The Treasury

Budget 2017 Information Release

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Further tax and transfer package options

Date:	Monday, 13 March 2017	**Report No:**	T2017/595
		File Number:	SH-13-5-2-3

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Steven Joyce)	**Note** the enclosed information.	Friday, 17 March 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]	[23]	✓
Dr Eina Wong	Senior Analyst, Tax Strategy	[39]	[23]	

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

None.

Note any feedback on the quality of the report	

Enclosure: Yes

Treasury Report: Further tax and transfer package options

Executive Summary

On Tuesday 7 March, you asked for the fiscal cost and distributional impacts for three tax and transfer packages. These packages are in addition to Packages 1, 2 and 3 presented in T2017/403. Preliminary results for the three additional packages were provided on Friday 10, March. As requested, we have amended Packages 5 and 6 (now Packages 5a and 6a) to increase the $14,000 threshold to $22,000.

We consider that Package 5a, out of the packages presented above, best achieves your objectives of improving work incentives and helping those on low incomes or in financial hardship. However, Package 5a does have a higher fiscal cost ($2,800 m) than Packages 4 ($2,000 m) and 6a ($2,350 m). All three packages would address the impact of fiscal drag on the $14,000 and $48,000 income tax thresholds to varying degrees. We present a range of options for changes to the Accommodation Supplement and Family Tax Credit components of the packages that increase or decrease the fiscal cost.

Each of the packages has a small number of losers arising from interactions between tax and transfer settings. The number of families losing is supressed to maintain confidentiality, values must have more than 3000 counts and 10 or more sample units.

Labour supply modelling (excluding changes to the Accommodation Supplement) suggests Package 4 will increase the total hours worked by around 0.25%, and Package 5 (increasing the $14,000 threshold to $21,000) about 0.28%. The labour supply impact of Packages 5a and 6a will be similar to Package 5. Increases in the Family Tax Credit rates or Accommodation Supplement, consistent with any increases to transfer payments, are likely to have a marginally negative labour supply response.

The Accommodation Supplement changes presented will result in average residual incomes for recipients being 5% higher on average than in 2006. Increasing the Accommodation Supplement significantly reduces the gap between Accommodation Supplement and the Income-Related Rent Subsidy, and improves incentives to leave social housing, particularly for recipients with higher incomes.

Recommended Action

We recommend that you **note** the contents of this report.

Dr Eina Wong
Senior Analyst, Tax Strategy

Steve Joyce
Minister of Finance

Treasury Report: Further tax and transfer package options

Purpose

1. On Tuesday 7 March, you requested the fiscal cost and distributional impacts for three tax and transfer packages (presented in table 4 on page 6). These packages are in addition to Packages 1, 2 and 3 presented in T2017/403. Very preliminary results for the three additional packages were provided on Friday 10 March (T2017/583 refers). As requested, we have amended Package 5 and 6 (now Package 5a and 6a) to increase the $14,000 threshold to $22,000. This report provides the completed results and further analysis for the amended packages. We also provide some generalised impacts for possible alternatives to these packages.

Objectives for packages

2. We understand that your overarching objective for a package is to improve work incentives, with consideration for helping those on low incomes or in financial hardship.

Improving work incentives

3. Increases in tax thresholds generally improve work incentives. In particular, increases at the $14,000 threshold are likely to improve work incentives for those on benefit as these individuals typically enter work at lower incomes. Increases at the $48,000 threshold are likely to improve individuals' incentives to work longer hours in aggregate. Due to the nature of the transfer system, families are the best unit of analysis for considering tax and transfer changes. Table 1 provides the current distribution of income by families' main source of income.

Table 1: Income distribution by family type[1]

Family taxable income	Number of families	Workers	Beneficiaries	NZS recipients
$0 - $14,000	349,000	14%	18%	1%
$14,000 - $31,000	492,000	23%	26%	34%
$31,000 - $48,000	399,000	55%	*	36%
$48,000 - $60,000	186,000	76%	*	17%
$60,000 - $70,000	117,000	72%	*	19%
$70,000 - $100,000	316,000	81%	*	12%
$100,000 - $125,000	189,000	81%	*	11%
$125,000 - $150,000	121,000	81%	*	14%
$150,000 +	231,000	83%	*	10%

Source: Treasury Taxwell
* Value suppressed to maintain confidentiality.

4. High effective marginal tax rates may discourage labour supply and skill acquisition, and encourage tax planning (T2017/4 refers). Table 2 shows the EMTRs for individuals who receive no transfers, Working for Families (WFF), Independent Earner Tax Credit (IETC), or Accommodation Supplement (AS). For simplicity, we have omitted those receiving benefits.

[1] 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.

Table 2: EMTR decomposition for the $14k to $60k taxable income range

Those having:	$14k - $48k taxable income		$48- $60k taxable income	
	EMTR	Number of individuals	EMTR	Number of individuals
No transfers abating (statutory MTRs)	17.5%	520,000	30%	244,000
IETC abating	30.5%	89,000	NA	NA
WFF abating	40%	68,000	52.5%	32,000
AS abating	42.5%	44,000	55%	* suppressed
AS and Working for Families abating	65%	16,000	77.5%	13,000

Source: Treasury Taxwell

5. The IETC decreases the average tax rate for a targeted group and has small positive impacts on labour supply (T2017/164 refers). However, it is likely that improving work incentives could be more effectively achieved 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.

Improving incomes for those in financial hardship

6. Residual incomes have been increasing for New Zealanders across the income scale since the mid-1990s. Changes in real incomes (after housing costs or AHC) by decile are shown in Table 3.

Table 3: Changes in after housing costs income 2007-2015

Top of decile	Change in AHC income 2007-2015
1	14%
2	12%
3	12%
4	15%
5	16%
6	18%
7	21%
8	18%
9	19%

Source: MSD Household Incomes Report 2016

7. However, particular groups, largely non-superannuitant AS recipients who are the individuals facing the greatest levels of housing stress, have seen declines in residual incomes. At September 2016, AS recipients spend, on average, 53% of their incomes on housing.

