

# Personal Income Tax Reform in New Zealand

by Keith Rankin, 5 February 2010

We have heard a lot of talk recently about how New Zealand's tax system is broken and that it requires radical surgery, the latest being the January 20 Report of the Victoria University tax working group (<http://www.victoria.ac.nz/sacl/cagtr/pdf/tax-report-website.pdf>), and the surrounding media commentary.

While I agree that the system is far from perfect, few of us understand the basics of our present personal tax scales, and workable suggestions of alternatives are few and far between.

A major problem is that the tax system and the benefit system now substantially overlap, and we no longer have clear principles defining where the boundaries between the two systems lie.

While some believe that there are no boundaries, and that taxes and benefits are two parts of a single system, I would not go that far. Here I propose two clear definitions of each concept, and suggest some basic reforms to the personal tax scales, based on either definition of what taxes are.

1. Personal taxes are actual payments levied by governments on tax-resident persons. Benefits are payments made by governments to tax-resident persons. This the definition is based on the direction of the payment. By this definition, neither taxes nor benefits can be negative amounts.
2. Personal taxes are payments or transfers levied on *or granted to* tax-residents by governments on an *individual* basis. Benefits are payments granted to *households*.

The second definition is I believe the one that provides the best basis for sustainable administrative reform of both taxes and benefits. Nevertheless the first definition is closer to underlying principles of public finance, and it is necessary to offer suggestions for reforming both personal taxation and benefit payment systems.

This paper looks at personal tax reform from an individual point of view. Subsequent papers will consider the tax and benefit ramifications of raising children.

Table 1 presents the main features of our present tax scale. It includes the 1.7% employee levy for ACC (Accident Compensation) and the \$520 "Independent Earner" concession available to persons earning in the \$24,000 to \$44,000 range. It makes no allowance for benefits that a person might qualify for. In line with definition 1, current tax scales do not (and can not) allow for a negative average tax rate.

<b>Table 1</b> income tax plus ACC levy (1.7%)			
<b>NZ Income Tax Thresholds as at March 2010</b>			
person only, excluding benefits			
<b>gross</b>	<b>net</b>	<b>average</b>	<b>marginal</b>
<b>\$ annual</b>		<b>rate</b>	<b>rate</b>
13,999	12,011.14	14.2%	14.2%
<b>14,000</b>	<b>12,012.00</b>	14.2%	22.7%
23,999	19,741.23	17.7%	-51977.3%
<b>24,000</b>	<b>20,262.00</b>	15.6%	22.7%
43,999	35,721.23	18.8%	22.7%
<b>44,000</b>	<b>35,722.00</b>	18.8%	35.7%
47,999	38,293.36	20.2%	35.7%
<b>48,000</b>	<b>38,294.00</b>	20.2%	34.7%
69,999	52,659.35	24.8%	34.7%
<b>70,000</b>	<b>52,660.00</b>	24.8%	39.7%

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Conventional tax scales are defined by a set of marginal rates, which apply to income earned above a threshold (in blue) for that rate. Thus persons earning \$14,000 or less per year pay 14.2% on every dollar earned. Once earnings exceed \$14,000 (the first threshold) they pay 22.7% on subsequent dollars earned. For persons earning more than \$14,000 per year, the marginal rate (on the last dollar earned) always exceeds the average rate, except where strange anomalies exist. Further, the average tax rate rises continuously as earnings exceed the first threshold.

The major problems with the present New Zealand scale are: higher average tax rates, compared to other countries, on lower incomes; the strange anomaly in which a person earning \$23,999 pays nearly \$520 more tax than a person earning \$24,000; and the fact that the higher marginal tax rates are above the company tax rate (of 30%).

The latter problem, while the most publicised, is the least important. It's normal overseas for marginal tax rates to exceed 40%, whereas company tax rates are rarely over 40%. There are ways to address this problem other than to eliminate all marginal rates above 30%.

*My focus here is on the other two problems, and in particular on how to make personal tax scales more equitable without raising the higher marginal rates.*

First, Table 2 shows the result of removing the \$24,000 wrinkle in the present scale. The solution is to replace the Independent Earner Tax Credit (IETC) introduced in April 2009, by creating a 15.8% marginal tax rate – 17.5% when combined with ACC – for incomes above \$14,000 and under \$24,000, and a 34% marginal tax rate – 35.7% when combined with ACC – for incomes between \$44,000 and \$48,000. Only "independent persons" earning between \$14,000 and \$24,000 would pay less tax, and nobody would pay more tax. It is an easy and inexpensive reform to commit to. (Independent persons are defined as persons receiving no benefits, as per definition 1.)

