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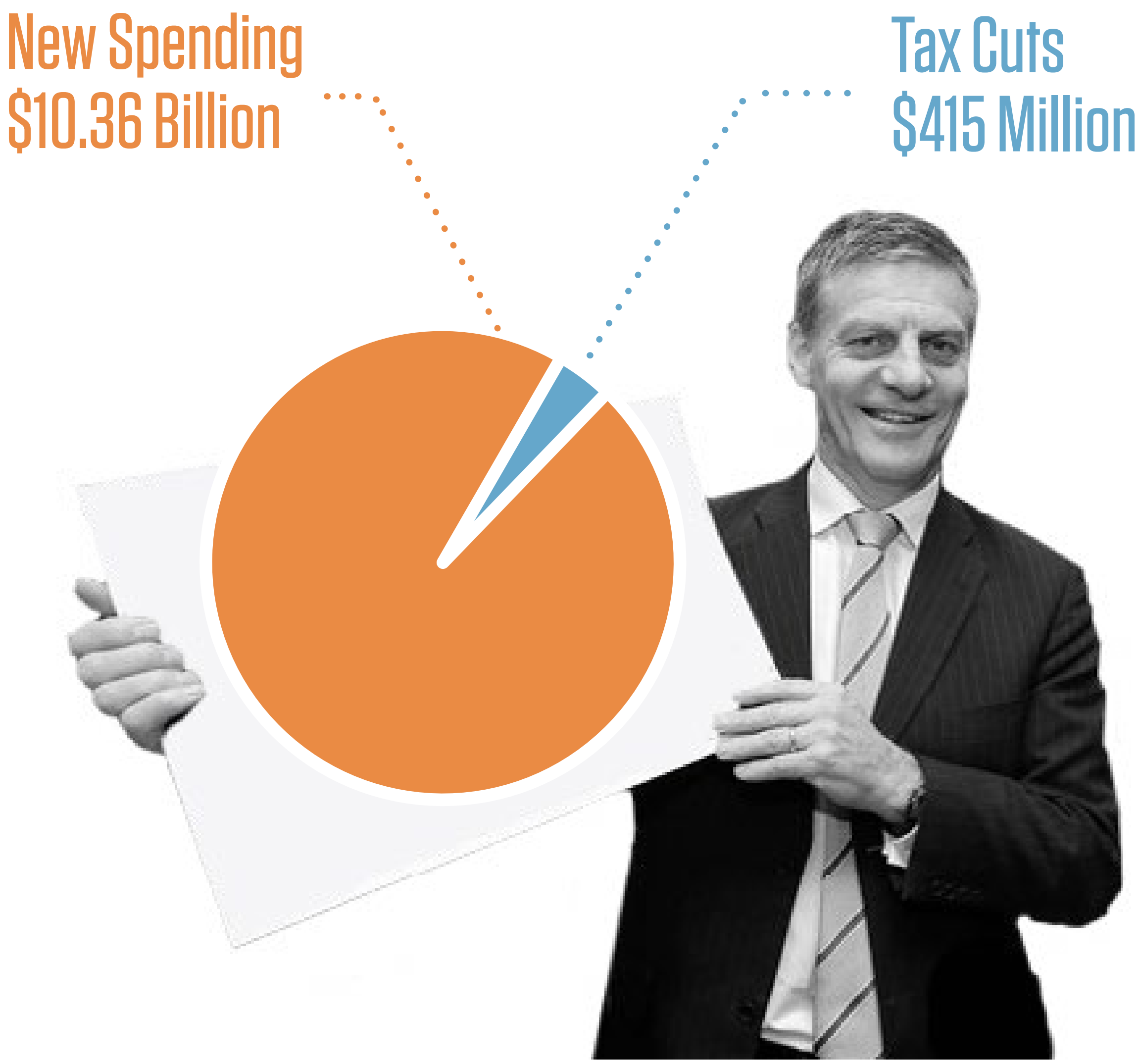
In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

5 Options for TAX RELIEF in 2017

TAXPAYERS' UNION

The National Party talk the talk on tax cuts, but it is time they walked the walk.

Budget allocations since 2008



FIVE OPTIONS FOR TAX RELIEF

In the coming weeks, Cabinet will be making decisions on Budget 2017 and its tax relief package. This discussion paper sets out five options for tax relief - a basis for taxpayers, members of the media, and political parties to assess options.

CONTENTS

WE SAY:

A taxpayer friendly Budget 2017 will:

1. fully compensate taxpayers for increasing taxes paid because higher wages have pushed wage and salary earners into higher tax brackets;

2. legislate for annual CPI indexation of tax thresholds, so that this extra taxation by stealth doesn't ever happen again.

Since 2010 the government has taken an additional $2.41 billion due to bracket creep. In the 2017/18 financial year alone, the cost to taxpayers is forecast to be $527 million.

"It is becoming obvious even to the National Party that it must fix the inequities caused by its seven years of tax hikes."
- Matthew Hooton

FOREWORD BY MATTHEW HOOTON

The discussion about tax cuts is one we shouldn't even be having.

As the Taxpayers' Union outlines in this excellent publication, through 'fiscal drag' or 'bracket creep' John Key and Bill English have been increasing our taxes by stealth every year since 2010.