8. The Family Tax Credit (FTC) and the AS are two levers for targeting transfers and increasing residual incomes. The FTC and the AS have different target profiles and changes to either or both will result in families with different circumstances being impacted differently.

9. AS is targeted to low-income individuals and families, with around 68% of AS recipients also receiving a main benefit, and around 12% also receiving New Zealand Superannuation. While AS is targeted on the basis of income, it gives the most to those with the highest housing costs. High housing costs are a significant driver of low residual (after housing costs) incomes in low-income households.

10. The FTC aims to increase family income to support families to raise their children. Increasing FTC payment rates (without changing abatement settings) will increase the cut-off point for FTC, meaning some families on higher incomes will be eligible for payments (and also increases the take-up of the In-Work Tax Credit). Increasing FTC payment rates also increases the entry threshold of the AS for families with children, reducing the amount of AS, although this has a relatively small impact. If FTC is increased without increases to the AS the number of losers will be higher.

11. There will be a risk of landlord capture with any mechanism used to increase the income of low-income households, including increases to the AS or FTC payment rate. The risk of landlord capture needs to be balanced against the risk of continually declining after-housing costs incomes of the lowest-income households. In recent advice (T2017/261 refers), we noted that based on theory and an observation of constrained housing supply, there is risk of some landlord capture if the AS is increased, but there is no robust evidence of the extent of this effect.

Overview of packages

12. Analysis for the three packages presented in Table 4 was requested. The fiscal costs and distributional impacts presented in this report are for an assumed 1 April 2018 implementation.

Table 4: Packages for consideration

	Package 4	Package 5a	Package 6a
Tax thresholds	Increase the $14,000 threshold to $18,000, and the $48,000 to $52,000.	Increase the $14,000 threshold to $22,000, and the $48,000 to $55,000.	Increase the $14,000 threshold to $22,000, and the $48,000 to $52,000.
Independent Earner Tax Credit (IETC)	Maintain the existing IETC.	Remove the IETC.	
Family Tax Credit (FTC)	Align the FTC rates to the eldest child rates, increase abatement rate to 23.75% and reduce the abatement threshold to $35,900.		
Accommodation Supplement	Update the maxima to reflect 2016 median rents, while re-allocating areas to reflect rental costs.		
Fiscal cost[2] (including clawback)	**$2,000 m**	**$2,800 m**	**$2,350 m**

[2] Rounded to the nearest $50 million.

Comparison of packages

13. We provided preliminary advice to you recently on similar packages (T2017/583 refers). This section compares the results for the amended packages (to include the $22,000 threshold change), and we have added further discussion on the packages. Details on the packages are provided in the Appendix.

14. Figure 1 compares the number of winners and losers by family taxable income. Figure 2 compares the average gains/losses by family taxable income. These comparisons do not include the impact of changes to AS. We are currently unable to accurately model the boundary changes to AS in Taxwell (Treasury's microsimulation model of the tax and transfer system). MSD has modelled these impacts and they are presented separately in Tables 5 and 6. We will provide to you separately a breakdown of the size of gains by family income bracket.

Figure 1: Comparison of package winners and losers by family taxable income

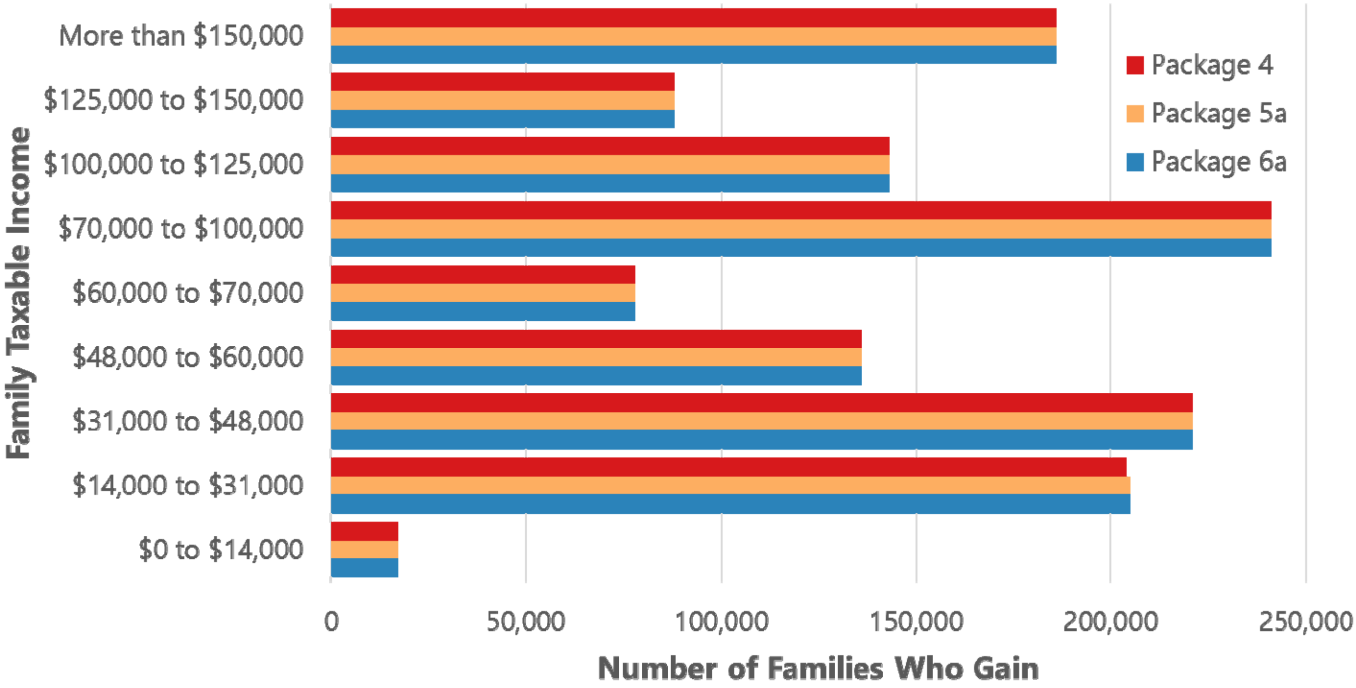

Table 5: Taxable income distributional analysis of AS changes, including the impact of TAS

