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To: Office of the Minister of Finance

From: Tax Strategy, Treasury

AIDE MEMOIRE: PERSONAL TAX REFORMS

This note provides supplementary information to our memos of 24 and 26 October on some aspects of personal tax reform. The note assumes that any changes must be justifiable both on a one-year stand alone basis and underpinned by and consistent with a longer term direction, even if that longer term direction is not publicised or even decided in detail at the time of the first set of changes.

Benchmark initial option

Comments provided start from a single short term option – the introduction of a $10 per week rebate, increase in the 33% threshold to $40k and the 39% threshold to $80k – for ease of reference. We understand that the magnitude of an option of this kind is broadly consistent with the general nature of discussions concerning the budget strategy report. Similar comments could be made on other options if required.

Moving from the current status quo (for the 2009/10 tax year) to this $10/$40k/$80k combination costs around $1.5 billion[1] and changes the Tax Gini (for individuals) from 58.7% to 59.3%.[2] That is, overall the new combination is more redistributive on average.

Table 1: Reform costs and equity

		Annual fiscal cost ($m)	**Tax Gini (in %)**	
			Individuals	**Eqivalised Households**
Current system:		-	58.7	48.5
Initial reform (2009/10):				
rebate	thresholds			
$10pw	$40k (lower) $80k (upper)	**-1,490**	59.3	49.0

These costs are in tax year terms. A start date of 1 April 2009 would suggest a cost in the 2008/09 forecast year of approximately $400 million.

[1] All costings are based on expected outcomes for the 2009/10 tax year – to ease comparisons with other results - though exact cost incurred depends on the timing of any change. Costings are indicative only.

[2] The 'Tax Gini' is the Gini coefficient of tax payments, measured here across deciles of the personal income distribution. A larger Tax Gini implies a **more redistributive** tax on average. The Tax Gini provides a more direct measure of the redistributive qualities of the tax.

Building on the benchmark

Additional/subsequent reforms could build on any the components of the additional reform – increases to rebate, changes to middle threshold/rate, changes to top threshold rate. Table 2 sets out the choices:

Table 2: Extending reform costs and equity

	Annual fiscal cost ($m)	Tax Gini (in %)	
		Individuals	Eqivalised Households
rebate: additional $1 pw	**-120**	+0.20	+0.20
top rate: 1% point reduction	**-180** [at $60k] **-115** [at $80k]	-0.16 -0.16	-0.16 -0.16
top threshold: $10k increase	**-190** [at $60k] **-105** [at $80k]	-0.22 -0.15	-0.22 -0.15

Managing fiscal impact

Who gets the rebate? For a $10pw rebate, narrowing focus to earned income makes a material difference.

- Earned income only (but including benefits and all income of super annuitants) saves $10-25m
- Salary and wage, self employment income and all income of super annuitants (excludes beneficiaries) saves $130-165m [this approximates existing LIR policy]
- Salary and wage, self employment income (excludes super annuitants and beneficiaries) saves $330-360m

