Design of the Income Tax/Transfer System

BACKGOUND PAPER FOR THE TAX WORKING GROUP

24 July 2009

1) Introduction

This paper aims to help the Tax Working Group consider the broad direction for any potential changes to the tax and transfer system. It concerns a subset of the wider tax and transfer system, specifically personal income tax and tax credits delivered through Working for Families (WFF) and the Independent Earner Tax Credit (IETC). Other forms of taxes are, or will be, discussed in separate papers.

A key concern with the current tax system is the levels of effective marginal tax rates (EMTRs) that people can face due to the combination of higher statutory marginal rates of tax and abating social assistance. Comprehensive reform of the tax system will likely need to consider taxes outside the scope of this paper in order to make gains across a range of objectives. Similarly, implications of tax reform on the interface with the social assistance system are not discussed in detail here, but would need to be analysed as a part of developing any reform options.

This paper assesses the current tax/transfer system against five key objectives: efficiency and growth; equity; fiscal integrity; compliance and administration; and fiscal cost. It highlights the importance of explicitly considering the trade-offs between these five objectives when considering these changes and acknowledging the value judgements about which objectives matter most.

Three appendices are attached to this paper. These contain further information on particular issues raised in this paper. The appendices are:

A. Designing Tax and Transfer Schemes: Some Basic Principles

B. Description of Targeting for Key Types of Social Assistance

C. Understanding the Interface between Tax, Tax Credits and Social Assistance

A Framework for Analysing Scenarios

The art of taxation, as was famously described by Jean-Baptiste Colbert[1], "consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing". Obviously, taxation is necessary for government administration to function and deliver the services it is there to provide, and the national tax burden is closely tied to the level of that government spending. But, of course, taxation is not just about revenue adequacy. Getting the right mix of taxation is about five key objectives:

- *Objective One: Efficiency and growth* - how can we best ensure that taxes distort decisions and hinder economic growth as little as possible?
- *Objective Two: Equity* - who bears the burden of taxes, how can transfer payments minimise income poverty rates, and what is the shape of the income distribution? This includes both *horizontal equity* – *w*hether or not taxes are "fair" in their treatment of those in similar positions – and *vertical equity* – whether or not taxes are "fair" in their treatment of those in different positions.
- *Objective Three: Fiscal integrity* - how do we limit the extent to which people alter their structuring and reporting of income for tax reasons?
- *Objective Four: Compliance & administration* - citizens understand their rights and obligations; delivery and compliance costs are as low as possible; taxpayers do not unnecessarily end up in debt or in credit to the Crown.
- *Objective Five: Fiscal cost* – meeting the Government's spending goals at the lowest possible cost

Unfortunately, there is no perfect or optimal tax and transfer system. As discussed in more detail in Appendix A, value judgements are inevitable in the design and evaluation of tax structures: there is no such thing as a value-free 'optimal' structure. There are inevitably trade-offs between objectives and *it is not possible to have a system that maximises all five objectives*. But, being explicit about desired outcomes helps in the decision about what aspects most need improving and what compromises can be lived with. For example, the concepts of equality of opportunity (everyone has a similar opportunity to pursue what is in their best interests), equality of outcome (everyone ends up with a similar income), and concern about the absolute consumption levels of the poor lead to quite different objectives in terms of the redistributive nature of the tax and tax credit system. The balance of attitudes to these concepts of equity can strongly influence discussion about what the tax system should look like.

Also, changes to improve certain objectives will inevitably have consequences for at least some of the other objectives, which may or may not be intended themselves. This is why it is important to consider the coherence of the system, and each specific measure must ultimately be examined in the light of how well it fits in with the tax and transfer system as a whole. For example, while progressive tax systems seek to shift the burden of taxation more toward those with higher incomes

[1] Served as the French Minister of Finance from 1665 to 1683 under the rule of King Louis XIV.

(i.e. reduce inequality), higher effective marginal tax rates can stifle labour market incentives, discourage growth and damage fiscal integrity at the top end. Similarly, the expansion of Working for Families tax credits in recent years has redistributed income to low- and middle-income households, but has raised fiscal cost and integrity problems. It has led to some positive labour market outcomes (especially for sole parents to move from the benefit into work) but has also led to some negative labour market incentives for others (e.g. reduced incentives for second-earners to move into employment). If revenue neutrality in a suite of tax changes is required, another simple constraint is that it ultimately requires a change in how the burden of taxation is distributed, i.e. a reduction of tax on one individual requires that tax to be raised from another individual elsewhere. Therefore, ***a revenue neutral tax change will inevitably involve winners and losers on an individual level***. Again, how the gains and losses should be distributed is a key value judgement.

Good empirical analysis can help in considering the fiscal, economic and social implications of different tax and transfer systems. It can also help to clarify the different impacts of, for example, high effective marginal tax rates (EMTRs) over a short income range (e.g. the Unemployment Benefit is abated at 70%) versus lower EMTRs spread over a longer income distribution (e.g. Working for Families tax credits are abated at 20%). (Refer to Appendix B for the abatement and targeting rules for key forms of social assistance.)

This said, just as there are value judgements associated with the balance of objectives, it should also be recognised that there are (implicit) value-judgements associated with the choice and interpretation of particular measures used to assess changes against those objectives. For example, there are a range of poverty measures commonly in use. Poverty levels can be considered against an absolute or relative poverty line, with the line set at various levels (e.g. 50%, 60% or 70% of median disposable incomes or another level). An absolute poverty measure can help indicate the number of people in society that may not be able to support a basic standard of living, whereas a relative poverty measure helps indicate the number of people that may not be able to support a certain standard of living from a social cohesion perspective.

Measures of income poverty typically ignore the presence of assets or individuals with only temporary low incomes (e.g. students). Moreover, individuals with low taxable incomes are not necessarily the same as in poverty (e.g. some secondary earners in medium or high income families). As such, caution must be taken in the weights placed on income-based measures alone[2]. Similarly, the static nature of poverty and inequality measures do not account for changes throughout people's lives in terms of income growth, changes to family composition and labour market opportunities.

It is also worth noting that static analysis does not take account of any behavioural changes. However, if there are behavioural changes that would for example improve labour market incentives, and improve participation and productivity, and thus raises individual and collective incomes, static analysis will not capture the equity, integrity, revenue and macroeconomic effects

[2] Targeting tax relief on income-based measures through the tax system may not be particularly efficient for some groups. For more information please see *Equity and Efficiency Measures of Tax-Transfer Systems: Some Evidence for New Zealand* New Zealand Treasury Working Paper 08/04, http://www.treasury.govt.nz/publications/research-policy/wp/2008/08-04

that may occur over time. (Note that the analysis in section 3 of this paper does not include any assumed behavioural impacts.)