Taxable income	Number of gainers
$70,000 +	200
$60,000 - $70,000	700
$48,000 - $60,000	4,000
$31,000 - $48,000	22,000
$14,000 - $31,000	78,000
$0 - $14,000	28,000

Source: MSD

Figure 2: Comparison of package winners and losers by average gain/loss

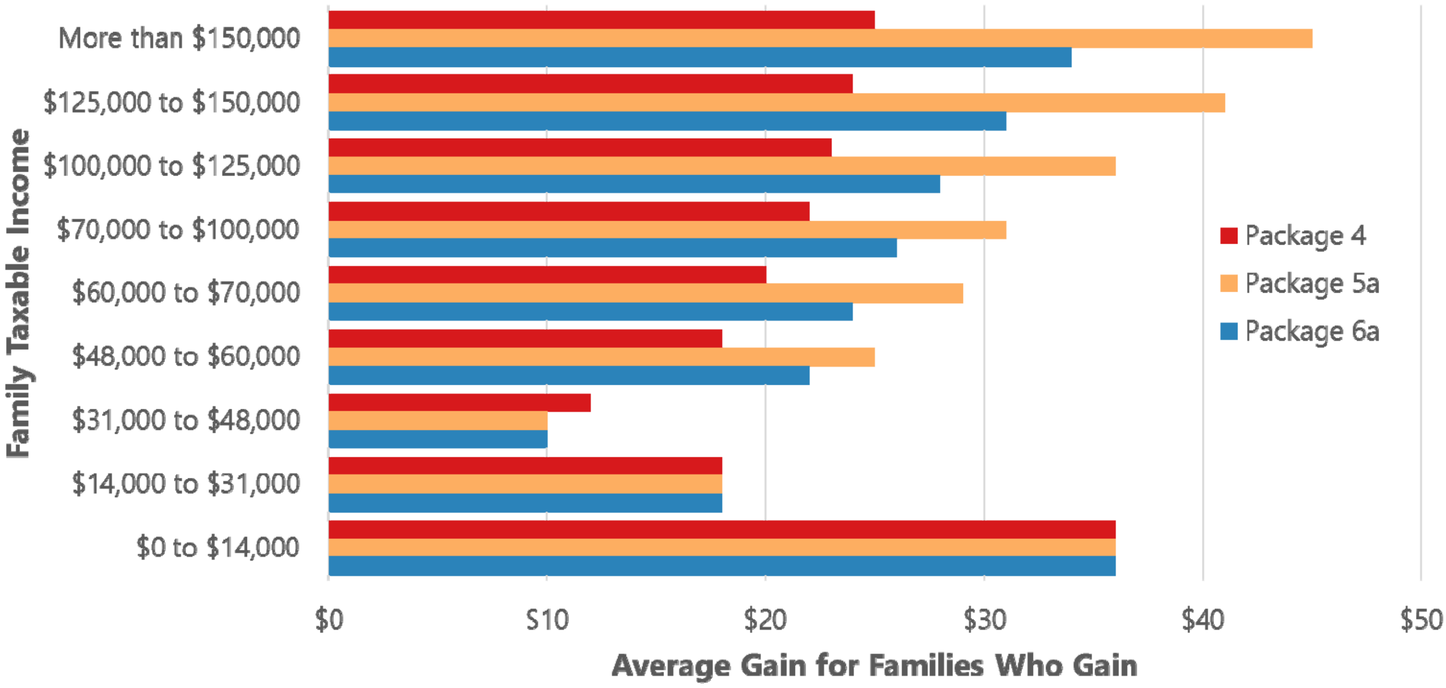

Table 6: Taxable income distributional analysis of AS changes, including the impact of TAS

Taxable income	Average weekly gain
$70,000 +	$54
$60,000 - $70,000	$60
$48,000 - $60,000	$59
$31,000 - $48,000	$52
$14,000 - $31,000	$36
$0 - $14,000	$27

Source: MSD

15. More detailed tables and graphs are included in the appendix. Note a small number of losers arises from increasing transfers and/or increasing income tax thresholds. This occurs due to the interaction between tax and transfer settings. The actual number of families is not presented because it is suppressed for confidentiality (values must have more than 3000 counts and 10 or more sample units).

Comment on packages

16. We consider that Package 5a, out of the packages presented in this report, best achieves your objectives of improving work incentives and helping those on low incomes or in financial hardship. However, Package 5a does have a higher fiscal cost than Packages 4 and 6a.

Improving work incentives

17. Package 4 is expected to increase the total hours worked by around 0.25%, and Package 5 (previously presented in T2017/583) about 0.28%.[3] The labour supply impact of Package 5a (increasing the $14,000 threshold to $22,000) will be very similar to Package 5. The impact for Package 6a has not been modelled, but we expect the results to be similar. All three packages would address the impact of fiscal drag on the $14,000 and $48,000 income tax thresholds.[4]

18. Increases to transfer payments such as AS and FTC often reduce incentives to work more hours, which can lead to a marginally negative labour supply response overall, particularly for couples with children. Because we are unable to model the impact on labour supply from changes to the AS, the impact is unclear. MSD are preparing further information on the work incentives from any changes to AS.

19. Removing IETC does not have an impact on labour supply in these packages.

20. The labour supply responses of these tax and transfer packages (excluding the impact of AS changes) indicate that the long-run impact on GDP is likely to be positive but small (less than 0.3%).

People on low incomes or in financial hardship

21. Average tax rates are an indication of whether proposed tax changes are more or less equitable across the income distribution. Increasing the $14,000 threshold will decrease the average tax rate for those on low incomes. Increasing the $14,000 threshold will also reduce the average tax rate for those on higher incomes, albeit to a lesser extent.

