

Date: 18 January 2008

SH-13-3-0

To: Office of the Minister of Finance

From: Tax Strategy, Treasury

TAX STRATEGY: POTENTIAL CHANGES IN PRACTICE

We understand your interest in a free zone stems primarily from an objective that all taxpayers should receive a 'dividend' from any tax cuts. This note considers the impact of a free zone and compares it with a similar low rate approach in order to identify the equity effects amongst differing groups, impacts on the work environment and implementation issues. We consider the difference between two scenarios of identical fiscal cost:

- Free zone to \$9 500, 21% thereafter – maximum tax relief \$1 425 per annum; or
- 10% rate to \$18 500, 21% thereafter – maximum tax relief \$1 465 per annum.¹

To help meet this objective, we have broken down taxpayers with taxable incomes under \$25,000 into mutually exclusive groups, showing which tax cut is likely to deliver the greatest tax reduction to the greatest number in that group.

SUMMARY

- **For those above \$18 500 gross income, the low rate would provide little more than the free zone (relative to status quo).** The difference is around \$40 per year.
- **For those below \$18 100 gross income, the free zone would provide more \$ per week (relative to status quo) in most cases.** Beneficiaries without additional income would receive nothing.
- **Some of the very low taxable-income groups are not in greatest need of tax relief.** Some groups will only have temporary low incomes (e.g. 15 -17 year olds), or their taxable income will be a poor proxy for wellbeing (e.g. secondary earners in families with over \$50k household incomes).
- **Work incentives would be better for those on DPB, Unemployment Benefit or NZ Super under low rate.** For example, someone on the DPB working 2 days per week at \$15 per hour would be \$1 per hour better off under a low rate.

Pulling these points together:

¹ The methodology behind these fiscal costs is covered at Annex 1 and depends in part on netting off reduced NZ Super Fund capital contributions in 2009/10. If the capital contributions were not netted off, the fiscally equivalent 10% rate would increase to around \$20 000. For purposes of comparison, using the Annex 1 methodology, extending the 15% rate to \$38 000 without a free zone has an identical cost to these two scenarios.

- there are a range of objectives to consider in choosing between alternative tax instruments, including (but not limited to):
 - first-round distributional impacts,
 - wider equity effects (such as work-force attachment and access to opportunities to increase income over time),
 - efficiency/economic growth considerations; and
 - administration and compliance costs;
- Treasury's advice is that there are more direct and effective means of achieving some first-round distributional objectives than using the tax system, although mechanisms are not in place to effect this for a small minority of the groups analysed;
- however, there may be limits of social acceptance and disadvantages to broader equity and efficiency objectives from using these alternatives (e.g. views on the level of benefits, or on differentiating between different groups through the transfer system);
- of the two alternative approaches analysed, as regards the first-round distributional effects and in terms of the number of groups and individuals involved, the free zone approach may have an advantage over the low rate approach;
- in terms of efficiency (economic growth) and broader equity objectives, the low rate approach has the advantage over the free zone approach for the larger number of groups and individuals;
- the administrative and compliance cost considerations are finely balanced between the two approaches;
- determining your preference between the two approaches will depend on:
 - the above considerations,
 - the weightings you give to the various objectives,
 - the significance to your calculation of the different groups affected; and
 - other factors considered relevant by you but not canvassed here (e.g. simplicity/ease of explanation).

Impacts on differing groups

Table 1: Impacts on differing groups

	No of taxpayers '000s	Free zone	Low rate
Who benefits more?			
Super annuitants ²	414	Single super annuitants prefer Majority married couples prefer	Minority of married couples prefer
On core benefit ³	283	No benefit	No benefit
Self-employed	87	Even split	Even split
Aged 15-17	207	Preferred	Less benefit
Student	197	Majority prefer	Minority prefer
Secondary earner, family >\$50k	210	Majority prefer	Minority prefer
Receives working for families	84	Majority prefer	Minority prefer
Aged 18-24	62	Even split	Even split
Secondary earner, family <\$50k	49	Preferred	Less benefit
Primary earner ⁴	115	Even split	Even split
Total	1 722		
How do work incentives change?			
Secondary earners		Increased incentive up to \$9 500, unchanged thereafter	Increased incentive up to \$18,500, unchanged thereafter
Domestic Purposes or Unemployment beneficiaries		Improved at both part and full time hours	Improved at both part and full time hours. Out performs the free zone scenario at part time hours
New Zealand Super annuitants working part time		No change to work incentives	Improved work incentives. Out performs the free zone scenario up to incomes of \$18,500
Administrative implications?			
Electing resident withholding tax rates		More compliance costs	No change
Taxpayers with child rebate or		Fewer compliance	No change

² Super annuitants may gain twice – both from the tax relief and from an increase in the net average wage leading to increased level of NZ Super. This increase in NZ Super is lower for single super annuitants under the 10% rate, leading to their preference for the free zone.

³ Benefits are set on a net basis.

⁴ Data shows some “primary earners” with losses or uneconomic incomes. In practice we would expect more primary earners to benefit from a 10% rate.

transitional tax allowance	costs	
PAYE implementation	No problems expected with 3 month lead time	No problems expected with 3 month lead time
Transition period	RWT system would be less accurate in the short term	RWT and PIE systems would be less accurate in the short term and slightly more complex to implement

Generally, taxpayers with taxable incomes under \$18 100 will receive a greater average tax rate reduction under the free zone. Taxpayers with incomes above \$18 500 would receive around \$40 per annum more under the low rate. The free zone therefore appears more attractive to the majority of low income taxpayers in absolute terms.

Redistribution and labour participation

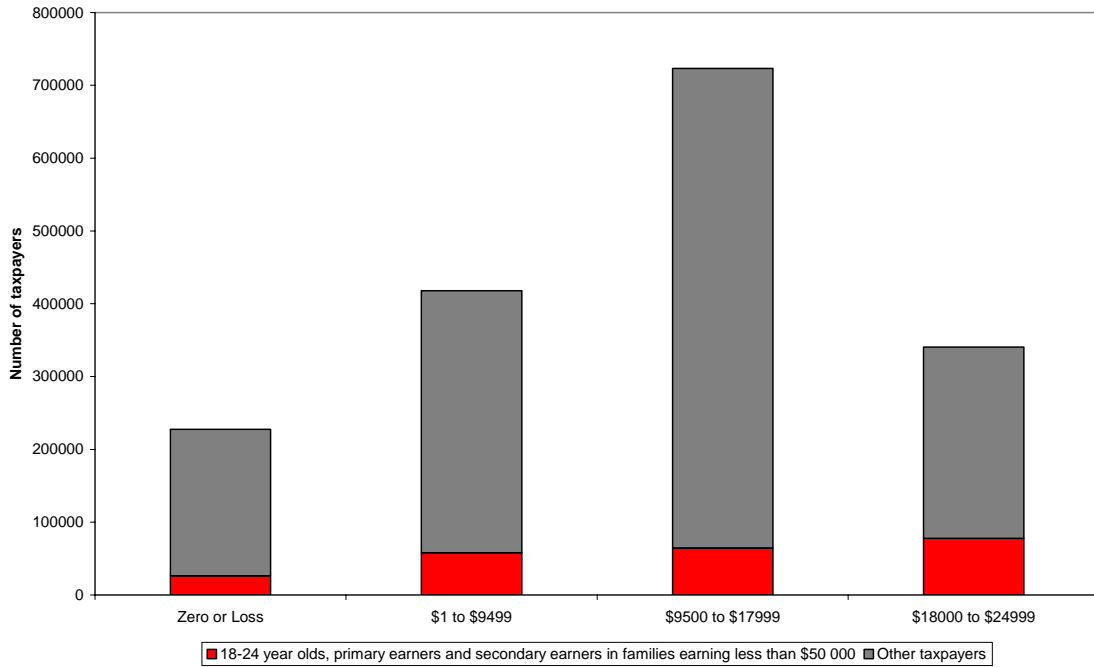
But the composition of low income taxpayers is also relevant when targeting any tax cut. The standard of living of the great bulk of low income people is currently largely determined by the state, i.e. through benefits, NZ superannuation, working for families tax credits and student allowances. These taxpayers can be targeted directly through increased transfer payments – that is, tax cuts are not the best tool for redistributing income.