This paper has sought to use a variety of measures to assess changes to the tax and tax credit system, but inevitably there is a trade-off between being concise and being complete. Thus we have not included measures against wealth rather than income, nor dynamic measures to recognise temporary or evolving circumstances. We have also not included in-kind Government social assistance, for example health or education spending. There is also a particular challenge in finding suitable measures to assess changes in efficiency and growth. This paper uses changes in effective marginal tax rates as a proxy for this, but it should be noted that this is a measure of changing incentives not necessarily of actual efficiency improvements. Nonetheless, we do know that incentives matter – in some circumstances, for some people and to some degree. What this means is that some changes in incentives can be expected to matter more than others. With these limitations in mind, the rest of this section discusses the performance of the current system against the five key objectives.

Objective One: Efficiency and growth

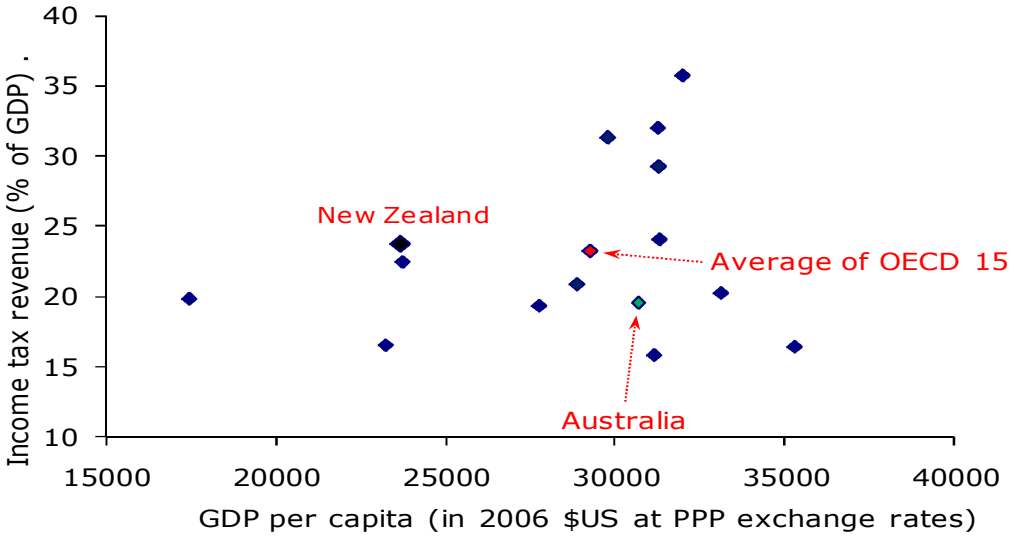
As discussed in the Treasury's *Medium Term Tax Policy Challenges and Opportunities*[3], New Zealand is an especially open economy for labour, capital and goods. To maintain tax revenue and integrity and avoid inefficiencies, taxes in New Zealand cannot be set independently of international settings.

Compared to other OECD countries:

- personal income taxes (as a % of GDP) are high, especially relative to comparable OECD members;
- New Zealand had the OECD's second highest growth of personal income tax revenues (as a % of GDP) from 2000-06.

[3] http://www.treasury.govt.nz/publications/informationreleases/taxconference

Figure 1: Income Tax Revenue versus GDP per capita (OECD countries, 2005)



Source: Medium Term Tax Policy Challenges and Opportunities

People respond to taxes, substituting away from heavily taxed activities towards less heavily taxed activities. This creates economic inefficiencies by biasing firms and households away from the activities that would be preferred in the absence of tax considerations. Moreover, there is increasingly robust evidence that any important source of inefficiency is the way in which taxes can affect GDP and productivity. Corporate and progressive income taxes seem to have the most adverse growth effects (in contrast, consumption and property taxes have the least). Cross country studies of the effects of taxes on growth end up providing average results across the set of countries being studied. It will always be important to assess whether or not New Zealand's circumstances will differ from the averages being reported in these studies and whether or not taxes may be creating important inefficiencies that are not picked up in these growth studies. Nevertheless these studies are important in raising questions about whether or not our tax settings are as efficient as they could be.

While New Zealand's top statutory marginal tax rates are not high by international standards, they may nonetheless raise integrity concerns, discourage entrepreneurship and participation in New Zealand's labour market, and may be an implicit factor in trans-Tasman migration[4]. The OECD estimates that a 5% fall in people's marginal tax rate increases GDP by 1% over the medium-term[5]. These effects must be balanced against any growth costs of reducing government spending by an equivalent amount.

Any assessment of the work incentives faced by New Zealanders is necessarily subject to value judgements about the types of incentives that are important, the people for whom they are important, and the degree to which high EMTRs can be accommodated to achieve equity and fiscal objectives. In New Zealand, the 33% and 38% rates plus abatement of Working for Families at a

[4] http://www.treasury.govt.nz/publications/informationreleases/taxconference

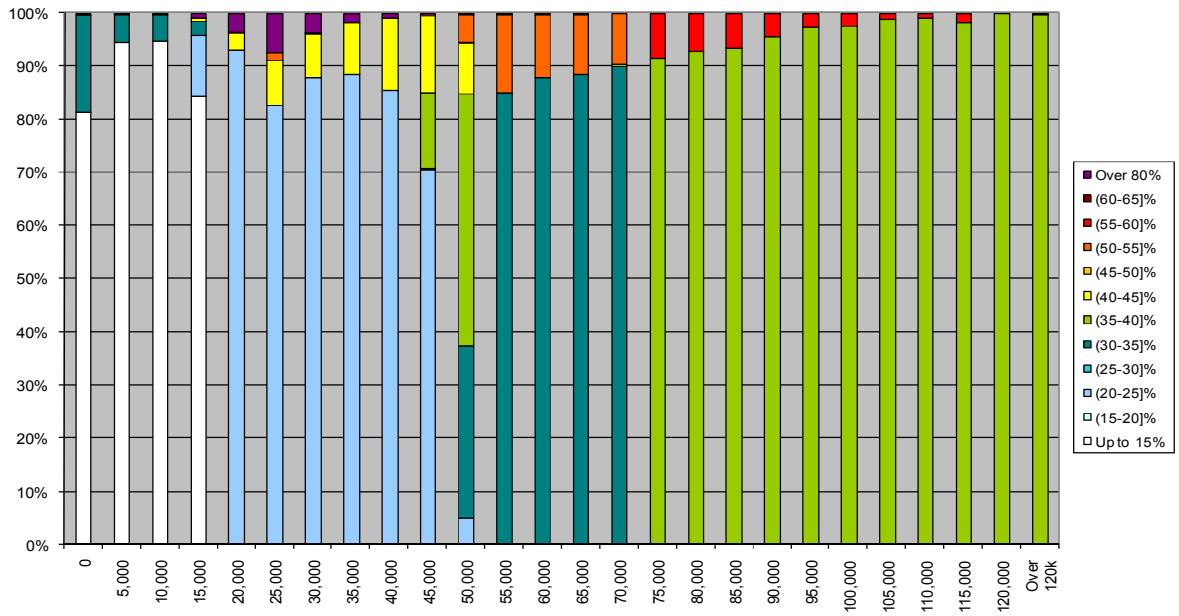
[5] OEDC (2008) *Tax and Economic Growth,* OECD Economics Department Working Paper No 620. (ECO/WKP(2008)28).

