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Insight

Getting real on a tax-free threshold

Labour's proposed tax-free threshold for the first $5,000 of wages and removing GST from fresh fruit and vegetables will cost around $1.7 billion in the first year. This is to be funded by raising the top tax rate for high income earners. From an economic perspective, these proposals would be a big step backward.

One of the big concerns is what raising the top tax rate would do to New Zealand's attractiveness as a place to live and work. For example, a new tax rate at $100,000 pa would have to be 53% – affecting around 131,000 people – to fund the $1.7 billion. Table 3 shows other combinations of tax rates at different income thresholds. A high marginal tax rate would just encourage efforts to avoid tax. Introducing exceptions to the broad GST structure would be inefficient as well.

New Zealand already has a welfare system to target low income households. If the aim is to assist those households, the policy focus should instead be on economic prosperity and reforming costly and inefficient welfare policies such as Working For Families ($2.8 billion a year).

Labour's tax policy

Labour leader Phil Goff proposed new tax policies in his State of the Nation speech on 25 January 2011:

- a tax-free income threshold of $5,000 with a compensating increase in the top tax rate
- removing GST from fresh fruit and vegetables.

Table 1 Fiscal impacts of proposals

Policy		$ billions
Tax-free threshold at $5,000	Loss in income tax	-1.64
	Gain in GST receipts	0.16
Removal of GST from fresh fruit and vegetables		-0.25
Increase in top tax rate	Gain in income tax	1.84
	Loss in GST receipts	-0.10

Source: Treasury, NZIER

The proposal would make the tax system less competitive

Introducing a tax-free threshold by increasing the top tax rate would be harmful for the tax system. Labour's proposed tax package would make the New Zealand tax system less competitive against Australia, which already enjoys higher wages. A highly skilled New Zealander earning $150,000 would become $150 a week worse off in New Zealand than earning the same income in Australia (from $17 a week better off in New Zealand currently). The removal of GST from fresh fruit and vegetables would cost nearly $250 million and only benefit the poorest 10% of households by a paltry $1.50 per week.

Heading in the wrong direction

Taxes affect the decision by households to work, buy and save. All tax systems suffer from inefficiencies, called 'dead weight losses'. However, broad-based taxes, such as the GST in New Zealand, minimise this deadweight loss. Removing GST on fresh food would increase enforcement and administration costs for both the government and businesses. It would create a favourable bias towards fresh food, which is healthy. However, it is unclear if the benefits would outweigh the additional costs. There are likely to be more cost-effective, better targeted approaches to improving diets.

Required top tax rates absurd

New policies need to be funded. Given Government borrowing is already beyond comfort levels, we have made estimates assuming the policies are fiscally neutral[1]. We estimate that:

- the $5,000 tax-free threshold will cost $1.5 billion[2]
- a top tax rate of 53% starting at $100,000 is required to pay for the tax-free threshold and removal of GST from fresh food
- the required top tax rate rises rapidly as the threshold is increased.

Note the following numbers do not take into account other potential adverse impacts of increasing the top tax rate, for example:[3]

- the exodus of more skilled labour to Australia will likely increase
- there will be increased use of trusts/companies/PIEs to avoid personal income tax
- incentives for high income earners will be to work less due to lower marginal rewards.

[1] So that the decrease in revenue from the tax-free threshold is fully offset by an increase in revenue from increasing the top tax rate.

[2] This is based on the direct costs of $1.64 billion in lost tax revenue offset by $0.16 billion of GST receipts from increased spending.

[3] These impacts will reduce revenue from a higher tax rate requiring even higher numbers than those estimated.

Table 2 Impact on households: $ per week

Figures represent single earner households

Household income (annual)	Net impact of tax changes(1)	Removal of GST on fruit & veg	Weekly benefit of tax changes
Under $20,000	$10	$1	$12
$20,000 to $28,899	$10	$2	$12
$28,900 to $39,699	$10	$2	$12
$39,700 to $51,399	$10	$2	$12
$51,400 to $63,199	$10	$3	$13
$63,200 to $76,099	$10	$3	$13
$76,100 to $92,199	$10	$3	$13
$92,200 to $110,799	$4	$3	$8
$110,800 to $147,699	-$102	$4	-$98
Over $147,700	-$230(2)	$4	-$226

Notes: 1 Includes tax-free threshold and increase of top tax threshold to 53% at $100,000 per annum

2 Represents single earner household with annual income of $162,500. Net impact declines by $38 per week per additional $10,000 of income

Source: NZIER

Table 3 New top tax rates required at different thresholds

		New top tax rate required to fund proposed policies	
Threshold that new tax rate kicks in (per annum)	Number of taxpayers affected	$5,000 tax-free threshold	Tax-free threshold + GST exempt fruit and vegetables
$70,000	334,740	43%	45%
$100,000	130,650	51%	53%
$150,000	45,510	64%	69%
$200,000	22,690	78%	86%

Source: NZIER

This Insight was written by Peter O'Connor, Economist at NZIER, 28 January 2011

For further information please contact Peter on peter.oconnor@nzier.org.nz

NZIER | (04) 472 1880 | econ@nzier.org.nz | PO Box 3479 Wellington