MINISTRY OF SOCIAL DEVELOPMENT
TE MANATŪ WHAKAHIATO ORA

Inland Revenue
Te Tari Taake

THE TREASURY
Kaitohutohu Kaupapa Rawa

Joint Report: Interactions Between Tax Working Group and Welfare Expert Advisory Group

Date:	7 March 2019	**Report No:**	T2019/531 MSD REP/19/3/172 IR2019/122
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Note** the contents of this report prior to your meeting on 12 March 2019	Tuesday 12 March 2019
Minister for Social Development (Hon Carmel Sepuloni)	**Note** the contents of this report prior to your meeting on 12 March 2019	Tuesday 12 March 2019
Minister of Revenue (Hon Stuart Nash)	**Note** the contents of this report prior to your meeting on 12 March 2019	Tuesday 12 March 2019

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Becky Prebble	Principal Advisor, Welfare and Oranga Tamariki	s9(2)(a)	✓
Sam Tendeter	Manager, Welfare and Oranga Tamariki		

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury, for distribution to MSD and Inland Revenue.

Note any feedback on the quality of the report	

Enclosure: No.

Joint Report: Interactions Between Tax Working Group and Welfare Expert Advisory Group

Executive Summary

The Ministers of Finance, Social Development, and Revenue are meeting on 12 March to discuss potential interactions between the Welfare Expert Advisory Group (WEAG) report (delivered on 25 February, under limited circulation) and the Tax Working Group (TWG) report (publicly released on 21 February).

One outcome you may wish to seek from this meeting is that Ministers get a shared understanding of the possible overlaps between the two reports, which would inform upcoming decisions on the Government response to each. There may also be overlaps with potential Budget 2019 income support initiatives within Vote Social Development.

To support that outcome, this report sets out:

- Our overall view that the two reports have relatively limited areas where they overlap and are not inconsistent where they do.
- Areas where the reports take different approaches to some shared themes. Specifically the TWG's recommendations would increase the post-tax incomes of all individuals earning over $14,000 per year whereas many of the WEAG's recommendations are more targeted. To the extent that implementing the full suite of recommendations over the short to medium term is not feasible, Ministers may need to consider which approach aligns best with their priorities.
- Key interactions that it would be useful to understand if Ministers are considering implementing some recommendations from each report at around the same time, in particular the combined impacts on:
  - distributional outcomes
  - child poverty measures
  - effective marginal tax rates and average tax rates for different groups, and
  - replacement rates between benefit incomes and low wage incomes.
- Some areas where recommendations in one report affect the "other" side of the tax and transfer system. For example, the TWG has suggested a personal tax cut with "flow through" to beneficiary incomes, which in substance would be a benefit increase. We do not consider that any of these interface issues are likely to present significant problems if the specific recommendations were adopted, but they are factors to be aware of and in some cases may require subsequent judgments about desired impacts as they are worked through.

Recommended Action

We recommend that you **note** the contents of this report prior to your meeting on 12 March 2019.

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Joint Report: Interactions Between Tax Working Group and Welfare Expert Advisory Group

Purpose of Report

1. The Ministers of Finance, Social Development, and Revenue are meeting on 12 March to discuss potential interactions between the WEAG report (delivered on 25 February, under limited circulation) and the TWG report (publicly released on 21 February). The public release of the WEAG report is planned for April.

2. The Government response to the TWG is planned for April 2019 and the WEAG response is planned by July 2019.

3. One outcome you may wish to seek from this meeting is that Ministers get a shared understanding of the possible overlaps between the two reports, which would inform upcoming decisions on the Government response to each. There may also be overlaps with potential Budget 2019 income support initiatives within Vote Social Development.[1]

4. This report sets out:
    - Our overall view that the two reports have relatively limited areas where they overlap and are not inconsistent when they do.
    - Areas where the reports take different approaches to some shared themes, potentially requiring Ministers to decide which approach to prioritise.
    - Key interactions that it would be useful to understand if Ministers are considering implementing some recommendations from each report at around the same time, in particular the combined impacts on:
        - distributional outcomes
        - child poverty measures
        - effective marginal tax rates and average tax rates for different groups, and
        - replacement rates between benefit incomes and low wage incomes.
    - Some areas where recommendations in one report affect the "other" side of the tax and transfer system.

