

The Treasury

Budget 2017 Information Release

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Budget Report: Advice on Personal Tax Cuts for Budget 2017

Date:	7 November 2016	Report No:	T2016/1948
		File Number:	SH-13-5-2-3

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Agree to recommendations	Tuesday, 8 November 2016

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Eina Wong	Senior Analyst, Tax Strategy	[39] (wk)	[23] (mob)	✓
Suzy Morrissey	Team Leader, Tax Strategy	[39] (wk)	[23] (mob)	

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

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Executive Summary

The Government has indicated that tax cuts could be part of Budget 2017 if economic and fiscal conditions allow. This report follows our previous report on potential tax and transfer options directed at improving income adequacy of low-income families. We have modelled the fiscal costs, distributional impacts, and labour supply impacts of changes that could be implemented on 1 April 2018.

While the 2010 tax reforms placed New Zealand's tax framework in a relatively desirable position and are effective at raising tax revenue, officials consider that there is a case for lowering personal taxes based on first-principle equity and efficiency grounds. Our starting position is to lower personal taxes while maintaining our existing level of tax revenue and taking the Government's budget constraint as given. However, in the absence of increasing other tax bases, there is still a case for reducing personal taxes if there is available operating allowance.

There are two options presented in this report. The first considers reducing the number of tax brackets from four to three, with reductions of the first two rates. This option benefits most families, and costs about \$1.3 billion. The second option is similar to the first, but instead of reducing the bottom tax rate, we include an increase in the Working for Families family tax credit by \$20 per week per child. This option distributes more benefits to families in comparison, and costs \$1.7 billion. Both options have very small labour supply impacts.

The main considerations in evaluating these options were based on equity objectives without adversely impacting economic efficiency. The options considered are based on discussions with you and subsequent feedback from your office.

We do not comment on the trade-offs with other spending or debt choices in this report. Further advice on this has been provided to you in the Treasury's fiscal strategy report on 4 November [T2016/2045 refers]. Our report discusses tax options of around \$1.4 to \$1.7 billion for illustration, should you choose to implement a tax reduction in Budget 2017. We also indicate at a very high level what a more ambitious welfare option could include if Ministers wish to delay tax and transfer changes. Separate advice will be provided on adjustments for fiscal drag.

We would like to discuss with you your preferences on refining the options in this report or the previous report [T2016/1650 refers], and whether you would like us to consider alternative supplementary benefits or transfers. To understand your preferences, we ask that you agree if our assumptions for a "target" income group of individuals is appropriate. This target income group is defined as those whose incomes fall between \$14,000 and \$48,000, in order to focus on improving income adequacy of low-income families.

Recommended Action

We recommend that you:

- a **note** that officials understand that personal tax reductions could be part of Budget 2017 decisions, and we have considered further preliminary options to illustrate potential impacts
- b **note** that following the significant tax reforms in 2010, New Zealand's tax framework is in a relatively desirable position, with a relatively simple tax framework that is efficient at raising revenue; however, we consider that there is room to lower personal tax rates on first-principle equity and efficiency grounds

- c **note** that Treasury's starting position regarding personal tax cuts is for revenue-neutral changes given the Government's budget constraint; however, in the absence of other base-broadening measures, there is still a case for cutting personal tax rates if there is available operating allowance
- d **note** that the two additional tax cut options included in this report are based on previous discussions with you and subsequent feedback from your office
- e **note** that the main considerations in evaluating these options were based on equity objectives for lower-income families without adversely impacting economic efficiency, as well as the potential fiscal envelope available out of potential Budget 2017 operating allowances
- f **note** that this report does not comment on the trade-offs with other spending or debt options
- g **note** that The Treasury's fiscal strategy report discusses these trade-offs in more detail and has been provided to you on 4 November
- h **agree** to meet with officials to discuss tax options

Agree/disagree

- i **agree** to direct officials to develop more detailed analyses of changes to the Accommodation Supplement

Agree/disagree.

- j **note** that if you agree to recommendation (h), this would involve modelling resources from MSD to estimate the impacts of changing Accommodation Supplement payments, and

- j if you agree to recommendation (h), **agree** that the "target" income group of individuals for changes to tax and transfers are those whose incomes fall between \$14,000 and \$48,000

Agree/disagree

Suzy Morrissey
Team Leader

Hon Bill English
Minister of Finance

Purpose of Report

1. You have indicated to officials that you would like to consider tax cuts as part of Budget 2017 decisions. This report presents two additional options to illustrate impacts of tax cuts that could be considered. It follows our recent advice on other potential options for tax cuts [T2016/1650 refers]. The primary purpose of both reports is to provide you with what tax options could look like so you can consider them against other spending or debt choices, and to seek feedback from you about how you would like officials to progress with the analysis.
2. This report does not comment on the trade-offs between spending, debt or tax options. Rather, further discussion on these trade-offs has been provided to you in The Treasury's fiscal strategy report [T2016/2045 refers].

Context with Budget Strategy

3. Because the Government's fiscal strategy has not been decided, we are providing the options in this report as illustrative, with fiscal costs around \$1.5 billion. The fiscal strategy report advises on possible increases in operating and capital allowances; however, the preliminary fiscal forecast and spending and capital pressures indicate that it is questionable whether the allowances will accommodate a tax option of this size.
4. This report discusses tax options of around \$1.4 to \$1.7 billion for illustration, should you choose to implement a tax reduction in Budget 2017. We will also discuss at a very high level what a more ambitious welfare option could include if Ministers wish to delay tax and transfer changes. Separate advice will be provided on adjustments for fiscal drag [T2016/2059 refers].
5. If the operating allowance limits a tax package to \$1 billion or less, a tax cut of this magnitude would limit the ability to redistribute tax cuts to low-income families and, at the same time, have a negligible effect on economic growth. Instead, if the available funds are limited, more targeted improvements could be achieved through transfers to low-income families alone. We discuss this in more detail later in the report.