The cumulative effect of these annual Key-English tax hikes has been to take an extra $483 a year – or $9.29 a week – out of the pay cheque of the average income earner. For the median two-parent household with two children $10.60 a week extra is taken from them by the annual Key-English tax hikes.

Overall, in the 2017/18 financial year, the National-led government will take an extra $527 million out of family incomes as a result of bracket creep. Were it not for this cynical ploy, that year's surplus would be only $170 million, not the $700 million advertised in the Treasury's last Economic and Fiscal Update. We would not have been talking about tax cuts because it would be obvious that almost all of that real surplus should be used for debt repayment.

As well as being cynical, the annual Key-English tax hikes are also ultimately poor politics. The government's political opponents have spent nine years crying that it has somehow "borrowed for tax cuts", whatever that could possibly mean. In fact, the value of the so-called 2010 tax-cut package in the 2017/17 financial year is just $415 million, according to the Taxpayers' Union analysis. This is dwarfed by the $527 million a year of new taxation imposed by bracket creep. There has been no borrowing for tax cuts because in net terms there haven't been any.

Worse, now that it is becoming obvious even to the National Party that it must fix the inequities caused by its seven years of tax hikes, it will again open itself up to accusations it is somehow reducing the overall burden of taxation at the expense of other priorities such as repaying the earthquake debt and strengthening the police. In fact, any fiscal package in this year's Budget worth less than $527 million a year will be nothing more than a reset back to 2010 levels.

All of this means that it is quite obvious that tax thresholds must be adjusted to reverse the entirety of the seven years of Key-English tax hikes and that they must thereafter be indexed to either inflation or, better, wages. Only then can the government legitimately begin to talk about genuine tax cuts – and other parties either praise or criticise Bill English and Steven Joyce for offering tax relief.

It is extremely unlikely any of the recommendations in this excellent report will be adopted. The government has said it will not cut tax before the election, yet afterwards it will be beholden to New Zealand First and the Maori Party, both of which have other plans for spending the $527 million now being raised annually from the Key-English tax hikes. Nevertheless, if this report is successful in at least correcting the language of the so-called tax-cut debate among the media and politicians over the next six months, the Taxpayers' Union will have once again earned your subscription.

[1]

Matthew Hooton
Political commentator

FOREWORD BY JORDAN WILLIAMS

Despite National-led governments, effective tax rates are increasing thanks to bracket creep – where inflation and average income growth pushes workers into high marginal tax brackets. Taxpayers are now carrying a much heavier burden than when the National Party last adjusted rates in 2010.

In 2017, the average income earner pays $483 more per year because of inflation alone. If income tax thresholds had been adjusted with average changes in earnings (so the average rate of tax paid stayed the same), they would be paying $1,361 per year (or $26 per week) less in tax.

In assessing the options contained in this paper, the above figures should be the starting point. Any 'tax cut' up until that amount, is simply a catch up to what was the status quo in 2010.

Last year John Key told Newstalk ZB that for 'meaningful' tax cuts the Government would need to set aside $3 billion. We agree. $3 billion is affordable and that is the figure used to produce the options in this paper.

To put $3 billion into perspective, since the National Party was elected in 2008, $10.3billion – or $6,015 per household – have been budgeted as new spending initiatives. Only 4% of that amount – $415 million – has been delivered in tax relief. This from the centre-right party that according to Mr Key "philosophically believe[s] in lower taxes and smaller government".

Tax relief is not spending...

The media often describe tax cuts as a 'bribe', as if they should be treated as an area of public spending. Sadly, in the political realm public money is for the elite to bestow magnanimously on the people. In reality, tax cuts are nothing more than a commitment from the school bully to take less lunch money. They are not government spending.

...and it's morally right to let people keep more.

While it is moral for the rich to pay more — to cover the social safety net and ensure public services and the good infrastructure which the government is in the best position to provide — it is morally wrong for the government to take even a dollar more than is needed.

As taxes increase, more and more transactions that would otherwise result in benefits to both parties are foregone. This shifting of economic activity from higher to lower value uses costs between $13 to $17 billion — roughly the amounts spent by government on education ($13.5 billion) and superannuation ($12.9 billion).

As the shining of the light on government waste by the Taxpayers' Union demonstrates, there is plenty more to do before anyone would accept that every dollar being collected is well spent. Until that happens, the Government should be making every effort possible to reduce the tax burden.

Are tax cuts always tomorrow under National?

Treasury's 2016 Half Year Economic and Fiscal Update shows economic growth is expected to average around 3% over the next five years. Surpluses are projected to rise to $8.5 billion by 2020. In addition, the financial accounts for the seven months to January show the tax take is tracking even higher than expected.

In 2010 the Government cancelled its promised tax cuts. Prior to the 2014 election Bill English committed to reduce taxes "when conditions allow it". If the current conditions aren't that, what are?

Budget 2017 is a chance for a major tax reset to set a course for economic prosperity. Tax cuts incentivise wealth creation and hard work. They fuel economic aspiration and growth. Bill English should grab the opportunity.

