Building a nest egg for New Zealand's future

Moving towards a schedular tax base to promote savings and growth in the economy

Jeremy Beckham

May 2015

This proposal is for an alternative design of the tax base to deliver better economic outcomes. The reforms signal a move away from a global income approach by providing for selected schedular treatment of certain receipts to encourage behaviour that is conducive to savings and growth.

Building a nest egg for New Zealand's future

MOVING TOWARDS A SCHEDULAR TAX BASE TO PROMOTE SAVINGS AND GROWTH IN THE ECONOMY

A SCHEDULAR APPROACH FOR TARGETING BEHAVIOUR

New Zealand has adopted a global income approach to the taxation of income which uses the concept of 'comprehensive income' to define the tax base. Based on the classic works of Haig and Simmons, this approach makes no distinction between the kinds of receipts received by taxpayers for income tax purposes. The logic of uniform taxation of all receipts has been challenged in a number of leading tax reviews on grounds of both efficiency and horizontal equity. A schedular approach could instead be used to promote targeted savings and growth in the economy. Impending fiscal pressures on the sustainability of our tax base to service the needs of an aging population makes a consideration of robust policy options essential.

Successive reports on the health of the New Zealand tax system have highlighted our reliance on personal and corporate taxes which are the most harmful to growth. Increasing competition and global mobility of investment capital and our workforce means that any over taxation will risk leading to the migration of skilled labour and/or capital flight. Modelling performed by the Treasury and Inland Revenue (2012) concluded that a cut in personal income tax rates would have the greatest economic benefits among a number of reform options considered. Under a global income approach, this will increase incentives for both savings and investment, and labour supply.

The way in which savings are taxed has an important influence on a person's decisions of whether to save or consume. This is an entirely separate behavior than that produced by the taxation of labour earnings which affects a person's preferences between work and leisure. A schedular approach that provides for differential treatment between these receipts could be used to deliver better and more appropriate outcomes. Much depends on New Zealand's economic goals when deciding on the design particulars of such reforms. A dual tax system where capital income is taxed at a low flat rate and labour income is taxed progressively is often presented as an alternative model and has found some success overseas. The wholesale separation of a deemed capital return from labour income as would be required under a dual tax system is not the aim of these reforms. The aim is instead to differentiate between passive investment returns and returns from the active participation in a trade or business. Such an approach is designed to have minimal impact on business decisions and is expected to be comparatively simpler to administer.

A SCHEDULAR DESIGN FOR THE TAX BASE

This proposal outlines a series of reforms to support a move to a schedular income tax base. The reforms consist of three core components:

1. Progressive schedular taxation of earned income (marginal rates)
2. Flat schedular taxation of savings income (aligned with the company tax rate at 28%)
3. A two-step rate for other income

The objective is to promote labour productivity in the economy by improving the quality of labour inputs and enhancing national savings. Downward pressure will be applied to the marginal tax rates applicable to schedular earned income to improve incentives to work. The country's savings imbalance will be addressed by introducing a flat rate applicable to schedular savings income as a final withholding combined with compulsory retirement savings. Equity and fairness concerns for low and middle income earners regarding the flat savings rate will be managed by focusing on what the government contributes to private savings (exchange fairness) as well as providing more options for withdrawal that support private savings.

Progressive schedular taxation of earned income

Rates applicable to earned income

Progressive taxation will apply to income derived by individuals from the active participation in business or employment (earned income). The progressive marginal tax bands for **gross schedular earned income** will apply as follows:

Schedular earned income	Income tax rate
up to $14,000	10.5%
from $14,001 to $48,000	17.5%
from $48,001 to $70,000	**28.0%**
$70,000 and over	33.0%

Quasi-alignment of the second-from-top rate with the company rate as examined by Treasury (2009) has been selected as a good fit under a schedular approach. The amount will also align with the savings rate and lower-tier rate for other income. Alignment is not essential but will contribute to the overall coherence of these reforms. A simplified return procedure will be implemented to facilitate compliance and processing.

