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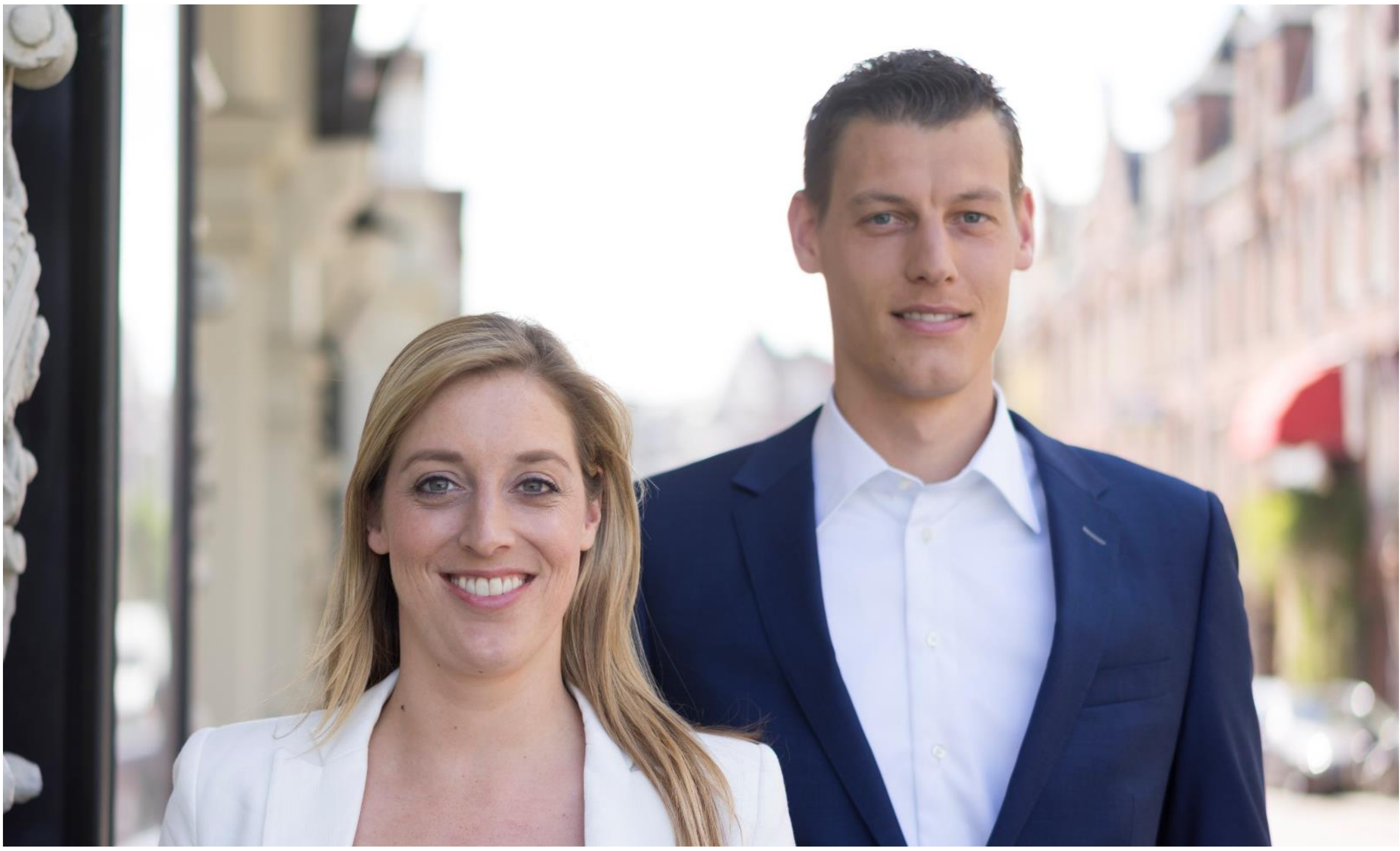


Paper Three – Removal of the Tax-Free Threshold

Exploring the Personal Income Tax System

This paper is the third in a three part series that explores opportunities to reform the Australian personal income tax system.

Many of the policy propositions for the reform of personal tax recently debated in Australia have been framed within the current structure of our personal income tax system.

The intent of these short papers is to examine some elements of that structure and to ask whether they should be reformed.