[1]

Jordan Williams
Executive Director
New Zealand Taxpayers' Union

"For the average income earner a $26 per week tax cut is simply a catch up to what was the status quo in 2010."
- Jordan Williams

OUR EXAMPLE TAXPAYERS

To illustrate the effect of bracket creep, and the options for tax relief contained in this paper, we have taken the following four taxpayers and calculated the annual and weekly financial implications for each.

Average worker

earning

$57,000

The first scenario is based on Statistics New Zealand data for the average weekly earnings for those in paid employment ($1,086 for 2016). We annualized the figure and rounded it to $57,000.

Family with two children

(both parents working) with combined earnings of

$100,000

Statistics New Zealand data for households described as 'couple with two dependent children' shows a median weekly income of $1,911 for 2016. We have annualized this figure and rounded to $100,000. For the purposes of analysis we assumed the earnings are attributable to a 70:30 split, i.e. the primary income earner has annual income of $70,000, and the secondary earner $30,000.

Low income worker

earning

$35,000

We have based this scenario on an individual on a full time hourly wage of approximately $16.80 (the minimum wage is currently $15.25).

Professional

earning

$120,000

This figure is based on a mid-tier salary for a lawyer, accountant or similar professional.

We also model a fifth option: cutting company tax to offer a comparison to the other options.

EFFECTS OF BRACKET CREEP

Personal income tax thresholds have remained constant since 2010. Due to inflation – where general wages and prices across the economy increase – income earners are pushed into higher marginal tax brackets, even when their real incomes remain the same. This is known as 'fiscal drag' or 'bracket creep'. As the table below illustrates, the average income earner is paying close to $10 extra per week, or $480 per year, because the Government has not adjusted tax thresholds to allow for inflation. These inflationary costs are even more significant for our couple and our professional, who lose $551 and $628 a year, respectively.

	Annual Tax Paid			Weekly Tax Paid			
	Current	**Fiscal Drag Adjusted**	**Annual Effect**	**Current**	**Fiscal Drag Adjusted**	**Weekly Effect**	**% Of Earnings**
Average Earner	$10,120	$9,637	$483	$194.62	$185.33	$9.29	0.8%
Couple	$18,290	$17,739	$551	$351.73	$341.13	$10.60	0.6%
Low Income	$5,145	$5,077	$68	$98.94	$97.63	$1.31	0.2%
Professional	$30,520	$29,892	$628	$586.92	$574.85	$12.08	0.5%

Indexing thresholds to growth in average earnings

Ideally, income tax thresholds should be indexed to the growth in average earnings. This would have the effect of keeping the marginal and average tax rates faced by average income earners constant over time. No income earner who has experienced a growth in incomes equivalent to average wage growth will be pushed into a higher tax bracket. Additionally, those income earners who do not see their wages grow relative to the average wage will be fairly compensated with lower average tax rates. The weekly/annual savings this policy would create for New Zealand households are significant. As shown below, if thresholds had been indexed annually since 2010, our average income earner would now pay $1,361 a year less in tax; our professional $2,186 a year; our couple $1,916 a year; and our low-income earner $236 a year.

	Annual Tax Paid			Weekly Tax Paid			
	Current	**Average Earnings Adjusted**	**Annual Effect**	**Current**	**Average Earnings Adjusted**	**Weekly Effect**	**% Of Earnings**
Average Earner	$1,0120	$8,759	$1,361	$194.62	$168.44	$26.17	2.4%
Couple	$18,290	$16,374	$1,916	$351.73	$314.88	$36.85	1.9%
Low Income	$5,145	$4,909	$236	$98.94	$94.40	$4.54	0.7%
Professional	$30,520	$28,334	$2,186	$586.92	$544.88	$42.04	1.8%

OPTION 1 – TAX FREE THRESHOL

Fiscal Impact: $2.85 billion

Under this option, the first $13,000 of income is tax free. To bring the fiscal effects below $3 billion per year, we have also reduced the 17.5% income tax threshold down from $14,000 to $13,000.

