The Treasury

Budget 2023 Tax Initiatives Information Release

July 2023

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Considerations for a contingent tax package

Date:	31 March 2023	**Report No:**	T2023/577
		File Number:	SH-13-5-3-10

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Discuss** the contents of this report with officials **Refer** the report to the Minister of Revenue	Weekly Agency Meeting, 11:30am, Monday 3 April, 2023

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Ben Gaukrodger	Principal Advisor, Tax Strategy	[39]	N/A (mob)	✓
Stephen Bond	Manager, Tax Strategy		N/A (mob)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Refer the report to the Minister of Revenue.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: Considerations for a contingent tax package

Executive Summary

After the Budget Ministers 5 meeting, it was suggested that the Budget 2023 tax package could be introduced contingent on economic conditions. In practice, such a rule would mean that the intended start date of 1 April 2024 could be delayed in response to “economic conditions”.

Careful sequencing of fiscal policy decisions is important in the current macroeconomic climate. Making a package contingent on economic conditions may offer some benefits in this regard, but it also has practical challenges and may have some unintended consequences. For example, implementing any package at the optimal time in the economic cycle will be difficult given data and implementation lags and forecast uncertainty.

If macroeconomic and fiscal risks are a major concern, it may be worth considering other options to manage them. For example, deferring the package to 1 April 2025 or more slowly phasing in the introduction of a tax-free threshold provide alternative ways of mitigating near-term macroeconomic risks. These options may be simpler to implement and communicate.

If a contingent package is desirable, numerous options exist to implement and communicate one. As an example, you could base a decision on whether inflationary pressures and excess capacity in the economy are moderating in line with forecasts or require that forecasts of medium-term inflation do not deteriorate. A key communication challenge will be setting rules that provide sufficient certainty and clarity, while maintaining sufficient flexibility to take decisions on whether to proceed or not with the tax package.

As a next step, we recommend discussing your objectives with officials at the Weekly Agency Meeting on Monday 3 April.

Recommended Action

We recommend that you:

a **discuss** the contents of this report with officials at the Weekly Agency Meeting on Monday 3 April.

Agree/disagree

b **refer** a copy of this report to the Minister of Revenue

Refer/not referred.

Stephen Bond
Manager, Tax Strategy

Hon Grant Robertson
Minister of Finance

_____/_____/_______

Treasury Report: Considerations for a contingent tax package

Purpose of Report

1. This report sets out some of the key considerations for introducing a tax package that is contingent on economic conditions. This advice focuses on the following issues:

    - The high-level considerations relevant to making a structural tax reform package contingent on economic conditions.
    - What economic conditions might warrant a delay in implementing the tax package?
    - How might a contingent package be implemented and communicated?
    - How would a contingent package affect the Treasury's economic and fiscal forecasts?

Context

2. This advice follows the recent Budget Ministers 5 meeting, where it was suggested that the introduction of a tax package could be contingent on economic conditions.

3. The Treasury has previously advised there are near-term risks associated with introducing a tax package in the current environment [T2023/313 and T2023/187 refer]. A tax package could impact macroeconomic objectives relating to inflation, or fiscal objectives relating to the return to surplus.

4. As the parameters of the tax package have been refined through the Budget process, a key focus has been on ensuring that the package is fiscally neutral across the forecast period. The package currently under consideration would align the dates for the introduction of a wealth tax and a tax-free threshold in April 2024, and phase the introduction of the tax-free threshold. These changes will mitigate some of the macroeconomic and fiscal risks identified in our earlier advice.

High-level Considerations for a Contingent Tax Package

In the current macroeconomic climate, there are benefits from carefully sequencing fiscal policy

5. The Treasury has previously advised that introducing a tax package in the current macroeconomic environment could work against your short-run macroeconomic and fiscal sustainability objectives.

6. The Treasury's recent fiscal strategy advice placed an elevated weight on macroeconomic considerations in the current environment, such that fiscal policy should aim to provide strong support to monetary policy in achieving price stability. With inflation forecast to be well above the Monetary Policy Committee's (MPC) target band, a more contractionary fiscal policy is likely to reinforce the credibility of the Government's commitment to achieving price stability, and thereby reduce the economic costs of returning inflation to the target band [T2023/187 refers].

7. The implementation of a tax package would involve trade-offs with your macroeconomic objectives. Due to the progressivity of the proposed package, the positive consumption response to the personal tax changes will likely outweigh the reduction in consumption from those subject to the wealth tax. Although aligning the dates of the wealth tax and personal tax changes reduces the impact, the package would still be expected to add to inflationary pressures. The impact would likely be concentrated in the months after implementation.

8. The scale of the macroeconomic risk will depend on the outlook for inflationary pressures at the time of implementation, and how the MPC adjusts the Official Cash Rate in response. In this context, the cumulative impact of the Budget will be the key fiscal policy consideration. We have recently advised you that the MPC is likely to be particularly sensitive to additional demand pressures while inflation remains outside the target band, and there is an elevated risk that households' and firms' expectations of future inflation become less anchored to the target midpoint (see T2023/374). Inflation is currently forecast to remain above target until September 2024.

