

**Treasury Report:** Treasury Report: Further information on fiscal impacts of potential tax reform options

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<b>Date:</b>	4 March 2019	<b>Report No:</b>	T2019/512
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**Action Sought**

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	<b>Action Sought</b>	<b>Deadline</b>
Minister of Finance (Hon Grant Robertson)	<p><b>Refer</b> this report to Minister of Revenue</p> <p><b>Discuss</b> fiscal parameters of tax reform package at Joint Ministers meeting on 5 March.</p>	Prior to meeting with Minister of Revenue at 4.15pm on Tuesday 5 March.

**Contact for Telephone Discussion (if required)**

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<b>Name</b>	<b>Position</b>	<b>Telephone</b>	<b>1st Contact</b>
Oscar Parkyn	Principal Advisor	s9(2)(a)	✓
Mark Vink	Manager		

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

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**Refer** a copy of this report to the Minister of Revenue.

**Return** the signed report to Treasury.

Note any feedback on the quality of the report

**Enclosure:** No

## Treasury Report: Treasury Report: Further information on fiscal impacts of potential tax reform options

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### Executive Summary

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This report provides information on the fiscal impacts of tax reform. The paper includes:

- Indicative estimates of potential fiscal headroom for revenue-negative or spending measures over the medium term; and
- Indicative estimates of the impact of different potential tax packages on net core Crown debt, operating balance before gains and losses, and core Crown tax revenue.

The estimates in this report should be interpreted with caution. They are partly based on HYEPU assumptions, and will be superseded by subsequent reporting. The preliminary Budget forecasts will be finalised on 15 March, and the Treasury will provide advice on the fiscal strategy and fiscal targets on 20 March.

#### **The size of fiscal headroom will depend on the fiscal outlook and the fiscal strategy...**

The fiscal headroom for a tax package and potential future spending initiatives will depend on the updated fiscal outlook and the Government's fiscal strategy, particularly beyond 2021/22.

We have calculated (on an indicative basis) the headroom that is available for tax reductions or higher spending through to 2025/26. For illustrative purposes, this analysis assumes that net debt is maintained at around 20% of GDP from 2021/22 and that personal income tax thresholds are not adjusted to account for fiscal drag.

Any changes to Budget 2019 operating and capital packages will also affect fiscal headroom. Our estimates are based on the HYEPU budget allowances.

#### **...and require a consideration of wider macroeconomic impacts.**

Using fiscal headroom for tax reductions or higher spending will require consideration of wider macroeconomic impacts. Macroeconomic considerations include:

- Managing fiscal risk – ensuring there is sufficient resilience to manage future shocks; and
- Managing the economic cycle – a significant fiscal impulse would impact on the economic outlook, and could lead to higher interest and exchange rates than otherwise.


#### **The estimates are subject to uncertainty, but suggest some headroom is available...**

Given current information about the fiscal outlook, and subject to our assumptions, some headroom is available from 2022/23. Nevertheless, the fiscal outlook is highly uncertain. Extending the taxation of capital income would provide additional fiscal headroom.

For illustrative purposes, we show the fiscal impacts of packages that include capital gains taxation <sup>s9(2)(f)(iv)</sup>.

- <sup>s9(2)(f)(iv)</sup>


s9(2)(f)(iv)



The impacts will also depend on other elements of tax reform, including any business tax and KiwiSaver measures.

**...yet there will be trade-offs involved in using headroom for tax packages**

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### Recommended Action

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We recommend that you:

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

*Refer/not referred.*

b **discuss** fiscal parameters for tax reform at Joint Ministers on 5 March.

*Agree/disagree.*

Mark Vink  
**Manager, Tax Strategy**

Hon Grant Robertson  
**Minister of Finance**

## Treasury Report: Treasury Report: Further information on fiscal impacts of potential tax reform options

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### Purpose of Report

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1. This report responds to your request for further information on the:
  - Indicative estimates of potential fiscal headroom for revenue-negative or spending measures over the medium term; and
  - Impact of different potential tax packages on net core Crown debt, operating balance before gains and losses, and core Crown tax revenue.
2. You also requested further information on distributional impacts of potential packages. This will be provided to you in a later report.