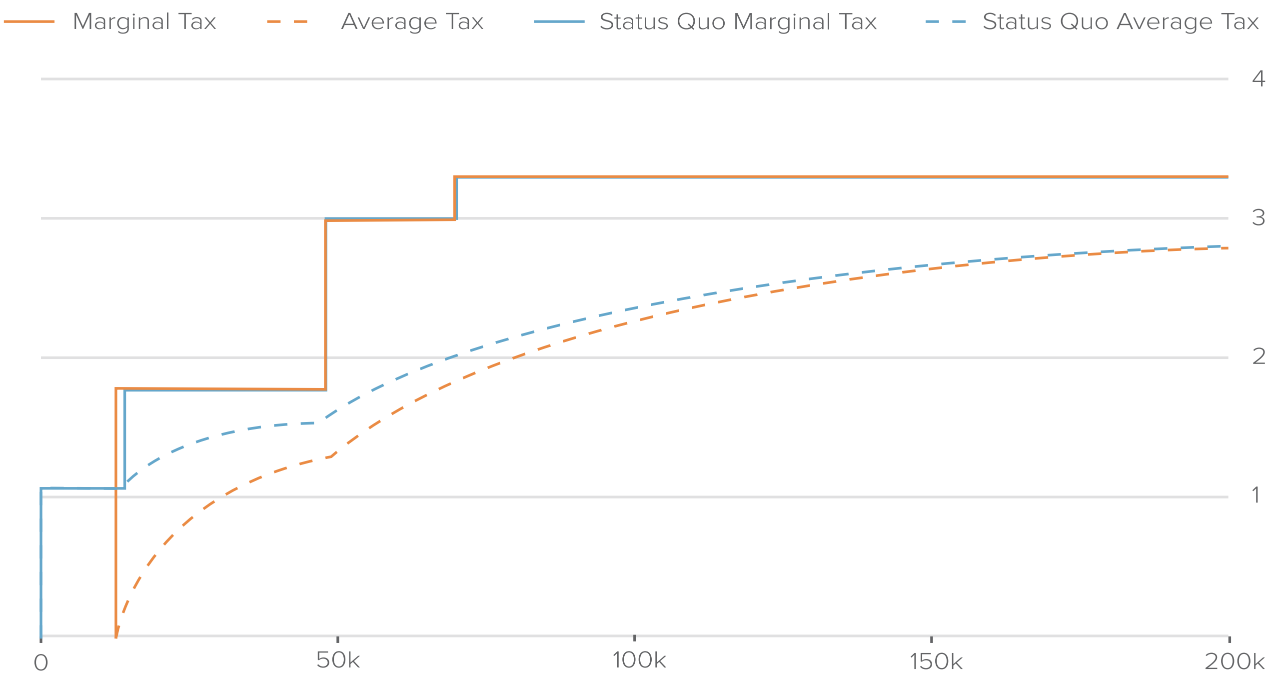
Current

0 - $14,000	10.5%
$14001 - $48,000	17.5%
$48,001 - $70,000	30%
$70,000+	33%

Option 1

0 - $ 13,000	0%
$13,001 - $48,000	17.5%
$48,001 - $70,000	30%
$70,001+	33%

Personal Income Tax Structure - Option 1



LD OF $13,000

Pros

- Targeted cuts to low-income earners provide the greatest economic gains to the wider economy. Because low-income earners tend to consume relatively more of their disposable income, a targeted tax cut at this group will do the most to induce consumption.
- Will reduce income inequality as the greatest gains are for low-earners (as a proportion of income).
- Will incentivise low-income individuals to work.
- All income earners will experience some tax relief.

Cons

- Low-income earners are already paying the smallest proportion of their income in tax, so it may be inequitable to reduce their relative tax burden further. In general, low-income earners also consume the greatest share in government services, whilst contributing the least to their provision.

	Annual Tax Paid			**Weekly Tax Paid**			
	Current	**Option 1**	**Annual Savings**	**Current**	**Option 1**	**Weekly Savings**	**% Of Earnings**
Average Earner	$10,120	$8,825	$1,295	$194.62	$169.71	$24.90	2.3%
Couple	$18,290	$15,700	$2,590	$351.73	$301.92	$49.81	2.6%
Low Income	$5,145	$3,850	$1,295	$98.94	$74.04	$24.90	3.7%
Professional	$30,520	$29,225	$1,295	$586.92	$562.02	$24.90	1.0%

The tax-free threshold provides every income earner with significant weekly and annual savings. All individual taxpayers who earn more than $13,000 a year will pay approximately $25 a week or $1,300 a year less in tax. Our low-income earner receives the largest tax relief as a proportion of income (an almost 4% boost in after-tax income) under this option. High income earners, such as our professional, get the least (only 1% of income). Our couple, given their dual-income earning, will save twice as much in real terms as the others.

OPTION 2 - ELIMINATE 30% BR FIRST BRACKET THRESHOLD TO

Fiscal Impact: $2.94 billion

Under this option, the 30% tax bracket is eliminated by increasing the application of the 17.5% marginal tax rate to income up to $70,000. To ensure low income earners also receive some tax relief, this option also increases the threshold of the 10.5% marginal tax rate from $14,000 to $24,000.

