The Treasury

Budget 2017 Information Release

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Date: 23 December 2016

To: Minister of Finance (Hon Steven Joyce)

Deadline: None

Aide Memoire: Advice on Adjusting Tax Thresholds and the Possible Impacts

Purpose

In the session with Treasury on 15 December you indicated that you would like to consider changing tax thresholds as part of Budget 2017 decisions. 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 2018. We also discuss labour supply impacts to respond to your interest in work incentives.

Background

The government has indicated that – economic and fiscal conditions permitting – it will consider lowering taxes as part of Budget 2017. Treasury has previously provided advice on the impact of adjusting tax thresholds for fiscal drag and lowering the tax rates, in reports T2016/1948 and T2016/2059 respectively. This report complements the previous analysis by analysing four indicative options for changing the tax thresholds.

As individuals cross tax thresholds, and move into a higher tax bracket, their marginal tax rates increase. If thresholds are not adjusted, average tax rates will increase over time, but most strongly for those on lower rates. Holding the tax thresholds constant will also alter the incentives to work as marginal tax rates change with nominal income, instead of taking account of the purchasing power of that income. This process where average tax rates increase as a result of price or wage growth is known as "fiscal drag".

The largest increase in tax rates occurs at the $48,000 threshold, which has informed the first three options presented in this report. Moving this threshold is likely to have the largest impact on work incentives within options exclusively focussed on tax threshold adjustments. Another potential way in which tax thresholds could be adjusted is by taking account of fiscal drag directly, by increasing the thresholds in line with price increases since 2010 (the last time personal tax thresholds were reviewed).[1] Option 4 explores this in more detail.

1 The Consumers Price Index (CPI), the headline measure of price inflation, increased by about 10% between June 2010 and June 2016.

Taxwell – Treasury's tax and transfer microsimulation model

Treasury has a microsimulation model, Taxwell, to provide information on the fiscal costs and distributional impacts of changing tax and welfare settings. Taxwell applies a tax and transfer system to individuals and families from the Household Economic Survey[2] to estimate the change in each component of the tax and transfer system. This change is then aggregated to estimate the fiscal cost and to provide a summary of who gains and who loses as a result of a particular policy change.

There is also a labour supply extension to Taxwell (Taxwell-B) that can estimate the likely changes in peoples' labour-force participation and hours worked as a result of changes to the tax and transfer system. However, it is important to note that:

- Taxwell-B does not model self-employed people, retirees or their partners, full-time students or people with disabilities. The labour supply choices of individuals in these groups are assumed to remain unchanged.
- Taxwell-B concentrates only on the supply-side of the labour market. That is, the model assumes that there is always sufficient demand from employers to absorb any increase in labour supply at peoples' prevailing wage rates. We believe this assumption to be reasonable for the options presented here.

Options

Four indicative options are presented. The first three options move the $48,000 tax threshold to $55,000, $62,000 and $70,000 respectively. Each of these options is progressively more expensive as more people who were previously subject to a 30% tax rate will now face a 17.5% tax rate. Moving the $48,000 threshold to $70,000 would eliminate the existing $48,000 to $70,000 band. The fourth option adjusts all of the tax thresholds for fiscal drag on a price inflation basis and is the only one of the options presented that would materially impact individuals who earn less than $48,000.

Status Quo		
Thresholds		Rates
$1	$14,000	10.50%
$14,001	$48,000	17.50%
$48,001	$70,000	30%
$70,001	+	33%
Fiscal cost (18/19 tax year)[3]		

Option 1 - $48k to $55k	
Thresholds	
$1	$14,000
$14,001	$55,000
$55,001	$70,000
$70,001	+
$ 1,100 m	

Option 2 - $48k to $62k	
Thresholds	
$1	$14,000
$14,001	$62,000
$62,001	$70,000
$70,001	+
$2,000 m	

2 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.

3 The fiscal costs include an approximate 10% clawback of GST and other indirect tax revenue through additional household spending that would be expected as a result of increased income.

Status Quo			Option 3 - $48k to $70k		Option 4 – Fiscal Drag Adjustment in 18/19	
Thresholds		Rates	Thresholds		Thresholds	
$1	$14,000	10.50%	$1	$14,000	$1	$15,476
$14,001	$48,000	17.50%	$14,001	$70,000	$15,477	$53,057
$48,001	$70,000	30%	[redacted]		$53,058	$77,375
$70,001	+	33%	$70,001	+	$77,376	+
Fiscal cost (18/19 tax year)			$2,700 m		$1,100 m	

There are 1,390,000 families with individuals who would benefit from any of the first three options. The average increase in disposable income per family per week for these families is $17 for option 1, $31 for option 2 and $41 for option 3. The number of families who would lose as a result of the first three options is below the reporting threshold of 3,000, and we expect that the amount lost is small. Option 4 will benefit 1,923,000 families with an average weekly gain of $13. There are a number of families that have less income under option 4 due to interactions between the tax and benefit systems, although the average weekly loss for these families is less than $0.50.

Labour supply impacts

Using our microsimulation model, the labour supply changes for all demographic groups are positive but only marginally so. For instance, the overall increase in participation is estimated to be less than a quarter of a percentage point, and this occurs in the fiscal drag compensation scenario (option 4).

This is due to the fact that the cuts to personal tax rates allow for small but relatively broad cuts to average tax rates rather than deep, targeted cuts to marginal tax rates. The latter would not be possible without a significant rebalancing of the tax system or a much larger fiscal allowance.

The labour supply changes are expected to reduce the total fiscal cost of the adjustments by 5-6% for options 1-3, and 8% for option 4, relative to the non-behavioural costs of the policy given above. This is due to the slightly improved work incentives.

Policy advice

Changing the tax thresholds would have relatively small labour supply gains. It is likely that delivering a similar sized package through targeted payments like Accommodation Supplement would have a noticeably larger impact on work incentives. We will provide further advice on the impact of Accommodation Supplement changes on work incentives, and on effective marginal tax rates (EMTRs), in January 2017.

If Ministers had an equity objective for Budget 2017 (to improve income adequacy for low-income families within the tax and transfer framework) these tax thresholds options would have limited effect. Combining some changes to the tax system with changes to Working for Families would have a larger equity impact for those people with dependent children.

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