Budget 2010 tax package and the preliminary economic and fiscal outlook

1.Tax package costs based on preliminary BEFU outlook

Initial costing of package (preliminary BEFU basis - excludes macroeconomic effects)

$ million	*2010/11*	*2011/12*	*2012/13*	*2013/14*	*total*
Personal Tax (10.5, 17.5, 30, 33)	-2,365	-3,720	-4,000	-4,250	-14,335
Net NZS	-255	-360	-385	-390	-1,390
Net main benefits	-75	-100	-100	-105	-380
WFF Compensation	-45	-65	-65	-65	-240
Other compensation	-40	-70	-70	-70	-250
GST (excluding clawback)	1,590	2,235	2,345	2,460	8,630
WFF de-indexation	0	15	50	40	105
WFF Integrity Measures	5	15	15	15	50
Company tax cut to 28%	-20	-340	-450	-305	-1,115
Building Depreciation (all buildings)	0	685	685	690	2,060
Depreciation Loading (grandfathering)	135	245	310	345	1,035
LAQCs (incl. remission loophole)	0	70	65	55	190
Thin Cap 60%	0	200	200	200	600
Depreciation - capital contributions	5	5	5	10	25
GST maintenance	15	60	60	60	195
5-year brightline	10	35	70	70	185
Tobacco excise	60	105	140	145	450
Audit activity (incl. admin)	85	170	170	130	555
Inland revenue admin costs	-10	0	0	0	-10
First round effects on revenue	***-905***	***-815***	***-955***	***-965***	***-3640***
Static clawback estimate	450	625	655	705	2435
Initial estimate of impact	**-455**	**-190**	**-300**	**-260**	**-1205**

*Figures rounded to nearest $5m

The tax package costing above involves the base package considered by the tax sub-group on 22 March 2010, with the addition of the following measures:

- Company tax cut to 28%
- GST maintenance (phoenix schemes)
- A 5-year brightline test on residential rental property (with grandfathering)
- Tobacco excise increase phased in over three years (includes CPI flow-through to benefit indexation)
- Inland Revenue audit activity
- Administrative costs for Inland Revenue (replaces previous contingency of $50m per year)

Macroeconomic impacts on the cost of the package are shown in box 4.

2. Economic impacts

We have quantified the labour supply, investment, saving, and productivity effects of the package as follows:

Overall: we estimate a 0.9% increase in the level of GDP. This is material and also conservative, as it excludes important effects which can be expected to boost growth, but which the literature struggles to quantify. We have not identified any excluded effects that would put material downward pressure on the estimate.

Labour supply: the package reduces the tax wedge (the sum of income tax and GST) between pre- and post-tax wages, boosting real after-tax incomes by about 1.8% on average.

We estimate this will increase private sector hours worked by 0.8% and increase participation rates by 0.5%, boosting the level of GDP by about 0.9% spread over 10 years. This assumes an hours worked elasticity of 0.44 and a participation elasticity of 0.28 (with a damping factor of 0.5 to adjust for the lower productivity of new workers).

Investment: the aggregate impact of the company tax rate reduction and base broadening measures is to increase average tax rates on firms by 1.5%. The personal tax rate reductions reduce this increase by at most 0.5%. Research commissioned by Treasury (Mintz) suggests that this would reduce firm investment by 0.5–1.5%.

However, the same research also indicates that the proposed base broadening measures will dramatically reduce inter-industry tax distortions, and significantly reduce inter-asset distortions. This will improve the allocation of investment. The growth effects of these allocative improvements have not been formally quantified.

Therefore our judgement is to assume that the aggregate effect on growth of the investment changes is zero. Although the allocative gains are hard to quantify, ignoring them would paint an unduly negative picture of the likely impact of the reforms. Therefore improved investment allocation is included to the extent it offsets the negative impact of the reduction in firm investment volumes.

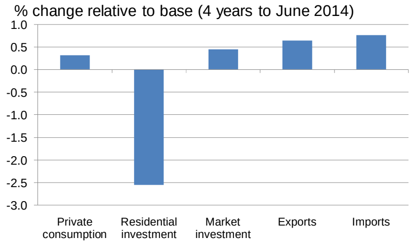
Productivity and saving: the package has a range of effects that can be expected to boost productivity, but which have been excluded from our estimate due to the lack of insight from the literature as to what reasonable quantitative estimates might be. On the labour side it increases incentives to study, train and seek career advancement, and to move to or stay in New Zealand. None of these effects are included in the estimate.