Accommodation Supplement

22. Packages 4 to 6 all include updating the locations and area maxima of the AS to be based on 2016 rents. The locations and area maxima are currently based on 2003 rents. The cost of these changes to the AS would be $295 million per year, based on an additional AS cost of $399 million per year and a decrease in Temporary Additional Support (TAS) of $104 million per year. This represents a 39% reduction in the cost of TAS.

23. The residual (after housing costs) incomes of AS recipients (excluding those receiving NZ Super or Veterans Pension, and non-beneficiaries) have declined by 8% on average since 2006. Some groups face significantly higher declines in residual incomes, particularly singles or couples without children (Attachment 6 of T2017/403 refers). The AS changes presented will result in average residual incomes for AS recipients being 5% higher on average than in 2006. Updating the locations and area maxima for AS will result in around 134,000 winners who gain an average $37.50 per week (46% of all AS recipients, only those currently at the AS maxima).

24. Increasing the AS significantly reduces the gap between AS and the Income-Related Rent Subsidy (IRRS) and improves incentives to leave social housing, particularly for recipients with higher incomes. Significant AS increases are also likely to reduce some

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[3] This analysis was carried out using Taxwell-B (Treasury's micro-simulation models of the tax and welfare system). All calculations should be considered estimates. The labour supply changes are modelled using 2014/15 Household Economic Survey data for the 2014/15 tax year. 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.

[4] To address fiscal drag since 2010 the $14,000 threshold would need to be increased to $16,000 and the $48,000 threshold to $54,000 (with rounding up to the nearest thousand).

pressure on the social housing register. Increasing the AS would not negate the need for broader reform of the housing subsidies in the longer-term but it would improve the financial incentive for tenants to move out of social housing into the private rental market.

25. Tables 7 and 8 present some additional distributional information about the changes to AS. Of note:

   - 79% of winners have a taxable income of less than $31,000 per year.
   - 45% of winners are singles with no children.
   - 58% of winners are beneficiaries.
   - 700 people will lose an average of $1.50 per week because of interactions with the Disability Allowance and TAS.

Table 7: Distributional analysis by family type of AS changes, including the impact of TAS

Family type	Number of gainers	Average weekly gain
Couple	12,000	$46
Couple, 1 child	6,000	$53
Couple, 2+ children	11,000	$53
Single	57,000	$27
Sole parent, 1 child	23,000	$44
Sole parent, 2+ children	24,000	$42

Source: MSD

Table 8: Distributional analysis by benefit type of AS changes, including the impact of TAS

Benefit type/non-beneficiary	Number of gainers	Average weekly gain
JobSeeker/ Emergency Benefit	35,000	$29
Sole Parent Support	24,000	$38
Supported Living Payment	19,000	$30
Youth benefits	200	$20
Non-beneficiaries	41,000	$51
NZ Super/Veteran's Pension	14,000	$32

Source: MSD

Options for changes

26. This section presents the general impacts of options for changes to the packages presented.

Accommodation Supplement

27. The AS component of the packages can be scaled back or altered to achieve coverage of AS recipients.

28. The AS component of the packages could be scaled back to:

a *Update only the locations, with no increase to the maxima* – this would cost around $134 million per year, and benefit around 76,000 AS recipients by an average of $30 per week.

b *Scale the increase in maxima* – increases in the maxima are scalable, between the current maxima (based on 2003 median rents) and the proposed maxima (based on 2016 median rents), to scale the cost of the package between $134 million and $300 million per year.

c *Time-limit access to AS homeowners to three or five years* – this would save around $20-35 million per year once fully implemented, but would save a maximum of $8 million over the next four years.[5] Around 44% (14,000) of AS homeowners have been receiving AS for more than three years, and are more likely to be superannuitants, or receiving the Supported Living Payment.

29. The AS component of the packages could be scaled up to include a reduction in the tenant co-payment from (30% to 25%) to include AS recipients who are below the maxima. This scaling costs $356 million per year (net fiscal cost based on additional AS cost of $473 million per year and a decrease in the cost of TAS of $117 million per year).

30. MSD's advice is that reducing the co-payment is the best way to provide support to the highest number of households with high levels of housing stress. We consider that more analysis is required to determine the benefits and wider impact of reducing the tenant co-payment.

Family Tax Credit

Family Tax Credit versus Accommodation Supplement

31. We consider the changes to FTC compared with the changes to AS are less targeted to assisting people in financial hardship and have limited simplification benefits. However, it is unclear whether the AS changes have a larger negative labour response than FTC changes.

32. Some of the benefit from changes to FTC will go to families with higher incomes. The approximate FTC family income cut-out point for an eligible family with one child (39.5% of families) is $57,800 and two children (34.2% of families) is $72,700. The cut-out points will be even higher if there are more children and if the family is also entitled to other Working for Families Tax Credits.

33. The FTC option was initially suggested as a simplification measure while improving incomes for lower and middle-income families. However, the simplification benefits are limited as families do not generally see the split rates when calculating entitlement. In addition, the alignment of FTC, as included in Packages 4 to 6a, will occur even if not included in a tax and transfer package, albeit at a later date, as indexation occurs.

34. If the available funds for a tax and transfer package for Budget 2017 is limited, prioritising the AS changes over the FTC changes could be considered.

[5] Assuming grand-parenting of current recipients. These estimates do not include impacts on TAS.

Changes to abatement settings

35. Options for phasing FTC changes were discussed in T2017/402. We understand that phasing is no longer being considered. To manage the fiscal cost of aligning the FTC rates, alignment of rates could be coupled with lowering the abatement threshold to the legislated target minimum of $35,000, and increasing the abatement rate to its maximum of 25% (T2017/402 refers). This will also target the allocation of FTC to lower-income families under the abatement threshold. We note, however, that should this option be considered, there will likely be losers for those families with children between 16 and 18 years old, as these rates will not increase but abatement settings will.