There is also some risk to your short-term OBEGAL target

9. To support fiscal sustainability your current tax package is designed to have a neutral impact on the fiscal position in the long-run. However, in the near-term the current package will have impacts on key indicators and could potentially risk the timing the Government return to an OBEGAL surplus. At this stage it is difficult to make a definite judgement on the timing of an OBEGAL surplus in our final fiscal forecast until we receive further information.

10. Table 1 shows a revised estimate of the net impact of the package on the OBEGAL track. Using the fiscal scenarios presented in the material for the Budget Ministers 5 meeting held on Wednesday 29 March 2023 as a base, these projections of the tax package would push the return to an OBEGAL surplus out to the 2026/27 year.

11. However, there will be other matters that will be included in the Treasury's final fiscal forecast which could keep the forecast return to surplus in the 2025/26 year. The indirect effects of the tax package on GST revenue, which could be material if the package drives a positive consumption response, could also influence the timing of the return to surplus.

Table 1: Net fiscal impacts of current tax package

$billions	2023/24	2024/25	2025/26	2026/27	Forecast period total
Net wealth tax	0.00	3.38	3.51	3.67	10.56
Phased TFT	-0.50	-2.32	-4.08	-3.69	-10.60
Admin costs	-0.02	-0.06	-0.05	-0.04	-0.16
Net impact	**-0.52**	**1.00**	**-0.62**	**-0.06**	**-0.20**

12. There is a large confidence interval around estimates of how much revenue would be raised through the implementation of the wealth tax, including because the wealth tax could be revised throughout the legislative process based on stakeholder feedback.

13. Moreover, the package is being proposed for implementation in the context of the forecast return to surplus being shifted out from 2024/25 to 2025/26 for other reasons, such as increased Government spending to support the recovery from the Cyclone. While we consider that forecasting a credible path back to OBEGAL surplus (and being able to project sustainable surpluses thereafter) is more important than targeting the precise year that surplus is achieved, shifting your target out by more than a year could impact the credibility of your fiscal strategy.

14. Between Budget 2023 and the year of your forecast return to OBEGAL surplus it is highly likely there will be material changes in the economic and/or fiscal outlook (e.g. due to future Budget decisions, and other changes that impact our forecasts) which could further affect your return to surplus target year. This is particularly risky if the BEFU forecasts only show a very small margin in the year that surplus is achieved.

A contingent approach to the tax package presents trade-offs and practical challenges

15. While the near-term implications outlined above are important to consider, the tax switch under consideration is a significant structural reform that will have both near-term and long-term effects. The cumulative effects of the structural change are likely to have the most significant impact on living standards over time.

16. Consistent with our previous recommendations, a contingent approach that enables a longer period of consultation on the wealth tax is likely to be beneficial. We have previously advised that the scale and pace of the reforms creates risks, and that consultation would minimise the risks of poor design and unintended consequences [T2023/313 refers].

17. Conversely, introducing uncertainty into the implementation process presents other risks. While it will provide you with some flexibility, making implementation contingent on economic conditions will introduce uncertainty, both for taxpayers and Inland Revenue. Also, given that high wealth taxpayers are likely to be forward-looking, some of the economic risks associated with the wealth tax may be realised even if the tax is not implemented.

18. Furthermore, there are limits to our ability to implement any tax package at the optimal time in the cycle. Economic and fiscal data is subject to lags, and economic and fiscal forecasts are imperfect. Moreover, there will be an implementation lag between any decision to proceed/defer, during which time economic conditions can always evolve. As an example, the tax reforms introduced in the 2008 Budget were fortunately timed in light of the Global Financial Crisis, but were not designed for this purpose.

19. It should also be noted that it is possible that at the point a decision is made, there may be trade-offs between cyclical stabilisation objectives and achieving your near-term fiscal targets.

Other options exist to manage macroeconomic and fiscal risks

20. While there are both advantages and disadvantages to making the package contingent on economic conditions, there are also other mechanisms available to mitigate the macroeconomic and fiscal risk. These alternatives may be simpler to implement and communicate. As noted above, by aligning the dates for the introduction of a wealth tax and a tax-free threshold in April 2024, and phasing the introduction of the tax-free threshold, the package currently being considered has already mitigated some of the risks identified in our earlier advice. Further deferring the package to 1 April 2025 or more slowly phasing in the introduction of a tax-free threshold provide alternative ways of further mitigating near-term macroeconomic risks.

Calibrating a Decision to Conditions

21. If you were to proceed with a contingent tax package, there will need to be a clear set of objectives and priorities upon which to base a decision. Whether to proceed or not would ideally be informed by a range of economic and fiscal indicators.

