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### **Why a Tax-Free Zone is a Bad Idea**

From time to time the idea is canvassed of not imposing any income tax below a certain level of income.

Such a tax-free zone could apply, for example, to the first \$9,500 of income, instead of the bottom 15% rate currently applied, or to the first \$14,000 of income instead of the 12.5% rate that will apply to that range of income after 1 October this year.

Superficially, the idea seems intuitively attractive. People who are struggling to make ends meet should not have to pay much, if any tax. The idea has populist appeal – some countries have a tax-free zone, and Winston Peters is promoting one as part of New Zealand First's election policy.

Interestingly, New Zealand once had a tax-free zone. It was abolished during Robert Muldoon's time as finance minister.

The Great Populist was not always impervious to rational argument.

The starting point in understanding why a tax-free zone is bad tax policy is to note that people on low taxable incomes already pay very little tax. Those in the income bracket 0 – \$10,000 (some 881,000 people or 21% of all taxpayers) pay just 1% of total income tax, according to the 2008 Budget documents. It follows that many people on very low incomes would derive little benefit from a tax-free zone.

Next, taxable income is not a good measure of need. As the 2001 Tax Review noted, "People in poverty have low taxable incomes, but most people on low taxable incomes are not in poverty."

For example, many are people working part-time or part-year, some are members of middle to high income households who are secondary income

earners or who have transferred income earning assets to trusts, others are superannuitants with a little investment income, and so forth.

Also beneficiaries with no market income would not benefit from a tax-free threshold. Gross benefits are usually adjusted for income tax changes so that such beneficiaries receive the same income in the hand.

A minority of people are dependent on low wage income and are genuinely needy. For them, government social assistance programmes are the best solution. They are also assisted by the Low Income Rebate (LIR). It reduces the statutory rate of tax on the first \$9,500 of salaries and wages from 19.5% to the 15% rate mentioned above. Every additional dollar earned over \$9,500 is subject to tax of 21% until the rebate is fully abated at an income of \$38,000. This targeted measure is being abolished.

Employing a tax-free zone instead of targeting those in need has very large fiscal costs. Treasury and IRD officials estimated that the net fiscal cost of establishing a free zone to \$9,500 with a 21% rate thereafter would be over \$2.6 billion (equal to about \$1,600 for each household) in 2009/10.

This arises because those on higher taxable incomes are also exempt from tax on income earned up to the threshold. They, rather than those on low incomes, get most of the benefits from the revenue forgone yet their marginal tax rates, which are what matter for incentives, are unchanged. If the lost revenue were to be recouped, much higher marginal tax rates further up the tax scale would be required.

Thus the 2001 McLeod Tax Review calculated that "introducing a free zone to \$9,500 would reduce the tax liability of someone on \$20,000 p.a. by an additional \$17.31 per week, but would require the other tax rates move to 26 percent, 39 percent and 49 percent, assuming the corporate rate is held at 33 percent, to fund this change."

Officials also advised that compliance and administrative costs would be reduced only for a small number of taxpayers with a tax-free zone, and more complex withholding tax rules for bank customers would be needed.

Finance minister Michael Cullen, to his credit, dropped the idea of a tax-free zone, but in also dropping the bottom rate and the LIR he made the tax scale wider rather than flatter, contrary to the advice of the McLeod Review and most tax professionals.

Introducing a tax-free zone would be yet another change that emphasised income redistribution over efficiency and economic growth. Pursuing these goals requires a lower and flatter tax scale.

A constitutional case can also be made for such moves. University of Chicago legal scholar Richard Epstein has argued that taxes paid should bear some relationship to benefits received, and that groups that advocate higher government spending should pay a share of the costs (see The Case for a Flat Tax, [www.nzbr.org.nz](http://www.nzbr.org.nz)).

Russia and a number of ex-Soviet Union and East European countries have moved to flat or flattish taxes. Bulgaria, still an overtly socialist country, is an example. It cut its personal income tax rate to 10% in January of this year to match its 10% corporate tax rate.

Everyone pays the 10% rate, regardless of income. With such regimes low income earners do not face higher tax rates as their incomes rise, and they share in the gains from faster economic growth and higher government revenues.

A few years ago the Treasury calculated that at an annual fiscal cost of \$4.7 billion, all income tax rates (personal and company) could be reduced to a maximum of 18% – around the top rates in Singapore and Hong Kong.

Moves in this direction would be a far better use of government revenue than a tax-free zone.

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