VICTORIA UNIVERSITY TAX WORKING GROUP

Second Session: Personal taxes, GST, and transfers 31 July 2009

The day

- Discussion on the framework in which to consider tax reform, the scope of the group, the group's output, and the December 1 conference
- Presentations from Treasury officials, followed by discussion, on:
  - Income taxes and transfers – the objectives of tax and transfers such as Working for Families; scenarios for examining the effects of different tax and transfer systems; and analysis of types of reforms
  - GST- the revenue, equity, and efficiency issues associated with changing the rate of GST
  - Taxes and demographics.

Objectives of the Tax Working Group

As an independent, Victoria University led group, the aim of the TWG is to consider the appropriate design of New Zealand's tax system in the medium-term and identify the key issues that Ministers will need to consider.

The Group has agreed that six principles should guide the design of the tax system:

- growth and efficiency - including New Zealand's need to compete for internationally highly mobile capital and labour
- equity and fairness – how progressive is the tax system; how it affects the distribution of income tax burdens; how far people with similar incomes pay similar taxes; and impacts on measures of economic hardship
- revenue adequacy – that enough money is raised for government spending
- revenue integrity – that the tax system and revenue will be sustainable over time, and minimises opportunities for tax avoidance and arbitrage
- simplicity of administration and compliance
- coherence – that the component parts of the overall tax system form a coherent whole in the sense that they conform to the same principles (e.g. broad-based low-rate)

The TWG will produce a short report before Christmas covering the principles of a good tax system, the key problems with the current tax system, key directions for reform, and analysis of specific illustrative reform options. A draft report will support the Group's one-day tax conference on 1 December and following that conference and feedback it will be finalised to present to Ministers in mid-December. While the TWG is a working group designed to help officials provide a framework for reform to Ministers, and not a formal "tax review", the members believe that a report is important to formalise and record its work.

Income taxes and transfers

The group looked at the current New Zealand personal income tax and transfer system, primarily Working for Families (WfF) and compared this with the recent past, and other OECD countries.

This included considering several (approximately revenue-neutral) hypothetical scenarios developed to deliberately highlight the effects across five areas - economic growth and efficiency measured by effective marginal and average tax rates (EMTRs), equity measured by equality and poverty indices, fiscal integrity, administrative and compliance aspects, and fiscal cost - of quite different tax and transfer packages. These included:

1. Removing tax credits; and a top rate of 23% - to show the effect of a fiscally neutral switch from tax credits to a reduction in the top rate of personal tax
2. Removing tax credits; and a top rate of 30% with a universal child payment of $2000/child - to show effect of improving incentives at higher incomes; reducing administrative difficulties of targeted tax credit system
3. Reduce WfF abatement threshold; two-stage abatement; top rate of 33% - to show effect of increased targeting of WFF at lower-middle income families
4. Increase WfF abatement rate; top rate of 33% - to show alternative method of increased targeting of WfF at lower-middle income families
5. 'Dual' tax schedule: opt in to 'family' schedule (if dependent children) – to show a simplification of the administration by reducing the "churn" of tax paid on one hand and returned via tax credits on the other.

Conclusions included:

- Scenarios 1, 2 and 5 improve EMTRs, fiscal integrity and administration, but at the cost of substantial increases in measures of after-tax-&-transfer income inequality and especially poverty
- Changes to Working for Families (scenarios 3 and 4)
    - do not change poverty measures and make little difference to inequality
    - have modest positive or ambiguous efficiency benefits
- Further consideration should be given to:
    - relaxing fiscal neutrality within tax/transfer system
    - whether extra revenue could allow efficiency/integrity improvements of 1, 2 & 5, and reduce or eliminate the equity problems
    - extending the 'dual' tax/welfare system to include transfer payments
    - examining some 'non-family' social assistance options.

Discussion

The group agreed that taxes and transfers are inextricably linked and that these were both within the scope of the TWG. In particular, social assistance where entitlement or abatement is linked to income is within the scope of the group. Other government expenditure including NZ Superannuation is not within the group's scope.

It needs to be clear that the tax system is the best way to deliver welfare assistance before it should be used for this. It is also important to be clear on who should receive assistance, and then about how the assistance should be delivered - and whether taxable income is a good proxy to achieve this outcome. If assistance is targeted, or abated by income, income testing may be the best available method of assessing assistance needs. However, delivering benefits through the tax system inevitably means that taxable income is being used as a proxy for the circumstances and wellbeing of a person and this is not always the best way to assess need.

