The pitfalls of a tax-free threshold for income tax

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What the political parties propose

The idea of introducing a tax-free threshold for income tax is back in the news. This paper will review the proposals by three major political parties and then argue that they are poorly targeted and ill-thought through.

The Labour Party Government, as part of the $13 billion tax package that included a wealth tax, considered phasing in a tax-free threshold for income tax of $10,000. The threshold would have been phased in over three years starting at $5,000 and then $7,500. The proposal for a tax-free threshold for income tax and the rest of the $13 billion package were abandoned as part of the new Prime Minister's policy bonfire, to focus on the basics in response to the cost-of-living crisis.

The Greens propose a $10,000 tax-free threshold for income tax as part of their $13 billion tax policy that includes a wealth tax and a guaranteed minimum income. Anyone earning under $125,000 will pay less tax under their Ending Poverty Together plan.

Te Pāti Māori propose a radical tax reform policy worth $23 billion with a tax-free threshold for income tax of $30,000 to be funded by a wealth tax as high as 8% on net worth over $10 million, as well as other taxes. More than three million people will be better off under these Te Pāti Māori proposals in the first instance.

The rest of this paper will discuss the pros and cons of introducing a tax-free threshold for income tax. The idea is to get a clear image of who gains and who loses and at what fiscal cost.

The classical origins of the tax-free threshold debate

The debate over the purpose of a tax-free threshold for income tax dates to the earliest days of classical economics prior to 1870. This was when the first canons of taxation were developed such as the ability to pay and the benefit principle or quid pro quo view that taxes should relate to the benefits obtained from the resulting tax financed government activities (Creedy et. al, 2008b).

The particular concern of classical economists such as John Stuart Mill was ensuring that taxes did not come in to play before wages reached a subsistence level (Creedy et. al, 2008b). This was a time before establishing a social safety net was possible, and the only option available to the destitute was the workhouse (Creedy and others 2008b). Large welfare states did not emerge in industrialised countries until after the Second World War. As the decades passed in the 20th century, a range of tax brackets emerged with high marginal tax rates on those with high incomes.

The role of the tax-free threshold in the social safety net

It became commonplace across the OECD member countries since 1945 for people to be paying income tax and receiving social assistance such as welfare benefits, family tax credits and family allowances. The social safety net was thought to be the better tool for helping those in poverty. This was because cash payments can be made directly to those in need at whatever generosity was thought appropriate with no spillovers to other higher income groups. Having a tax-free threshold was in some ways a legacy of times when there was next to no social safety net.

New Zealand is (almost) unique.

New Zealand is one of the few countries in the OECD area that has no tax-free threshold for income tax. The only other country in the OECD without a tax-free threshold appears to be Hungary.

This absence of a tax-free threshold dates to the introduction of income tax in New Zealand in 1891. But up until 1972, the availability of various personal allowances meant that low-income taxpayers paid no tax (Creedy et. al, 2008b). Since then, there has been no tax-free threshold in New Zealand. The bottom income tax rate is currently 10.5%. As recently as 1998, the bottom income tax rate was as high as 24%.

Refundable tax credits for low-income taxpayers

In the late 20th century, the concept of refundable tax credits emerged, such as the Working for Families family tax credits, where families received more back in cash than they pay in tax. This allowed large amounts of family assistance to be paid through the tax system on a fortnightly basis rather than requiring a separate administrative substructure and separate applications.

Refundable tax credits emerged for single taxpayers where they could receive more back in tax credits than they paid in tax. An example of this in the USA is the $538 Earned Income Tax Credit for low-paid singles which more than rebates what is paid in tax but then is withdrawn rapidly at a 40% abatement rate.