further 20%, create EMTRs of at least 53% over much of the middle of the income distribution (see figure 2 below; see also illustrative scenario '0' in Section 3).

Evidence from the evaluation of the Working for Families package shows that this had a notable impact in the movement of sole parents receiving the Domestic Purposes Benefit into employment[6]. Between June 2004 and June 2008, the percentage of sole parents in paid employment for at least one hour per week increased from 48% to 58%. Around two-thirds of the increased employment rate of sole parents was due to changes in tax credits and social assistance. In June 2007, there were an estimated additional 8,100 sole parents engaged in some paid employment as a result of the policy changes.

This said, sole parent beneficiary numbers have since risen in the economic recession. There is also likely to have been some compensatory reduction in the participation rate of (in particular) second earners, who are facing high EMTRs, but analysis of this has yet to be completed.

Figure 2: Share of 2010 taxpayers in each income band facing each EMTR band



Source: Inland Revenue (includes tax, IETC, ACC, WFF, benefit abatement)

Aside from where beneficiaries move into paid work, relatively high EMTRs occur where recipients of WFF tax credits earn sufficient income that they are also facing the top personal tax rate of 38% (i.e. above $70,000 of taxable income).

Design of the tax credit system can therefore play a notable impact on participation. However, design of the tax credit system also has major implications for the overall social security system. If a well-designed tax system should encourage (or at least not discourage) growth, it is similarly

[6] Ministry of Social Development and Inland Revenue (2009), Employment incentives for sole parents: Labour market effects of changes to financial incentives and support (http://www.msd.govt.nz/about-msd-and-our-work/publications-resources/evaluation/receipt-working-for-families/index.html).

important that tax credits maintain the relativity of working above being on a benefit – this was a key principle behind the In Work Tax Credit component of WFF. Flow-ons to the benefit system associated with any change to the tax/tax credit system also need to be carefully thought through, in particular because these flow-ons themselves involve trade-offs, and can alter the balance of outcomes achieved through reform of the tax/tax credit system. While this issue is beyond the scope of this paper, further information on linkages with the benefit system is included in Appendix C.

The Government's stated objectives for the tax system are to build a stronger economy and increase productivity. Through its confidence and supply agreements with ACT, and as favoured by United Future, it has committed to a desirable medium-term goal of reducing and aligning personal, trust and company tax rates at a maximum rate of 30%.

Objective Two: Equity

To differing degrees, Governments are concerned with two broad equity objectives: 1) maintaining an 'acceptable' distribution of after tax incomes; and 2) ensuring a minimum level of income for households. The first objective relates to the cohesion of society and to what extent money should be redistributed from the rich to the poor, from individuals to families, or from working-age people to those who are older. The second objective is about minimising income poverty, especially for families with children.

Any assessment of the fairness of New Zealand's tax/transfer system depends on value-judgements about the balance between these objectives and what assessment measures are used. This does not render measures worthless, just that care must be taken in terms of the conclusions drawn from the analysis. In fact, there a number of measures that provide a means to consider and compare New Zealand's own situation over time and/or comparisons internationally, which can usefully inform the debate.

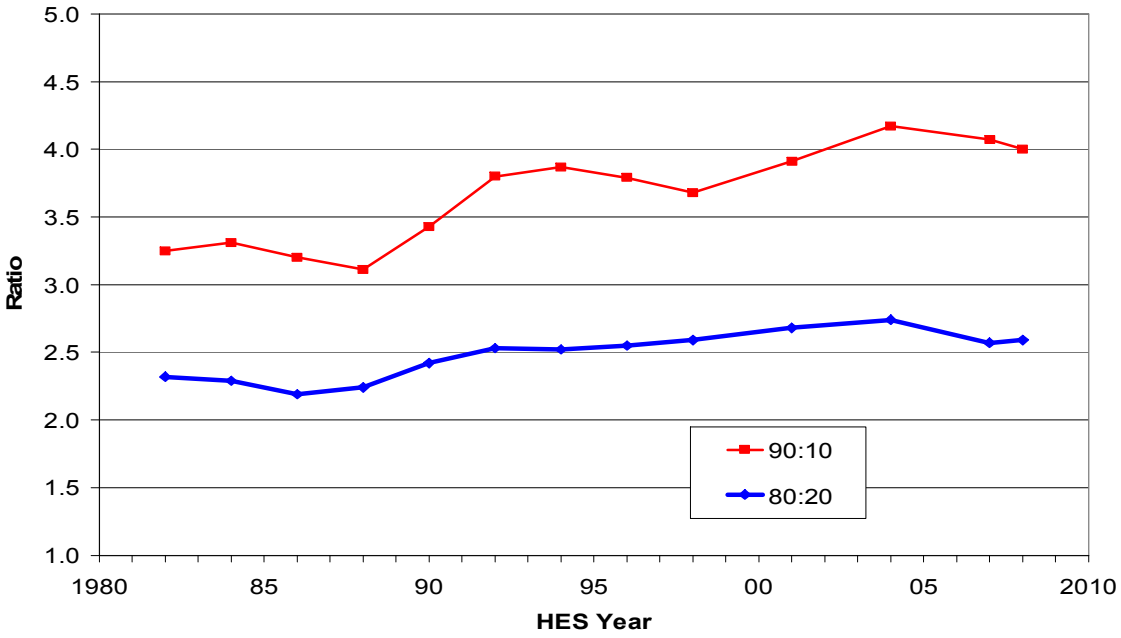
Potential indicators that can help assess equity include:

- percentile ratios (90:10 and 80:20)
- the Gini coefficient or score (a measure of income inequality across society)
- poverty line statistics (using household incomes either before or after deducting housing costs)
- disposable income per income decile
- 'net' taxes paid (that is, income tax paid less transfers received)
- Budget constraint curves by family type.

