occurred before that date, but on which GST has yet to be paid. They also provide the ability to modify existing agreements and contracts, and any fees and charges set by regulation, to reflect the higher tax rate, as well as such things as the treatment of the additional GST paid on any bad debts from earlier periods that are written off after the rate change.

No modifications are proposed to the standard rules in the GST Act around when a supply is recognised. Some taxpayers may try to take advantage of these standard rules – for example, by prepaying or pre-invoicing services that may actually be provided subsequent to the rate change, so that the supply is charged at the previous lower rate.[17] This issue was recognised when considering the legislative mechanisms before the 1989 rate change, but it was ultimately decided to build on the existing known time of supply rules on compliance cost grounds.

We propose following the same approach this time too. The alternative would be to have special "time of supply" rules for transactions entered into in the run up to the rate change that would directly target when goods are delivered or made available, or when a service is performed. This would require the valuation of work in progress and re-invoicing for services that spanned the rate change date to reflect any unexpired portion at that date. We consider these additional compliance costs to not be warranted, particularly given that the envisaged rate increase is relatively small and the proposed time period between its announcement and implementation is relatively short.

[17] GST is payable on the earlier of the date an invoice is issued by the supplier or the date any payment in respect of that supply is received by the supplier. The recipient of the supply may avoid the higher rate of tax by making a pre-payment or requesting an invoice to be issued before the date of change. This could result initially in less additional revenue from the rate increase.

__Administrative changes__

There are a number of administrative issues associated with a change in the rate of GST:

Managing transitional period GST returns

There are currently over 665,000 GST registered persons, most of which file either two-monthly or six-monthly GST returns. GST registered persons whose two monthly or six monthly filing period straddle the rate change date would be required to file a GST return in two parts to account for the old and new rates. As noted in the report on the implementation of the tax reform package (T2010/73; PAD2010/8 refers), officials' preference is for a 1 October implementation date as this has the least impact on these filers.[18]

Further work is currently being undertaken to determine the best approach for managing returns over the transition period with the aim of avoiding the use of data manual entry where possible.[19] However, irrespective of the approach, changes to Inland Revenue's FIRST computer system would be required in order to capture return information and validate GST calculations for the transition period. Changes would also be required to the standard returns to reflect the new GST rate.

Impact on other taxes and levies

ACC levies are set by regulation exclusive of GST. However, GST is subsequently charged on ACC earner levies collected by Inland Revenue through the PAYE system. This would mean that an increase in the rate of GST would result in a part-year change to PAYE calculation tables for employers, unless the ACC absorbs some of the tax increase and the regulations are altered accordingly. This can be managed as part of implementing changes to personal income tax rates assuming they are implemented at the same time.

A number of other taxes and other government charges would be affected by a GST rate increase and we are investigating what administrative implications this would have for departments. Returns for FBT and gaming machine duty would need to be updated. Transitional returns would also need to be devised for employers who file FBT on an annual or income year basis.

Handling of credits

Existing provisions in the GST Act require Inland Revenue to carry forward certain credits that result from a change in the rate of GST. Inland Revenue would need to make changes to its systems to identify these credits and account for them until they are used. Alternatively, making a legislative amendment to allow these credits to be refunded or offset against other tax liabilities would reduce the need to retain and account for them.

Education and communication

[18] A GST rate change from 1 October 2010 would require only around 100,000 filers to prepare split returns for the period spanning the rate change date compared with over 500,000 if the rate were increased from either 1 September 2010 or 1 November 2010. The alternative date preferred for implementing a GST rate increase would be 1 April 2011 when the impact on GST return filers is also relatively low.

[19] The alignment of GST and provisional tax adds to the complexity.

Educating taxpayers about the changes and the transition, amending information material, and responding to their enquiries, would all have significant resourcing implications for Inland Revenue. We note that the 1989 increase was accompanied by a substantial advertising and education campaign. There would also be increased audit activity in relation to the transitional period to monitor, for example, the adjustments resulting from different accounting methods and the rate increase.

Timing

Although this would be the first rate change in over 20 years, based on our recent experience with other rate changes, we consider a timeframe of four months to be feasible. A formal announcement in May and implementation on 1 October 2010 should provide adequate time for taxpayers to make systems changes.

Given Budget secrecy, we have not been able to discuss systems changes with private sector accounting software providers to verify that there would be sufficient time for them to make the changes necessary to accommodate our envisaged transitional return arrangements. Accordingly, we have used our experience with them making changes to accommodate the personal tax rate reductions to reach the conclusion that a time period of four months should be adequate. Inland Revenue would, of course, be working with accounting software providers after the Budget.

Given that a significant amount of GST is collected by the New Zealand Customs Service (Customs), we have discussed implementation dates with them. Customs advise that 1 October 2010 appears feasible, subject to some systems testing. Some administrative changes would be required, including amending Customs' fees that are quoted inclusive of GST. Customs would need to liaise with Inland Revenue to ensure consistency of messages in their communications strategy.

