The Treasury

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Treasury Report: Removing the Independent Earner Tax Credit

Date:	3 February 2017	**Report No:**	T2017/164
		File Number:	MS-9-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Steven Joyce)	**Discuss** options for the Independent Earner Tax Credit with officials.	17 February 2017
Associate Minister of Finance (Hon Simon Bridges)		
Associate Minister of Finance (Hon Amy Adams)		

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
[34]	Analyst, Tax Strategy	[39] (wk)	[23] (mob)	✓
Dr Eina Wong	Senior Analyst, 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

You have requested advice on changing tax settings as part of Budget 2017. We understand your overarching goal in considering personal tax changes is to improve work incentives.

Removing the Independent Earner Tax Credit (IETC) would have a fiscal saving of around $200 million per annum and could be considered as part of a tax package in Budget 2017.

The IETC has small positive impacts on labour supply. However, it is likely that this objective could be achieved more effectively by removing the IETC and making other changes to tax and transfer settings. The IETC is poorly targeted, administratively complex and increases effective marginal tax rates when it is abated.

IETC is received by 513,000 individuals (2015 tax year). The IETC delivers $10 per week or $520 per year to individuals earning between $24,000 and $44,000. Individuals who receive a main benefit, Working for Families or New Zealand Superannuation are not eligible to receive the IETC. The IETC abates at a rate of 13 cents for every dollar of income over $44,000, meaning it is fully abated at $48,000.

There are slightly more females (52%) than males (48%) receiving the IETC. IETC recipients tend to be younger, a third of all men aged 23 or 24 received IETC in 2014. Recipients under 35 are mainly male and over 35 are mainly female. Removing the IETC will make 107,000 individuals earning between $14,000 and $31,000 worse off by $10 on average per week, and 385,000 individuals earning between $31,000 to $48,000 worse off by $9 on average per week.

Fully compensating individuals made worse off from this change through income tax changes would entail reducing the 17.5 per cent tax rate on incomes between $14,000 and $48,000. This would have a high fiscal cost.

If the IETC is maintained, you could consider modifying its parameters to be more tightly targeted and/or reduce the abatement rate.

Recommended Action

We recommend that you **discuss** options for the Independent Earner Tax Credit with officials.

Agree/disagree.

Dr Eina Wong
Senior Analyst

Steven Joyce
Minister of Finance

Hon Simon Bridge
Associate Minister of Finance

Hon Amy Adams
Associate Minister of Finance

1. You indicated in a meeting with officials on 15 December 2016 that you would like to consider changing tax settings as part of Budget 2017. We understand your overarching goal in considering personal tax changes is to improve work incentives. Removing the Independent Earner Tax Credit (IETC) could be considered as part of any personal tax changes. It is likely that a better labour supply impact could be achieved by removing the IETC and targeting that spend to other areas.

2. This report provides background information about the IETC, an overview of current IETC recipients, and discusses the impact of removing the IETC effective from 1 April 2018. We will report to you next week about options more generally for tax and Working for Families packages, which can include removing the IETC.

IETC Background

3. The IETC delivers $10 per week or $520 per year to individuals earning between $24,000 and $44,000. Individuals who receive a main benefit, Working for Families or New Zealand Superannuation are not eligible to receive the IETC. The IETC abates at a rate of 13 cents for every dollar of income over $44,000, meaning it is fully abated at $48,000. For the 2016 tax year, an estimated $223 million will be paid.[1]

4. The IETC at the entry threshold lowers the marginal tax rate and average tax rate for recipients. There is a slightly regressive element to the IETC. The minimum level of annual income - $24,000 – that a person needs to earn in order to qualify for the IETC means that people who earn between $21,523 and $23,999 pay the same amount of tax as an individual who earns $2,971 more than them.