Background

The New Zealand tax framework and potential changes

6. The 2010 tax reforms were significant, with the main changes being:
 - Reductions in the personal tax rates
 - An increase in the GST rate, accompanied by commensurate increases in benefits and transfers to families with children
 - A reduction in the corporate tax rate

7. The changes were made with the primary objectives of improving economic efficiency and international competitiveness, with distribution-neutral impacts. The reforms have placed us in a relatively desirable position compared to other OECD countries, with a relatively simple tax framework that is efficient at raising revenue. Our assessment is that our broad-base, low-rate system is the best system for New Zealand.
8. We believe that there is room to enhance that framework with reductions to personal taxes. Personal taxes are considered to be relatively inefficient tools to raise revenue as they distort households' labour/leisure and savings decisions, for example, and can have negative impacts on growth.¹ While personal tax rates were reduced relatively significantly in 2010, we could lower them further within the bounds of possible operating allowances, and without significantly affecting equity and efficiency trade-offs.
9. In the bigger picture, unless the fiscal strategy indicates that spending or debt pressures have changed significantly and that the Government's budget constraint should be readjusted, our starting position is for any tax changes to be revenue-neutral. Possible increases to other tax bases to offset reductions in personal taxes could include, for example: widening the taxation of capital gains, introducing a land tax, or broadening the GST base. We have been directed to not prioritise a revenue-neutral tax change via an increase in the GST rate for Budget 2017.
10. For completeness, we would not prioritise increases to the GST rate as a tax-switch to offset reductions to personal taxes at this time. Increases to the GST rate could create revenue risk and inefficiencies if its broad base is eroded through exemptions. A tax switch would also require a wider review of the tax system which may not be timely because it hasn't been long since the 2010 reforms.
11. We would also not prioritise reducing the corporate tax rate. Although it would likely benefit to foreign investors by lowering taxes on economic rents, it could make New Zealanders as a whole worse off. It may also increase certain tax structuring incentives. This in turn would reduce revenue from personal taxation but in a non-neutral and unprincipled manner. These issues are explained in a recent report [T2016/1968 refers].

Equity-based personal tax cuts

12. Reductions to personal taxes involve trade-offs among key objectives of: efficiency/growth, equity, fiscal integrity, ease of compliance/administration, and fiscal cost. There is no perfect or optimal tax and transfer system, and any tax structure will incorporate value judgments of the central decision maker. Even within one of the stated objectives, such as equity-based changes, there are different concepts of what is fair and those concepts may result in different design and redistribution outcomes, as well as impacts on other objectives. In other words, if the overarching objective is to improve equity, the changes will likely have impacts on efficiency, fiscal cost, and compliance or administration, as well as winners and losers.
13. There are several factors to consider in designing changes:
 - Distributional impacts, and the impact on individuals' average tax rates for individuals, and how these rates differ across the income distribution with changes to the personal tax schedule.
 - Impact on effective marginal tax rates (EMTRs), and how this may impact on the labour or leisure decisions at different points on the income distribution. This takes into account any transfers such as benefits or tax credits and abatement rates.

1 Consumption taxes such as GST also affect labour/leisure and savings decisions, but our flat rate helps to mitigate the impacts.

- Fiscal costs.
 - Tax compliance, and how changes to thresholds and rates may increase incentives for tax structuring. Research indicates that individuals can be very responsive to tax changes, with annual incomes “peaking” just before a higher threshold. This was shown to be the case when tax rates were cut in 2010, for example.
 - Long run macroeconomic impacts.
 - Potential administrative implications.
14. Based on previous discussions with you and subsequent feedback from your office, we have considered potential changes that may provide benefits to lower-income families within the potential fiscal envelope available. We provided you with some possible options recently that considered changes to the tax rates or threshold in the lowest two tax brackets [T2016/1650 refers]. In this report, we provide you with two options that reduce the number of tax brackets from four to three, as well as reducing average tax rates.
 15. Ultimately, the impacts of any proposed tax changes should be assessed against changes to the “excess burden” of taxation, the excess of the money measure of the welfare change over the tax paid. The Government can assess whether the efficiency gains or losses are acceptable given other impacts of the policy. Welfare measures allow for a more accurate assessment to be made by taking into account different individuals’ responses to policy changes. They may also allow for a preferred level of inequality aversion.
 16. Presently, we are able to measure some but not all of the response to tax changes, which could under- or over-estimate efficiency or welfare impacts. We have been developing modelling code that will allow us to measure welfare changes occurring as a result of tax changes. We will be able to report the excess tax burden shortly.

Composition of taxpayers

17. To help us understand where changes could be targeted in the personal tax and transfer framework, we can look at the types of taxpayers in each income tax band. In Appendix 4, we provide analysis that outlines the extent to which individual taxable income is a good proxy for economic wellbeing, and the extent to which tax changes are the most targeted way of improving incomes as compared with transfer policies. We used administrative data on individuals from Inland Revenue for tax year 2014/15.
18. In that analysis, our assumption is that the target group is likely to be those individuals who are not already receiving transfers, and those who are not young or students. For those receiving transfers, more assistance can be given directly through the transfer system. Young individuals or students are likely in a transitional part of their lifecycles with temporarily low incomes.
19. Provided that Ministers agree with officials’ assumptions about the appropriate “target group”, the descriptive results indicate that many of the targeted group have incomes between \$14,000 and \$48,000. This is a relatively large tax band and captures 35% of taxpayers in our target group. The analysis below focuses on improving equity objectives for this group of taxpayers.
20. In deciding design details of a tax reduction, we would not prioritise cuts for the lowest tax bracket. Not only are the economic benefits at this range likely to be small when there are more direct means of increasing assistance, but there would also be higher fiscal costs and efficiency implications as everyone higher in the income distribution would gain significantly more from these tax cuts.