### Fiscal headroom

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#### ***Fiscal headroom depends on the fiscal outlook and fiscal strategy***

3. The fiscal headroom for a tax package and potential future initiatives will depend on the updated fiscal outlook and the Government's fiscal strategy, particularly beyond 2021/22. The preliminary Budget fiscal forecasts will be finalised on 15 March. The Treasury will provide advice on the fiscal strategy and fiscal targets on 20 March.

#### ***Indicative estimates of fiscal headroom depend on assumptions***

4. To assist your thinking about the potential fiscal parameters of a tax package, we have calculated indicative amounts of fiscal headroom to 2025/26. The calculation of fiscal headroom is the amount of new spending or revenue reduction that could be consistent with your fiscal strategy.
5. The calculation of fiscal headroom depends on assumptions about government policy and the path of net debt, which requires judgments about the size of fiscal buffers for future pressures and shocks.
6. You have received advice on potential operating and capital packages for Budget 2019 [T2019/359]. Decisions on the Budget 2019 package will impact on the degree of fiscal headroom available. There will be less fiscal headroom if the Budget 2019 package is higher than the allowance assumed in HYEPU.

#### ***However, there are broader macroeconomic considerations for the use of any fiscal headroom***

7. The use of any fiscal headroom for tax reductions or higher spending firstly requires a judgment about whether there are other measures that could better enhance wellbeing or alternatively whether it is better to maintain a greater buffer for future opportunities and pressures on the public finances.
8. Macroeconomic considerations in using fiscal headroom for tax reductions or higher spending are:
  - **Managing fiscal risk** – ensuring there is sufficient resilience to manage future shocks as the fiscal outlook is uncertain; and

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- **Managing the economic cycle** – a significant fiscal impulse would impact on the economic outlook, and could lead to higher interest and exchange rates than otherwise.
9. In order to manage fiscal risk, it will be important that policy commitments are consistent with the Government’s fiscal strategy and keeping debt at prudent levels. A buffer would enable debt to rise following a recession or natural disaster. It may be particularly important for fiscal policy to help stabilise the economy in a recession, given limited room for the Reserve Bank to cut interest rates.
  10. Using fiscal headroom by substantially increasing spending or reducing revenue would have implications for the economic outlook. The effects of any fiscal impulse will depend on the state of the economic cycle and the size and composition of any policy change. Macroeconomic effects would have tax revenue implications, which has not been modelled in our calculations of fiscal headroom.
  11. A large fiscal impulse would be expected to increase aggregate spending in the economy, which would create additional inflationary pressure in an already capacity-constrained economy. Therefore, a large fiscal impulse would be expected to lead to the Reserve Bank setting the Official Cash Rate higher than otherwise, which would place upward pressure on the exchange rate at the margin.
  12. The above macroeconomic considerations will be addressed in the Treasury’s advice on fiscal strategy and long-term fiscal targets on 20 March.

***Indicative estimates of fiscal headroom assume the operating and capital allowances in HYEFU 2018...***

13. Budget operating and capital allowances provide fiscal headroom for new operating and capital initiatives. In this analysis, we keep the HYEFU 2018 assumptions for Budget allowances (see Table 1). Therefore, the analysis assumes that current and future Budget operating and capital packages can be met from these allowances. However, there are significant pressures on the allowances.

**Table 1: Operating and capital allowance assumptions (HYEFU 2018)**

\$ billion	Forecast period				Projection assumption		
	2019	2020	2021	2022	2023	2024	2025
Budget							
Operating Allowance	2.4	2.4	2.4	2.4	2.6	2.7	2.8
Capital Allowance	13.1 (multi-year envelope)				6.6	6.9	7.2

14. The degree of headroom could be greater if the Government raised tax revenue (eg, by extending the taxation of capital gains) or was comfortable with higher public debt than currently projected (eg, by maintaining net debt at 20% of GDP from 2021/22).
15. Preliminary Budget fiscal forecasts will be finalised on 15 March. The Treasury has updated its macroeconomic and tax forecasts [T2019/381 refers]. These macroeconomic and tax forecasts have been used to provide an early, indicative forecast of net debt over the forecast period. This is subject to change once preliminary fiscal forecasts are finalised on 15 March. The early, indicative forecasts suggest that net debt is expected to be below 20% of GDP from 2021/22, in line with the Budget Responsibility Rules (Table 2).