For other taxpayers – the self-employed, secondary earners in families earning >\$50k, children aged 15-17 – taxable income is a poor proxy for wellbeing, so tax relief is less likely to lead to significant changes in their welfare.

This leaves primary earners, secondary earners in families with combined earnings <\$50k, and 18-24 year olds not in tertiary education as groups that cannot be readily targeted using existing instruments and are likely to benefit significantly from redistribution using the tax system.

Figure 1 shows these groups are found in greater numbers as \$25,000 is approached – we estimate around 226,000 taxpayers are in these groups. However, for some, low incomes may not be persistent. Inland Revenue data suggests that nearly 50% of taxpayers (excluding 15-17 year olds, beneficiaries and super annuitants) that earned less than \$18 000 in 2001 that could be identified in 2006 earned more than \$18 000.

Figure 1: Share of low income taxpayers for whom tax changes might be a primary redistributive instrument



While a low rate delivers a lesser ‘dividend’ to taxpayers reporting very low incomes, it has the potential to deliver different work incentives to groups such as secondary earners and those coming off benefits, potentially a much more numerous group.

For example, for secondary earners with opportunities to earn at \$12 per hour, relative to a free zone, their net change in income from increasing their work under a low rate option would be:

- *Same* – if they go from not working to working more than 4 days/week;
- *Lower* – if they go from not working to working less than 4 days per week;
- *Higher* - taxpayers already working up to 2 days per week would receive further tax reductions by increasing work up to 4 days a week under the low tax scenario

For people on the DPB or unemployment benefit, benefit abatement at 70% means that marginal tax rates drop from 91% to 80% over a range of income. At \$12 per hour, relative to the free zone, their net change in income from increased work under a low rate option would be:

- *Same* – if they go from not working to working more than 2 days;
- *Lower* – no one: as core benefit levels generally exceed the free zone a beneficiaries’ first dollar of income would face a 21% marginal tax rate;
- *Higher* - if they go from not working to working 1 or 2 days per week

International comparisons

Most other countries have free zones for personal taxes but this often does not extend to social security contributions or payroll taxes. So looking at the tax wedge – income

and social security taxes as a proportion of total labour costs – is a more accurate measure.

At relatively low levels of income (full time minimum wage) tax wedges in many countries are higher than in New Zealand. At 67% and 100% of the average wage tax wedges are higher in most other countries.

Either the free zone or low rate would reduce New Zealand's tax wedge at low levels of income by a similar amount.

Implementing the changes

Each alternative is possible in administrative and compliance terms although a lower rate would make the resident withholding tax (RWT) and PIE rates less accurate in the short term. RWT and PIE tax rates pose some significant issues under both options and more work is required on options. In particular, we would anticipate a time lag before banks and PIEs were able to introduce changes to reflect the more progressive nature of the tax system.

Phasing the changes could also lead to some odd transitional marginal tax rates; however, these are unlikely to be significant.

There appears to be an element of choice around the LIR: it could be abolished with retrospective effect, removed mid year, or retained for one final year.

Consultation with Inland Revenue

We have discussed this note with Inland Revenue on a confidential basis and incorporated its comments in full.

CHARACTERISTICS OF LOW INCOME TAXPAYERS

Taxpayers reporting income <\$25k are very diverse.

We have allocated these taxpayers to one of ten mutually exclusive groups.

- Super annuitants
- Beneficiaries
- Self employed
- Aged 15-17
- Students
- Secondary earner in a family with taxable income greater than \$50 000
- Receives working for families tax credits
- Aged 18-24
- Secondary earner in a family with taxable income less than \$50 000
- Other (deemed primary earner)

Table 2 shows the larger concentrations of taxpayers at different income levels.

Table 2: Taxpayers at different income levels

	Income level			
	Zero or loss	\$1 – 9,499	\$9,500 – \$17,999	\$18,000 – \$24,999
Super annuitant			XX	X
Beneficiaries		X	XX	
Age 15-17	X	XX		
Student		X		
Secondary earner, family >\$50k		X	X	X
Primary earner				X

Key: (XX: greater than 100,000 taxpayers, X greater than 50,000).

Data sources are explained at Annex 2 and a full breakdown is given at Annex 3.

For those taxpayers falling within all groups except the primary earners group in table 2, tax relief through changes to the personal tax schedule might not a primary redistributive instrument; alternately these taxpayers might not be the target of redistribution because they are dependent on the incomes of other family members.

But tax could be a main redistributive instrument for those taxpayers we have classed as primary earners, secondary earners in families with combined earnings <\$50k, and 18-24 year olds not in tertiary education. These taxpayers are more likely to be (and stay) poor as a result of low taxable income.

Table 3 breaks down the numbers of these taxpayers in more detail:

Table 3: Taxpayers likely to benefit from redistribution

	Income level				Total
	Zero or loss	\$1 – 9,499	\$9,500 – \$17,999	\$18,000 – \$24,999	

Age 18-24	SOME	16, 189	20,247	25,837	62,273
Secondary earner, family <\$50k	13,600	21,907	13,667	SOME	49,174
Primary earner	12,922	19,968	30,611	52,037	115,538

Note that some of the numbers in table 3 are based on a small number of observations, so it may not be possible to further analyse the characteristics of these groups. For some of those on very low incomes, for one reason or another taxable income may not reflect their economic reality; receipt of untaxed income is one possible example.

Special cases are discussed briefly in the 3 sections below and then excluded from the analysis in the rest of the paper.

Super annuitants

The mechanism for setting rates of New Zealand Super will also be affected by tax cuts.⁵ Under the free zone the married couple rate of New Zealand Super will increase by \$56.28 per week (\$28.14 each); this would increase the married couple rate to just under 70% of the net average ordinary time weekly earnings (AOTWE). The net rate for a single living alone would increase by \$36.58 (this is 65% of the increase to the married couple rate and is more than the maximum increase for other taxpayers of \$27.40).

With the low rate the increase to the married couple net rate would be lower, increasing by \$36.90 per week (\$18.45 each) and to 67.8% of the net AOTWE. The total value of the tax reduction would be higher if the married couple had other sources of income. The rate for single living alone increases by \$24 per week; because the gross value of the new NZ Super rate would exceed \$18 500 the tax change would not affect other income sources (unlike the case for married couples).