Other potential changes that may arise

It is possible that during the policy process and the drafting of new legislation we will become aware of further minor mechanical changes that are required in order to reflect the final package. It is recommended that officials be given permission to make these minor drafting changes. If any of these changes are more than mechanical it will be specifically highlighted in future reports to Ministers.

Administrative implications and costs

The changes have administrative implications which differ according to whether the start date of the new package is 1 October 2010 or 1 April 2011. Some activities will be necessary regardless of which start date is chosen (e.g. communication activities and responding to increased call volumes).

High level initial estimates are that the administrative costs associated with changes to personal tax rates will be approximately $5.5 million to $7.75 million over three years. It should be noted that this high level costing has been prepared with limited consultation owing to budget secrecy concerns.

Further analysis of the options available to Inland Revenue for managing the transition of a GST rate change needs to be undertaken before administrative costs of a rate change are known.

The extent to which the costs can be met from Inland Revenue's baselines has not been assessed. Approval for additional funding for any of these costs will be sought at a future date.

Appendix 2 – decomposition of low-income taxpayers

This appendix provides a decomposition of low-income taxpayers. It outlines the extent to which low individual taxable income is a good proxy for economic wellbeing and where tax policy can be a good redistributive instrument. It updates previous analysis from 2008 (refer Stocktake of Distributional Analysis for Personal Tax Changes).[20] It differs from the previous analysis in that it uses more recent data, is for the 2011/12 year, and focuses on those below $14,000 income in line with the bottom tax threshold (as opposed to $18,000 previously).

A person with low taxable income does not necessarily have low economic wellbeing, and tax changes may have a limited effect on disposable incomes

Our analysis suggests that individuals reporting low taxable income fall within one of the following four categories:

(a) *Disposable income may not be affected by tax cuts or may be insensitive to specific design in the medium term (as net income is determined by a legislative formula).*

(b) *Low taxable income may be temporary only.*

(c) *Low taxable income is not a good indicator of economic wellbeing, as low income individuals may benefit from the income of others or taxable income might be quite different from actual economic or disposable income.*

(d) *Low taxable income does reflect economic wellbeing.*

Tax might be a good instrument for redistribution for those falling in category 4 only. However our analysis of low income individuals and household incomes suggests only a small proportion of individuals fall within this category.

Analysis of individuals

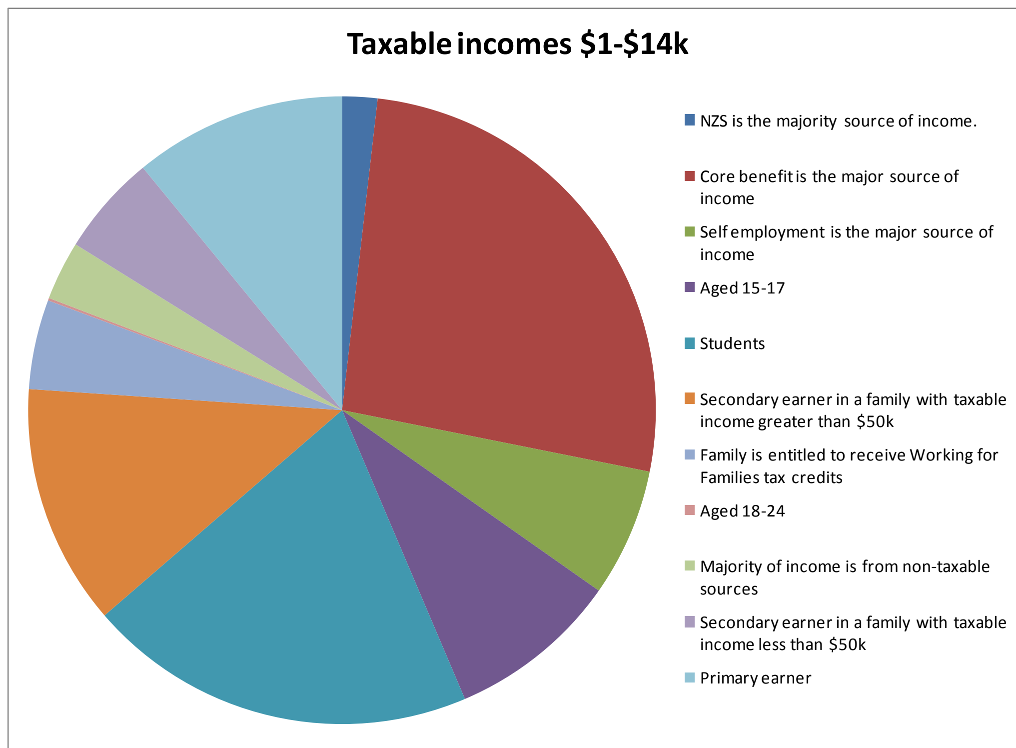
Only a small proportion of people with low taxable income will have low economic wellbeing

We have focused our analysis on the 660,000 individuals with taxable income below $14,000; this is just above the income of someone working 20 hours per week at the minimum wage ($13,260 per annum). Those with zero taxable income are excluded here. Over 83% could be characterised as those with temporary low taxable income (18-24 year olds and students), those relying on other economic or disposable income (self-employed, recipients of working for families, many secondary earners and 15-17 year olds) and those who get support through the benefit system and are less affected by tax design (superannuitants and beneficiaries). Figure 1 splits these low income

[20] Released by the previous government under the Official Information Act, at http://www.treasury.govt.nz/publications/informationreleases/budget/2008/pdfs/b08-am-tsy-mof-8apr08.pdf

individuals into one of 11 mutually exclusive groups; only those in the last two groups are most likely to have low economic wellbeing as a result of low taxable income.

