The Treasury

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To: Minister of Finance (Hon Bill English)

Deadline: None

Aide Memoire: Advice on Adjusting for Fiscal Drag and the Possible Impacts

Purpose

You have indicated that you would like to consider tax cuts as part of Budget 2017 decisions. As part of any potential changes to the personal tax and transfer system, we would consider the economic impacts of fiscal drag. This report discusses what the personal tax schedule and fiscal cost impacts of adjusting tax thresholds would be if the adjustments were assumed to be effective from 1 April 2017 and annually for each of the next three years.[1] We also discuss labour supply impacts. Advice on cuts to personal taxes with a focus on equity objectives will be provided separately.

New thresholds and fiscal cost

Fiscal drag may be defined as increases in individuals' average tax rates as a result of price or wage inflation. As individuals cross tax thresholds, and move into a higher tax bracket, their marginal tax rates increase. The case for adjusting tax rate thresholds for fiscal drag has three primary justifications:

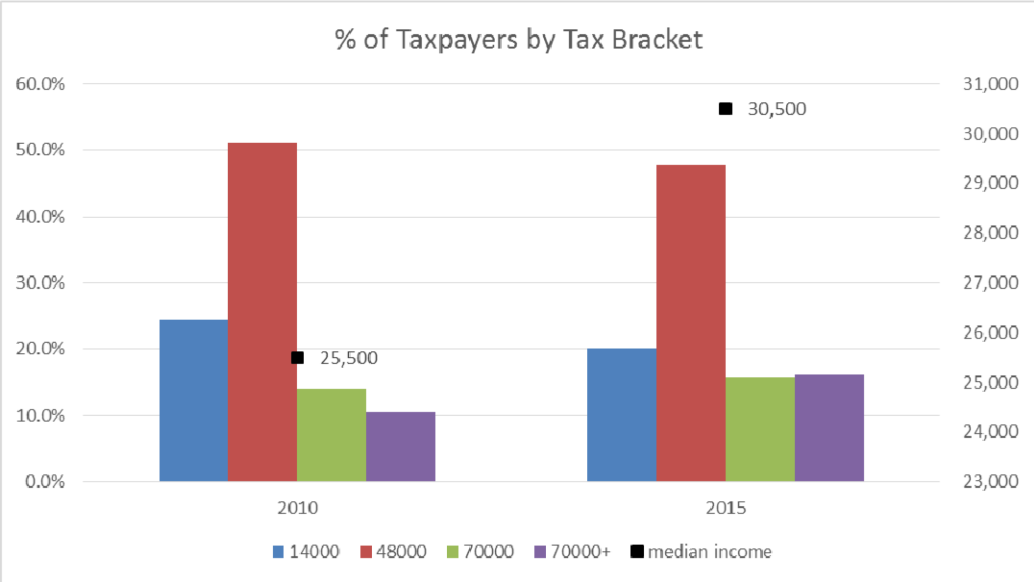
- If thresholds are not adjusted, average tax rates increase over time, but most strongly for those on lower rates. In New Zealand, under our current threshold structure, this occurs most for those whose income crosses the $48,000 threshold. This reduces progressivity.
- When the tax thresholds were last reviewed, the thresholds were set at levels the Government considered to be optimal, balancing many considerations. Fiscal drag adjusts the real value of those thresholds in an arbitrary way. If there has been no reappraisal of the optimal levels, these new thresholds are suboptimal relative to indexed thresholds.
- If thresholds are not adjusted, government revenue as a proportion of GDP increases. If there has been no reappraisal of the optimal proportion, this new level will be suboptimal relative to the level that existed when tax thresholds were last explicitly reviewed.

The above justifications support adjusting the thresholds to their real value in 2010 (the last time personal tax thresholds were reviewed). CPI increased by about 10%

1 Note that fiscal drag adjustments for 1 April 2017 are not suggested as operationally achievable, but we include the modelling results for illustration.

between June 2010 and June 2016. The graph below shows how the distribution of taxpayers has changed between 2010 and 2015, by tax bracket:

Figure 1. Changes in distribution of taxpayers by tax bracket[2]



The percentage of taxpayers in the lowest two tax brackets has declined, and increased in the top two tax brackets. Median incomes for taxpayers increased 19.6%. While price and wage increases indicate that some individuals have moved up tax brackets over time, the appropriate level of adjustments to tax thresholds for price or wage inflation would still need to consider what is the desired distribution of taxpayers across tax brackets, and not just price or wage increases.

