Australian Government

The Treasury

Senate Economics Legislation Committee

Submission to the inquiry into the Treasury Laws Amendment (Personal Income Tax Plan) Bill 2018

31 May 2018

CONTENTS

Introduction

The Department of the Treasury (the Treasury) welcomes the opportunity to provide a submission to the Senate Economics Legislation Committee regarding the Treasury Laws Amendment (Personal Income Tax Plan) Bill 2018.

In the 2018-19 Budget, the Australian Government (the Government) announced its seven-year Personal Income Tax Plan, which will be implemented in stages from 2018-19 to 2024-25.

The purpose of this submission is to provide information to the Committee on the Australian personal income tax system. This includes describing the difference between progressive, proportional and regressive tax systems, outlining how effective marginal tax rates are affected by the proposed changes, and explaining the limitations around medium term cost estimates of the Government's Personal Income Tax Plan.

Summary of the Government's Personal Income Tax Plan

The Government's Personal Income Tax Plan announced in the 2018-19 Budget will be implemented in three steps.

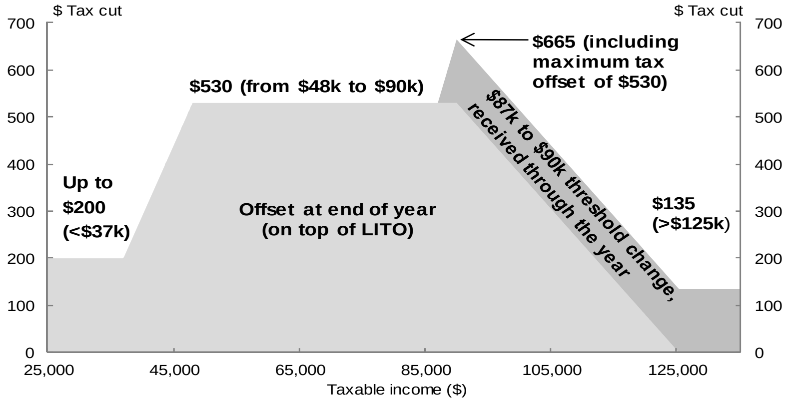
Step 1 – Introduction of a low and middle-income tax offset

A non-refundable low and middle-income tax offset will be introduced for the 2018-19, 2019-20, 2020-21 and 2021-22 income years. The offset will be received as a lump sum on assessment after an individual lodges their tax return. The offset will provide a benefit of up to $200 for taxpayers with taxable income of $37,000 or less. Between taxable incomes of $37,000 and $48,000, the value of the offset will increase at a rate of 3 cents in the dollar to a maximum benefit of $530. Taxpayers with taxable incomes from $48,000 to $90,000 will be eligible for the maximum benefit of $530. From taxable incomes of $90,001 to $125,333, the offset will phase out at a rate of 1.5 cents per dollar. Over 10 million individuals are projected to receive some benefit from the new offset, with around 4.4 million individuals projected to receive the full $530 benefit for the 2018-19 income year (Chart 1).

The offset is non-refundable which means that it can reduce an individual's income tax liability to zero, but it cannot result in a payment to the taxpayer on its own. For example, taxpayers with taxable incomes less than $37,000 will receive tax relief of up to $200. However, if the individual's income tax liability is less than $200, the offset will reduce their tax payable to nil and the benefit they receive will be less than $200. The offset cannot be used to reduce an individual's Medicare levy liability.

The low and middle-income tax offset is in addition to the low income tax offset (LITO).

Chart 1: Annual tax relief 2018–19 to 2021–22 from the offset and increasing the top threshold of the 32.5 per cent bracket



Source: Treasury.

Step 2 – Increase to thresholds

From 1 July 2018, the top threshold of the 32.5 per cent tax bracket will be increased from $87,000 to $90,000. This is expected to provide a tax cut of up to $135 per year to around 3 million people, and prevent around 200,000 Australians from paying tax at the 37 per cent marginal tax rate.

From 1 July 2022, the low and middle-income tax offset (from step 1) will be removed but the benefit it provided will remain in the system via other mechanisms. The top threshold of the 19 per cent tax bracket will be increased from $37,000 to $41,000 providing tax relief of up to $540 per year, and the low income tax offset will be increased from $445 to $645. The increased low income tax offset will be withdrawn at a rate of 6.5 cents per dollar between incomes of $37,000 and $41,000 and at a rate of 1.5 cents per dollar between incomes of $41,000 and $66,667.