Policy rationale

Growth is achieved by applying downward pressure on the marginal rates applicable to earned income and improving incentives to work. This will help to attract and retain skilled labour and entrepreneurial talent in

New Zealand. The ability to access lower marginal tax bands in a schedular setting may also provide greater incentives for skilled persons at or near the age of retirement to continue to work (a key matter given New Zealand's changing age demographics). Passive returns on retirement savings under a global approach can reduce the incentive to work as higher effective marginal tax rates will apply to every dollar of earned income.

Boundary issue

Earned income will include all income derived by individuals in connection with their employment or service as well as certain transfer payments. These amounts will be reasonably simple to identify. To ensure horizontal equity between salary and wage earners and the self-employed, the progressive schedular rate structure will also be made available to individuals in business on their own account. The reforms will therefore create a new boundary issue in the tax system that needs to be addressed. Remuneration arrangements in a close company setting will also need to be considered.

One option would be for Inland Revenue to publish guidance on remuneration bands where business income is likely to include a significant passive return.

Flat schedular taxation of savings income

Rates applicable to savings income

A flat tax rate of 28% will apply to certain defined **gross schedular savings income** of any amount as follows:

Schedular savings income	Income tax rate
All income	**28.0%**

The rate is intended to be concessionary for NZ resident high income earners and has been selected to align with the company tax rate. Savings income eligible for this schedular treatment will be limited to amounts derived from domestically-sourced interest and dividend income. Both individuals and trustees will be eligible to treat these amounts as schedular. Schedular treatment will only be available where the recipient of the savings income is not associated with the payer. PIE income will also be taxed at 28%.

Contributions to KiwiSaver will be made compulsory to ensure low and middle income earners continue to contribute and have their savings taxed at a higher rate.

Policy rationale

Low saving is associated with lower wealth accumulation and lower income. The Savings Working Group (2011) has found that New Zealand's low labour productivity reflects a low capital-to-labour ratio and can be improved by stimulating national savings. Evidence is mixed whether a reduction in taxes on savings income would increase private savings due to the offsetting "substitution" and "income" effects. A reduction in income taxes on private savings will decrease tax collections and may lead to less in terms of national savings (combined private and government savings). Simulations performed by officials from Inland Revenue suggest that in New Zealand this may be the case.

The 28% flat savings rate is deliberately targeted at savings products that are conducive to growth. The rate is intended to offset the fiscal costs of reducing marginal tax rates on earned income and to create a sustainable revenue base for the government. The rate will provide high income earners with an incentive to save voluntarily in investment products that contribute positively to growth in the economy. Maintaining annual savings incentives in the form of a capped tax credit and creating a system of fixed entitlements will mean that an equitable exchange relationship can be managed for low and middle income earners. More options for early savings withdrawals that promote private savings behaviour (such as paying down first-home mortgages) should be considered.

- **Improved coherence**

A flat rate on schedular savings income will contribute to the overall coherence of the tax system. Returns from passive investments are generally easier to divert to related parties or to shift between periods than other sorts of receipts. Removal of the marginal tax bands removes this incentive. Consistent treatment of PIE income and schedular savings income at 28% will create neutrality between savings vehicles.

Significant administrative advantages are expected to result. Fully imputed dividends will not attract any further withholding and a consistent rate can be applied to other distributions. Schedular treatment will effectively result in this being a final tax. The objectives of the imputation system may need to be revisited.

