Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Briefing note – tax package for Budget 2010

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Subject: Tax package for Budget 2010

This briefing note provides a summary of distributional analysis relating to various potential personal tax rate structure scenarios being considered for inclusion in the tax package for Budget 2010. The note also shows the distributional effects of certain base-broadening measures being considered.

BACKGROUND

As part of the Budget 2010 tax package, Ministers are working towards a set of measures that would improve efficiency and growth, and deal with current integrity issues in the tax system. The cornerstone of such reform is a shift in the balance of government tax revenues from income tax to GST.

Achieving this implies base-broadening that impacts the company sector which will, in turn, have an impact on their incentive to invest. The extent to which the burden of taxation should be shifted from individuals to companies focuses on the trade-off between supporting the fairness of the tax system with across the board personal tax rate reductions, versus raising taxes on investment. A decision is therefore being sought on whether the package should be rebalanced towards the corporate sector (this can be achieved by either reducing the company tax rate or scaling back base-broadening measures affecting the corporate sector).

In addition to the current base scenario, four alternative personal tax rate options are being considered that will:

- if necessary, ensure that the final package remains revenue neutral; and
- if desired, allow a rebalancing of the current base scenario to reduce its impact on the company sector.

Officials are currently finalising a report that will describe the distributional impacts of these scenarios (and key base-broadening measures) in order to allow Ministers to make a decision on the final structure of the tax reform package. This memo provides an indicative summary of these impacts.

Inland Revenue considers that the current base scenario tax package would deliver on the promise of improving the efficiency, growth and integrity of the tax system without requiring any rebalancing to reduce the impact on the company sector. It considers that the current base scenario package would largely remove integrity pressures which have arisen from tax rate misalignment, increase incentives for New Zealanders' to save and generally boost the productivity of investment. If, however, Ministers do want to reduce the impact on companies, Inland Revenue would recommend scaling back certain base-broadening measures affecting companies rather than reducing the company tax rate.

Treasury, on the other hand, sees the primary policy motivation for these base-broadening measures is to reduce tax preferences for particular forms of investment. This causes capital to flow to investments that are more productive for the economy as a whole. Scaling back the base-broadening would dilute this benefit. The solution is to use base-broadening revenues to lower tax rates. This redirects capital to more productive uses and reduces tax on fully-taxed activities. These two policy "wins" are the logic behind the "broad-base low-rate" approach. Concerns with integrity issues from a 5c gap between the company and top personal tax rates need to be kept in perspective. A 5c gap would be an improvement on the status quo. It is less than the current 8c gap, and less than the historic 6c gap between the 33c company and 39c personal tax rate.

INDICATIVE DISTRIBUTIONAL ANALYSIS OF KEY BASE-BROADENING MEASURES

The following data is based on individuals and not households.

Depreciation denial

First round impacts

Removing depreciation on buildings will first impact those property owners claiming depreciation. This impact will be divided between onshore and offshore owners; and will flow either directly to individuals (where held directly), or through other structures such as companies and trusts (where property is held indirectly).

Some of the impact of the depreciation changes will be on foreign-owned companies. Companies owned by domestic residents will also be affected.

Residential buildings

Figure 1 below (based on the Survey of Family, Income, and Employment (SoFIE)) shows the proportion of each income band that holds rental property. Up until incomes of $120,000 the proportion of people owning property tends to increase across income bands.

Figure 1: Proportion of income band who hold rental property

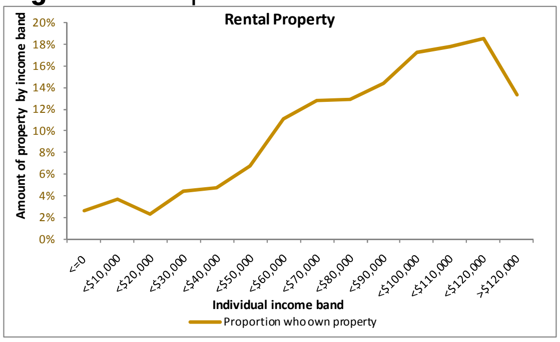
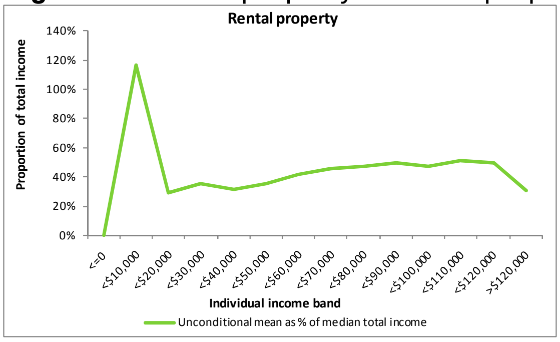