**Table 2: Net debt outlook with no changes to tax settings (with HYEFU 2018 allowances)**

Fiscal year	Forecast horizon					Projection horizon		
	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
Net debt (% of GDP)	21.0%	20.9%	20.4%	19.5%	18.0%	16.6%	15.2%	14.1%

***...and assume net debt is maintained at 20% of GDP...***

16. As an indicative assumption for the analysis, we have taken the Budget Responsibility Rule that net debt should not exceed 20% of GDP 2021/22, and calculated headroom to ensure net debt is stabilised at this level beyond 2021/22.
17. For the purposes of illustrating potential fiscal headroom, we make the following modelling assumptions:
  - The forecast base uses the preliminary Budget 2019 economic, tax and benefit forecasts, with other fiscal forecasts based on HYEFU 2018;
  - HYEFU 2018 operating and capital allowance assumptions;
  - Personal income tax thresholds are left unchanged in the projection period, so that fiscal drag leads to higher revenue as a percentage of GDP in the projection period; and
  - Core Crown net debt is maintained at around 20% of GDP from 2021/22 to 2025/26.

**Box 1: Fiscal drag assumptions**

The fiscal headroom calculations assume fiscal drag continues into the projection period (T2019/341 refers), ie that current legislated policy settings remain unchanged over the projection period. This assumption causes tax revenue to rise as a percentage of GDP and differs from the standard technical assumption used in the Government's fiscal projections (beyond the forecast horizon). The Government's fiscal projections, published in the 2018 *Fiscal Strategy Report*, assume that tax revenue remains at a stable percentage of GDP. Therefore, this analysis indicates considerably more fiscal headroom than if tax revenue is assumed to remain at a stable percentage of GDP.

Projection assumptions for the Government's 2019 *Fiscal Strategy Report* will need to be further considered following Budget 2019 policy decisions in April.

***...and consider revenue-raising options in the Tax Working Group's report...***

18. Tables 3-5 show the amount of fiscal headroom under three tax policy scenarios:
  - Status quo: no change to tax policy;
  - Comprehensive extension of capital gains taxation (excluding the family home); and
  - Extension of capital gains taxation to residential investment property and second homes.
19. Under the status quo, the additional headroom for higher expenses or revenue reduction is around \$1.9 billion in 2021/22 and around \$4.9 billion in 2022/23 and subsequent years (Table 3). This indicates the amount of additional spending or revenue reduction, in addition to operating and capital allowances, consistent with keeping net debt at around 20% of GDP.

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**Table 3: Fiscal headroom to stabilise net debt under status quo (in addition to HYEFU 2018 allowances)**

Fiscal year	Forecast horizon					Projection horizon			5 year total
	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	
Status quo: Headroom for additional operating expenses or revenue reduction (\$ billion)	-	-	-	1.9	4.9	4.9	4.9	4.9	21.5
Net debt (% of GDP)	21.0%	20.9%	20.4%	20.0%	20.0%	19.8%	19.7%	19.7%	

20. If revenue was raised with a comprehensive extension of capital gains taxation (majority recommendation of Tax Working Group), the additional headroom for higher expenses or revenue reduction is \$2.4 billion in 2021/22, \$5.9 billion in 2022/23 and builds up in subsequent years (Table 4).