New Zealand has a version of this: the Independent Earner Tax Credit. A New Zealand tax resident earning between $24,000 and $48,000 in a tax year gets the Independent Earner Tax Credit if they get their income from salary or wages, ACC compensation payments, paid parental leave, investments, self-employment, and other types of business income. They are ineligible if they or their partner are entitled to Working for Families Tax Credits, an income-tested benefit, New Zealand Superannuation, or a Veteran's Pension. If income (before tax) in the tax year is between $24,000 and $44,000, the credit is $10 per week. Between $44,001 and $48,000, the independent earner tax credit entitlement reduces by 13 cents for every dollar earnt over $44,000.

When the Independent Earner Tax Credit was first established, many low-waged workers benefited from it. That is no longer so. The annual income of a minimum wage worker is $47,216.

Taxes and the social safety net

In New Zealand, different social entitlements receive different tax treatments. Welfare benefits are set in net of tax terms. Tax increases and tax decreases do not change the amount that beneficiaries receive after tax. The gross amount of their benefit is adjusted up or down to offset dollar per dollar the change in tax rates. New Zealand Superannuation and Veterans' Pensions are, in the first instance, set gross of tax so any change in the tax threshold will see tax cuts for senior citizens and veterans. However, there is a back door regarding New Zealand superannuation because it is set at a statutory rate of 66% of average weekly earnings after-tax so in time a tax cut could be clawed-back.

Who gains from introducing a tax-free threshold?

The proposals by Te Pāti Māori provide a convenient illustration of how even radical proposals for the tax-free threshold do not necessarily benefit those most in need. Te Pāti Māori says that more than two million (47%) people earn below $30,000 per year and will benefit from their tax proposals. Who these two million people are, and why they are on low incomes is of considerable importance to whether a tax-free threshold of whatever amount for income tax is an effective social policy tool.

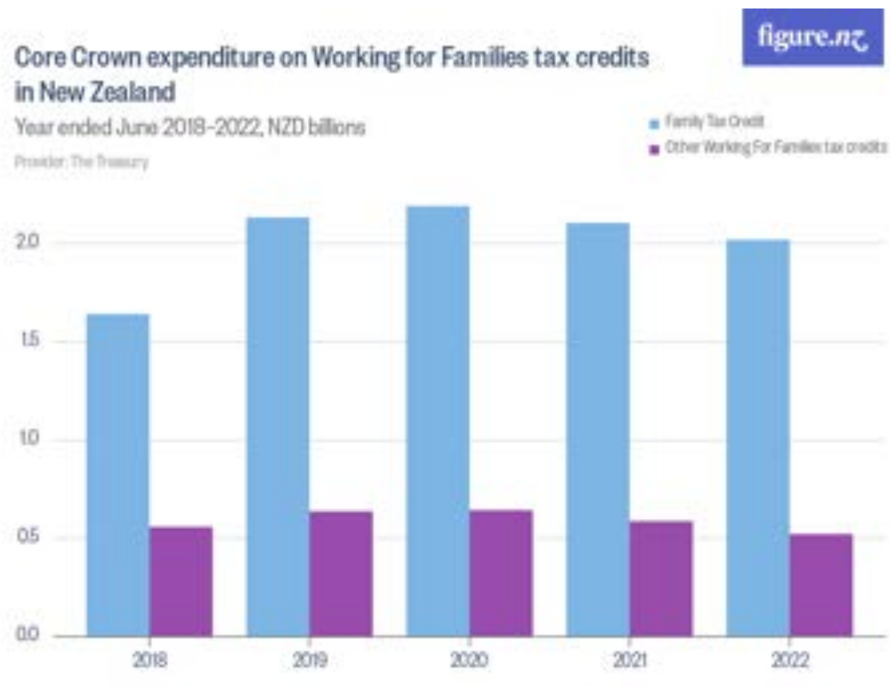
For example, nearly 900,000 people received New Zealand Superannuation as shown in the graph below from figure.nz. Research by the Retirement Commissioner found that 40% of people aged 65 and over have virtually no other income besides NZ Superannuation and another 20% having only a little more. On the other hand, 49% of those in the 65 to 69 age-bracket are still working and receive NZ superannuation as well because this old age pension is not income tested or asset tested.