Depending on the level of other income, married couples could have a slight preference for the low rate; changes to the rate of net NZ Super for singles living alone would always be higher under the free zone.

We would not anticipate this to cause any significant behavioural response.

Beneficiaries

Because benefits are set on a net basis, tax reductions will not automatically flow through to benefit income. This means a low income household reliant on benefit income will not benefit directly from any tax change.

Zero taxable income or loss position

There could be up to 230 000 people aged 15 or over with zero taxable income or in a loss position. The self employed make up a large proportion of this group as do people relying on the taxable income of others.

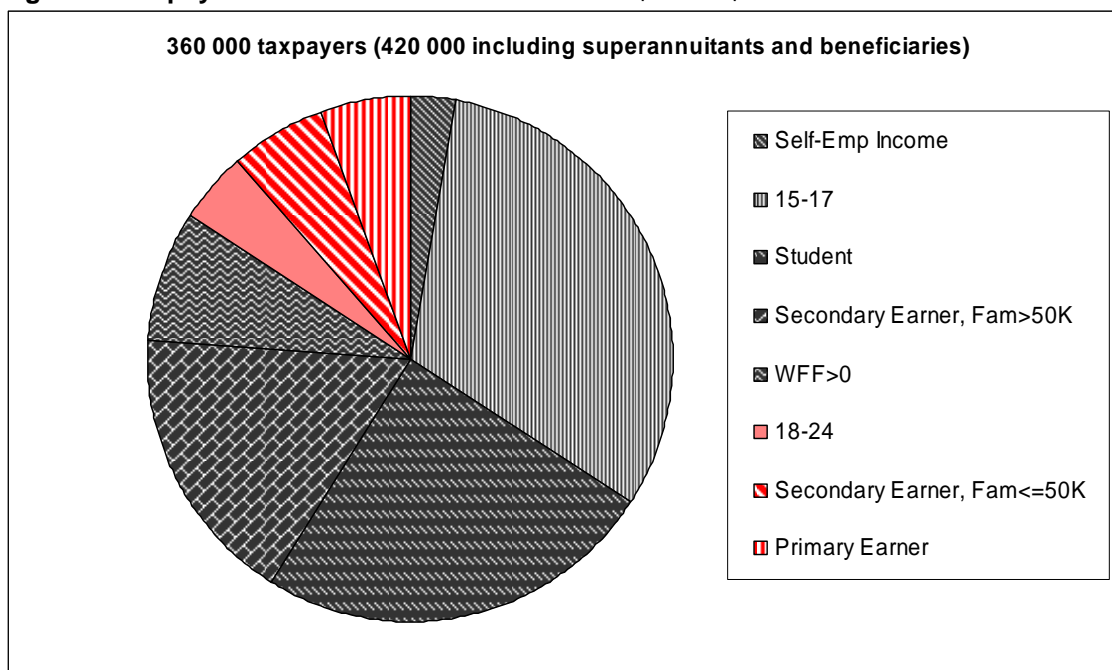
⁵ NZ Super is legislated on a gross basis, so any tax change would directly increase the amount of net NZ Super payments. This higher level of net NZ Super is then CPI adjusted on 1 April each year. Finally, because this CPI adjusted net NZ Super cannot fall below 65% of the net AOTWE; net NZ Super may be increased again depending on the level of the tax reduction to the average worker.

Taxable income between \$1 and \$9 499

With a free zone of \$9 500 the approximate 420 000 taxpayers falling within this income range would pay no tax (360 000 where super annuitants and beneficiaries are excluded). However nearly 115 000 of these taxpayers earn between \$1 and \$999 so tax reductions for these taxpayers would be small (less than \$4 per week).

Figure 2 provides a breakdown of non super annuitant and beneficiary taxpayers in this income range:

Figure 2: Taxpayers with taxable income between \$1 and \$9 499



Key observations:

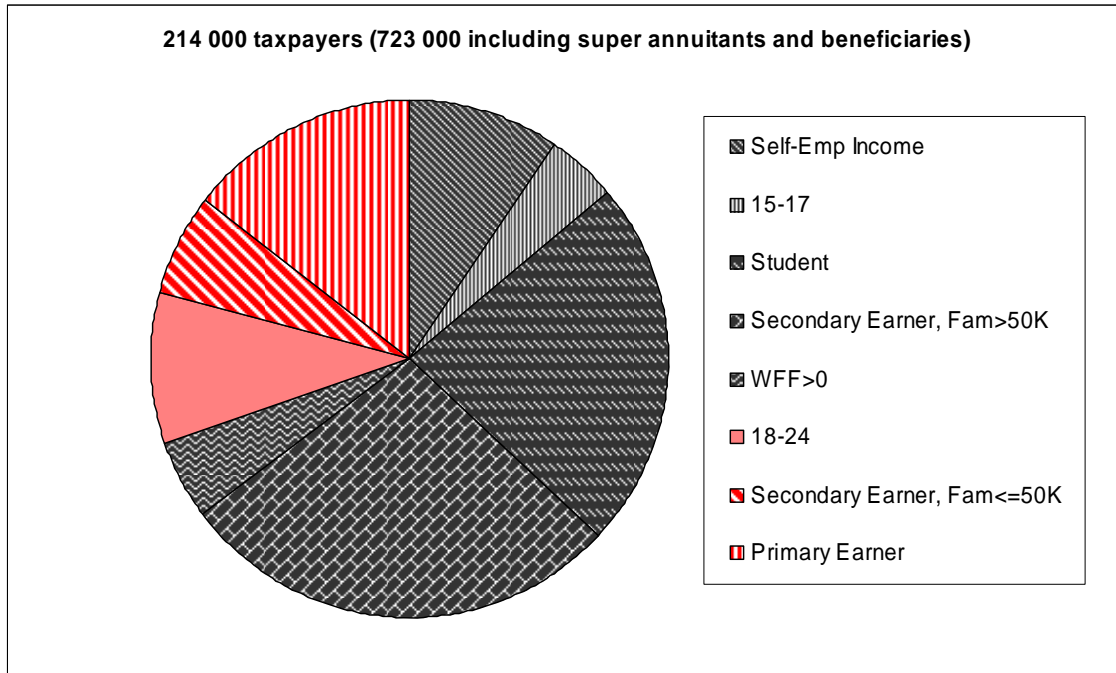
- The 'red zone' includes 59 000 people in this income range. A large proportion of those taxpayers from the red segments will be part year and part time workers. Investment income is the major income source for 30% of the primary earners and 39% of the 18-24 year olds in this income range. These taxpayers also earn less than the unemployment benefit;
- Tax data suggests that for many taxpayers in this group low incomes are not persistent. 45% of taxpayers (excluding super annuitants and beneficiaries) with incomes in this range in 2001, who could be identified again in 2006,⁶ earned more than \$18 000 (33% more than \$25 000); and
- A large proportion of these taxpayers are dependent on incomes of other income earners.

⁶ Some taxpayers that were in the sample of taxpayers in 2001 could not be identified in 2006, so no income match could be made. A failed match would arise where a taxpayer did not earn salary or wage income or did not file a tax return or request a personal tax summary in 2006.