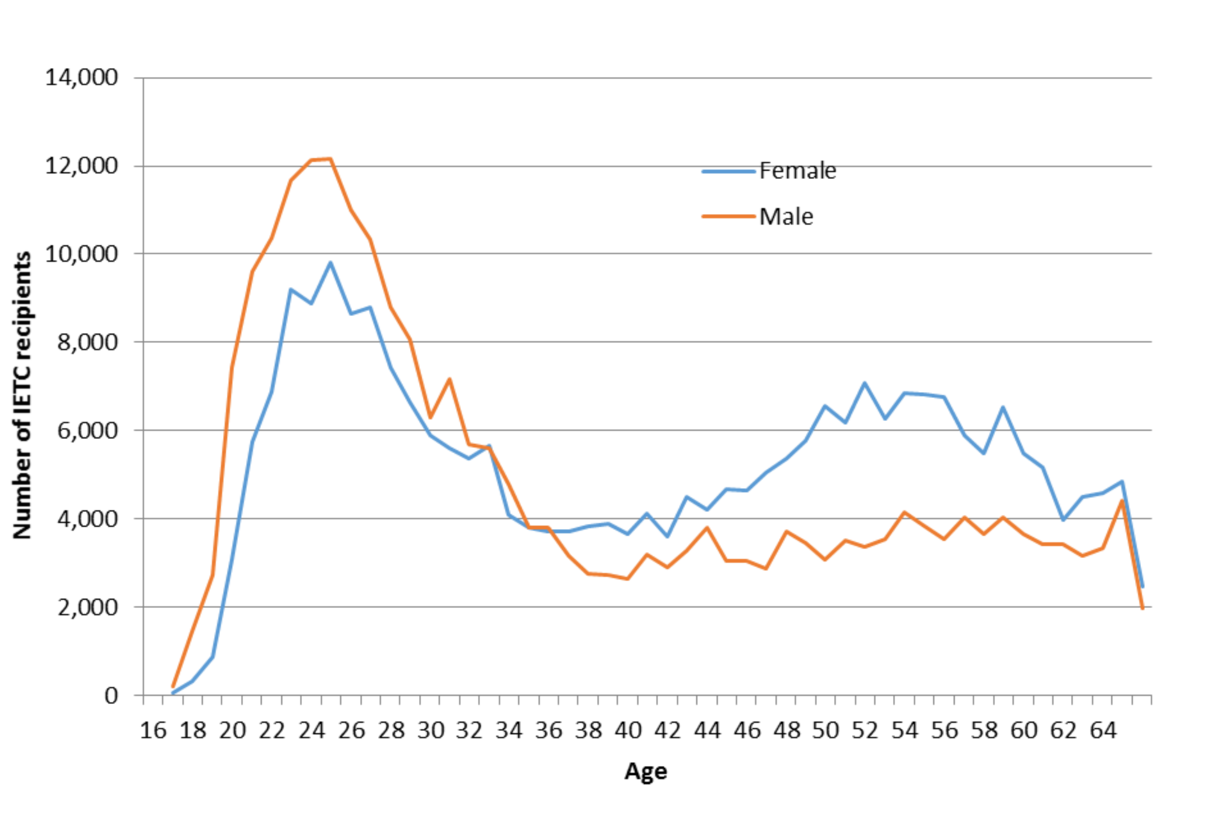
5. When introduced in 2009, the IETC was intended to increase incentives for participation in the workforce by targeting those earning below the full-time minimum wage of just above $24,000 per annum. At the time, personal tax rates were higher, with the bottom two rates being 12.5% and 21% respectively.

Recipients of IETC

6. In the 2015 tax year, 513,000 individuals received the IETC. There are slightly more females (52%) than males (48%) receiving the IETC. Recipients tend to be younger, a third of all men aged 23 or 24 received IETC in 2014. Recipients under 35 are mainly male and over 35 are mainly female.