Should we reply upon our current 'tax bracket regime'? Is our taxation treatment of capital income and labour income optimal? Should capital and labour income be taxed within the same personal tax system? Should we allow some individuals to be entirely outside the system with an elevated tax-free threshold?

Introduction

Australia's tax-free threshold was just $6,000 until 2011 when it was increased dramatically as part of the package to compensate for the introduction of the 'carbon tax'. The Henry Tax Review had favoured a tax-free threshold of $25,000 partly so that significantly fewer people would need to file a tax return. The dramatic threshold increase undertaken in 2011 did exclude many individuals from the system.

However, the carbon tax never eventuated. In addition, modern data management techniques overtook many of the concerns about return preparation for low income earners, while New Zealand has successfully enacted a system which has no tax-free threshold and no tax return filing obligation. So the question now arises: why does Australia have an $18,200 tax-free threshold for individuals?

What is the tax-free threshold?

The basis of the personal income tax system is a progressive tax rate and bracket regime, applied to each individual's entire personal income earned from their labour and invested capital.

Under this 'tax bracket regime', the rate of tax applied to each dollar of income earned by an individual depends upon the 'bracket' into which that dollar falls. In the 2019 financial year, every dollar earned by an individual up to $18,200 has an applicable tax rate of nil. In other words, the first $18,200 of income is tax-free irrespective of the total amount of taxable income an individual earns. Income beyond that level is subject to tax at rates that rise with the different income brackets.

What is the problem?

The current tax-free threshold is not well targeted. It benefits all taxpayers because it applies to the first $18,200 of everyone's income. As a result, from the perspective of a progressive tax system, the threshold is arguably 'wasted' on high income earners and on low income earners who live in high income or wealthy households (who can utilise the threshold via income splitting). Arguably, from an efficiency perspective, the threshold is also wasted on individuals whose workforce participation is not very responsive to tax rates.

Importantly, if the benefit of the tax-free threshold was provided on a more targeted basis, it would be possible to either increase overall government revenue or fund a reduction in tax rates, either across all tax brackets or for lower income earners.

The tax-free threshold also reduces the number of 'stakeholders' in the system. For the 2015-16 income year, one in five people who filed a tax return had income of less than $18,200[1]. Among all people over 18, the proportion who pay no income tax is close to half[2]. This leads to claims of a major division in society between the 'taxed' and the 'taxed-nots', although opinions differ as to whether this is a problem.

A possible solution

One solution would be to remove the tax-free threshold altogether, impose tax from the first dollar of income, and introduce a new 'tax offset'. This offset would enable a reduction in the amount of tax otherwise payable but its availability would be restricted to low and middle income earners. For those people, the tax offset would produce the same net tax position as the previous tax-free threshold. In other words, they would pay tax from the first dollar of income earned but all or part of the tax payable on the first $18,200 would be returned to them by way of an offset. High income earners would also be liable for tax from the first dollar of income earned, however, they would not enjoy the benefit of the offset.

The key design issues to such a proposal concern the offset: the maximum dollar amount of the new offset, the income level at which its withdrawal would commence, and the rate of withdrawal. The maximum amount would be the tax payable on the first $18,200 of income. The income level for commencement of withdrawal, and the rate of withdrawal, would be determined by a range of considerations, including equity, the impact on workforce participation, and revenue generation.

The higher the income level at which withdrawal commences, the greater the number of taxpayers who would enjoy the offset, and the higher the cost to the revenue. The faster the rate of withdrawal, the higher the 'effective marginal tax rates' (EMTRs) created. The slower the rate of withdrawal, the higher the cost to the revenue.

The EMTR of an individual is the rate of tax that would be payable by that individual on an additional dollar of income earned, taking into account the operation of the tax bracket regime and any applicable tax offsets and other adjustments. For example, the nominal marginal tax rate for an individual on an income of $92,000 in the 2019 financial year is 37 per cent. However, at that income level, the individual is suffering from the withdrawal of the new 'Low and Middle Income Tax Offset' ('LMITO'[3]). The taper rate for that offset is 1.5 cents per dollar, which means that the individual has an EMTR of 38.5 per cent.