Source: https://figure.nz/chart/zuWR5o4dLKH08ckO

The details of each sub-population with a low income are of importance in terms of which is the most effective social tool for helping those in need. A married couple on New Zealand Superannuation will receive $22,869 each before tax so they will not fully benefit from the radical $30,000 tax-free threshold proposed by Te Pāti Māori unless they have other taxable income. Withdrawals they may make from their KiwiSaver retirement savings accounts are not taxable. A married couple who are still working will on the other hand benefit in full from a tax-free threshold of $30,000 for income tax. In this way, a tax-free threshold can be seen to be a poorly targeted way attempt at providing a social safety net to those in most need.

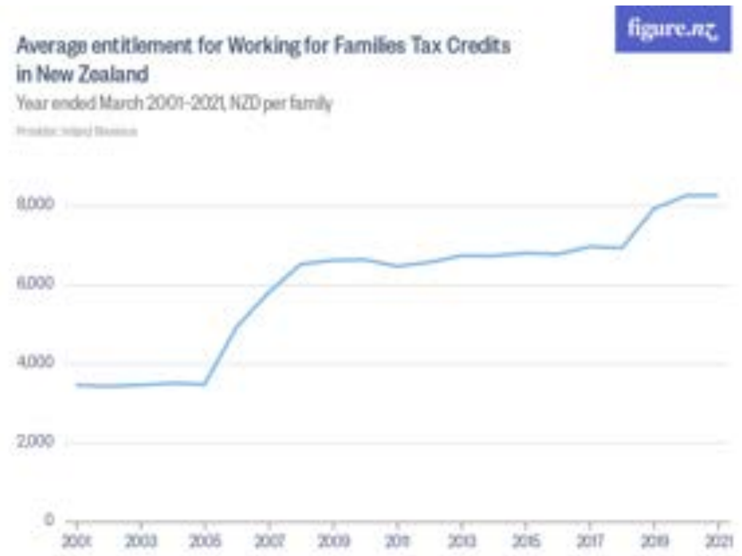
The more modest proposals considered by the Labour Party Government (and the Greens) to phase in a tax-free threshold for income tax of $10,000 would benefit all those on New Zealand Superannuation and Veterans' Pensions to the tune of about $20 a week. However, this same handout would also be given New Zealand's wealthiest residents at tremendous fiscal cost. Those on welfare benefits would not benefit at all because their rates are set net of tax.

The papers released by the Treasury and the Inland Revenue Department under the Official Information Act on the costings of the Government's tax package estimated that a $10,000 tax-free threshold for income tax would forego $3 billion in tax revenue. As shown in the figure.nz graph below, this is $500 million more than the total amount currently spent on Working for Families tax credits. It would be possible to double the Working for Families tax credits for less than the same fiscal cost as a $10,000 tax-free threshold for income tax and have a much greater impact on family poverty.



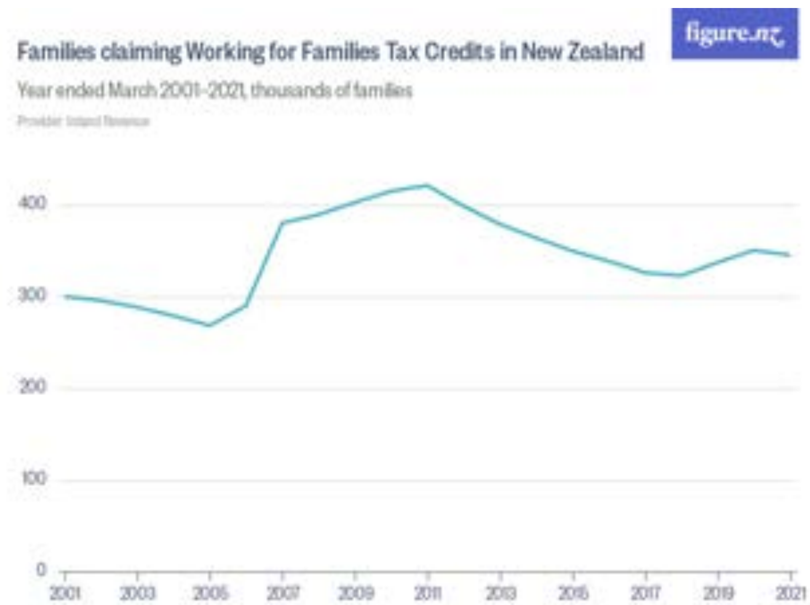
Source: https://figure.nz/chart/7BVoZ2u8VaoQuO5C