1 This figure will increase as some eligible individuals have yet to claim their IETC entitlement.

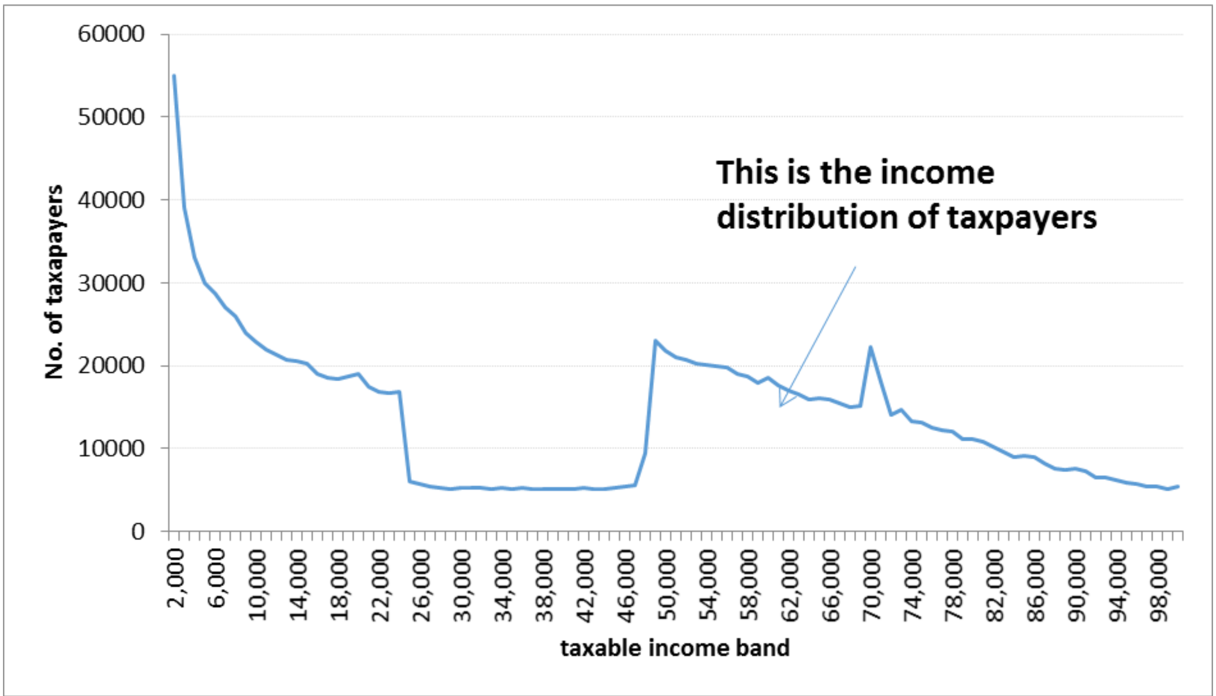
Figure 1: IETC recipients by age (16-65) and gender



Source: Inland Revenue administrative data

7. Figure 2 shows the distribution of taxpayers not receiving Working for Families and the IETC. The large basin in the middle of the graph reflects the income eligibility range for the IETC ($24,000 to $48,000 where the IETC is fully abated).

Figure 2: Income distribution of taxpayers not receiving Working for Families and IETC



Source: Inland Revenue administrative data

The target group of recipients has changed

8. The number of individuals receiving the IETC has not changed significantly overtime, but the types of people receiving it differ from those who initially would have been entitled to the IETC in 2009. A full-time worker earning the minimum hourly wage in 2015 would have an annual income of $30,300 compared with $24,050 in 2009. Although the IETC is now received by lower-income individuals, it means many more part-time workers are entitled to the IETC where they wouldn't have qualified before. It also means a person earning the minimum wage needs to work 30.5 hours per week from 1 April 2016 to qualify for the IETC, which is fewer than the 37 hours per week needed in 2009.

High income families are recipients

9. The table below shows that an estimated 105,000 IETC recipients are partnered with a significantly higher-income earner ($70,000 or higher). These couples may or may not have children, but if they do, their family income should mean they do not qualify for Working for Families.

Table 1: IETC recipients with partners by partner's income band

Partner's income			Partners	Cost
	Less than	0	14,000	$7,000,000
0	-	14,000	27,000	$13,000,000
14,000	-	31,000	24,000	$9,000,000
31,000	-	48,000	*	*
48,000	-	60,000	48,000	$23,000,000
60,000	-	70,000	36,000	$17,000,000
70,000	-	100,000	64,000	$30,000,000
100,000	-	125,000	16,000	$8,000,000
125,000	-	150,000	11,000	$5,000,000
150,000	+		14,000	$6,000,000
			255,000	$117,000,000

Source: Treasury Taxwell

*Suppressed – count fewer than 3000.