Figure 2 shows that rental property ownership as a fraction of income increases very gradually between income bands of $10,000 to $20,000 and $110,000 to $120,000. There is a major peak in the income band $0 to $10,000. We are endeavouring to investigate why this is the case. Those earning over $120,000 hold slightly less rental property as a proportion of their average median income.[1]

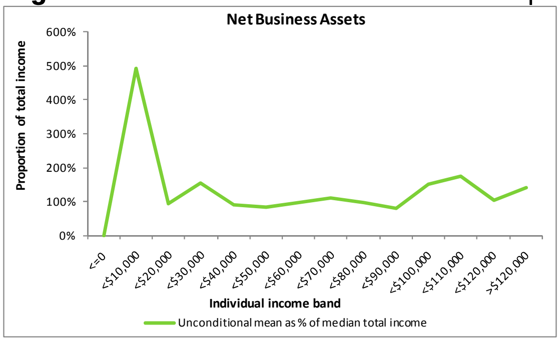
Figure 2: Rental property asset as proportion of median total income



Non-residential buildings
Removal of depreciation will also affect individuals through their holdings of companies, trusts and other businesses.

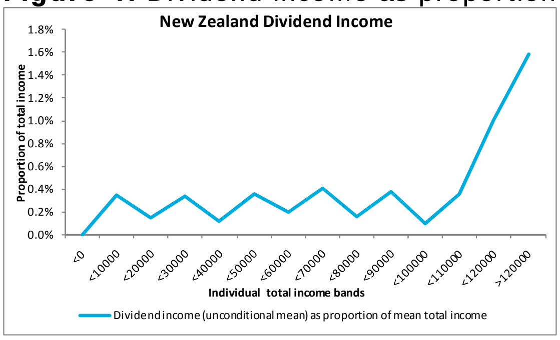
Figure 3 shows that apart from a spike in the $0 to $10,000 band, net business asset value is reasonably constant across income bands. We are also investigating the reason for this peak.

Figure 3: Net business asset value as proportion of median total income



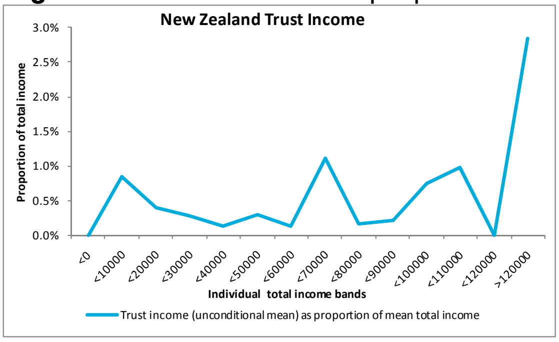
Figures 4 and 5 show little trend growth in dividends and trust income across lower income bands but that these are very significant forms of income for those on higher incomes (above $100,000).

Figure 4: Dividend income as proportion of mean total income



[1] Average median income for the range of incomes over $120,000 is likely to underestimate actual median income. Actual median income is not available due to data limitations.

Figure 5: Trust income as proportion of mean total income



Second round impacts

Second round impacts of depreciation changes on residential property will impact rent and on house prices. As set out in the depreciation paper, medium term changes to rents and house prices are expected to be modest.

We will provide further information on the impact of these changes before the final subgroup meeting on 29 March.

Depreciation loading

Depreciation loading will affect individuals and companies that own plant and equipment that was bought new. These assets are more short-lived than buildings; and as this change under the base scenario will be grandfathered, it will not affect existing owners of plant and equipment in respect of which depreciation loading is currently being claimed. This is more likely to affect companies than building depreciation denial (due to the increased likelihood that companies will own assets subject to the loading rather than owning buildings), and the impacts will flow through to households in a similar manner to the non-residential buildings discussed above.

As with building depreciation denial, officials would expect some of the impact of this measure to be distributed offshore.

Thin capitalisation

Thin capitalisation impacts are likely to be felt entirely offshore as the rules apply to foreign-owned New Zealand companies.