Inequality statistics

Figure 3 shows the trends in the 90:10 and 80:20 percentile ratios. In 2008 the equivalised[7] disposable income of a household at the 90th percentile was 4.0 times larger than that of a household at the 10th percentile. In 1988 it was 3.1 times; in 2004 this figure was 4.2 times.

Figure 3: Inequality in New Zealand: the 90:10 and 80:20 ratios of equivalised disposable household income, 1982–2008

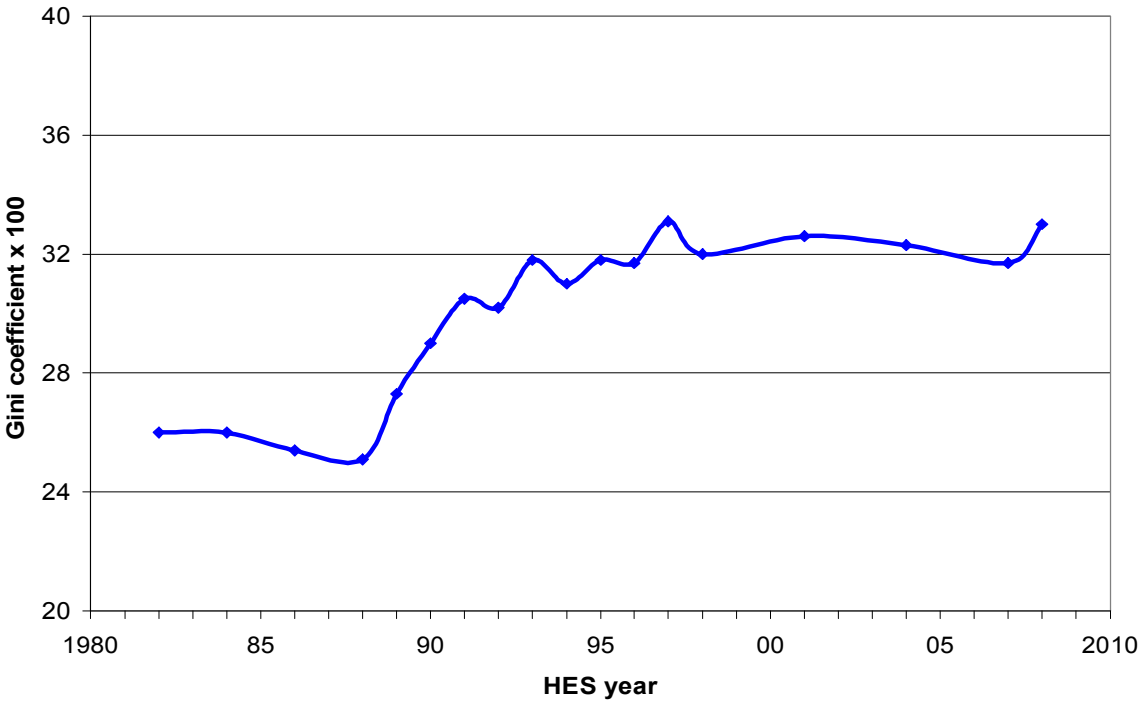


Source: Perry (2009)

Figure 4 shows the trend in inequality using the Gini coefficient. In contrast to the percentile ratios, the Gini coefficient takes the incomes of all individuals into account. It gives a summary of the income differences between each person in the population and every other person in the population. The Gini scores (x100) range from 0 to 100 with scores closer to 100 indicating higher inequality and those nearer zero indicating lower inequality (i.e. greater equality).

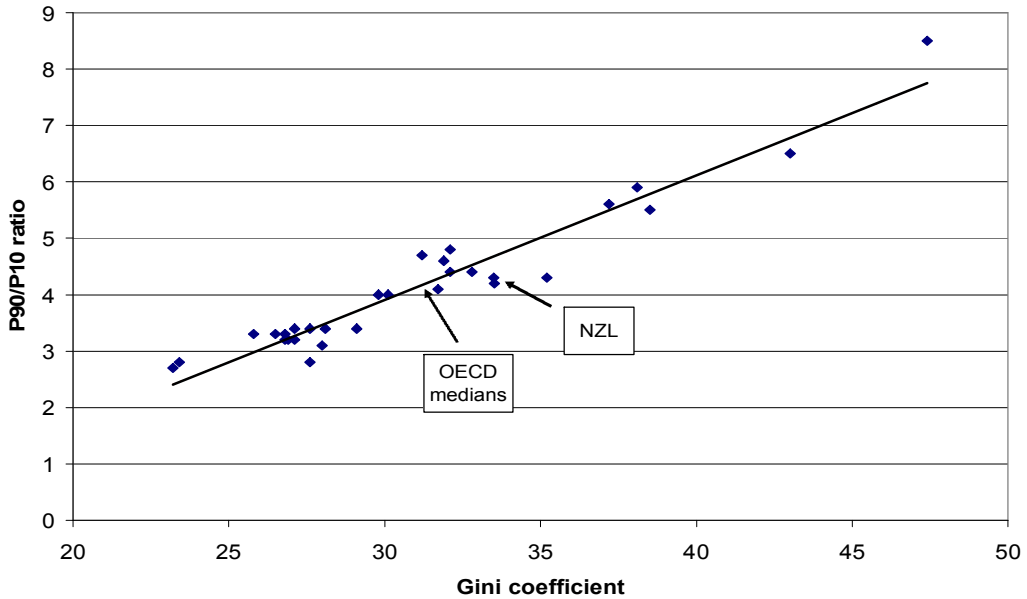
[7] Equivalisation reduces the household incomes to that of an equivalent adult in that household, where the same share of income is attributed to each adult. While this involves value judgement, it is helpful in comparing households of different sizes.

Figure 4: Inequality in New Zealand: the Gini Coefficient , 1982–2008



Comparisons with other OECD countries are available using the Gini coefficient and the 90:10 ratio. Rankings are very similar on both measures. The latest comparative information is for 2004 and is shown in Figure 5.