Figure 1:
Composition of individuals on incomes below $14,000 per annum (HES 2007/08)



Source: Treasury, Household Economic Survey 2007/08

The 11 groups, and reasons why low taxable income might not reflect low economic wellbeing, or why tax may be a poor redistributive instrument, are outlined below.

1. *NZ Super is the majority source of income*: While tax cuts at the level of NZ Super would increase disposable income in the short term, in the medium term (between 1-3 years) tax changes at the average wage have the greatest impact on net NZ Super as a result of the legislative formula that sets the net NZ Super at between 65-72.5% of the net ordinary time average weekly earnings and annual CPI adjustments. Most superannuation payments exceed $14,000 annually. **(Category A)**

2. *Core benefit is the major source of income*: Benefits are set as a net rate in legislation. This means that where tax changes reduce the tax paid on benefit income, gross payments are reduced by an amount equivalent to the tax change leaving the net rate unchanged. Therefore tax changes have no effect on disposable income for those receiving benefit income alone. **(Category A)**

3. *Self employment is the major source of income*: While reported taxable income from self employment might be low, economic income could in many cases be much higher (due to business profits being retained within a company or losses being used to offset personal income etc). This may not apply in all cases and low taxable income may reflect low economic wellbeing for some self employed; for some this will be persistent. **(Most Category B, some <u>Category D</u>)**

4. *Aged 15-17*: Economic wellbeing for most 15-17 year olds would be dependent on their parents' income. **(Most Category B)**

5. *Students*: Students are most likely to have temporary low income as they forego market income while engaged in study. Other policy instruments could be better targeted to increasing student income such as increasing levels of student allowance and changes to student loan policy. **(Most Category C, possibly some Category B)**

6. *Secondary earner in a family with taxable income greater than $50,000*: Although family income of $50,000 might not be considered high, a low income secondary earner from such a family would not face low household income and would not have low economic wellbeing. **(Category B)**

7. *Family is entitled to receive working for families tax credits*: Families with low taxable income receiving working for families may pay little or negative amounts of tax. This means disposable income, once working for families is taken into account, can exceed taxable income. Although disposable income may still be low there are other policy levers that might be better targeted at increasing incomes. **(Category B)**

8. *Individual is aged 18-24*: Low taxable income might be temporary for many of these individuals, reflecting recent entry into the workforce (i.e. part way through a year) and higher income may be expected in the future with greater experience. (Note 20 hours per week at the minimum wage would provide annual income of $13,260). For some however low incomes will not be temporary and may reflect low economic wellbeing. **(Most Category C, some <u>Category D</u>)**

9. *Majority of income is from non-taxable sources*: While taxable income is low, a greater amount of income is derived from non-taxable sources. Total income may still be low, but it still exceeds taxable income. **(Most Category B, some <u>Category D</u>)**

10. *Secondary earner in a family with taxable income less than $50,000*: There is a much greater possibility that individuals in this group would be members of low income households and have low economic wellbeing. Individuals in this group do not have children (as are not eligible for WFF) and given their taxable income level would be unlikely to be in full time work. **(Most <u>Category D</u>, but some within Category C)**

11. *Primary earner*: This group is most likely to face low household income and economic wellbeing. For these individuals a majority of income comes from sources other than benefit, NZ Super and self employment, and are not members of a higher income household. **(Most Category D, but some within Category C)**

Up to 127,000 individuals with low taxable income might have low economic wellbeing

This figure most likely represents an upper bound, since we know that for some of these individuals low economic well-being is not persistent – for example, individuals who entered the workforce part way through the year would have low income for the survey period although they might be in full time work, and individuals might be temporarily out of the work force during the survey period. Some individuals within other categories, such as some self employed and 18-24 year olds may also face persistently low economic wellbeing. Broadly however, based on the classifications identified above (attributing each group to the category most individuals would fall into), the number of individuals in each category are shown in table 2 below:

Table 2:
Approximate breakdown of low income individuals

	Proportion of low income taxpayers
Category A: Disposable income not affected or insensitive to specific design	28.1%
Category B: Low taxable income is temporary only	35.5%
Category C: Low taxable income not a good proxy for economic well being	20.2%
Category D: Low taxable income does reflect economic wellbeing and may be persistent	**16.1%**

…but there are also those individuals who report zero taxable income

According to the data, around another 240,000 individuals have zero taxable income. Of these, about 58,000 receive some non-taxable income. Further analysis of these groups will follow in subsequent reports.