Analysis

There is limited overlap between the two reports and their messaging is not inconsistent

5. The reports of the TWG and the WEAG both address aspects of the overall tax and transfer system, but with different objectives:

[1] In addition to the income support bids that have already been submitted, the Ministers for Child Poverty Reduction and Social Development have indicated that they wish to submit a late Budget bid for the indexation of main benefit rates to wages
s9(2)(f)(iv)

- the TWG primarily considered the structure, fairness, and balance of the tax system, and
- the WEAG considered the welfare system (including Working for Families tax credits) to ensure people have an adequate income, are treated with and can live in dignity, and are able to participate meaningfully in their communities.

6. Consistently with both groups' terms of reference, the TWG made a number of recommendations about the personal tax system and the WEAG made recommendations about the income support system. The terms of reference of the two working groups were distinct, so in general there is limited overlap between the two reports.

7. Although the two reports address separate sides of the tax and transfer system, their recommendations are not inconsistent. In particular, the TWG report recommends that if the Government wishes to improve incomes for very low-income households, the best means of doing so is through welfare transfers (as recommended in the WEAG report). Both groups also recommend being aware of the overall impact on tax and transfers from any individual changes to tax rates or abatements.

8. Annex 1 sets out the primary recommendations of each report that address either the income support system (WEAG) or the personal tax system (TWG). For the purposes of these two reports, Working for Families tax credits have been considered part of the income support system and were included in the WEAG's Terms of Reference.

9. Both reports are broad and, consistently with their terms of reference, make a number of recommendations beyond the personal tax and income support systems. Where the reports make recommendations in the same general area – for example housing – there is broad consistency of messaging. Annex 2 sets out the key areas (outside the personal tax and income support systems) where the two reports cover similar ground and notes key recommendations.

Both sets of recommendations would be fiscally significant if adopted

10. The TWG identified a preferred mechanism for delivering personal income tax changes within its terms of reference – increasing the bottom personal income threshold, currently set at $14,000. It then identified a number of illustrative options that could be part of a revenue neutral tax package: [2]

Option	Fiscal cost	Tax saving / gain per year
a. Increase the first tax threshold to $20,000.	$ 1.2 billion (2022/23) $ 6.1 billion over 5 years	Up to $420
b. Increase the first tax threshold to $22,500.	$ 1.6 billion (2022/23) $ 8.3 billion over 5 years	Up to $595
c. Increase the first tax threshold to $30,000, and the second tax rate raised to 21%.	$ 1.6 billion (2022/23) $ 8.3 billion over 5 years	Up to $1,120 for those earning up to $30,000. Those earning above $48,000 gain $490.

2 The Final Report also gives consideration to a tax-free zone, although this is not the Group's preferred option. A $5,000 tax free zone would cost $1.6 billion per annum (2022/23), delivering a tax saving of up to $525.

11. The WEAG has costed its recommended set of changes to the income support system (covering both level and design) at $5.2 billion per year.[3]

While there is limited specific overlap, the reports have some shared themes and to some extent propose different approaches to addressing them

12. Both sets of recommendations, either by themselves or in different combinations, would likely affect incentives to work, distributional outcomes, and child poverty measures. Previous advice on potential tax packages has considered some distributional implications of different combinations of tax changes, as did the final TWG report itself.[4] We have not yet provided advice on these implications for different WEAG recommendations, although the WEAG's final report provides some information on these impacts for its recommended package of changes to income support. We have not provided any advice on the impacts of possible combinations of measures across the two reports.

13. While at a high level both sets of recommendations aim to increase post-tax incomes for some households, the specific households affected would differ. This difference primarily arises from the different scopes of the two terms of reference. Specifically:

    - The personal income tax changes recommended by the TWG would result in higher post-tax incomes for all individuals earning above $14,0005.
    - The WEAG recommendations, in contrast, would primarily affect low to middle-income households, with gains weighted towards the poorest households and households with children (the WEAG proposed a 50% abatement rate for the Family Tax Credit for households with incomes of $160,000 and over).

14. These approaches are not in principle inconsistent: it is possible to proceed with personal tax cuts at the same time as delivering more targeted assistance to some households. However, due to the significant fiscal costs associated with either set of recommendations, it is unlikely to be possible to proceed with the full suite of recommendations from each working group in the short to medium term.

15. In deciding on responses to both reports, Ministers have choices about which approach to prioritise and will need to consider the trade-offs with the fiscal impacts, income distributions, behavioural incentives, implementation timeframes and impact on agencies.

There are recommendations that, if implemented at around the same time, would have combined impacts that it would be useful to understand in advance

16. If the Government is interested in implementing some recommendations from the TWG and some from the WEAG at around the same time (and/or some income support initiatives submitted by Minister Sepuloni for Budget 2019), it would be useful to get a better understanding of the combined impacts of those options before making a final decision.