Figure 5: International comparisons of income inequality: the Gini and the 90:10 ratio in the OECD



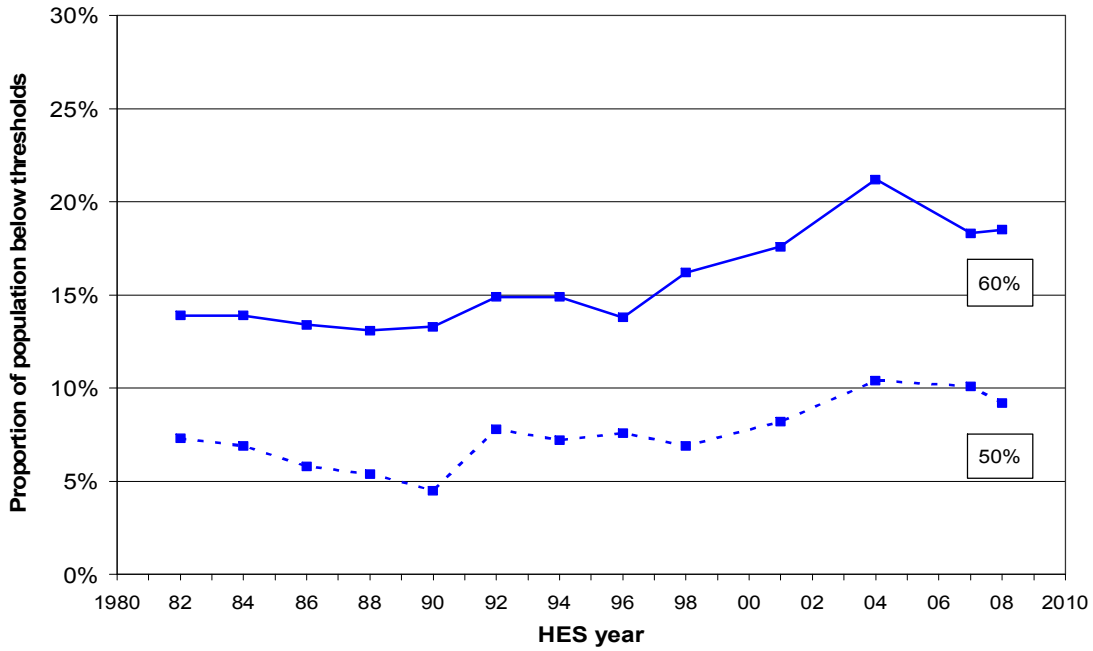
New Zealand's Gini score of 34 in 2004 was below that of the United States (38), very close to the United Kingdom (34) and Ireland (33), a little above Canada and Japan (32), and a little further above

the OECD median (31) and Australia (30). Denmark and Sweden had the lowest Gini scores of 23. In 2008 the Gini for New Zealand was still 34.[8]

Income poverty statistics

A poverty line set at 50% of median household income is used for international comparisons by the OECD. The EU nations have agreed to use 60% of the median as their benchmark. The trends for New Zealand using these measures are shown in Figure 6.

Figure 6: Proportion of population in households with incomes below 50% and 60% of median thresholds, 1982–2008



Source: Perry (2009)

Using the EU measure (60% of median), New Zealand's population poverty rate in 2006 (18%) was just above the EU average (16%). Using the OECD measure (50% of median) New Zealand in 2004 was at the OECD median of 11%. For child poverty, New Zealand is around the EU average (2006) and a little above the OECD median (15% compared with 12%). For child poverty, New Zealand is around the EU average but a little above the OECD median (15% compared with 12%). On the OECD measure, the New Zealand ratio of child poverty to adult poverty is above average for OECD countries.

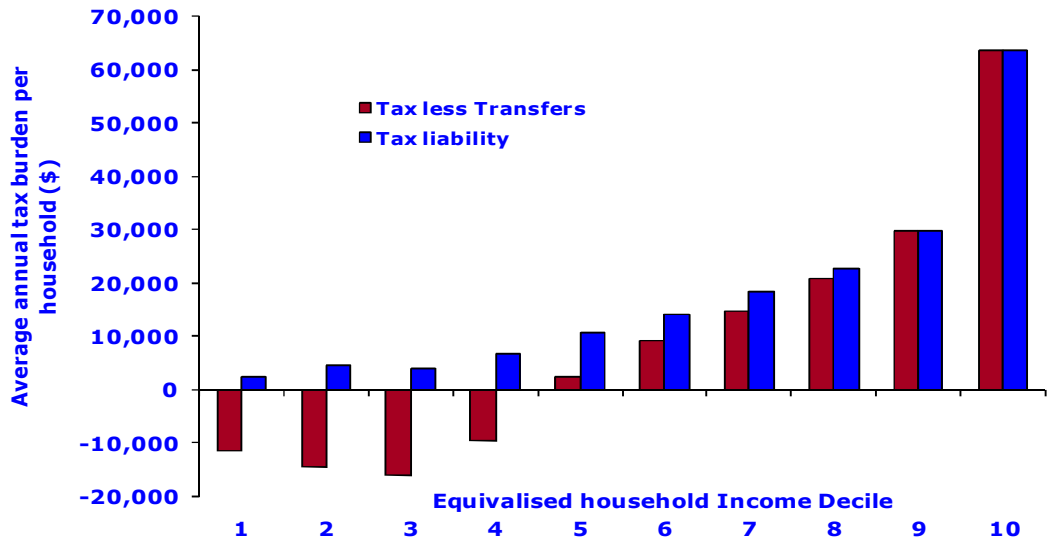
Net taxes paid by households with different incomes

In terms of 'net' taxes (that is, income tax paid less WFF tax credits, New Zealand Superannuation and Benefits received), these are negligible or negative for around half of all households. This is

[8] There are slight differences between the values of the Gini used in the OECD comparisons and those in Figure 4. These differences arise because of the different equivalence scales used. The overall trends and so on are not affected by the choice of equivalence scale.

shown in Figure 7. An 'average' household in the lowest decile receives a net transfer (negative tax burden) equal to -83% of their taxable income. A negative net tax liability applies to the bottom four deciles, with an almost zero liability for the 5th decile, and rising to a positive liability of 31% of taxable income for the top decile.