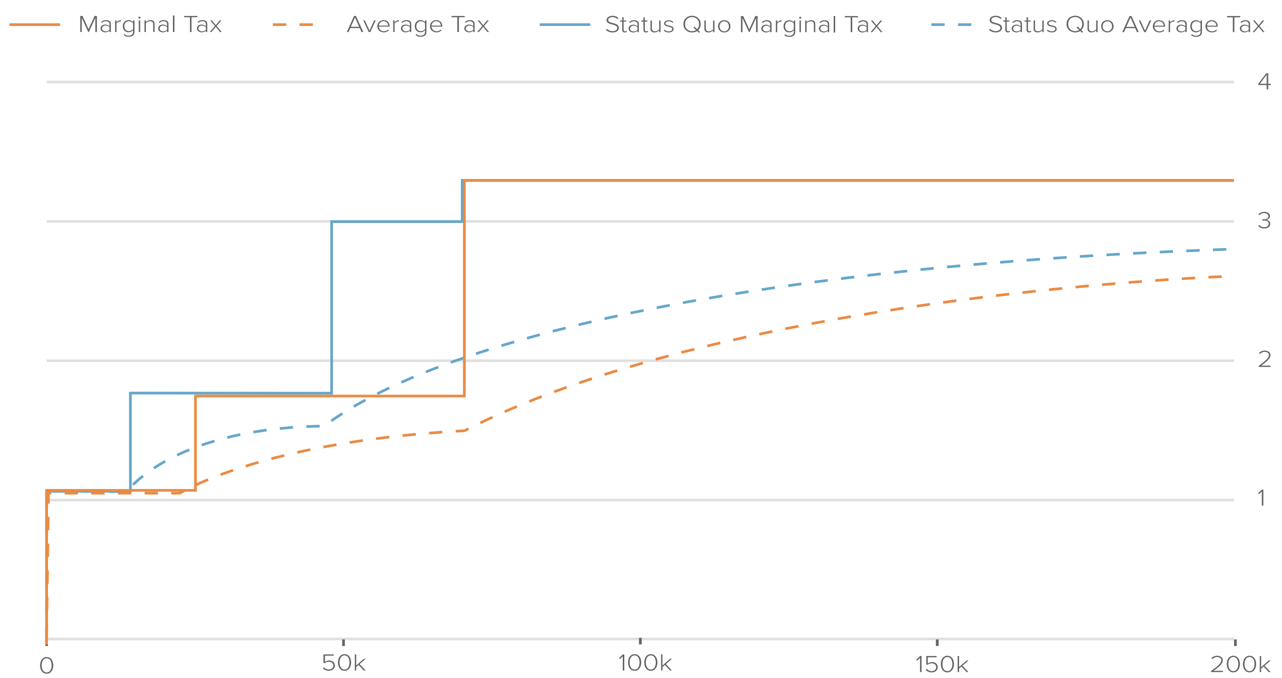
Current

0 - $14,000	10.5%
$14,001 - $48,000	17.5%
$48,001 - $70,000	30%
$70,001+	33%

Option 2

0 - $24,000	10.5%
$24,001 - $70,000	17.5%
$70,001+	33%

Personal Income Tax Structure - Option 2



RACKET AND INCREASE
O $24,000

Pros

- The median income earner has a current marginal income tax rate of 30%. Reducing this rate by 12.5 percentage points targets tax relief to middle income earners.
- All full-time workers will experience some tax-relief and the savings are widely spread.

Cons

- This options results in a greater disparity between the top tax-rate and increases the progressivity of the tax system as a whole.

	Annual Tax Paid			Weekly Tax Paid			
	Current	**Option 2**	**Annual Savings**	**Current**	**Option 2**	**Weekly Savings**	**% Of Earnings**
Average Earner	$10,120	$8,295	$1,825	$194.62	$159.52	$35.10	3.2%
Couple	$18,290	$14,140	$4,150	$351.73	$271.92	$79.81	4.2%
Low Income	$5,145	$4,445	$700	$98.94	$85.48	$13.46	2.0%
Professional	$30,520	$27,070	$3,450	$586.92	$520.58	$66.35	2.8%

The elimination of the 30% bracket provides meaningful tax relief to middle-income earners. The average income earner will pay $35 a week, or $1,825 a year less in tax. That is equivalent to more than 3% of their income. Combined with the proposed increase in the bottom income tax threshold to $24,000, low income taxpayers also share the benefits. Our low-income earner will save $700 a year (2% of income); our professional will save approximately $3,500 a year (2.8% of income); and our couple will save more than $4,100 a year (4.2% of income).

OPTION 3 – ELIMINATE TOP BRAC

Fiscal Impact: $2.98 billion

This option focuses tax relief on those earning above the median by reducing the top two marginal income tax rates to 26%. The company and trust rates are also reduced so that they match the top marginal rate.