The average entitlement for the Working for Families tax credit is about $8500 per year, as shown from the figure.nz graphic below. This is more than double that what was paid nearly 20 years ago to working families. This figure below was before the recent increases in Working for Families.



Source: https://figure.nz/chart/cAm7QBY576Pjwp4k

Working for Families makes a real difference to working family incomes. The graph below from figures.nz shows about 350,000 families currently benefit from Working for Families tax credits. This is down from 400,000 in 2011 because of a failure to index the payment to inflation and an increase in the abatement rate from 20% to 27%.



Source: https://figure.nz/chart/aXrqvIi6PHsp7zX2

Who are the low-income taxpayers?

The Greens, the Labour Party and Te Pāti Māori want at considerable fiscal cost to assist people on low-incomes through tax-free thresholds when there are better direct methods such as family tax credits and individual refundable tax credits for single people. There is also the option of increasing New Zealand Superannuation directly and increasing welfare benefits directly as well.

The question must be asked as to whether people on low incomes have some attributes that makes it difficult for them to be helped in any other way. The table below reproduces data from Creedy and others (2008a) from the Household Economic Survey 2006/07. The below $18,000 income level was used because this captured those on welfare benefits and New Zealand Superannuation. This is equivalent to around $26,000 today, which is the single living alone rate for NZ Superannuation.

Characteristics of low-income taxpayers, Household Economic Survey 2006/07

Category of income below $18,000	% of total	Potential to benefit from tax changes
NZ super	20	Post-tax income set by legislative formula
Benefit	19	Post-tax income set by legislative formula
self-employed	4	Taxable income can differ from economic income
aged 15-17	10	Benefits from parent's income
Students	13	Temporary low income
2nd earner, family income >$50,000	10	Benefits from income of another
eligible for working for families	5	Taxable income differs from economic income
aged 18-24 excluding students	5	Part-time young worker
majority of income not taxable	2	
2nd earner, family income <$50,000	4	Low economic income
primary earner	7	Low economic income

Source: Creedy et. al, (2008a).

The first general point that can be made about the table is just about every line tells a different story.

- 20% of those on low incomes were on New Zealand Superannuation. Their incomes could be lifted directly through an increase in New Zealand Superannuation.
- 19% of those on low incomes were beneficiaries so their income is decided on an after-tax basis, and they too can benefit from a policy decision to increase the level of their benefits.
- 10% of those on low incomes are aged 15 to 17 and likely to be working part-time and living at home still benefiting from their parents' income.
- 13% were students likely working part-time and temporarily on low incomes while they were studying.
- 10% were a second earner in a household where the family income exceeded $50,000.
- 5% were aged 18 to 24 excluding students so they were low paid part-time workers.
- Only 7% were primary earners and another 4% second earners in a household with a family income less than $50,000.