An approximate calculation indicates that such an adjustment for price inflation starting from 1 April 2017 would cost about $1 billion in the first year. Given this large cost, we have instead modelled adjustments to thresholds based on price inflation over a single year, from June 2017 to June 2018, and applying that inflation factor to current thresholds beginning 1 April 2017. The thresholds would be:[3]

Table 1: Tax thresholds adjusted for price inflation

Status Quo			2017/18		2018/19		2019/20	
Thresholds		Rates	Thresholds		Thresholds		Thresholds	
$1	$14,000	10.50%	$1	$14,276	$1	$14,551	$1	$14,861
$14,001	$48,000	17.50%	$14,277	$48,945	$14,552	$49,890	$14,862	$50,953
$48,001	$70,000	30%	$48,946	$71,378	$49,891	$72,756	$50,954	$74,307
$70,001	+	33%	$71,379	+	$72,757	+	$74,308	+
Fiscal cost (tax year)[4]			$ 220 m		$450 m		$ 720 m	

2 Using IRD administrative data and approximating median wages.

3 2017/18 thresholds are adjusted for 2.0% CPI inflation, 2018/19 thresholds for 1.9% inflation, and 2019/20 thresholds for 2.1% inflation. These inflation figures are based on Budget 2016 (BEFU) forecasts.

4 For completeness, including an approximate 10% clawback of GST and other indirect tax revenue through household spending would reduce the annual fiscal costs to $198 m, $405 m, and $650 m, respectively.

Adjusting thresholds for CPI removes the effect of price inflation, but average tax rates would continue to increase with real wage increases as a result of productivity gains. We have not adjusted the thresholds for real wage increases for several reasons. First, it would be costly. On average, nominal wages have increased more than prices and are forecast to grow at 1.7%, 2.3%, and 2.9% for the years above. Between June 2010 and June 2016, nominal wages have increased by 16% (and real wages by 5.8%). Using these as adjustment factors would obviously raise thresholds more than adjusting for price inflation, with commensurate fiscal costs. In addition, using real wage increases would be more complex as it requires base assumptions about the appropriate size of wage increases. Some individuals in the income distribution have seen large increases in their real wages, while others have not.

Average tax rates

Average tax rates for hypothetical individual earners under status quo thresholds and adjustments are given in Table 2 below. We have held wages constant for these individuals.

Table 2: Average tax rates

	Annual Income	Status Quo	17/18	18/19	19/20
40 hours, minimum wage	$ 31,720	14.41%	14.35%	14.29%	14.22%
40 hours, average wage	$ 58,189	18.0%	17.77%	17.53%	17.27%
40 hours, 2x average wage	$ 116,378	25.2%	25.04%	24.89%	24.72%

The average tax rates in the table do not decline as much as they could under a personal tax cut such as those presented in our other report, which discusses options to improve income adequacy for the low-income families [T2016/1948 refers]. In other words, you can still achieve lower average tax rates with a package that is not solely about adjusting thresholds for price inflation.

Labour supply impacts

Using our microsimulation model, the labour supply changes for all demographic groups are positive but small. We modelled the labour supply changes based on the adjusted tax thresholds for the 2019/20 tax year. The responses indicate individuals' work decisions following the tax changes in the same year. We assume no adjustments to Working for Families tax credits or abatement rates. The largest average increase is for sole parents, who have low participation rates (about 40%). Sole parents show increases both in terms of choosing to work, as well as increasing hours of work.

Adjustments for fiscal drag are estimated to increase the proportion choosing to work by 0.2% points for sole parents and 0.1% points for other demographic groups. For those already in work, the number of sole parents working more increases by 0.3% points of the population, and less than 0.2% points for other demographic groups.

The labour supply changes are expected to reduce the total fiscal cost of the adjustments by 10% as a result of the improved work incentives and reduction of welfare benefits for sole parents.

Policy advice

We do not prioritise adjustments for fiscal drag as a tax policy change at this time. This is because of both the relatively small labour supply gains, as well as the limited effect in meeting your equity objectives of improving the income adequacy for low-income families within the tax and transfer framework as part of Budget 2017.

Automatic annual indexation

On a related note, we also do not recommend automatic annual indexation of tax thresholds to mitigate the effects of fiscal drag. As discussed above, adjustments to lower average tax rates can be done not only through adjustments to tax thresholds, but through combinations of cuts to tax rates and threshold changes. In addition, allowing some fiscal drag to occur temporarily may offer a buffer for economic downturns. Fiscal drag also has benefits for periods of economic boom with a countercyclical effect. Administratively, more regular adjustments would also mean that taxpayers are less likely to be aware of what the thresholds are, implying that there are simplicity benefits from infrequent adjustments.

While the United States automatically indexes thresholds annually to price inflation, most countries adjust thresholds on an ad hoc basis. A downside to not annually indexing is that there is less transparency for taxpayers; however, we consider that on balance, it is preferable to adjust on an ad hoc basis.

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