Figure 7: Redistribution and New Zealand's Personal Tax & Transfers

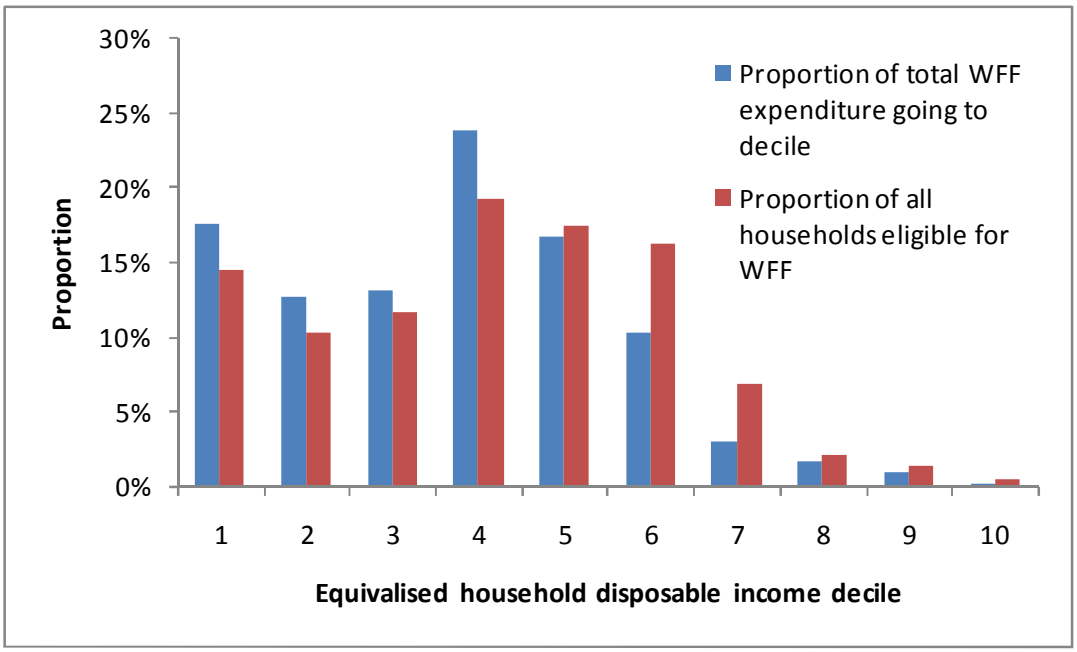


Source: Medium Term Tax Policy Challenges and Opportunities

Note that the imposition of progressive personal income tax does not drive large income redistribution it its own right, but may do more so through the transfer payments and provision of other services they are spent on. Whereas the contribution of transfers to household's net incomes range from 99% of net incomes (for decile 1) to 0% of incomes (for decile 10), the range for taxes is much smaller: from 17% (decile 1) to 31% (decile 10). The system of social transfers can therefore be seen to play the primary role in the redistribution of income though the combined tax-transfer system.

Figure 8 provides some evidence on the degree of targeting in the NZ tax credit system, by showing the percentages of eligible families and WFF expenditure by income level based on 2006/07 HES data – with 2009/10 parameters imposed. It shows that although around a quarter of households eligible to receive WFF are in decile 6 or above (23%), 'only' 16% of total WFF expenditure goes to these households (ie 84% of total WFF expenditure goes to households in the first five deciles). Evaluating the 'appropriate' degree of targeting (i.e. income thresholds and abatement rates) by WFF depends on the poverty alleviation, economic growth and redistributional aims of the government, although achieving those objectives can be informed by analysis of both poverty and labour market incentives.

Figure 8: Cumulative Percentages of Working for Families Tax Credits by Income



Source: Treasury

Objective Three: Fiscal Integrity

An important feature of any tax/tax credit system is integrity. But the degree to which integrity should be pursued in the system at the expense of other objectives (i.e. fiscal and equity objectives) is again a value judgement. A tax system has integrity if taxpayers face the same marginal rates regardless of how they structure their income, investment and savings. Integrity suffers when taxpayers are able to shelter income to either pay less tax or receive more government assistance, or both. Taxpayers can achieve this by channelling income through different legal entities (e.g. a company or trust) that are either taxed at a lower rate or from which income is not counted for family assistance purposes (e.g. a Portfolio Investment Entity).

A tax/tax credit system that lacks integrity will result in:

- *Loss of tax revenue and higher spending on family assistance*;
- *A negative impact on both horizontal and vertical equity objectives*. Higher income taxpayers face a lower tax rate, which undermines the progressivity of the tax system. Further, those income groups which the tax/transfer system is trying to collect from can include those that are actually receiving the family assistance;
- *Ineffective policy*. Attempts to target family assistance to specific income groups do not work;
- *Inefficiencies*. There is a cost to the economy if resources that could otherwise be allocated to productive activities are instead spent setting up tax-efficient entities; and

- *Additional resources required for enforcement activity*. As the use of, for example, trading trusts to shelter income becomes more common, greater monitoring and auditing is required with the risk of litigation.

- *Uncertainty* among taxpayers and in Inland Revenue about when escaping higher marginal tax rates is acceptable given current law and when it becomes unacceptable tax avoidance. This is costly for business and puts pressure on voluntary compliance.

A key concern with the current tax system is the way in which people are able to structure their affairs to avoid higher statutory or effective marginal tax rates. This can come from two key risks to the integrity of the tax/transfer system:

- the differences between the top personal rate and the company and trust rates; and

- the taxable income measure used for family assistance purposes does not take account of all income

To maintain integrity requires either an alignment of rates or measures that prevent the sheltering of income for tax and family assistance purposes. The latter approach may be necessary even with an alignment of rates because the incentive to shelter income for family assistance purposes would still exist if there is an income range over which assistance is abated.

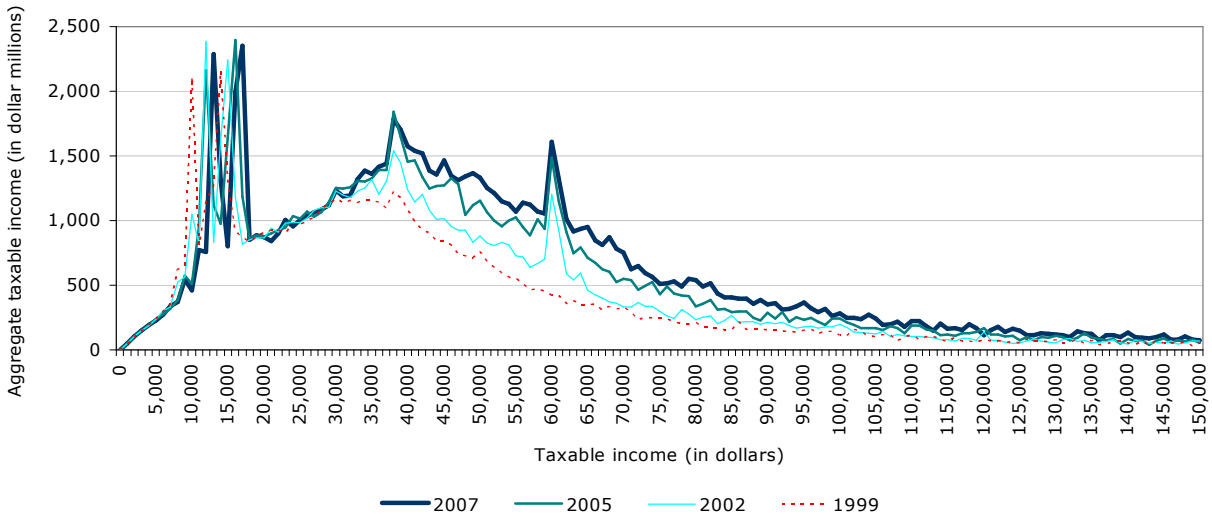
Since 2000 New Zealand's tax/transfer system has experienced two structural changes that have undermined the integrity of the system:

- The top personal income tax rate has increased (now 38%) while the trust, company and PIE rates have stayed the same or fallen; and

- The introduction and extension of Working for Families tax credits means that more taxpayers are eligible for greater amounts of family assistance and those receiving family assistance are further up the income scale.