Appendix: Distributional tables and graphs for packages 4, 5a and 6a

Package 4

Package 4 includes:

- Increasing the $14,000 threshold to $18,000, and increasing the $48,000 threshold to $52,000;
- Maintaining the existing IETC;
- Aligning the FTC rates to the eldest child rates, increase abatement rate to 23.75% and reduce the abatement threshold to $35,900; and
- Updating the AS maxima to reflect 2016 median rents, while re-allocating areas to reflect rental costs.

Table 1: Package 4 distributional analysis

Family taxable income	Total number of families	Number of families gaining	Average weekly gain for gaining families	Number of families disadvantaged	Average weekly loss for losing families
0 - $14,000	200,000	17,000	$36	*	*
$14,000 - $31,000	249,000	204,000	$18	*	*
$31,000 - $48,000	221,000	221,000	$12	*	*
$48,000 - $60,000	136,000	136,000	$18	*	*
$60,000 - $70,000	78,000	78,000	$20	*	*
$70,000 - $100,000	241,000	241,000	$22	*	*
$100,000 - $125,000	143,000	143,000	$23	*	*
$125,000 - $150,000	88,000	88,000	$24	*	*
$150,000 +	186,000	186,000	$25	*	*
	1,542,000	1,313,000	$20	4,000	$-1

Source: Treasury Taxwell

* Suppressed for confidentiality, values must have more than 3000 counts (weighted) and 10 or more sample units

Figure 1: Package 4 winners and losers by family taxable income

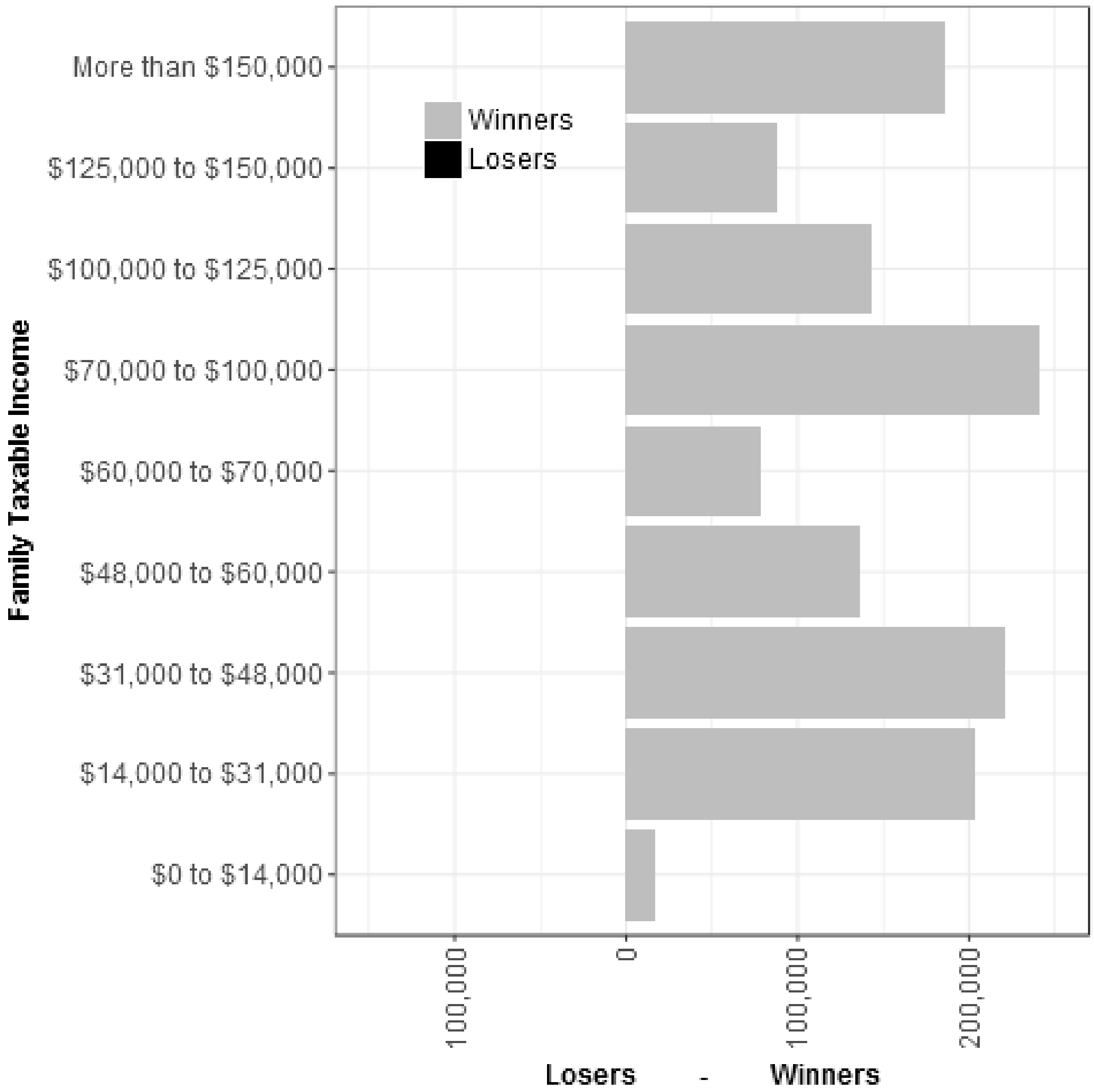
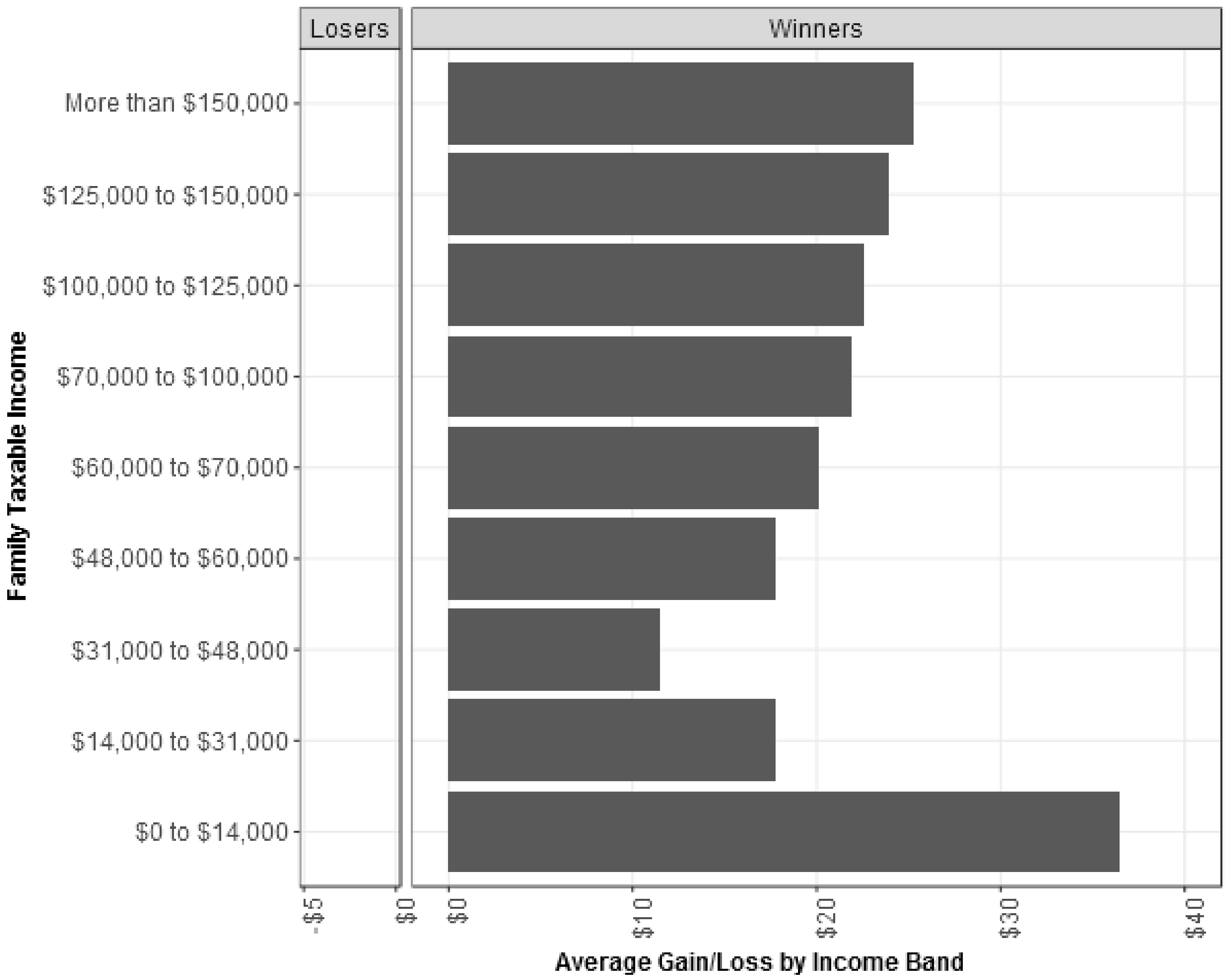