17. For example, if Ministers were considering an increase in the bottom tax threshold, an extension on taxation of capital income, and a benefit increase, the following modelling would be desirable to ensure that the impacts of the combination are fully understood:

[3] The WEAG's report notes that the fiscal cost of their recommended income adequacy package is estimated to be $5.2 billion per year when implemented. This figure covers proposals outlined in table 2 in the 'Achieving security requires adequate income' chapter of the WEAG's final report only.

[4] See the Final Report of the Tax Working Group; Potential revenue negative packages II (position paper for session 23 of the Tax Working Group), 22 – 23 November 2018; Fiscal and distributional analysis of tax-free zone and KiwiSaver proposals [T2019/1]; and Analysis of introducing a tax free zone into the personal tax system [T2018/3657].

[5] Taxpayers will also be affected by the TWG's proposed changes to capital income taxation and KiwiSaver.

- the distributional impacts of the changes (any plausible combination is likely to result in a more progressive system than any initiative by itself, but it would be useful to understand the extent of the changes)
- impacts on child poverty measures (these can be difficult to predict in advance due to possible changes to median incomes)
- impacts on effective marginal tax rates and average tax rates for different groups, and
- replacement rates between benefit incomes and minimum wage incomes.

18. If you are interested in pursuing other options from both the WEAG and TWG we can model the various impacts that would be relevant to that particular combination of initiatives.

There are also some specific recommendations that present interface issues

19. While as noted above there are limited overlaps between the two reports' recommendations, some specific recommendations from each report would affect the "other" side of the tax and transfer system. In general we do not consider that these interfaces present serious problems, but they are factors to be aware of and in some cases would require subsequent judgements as they are worked through.

20. **Benefit flow-through**: The TWG recommends an increase in the bottom tax threshold in order to reduce the tax paid by lower income households (noting that this change would to an extent flow through to higher income households too). Since welfare benefits are set net of tax, personal income tax cuts do not generally have an automatic impact on benefit payments.[6] The TWG recommended that any tax reductions be paired with equivalent increases in benefit levels.

21. **Change Working for Families abatement to offset tax increase:** The TWG noted that effective marginal tax rates are already high for families receiving Working For Families tax credits, and increasing the second marginal tax rate (a TWG recommendation) would increase them further. Consequently, the TWG suggested that the Government consider a reduction of the abatement rate of Working for Families tax credits to offset the impact of the increase, if it were to be adopted. The WEAG also recommend increases to the Family Tax Credit rate to offset the negative impact of some simplification in the income support system.

22. **Impact on rents and Accommodation Supplement:** The TWG notes that their recommendation to extend taxation on capital income may lead to some small upward pressure on rents (and downward pressure on housing prices). The WEAG report notes the housing cost pressures on low income families and recommends further housing support be provided, including increasing the Accommodation Supplement maxima to reflect movement in median rental levels over time. The timing of any impact of tax changes on rents is unknown.

23. **Effective marginal tax rates:** The WEAG notes interactions with the personal tax system when it considers the overall impact of changes to rates and abatement settings on the effective marginal tax rates facing people at different income levels. The WEAG preference is to try to smooth abatement rates alongside taxes to prevent high effective marginal tax rates at low and low-middle income levels. The WEAG's proposed Earned Income Tax Credit seeks to use the tax system to lower effective marginal tax rates at low income levels for those working, and suggests making it available to people without children, which would replace the tax system's Independent Earner Tax Credit.

Annex 1:

Recommendations from TWG and WEAG reports that address the personal income tax and income support systems

TWG recommendations about personal income tax (recs 46-52 in the report)

- Consider increases in the bottom threshold of personal tax to increase the progressivity of the personal tax system.
- Consider combining increases in the bottom threshold with an increase in the second marginal tax rate.
- If this higher tax rate is adopted, the Government consider a reduction of the abatement rate of Working for Families tax credits to offset the impact of the increase.
- Note the group's preference for increasing the bottom threshold to introducing a tax-free threshold.
- Consider an increase in net benefit payments to ensure beneficiaries receive the same post-tax increase as other people on the same income.
- Consider changes to tax rates and thresholds alongside any recommendations made by the Welfare Expert Advisory Group.
- Not reduce the top marginal tax rate on vertical equity grounds because it is already low by international standards and it would not increase progressivity of the tax system.
- Note that many submissions called for increasing top personal tax rates in order to enable policies that would make a material reduction in income inequality through the personal tax system. As such increases are precluded by the Group's Terms of Reference the Group did not undertake an analysis of the options (and their effectiveness).