There are already a number of tax offsets in the system, including the 'Low Income Tax Offset' ('LITO')[4] and, from 1 July this year, the new LMITO. Logically, a new offset under a system with no tax-free threshold would be merged with the LITO and the LMITO to minimise complexity.

Example

For the purposes of illustration, this example models the removal of the tax-free threshold and a re-adjustment of the current tax brackets to result in total revenue remaining the same as the Federal Budget 2018-19 estimate.

It only looks at the five major personal tax arrangements – the tax brackets, the Medicare Levy, the LITO, the LMITO and the Seniors and Pensioners Tax Offset ('SAPTO') – with other exceptions and levies dealt with in adjustments to the totals. The Medicare Levy and the SAPTO have all remained unchanged and the LMITO, the LITO and the proposed new tax offset have been merged into a single tax offset, referred to here for illustrative purposes as the LITO.

Table 1: Modelled schedule of rates

Band of income	Rate applied
$0 – $20,000	9.5%
$20,001 – $40,000	17%
$40,001 – $60,000	26%
$60,001 – $98,000	32.50%
$98,000 – $180,000	39%
$180,001+	45%

The modelled arrangements for the LITO are set so that the full benefit of offsetting all tax is felt by the same taxpayer (income of $21,595) as previous arrangements (i.e. no change between current and modelled arrangements for a person earning $21,595). The modelled LITO is $2,603 available for income earners under $37,000, reducing at 8.8 cents per dollar of income up to $66,667.

This modelled schedule of rates is used to illustrate the opportunity created by an elimination of the tax-free threshold, but has some obvious weaknesses. The accelerated taper rate means EMTR's at low incomes are too high, and higher than at middle incomes. A longer taper would resolve this issue and could be instituted while maintaining overall revenue neutrality.

[1] https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics-2015-16/?anchor=info1#info1
[2] https://grattan.edu.au/report/a-better-super-system-assessing-the-2016-tax-reforms/
[3] The maximum LMITO is $530. It applies to individuals with a taxable income of less than $90,000. It is reduced at the rate of 1.5 cents for every dollar of income above $90,000 such that it disappears altogether at $125,333
[4] The maximum LITO is $445 being the amount of tax otherwise payable on an income of $20,542. It applies to individuals with a taxable income of less than $37,000. It is reduced at the rate of 1.5 cents for every dollar of income above $37,000 such that it disappears altogether at $66,667

Modelled impact

Table 2: Individual revenue collections ($ millions)

Collection	2018-19 Budget estimate	2018-19 modelled result
Personal income rate	205,032	210,323
Medicare	17,987	17,987
LITO	(2,771)	–
SAPTO	(4,988)	(611)
LMITO	(3,640)	–
New offset	–	(16,010)
Adjustment for other arrangements	6,380	6,382
Total	**218,000**	**218,072**

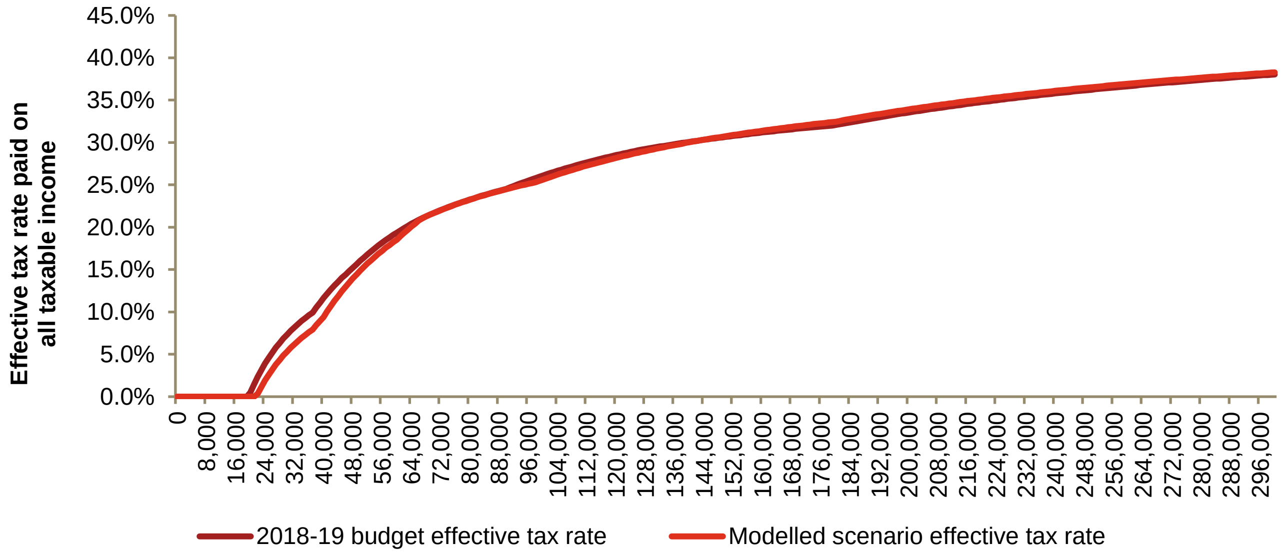
Source: PwC modelling using ATO data (2015-16 samples files) and parameters from the Australian Federal Budget 2018-19.