Additional Potential Options (Reducing a Tax Bracket)

21. In our previous report [T2016/1650 refers], we presented a series of options with low, medium, and high fiscal costs. These options included combinations of tax cuts, Working for Families (WFF) family tax credit increases, and benefits increases, keeping four tax brackets.
22. This report presents two options that reduce the number of tax brackets to three:

Table 1. Other illustrative tax options

<u>Status Quo</u>			<u>Option A</u>			<u>Option B</u>		
\$1	\$14,000	10.5%	\$1	\$14,000	10.0%	\$1	\$14,000	10.5%
\$14,001	\$48,000	17.5%	\$14,001	\$52,000	16%	\$14,001	\$52,000	16%
\$48,001	\$70,000	30%	\$52,001	+	33%	\$52,001	+	33%
\$70,001	+	33%						

(Tax cuts only)

(With increase in WFF of \$20 per week for all child rates)

23. The tax changes above are very similar, apart from the lowest rate. Option A lowers average tax rates across the income distribution relative to the status quo, and as a result, has a higher fiscal cost compared to the tax cuts in Option B. Option B, while giving away less in the form of tax cuts for those in the lowest tax bracket, is presented jointly with an increase in the family tax credit of \$20 per week per child. The purpose is to illustrate that greater benefit may be given to lower-income families than a tax cut in the lowest bracket.
24. The annual increases to the WFF tax credits are as follows:

Table 2. Potential increases to WFF tax credit (specifically, the family tax credit)

	<u>Status Quo</u>	<u>Option B</u>
1 st child		
ages 0-15	\$4,822	\$5,862
ages 16-18	\$5,303	\$6,343
2 nd child		
ages 0-12	\$3,351	\$4,391
ages 13-15	\$3,822	\$4,862
ages 16-18	\$4,745	\$5,785

25. To illustrate, for a hypothetical family with two children aged 16 and 14, WFF tax credits fully abates at a family income level of \$93,546 under the status quo (and assuming eligibility for in-work tax credit). Under Option B, full abatement occurs at family income of \$102,790, assuming abatement thresholds and rates do not change.

- 26. The family tax credit is currently expected to be adjusted for its cumulative inflation amount, which will be around 5.5% on 1 April 2019. The fiscal costs of Option B have taken this into account, and the costs provided below are additional if Option B is implemented on 1 April 2018. The increase in Table 2 would exceed that amount and restart the inflation clock on 1 April 2018 (or when the change is implemented).
- 27. The fiscal cost of the options are:

Table 3. Fiscal costs of illustrative options

	<u>Option A</u>	<u>Option B</u>
Gross cost	\$1.4 b	\$1.9 b
With 10% clawback	\$1.3 b	\$1.7 b

- 28. The gross cost of the WFF change by itself is approximately \$700 million. This WFF cost illustrates a potential package within the possible operating allowances, but the WFF could be scaled back almost linearly if desired. For example, a \$10 weekly increase to all child rates would cost approximately \$350 million.
- 29. Clawback refers to the additional revenue that the Government receives from a personal tax cut or welfare transfer increase, which is largely due to increased spending that generates GST. The level of clawback depends on the proportion of disposable income that households spend on goods and services that generate GST or are subject to excise duties. This proportion tends to be higher at lower household income levels because households with lower disposable incomes tend to spend a greater proportion of incomes on goods and services subject to excise duties or GST. In this analysis, we have used an average 10% clawback rate, assuming that personal tax and transfer changes affect households uniformly. The clawback rate will be higher when personal tax and transfer changes are targeted at lower-income households.
- 30. We will report to you shortly on the more technical aspects that we have identified in a recent review of the clawback calculation. Once we have done that, we will include fully-modelled clawback estimates in our future reports, rather than the average 10% estimate that we have used in this report.

Analysis of Options

- 31. Earlier in this report, we identified several factors to assess when considering personal tax changes. In this section, we compare the options against these factors. All changes are modelled to occur on 1 April 2018.

Distributional Impacts

- 32. The distributional impacts are reported by income deciles, and are on a family basis. The results are shown in detail in Appendix 2 and in the figures below.

Figure 1. Average weekly gain per family

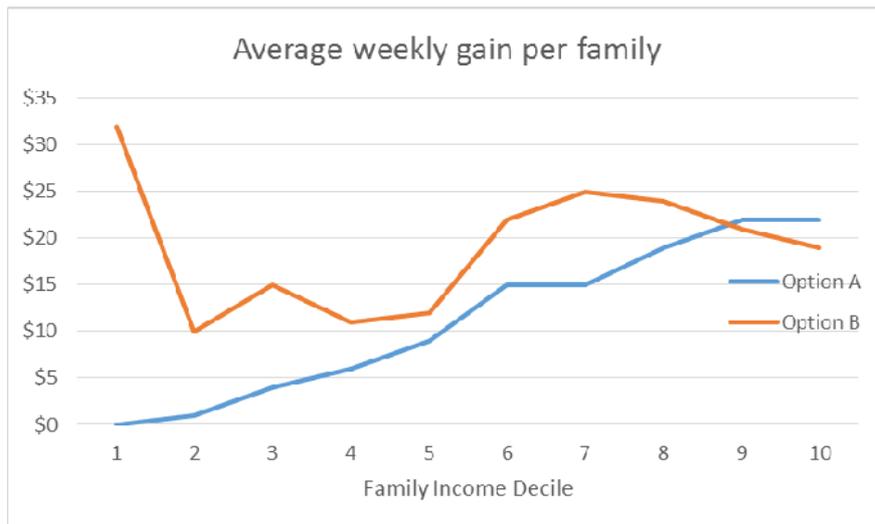
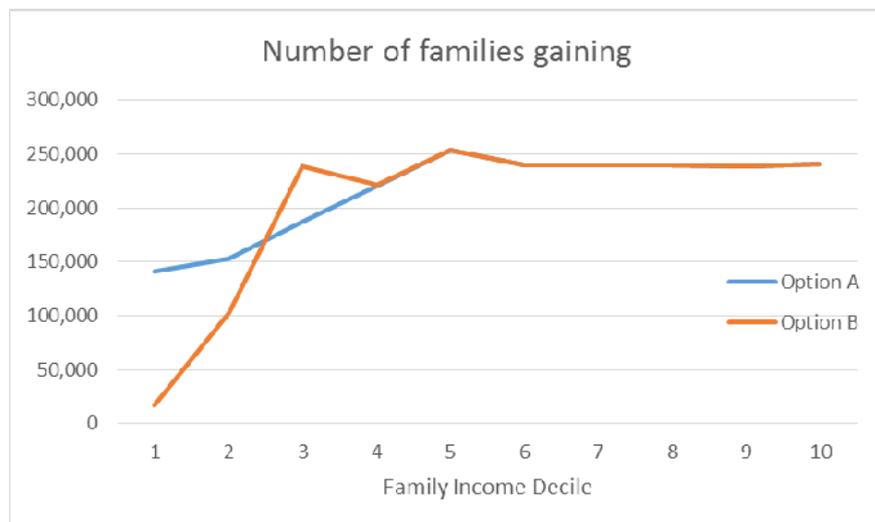