Working for Families has several aims. It aims to provide assistance to families in need, but was also designed to encourage people into work. These objectives may not fit together, and there are questions about how well the four tax credit components making up WfF were designed to work together. Therefore it is critical that WfF, as well as other assistance delivered through the tax system, has clear objectives.

The TWG asked officials to investigate options involving a flat tax rate with a universal allowance or a targeted allowance to replace Working for Families; a scaled version of WfF; and an option with a choice of individual and family tax schedules. A key area of concern was the sensitivity of poverty measures to the amount of a child payment.

GST

Changing the rate of GST could provide extra revenue as part of a broader tax package, and if used to shift the mix of taxes away from income taxes, could increase the efficiency of the economy in the long term. The amount of additional revenue received, for example, at the 15% rate, is $2.15 billion, in the absence of behavioural changes.

GST is arguably New Zealand's most efficient tax, and the broad base and few exemptions mean there is a high rate of compliance among taxpayers. Because of this, and the low 12.5% rate (both relative to other taxes, and to other countries), raising GST is less at risk from avoidance and more efficient than it otherwise would be. Further, as GST is already in place, increasing the rate does not require fundamental system redesign or implementation of new systems. Inland Revenue commented that from an integrity perspective, shifting the tax mix toward GST was potentially a good move. However officials were strongly against an increased rate of GST combined with additional exemptions from the base. Maintaining a broad base is critical to the efficiency, fairness, revenue potential, and administration of the tax and the group was generally in agreement with that position.

There may be fairness issues with changing the GST rate. Although GST is less regressive than generally believed- particularly if measured by expenditure or on a lifetime basis - increasing the rate could impact lower income or vulnerable households, particularly in the short run. In addition, there could be short run macroeconomic impacts that should be taken into account, including changes in consumption, and price levels.

It was generally accepted by the TWG that changes to GST would be an effective way of altering the tax system. However GST should not be raised to fund additional spending, but to contribute to a revenue-neutral package of tax reform. The TWG thought the avoidance risks were less at higher rates (17.5% or 20%) than the papers suggested; they also thought that any GST increase would be only slightly regressive but felt that this could in part be addressed by automatic compensation mechanisms for most of those on low incomes, and other tax changes for those on middle incomes.

If the GST rate is to be changed, then compensation for those on lower incomes should be considered further as part of any tax reform package.

Demographics: impact on tax system

Although the future of NZ Superannuation (NZS) in association with future demographic ageing is outside the brief of the TWG, projected demographic changes are important in considering future tax changes. In short, demographic trends will increase pressures already faced in the system - our already unsustainable tax system is going to become more unsustainable especially if increased revenues are required to fund projected NZS growth. Without any change in policy settings for NZS, or major fiscal consolidation, significant tax increases would be required to meet the increasing cost of superannuation within 20 years.

With current NZS settings, the costs of NZS are expected to approximately double over the next 40 years; and most of this occurs over the next 20 years. Measured in terms of personal income tax revenues, NZS expenditures rise from around 22% in 2010 to 36% by 2030 and 42% by 2050. This 'pure ageing' effect means that NZS cost will rise from $5.2 bn. to $9.9 bn.

Currently, NZ Superannuation income pays 6% of all personal income tax and GST revenue. This proportion will rise to 11% by 2050. This means that a smaller share of tax revenue will be paid by the rest of economy; and also that changes to NZS will affect tax revenues.

The Group's future work

The next two sessions will cover:

- Base broadening options (Sept 16)
- Corporate taxes and tax integrity (Oct 9)

The Group is aiming by the final session to have a number of 'combined' reform scenarios to consider involving changes to personal incomes and transfers, GST, corporate and other taxes. It has asked Treasury and IRD to provide a set of options (using the 6 principles of analysis) for replacing or reshaping WfF funded by an increase to the rate of GST or by other taxes. As the TWG's next meeting will focus on base extension options, officials will provide worked examples involving funding changes via a land or property tax and/or Capital Gains Tax or by combinations of GST, land tax and/or Capital Gains Tax.