Figure 2: Package 4 winners and losers by average gain/loss



Package 5a

Package 5a includes:

- Increasing the $14,000 threshold to $22,000, and increasing the $48,000 threshold to $55,000;
- Removing the IETC;
- Aligning the FTC rates to the eldest child rates, increase abatement rate to 23.75% and reduce the abatement threshold to $35,900; and
- Updating the AS maxima to reflect 2016 median rents, while re-allocating areas to reflect rental costs.

Table 2: Package 5a distributional analysis

Family taxable income	Total number of families	Number of families gaining	Average weekly gain for gaining families	Number of families disadvantaged	Average weekly loss for losing families
0 - $14,000	200,000	17,000	$36	*	*
$14,000 - $31,000	249,000	205,000	$18	*	*
$31,000 - $48,000	221,000	221,000	$10	*	*
$48,000 - $60,000	136,000	136,000	$25	*	*
$60,000 - $70,000	78,000	78,000	$29	*	*
$70,000 - $100,000	241,000	241,000	$31	*	*
$100,000 - $125,000	143,000	143,000	$36	*	*
$125,000 - $150,000	88,000	88,000	$41	*	*
$150,000 +	186,000	186,000	$45	*	*
	1,542,000	1,314,000	$28	3,000	$-1

Source: Treasury Taxwell
* Suppressed for confidentiality, values must have more than 3000 counts (weighted) and 10 or more sample units