Figure 2. Number of families gaining



33. Unsurprisingly, there are more families gaining in the bottom two deciles (up to \$19,900 annual income) under Option A with the small tax cut from 10.5% to 10%. However, the average gain per family is significantly smaller with Option A, with the average family gaining about \$1 per week. For both options, some families in the bottom two deciles experience a negative impact, although this will not be significant (less than \$1), indicated in Appendix 2. These families will have many changes in circumstance throughout the year, typically interacting with work, the welfare system, Accommodation Supplement, and WFF.
34. In Option B, while there are fewer families gaining in these bottom two deciles in comparison, those families also gain an average of \$32 per week for the bottom decile, and \$10 per week for families in income decile 2. The large gain for families in income decile 1 is likely because those families that gain (approximately 17,000 families) on average have more children than gaining families in other deciles. In deciles 3 and 4, there are also more families gaining compared to Option A, and higher average weekly gains. For income decile 5 and above, families receive higher average weekly gains compared to Option A.

35. If Option B results are preferred, other ways of addressing income adequacy for the bottom deciles is to also consider increasing the rates of the main working-age benefits or one of the major supplementary benefits such as Accommodation Supplement. We discuss this later in the report.

Average tax rates

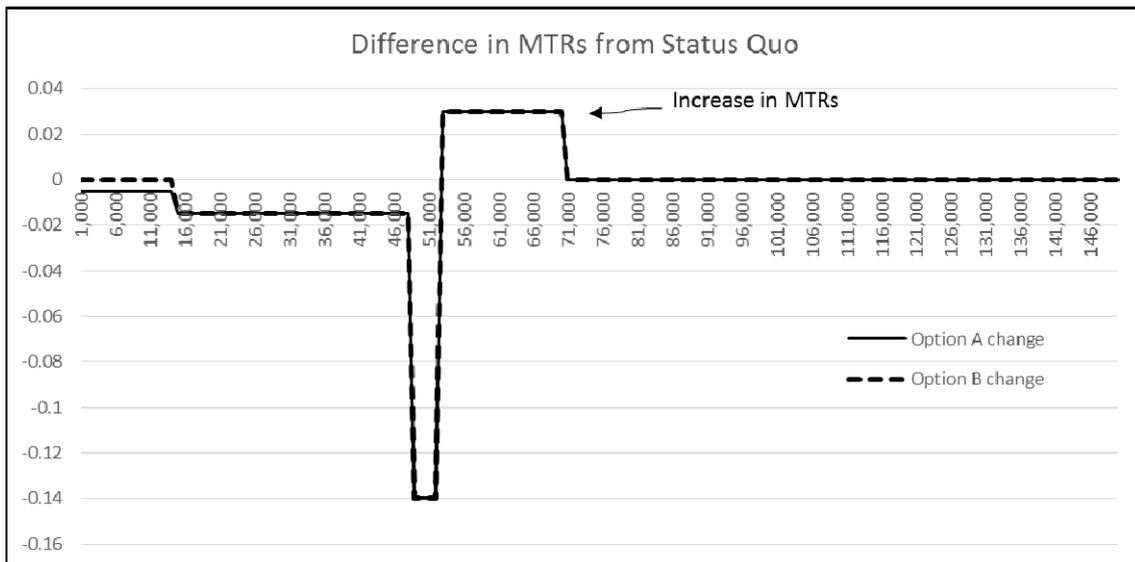
36. Average tax rates for hypothetical individuals are given in the following table:

Table 4. Change in average tax rates

	<u>Annual Income</u>	<u>Status Quo</u>	<u>Option A</u>	<u>Option B</u>
20 hours, minimum wage	\$ 15,860	11.32%	10.70%	11.14%
40 hours, minimum wage	\$ 31,720	14.41%	13.35%	13.57%
20 hours, average wage	\$ 29,095	14.13%	13.11%	13.35%
40 hours, average wage	\$ 58,189	18.0%	16.36%	16.48%
40 hours, 2x average wage	\$116,378	25.2%	24.68%	24.74%

37. Average tax rates are an indication of whether proposed tax changes are more or less equitable across the income distribution. For progressive tax structures, average tax rates increase with incomes. Both of these options keep the tax structure relatively progressive because the changes are at the lower and middle incomes of the distribution.
38. In both options, average tax rates decrease for earners compared to the status quo, with bigger changes under Option A. The greatest gains using this measure go to those who earn around the full time average wage, around \$58,000. This is because they will benefit from the relatively large decrease in marginal tax rate from the current 30% to 16% for earned income between \$48,000 and \$52,000.
39. The chart below shows the difference in marginal tax rates with both options, compared to the status quo:

Figure 3. Difference in marginal tax rates relative to status quo

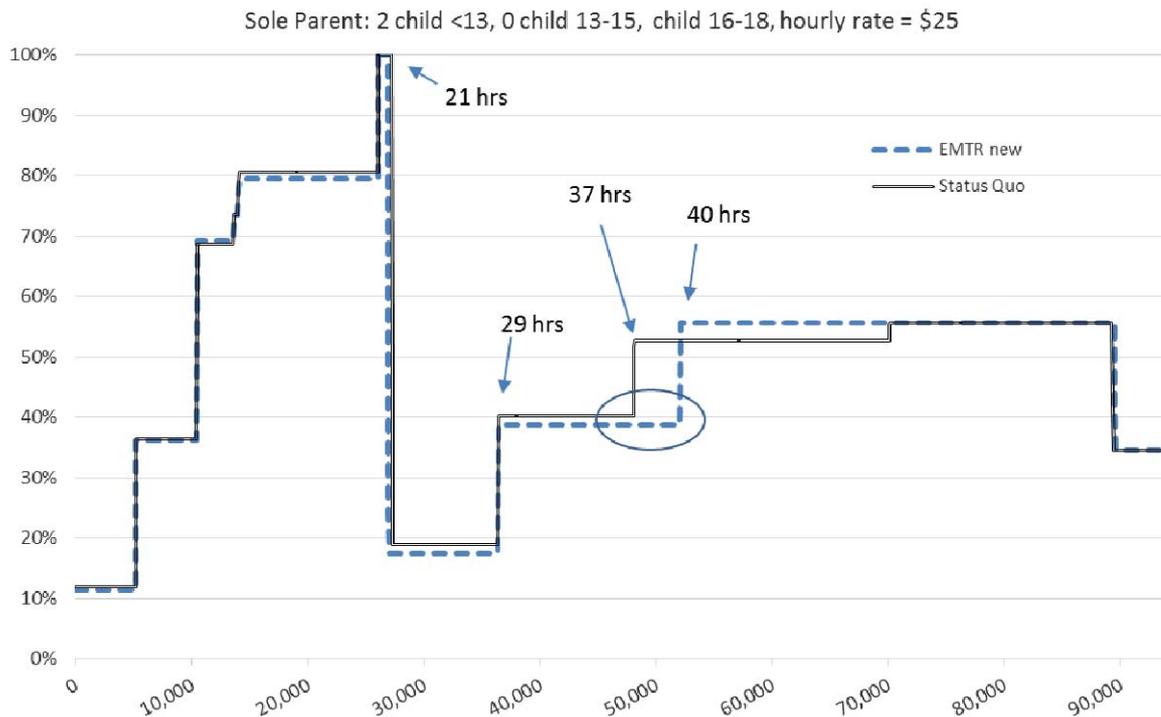


40. While Option A reduces average tax rates more than Option B, we should take into account the EMTRs under both scenarios.

EMTRs and labour supply impacts

41. Social assistance via our tax and transfer system impacts individuals' incentives as it can reduce the relative return from work. The withdrawal, or abatement, of assistance raises EMTRs, which reduces incentives to work. Increases in transfers can also work to help individuals overcome barriers to work, such as increasing child care assistance. However, trade-offs exist and depend on population heterogeneity.
42. For the options presented above, the EMTRs will not differ from each other except in marginal cases where families are currently within the abatement range. For these families, an increase in the family tax credit delays the point of income at which the credit fully abates. We have provided advice to you recently regarding the interaction of increasing the family tax credit and abatement thresholds [T2016/1847 refers].
43. When compared to the status quo, the tax options similarly will not increase EMTRs for families until they earn \$52,000, the point at which they move into a higher tax bracket. By extension, these families will need to work more hours before they encounter the higher EMTR. We look at a hypothetical sole parent with two children scenario to illustrate this:

Figure 4. Comparison of EMTRs under status quo and Option A



44. In Figure 4, the most notable change in EMTRs for the sole parent earning \$25 per hour will be after the minimum family tax credit fully abates, around \$27,000. After this point, EMTRs will be lower than the status quo until their income reaches \$52,000, where the new tax threshold would be reached. In this particular hypothetical family, there may be an increased incentive to work more hours, particularly if the sole parent is currently working around 36 hours, and they may choose to work until just under 40 hours (indicated by the circled range in the figure).
45. EMTRs will be very similar under Options A and B. The difference is that at lower tax rates, EMTRs will be slightly higher (compared to the status quo) under Option B for sole parents earning under \$14,000 as benefits abate.
46. Using microsimulation modelling for labour supply behavioural responses, the overall result is that with either tax option, labour supply effects will be very small. The largest responses will likely come from sole parents who are more responsive to changes in Option B with a 1.3% point increase of the population going from not working to working. In comparison, an increase of 0.7% points of the population will go from not working to working under Option A.
47. For individuals already working, more sole parents are likely to increase their working hours under Option A while couples are more likely to reduce their working hours under Option B. For couples, the population of workers working fewer hours increases by 0.2% points and 0.1% points under Options B and A, respectively. Appendix 3 provides detailed tables that compare the labour supply responses for your reference.
48. The labour supply changes are expected to reduce the total fiscal cost of the tax changes in Table 3 by 11% under Option A, and by 1% under Option B. The lower adjustment for costs under Option B is due to the smaller labour supply response and the increased expenditure for WFF.

Impacts on GDP

49. The small increase in labour supply implies an increase in the level, but not growth rate, of GDP in the long run. Under Option A, GDP is expected to be only 0.6% higher, assuming that capital adjusts in the long run to the higher labour input. With Option B, for which the aggregate change in labour supply is even smaller, the long run effect on GDP is commensurately lower.
50. Although the tax options presented in this report are provided mainly to illustrate the possible design of tax reductions, we include their potential impacts on GDP to demonstrate how tax cuts could be balanced against possible spending choices or debt objectives.

Tax compliance

51. We mentioned earlier that changes to the personal tax structure generally invoke behavioural responses with regards to tax compliance. This is because individuals' elasticities of taxable incomes tend to be higher when their sources of income are not withheld at source. As a result, taxpayers might under-report income to evade tax, or structure their affairs to evade, avoid, or minimise tax. Analysis of the 2010 tax changes showed "bunching" of reported taxable income at the \$48,000 and \$70,000 income levels, indicating that taxpayers are responsive to changes and may structure their tax affairs around the tax schedule.
52. The options above are also likely to result in bunching at the \$52,000 income level, and the peak may be relatively higher than with the current tax schedule because there would be fewer tax brackets. If this occurs, and depending on the extent that bunching occurs, it may have an impact on tax revenue, although it is difficult to quantify this impact. The modelling that we have carried out as part of this report does not take into account the compliance response.

