Forward from the past?
Twenty-first century tax reform based on 1970s'-style personal tax credits.

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It is clear that the Labour-led government will announce a new package of personal income tax cuts, probably in the 2007 Budget, and implement part of it before the 2008 general election. National will counter that with an alternative and somewhat more generous offering. To be electable, National's offering will probably be much along the lines of its 2005 tax policy, which targets middle-income rather than high-income earners.

Labour has a problem in that it seems to be unable to come up with any kind of tax reductions other than targeted tax relief to families with children. It needs a policy to retain the loyalty of past centre-left voters, while differentiating itself from National's policy that will also be pitched to the political centre.

New Zealand's income tax scales contain two anomalous features that the debate this year has barely touched. Compared to other countries, New Zealand does not have a zero marginal rate for the first few thousand dollars of income. Second, all tax relief to families with children is means-tested, which means that higher-income families with children pay exactly the same amount of tax as similar income households without children.

It is these anomalies that Labour should be addressing, given that National is not. The problem is that, in the absence of innovative thinking, addressing these problems can be technically challenging. I suggest that Michael Cullen and Helen Clarke draw inspiration from the income tax reforms presented in Bill Rowling's 1973 Budget. The country that best represents that approach today is Canada.

In 1973, to create a budget that delivered both government spending increases and tax cuts, Rowling flattened the tax scale and introduced a personal tax rebate that more than offset the higher taxes levied on low-income workers.

Robert Muldoon abolished the inflation-eroded Rowling rebate in 1978, leaving low income workers to pay unusually high average tax rates. By the late 1970s, the emphasis in tax policy had shifted from average to marginal tax rates.

In Canada they reinvented the Rowling personal tax rebate. It is known there as a "non-refundable tax credit". It's also known in the OECD as a "wastable tax credit". It is non-refundable in that the amount of the tax credit can never exceed the amount payable through the application of the basic tax scales. It is a rebate, not a benefit.

If New Zealand had a non-refundable personal tax credit of $5,000 per annum, a person assessed to pay $20,000 would in fact pay $15,000. And a person assessed to pay just $3,000 in personal tax would pay nothing.

Given that New Zealand's tax scale is already quite flat by the standards of other western nations, it would be possible to reintroduce a Rowling-style personal tax credit while replacing our graduated tax scale with a flat-rate 33% income tax.

If we were to do so, all persons earning at least $15,545 would get a personal tax credit of $5,130 ($99 per week). Persons earning less than the $15,545 threshold would pay zero tax. The tax credit would need to be inflation indexed.

The accompanying graph shows that low-income recipients would benefit significantly, while high income earners would also benefit from the removal of the 39% upper tax rate. Middle-income earners would not gain.

However, many middle income households with children contain one higher earner and one lower earner. Those households are currently disadvantaged – hence United-Future's policy of spouse income splitting for tax purposes. The lower earner often is a mother working part-time. She would certainly benefit from a tax reform based on a flat (or flatter) tax scale offset by a personal tax credit.

A slightly modified version of my proposal, which might be more attractive to Labour, would see the 33% tax rate come down to 32%, with the 39% top rate being retained. As the graph suggests, both proposals would be more affordable than the tax cuts proposed by National in 2005.

This tax reform contains the general advantage that low-income workers, whether employed part-time or full-time, become much better off. This has the effect of making any kind of paid work more attractive to beneficiaries. Realistically, many beneficiaries and 60-somethings can only be expected to take up part-time employment. The personal tax credit is a much better and more general "welfare to work" incentive than the IWP ("in-work payment") currently paid (from 1 April 2006) to caregivers of children in non-beneficiary families.

Indeed, the tax reform that I have suggested could easily be accompanied by a proposal to replace the IWP by a universal (ie non-means-tested) child tax credit. That would both reduce effective marginal tax rates faced by middle-income earners, and resolve the second anomaly in New Zealand's income tax system; namely, the denial of tax relief to higher-earning families with children.

If Labour were to put to the electorate a tax reform package such as I've outlined, then not only could it be an election winner, but also it could stimulate intelligent and much-needed public debate on the principles underpinning public finance and income distribution.

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