WEAG recommendations about income support (recs 20 – 23, 27, 33 in the report)

- Increase main benefits payment rates by between 12% and 47%.
- Increase abatement thresholds for main benefits.
- Index income support payments (including main benefits and Working for Families tax credits) to wages rather than prices; index Accommodation Supplement to movements in housing costs.
- Increase the government co-payment rate from 70% to 75% in Accommodation Supplement.
- Consider a Living Alone Payment to contribute to the higher costs of adults living alone.

[6] The only welfare payments that would automatically increase under current legislation are Superannuation and the Minimum Family Tax Credit.

- Increase the rates of the Family Tax Credit and abate it more gradually for most families (i.e. at 10% from an annual family income of $48,000 to $65,000 and from 15% from $65,000 to $160,000), with higher abatement for high-income families (i.e. at 50% on family incomes over $160,000).

- Replace the In-Work Tax Credit, Minimum Family Tax Credit, and Independent Earner Tax Credit with a new Earned Income Tax Credit of up to $50 per week (a work incentive tax credit that is more targeted to people on low and middle incomes, and is for people with and without children with a family-based income test).

- Make the Best Start Payment universal for all children under 3.

- Pass on child support to receiving carers.

Annex 2: Other areas of overlap between TWG and WEAG recommendations

Debt

TWG

- Establish a single Crown debt agency, to achieve economies of scale and more equitable outcomes across all Crown debtors.

WEAG

- Continue to prioritise a reduction in outstanding benefit debt through sustainable repayments, and minimise the creation of overpayments, including reviewing recoverable hardship assistance and current practice, to be more consistent with whakamana tāngata.
- Align the regulations and practice around benefit debt so that it is treated in substantially the same way as Inland Revenue treats taxpayer debt.
- Instigate a cross-government approach to managing debt to government agencies.

Productivity

TWG

- Recommended a broad extension of the taxation of capital gains, which would help improve the allocation of investment across the economy
- Proposed reforming the treatment of black-hole expenditure, which would increase the neutrality of investment by improving incentives for innovation and risk-taking.
- Recommended changing the loss-continuity rules to support the growth of innovative start-up firms.
- Recommended that the Government consider restoring depreciation deductions for multi-unit residential, industrial and commercial buildings if there is an extension of the taxation of capital gains. This would help increase the neutrality of investment by reducing the tax cost of investing in buildings and building-owning businesses.
- Recommended a number of measures to reduce compliance costs imposed by the tax system, particularly on small businesses.
- Recommended a number of measures to support people saving for their retirement using KiwiSaver, including reducing the tax rate on income earned in KiwiSaver funds for low-income savers, increasing the Government contribution to people who are adding to their funds, and refunding the employer's superannuation contribution tax to low and middle income savers KiwiSaver funds.

WEAG

- Establish an effective employment service of the Ministry of Social Development so it is better able to assist people to obtain and keep good, sustainable work.
- Revamp active labour market, labour market, employment and training policies across government to make them more coherent and effective.

- Strengthen Ministry of Social Development redundancy support policies to better support displaced workers.

- Ensure people can resume benefits readily (to allow for unpredictable changes in income and to provide people with confidence to take up employment), including removal of income stand-down periods.

Housing

TWG

- On balance, the Group expects that an extension of capital gains taxation would lead to some small upward pressure on rents and downward pressure on house prices. These impacts are likely to be small in relation to the impacts of more fundamental housing policy initiatives, such as the Government's KiwiBuild programme.

- Suggested the Government consider whether or not it wishes to remove loss ring-fencing on residential rental property if the taxation of capital gains is extended to include residential rental investment property.

- The recommendation to provide depreciation deductions for multi-unit residential buildings would encourage the supply of rental accommodation.

WEAG

- Urgently expand and accelerate government efforts to substantially increase public housing on an industrial scale and continue urgent efforts to end homelessness.

- Increase the range of home ownership and tenure options for people on low and low–middle incomes, and increase the capacity of third-sector community-based housing providers.

- Develop and enact laws and regulations to ensure healthy homes and housing security, decent standards of housing quality, universal design, and accessibility.

- Subsidise housing costs for people on low incomes (in addition to raising main benefit rates to provide an adequate income) and ensure the combination of changes to housing support and abatement rates make households better off.

- Improve access to affordable, suitable housing support for people on low and low–middle incomes, including a range of affordable home-ownership products and papakāinga housing.