Combined, these two events have significantly increased the incentives for taxpayers to shelter or split income. The use of trust structures (typically trading companies owned by trusts), for example, not only enables top rate taxpayers to be taxed at 33% but they can also shelter income in the trust and receive appreciable amounts of family assistance. Figure 9 shows that following the introduction in 1999 of the 39 percent top marginal rate for incomes above $60,000, an obvious spike has appeared in the number of taxpayers clustered at $60,000. This indicates that those who would otherwise be facing the top marginal rate are using companies, trusts and other savings vehicles to shelter income from higher rates of personal tax.

Figure 9: **Aggregate taxable income of individuals by $1,000 bands of taxable income**



Note: The data for the year ended March 2007 is at June 2008 and incomplete.

Source: Inland Revenue

The Inland Revenue Briefing for the Incoming Minister of Revenue 2008 reported a number of other indicators of growing integrity concerns.

There is also growing evidence that taxpayers that are not part of the target income group are receiving Working for Families tax credits by either:

- Reducing their "income" as defined for Working for Families tax credits purposes; and/or
- Converting income into forms that are not treated as "income" for Working for Families tax credits purposes.

There are a number of ways in which income can be earned so as to avoid the higher EMTRs that would arise if the income were earned directly as personal income. Even if the top marginal tax were aligned with the company tax rate and the trustee tax rate (as in the 30:30:30 option), there are a number of ways the income could be earned which would avoid the higher EMTRs that arise when Working for Families (WFF) is abated that should be considered from a policy perspective:

- Income accumulating in companies is taxed at the company rate which is less than the EMTR which would arise if that income were earned directly by those on higher EMTRs.
- Income accumulating in trusts and distributions from trusts of amounts that have been previously taxed as trustee income are not counted as income for WFF purposes (following the income tax treatment). A common structure that can take advantage of this feature to avoid high EMTRs involving WFF credits is a trading company owned by a trust. The distributed company income is taxed as trustee income to the trustee with subsequent distributions of these amounts from the trust to the beneficiaries who may be claiming WFF credits. This means that substantial receipts by beneficiaries of trusts are not taken into account in determining their WFF entitlement.

- Instead of receiving taxable wages and salary there is an incentive for WFF recipients to maximise the fringe benefits they receive from their employers. These fringe benefits can be closely substitutable with cash, for example, the use of an employer's credit card. This risk is particularly high with closely held companies.

- Instead of investing in a normal bank account and receiving interest that is counted for WFF purposes, WFF recipients have an incentive to invest in cash PIEs (ie, PIE investments that are not locked in until retirement age) because distributions from PIEs are not taken into account in determining their WFF entitlement. Similar incentives can arise with other widely-held savings vehicles.

- Rental losses from investment properties (not amounting to a business) of WFF recipients are not added back in determining their WFF entitlement. This is inconsistent with the treatment of other losses which are added back.

There are, for example, over 9,700 families with rental losses offsetting other income, who receive Working for Families tax credits.

The example on Box 1 shows how earning income well above the top tax rate threshold can be sheltered such that a family is still eligible for Working for Families tax credits.

Box 1: Trust/company example

A couple family with 2 dependent children; both under 13 years of age. The husband and wife are settlors of a family trust.

The beneficiaries of the family trust are the husband and wife and their 3 children (1 child is independent).

The trust is the sole shareholder of an incorporated company involved in construction. Having the trust as shareholder circumvents the rule which attributes the undistributed income of closely held companies to their shareholders.

The husband draws a low salary ($27,303 - $525.06 per week in 2007) as managing director of the construction company in which he is actively employed.

The salary received contrasts with Statistics NZ's estimate of average weekly household expenditure for a family of two adults and two children as $956 in 2007.

However, the salary income is supplemented by:

- drawings by the husband from the Trust of approximately $67,000 in recent years; and

- advances to the husband and wife against their respective beneficiary current accounts in the Trust.

The company returns taxable income of $770,741, $139,960 of fully imputed dividends distributed to the Trust.

Entitlement to family tax credit and the in-work tax credit based on the salary income of **$27,303** would be $10,348 for the 2007 tax year. Note that the family's salary income is below the WFF abatement threshold of $35,000.

Objective Four: Compliance and Administration

A tax/transfer system cannot function without both effective policy and effective administration. Although the administration of policy should not be the primary motivation in designing a tax/transfer system, it will impact on the fiscal and delivery costs and the policy's effectiveness (such as proper targeting or incentives to work).

Ideally the tax/transfer system would be:

- *Simple and coherent*. A more complicated tax/transfer structure results in less accurate payments, more resources and less compliance.
- *Efficient*. Only the information required for assessment and collection is gathered, and only the information required to understand and comply with the system is provided. The collection of taxes and delivery of social policies should be as automated as possible, minimising compliance costs.
- *Low cost*. The above features should reduce delivery costs, increase revenue collection and reduce non-compliance. Note that in the New Zealand context, many social policies are more costly to deliver because they are targeted and therefore require more information to be collected.

These features are desirable regardless of the tax/transfer policy adopted. There are a number of improvements that could, for example, be made to the current delivery of the Working for Families tax credits. However, some tax/transfer structures will come closer to meeting these objectives than others. An obvious example is a universal child benefit that does not require abatement against income.

Inland Revenue delivery

Inland Revenue is no longer simply a tax collection agency. Rather, over half of Inland Revenue's business is delivering social policy programmes, including student loans, child support, Working for Families and KiwiSaver. The Inland Revenue is delivering more complex schemes to more people. In 2004 Inland Revenue distributed the pre-cursor to Working for Families to 123,000 families. By 2008 this figure had risen to 281,900.