Potential longer-run productivity and risk improvements from increased saving improving the investment-saving imbalances in the economy are not quantified. The reduction in income tax rates will boost after-tax returns by about 5%, potentially boosting household saving by 1.5% or so (with a savings elasticity of 0.30).

3. How the tax package changes the economic outlook

The preliminary BEFU economic forecasts have been updated to reflect the economic impacts of the tax package.

Change in GDP composition



Note: while residential investment shows largest % change, it is by far the smallest component.

By June 2014 the level of real GDP is 0.4% higher, increasing to 0.9% over the projection period.

Consumption is higher reflecting that the income tax gains are greater than the GST increase. Income rises due to higher labour force participation and more hours worked.

Market investment is higher due to the shift from residential investment.

Exports are higher as more investment focused on traded sector.

Imports are higher due to stronger consumption and market investment having a larger import component than residential.

Saving

The current account deficit is expected to be slightly smaller, with household saving slightly improved.

Labour market

The tax package encourages a greater number of people to participate in the labour force and a modest increase in the number of hours people work.

Employment around ½% higher (around 10,000 people) by 2014.

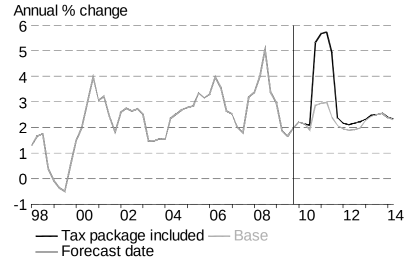
Unemployment rate lower by up to 0.2%pts.

Nominal GDP

GDP is a GST inclusive measure, so the increase in GST plays a key role in generating higher nominal GDP. For this reason care needs to be taken when referring to nominal GDP holes.

Nominal GDP is a cumulative $20 billion higher over the 2011 to 2014 June years.

Inflation



The increase in GST is the main driver of the spike in CPI inflation which peaks at 5.7% in the first half of 2011.

It is assumed that there is no flow through to public sector wage rates and that the impact on private sector wage claims is much more muted than usual.

If inflation expectations are significantly affected then there is the risk of monetary policy responding.

Note: In the latest GDP outturn, real GDP growth was in line with forecast but nominal GDP was weaker (0.5% versus 1.8% forecast).

4. Tax package costs incorporating economic impacts

More complete costing of package

	2011	2012	2013	2014	4-year total
	Forecast	Forecast	Forecast	Forecast	Total
Increase/(decrease)	$m	$m	$m	$m	$m
Impact on operating balance before gains and losses					
Tax revenue	-258	108	232	560	642
Reduction in tax impairments	36	122	122	85	365
Benefit & other expenses	-206	-353	-410	-440	-1,409
Finance costs	-20	-41	-41	-30	-132
Operating balance before gains and losses	**-448**	**-164**	**-97**	**175**	**-534**

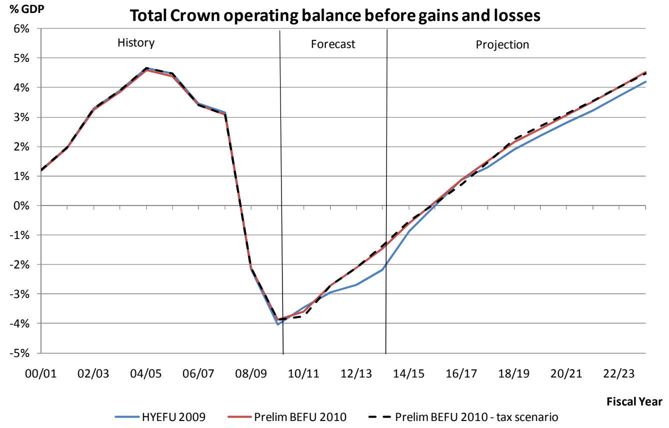
- The tax package costs $530 million over the forecast period including macroeconomic impacts, compared to $1,205 million in the static costing.
- The main difference between these and the static costings are:
  - Expenses are $510m higher than the static cost – driven by higher benefit expenses from higher inflation.
  - Incorporation of finance costs ($130 million) resulting from a $700 million debt impact in 2010/11 from the initial revenue reduction of the tax package.
  - Tax package generates around $3.6 billion revenue through a combination of static clawback ($1.8b indirect + $0.7b direct) and labour supply response ($1.1b). This is $1.2 billion more than the clawback estimate allowed for in the static costing (which did not include labour supply effects).