In addition, from 1 July 2022, the top threshold of the 32.5 per cent tax bracket will be increased from $90,000 to $120,000 providing tax relief of up to $1,350 per year. This is projected to prevent around 1.8 million taxpayers facing the 37 per cent tax rate in 2022-23.

Step 3 – Removal of the 37 per cent tax bracket

From 1 July 2024, the top threshold of the 32.5 per cent tax bracket will be increased from $120,000 to $200,000, removing the 37 per cent tax bracket completely. The top marginal tax rate of 45 per cent will apply to taxable incomes above $200,000. At this point around 94 per cent of all taxpayers are projected to face a marginal tax rate of 32.5 per cent or less in 2024-25. This compares with a projected 63 per cent of taxpayers in 2024-25 without change to current settings.

Table 1 below shows the new personal tax rates and thresholds under the Personal Income Tax Plan in 2018-19, 2022-23 and 2024-25.

Table 1: New personal tax rates and thresholds 2018–19, 2022–23 and 2024–25

Rate (%)	Current tax thresholds Income range ($)	New tax thresholds From 1 July 2018 Income range ($)	New tax thresholds From 1 July 2022 Income range ($)	New tax thresholds From 1 July 2024 Income range ($)
Tax free	0 - 18,200	0 - 18,200	0 - 18,200	0 - 18,200
19	18,201 - 37,000	18,201 - 37,000	18,201 - 41,000	18,201 - 41,000
32.5	37,001 - 87,000	37,001 - 90,000	41,001 - 120,000	41,001 - 200,000
37	87,001 - 180,000	90,001 - 180,000	120,001 - 180,000	-
45	>180,000	>180,000	>180,000	>200,000
Low and middle income tax offset	-	Up to 530	-	-
LITO	Up to 445	Up to 445	Up to 645	Up to 645

Australia's personal income tax system

Personal income tax accounts for a significant share of Commonwealth tax receipts, raising around $187 billion in 2015-16 and $194 billion in 2016-17. Personal income tax has consistently raised around half of the Commonwealth Government's tax receipts since the 1970s, and raised around 52 per cent in 2015-16 and 51 per cent in 2016-17. As a proportion of gross domestic product (GDP), this equates to around 11 per cent in both 2015-16 and 2016-17. Other major contributing tax bases to Commonwealth tax receipts in 2015-16 include company tax $63 billion; GST $57 billion (which goes to the States and Territories); and excise and customs duty $35 billion.[1]

Table 2 compares Australia's personal income tax revenue as a share of total tax revenue and GDP with select OECD countries and the OECD average. In 2015, personal income tax accounted for 41.5 per cent of the tax revenue raised by all levels of government in Australia and 11.7 per cent of GDP. This compares with the OECD average of 24.4 per cent and 8.4 per cent respectively.

Table 2: OECD Revenue Statistics, 2015

Country	Personal income tax as a per cent of total tax revenue (all levels of government)[a]	Personal income tax as a per cent of GDP (all levels of government)[b]
Australia	41.5	11.7
Canada	36.9	11.8
New Zealand	38.1	12.6
United Kingdom	27.7	9.0
United States	40.5	10.6
OECD Average	24.4	8.4

Source: OECD Revenue Statistics – OECD countries: Comparative tables. [a]Personal income tax includes taxes on income, profits and capital gains of individuals collected by all levels of government as a per cent of total tax revenue collected by all levels of government. [b]Personal income tax as a per cent of GDP includes taxes on income, profits and capital gains of individuals collected by all levels of government as a per cent of the country's GDP. The OECD only prepares statistics on tax structures on an accrual basis and for a calendar year (1 Jan to 31 Dec). Personal income tax includes fringe benefits tax. These statistics are not directly comparable with the tax receipts figures from the Final Budget Outcome in the text above.

[1] Commonwealth tax receipts in this paragraph are from the 2015-16 and 2016-17 Final Budget Outcome. Due to a difference in accounting treatment, these may be different to those recorded in the ATO Taxation Statistics 2015-16.

In 2015-16 (the latest ATO Taxation Statistics), there were around 10.1 million taxpayers in the personal income tax system. In this context, a taxpayer is someone who lodged a tax return and paid more than $0 in personal income tax for the year. Table 3 shows how these taxpayers were distributed across the 2015-16 income tax brackets. The table also shows the proportion of total taxable income and tax paid within each bracket. It shows for example that the 416,000 taxpayers with taxable incomes over $180,000 together had taxable incomes totalling $143.7 billion and together paid $56.4 billion in tax.