Taxable income between \$9 500 and \$17 999

Taxpayers in this income group would enjoy a tax reduction of \$1 425 per annum (or \$27 per week) with a free zone of \$9 500. The tax reduction from the low rate scenario is lower across this income range. Of the approximately 723 000 people in this income range the majority are super annuitants and beneficiaries (see Annex 2). The remaining 214 000 people within this income range are broken down in figure 3:

Figure 3: Taxpayers with taxable income between \$9 500 and \$17 999



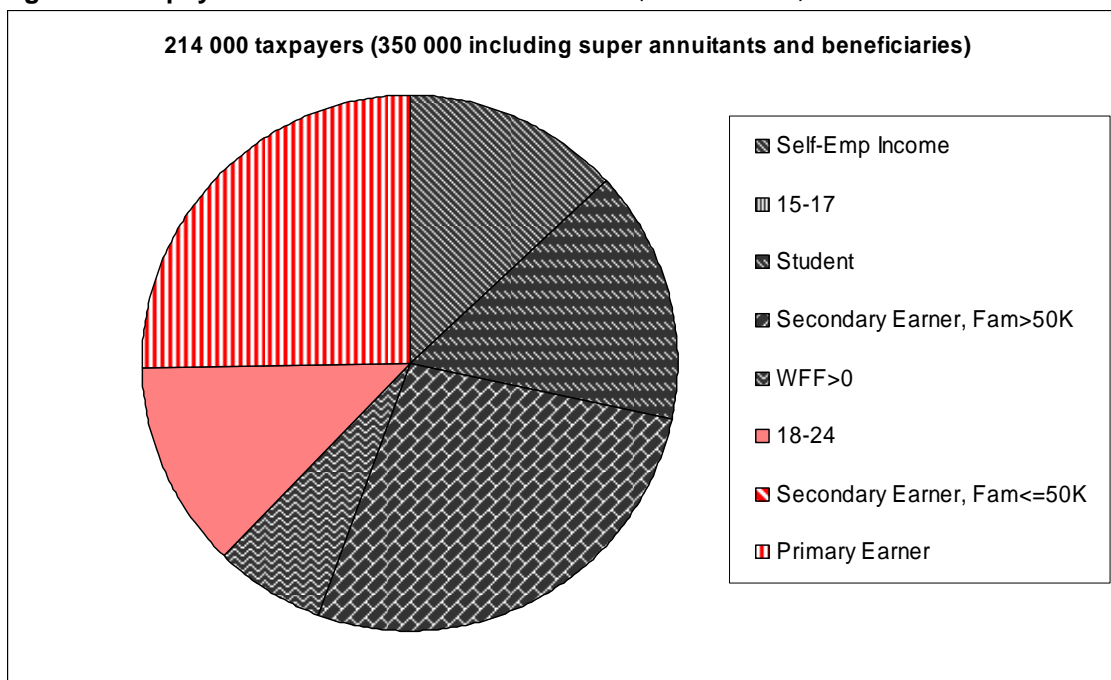
Key observations:

- There are up to 65 000 taxpayers from the red segments who would benefit from a free zone. Within this income range these taxpayers might be part time or part year workers;
- Students and secondary earners in families with taxable income of more than \$50 000 make up half of this group; and
- Inland Revenue data indicates that 55% of taxpayers (excluding super annuitants and beneficiaries) with incomes within this range in 2001 earned more than \$18 000 in 2006 (40% more than \$25 000).

Taxable income between \$18 000 and \$24 999

There are nearly 350 000 taxpayers falling within this income range. Again, each would receive a tax reduction of \$1 425 from the free zone; taxpayers would receive \$1 465 from the low rate scenario. Excluding super annuitants and beneficiaries, the remaining 214 000 people in this group can be broken down as follows:

Figure 4: Taxpayers with taxable income between \$18 000 and \$24 999



Key observations:

- As income increases, so does the proportion of ‘red zone’ taxpayers;
- Approximately 85 000 people fall within the red zone for this income range;
- Many of these people might be working full time at very low wages (current annualised full time minimum wage is \$17 550 for a 30 hour week and \$23 400 at 40 hours);⁷ and
- Some of the secondary earners from families with taxable income exceeding \$50 000 may only earn slightly less than their higher paid partner (a secondary earner with an income of \$23 400 and a partner earning \$28 000 would fall in the over \$50 000 group; neither represent high incomes).

⁷ This analysis is based 2003/04 survey data so wage growth assumptions have been made to present analysis for the 2007/08 year. Because the minimum wage has increased faster than nominal wage growth, taxpayers that earned the minimum wage in 2003/04 may now have higher incomes than assumed in this analysis. This means that some of the red zone taxpayers within the \$9 500 to \$17 999 income range might have actual incomes falling in the \$18 000 to \$25 000 income range.

ENTERING THE WORKFORCE: EFFECT ON MARGINAL DECISIONS

All income tested 'parent benefits', such as unemployment, sickness, invalid and DPB, are set in after tax terms and then grossed up. These benefits would generally exceed a free zone of \$9 500, with the implication that beneficiaries will not be better off as a result of the tax change.

Although net benefit rates remain unchanged under any tax cut scenario, the incentives to move between benefit and employment will alter as market income will be subject to new tax schedules.

As a beneficiary enters the workforce, employment income is taxed at their marginal rate (21% under the free zone⁸, 10% with the low rate) but benefits abate (generally) at 70%, leading to a marginal tax rate of 91% under the free zone compared to 80% under the low rate.

This pattern applies over quite a wide income range. For dependent children, at 20 hours work per week, decisions are complicated by the in work tax credit (IWTC) and minimum family tax credit (MFTC). These create an income range with marginal tax rates of 100%, although in practice the number of claimants to which this applies is small. It is estimated that approximately 3 000 families will access the MFTC in the current year.

We model two types of beneficiaries to show these points – a single person on the Unemployment Benefit; and a Domestic Purposes Beneficiary, so the interaction with Working for Families can be observed. There are several other benefit types but the results will be similar.

Unemployment Benefit

The movement from benefit to full employment under the status quo is set out in figure 5.

⁸ Assuming abolition of the LIR.