As expected, this shows that the amount collected on the basic rate increases, but this is offset by the expansion of the LITO for low income earners. The adjustment in the SAPTO shows that pensioners are drawing slightly more on the LITO and therefore do not need as much additional adjustment.

Figure 1 (below) shows the change to the effective tax rate (tax paid as a proportion of total taxable income) for any individual income under $300,000.

This shows a very similar outcome for most taxpayers, with a slight benefit for those individuals with incomes under $70,000 where the new offset targets the revenue gains from the removal of the tax-free threshold to the cohort that the policy is aimed at.

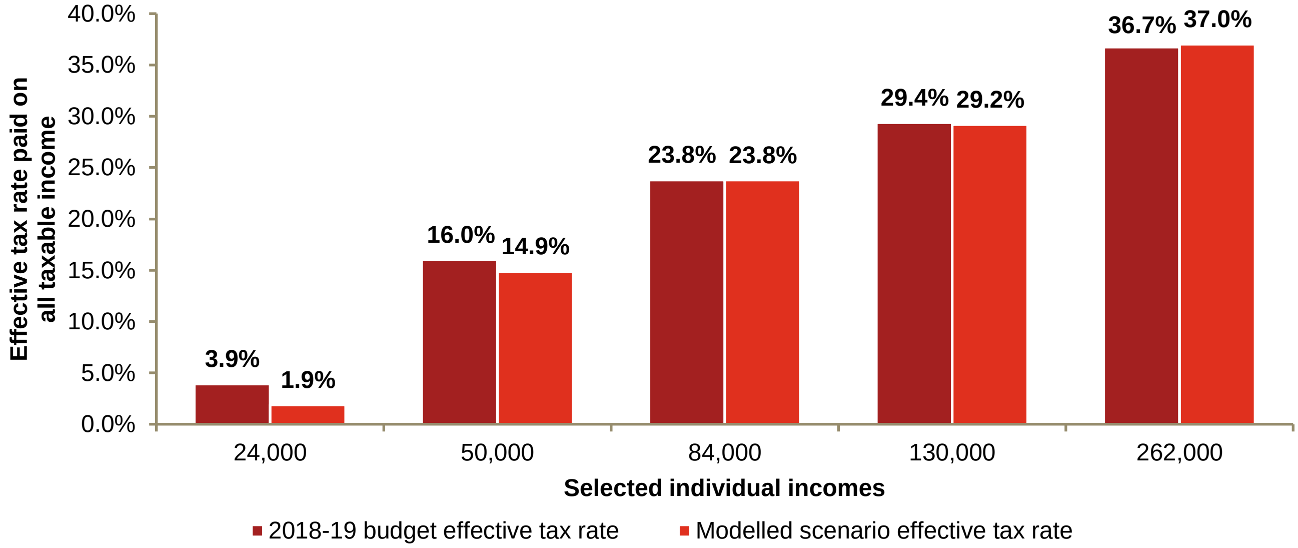
Figure 1: Effective rates paid on individual incomes in 2018-19 on budget proposals compared to scenario of removal of tax-free threshold



Source: PwC modelling using ATO data (2015-16 samples files) and parameters from the Australian Federal Budget 2018-19.
Note: Effective tax rate is calculated on taxable income (after consideration of deductions) and includes income tax, medicare levy, LITO and LMITO.