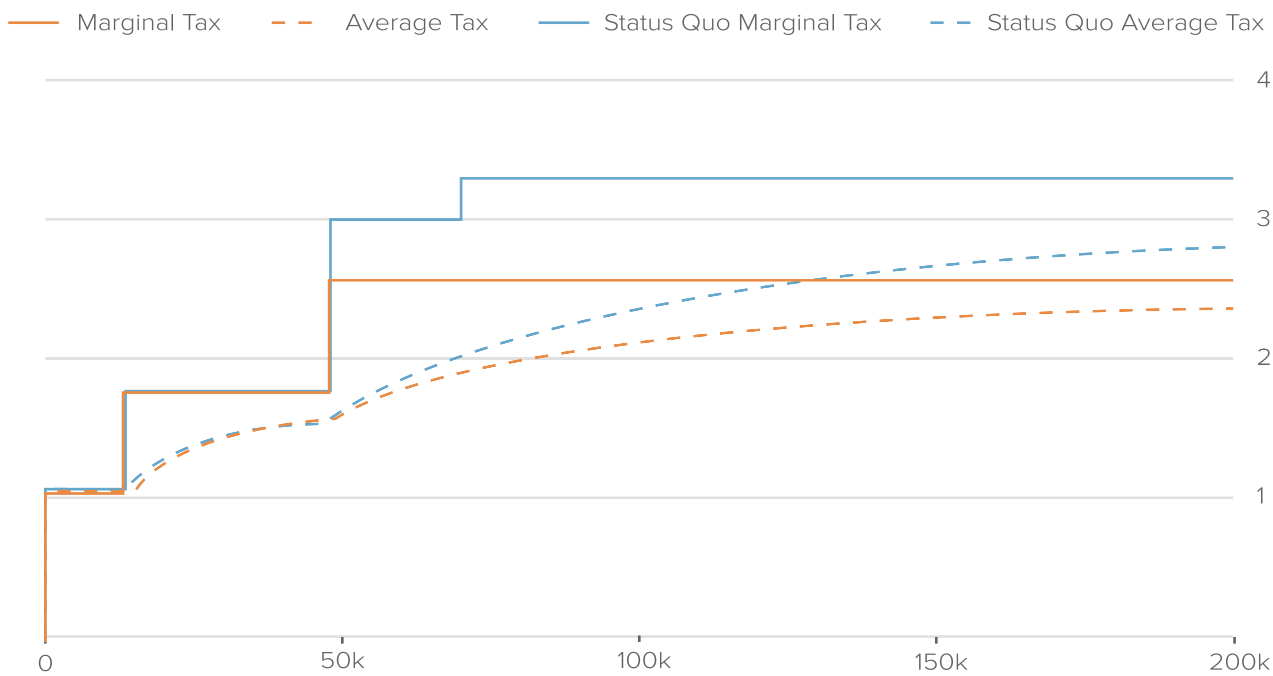
Current

0 - $14,000	10.5%
$14,001 - $48,000	17.5%
$48,001 - $70,000	30%
$70,001+	33%
Company	28%
Trustee Income	33%

Option 3

0 - $14,000	10.5%
$14,001 - $48,000	17.5%
$48,001 +	26%
Company	26%
Trustee Income	26%

Personal Income Tax Structure - Option 3



CKET AND CAP RATES AT 26%

Pros

- Synchronizing the top personal rate with the company tax reduces administrative burden and the incentives for shifting personal income to a corporate entity.
- Reducing the tax burden of top earners is likely to increase the labour supply of those most productive.
- Reducing the company tax rate makes New Zealand a more competitive choice for foreign investors.
- There are strong economic arguments in reducing the redistributive nature of the tax system.
- Reduces the disincentive for individuals to move up the income tax brackets.

Cons

- Targeting tax relief at the top earners would increase post-tax income inequality.

	Annual Tax Paid			**Weekly Tax Paid**			
	Current	**Option 3**	**Annual Savings**	**Current**	**Option 3**	**Weekly Savings**	**% Of Earnings**
Average Earner	$10,120	$9,760	$360	$194.62	$187.69	$6.92	0.7%
Couple	$18,290	$17,410	$880	$351.73	$334.81	$16.92	0.9%
Low Income	$5,145	$5,145	$0	$98.94	$98.94	$0	0.0%
Professional	$30,520	$26,140	$4380	$586.92	$502.69	$84.23	3.6%

Removing the top tax bracket and reducing the new top tax rate to 26%, targets tax relief at those who currently pay the highest levels of tax. Top earners pay the largest share of their income in tax but also the largest absolute levels of tax. Only around 34% of working age people earn more than $48,000, however, they pay more than 78% of total income tax. The top 2%, earning more than $150,000, pay 22% of the total.

Our professional is the biggest winner under this option, saving more than $80 a week, or $4,380 a year. Considering that 17% of all taxpayers fall into the top income bracket, this would be a welcome tax saving to a large proportion of the population. Because of the targeted nature of this option, our low-income earner will not receive any tax relief; our average earner will save $360 a year; and our couple will save $880 a year.

OPTION 4 - INCREASE TAX BRA

Fiscal Impact: $2.84 billion

This option is a balanced approach of increasing tax thresholds. It increases the brackets from $13,000 to $25,000; $48,000 to $64,000; and $70,000 to $100,000, respectively. Marginal tax rates remain the same.