Figure 5: Single person on unemployment benefit

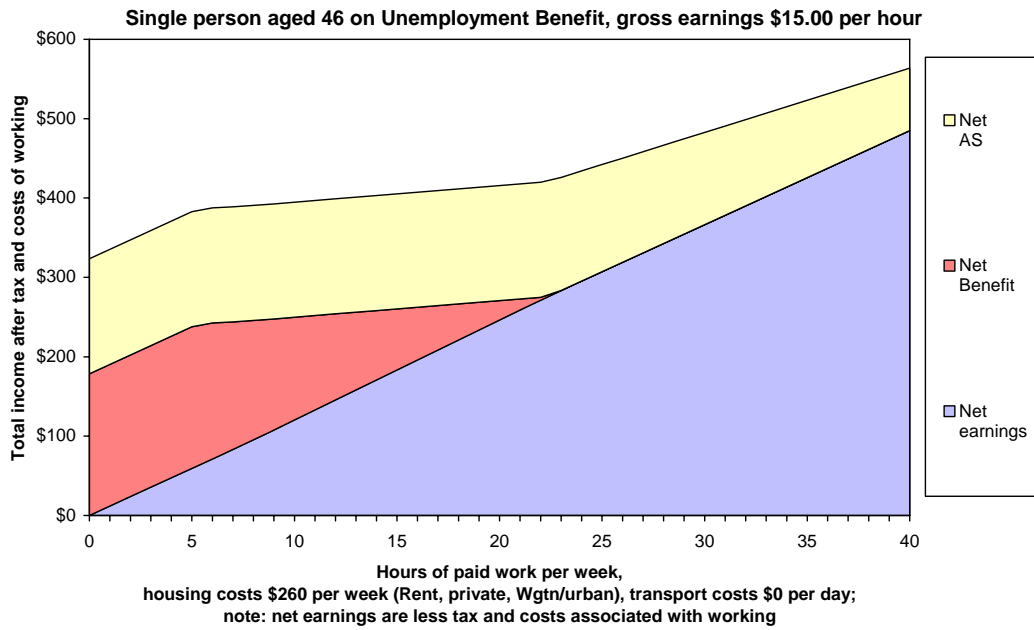


Figure 6 shows the total net income received over the transition from benefit to fulltime employment under the status quo and the two scenarios.

Figure 6: transition from benefit to full time employment



Key observations

- The low rate scenario outperforms the free zone scenario at part time levels of employment. From about the 18 hour mark there is no discernable difference between the two scenarios

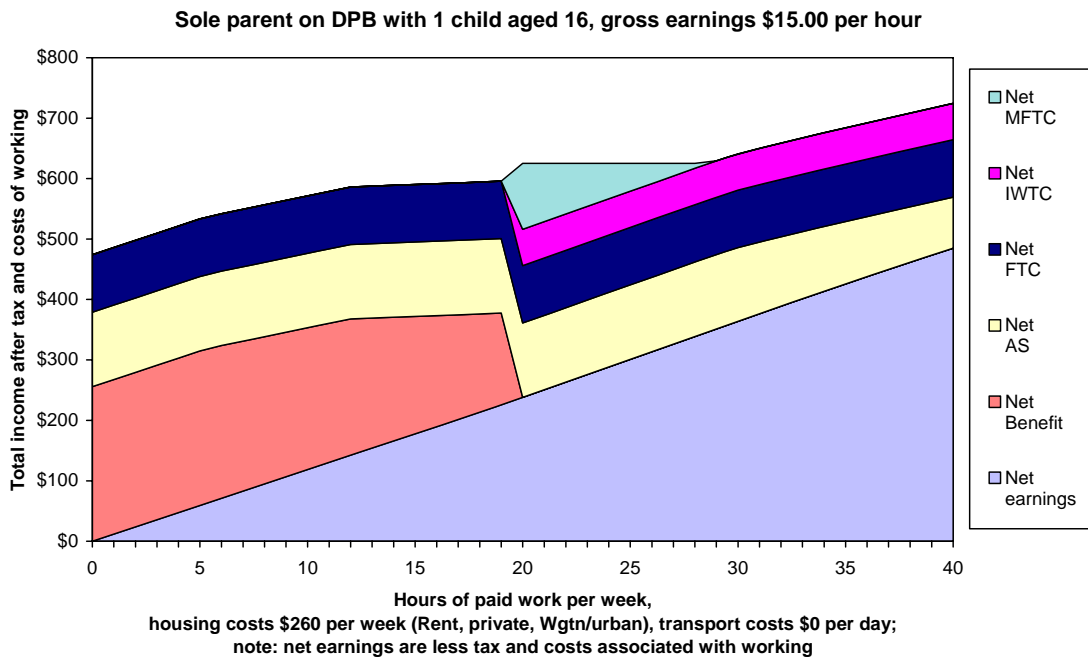
- Both scenarios out perform the status quo over the full range and therefore result in some increased incentive to move into employment.

Domestic Purposes Benefit

This scenario models a single beneficiary with one dependant child (aged 16) in rental accommodation and facing a potential wage rate of \$15 per hour.

Under the status quo this person faces the following schedule as they transition from benefit to full-time employment (40 hours).

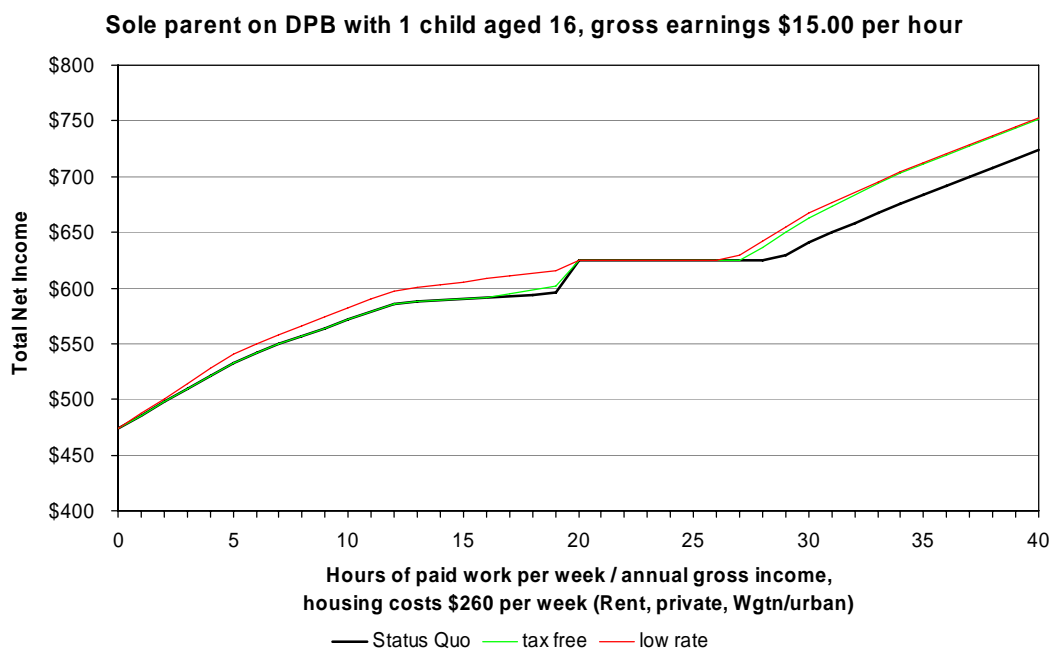
Figure 7: DPB with one child



Note that at 20 hours per week this person is eligible for IWTC and MFTC and that this more than offsets the level of net benefit at this point. Hence, at 20 hours per week, this person comes off benefit.

Figure 8 compares the total net incomes across the three scenarios.

Figure 8: transition from DPB to full time employment



Key Observations

- Prior to the MFTC and the IWTC kicking in at 20 hours, the low rate option provides higher net incomes across all hours compared to the status quo and the free zone option. Bearing in mind that the gross benefit at zero hours is greater than \$9 500 p.a. but under \$18 000 p.a., the additional dollar of non-benefit income earned under the low rate option is taxed at 10%. Under both the status quo option and the free zone option this marginal dollar would be taxed at 21%.
- Total net income for the free zone option is identical to the status quo option until this person works 17 hours per week at which point net incomes are higher under the free zone option. This is because at this point the level of gross abated benefit falls below \$9 500. Therefore, from this point onwards, a further dollar of non-benefit income reduces the benefit by \$0.70 and is then taxed at 0% giving an effective marginal tax rate of 70%. However, prior to the abated level of gross benefit falling below \$9 500, an additional \$1 reduced the benefit by \$0.70 and was also being taxed at 21% - giving an effective marginal tax rate of 91%.
- The MFTC is designed in such a way that all three options have the same level of total net income at the 20 hours per week point.
- The MFTC abates faster under both tax cut options than the status quo given that net incomes are rising faster due to lower tax rates. This condenses the problem of the 100% abatement rate that the MFTC causes.
- There is no discernable difference between both options after the MFTC has abated although both options are significantly higher than the status quo.