Administration impacts effectiveness

10. The IETC is delivered to salary and wage earners through the PAYE system on a pay period basis and to other individuals through the end-of-year tax return process. Around 65% of IETC recipients receive the tax credit after year-end as a refund after filing a tax return or requesting a personal tax summary. Delivery on a pay period basis more directly links the IETC payments with work incentives.

11. While 90% of the IETC recipients earn mainly salary and wage income (and so could receive the IETC through the PAYE system), the number of IETC recipients receiving the $10 each week on a pay period basis has declined each year. It is not clear what the cause of this trend is. However, there is possibly a lack of awareness of the ME tax code or people choosing are not to use it due to uncertainty about income for the current year.

Table 2: IETC payment split between PAYE and year-end

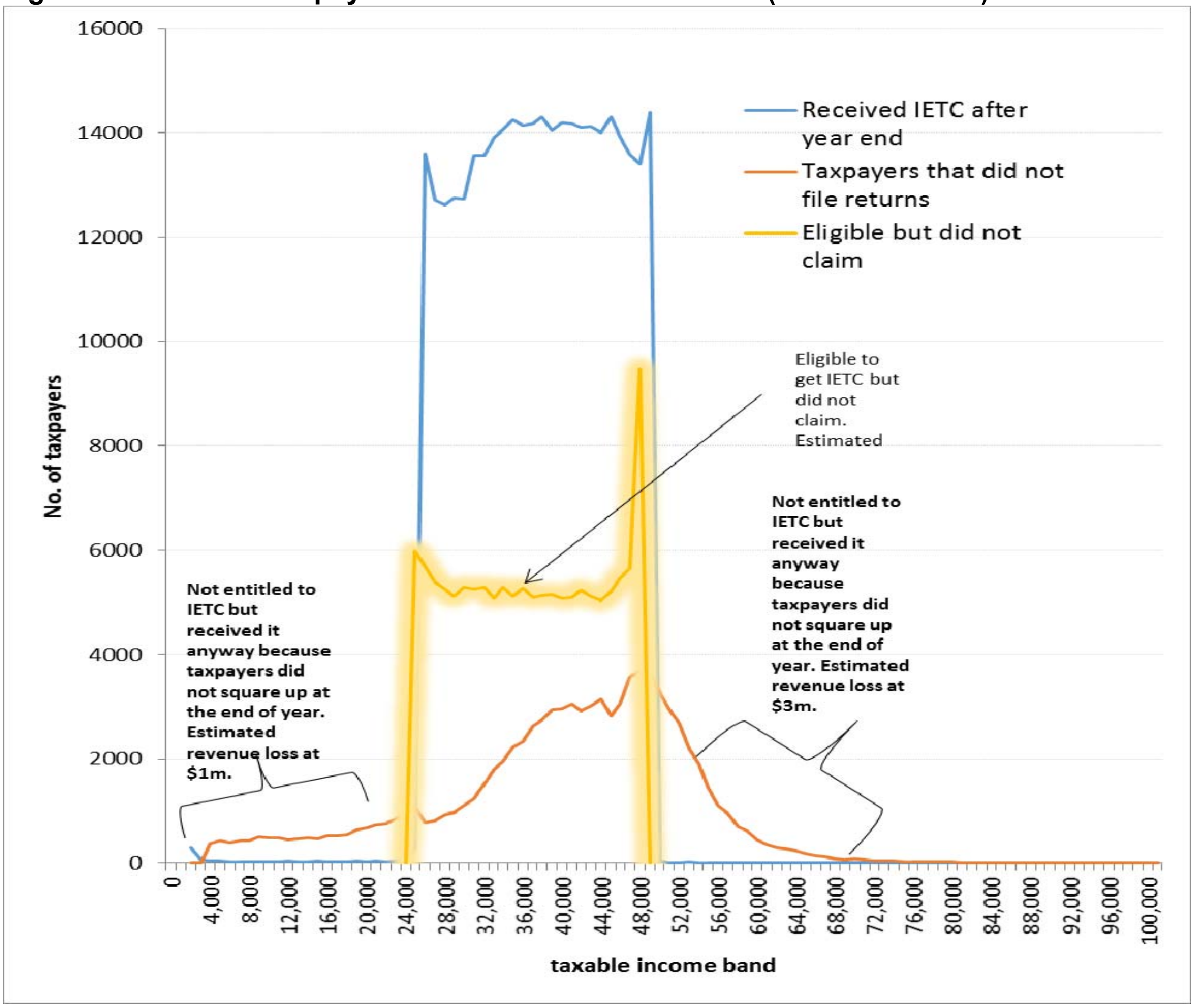
Tax year	Recipients	Total paid (million)	Payments during the year (million)	Payments after year-end (million)
2012	513,000	$223	$71	$152
2013	514,000	$221	$66	$155
2014	515,000	$220	$62	$158
2015	513,000	$218	$57	$161