DISTRIBUTIONAL IMPACT OF POTENTIAL PERSONAL TAX RATE STRUCTURE SCENARIOS

Current base scenario

The following table represents the current base scenario of the personal income tax rate structure being considered for Budget 2010:

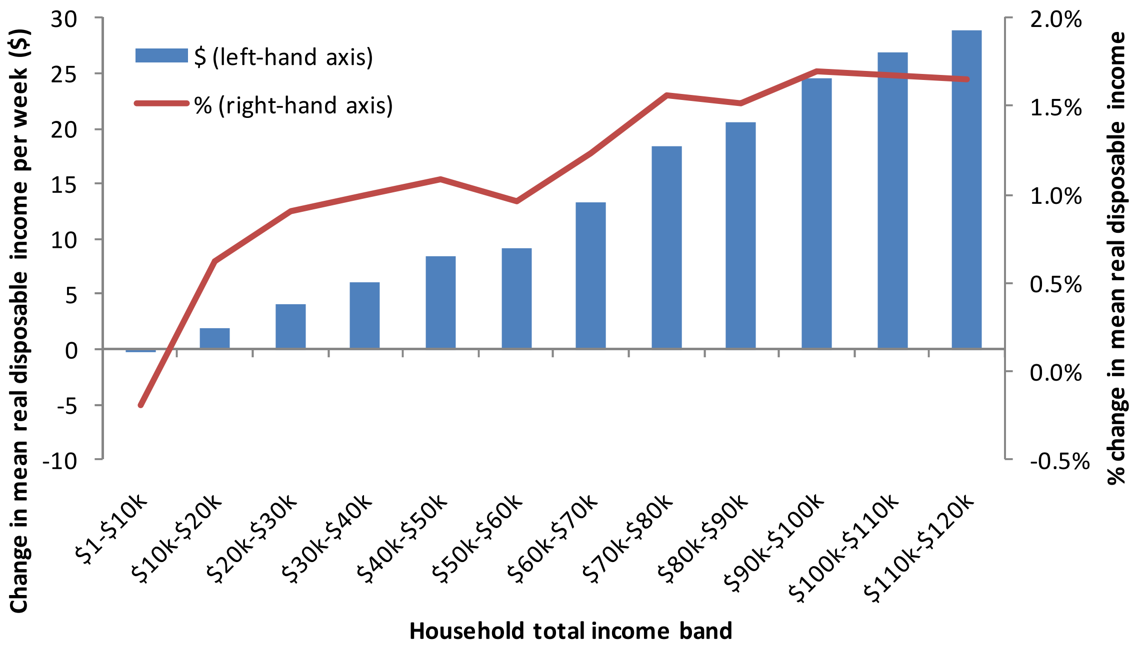
Thresholds	Rates
0 - 14,000	10.5%
14,001 - 48,000	17.5%
48,001 - 70,000	30%
70,000+	33%

Distributional analysis of current base scenario

Distributional analysis on the 10.5%/17.5%/30%/33% base scenario has already been provided (T2010/191;PAD2010/16 refers). Figure 6 shows that households with total income over $10,000 are *on average* better off after the price effect of GST is taken into account.

Figure 6 does not take account of the compensatory increases to non-taxable social welfare income, which are discussed in T2010/191;PAD2010/16 – and therefore the slight reduction that is apparent below $10,000 (equivalent to an average of 21c per week) is an overestimate of the decrease in disposable income (if there is a decline at all) assuming these measures are agreed to.

Figure 6



Current funding shortfalls
As previously discussed with Ministers, the following table shows the funding shortfall with respect to the base scenario:

$ million	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Personal tax	-2345	-3560	-3890	-4080
Net NZS	-235	-330	-350	-370
Net Benefits	-80	-110	-110	-110
WFF compensation	-50	-70	-75	-70
GST (including clawback)	1935	2615	2735	2850
Building depn (all buildings)	0	720	725	730
Depn loading (with grandfathering)	140	260	330	370
Thin cap 60%	0	210	210	210
WFF de-indexation	0	25	95	95
Net	**-635**	**-240**	**-330**	**-375**

- This table assumes no cut to the company tax rate.
- Numbers for NZS, Benefits & WfF compensation are Treasury numbers; these are being worked through with MSD and will increase slightly when flow-on compensation measures to supplementary assistance are included.
- The thin capitalisation figures in the tables are maximums based on an assumption that worldwide group debt percentages do not allow for deductions if the safe harbour is breached. To the extent that assumption does not hold, these figures will be overstated.

Funding shortfalls could be filled by identifying other base-broadening measures, by altering the proposed rate schedule or a combination of the two.

Alternative scenarios
The following section considers four alternative rate structures to the base scenario. These are shown in the table below.