A two-step rate for other income

- **Rates applicable to other income**

A two-step rate will apply for **all other income**:

Other income*	Income tax rate
up to $70,000	**28.0%**
$70,000 and over	33.0%

*includes gross schedular earned income

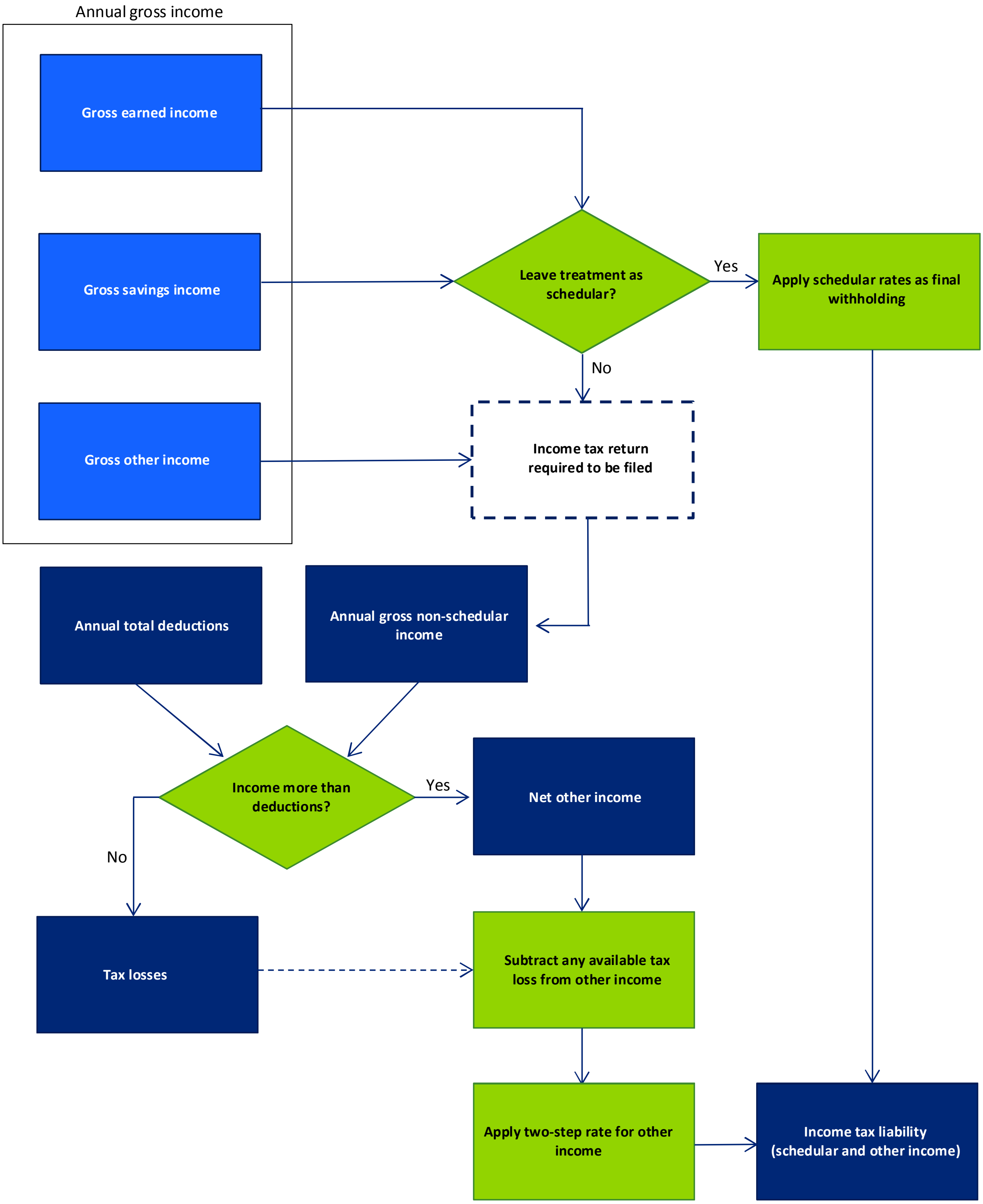
Taxpayers will be required to first include the quantum of any schedular earned income derived in the above bands when determining what rate should apply to other income. The top rate of 33% will continue to apply to trustee income unless schedular treatment is available. The two-step rate is designed to align with the top two marginal tax rates applicable to schedular earned income. Supporting reforms that are designed to ensure a minimum equity investment in certain products (such as domestic thin capitalisation rules for the New Zealand housing market) will be implemented to prevent returns being eroded.