Accommodation Supplement

53. The over-arching objective of the work on personal tax cuts is to improve income adequacy of the low-income population. Housing costs in particular have become an increasing concern as the proportion of incomes spent on housing has risen, particularly for low-income families.
54. Market rents are increasing faster than incomes of beneficiaries and low-income earners. For those who receive AS currently (about 290,000 individuals), housing is increasingly more expensive or unaffordable because rents have increased and AS maximum rates haven't increased since 2006 (with figures based on 2003 rents).
55. There's a question of whether AS gets captured by landlords through increasing household purchasing power in a supply-constrained market, resulting in higher market rents or mismatch of property to needs. Statistics indicate that housing supply is extremely constrained and may point to landlord-capture. From 2005 to 2015, nominal prices went up 62%², and only triggered an 11% supply increase from 2006 to 2016. If landlord-capture does exist, it is likely due to the circumstances of those receiving AS (i.e., those in housing stress), rather than the design of the payment.

2 For the same period, nominal prices increased 107% in Auckland.

56. While there may be a landlord-capture issue, AS is the most significant and targeted instrument for addressing housing costs. Increases through other instruments such as benefits or WFF will also go toward those families who are not necessarily in housing stress and so these payments are less likely to be captured by landlords; however, these payments are less targeted to those facing financial stress from housing costs.
57. The Auckland Unitary Plan will allow an increase in supply from current levels in Auckland; however, it is unlikely to reduce the price of housing from current levels. A more competitive and developable land market, rather than an increase in housing supply, may be required to prevent an increase in the ability/willingness of households to pay for housing which results in higher land prices and rents. It is important to note that while supply constraints are most significant in Auckland, housing stress in low-income households is common in many parts of NZ.
58. Officials consider that the existing housing subsidy structure (income-related rent subsidy (IRRS), accommodation supplement, and temporary additional support (TAS)) is not fit-for-purpose. AS does not adequately alleviate housing stress, and IRRS and TAS have poor work incentives and are increasingly costly. One of the key factors driving increases to TAS is the increasing inadequacy of AS to cover housing costs. MSD is progressing work on subsidy reform, and we have been keeping in close touch with the developments.
59. If improving the incomes of low-income families is a key objective of tax and transfer changes, personal tax cuts alone will not be able to achieve this. Changes will need to include one or more of the main transfer payments to those on low incomes, such as benefits, WFF, or AS. We are not able to comment on which of these payments would be preferable to include in a package because each has different target populations and different impacts. If these options are to be considered, then further analysis is needed to provide Ministers with advice, and we would like direction to progress this. This work would primarily involve modelling resources from MSD as they have the appropriate model for estimating impacts from changing AS. Treasury's Taxwell model is not compatible with MSD's.

Addressing Fiscal Drag – Out of Scope

60. We have provided advice to you on potentially addressing fiscal drag as an alternative to reducing personal taxes for a Budget 2017 decision [T2016/2059 refers]. In summary, because fiscal drag could have detrimental impacts on efficiency and equity outcomes if left untreated, there is a case for adjusting tax thresholds over time. However, because price inflation has been at all-time lows since 2010 and the anticipation is for the trend to continue and possibly for interest rates to decline further, the case for addressing fiscal drag immediately has less priority given the trade-offs with a potentially wider tax package. In addition, the efficiency gains are likely to be minimal.
61. To be clear, for the tax options discussed in this report, average tax rates will decline for all those earning beyond the first threshold. The efficiency and fairness objectives would be directionally similar to a policy of adjusting for fiscal drag.
62. If price inflation speeds up, we would revisit whether fiscal drag effects are significant and consider adjusting tax thresholds at that time.

Next Steps

63. We have provided two tax options in this report at the request of your office. The fiscal strategy for Budget 2017 has not yet been agreed, and we do not know whether the available operating allowance might accommodate a tax cut of this magnitude. If operating allowances are constrained so that the amount available for a tax cut is less than \$1 billion, we suggest that focus be given on targeted transfers, rather than a combination of tax cuts and transfers. These transfers could be in the form of increasing family tax credits as discussed in this report, or perhaps transfers that are targeted at other low-income sub-populations, such as the Accommodation Supplement, although the latter would need more analysis to estimate impacts.
64. As discussed above, the fiscal strategy report presents trade-offs of spending, debt or tax decisions as part of Budget 2017. If a decision is made to delay tax and transfer changes as part of this Budget, one further option is to consider a more ambitious welfare change with a bigger fiscal cost to be implemented in perhaps two or three years' time. This would have an additional benefit of waiting to see if other pressures develop, including increasing effects of fiscal drag or other economic shocks, and allow us to assess the priority of policy changes at that time.
65. We think that a more ambitious welfare package could include a significant review of the Accommodation Supplement, with a view to at least simplifying its structure and improving targeting of payments, or perhaps reconsidering it altogether. We have not discussed this with MSD yet. Another area would be a review of the minimum family tax credit and in-work tax credit of the WFF framework, and the independent earner tax credit. At the same time, we would consider the interactions with the benefits structure, but not with a view to promote change in the latter.
66. We would like to discuss with you your preferences for potential changes to the tax and transfer framework. In particular:
 - Whether you would like us to consider refinements to either the options presented in this report, or the options in our previous report [T2016/1650 refers]
 - If you would like us to focus on alternative policies directed at low-income populations, such as changes to Accommodation Supplement, or perhaps a combination of changes to both Accommodation Supplement and WFF.