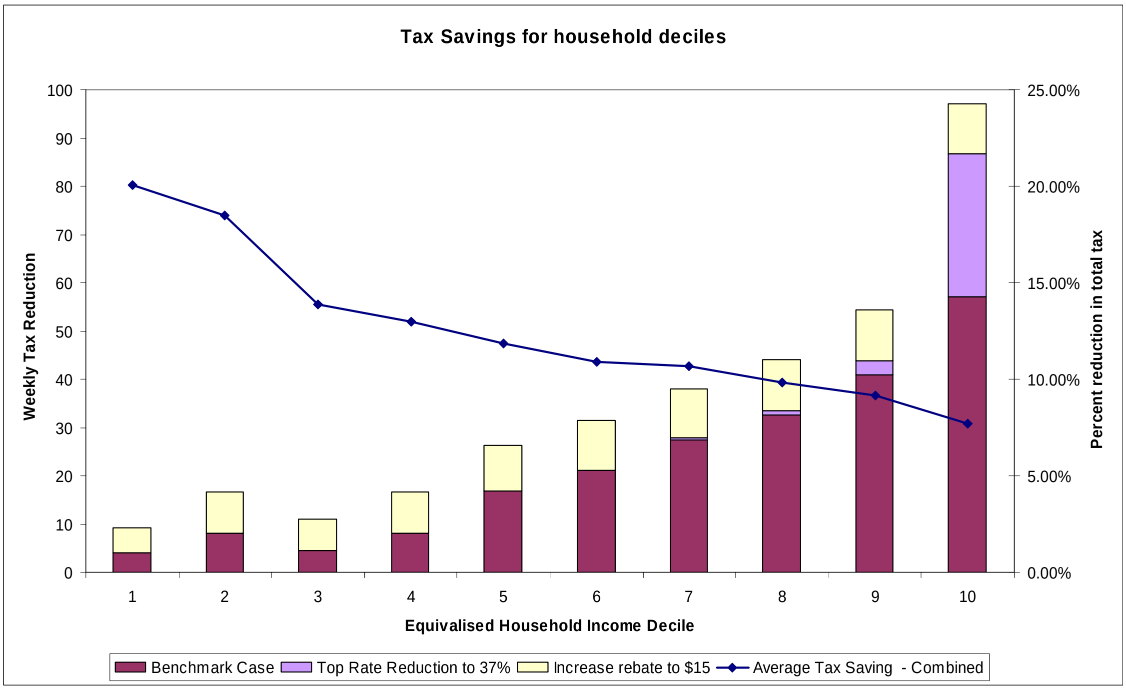
Abatement, or continuation of an LIR type mechanism, would lead to better targeting but higher EMTRs.

Who gains?

In terms of tax cost per week across different income levels, Figure 1 shows that the ‘benchmark option’ ($10/$40k/$80k – red bars) yields gains for all deciles of the household income distributions, rising from $5pw to around $55pw.

The chart also shows how a 2% point reduction in the top rate to 37%, combined with an additional $5 on the $10 rebate affects each decile (yellow and violet bars). As expected, the gains from the rate reduction mainly benefit the top decile, compensated by more even gains across the deciles from the rebate increase.

Figure 1: Tax Savings for household deciles



Key trade offs and design considerations

A two step tax system with rebate in the longer term?

- A two step system is administratively simpler than current
- Administrative Impact of any rebate system is unclear– depends on design
- Lower MTRs at higher incomes, ambiguous effects lower down?
- Significant cash benefit inevitably goes to higher income taxpayers
- But rebates can achieve approximate distributional neutrality at relatively modest cost
- Lower fiscal drag

Consistency with other government policies?

- Changes to minimum wage, working hours, superannuation, benefits, working for families tax credits, GP fees, free ECE could all affect rebate recipients.

Lower rates or increase thresholds?

- A 1% point reduction in the top rate costs about the same as a $10k increase in the top threshold. Rate reduction delivers permanently lower MTRs. Rate reductions have similar equity effects compared with revenue-neutral threshold changes.
- Increasing 33% threshold delivers significant, but temporary MTR reduction around the average full time wage.
- But reducing rates towards 30% (company/PIE) increases system integrity.
- For those on higher incomes, key choices around:
    - o a lower rate (e.g. 30%) and lower relative threshold (meaning higher MTRs at lower incomes); or

- o a higher rate or rates (e.g. 33 or 33/39) and higher relative threshold (meaning lower MTRs at lower incomes).

Maintaining equity?

- Longer-term reductions in the top rate could be achieved without harming inequality, as measured by Tax Gini coefficients, if each 1% point reduction was accompanied by less than $1pw added to the rebate.
- The fiscal cost would be up to $235 million for both measures.

The future for those on low/modest incomes?

This note assumes that a rebate will replace the LIR. Is this the right long term choice?