<b>Table 2</b> income tax plus ACC levy (1.7%)			
<b>NZ Income Tax Thresholds as at March 2010</b>			
person only, excluding benefits, <i>de-wrinkled</i>			
<b>gross</b>	<b>net</b>	<b>average</b>	<b>marginal</b>
<b>\$ annual</b>		<b>rate</b>	<b>rate</b>
13,999	12,011.14	14.2%	14.2%
<b>14,000</b>	12,012.00	14.2%	17.5%
23,999	20,261.18	15.6%	17.5%
<b>24,000</b>	20,262.00	15.6%	22.7%
43,999	35,721.23	18.8%	22.7%
<b>44,000</b>	35,722.00	18.8%	35.7%
47,999	38,293.36	20.2%	35.7%
<b>48,000</b>	38,294.00	20.2%	34.7%
69,999	52,659.35	24.8%	34.7%
<b>70,000</b>	52,660.00	24.8%	39.7%

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The next commitment should be to use the postponed 2011 tax cuts as a launching pad for any further reform. These tax cuts, which favoured middle-income recipients and were voted for in 2008, must take precedence over any alternative cuts suggested in recent reports which have not been voted for and which relatively favour persons on high incomes.

Table 3 shows the postponed April 2011 scale, with the IETC wrinkle once again ironed out, and with differences shown from the present Table 1 scale. While persons earning \$14,000 or less will not benefit much, the scale at least will be simple, coherent, and democratic.

**Table 3** income tax (multiple rates) plus ACC levy (1.7%)**NZ Income Tax Thresholds for April 2011** (de-wrinkled version of postponed cuts)

person only, excluding benefits

gross \$ annual	net	average rate	marginal rate	difference from March 2010	
				\$ annual	\$ week
13,999	12,028.64	14.1%	14.1%	17.50	0.34
<b>14,000</b>	12,029.50	14.1%	14.1%	17.50	0.34
23,999	20,621.14	14.1%	14.1%	879.91	16.92
<b>24,000</b>	20,622.00	14.1%	21.7%	360.00	6.92
43,999	36,281.22	17.5%	21.7%	559.99	10.77
<b>44,000</b>	36,282.00	17.5%	34.7%	560.00	10.77
47,999	38,893.35	19.0%	34.7%	599.99	11.54
<b>48,000</b>	38,894.00	19.0%	34.7%	600.00	11.54
69,999	53,259.35	23.9%	34.7%	600.00	11.54
<b>70,000</b>	53,260.00	23.9%	38.7%	600.00	11.54

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The final reform of this sequence is to introduce a "non-refundable tax credit" of \$1,830 per year (Table 4). Such tax credits currently operate in Ireland and Canada, and operated in New Zealand between 1973 and 1978. In New Zealand's case, the 1970s "personal tax rebate" (as it was then called) was allowed to erode in the face of heavy inflation, and was abolished in the belief that lower marginal taxes for middle-income workers were a higher priority than low average taxes for low income workers.

**Table 4** income tax (multiple rates) plus ACC levy (1.7%)**NZ Income Tax Thresholds for April 2011** (based on postponed cuts)

person only, excluding benefits, including "non-refundable" credit of up to \$1,830

gross \$ annual	net	average rate	marginal rate	difference from March 2010	
				\$ annual	\$ week
9,149	8,993.47	1.7%	1.7%	1143.63	21.99
<b>9,150</b>	8,994.45	1.7%	21.7%	1143.75	22.00
13,999	12,791.22	8.6%	21.7%	780.08	15.00
<b>14,000</b>	12,792.00	8.6%	21.7%	780.00	15.00
23,999	20,621.22	14.1%	21.7%	879.99	16.92
<b>24,000</b>	20,622.00	14.1%	21.7%	360.00	6.92
43,999	36,281.22	17.5%	21.7%	559.99	10.77
<b>44,000</b>	36,282.00	17.5%	34.7%	560.00	10.77
47,999	38,893.35	19.0%	34.7%	599.99	11.54
<b>48,000</b>	38,894.00	19.0%	34.7%	600.00	11.54
69,999	53,259.35	23.9%	34.7%	600.00	11.54
<b>70,000</b>	53,260.00	23.9%	38.7%	600.00	11.54

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The non-refundable tax credit shown in Table 4 is the equivalent of a zero tax rate on incomes under \$9,150. (Thus the only income tax payable by persons earning less than \$9,150 would be the ACC levy of 1.7%.) This tax cut for persons on very low incomes would not affect anyone earning more than \$24,000, thanks to a rise in the marginal tax rate to 20% (21.7% with ACC) for persons earning above \$9,150. Only persons earning under \$24,000 would be affected by this reform. Persons earning less than \$14,000 per year – the overlooked ones – would finally receive meaningful tax cuts.