Appendix 1. Summary of Options

Note that all policy options are modelled for tax year 2018/19

Proposed tax cuts

<u>Status Quo</u>			<u>Option A</u>			<u>Option B</u>		
\$1	\$14,000	10.5%	\$1	\$14,000	10.0%	\$1	\$14,000	10.5%
\$14,001	\$48,000	17.5%	\$14,001	\$52,000	16%	\$14,001	\$52,000	16%
\$48,001	\$70,000	30%	\$52,001	+	33%	\$52,001	+	33%
\$70,001	+	33%						

(Tax cuts only)

(With increase in WFF \$20 per week all child rates)

Proposed increases to annual Working for Families payments

	<u>Status Quo</u>	<u>Option B</u>
1 st child		
ages 0-15	\$ 4,822	\$ 5,862
ages 16-18	\$ 5,303	\$ 6,343
2 nd child		
ages 0-12	\$ 3,351	\$ 4,391
ages 13-15	\$ 3,822	\$ 4,862
ages 16-18	\$ 4,745	\$ 5,785

Appendix 2. Distributional Impacts of Tax Options

Option A. Tax-only changes

Deciles	Decile lower bound	Number of families with positive taxable income	% of families with positive taxable income	Number of families gaining	% of decile gaining	Average weekly gain for gaining families	Number of families disadvantaged	% of decile disadvantaged	Average weekly loss for losing families
1	\$0	152,000	7%	141,000	92%	\$0			
2	\$9,800	235,000	10%	153,000	65%	\$1	7,000	2%	<\$1
3	\$19,900	245,000	11%	187,000	76%	\$4	*	*	*
4	\$25,200	226,000	10%	220,000	97%	\$6	*	*	*
5	\$36,100	254,000	11%	254,000	100%	\$9	*	*	*
6	\$45,200	240,000	10%	240,000	100%	\$15	*	*	*
7	\$60,900	240,000	10%	240,000	100%	\$15	*	*	*
8	\$80,000	240,000	10%	240,000	100%	\$19	*	*	*
9	\$106,100	239,000	10%	239,000	100%	\$22	*	*	*
10	\$146,500	241,000	10%	241,000	100%	\$22	*	*	*
All		2,312,000	100%	2,155,000	93%	\$13	*	2%	\$0

Option B. Tax changes with WFF increases

Deciles	Decile lower bound	Number of families with positive taxable income	% of families with positive taxable income	Number of families gaining	% of decile gaining	Average weekly gain for gaining families	Number of families disadvantaged	% of decile disadvantaged	Average weekly loss for losing families
1	\$0	152,000	7%	17,000	11%	\$32			
2	\$9,800	235,000	10%	103,000	44%	\$10	5,000	1%	<\$1
3	\$19,900	245,000	11%	239,000	98%	\$15	*	*	*
4	\$25,200	226,000	10%	221,000	98%	\$11	*	*	*
5	\$36,100	254,000	11%	254,000	100%	\$12	*	*	*
6	\$45,200	240,000	10%	240,000	100%	\$22	*	*	*
7	\$60,900	240,000	10%	240,000	100%	\$25	*	*	*
8	\$80,000	240,000	10%	240,000	100%	\$24	*	*	*
9	\$106,100	239,000	10%	239,000	100%	\$21	*	*	*
10	\$146,500	241,000	10%	241,000	100%	\$19	*	*	*
All		2,312,000	100%	2,035,000	88%	\$18	*	1%	\$0

This analysis was carried out using Treasury's micro-simulation model of the tax and welfare system - Taxwell. All calculations should be considered as estimates.

Estimates are for the 2018/19 tax year using HES 15 inflated and population adjusted with BEFU 2016 inflation estimates.

Access to the Household Economic Survey data was provided by Statistics New Zealand under conditions designed to give effect to the security and confidentiality provisions of the Statistics Act 1975. The results presented here are the work of Treasury, not Statistics New Zealand.

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Appendix 3. Labour Supply Impacts of Proposed Changes

The tables below provide more detail of the potential impacts on labour supply decisions by type of income earners.

The first two rows report the percentages of individuals working within that individual's type. For example, 59.3% of married men are currently working. Under the Option A tax proposal, 59.5% of married men would be working, indicating a 0.2% point increase in employment, or an increase from not working to working (the difference between rows 1 and 2 is equivalent to the difference between rows 3 and 4).

Rows 5 and 6 represent changes in labour supply for those *already working*. For example, for sole parents who currently work, 0.5% would work more, and 0.2% would work less. On balance, 0.3% would work more (the difference between rows 5 and 6). Overall, sole parents increase their working hours by 0.3 hours per week (row 7)

The results indicate that more sole parents are more likely to participate in the labour market under Option B (1.3% versus 0.7%). However, married couples *already working* are more likely to work less under Option B compared to Option A.

The overall results indicate that labour supply changes will be very small regardless of either tax option. As a point of reference, the labour supply impacts from the 2010 reforms were estimated to be a 0.9% point increase in the sole parent population, going from not working to working. The 2010 reforms were designed to be revenue- and distribution-neutral, however, so the impacts are not directly comparable.

Option A

		Married		Single		
		Men	Women	Men	Women	Parents
1	Salaried worker (% before reform)	59.3	56.0	54.9	46.6	46.3
2	Salaried worker (% after reform)	59.5	56.3	55.0	47.2	47.0
Behavioural Response						
3	Non-work to work (ppt)	0.2	0.3	0.1	0.6	0.7
4	Work to non-work (ppt)	0.0	0.0	0.0	0.0	0.0
5	Workers working more (ppt)	0.1	0.1	0.0	0.4	0.5
6	Workers working less (ppt)	0.1	0.1	0.0	0.1	0.2
7	Average hours change per week	0.1	0.1	0.1	0.3	0.3

Option B

		Married		Single		
		Men	Women	Men	Women	Parents
1	Salaried worker (% before reform)	59.4	56.0	54.9	46.6	46.3
2	Salaried worker (% after reform)	59.4	56.0	55.0	47.1	47.6
Behavioural Response						
3	Non-work to work (ppt)	0.1	0.2	0.1	0.5	1.3
4	Work to non-work (ppt)	0.1	0.2	0.0	0.0	0.0
5	Workers working more (ppt)	0.1	0.1	0.0	0.5	0.3
6	Workers working less (ppt)	0.2	0.2	0.0	0.1	0.4
7	Average hours change per week	0.0	0.0	0.1	0.3	0.3

This analysis was carried out using Treasury's behavioural micro-simulation model of the tax and welfare system, Taxwell-B. All estimates are based on Household Economic Survey 2015.