Table 3 (below) shows the change to the effective tax rate (tax paid as a proportion of total taxable income) for individuals at selected incomes (that represent quintiles of household incomes).

Table 3: Effective rates paid on selected individual incomes in 2018-19 on Federal Budget proposals compared to scenario of removal of tax-free threshold

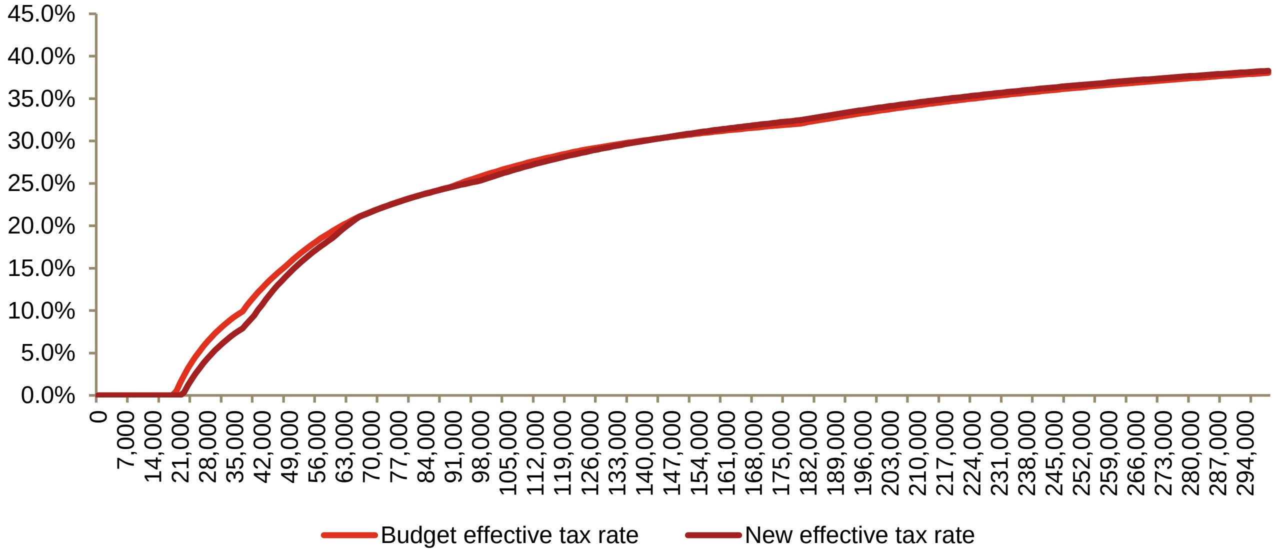


Source: PwC modelling using ATO data (2015-16 samples files) and parameters from the Australian Federal Budget 2018-19.
Note: Effective tax rate is calculated on taxable income (after consideration of deductions) and includes income tax, Medicare levy, LITO and LMITO.

Broadly speaking, the impact of the changes is to reduce the tax burden on lower income earners. This reflects the combination of lower tax rates on income in the $20,000-$60,000 range and the new tax offset. It is funded by a marginally larger tax burden for higher income earners as a result of losing access to the tax-free threshold on their first $18,200 of income and being only partly compensated by lower tax rates on income in the $20,000-$60,000 range.

This outcome is illustrated in Figure 2 (over the page) through a comparison of effective tax rates across all incomes up to $300,000.

Figure 2: Effective rates paid on individual incomes in 2018-19 on Federal Budget proposals compared to scenario of removal of tax free threshold



Conclusion

The replacement of the current tax-free threshold by a more comprehensive tax offset would facilitate much better targeting of concessional tax treatment for low income levels.

There may be concern about the response of low income earners as tax offsets may not be as well understood or as transparent as tax brackets. There could be an issue as to whether a new offset of the type necessary to compensate for the removal of the tax-free threshold would be less likely to influence the workforce participation behaviour of some individuals in the system. However, the current system already encompasses several tax offsets.

It might also be argued that a tax offset is more complex than a tax-free threshold. To take advantage of the proposed new tax offset, a taxpayer may have to file a tax return for the relevant income year and the benefit may only be received by the taxpayer in the form of a refund at a date after the tax return was filed. However, this is not seen as a major obstacle given the existing use of tax offsets in the current system. Any increase in complexity should be more than outweighed by the benefit of better targeting.