- From a replacement rate perspective, and picking 3 points along the hours distribution – 16 hours, 24 hours and 40 hours⁹:
 - The incentives to move to full-time employment (40 hours) are identical under both scenarios and are both improvements from the status quo
 - The incentives to move to 24 hours are identical under all scenarios given this coincides with the MFTC
 - The incentive to move to 16 hours is significantly higher for the low rate scenario than the free zone and the status quo. At 16 hours, this person’s net income is almost \$16 per week higher than the other two scenarios.

New Zealand Super annuitants working part-time

Table 4 shows the net earned income for New Zealand super annuitants wishing to work 1 or 2 extra days under the free zone versus the low rate option. The wage rate assumed is \$18 per hour.

Table 4: Super annuitants working part time

Income	Number	Number of extra work days	Weekly Net Earned Income ¹⁰		
			Free Zone	Low Rate	Difference
\$1 - \$9 499	Some	1	\$132.94	\$129.60	(\$3.34)
		2	\$246.71	\$256.62	\$9.91
\$9 500 - \$14 499	152,614	1	\$113.76	\$127.52	\$13.76
		2	\$227.52	\$241.27	\$13.76
\$14 500 - \$17 999	167,149	1	\$113.76	\$118.52	\$4.76
		2	\$227.52	\$232.29	\$4.76
\$18 000 - \$24 999	94,250	1	\$113.76	\$113.76	\$0
		2	\$227.52	\$227.52	\$0

This shows that apart from working one extra day for those who have incomes less than \$9 500 (of which there are very few), the low rate option provides the greater incentive (or is neutral at the highest incomes) to increase the number of days in paid employment. This is due to a greater proportion of the earned income falling in the 10% marginal rate zone (under the low rate option) rather than the 21% marginal rate zone (under the free zone option).

Secondary earners

Tax changes can also improve work incentives for some second earners with children. Currently a second earner with children receiving working for families’ tax credits faces an EMTR of 35% on the first dollar of income (15% tax rate and 20% abatement rate). Both tax change options would reduce this EMTR but would affect incentives differently. The free zone would provide a stronger incentive to earn income up to \$9 500 compared to the 10% low rate, but incentives to earn additional income would be unchanged once this income level is achieved. With the low rate secondary earners earning between \$9 500 and \$18 500 would continue to face a lower EMTR on additional income.

⁹ On the assumption that few people can choose whatever number of hours they wish to work per week and instead will need to move to a particular number of days per week.

¹⁰ Calculated at the midpoint of the income band.

Table 5 shows for different wage levels the number of days per week that would need to be worked for the full value of each tax change to be obtained and for the decision to work an additional day to be unaffected by the tax changes.

Table 5: Secondary earners working part time

Hourly wage rate	Free Zone to \$9 500	10% rate to \$18 500
\$12.00	2 days	4 days
\$15.00	2 days	3 days
\$23.00	1 day	2 days

*Calculations are based on a two earner family with two children, with the primary earner on the average wage.

For example, a secondary earner with a wage of \$12.00 per hour would need to work 2 days per week for income to exceed \$9 500; at this income the decision to work another day per week is unaffected by the tax change (the average tax rate reduction has been maximised). With the low rate the same secondary earner would, compared to the status quo, have an additional incentive to work 3 and 4 days per week as they would continue to face a lower EMTR until 4 days are worked (although if working less than 4 days per week the value of the tax reduction is lower than it would be under a free zone).

Other non-beneficiaries that are entering the workforce would face similar incentives to the secondary earner.

INTERNATIONAL COMPARABILITY

Free zones internationally

Key observations

- Most other countries do have a free zone for income tax; however, this may not extend to social security contributions.
- At relatively low levels income (full time minimum wage) tax wedges in many countries are higher than in New Zealand. At 67% and 100% of the average wage tax wedges are higher in most other countries.
- A free zone and a low rate would reduce New Zealand's tax wedge at low levels of income by a similar amount.

Which taxes on labour have tax free zones is shown in table 6 for selected countries (based on latest available information, for some countries this is 2006). A tick signals that a free zone applies: ¹¹

Table 6: Free zones for different taxes on labour

Country	Personal Income Tax	Employee SSC	Employer SSC / Payroll tax ¹²
New Zealand	x	No Tax	No Tax
Australia	✓	No Tax	x
Germany	✓	✓	x
Hong Kong	✓	x	x
India	✓	x	x
Ireland	✓	✓	x
Japan	✓	x	x
Korea	✓	x	x
Singapore	✓	x	x
United Kingdom	✓	✓	✓
United States	✓	x	x

Note that each country does provide a free zone for income tax, but only the United Kingdom has a free zone for employee and employer SCC contributions. So looking at the combined tax wedge gives a better comparison. The tax wedge measures the level of income tax and employee and employer Social Security Contributions as a proportion of labour cost.

¹¹ The above table applies for labour income only and the tax treatment of investment income may differ (some countries provide allowances for labour income; these would not apply for investment income).

¹² Some countries provide exemptions from payroll and Social Security taxes for small employers. These are generally based on total payroll and are not targeted to low income taxpayers

Tax wedges at the minimum wage

The tax wedge at the full time minimum wage is shown for selected countries in figure 9; taxes paid by the employee and the employer have been separated.

Although each country has an income tax free zone, the tax wedges for 4 of the 7 countries are higher than or equal to New Zealand's. So while a free zone might provide average tax rate reductions at very low incomes, the tax wedge can be high even at the full time minimum wage.

Figure 9: Tax Wedge at the statutory full time minimum wage 2006:

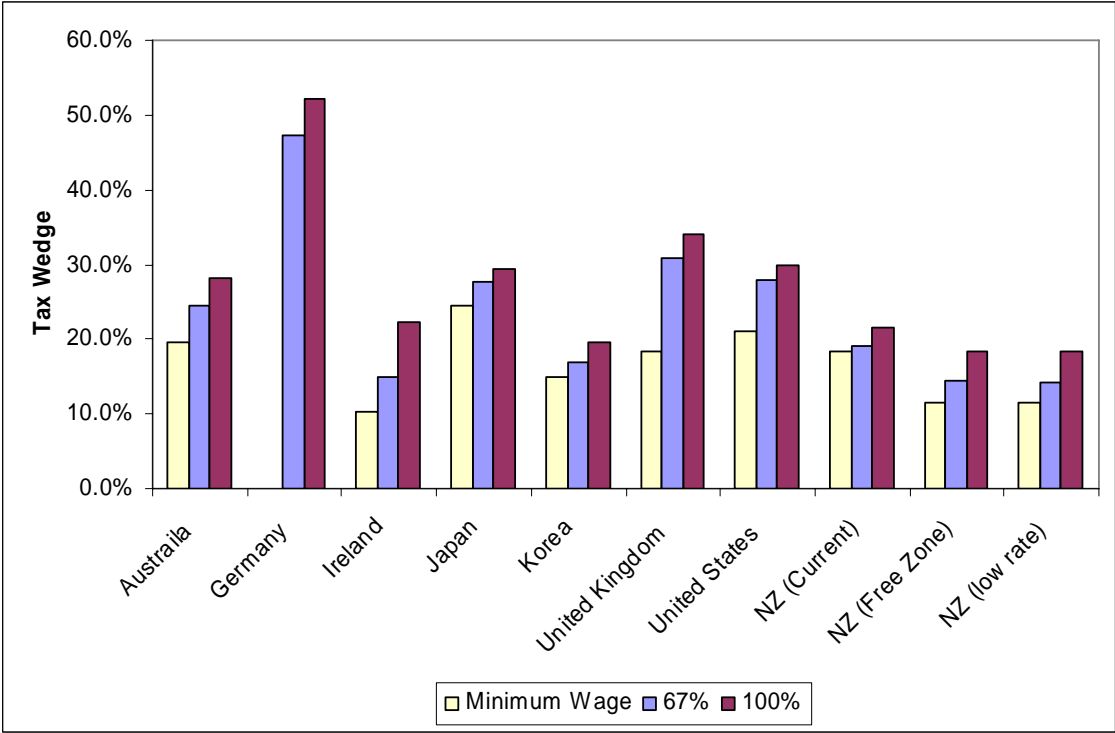


Source: OECD Taxing Wages 2005-06 special feature on the tax treatment of minimum wages

Tax wedges are higher for incomes of 67% and 100% of the average wage.

- Figure 10 shows that in 2007 of the selected countries only Korea has a lower tax wedge than New Zealand (Mexico is the only other OECD country with a lower tax wedge), this is despite each country having a free zone for personal income tax.
- Note the large difference between the tax wedge at the minimum wage and 100% of the AW for some countries.

Figure 10: Tax wedge at the minimum wage and 67% and 100% of the average wage



Note that this analysis is for a single worker only and tax wedges may be lower for families with children as a result of targeted transfers for workers with children.

PRACTICAL IMPLICATIONS

From an administrative and compliance perspective, there is generally little difference between a tax-free zone and a fiscally equivalent low rate. Compliance and administrative costs would be reduced for a small number of taxpayers under a tax-free zone option, and some parts of the tax system would be simplified. On the other hand, more complex RWT rules for bank customers would need to be introduced under a free zone, which would impose extra compliance and administrative costs. Transitioning to a free zone might be slightly easier than for a 10% rate.

Advantages of a free zone

Compliance and administrative costs would be reduced for a small number of taxpayers under a free zone option, and some parts of the tax system would be simplified. This is because the child rebate, which provides a 0% tax rate for some schoolchildren, and the transitional tax allowance, which provides a reduction in tax for certain taxpayers who earn under \$9,880, could be removed as they would no longer be necessary.

Further, it may be easier to introduce a free zone than a low rate. This is because it is likely that the new 0% rate could be incorporated into the current bank and PIE systems that provide for taxpayers who are exempt from RWT or have a 0% PIE rate.

[information deleted in order to avoid prejudice to the substantial economic interests of New Zealand]

Implementation

PAYE

As previously noted, our provisional estimates are that PAYE changes should be feasible about three months after announcement and enactment. This is mainly due to implementing the new PAYE rates, which is expected to take approximately three months (however, there is a possibility that it could take longer than three months for external payroll providers to implement, because these changes would occur outside external payroll providers' "normal cycle" for payroll changes).

RWT on interest

Resident withholding tax (RWT) is imposed on residents' interest and dividend income, and is withheld by the payer of that income (e.g. a bank). The current rates of RWT for interest are:

- 0% (for taxpayers with a certificate of exemption, such as banks and charities)
- 19.5% (for taxpayers earning \$38 000 or less)
- 33% (for taxpayers earning between \$38 001 and \$60 000)
- 39% (for taxpayers earning \$60 001 or more)

If the taxpayer earns interest of \$200 or more that was taxed at too low an RWT rate, they must file a return and pay the excess.

Free zone

Assuming that the RWT rates are the same as the statutory rates, under a free zone the RWT rates would be:

- 0% (for taxpayers earning under \$9500 or under, and taxpayers with a certificate of exemption)
- 21%
- 33%
- 39%

At this stage it would appear preferable to change the 19.5% rate to 21%, with no option for customers to elect 0% until the free-zone is fully implemented. Broadly, this maintains the status quo until the free-zone is implemented (with a small increase in tax, which would be correct for the majority of taxpayers). This would overtax taxpayers who earn \$9500 or under, although they would be able to file a return at the end of the year in order to obtain a refund. While this option would temporarily overtax the interest income of taxpayers who earn under \$9 500, it should be easier to implement particularly if the changes are phased in over more than one year.

It should be noted, however, that this will significantly increase the number of taxpayers who file returns to obtain refunds. We will look at different ways to handle this. One option could be to make the 21% rate (or keep the rate at 19.5%) a final tax rate for the transitional period.

Low rate

For a low rate, there would be some added complexity because banks would need to administer five RWT rates instead of four. However, if the 21% applied for the transition years with taxpayers entitled to the 10% rate being able to file a return to obtain a refund, banks should have sufficient time to implement the new rate.

PIEs

The tax that PIEs pay on their income reflects the marginal tax rate of investors. This is achieved by investors electing a tax rate with the PIE depending on their income in either of the previous two years. Unlike RWT, PIE tax is a final tax, meaning that investors cannot file tax returns to obtain refunds.

The PIE tax rates from 1 April 2008 are:

- 0% (for non-natural persons such as companies, trusts, and other PIEs)
- 19.5% (in general, if the person's income in either of the previous two years was \$38 000 or less)
- 30% (for other investors)

Free zone

Applying a new 0% rate for natural persons immediately would not appear to present major administrative difficulties for most PIEs.

A low rate

Introducing a new rate will require systems changes for PIEs and would therefore take more time to introduce. This means that there will be some inaccuracy for a short transitional period. It may be possible for the rate to be introduced with effect from 1 April 2009.

Phase-in of free zone

There are two main alternatives for phasing in a free zone – increasing the free threshold each year (eg \$3 500, \$6 500, \$9 500) or successively dropping the bottom rate for \$9 500 (eg 10%, then 5% then 0%).

Increasing the threshold is the preferred administrative approach as this means that banks and PIEs will not need to administer a temporary additional rate for one or two years.

LIR

Similarly, choices around the LIR seem possible if mid-year implementation is preferred. While its abolition could be backdated to the start of an income year, a mid-year composite approach was taken to the LIR in the 1998 tax changes, without significant practical difficulties.