All of these steps are technically very easy to do, create scales that are more equitable without increasing anyone's taxes, and represent a low fiscal cost to the government.

There are limits, however, to how far you can take tax reform, by refusing to allow for negative taxes. If we shift to definition 2, then the realm of taxation is the individual and the recipient of benefits is the household. Thus one agency – the Inland Revenue Department (in New Zealand) – focuses only on individuals and keeps no records of the household circumstances of tax-residents. Another agency – Work and Income (in New Zealand) – pays benefits on the basis of household circumstances.

Moving to this definition enables us to adopt the simplest and most elegant solution of all, the "refundable tax credit". This reform option (RTC), shown in Table 5, works as a negative income tax for low earners; in other words a low payment to individuals who pay little or no tax.

**Table 5** income tax (34.5%) plus ACC levy (1.7%), "Refundable Tax Credit" option  
possible NZ Income Tax outcomes for April 2011  
person only, incorporating annual credit of \$8,600

gross \$ annual	net	average rate	marginal rate	difference from previous table	
				\$ annual	\$ week
0	8,600.00			8600.00	165.38
13,999	17,531.36	-25.2%	36.2%	4740.15	91.16
14,000	17,532.00	-25.2%	36.2%	4740.00	91.15
23,999	23,911.36	0.4%	36.2%	3290.15	63.27
24,000	23,912.00	0.4%	36.2%	3290.00	63.27
43,999	36,671.36	16.7%	36.2%	390.14	7.50
44,000	36,672.00	16.7%	36.2%	390.00	7.50
47,999	39,223.36	18.3%	36.2%	330.01	6.35
48,000	39,224.00	18.3%	36.2%	330.00	6.35
69,999	53,259.36	23.9%	36.2%	0.01	0.00
70,000	53,260.00	23.9%	36.2%	0.00	0.00

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The illustration given here uses a tax credit based on the individual unemployment benefit for a married person – \$158.65 per week in March 2010 – with two years of adjustment for inflation. (\$165.38 is 4.2% above \$158.65.)

By using a single tax rate of 34.5% (36.2% with ACC included). The RTC option makes no difference to a tax-resident earning \$70,000, compared to the 2011 tax rates legislated for in December 2008. For persons earning over \$70,000 the RTC option represents a tax cut, because the marginal rate falls from 38.7% in Table 4 to 36.2% in Table 5.

The average tax rate becomes negative for persons earning under \$24,000. Under definition 1, we would call this payment a benefit. Under definition 2, this payment which can range between \$0 and \$165.38 per week is understood as a tax credit – a negative tax – payable to individuals solely on the basis of their earnings.

Most individuals earning under \$24,000 qualify for some form of benefit today – typically a primary benefit such as Unemployment Benefit, Sickness Benefit, Invalids Benefit, Student Allowance and/or an Accommodation Supplement. The proposed individual benefit of \$165.38 per week – effective from April 2011 – would substantially replace such benefits.

A welfare agency – Work and Income – would still be required to apply vertical equity (defined as treating people with different circumstances differently, in contrast to horizontal equity which is treating equals equally). For example, if Unemployment Benefits are 4.2% higher in April 2011, then an unemployed person over 25 living independently would be receiving \$198.39 plus an Accommodation Supplement. Such persons, if they have no earnings, might therefore require a Work and Income benefit of say \$100 per week – subject to earnings-related-abatement – in addition to the refundable tax credit that they are automatically entitled to. Many such persons would not bother applying for small benefits, preferring to avoid engagement with a government authority such as Work and Income. Thus, the welfare agency would operate on a much smaller scale once this kind of reform is introduced.

Another advantage of the Table 5 tax scale is that, with a constant marginal tax rate, married couples pay the same total tax whether they individually have very similar or very different incomes. Thus the case for "income splitting tax credits" disappears in the face of this wider reform.

To conclude, reform of personal taxation is possible, with elegance and simplicity, and without substantial income redistribution. The proposals suggested all address the tax inequities faced at present by low income workers; generally workers on low wage rates or reduced hours. Further the final proposal reduces the amount of bureaucracy that New Zealanders must face, while raising the incentives for people to raise their incomes.

Other aspects of tax reform – for example issues related to families, company taxation, property investment, expenditure taxes – still need to be addressed. Nevertheless, the proposals advanced here represent a practical reform which is easily expanded to accommodate these other aspects of taxation and benefits.

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