Thresholds	Base scenario	Alt. 1	Alt. 2	Alt. 3	Alt. 4
0 - 14,000	10.5%	10%	10.5%	10.5%	10%
14,001 - 48,000	17.5%	18%	18.5%	17.5%	18.5%
48,001 - 70,000	30%	30%	30%	33%	33%
70,000+	33%	33%	33%	(33%)	(33%)

Cost reduction of alternative scenarios
The marginal tax rates are at or above those in the base scenario – therefore they cost less. The reduction in cost compared to the cost of the base scenario is shown below (indicative figures only[2]):

Reduced cost compared to base scenario (10.5/17.5/30/33): $ million						
Scenario		**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Alt. 1	10/18/30/33	0	30	45	50	55
Alt. 2	10.5/18.5/30/33	0	305	420	440	455
Alt. 3	10.5/17.5/33	0	235	335	365	390
Alt. 4	10.5/18.5/33	0	540	755	800	845

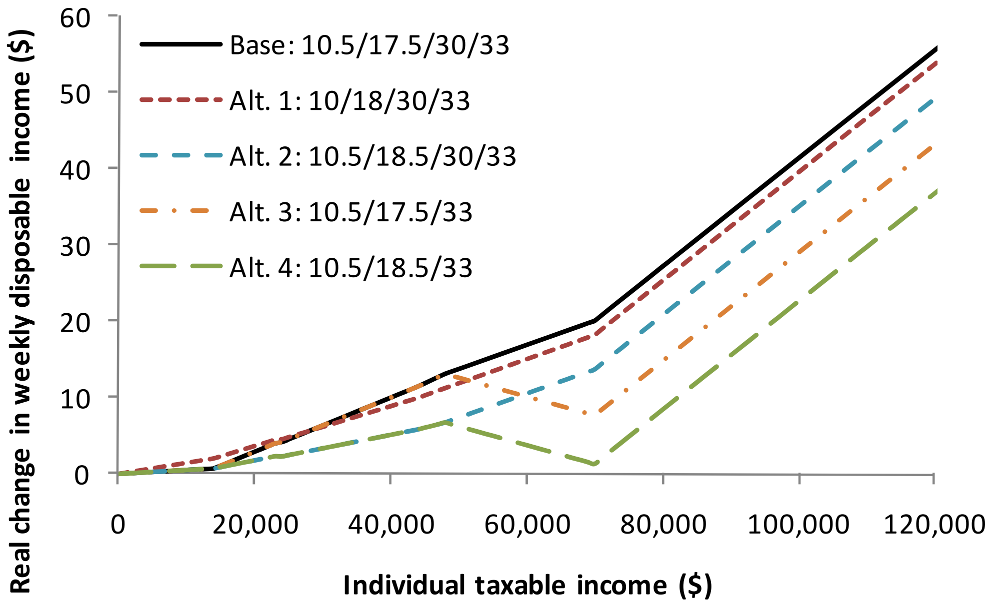
Alternative 1 (as requested by the sub-group) is a minor variation of the base scenario, and so has little revenue impact.

Alternatives 2 and 3 would, other than in the first year, provide sufficient funds to make the base scenario package (without company tax relief) revenue neutral in the absence of other base-broadening measures.

Alternative 4 would provide sufficient funds to provide company tax relief. The relief could be provided through a reduction of the company tax rate to 28 percent or through scaling back of base-broadening impacting companies. These issues are discussed in the report “The company tax rate”, (T2010/373, PAD2010/43 refers).

Distributional effects of alternative scenarios
The chart below shows a representation of the distributional effects of the alternative scenarios and the base scenario. In contrast to Figure 6, the chart shows the effect on an individual’s (rather than household) real disposable income[3] based on their taxable (rather than total) income.

[2] These figures are indicative only, and do not properly account for the interaction with the welfare system.



Alternative 1, compared to the base scenario, shifts the balance slightly between the bottom two tax rates. Gains are very slightly higher (up to $1.20/wk) for those earning less than $28,000 per annum, while very slightly lower (~$1/wk) for those earning over $28,000. The alternative has little impact on the overall fiscal package.

Alternative 2 makes all taxpayers earning more than $14,000 worse off compared to the base scenario. The amount of reduction increases until the top of the second rate band, ($48,000). It would essentially fill the revenue gap of the base scenario.

Alternative 3 would also fill the base scenario revenue gap. Reductions of benefit relative to the base scenario would impact taxpayers starting at $48,000, reaching a maximum at the top threshold of $70,000 after which they would be constant. Compared to Alternative 2 it would concentrate the impact on higher income taxpayers.

Alternative 4 combines these changes to give the greatest cost reduction (compared to the base scenario) of around $800 million per annum over the forecast period. While no taxpayer is worse off compared to the present system, taxpayers at $70,000 have little benefit. This alternative would fill the base scenario revenue gap and allow relief to be provided to companies.