22. As an example, such a decision could be based on whether the outlook for medium-term inflationary pressures is moderating in line with our current forecasts, and that

fiscal policy is supporting monetary policy to return inflation to target. This could involve making the decision contingent on evidence that:

- near-term inflationary pressures and excess capacity in the economy are moderating in line with forecasts;
- forecasts of medium-term inflation do not deteriorate, including that measures of core inflation and inflation expectations remain anchored;
- fiscal indicators showing a contractionary stance over the forecast period (unless downside risks to the economy and inflation eventuate).

23. Alternatively, your announcement could commit to the package as a whole having a neutral impact on the fiscal position, and signal that the package will be reassessed if there is a significant impact on forecast for the operating balance. For example, you could make your decision to implement the current package contingent on evidence that the Government remains in a position to credibly forecast a return to surplus and project sustainable surpluses thereafter.

24. However, we note that any calibration to fiscal conditions would be difficult to achieve due to the complexity and lags involved in fiscal forecasts and outturns. We would advise against adopting anything prescriptive and recommend instead assessing general fiscal conditions as needed.

25. Engagement with rating agencies in coming months would help inform our understanding of scenarios where implementation of the package could have an adverse market impact. You should also take into account the broader macroeconomic and financial environment, including the potential for fiscal decisions to contribute to economic imbalances, such as the current account deficit and net external liabilities.

26. In addition, engagement with the MPC in coming months may be appropriate to understand how they would react to implementation of the package. The nature of your commitment to defer the tax package under certain economic conditions would also affect to what extent the MPC adjusts interest rates in response to any announcement.

27. The Treasury can provide more detailed advice on potential objectives and indicators if required.

Implementing and Communicating a Contingent Tax Package

Several options exist to make a tax package contingent on economic conditions

28. There are several ways in which a tax package could be made contingent on economic conditions. These include:

    a. **Consult before legislating:** A consultation on the net wealth tax policy could be announced or released as part of the Budget, with legislation introduced later, subject to feedback from the consultation process and prevailing economic conditions.

    b. **Withdraw legislation:** Legislation could be introduced in the House as part of the Budget, but could be withdrawn during the legislative process if warranted by economic conditions.

    c. **Amend legislation:** Legislation could be introduced in the House and passed, but amended subsequently in order to delay introduction.

d. **Order in Council:** Legislation would be passed, but would only come into force on a date appointed by the Governor-General by Order in Council made on the recommendation of the Minister of Revenue.

29. As noted above, an option that enables more consultation on the wealth tax is likely to have benefits. Of the remaining options, the Order in Council option is likely to be simplest to implement but we will provide further advice on that approach if required.

How any contingent tax package is communicated will be critical

30. There will also be a trade-off between certainty and flexibility in terms of how you signal the nature of the conditionality. Providing greater certainty about when the tax package would be deferred or adjusted may add to signalling benefits arising from conditionality (e.g. in influencing the MPC and rating agencies). On the other hand, it is difficult to specify economic and fiscal scenarios in advance, and there is a risk that too much prescription could result in the contingency being triggered when it is not warranted.

31. If you decide to introduce conditionality into the tax package, the balance between certainty and flexibility will need to be carefully managed.

32. We will work with you and your office through the Budget production process, including the drafting of the Fiscal Strategy Report and other Budget Day collateral, if you wish to proceed with a tax package that is contingent on economic conditions.

Interaction with the Budget Forecasts

33. Under the Public Finance Act 1989 the fiscal forecasts presented in the Treasury's Economic and Fiscal Update must include all Government decisions and other circumstances to the fullest extent possible. However, inclusion in the forecasts must not compromise the Government in a material way in negotiation, or result in a material loss of value to the Government.

34. The fiscal forecasts represent the Treasury's best estimate of the Government's fiscal performance and position over the next five years. These forecasts involve judgement on the part of the Treasury in relation to uncertain circumstances.

35. Forecasting will always include some level of judgement. To guide our judgement the following framework is used to consider when an item should be included in the forecasts:

i Decision has been taken, or a decision has not yet been taken but it is reasonably probable[1] the matter will be approved, or it is reasonably probable the situation will occur.

ii The matter can be quantified for particular years with reasonable certainty.

36. If Cabinet have agreed to progress with a policy change and the matter can be measured it would need to be reflected in our fiscal forecasts. If there are conditions attached to the policy progressing we would need to make a judgement on the likelihood of these conditions being met to determine the treatment in our fiscal

[1] For these purposes "reasonably probable" is taken to mean that the matter is <u>more likely than not</u> to be approved within the forecast period (by considering, for example, whether there is a better than 50% chance of the matter occurring or being approved). A lower hurdle "reasonably possible" is used for determining if an item should be included in fiscal risks.

forecast. Logically, in this situation we would only exclude the tax package from our forecasts if the conditions are not forecast to be met.

37. In the case where Cabinet decides to hold off making final decisions until after a consultation process, the Treasury will need to make a judgement on whether it is more likely than not the policy will go ahead or not. As an example, some previous changes to GST which went out for public consultation were considered to meet the criteria for inclusion in our fiscal forecast, although Cabinet had not yet made final decisions on the policy changes.