**Table 4: Fiscal headroom to stabilise net debt with comprehensive taxation of capital gains (in addition to HYEFU 2018 allowances)**

Fiscal year	Forecast horizon					Projection horizon			5 year total
	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	
Status quo: headroom for additional operating expenses or revenue reduction (\$ billion)	-	-	-	1.9	4.9	4.9	4.9	4.9	21.5
Additional revenue from comprehensive taxation of capital gains (\$ billion)	-	-	-	0.5	1.0	1.7	2.3	2.8	8.3
<b>Total headroom under comprehensive taxation of capital gains (\$ billion)</b>	-	-	-	<b>2.4</b>	<b>5.9</b>	<b>6.6</b>	<b>7.3</b>	<b>8.1</b>	<b>30</b>
Net debt (% of GDP)	21.0%	20.9%	20.4%	20.0%	20.0%	19.8%	19.8%	19.9%	

21. If revenue was raised with an extension of capital gains taxation to residential investment property and second homes, the additional headroom for higher expenses or revenue reduction is \$1.9 billion in 2021/22, \$5.1 billion in 2022/23 and slightly higher in subsequent years (Table 5).

**Table 5: Fiscal headroom to stabilise net debt with taxation of capital gains from residential property (in addition to HYEFU 2018 allowances)**

Fiscal year	Forecast horizon					Projection horizon			5 year total
	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	
Status quo: headroom for additional operating expenses or revenue reduction (\$ billion)	-	-	-	1.9	4.9	4.9	4.9	4.9	21.5
Additional revenue from taxation of capital gains on residential investment property and second homes (\$ billion)	-	-	-	0.0	0.2	0.4	0.7	1.0	2.3
<b>Total headroom under taxation of capital gains on residential investment property and second homes (\$ billion)</b>	-	-	-	<b>1.9</b>	<b>5.1</b>	<b>5.4</b>	<b>5.7</b>	<b>6.0</b>	<b>24</b>
Net debt (% of GDP)	21.0%	20.9%	20.4%	20.0%	20.0%	19.8%	19.7%	19.8%	

## Potential packages

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### ***The fiscal impact of packages depend on your choices on revenue raisers and revenue-negative options***

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*Note: Revenue estimates are preliminary and indicative and may change following further refinement or incorporation of macroeconomic effects.*

#### ***Excluding second homes from capital gains taxation will decrease revenue***

23. You requested further information on the fiscal impact of excluding second homes (including baches). Over five years, the estimated foregone revenue due to excluding second homes is approximately \$360 million. This is slightly less than that reported to you previously, as the estimate has been converted to fiscal years. We are reporting to you separately on this issue (IR 2019/111, TSY 2019/563 refer).

#### ***There is fiscal headroom available for revenue-negative tax packages depending on your objectives and other Budget 2019 decisions***

24. Broadly there is potential fiscal headroom for these indicative packages from 2022/23. However, there is minimal headroom for revenue-negative impacts in 2021/22 in order to meet the Budget Responsibility Rules.

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25. The degree of headroom will also depend on updated fiscal forecasts and on other Budget 2019 decisions. If the Budget 2019 package ends up higher than what was assumed at HYEFU, this would also reduce headroom.

#### ***These packages will reduce your headroom for other spending measures or debt reduction***

26. The packages outlined in Table 6 would reduce the fiscal headroom for other spending measures or debt reduction. Over the five years to 2025/26:



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### Next steps

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28. We recommend you refer this paper to the Minister of Revenue and discuss fiscal parameters for tax reform at the Joint Ministers meeting on 5 March.

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<sup>1</sup> Estimates are indicative only.

Annex: Impact of packages on key fiscal indicators

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29. Figures 7-18 below provide preliminary modelling of the impact on the Government's fiscal position of the 6 illustrative packages. These update those provided in our previous report (*Options for building a package of tax reform, T2019/341, IRD 2019/103 refer*) and reflect the preliminary Budget 2019 economic, tax, and benefit forecasts.
30. Similar to the previous report, these indicate that all packages are consistent with the maintenance of operating surpluses. However, the packages risk the achievement of the net debt target. In addition, there are broader macroeconomic considerations for the use of any fiscal headroom which are considered in paragraphs 7-12 of this report.

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Note: Pages 11 to 17 have been removed under section 9(2)(f)(iv) OIA