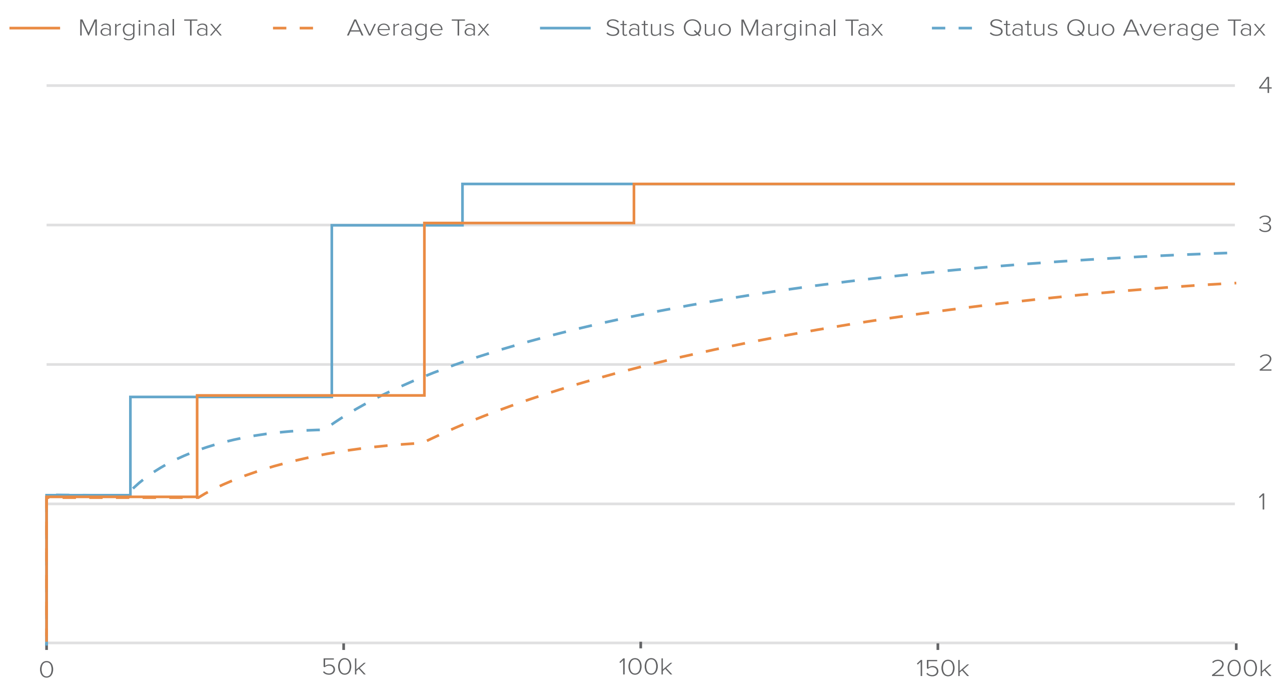
Current

0 - $14,000	10.5%
$14,001 - $48,000	17.5%
$48,001 - $70,000	30%
$70,001+	33%

Option 4

0 - $25,000	10.5%
$25,001 - $64,000	17.5%
$64,001 - $100,000	30%
$100,001+	33%

Personal Income Tax Structure - Option 4



CKETS ACROSS THE BOARD

Pros

- This would counter the effects that fiscal drag, as well as average wage growth, has had on the distribution of incomes within the tax brackets.
- The gains from the tax relief are evenly distributed across the income spectrum – therefore the current progressivity of the tax structure would essentially remain.
- Income inequality largely unchanged.
- Would increase the distance between the average and median income earner and the top tax bracket.

Cons

- Unlikely to have effect as large as other options in terms of economic growth or increase in supply of most productive labour.

	Annual Tax Paid			Weekly Tax Paid			
	Current	**Option 4**	**Annual Savings**	**Current**	**Option 4**	**Weekly Savings**	**% Of Earnings**
Average Earner	$10,120	$8,225	$1,895	$194.62	$158.17	$36.44	3.4%
Couple	$18,290	$14,750	$3,540	$351.73	$283.65	$68.08	3.5%
Low Income	$5,145	$4,375	$770	$98.94	$84.13	$14.81	2.2%
Professional	$30,520	$26,850	$3,670	$586.92	$516.35	$70.58	3.0%

Increasing the income thresholds of each tax bracket will result in savings to all income earners without changing the tax rates. Our low-income earner saves $15 a week ($770 a year) equivalent to 2.2% of income. Our average earner will save $36 a week ($1,900 a year) equivalent to 3.4% of income. Lastly, our professional and couple will both save approximately $70 a week ($3,500 a year) equivalent to 3% and 3.5% of income, respectively.