Access to the Household Economic Survey data was provided by Statistics New Zealand under conditions designed to give effect to the security and confidentiality provisions of the Statistics Act 1975. The results presented here are the work of Treasury, not Statistics New Zealand.

Appendix 4. Composition of Taxpayer Population

The primary objective of the personal tax cuts being considered is to improve the income adequacy of low-income families. To help us understand where changes could be targeted in the personal tax and transfer framework, we should look at the composition of individuals in the income distribution. This analysis outlines the extent to which individual taxable income is a good proxy for economic wellbeing, and the extent to which tax changes are the most targeted way of improving incomes as compared with transfer policies.

Note that the following analysis is based on individuals using Inland Revenue administrative data from 2014/15 tax year. This allows more accurate analysis of taxpayer types; however, we cannot draw conclusions on a family basis. Despite this, we think the analysis is useful for our purposes. The sample data using the Household Economic Survey for the low-income populations has some reporting issues that make it less useful for this type of analysis.

The following analysis was done on a mutually exclusive basis. That is, for us to look at who we believe are the relevant target for tax cuts and WFF increases, we first pull out those individuals who receive other forms of income or assistance, and are left with a group that does not include any of the already identified taxpayers. We then select another characteristic to single out. In this case, we single out, in the following order, those individuals who:

1. received income from NZ Superannuation
2. received income from a taxable welfare benefit
3. received a student allowance
4. were 25 or younger
5. had part year wages
6. received a WFF payment (or their partner did)

We considered that 1 and 2 are individuals whose incomes can be directly altered and tax changes may not be the optimal way of targeting changes for them. Note that welfare benefit rates are after-tax amounts, and so tax changes do not flow through to benefit recipients. Working for Families tax credits are not taxable income, and so tax changes do not affect net amounts for these recipients. New Zealand Superannuation is taxable and is a pre-tax amount, and so tax changes do affect the level of payment to super annuitants. Their amounts are also annually indexed according to after-tax median wages, meaning they get a secondary boost from tax cuts.

Individuals in groups 3 and 4 are likely to be younger and are in the stage of their lifecycles when incomes are temporarily low as they are studying or perhaps dependent on their parents as they begin adulthood. Individuals in group 5 may also have temporarily low incomes if they are between job contracts.

Those individuals who received a WFF payment (or their partner) are also singled out, so that we may use that data to look at the distribution of WFF recipients.

The table below summarises the breakdown of types of taxpayer by tax bracket:

Table A4.1. Composition of taxpayers

	<u>Nil taxable</u>	<u>\$0 to \$14k</u>	<u>\$14k to \$48k</u>	<u>\$48k to \$52k</u>	<u>\$52k to \$70k</u>	<u>Over \$70k</u>	<u>Total</u>
super	4,400	37,600	514,700	12,300	43,600	58,400	671,000
welfare	1,400	195,300	257,500	2,000	3,700	1,200	461,100
student allowance	200	35,800	25,700	200	300	-	62,200
under 25	7,700	214,300	166,900	9,500	17,400	5,200	421,000
part year wage	3,400	102,000	38,400	2,400	5,900	8,600	160,700
getting WFF credits	42,900	32,900	135,600	15,700	47,900	22,000	297,000
residual group	40,400	92,400	540,200	85,800	310,700	473,500	1,543,000
Total	100,400	710,300	1,679,000	127,900	429,500	568,900	3,616,000

The ordering matters in this exercise. As an example, the number of taxpayers in the \$0 to \$14k column in Table A4.1 who receive a student allowance is 35,800. The number of under 25 taxpayers in that same column is 214,300. Because the under 25 row comes **after** the student allowance row, the correct interpretation is that there are 214,300 under 25 taxpayers who do **not** receive a student allowance (and who also do not receive super or welfare).

The highlighted row “residual group” is possibly the group of individuals that could be considered the target of potential personal tax reductions. By shifting the third tax threshold from \$48,000 to \$52,000, there are an estimated 85,800 individuals who would gain by having a marginal tax rate of 16% rather than the current 30%.

The next table presents these distributions by proportion of taxpayer type:

Table A4.2. Composition of taxpayers by type

	<u>Nil taxable</u>	<u>\$0 to \$14k</u>	<u>\$14k to \$48k</u>	<u>\$48k to \$52k</u>	<u>\$52k to \$70k</u>	<u>Over \$70k</u>	<u>Total</u>
super	1%	6%	77%	2%	6%	9%	100%
welfare	0%	42%	56%	0%	1%	0%	100%
student allowance	0%	58%	41%	0%	0%	0%	100%
under 25	2%	51%	40%	2%	4%	1%	100%
part year wage	2%	63%	24%	1%	4%	5%	100%
getting WFF credits	14%	11%	46%	5%	16%	7%	100%
residual group	3%	6%	35%	6%	20%	31%	100%
Total	3%	20%	46%	4%	12%	16%	100%

As indicated in the table, of the residual “target” group, 41% (35% + 6%) of individuals would benefit from the increase of the third tax threshold to \$52,000. However, 20% of individuals would also see an increase in their highest marginal tax rate by 3%.

It is interesting to note the composition of individuals earning between \$0 and \$14,000. Of the target group, only 6% of individuals fall into this tax bracket. These individuals may be experiencing low economic wellbeing if we consider low-income to be a proxy for wellbeing. However, it is unknown whether this state is persistent for these individuals. For example, the target group includes those who report as self-employed, and those who earn only investment income. For those who fall into the bottom tax bracket, it could be that it was an unusual year of low returns or perhaps there were tax losses from previous years.

Also of interest is the distribution of WFF recipients. WFF payments are relatively spread across the income distribution. Aggregated, the group falling into the \$14,000 to \$48,000 tax bracket (and to \$52,000 by extension) represents nearly half of the recipients. These

individuals would also see the greatest benefit of a tax cut if coupled with an increase in family tax credit, but the amount of family tax credit is not affected by a tax change.

The column of individuals with nil taxable income are those who have tax losses offsetting their income.