Figure 3: Package 5a winners and losers by family taxable income

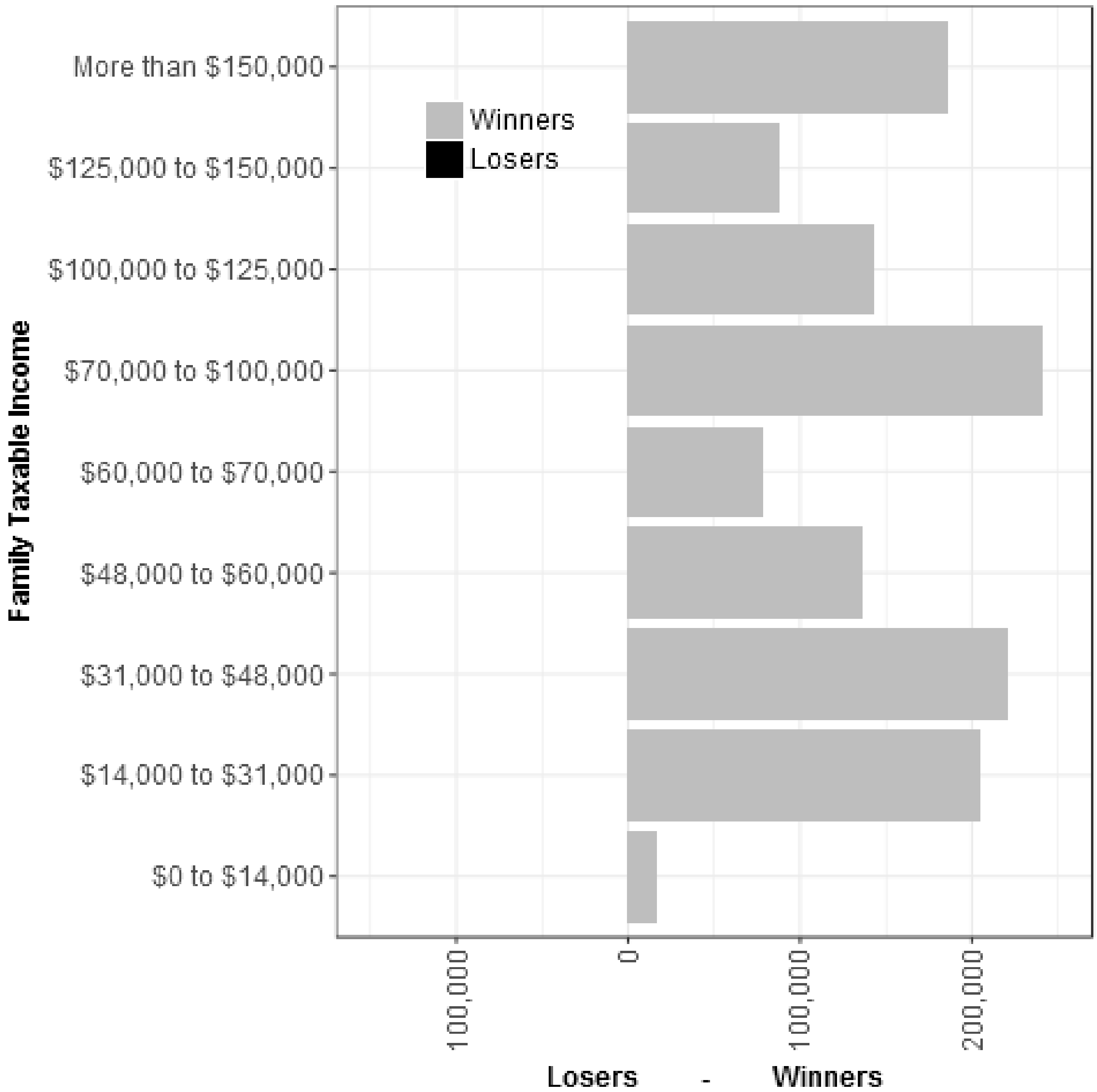
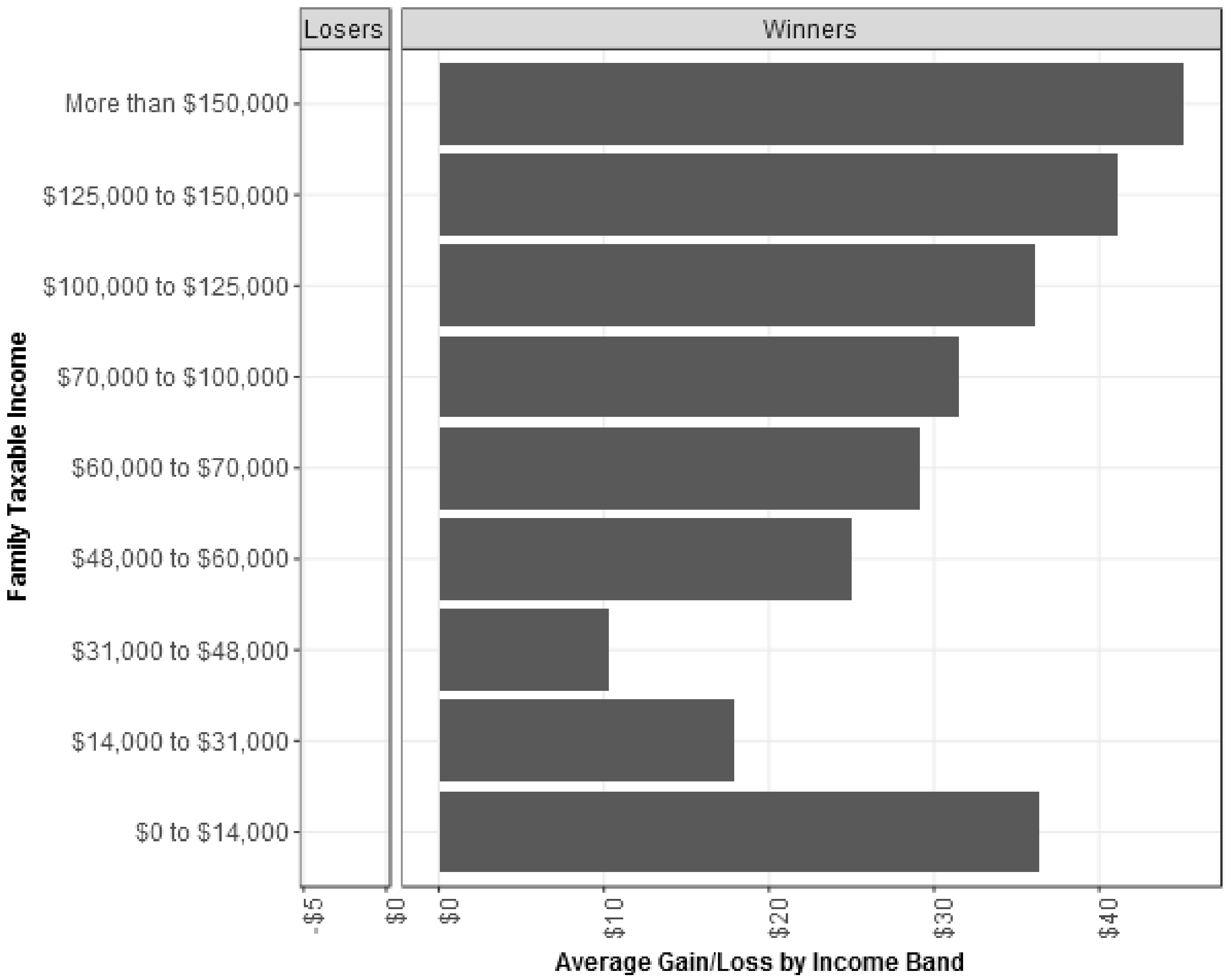