Source: Inland Revenue administrative data

12. There are many eligible individuals who are not expressly required to file an income tax return or request a personal tax summary, and also do not receive the IETC due to incorrect tax code selection. Conversely, there are a number of individuals who receive the IETC during the year but end up paying back all of the tax credit they received. However, the number of individuals in this position has declined from 74,000 people in 2009/2010 to 57,000 in 2013/14.

13. Figure 3 is a snapshot of IETC recipients as at June 2016 for the 2015 tax year. The "Received IETC after year end" line shows the number of IETC recipients by income band that did not receive IETC on a pay period basis. The "Eligible but did not claim" line shows the number of individuals by income band that are eligible to receive IETC but are not receiving the IETC either due to selecting the wrong tax code or not filing a tax return to claim the tax credit.

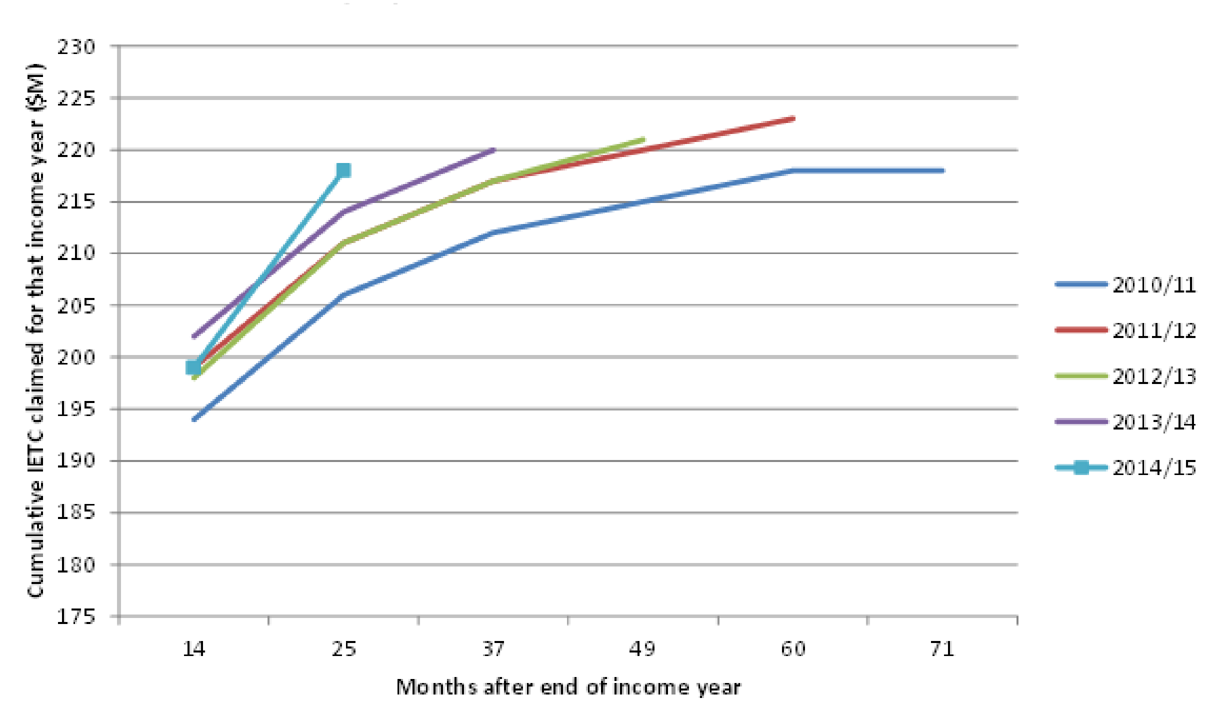
Figure 3: Number of taxpayers who received IETC in 2015 (as at June 2016)