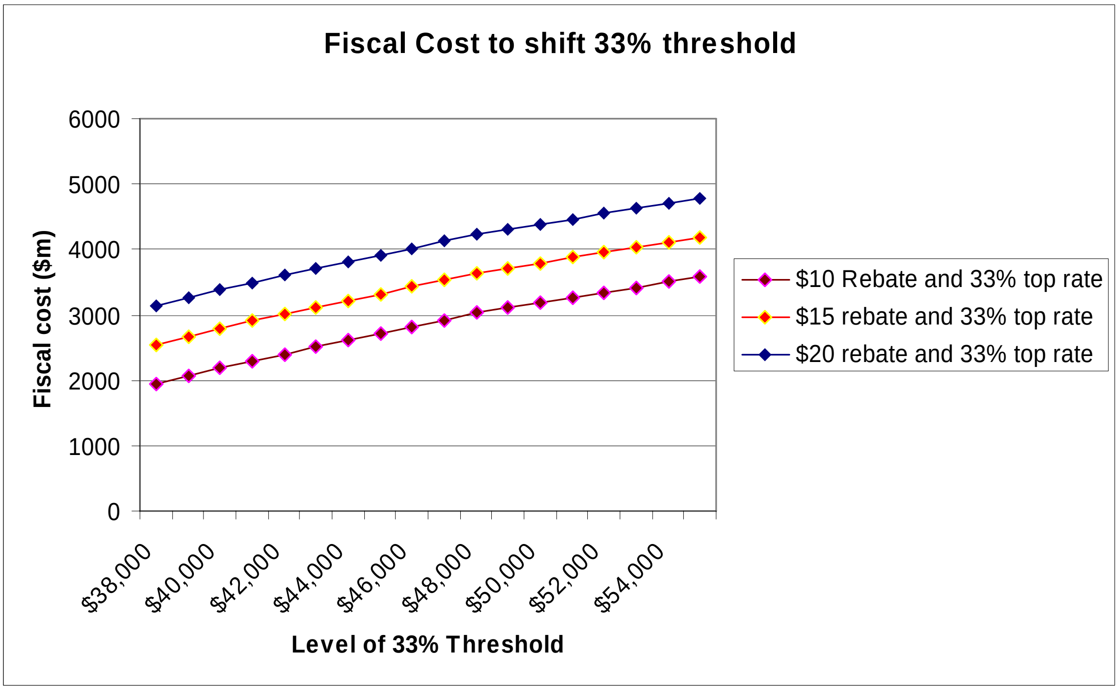
- Under a rebate, those newly paying zero tax cannot benefit from subsequent reforms.
- Keeping the LIR and reducing the 15% tax rate that currently applies on earned income below $9,500 would overcome this.
- If the LIR is retained, the closest approximation to the rebate approach is to keep the $9,500 threshold unchanged and to reduce the effective tax rate below that level.
- Increasing the LIR could be an alternate option. As an example, effective rates of 14% to $9,500 and 19.5% to $38,000 provide a slightly higher tax reduction than the $10pw rebate for taxpayers earning more than $9,500 at an equivalent fiscal cost. Further work could examine distributive and efficiency qualities of the different rebates and fiscally equivalent potential changes to the LIR (taking account of the specific mechanics of the current LIR).

Long-Run Goals for the Income Tax Scale

As discussed, one potential long-run target for tax reform is a two-step tax scale with 19.5% and 33% rates, with the LIR replaced by a tax rebate of similar or greater effect.

This graph summarises the fiscal cost of reducing the 39% rate to 33%, $10, $15 and $20 per week rebates and either keeping or increasing the 33% threshold.

Figure 2: Fiscal costs for long term reform



Transition Paths Link Short-Run and Long-Run Goals

The choice of transition path cannot change the fact that sooner or later the chosen changes – replacing LIR with a rebate, plus lowering the 39% rate to 33% and possibly increasing the $38,000 threshold at which the 33% rate starts - must occur if the above end-point is to be achieved. However, some transition paths will be less disruptive, or improve the likelihood of achieving a particular end-point, or better reflect the Government's priorities, compared to other transition paths.

At any point in the tax reduction process the ultimate total size and timing of a series of tax reductions will probably not be known. Future reductions will always be contingent on fiscal and economic performance and expenditure control. The risk that a programme of tax cuts will only be partially implemented needs to be managed. In practice this means developing transition paths that balance the Government's long-term and short-term priorities, and ensuring that each round of tax cuts contributes to key government policies in its own right.

Using the above long term goal as an example, if the long-term goal is a tax rebate of $20, and this is done in the first round, subsequent rounds can only benefit those earning over $38,000, as the only options left are changes in the 33% threshold and the 39% rate. The distributional implications of such skewed tax cuts, isolated in time from earlier measures, would make such tax cuts difficult to sustain. Therefore, the design of each round of tax cuts needs to balance the Government's short-run priorities without and long-run objectives.