Figure 4: Package 5a winners and losers by average gain/loss



Package 6a

Package 6a includes:

- Increasing the $14,000 threshold to $22,000, and increasing the $48,000 threshold to $52,000;
- Removing the IETC;
- Aligning the FTC rates to the eldest child rates, increase abatement rate to 23.75% and reduce the abatement threshold to $35,900; and
- Updating the AS maxima to reflect 2016 median rents, while re-allocating areas to reflect rental costs.

Table 1: Package 6a distributional analysis

Family taxable income	Total number of families	Number of families gaining	Average weekly gain for gaining families	Number of families disadvantaged	Average weekly loss for losing families
0 - $14,000	200,000	17,000	$36	*	*
$14,000 - $31,000	249,000	205,000	$18	*	*
$31,000 - $48,000	221,000	221,000	$10	*	*
$48,000 - $60,000	136,000	136,000	$22	*	*
$60,000 - $70,000	78,000	78,000	$24	*	*
$70,000 - $100,000	241,000	241,000	$26	*	*
$100,000 - $125,000	143,000	143,000	$28	*	*
$125,000 - $150,000	88,000	88,000	$31	*	*
$150,000 +	186,000	186,000	$34	*	*
	1,542,000	1,314,000	$23	3,000	$-1

Source: Treasury Taxwell

* Suppressed for confidentiality, values must have more than 3000 counts (weighted) and 10 or more sample units

Figure 1: Package 6a winners and losers by family taxable income

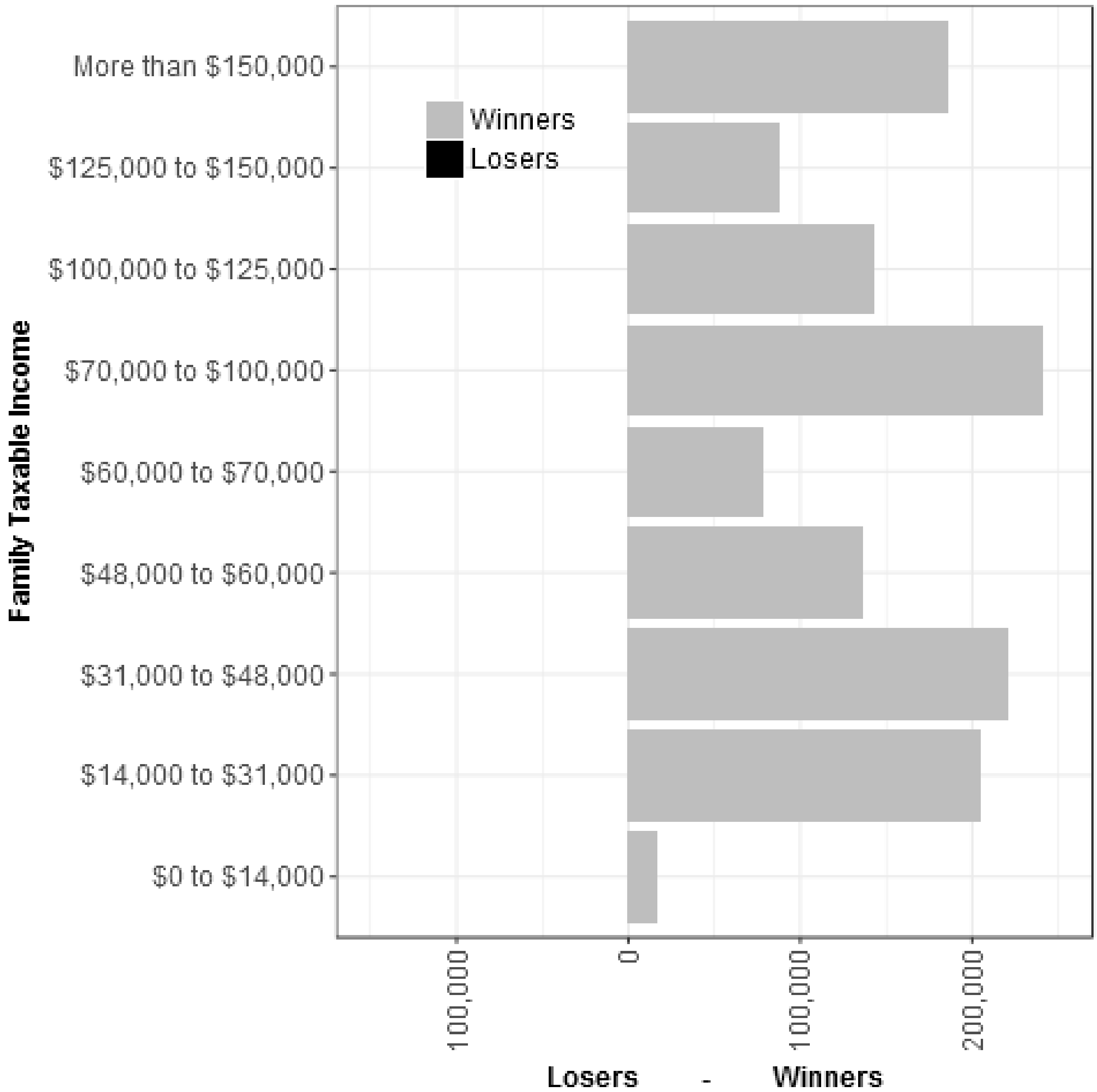


Figure 2: Package 6a winners and losers by average gain/loss