Source: Inland Revenue administrative data

14. As shown in Figure 4, some year-end IETC recipients are not claiming the IETC until up to four years after the tax year for entitlement. It is less likely that the IETC increases work incentives when there is a significant lag between when the IETC is paid and when the income giving rise to the entitlement is earned.

Figure 4: Independent Earner Tax Credit by entitlement year – and the time taken to claim it



Source: Inland Revenue administrative data

Removing the IETC

15. Changes 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. As mentioned before, we understand your overarching goal in considering tax changes is to improve work incentives.

Distributional impact

16. Table 3 below shows the distributional impact for individuals of removing IETC. Table 4 shows the distributional impact for families of removing IETC.

Table 3: Distributional impact for individuals of removing IETC[2]

Individual taxable income	Number of individuals	Number of individuals worse off	Average weekly change ($)
0 - $14,000	539,000	0	0
$14000 - $31,000	408,000	107,000	(10)
$31,000 - $48,000	463,000	385,000	(9)
$48,000 - $60,000	305,000	0	0
$60,000 - $70,000	171,000	0	0
$70,000 - $100,000	327,000	0	0
$100,000 - $125,000	117,000	0	0
$125,000 - $150,000	57,000	0	0
Greater than $150,000	97,000	0	0

Source: Treasury Taxwell

Table 4: Distributional impact for families of removing IETC[3]

Family taxable income	Number of families	Number of families worse off	Average weekly change ($)
0 - $14,000	*	*	*
$14000 - $31,000	249,000	43,000	(10)
$31,000 - $48,000	221,000	167,000	(9)
$48,000 - $60,000	136,000	13,000	(13)
$60,000 - $70,000	78,000	15,000	(14)
$70,000 - $100,000	241,000	76,000	(12)
$100,000 - $125,000	143,000	59,000	(9)
$125,000 - $150,000	88,000	22,000	(9)
Greater than $150,000	186,000	28,000	(8)

Source: Treasury Taxwell

*Suppressed – count fewer than 3000.

17. The distributional, fiscal and labour supply impacts of these two options will depend on decisions about any changes to personal tax, Working for Families and other government assistance.

18. Removing the IETC with no changes to the personal tax rates or thresholds below $48,000, would mean approximately 513,000 individuals would no longer have an IETC entitlement (using existing administrative data). Lifting the $48,000 personal income tax threshold will do nothing to compensate those who lose the IETC if it is abolished. This could be achieved through a reduction in the 17.5% tax rate on income between $14,000 and $48,000 per annum (or, alternatively, a lift in the $14,000 threshold or reductions to the 10.5% tax rate). Such a change would have a fiscal cost that well exceeds removing the IETC. However, such a tax rate change may be considered as part of a broader tax package if it achieves wider objectives.

Labour supply impact[4]

19. Removing IETC would have a very small negative impact on labour supply. It is likely that labour supply objectives could be achieved more effectively by removing the IETC

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2 Zeros may include counts that have been supressed to maintain confidentiality. Values must be based on at least 3000 counts and at least 10 sample units.

3 Zeros may include counts that have been supressed to maintain confidentiality. Values must be based on at least 3000 counts and at least 10 sample units.

4 This analysis was carried out using the Treasury's behavioural micro-simulation model of 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 the Treasury, not Statistics New Zealand.

and making other changes to tax and transfer settings. The table below provides more detail of the potential impacts on labour supply decisions by type of income earners if the IETC is removed.

20. The first two rows report the percentages of individuals working within that individual's type. For example, 50.6% of coupled men without children are currently working. If IETC is removed, 50.56% of coupled men without children would be working, indicating a 0.04% point decrease in employment, or an increase from working to not working (the difference between rows 1 and 2 is equivalent to the difference between rows 3 and 4).