Consequential on this increased role for Inland Revenue in social policy has been significant administrative stress. The primary issue is that Inland Revenue's core business system (FIRST) is an aging tax focussed IT system which is not ideally suited to the way in which social policy information has to be collected, assessed and distributed. This problem arises from the different frameworks underlying the design of social policy and tax. The social policy measures Inland Revenue administers have been placed within a standard tax framework of an annual period of entitlement with a year end square-up. Both these elements are problematic. The annual period of assessment

can disguise fluctuations in income during the year while recovery of overpayments can impose cause significant stress.

There may be an option to use income information from the PAYE system as the primary basis for assessing social policy entitlement. There are a number of advantages of using the PAYE as the basis of assessment for social policy entitlement. The establishment of entitlement and liability are relatively simple and inexpensive, enabling a shorter period of assessment to be adopted; this is better aligned with the more "real time" nature of social policy. The Government has provided $30 million over three years to apply this approach to the Student Loan Scheme Act. As part of this reform there will be no annual return process for employees and the primarily contact channel will be electronic.

Ministry of Social Development delivery

- The Ministry of Social Development (MSD) currently delivers the Family Tax Credit on behalf of Inland Revenue to most beneficiaries. As discussed in Appendix C, MSD also delivers a range of other social assistance payments to beneficiaries and to working families and individuals. There is significant overlap between IRD and MSD 'customer' groups.

- MSD's current delivery arrangements are mostly designed to deliver targeted assistance, with a relatively low tolerance for error, and strong focus on maintaining integrity. As a result MSD systems tend to have higher compliance costs for individuals relative to Inland Revenue's, but has more interaction with individuals and more ability to tailor services to individual need. MSD has strong regional networks, including physical offices in most population centres, supported by call centres and online services.

- MSD is currently experiencing strong increases in the number of jobseekers seeking its services due to the economic climate. This is putting strain on front line resources, and can be expected to continue to do so for some years.

- MSD can provide a solid and proven platform for delivery of payments to individuals and families, but its focus is much wider than this. Work and Income also provides a public employment service and delivers other social services. Across the economic cycle, it is critical that Work and Income is able to maintain its focus on moving people into employment, and that any impact of changes to financial assistance parameters upon this is minimised.

Objective Five: Fiscal Cost

The final objective is fiscal cost. In short, this means meeting the Government's spending goals at the lowest possible cost. The value judgements involved in the fiscal objective primarily arise from the intended use of the revenue raised. In 2009/10 personal income tax is estimated to generate revenue on the order of $23 billion, i.e. about a half of total tax revenue. The Government also pays

out approximately $2.9 billion in Working for Families tax credits, plus a further $0.3 billion in the Independent Earner Tax Credit[9].

Given the current economic and financial climate, it is likely that any reform options (across the range of issues being considered by the Tax Working Group) would need to be either revenue neutral or revenue positive. The following tables provide a sense of the relative magnitudes of the approximate costs, savings and reductions in revenue – excluding any behavioural impacts – from a series of hypothetical changes to the tax and tax credit system.

Reductions in personal income tax rates[10]

Tax scale	Indicative one-year cost ($m)
Top rate to 33%	650
Top rate to 30%	1,370
Top rate to 28%	1,860
Top rate to 26%	2,340
Top rate to 25%	2,580
Top rate to 24%	2,820
12.5%, 21%,21%,30% (retain current thresholds)	2,380
10%, 20%,30%,30% (retain current thresholds)	2,810

Independent earner tax credit[11]

Cost of current IETC	Cost ($m)
$10 per week over $24k, 13c abatement over $44k	290

Scenario	Cost ($m)
Adjust threshold by $1k	10

Changes to Working for families[11]

Breakdown of current components	Cost ($m)
Family tax credit	2,210
In Work tax credit	650
Parental tax credit	40
Minimum family tax credit	20

[9] Estimates based on 2007/08 HES data inflated to 2009/10.

[10] Estimates are based on 2007/08 HES data inflated to 2009/10. One-year costs are provided for 2009/10 tax year and are rounded to the nearest $10m. Effect on personal tax revenue only – does not include flow-on effects to government expenditure or clawback of tax revenue through household expenditure. Nominal and real costs will increase over time due to inflation and reduction in fiscal drag from flattening the tax scale.

[11] Estimates based on 2007/08 HES data inflated to 2009/10.

Scenario	Cost/saving ($m)
Remove WFF above $36,827	850 (saving)
Universalise WFF (remove abatement)	2,590 (cost)

Summary

This section has highlighted the five key objectives that are used to assess different tax/transfer reform scenarios. It has discussed how there are inevitably value judgements and trade-offs in choosing which objectives to advance, and what the implications of this might be for other objectives. A discussion of the current system against those broad objectives has been presented. Some of the issues raised in relation to the status quo are:

- High reliance on income taxation relative to other OECD countries may be inefficient and inhibiting labour productivity and growth.
- Generally, progressive and/or high effective marginal tax rates may discourage people from making efficient decisions on how much to (or indeed *if* to) work, save or invest, although by international standards the gap between our top and lowest marginal tax rate is relatively low. A particular concern for New Zealand is the international mobility of its labour force and particularly its highly skilled labour force[12]. Top statutory marginal tax rates (MTRs) are not high by international standards but may nonetheless be inhibiting productivity and growth.
- High marginal tax rates can discourage people from making efficient savings decisions and compound distortions that are created when not all forms of savings and investment are taxed neutrally.
- Differences in higher rates of personal tax and the tax rates on trusts, companies, PIEs and other savings entities has led to increasing lack of coherence in the tax system. There is a concern that tax liabilities depend in a material way on how people structure their savings decisions and their form of business organisation.
- Like most OECD countries, income inequality in New Zealand rose from the late 1980s to the mid-1990s, but remained approximately constant thereafter. In 2004 a Gini coefficient of 34% was slightly above the OECD average (=31). NZ ranked 23rd out of 30 countries (from lowest to highest); and 19th out of 30 according to the 90%:10% income ratio measure. At 4.3 the 90:10 ratio is close to the OECD average of 4.1.
- Poverty rates: using a '50% of median income' measure, NZ is around the OECD average, ranking 16th out of 30. Child poverty (in 2004) was 15%, placing NZ 20th out of 30 OECD countries. The ratio of child poverty to adult poverty is higher in New Zealand than the average for the OECD.

The challenge will be to find reform options that improve some of these aims without undue adverse effects on other objectives, particularly those associated with equity.

[12] Refer Figure 1.2 in Medium Term Tax Policy Challenges and Opportunities http://www.treasury.govt.nz/publications/informationreleases/taxconference