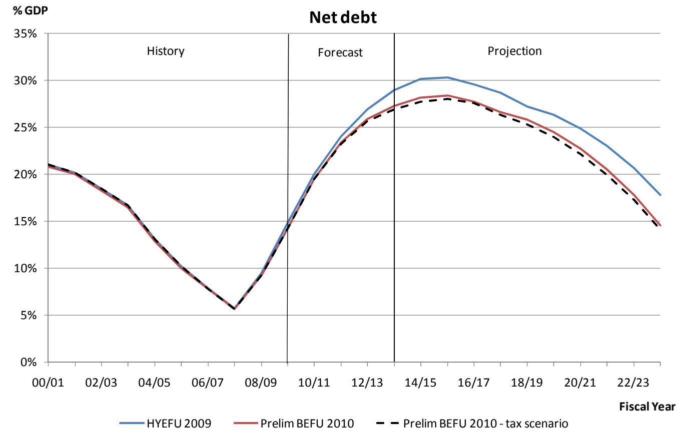
Increase/(decrease) $ million	2011	2012	2013	2014	4-year total
Tax package policy cost (tax only)	-802	-634	-779	-722	-2,937
Indirect tax clawback (static)	333	398	445	593	1,769
Direct tax clawback (i.e. tax on profits)	153	148	190	184	674
Tax effect of labour supply response	59	195	377	505	1,136
Net tax forecast change	**-258**	**108**	**232**	**560**	**642**

- If the CPI effect from the tobacco excise increase was not flowed through to benefit indexation, the savings would be:

Increase/(decrease) $ million	2011	2012	2013	2014	4-year total
Remove excise CPI from benefit indexation	5	20	45	45	115

5. Fiscal outlook (including medium term)





The tax package is broadly fiscally neutral as a percentage of GDP.

The table below shows the estimated change since the HYEFU.

Operating balance before gains/losses - $b	2010	2011	2012	2013	2014	5 Yr-Total
Tax revenue	(0.6)	(0.1)	0.5	0.7	0.9	1.4
Benefit forecasts	0.1	0.2	0.2	0.3	0.3	1.1
Other changes	0.6	(0.6)	(0.4)	0.2	0.4	0.1
	0.1	**(0.5)**	**0.3**	**1.2**	**1.6**	**2.6**
Tax package	-	(0.4)	(0.2)	(0.1)	0.2	(0.5)
	0.1	**(0.9)**	**0.1**	**1.1**	**1.8**	**2.1**

Net debt is projected to peak at about 28% of GDP in 2015/16 (compared to 30.3% of GDP at HYEFU in the same year) and by 2023/24 ends up at just over 14% of GDP (17.8% of GDP at HYEFU).

The operating balance before gains and losses is projected to return to surplus at a similar time to what was predicted at the HYEFU.

6. Policy advice

These costings include the 5-year brightline test and the tobacco excise increase. A decision to not proceed with these or any other revenue positive policy changes would weaken the broad fiscal neutrality of the overall package and further revenue gains or savings would need to be found to achieve fiscal neutrality.

We recommend that you consider further principled base-broadening options beyond those that have so far been agreed to limit the risks to fiscal neutrality.

	$m increase/(decrease)			
	2010/11	2011/12	2012/13	2013/14
Working for Families Integrity	10	10	10	10
Additional Audit Activity	30	30	30	30
Deleted – confidentiality of advice				
Tobacco Excise - No Indexation	5	20	45	45

Note that policy issues and risks would need to be carefully considered before making changes to the banking thin capitalisation rules.

7. Key assumptions

These preliminary forecasts reflect our best professional judgement. However, they were produced ahead of schedule. They were compiled using abridged processes, including QA, and in some cases do not include our usual data inputs.

Significant assumptions used in estimating the fiscal impact of the updated macroeconomic outlook include[1]:

- Fiscal forecasts are based on FBU data updated for tax revenue, benefits and finance costs. We do not expect significant changes from budget data.
- A build-up in tax losses through the recent recession retards growth in corporate taxes for the next few years. This will have run its course by the end of the forecast period.
- Operating and capital allowances at HYEFU levels.
- The projections incorporate no further changes to tax rates or thresholds other than incorporated in the current package. As a result fiscal drag operates throughout the projection period.

[1] Draft detailed assumptions used in compiling the forecasts are available

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