21. Rows 5 and 6 represent changes in labour supply for those *already working*. For example, for single females who currently work, 0.4% would work more, and 0.14% would work less. On balance, 0.26% would work more (the difference between rows 5 and 6). Overall, single females decrease their working hours by 0.09 hours per week (row 7).

22. The overall results indicate labour supply changes will be very small if IETC is removed. As a point of reference, the labour supply impacts from the 2010 reforms were estimated to be a 0.9% 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.

Table 5: Labour supply impact of removing the IETC

		Couples without children		**Couples with children**		**Single**		
		Men	**Women**	**Men**	**Women**	**Men**	**Women**	**Parents**
1	Salaried worker (% before reform)	50.6	54.27	72.66	58.59	54.93	46.62	46.33
2	Salaried worker (% after reform)	50.56	54.2	72.65	58.48	54.91	46.34	46.33
	Behavioural response							
3	Non-work to work (ppt)	0.02	0.02	0.01	0	0	0.02	0
4	Work to non-work (ppt)	0.06	0.08	0.02	0.11	0.02	0.3	0
5	Workers working more(ppt)	0.11	0.09	0.08	0.06	0.02	0.4	0
6	Workers working less(ppt)	0.03	0.07	0.05	0.08	0.02	0.14	0
7	Average hours change per week[5]	-0.01	-0.02	0	-0.04	-0.01	-0.09	0

Fiscal impact

23. The forecasted fiscal saving from removing IETC effective 1 April 2018 is shown in the table below. It does not take into account any behavioural responses or the expected increase in take-up when the filing obligations for individuals are simplified in 2020. The extra savings could be around $68 million (discussed next).

Figure 6: Fiscal saving from removing IETC (Inland Revenue administrative data)

Tax year	2017/18	2018/19	2019/2020	2020/2021	2021/2022	2022/2023
Fiscal saving ($million)	$15	$129	$198	$210	$216	$220

Source: Inland Revenue administrative data

Changes to the filing obligations for individuals

24. Treasury officials have been working with Inland Revenue officials on preparing a consultation document with proposals to simplify the rules about when an individual needs to file an income tax return. This is part of the policy work to support Inland Revenue's Business Transformation programme. The main proposal is that individuals who only receive income from sources with third party reporting (i.e., salary and wages, or interest income) would not have to provide any year-end information to Inland Revenue. For these individuals, Inland Revenue would automatically calculate a refund or amount of tax to pay.

25. Inland Revenue estimates that for the 2015 tax year approximately $68m of IETC was not claimed by potentially eligible individuals. If the IETC is retained, then the main proposal in that discussion document would significantly increase take-up and fiscal cost for IETC. Inland Revenue expect to recommend that the Minister of Revenue submits the discussion document to EGI for its meeting of 22 March 2017, so that the discussion document could be released publically on 31 March 2017. A possible implementation date for this proposal is 2020.

Modifying the IETC parameters

26. If the IETC is maintained, you could consider modifying its parameters to be more tightly targeted and/or reduce the abatement rate.

27. Updating the IETC minimum income threshold could be considered to align IETC recipients with the original target group. The $24,000 minimum income threshold was set in 2009 to target those earning just below the 2009 full-time minimum wage. To maintain this policy intent, the minimum income threshold could be increased to around $30,000, just below the 1 April 2017 full-time minimum wage of $30,300. To increase the savings from this proposal and avoid high effective marginal tax rates, the maximum income threshold could remain at $48,000.

28. Updating the IETC minimum income threshold would mean those currently earning between $24,000 and the new minimum income threshold would lose their IETC entitlement. If you are interested in this option, we can model the labour supply and distributional impact and costs for some threshold options. An additional consideration would be whether to extend the abatement range and lower the abatement rate. Doing so could reduce the cost of IETC and reduce marginal tax rates for those being abated. If you are interested in this option, we can model the labour supply and distributional impact and costs for some threshold options.

29. Updating the IETC minimum income threshold would mean some individuals in high income families would still receive the IETC. We would not recommend basing IETC entitlement off family income. A family income test for IETC would create additional complexity and be administratively difficult as Inland Revenue does not currently have family details for IETC recipients.