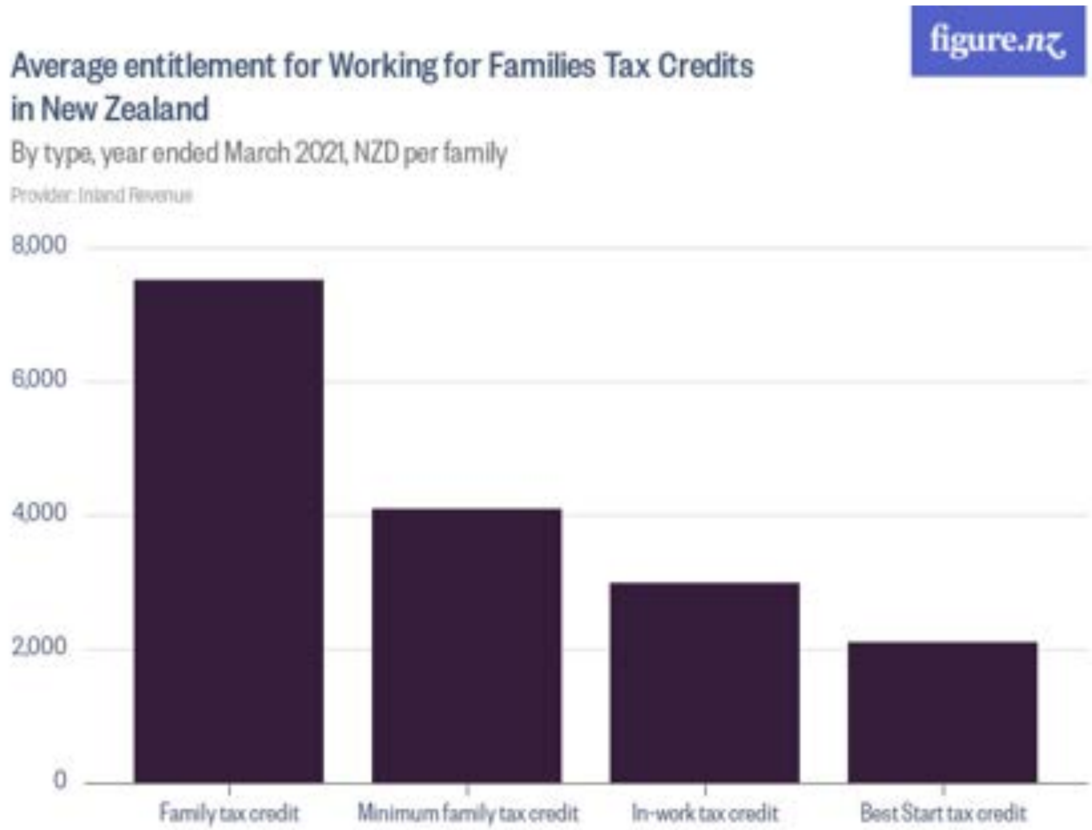
All in all, Creedy et. al, (2008a) found that 89% of those with an income below $18,000 did not have incomes that were persistently low or otherwise were not affected by tax design because their after-tax incomes were decided by statutory formulas, or they benefited from the incomes of others. Much better targeted policy tools exist such as family and individual tax credits that rebate after a certain income level is reached or increasing benefit or NZ Superannuation levels.

The current annual income of a worker on the minimum wage who works year-round is $47,216. This is well above the tax-free thresholds proposed by the three political parties. Low-income working families do not effectively pay tax because of family tax credits. Changes in income tax design will not benefit working families and individual workers on low incomes because they don't pay much tax, if any.

Family tax credits are targeted help for the poor and low-paid.

There are far more effective and obvious ways to help low-income people than the proposals by the Labour Party Government, Greens, and Te Pāti Māori for a tax-free threshold.

A tax-free threshold of $10,000 cuts taxes by $20 per week. As shown in the figure.nz graphic below, the average entitlement for a family tax credit is nearly $8000, $4000 for the minimum family tax credit, nearly $3000 for the In-work tax credit, and nearly $2000 for the Best Start tax credit. All of these can be increased greatly for the same fiscal cost as a tax-free threshold of $10,000.