ANNEX 1: BREAKDOWN OF FISCAL COSTS

The free zone and low rate options have an equivalent fiscal cost according to the methodology outlined in November (note entitled “Communicating Tax Packages”). The fiscal cost takes into account not only the reduction in tax revenues but changes to superannuation and benefit appropriations to give the change in taxpayer disposable income. We also take into account likely increases to other taxes such as GST, RWT and Company tax, which is estimated to be 25% of the change in disposable income in the first year. Changes in the capital contribution to the New Zealand Super Fund and to investment income from DMO bonds are also included to give the net fiscal cost. The breakdown of the net fiscal cost for both scenarios is outlined below:

Scenario 1

Threshold ¹	Rate
0k	0%
9.5k	21%
38k	33%
60k	39%

1. LIR removed

Fiscal Cost (\$ million)	2009/10
Gross Cost	4079
NZS Impact	174
Benefit appropriations	-524
<i>Disposable income</i>	<i>3729</i>
Extra tax revenue	-932
NZS Fund Contributions	-323
Investment Income	148
Net Fiscal Cost	2622

Scenario 2

Threshold ¹	Rate
0k	10%
18.5k	21%
38k	33%
60k	39%

1. LIR removed

Fiscal Cost (\$ million)	2009/10
Gross Cost	3709
NZS Impact	23
Benefit appropriations	-298
<i>Disposable income</i>	<i>3434</i>
Extra tax revenue	-859
NZS Fund Contributions	-88
Investment Income	149
Net Fiscal Cost	2637

Note that contributions to the NZ Super fund fall in 2009/10 by \$323 million under the free zone scenario. This is due to the smoothing algorithm of the New Zealand Super Fund model which smoothes the combined annual cost of net NZ Super and capital contributions over 40 years. The large increase in net NZ Super in 2009/10 from the free zone leads to a reduction in capital contributions in that year under this smoothing algorithm.

ANNEX 2: DATA SOURCES

To decompose the group of low income taxpayers we have used the Treasury's TaxWell model and tax data from the Inland Revenue.

TaxWell uses data from the 2003/04 Household Economic Survey and provides income, family and household composition information. Inland Revenue data can also provide information about families, but this is not as rich as that available from TaxWell. Importantly the Inland Revenue data can track taxpayers over time allowing us to assess whether low income reported in a given year is persistent. For the purposes of the low income decomposition we have focused on those people aged 15 and over.¹³

We have broken the population of low income taxpayers into mutually exclusive groups. A taxpayer is included within the first relevant group; taxpayers that do not fall within any of the groups will be included in the final group. The mutually exclusive groups in order are as follows:

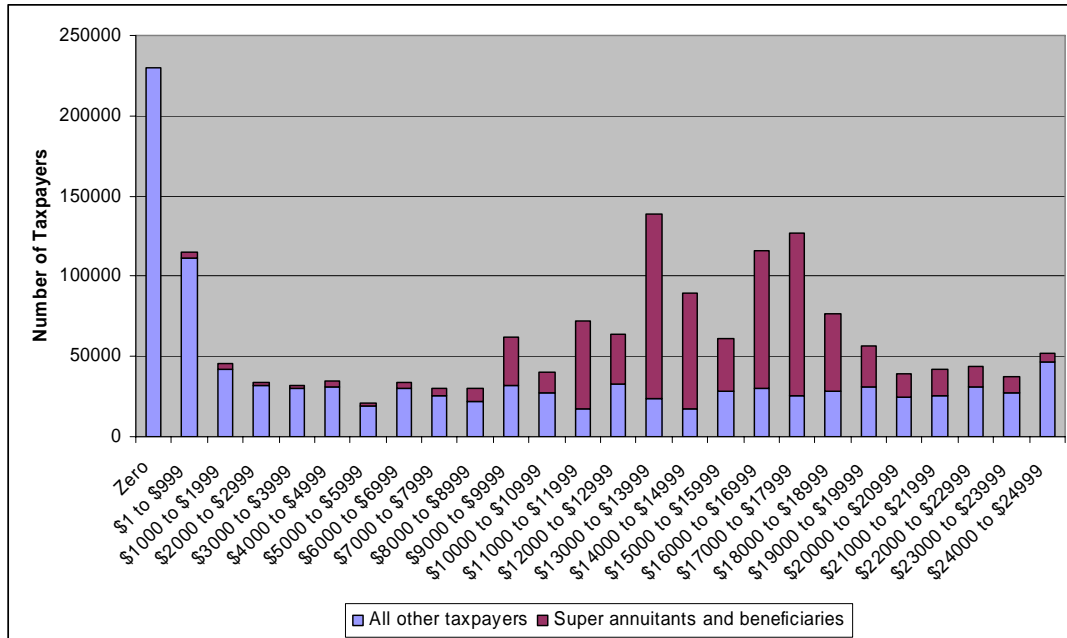
1. Major source of income is from New Zealand Superannuation
2. Major source of income is from welfare benefits (this does not include Student Allowance)
3. Major source of income is from self employment (based on a "absolute value" basis, if losses from self employment exceed wage and salary income, the taxpayer is deemed to receive major source of income from self employment)
4. The taxpayer is 15-17 years old
5. The taxpayer is a student
6. The taxpayer is a secondary earner in a family with taxable income greater than \$50 000 (secondary earner earns less than the main earner)
7. The taxpayer is a member of a family that receives working for families tax credits
8. The taxpayer is aged 18-24
9. The taxpayer is a secondary earner a family with taxable income less than \$50 000
10. A taxpayer not falling into any of the preceding groups is deemed a primary earner

¹³ Because of TaxWell's superior information regarding families and taxpayer characteristics we have used this as our primary source of information. Inland Revenue data is better for taxpayers that earn income for part of a year only (those who earn income for part of the year and are overseas when the HES survey is completed), also the Household Economic Survey only covers private dwellings so does not include people living in institutions such as student hostels. For these reasons TaxWell does understate the number of students and 18-24 year olds. Conversely, the sample of taxpayers used by Inland Revenue includes only those who earn salary and wage income or file a return or request a personal tax summary. IRD data will therefore understate the number of taxpayers with Zero income and those earning investment income only.

ANNEX 3: LOW INCOME TAXPAYERS DECOMPOSED

	Zero		\$1 to \$9,499		\$9,500 to \$17,999		\$18,000 to \$24,999		Total
Super annuitant	0	0%	SOME		319764	44%	94250	28%	414014
On Core Benefit	0	0%	54140	13%	189581	26%	39588	12%	283309
Self-Emp Income	30042	13%	9725	2%	20393	3%	26970	8%	87130
15-17	83403	37%	114551	27%	9324	1%	SOME		207278
Student	25284	11%	90102	22%	49522	7%	31680	9%	196588
Secondary Earner, Fam>50K	32568	14%	62315	15%	59293	8%	56058	16%	210234
WFF>0	29777	13%	28890	7%	10745	1%	14088	4%	83500
18-24	SOME		16189	4%	20247	3%	25837	8%	62273
Secondary Earner, Fam<=50K	13600	6%	21907	5%	13667	2%	SOME		49174
Primary Earner	12922	6%	19968	5%	30611	4%	52037	15%	115538
Total	227596	100%	417787	100%	723147	100%	340508	100%	1721498

Figure 11 distribution of taxpayers earning less than \$25 000 in \$1 000 income bands



Source: 2003/04 Household Economic Survey

Figure 11 shows that, after removing beneficiaries and super annuitants, taxpayers' income distribution is relatively even – no obvious spikes.