An important feature of the schedular design is that the treatment **will be elective** meaning a taxpayer may opt out and use the rates applicable to other income. Current year deductions and losses carried forward by taxpayers cannot be offset against gross income that is treated as schedular. Taxpayers receiving only schedular income should not be required to file a tax return and administratively simpler options will be made available. A taxpayer may choose to file a tax return and opt out of schedular treatment to take advantage of losses or credits available.

Impact on investment capital

Options to improve growth by addressing the Saving – Investment imbalance should be directed to promoting a higher rate of national saving (rather than by affecting national investment) given the relatively capital-shallow nature of the economy. New Zealand is a net importer of capital and relies on foreign investment. Foreign investment will be largely unaffected by these reforms where dealt with under the non-resident withholding tax (NRWT) rules or similar regimes that limit the final tax impost. Exceptions exist for non-resident individuals investing in particular New Zealand sourced income such as income from real property. Risk of domestic capital flight is expected to be low given that New Zealand has robust international tax rules and residents would have to migrate with their capital.

CALCULATION OF ANNUAL INCOME TAX LIABILITY



REFERENCES

Brook, Anne-Marie (2014), "Options to Narrow New Zealand's Saving – Investment Imbalance." Wellington, The Treasury, Treasury Working Paper 14/17, http://www.treasury.govt.nz/publications/research-policy/wp/2014/14-17/

Capital Market Development Taskforce (2009), *Capital Markets Matter*, Rob Cameron, Report of the Capital Market Development Taskforce, December 2009.

Henry, Ken *et al* (2009), *Australia's future tax system: Report to the Treasurer*, Ken Henry, Jeff Harmer, John Piggott, Heather Ridout and Greg Smith, Commonwealth of Australia, December 2009.

IMF (2011), "How well do standard models explain Australian and New Zealand saving behaviour?", New Zealand: Selected Issues Paper, IMF Country Report No. 11/103.

Inland Revenue (2014), *Briefing for the Income Minister of Revenue – 2014*, October 2014 https://www.ird.govt.nz/resources/f/8/f85d92b8-42fa-433e-adf9-320d221d867f/bim-2014.pdf

Mirrlees *et al* (2011), *Tax by Design: the Mirrlees Review*, J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba, Oxford University Press: September 2011.

OECD (2007), "Encouraging Savings through Tax-Preferred Accounts", OECD Tax Policy Studies No. 15.

Sorenson, Peter (2009), "Dual Income Taxes: A Nordic Tax System", February 2009, Paper prepared for the conference on *New Zealand Tax Reform – Where to Next?* At the Victoria University of Wellington

Savings Working Group (2011), "Saving New Zealand: Reducing Vulnerabilities and Barriers to Growth and Prosperity", Final Report to the Minister of Finance, ISBN: 978-0-478-35095-1.

Treasury and IRD (2012), "Report on the Taxation of Savings and Investment Income", Joint report, available at http://www.treasury.govt.nz/publications/informationreleases /tax/savingsinvestmentincome.

Treasury (2013), "The role of tax in maintaining a sustainable fiscal position: Draft paper for the Long-term Fiscal External Panel", January 2013, http://www.treasury.govt.nz/government/longterm/externalpanel/pdfs/ltfep-s3-02.pdf

Treasury (2009), "Where to From Here for Tax Reform?", Treasury Report T2009/2714, http://www.treasury.govt.nz/publications/informationreleases/budget/2010/pdfs/b10-t2009-2714.pdf

Victoria University of Wellington Tax Working Group (2010) "A Tax System for New Zealand's Future", January 2010, http://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/pdf/tax-report-website.pdf