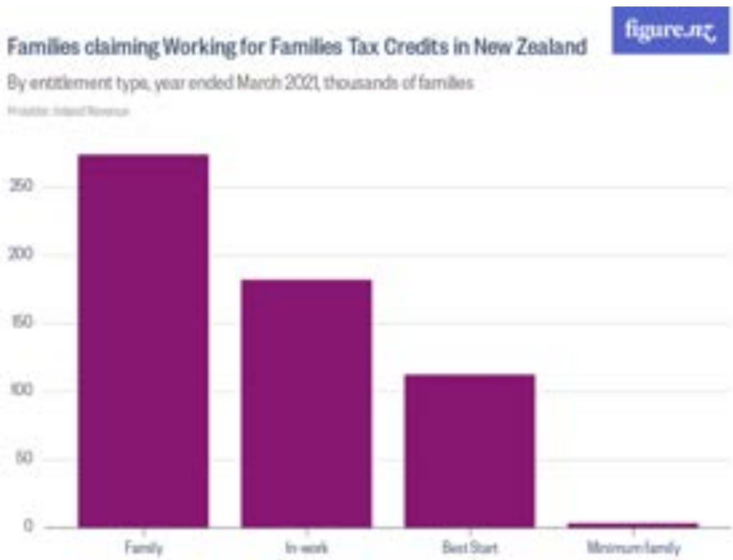
Source: https://figure.nz/chart/JehEI5Nbu7FaPR6U

The targeting efficiency of family tax credits

Furthermore, each of the four tax credits can be tailored to different social purposes and claimants that can be targeted individually if so desired as shown in the figure.nz graphic below.

- The family tax credit provides general assistance to 260,000 families. The family tax credit, for example, is currently(for the first child) $127 per week with an abatement rate of $0.27 on the dollar after $42,700 in family income. It could be increased if more general assistance to ordinary families was desired with no leakage to other groups.
- The Minimum Family Tax Credit ensures that family incomes never fall below $32,864. 3,200 families are eligible for this top-up.
- The In-work Tax Credit increases the gap between the benefit and taking a job with a payment of $72 per week for the first child, also abating at $0.27 on the dollar for family income above $42,700. This work incentive benefits 182,000 families. It could be increased to improve the incentive to work with no leakage to other groups.
- The Best Start tax credit targets assistance to 112,000 young families because they have children under the age of three. They receive $65 per child per week, abating at $0.27 on the dollar from $78,500 in family income. It could be increased if young families were the priority with no leakage to other groups.

All these social priorities can be approached with a refined policy tool. Family tax credits have great target efficiency because there is no leakage to other groups. This is rather than the bluntness of a tax-free threshold which cuts taxes for all, poor or not. Most of the fiscal cost of a tax-free threshold goes to those who are not a priority for poverty reduction such as those on higher incomes.



Source: https://figure.nz/chart/NTxoeduTpqIUmiSd

The other, more important, tax threshold

As previously noted, the annual income of a minimum wage worker is now $47,216 which is just below the second tax bracket of $48,000 where a 30% marginal tax rate applies.

If the political parties want to adjust tax to help working families, they should focus more on indexing tax brackets so that working families do not face ruinous effective marginal tax rates whenever they receive a pay rise. For example, for a family that receives Working for Families, they face a marginal tax rate of 30% on their income and a family tax credit abatement rate of 27%. Not only does this discourage work, but it also gobbles up most of any wage rise in the middle of a cost-of-living crisis.

Conclusions

The three political parties have proposed tax-free thresholds on income that will cost more than what is currently spent on Working for Families but will benefit all taxpayers rather than just those on low-incomes or ordinary families. Most of the people who are on low-incomes are on NZ superannuation, or a benefit. or are students working part-time, or are second earners again working part-time. The same policy objectives could be achieved in terms of helping ordinary families and the low-paid by increasing Working for Families and by changing the Independent Earner Tax Credit.

References

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