OPTION 5 – CUT COMPANY TAX

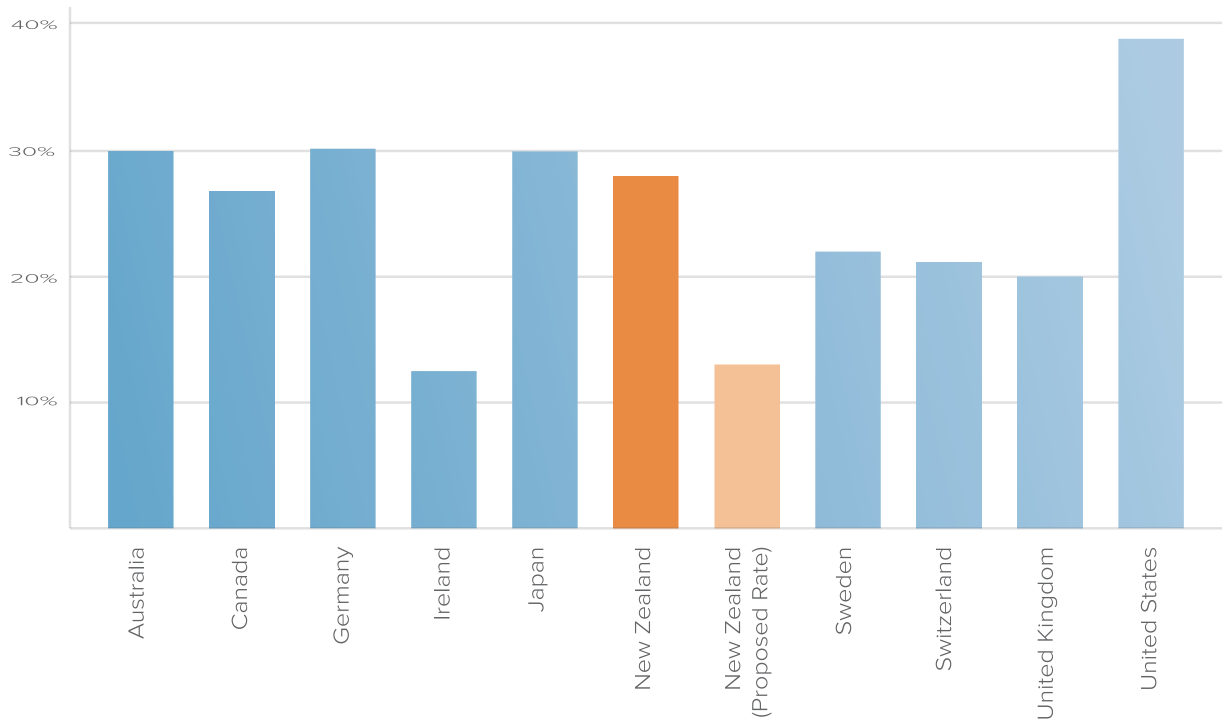
Fiscal Impact: $2.88 billion

This option applies the full amount of the funds available to reducing the company tax rate from the current 28% (one of highest in the world) to 13% (making it one of the lowest).

The company tax rate signals the openness of a country to entrepreneurship and business. The company tax rate can be viewed as an expense of doing business. To make New Zealand more globally tax competitive, this option proposes lowering the company tax rate to 13%. This proposed rate would make us the second most tax competitive country among the 35 OECD members, behind Ireland at 12.5%. At our current company tax rate of 28% we are ranked a modest 24th.

Lower company taxes attract greater investment, stimulate the economy, and lift the income levels of society. Devereux, Griffith and Klemm (2002) examine the increased investment in Ireland as a result of the reduction in company tax rates from 45% to 10%. They also show that despite the trend of long-term reductions in company tax rates, company tax revenue as a share of GDP has remained constant over time. Their paper would suggest that many Australian companies would consider moving to New Zealand if our company tax rate were significantly lower than across the Tasman.

There is also growing signs that other countries are moving to lower their company tax rates. UK Prime Minister, Theresa May, US President Donald Trump, and Australian Prime Minister, Malcolm Turnbull, have all signalled that the company rates in their respective countries will soon be lowered. This will make New Zealand's company tax rate even less competitive, and reduce New Zealand's relative attractiveness for foreign investment. The graph below illustrates New Zealand competitiveness against selected OECD countries at the current and proposed company tax rates



Source: OECD http://stats.oecd.org//Index.aspx?QueryId=58204
Note: these are combined company tax rates

METHODOLOGY & ACKNOWLEDGEMENTS

The proposals in this paper assume that $3 billion is available for tax relief in 2017/2018. The changes in tax revenue were calculated using Treasury estimates which specify the total taxable income within given income bands. Up to incomes of $80,000, total taxable income is calculated within each $1,000 band. For incomes above $80,000, total taxable income is calculated within each $5,000 band.

Changes in company tax revenue were calculated using Treasury estimates for the 2016/2017 year.

For Option 3 we have used Treasury's estimate of $375 million net reduction in tax for each percentage point change in the company tax rate. This figure takes into account taxes otherwise paid by Crown-owned companies and does not include any offset in personal tax (in this option the company tax and personal income tax move in tandem).

For Option 5 we have used Treasury's estimate of $240 million net reduction in tax for each percentage point change in the company tax rate excluding Crown-owned companies less personal tax offset. The value includes the offset in personal tax revenue due to personal income tax rates remaining constant.

Dynamic effects

Because tax changes affect decision-making in the labour, capital, and goods and services markets, our revenue-loss estimates account for a feedback effect. For example, when personal income tax rates are lowered there is an increased incentive to supply labour – hence the lowered income tax revenue will be partially offset by greater labour force participation/hours worked. Likewise, individuals who generate additional income as a result of tax relief will consume some part of this extra income, resulting in increased GST revenue.

Using the Mankiw and Weinzierl' (2004) guide for dynamic scoring, we have attributed a tax revenue offset from a reduction in personal income tax and company tax as 0.15 and 0.2 respectively. For trustee income tax (Option 3) we have applied 0.1. These offsets are specific to the labour and capital market adjustments.

These figures are relatively conservative estimates derived from the most cautious parameter values. For example, using alternative parameter values they find a company tax feedback of 0.5, which would greatly reduce the tax revenue loss from company tax cuts.

In regard to the GST feedback loop, we use the default Treasury value of 0.15. This implies that for every dollar of tax revenue forgone in personal income tax cuts 15 cents will be recouped through greater consumption and therefore GST revenue.

All of our estimates are independent of Working for Families as the scheme is based on before-tax income. In theory, Working for Families is unaffected by changes in the personal income tax structure.

Fiscal Drag

The inflation-adjusted income thresholds have been calculated using consumers' price index (CPI). CPI data was sourced from the Reserve Bank of New Zealand. Average and median earnings are sourced from the Household Labour Force Survey, and forecasted figures for 2017 are from Reserve Bank projections.

The excel spreadsheet models used to derive the figures in this paper are available on request.

Acknowledgements

While this paper was prepared by in-house researchers, we would like to acknowledge and thank our Research Fellow Jim Rose, tax expert Robin Oliver, and economist Dr Michael Dunn for their respective inputs.