Table 3: Distribution of taxpayers across income ranges, 2015-16

Taxable income range	Number of taxable individuals	Share of taxable individuals	Taxable income ($b)	Share of taxable income	Personal income tax payable ($b)	Share of personal income tax
$18,200 or less	45,000	0.4%	0.3	..	0.1	..
$18,201 to $37,000	2,287,000	22.5%	66.4	8.8%	4.4	2.3%
$37,001 to $80,000	4,988,000	49.1%	277.0	36.7%	51.3	27.5%
$80,001 to $180,000	2,415,000	23.8%	267.0	35.4%	74.1	39.8%
Over $180,000	416,000	4.1%	143.7	19.0%	56.4	30.3%
Total	10,151,000	100.0%	754.4	100.0%	186.3	100.0%

Source: ATO Taxation Statistics 2015-16 Individuals Table 4; '..' rounds to zero. The figures above are based on tax returns lodged by 31 October 2017. In this context, a personal income taxpayer is someone who lodged a tax return and paid more than $0 in personal income tax for the year.

Current structure of the personal income tax system

Income that is subject to tax in the personal income tax system is called 'taxable income', which is broadly gross personal income less any expenses (deductions) incurred in generating that income. The amount of tax that people pay on their taxable income is primarily determined by the schedule of marginal rates and thresholds. It can also be either increased by levies or reduced by any concessions or offsets for which a person is either liable or eligible.

Australia has a high tax-free threshold followed by increasing marginal tax rates at subsequent thresholds (see Table 4 below). The rate specified at each tax bracket is the 'marginal' tax rate, which is the amount of tax payable on a taxpayer's next dollar of taxable income.

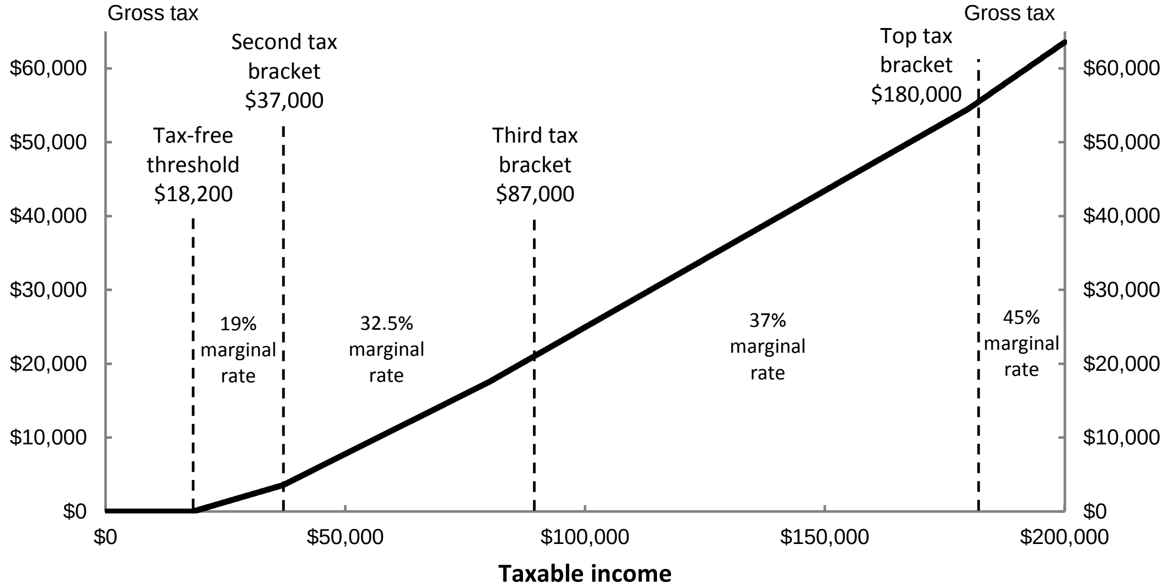
Table 4: Schedule of marginal rates and thresholds, 2017-18

Taxable income	Tax on this income
0 - $18,200	Nil
$18,201 - $37,000	19c for each $1 over $18,200
$37,001 - $87,000	$3,572 plus 32.5c for each $1 over $37,000
$87,001 - $180,000	$19,822 plus 37c for each $1 over $87,000
$180,001 and over	$54,232 plus 45c for each $1 over $180,000

Note: The above rates do not include the Medicare levy of 2%.

Australians with incomes below $18,200 pay no personal income tax (note that this does not include the LITO, see page 7). As an individual's income increases and they move into higher tax brackets, they will pay more tax on every extra dollar they earn. Chart 2 shows tax payable based on the schedule of marginal rates and thresholds (Table 4), that is, gross tax.

Chart 2: Gross tax payable by taxable income, 2017-18



Note: Gross tax is the tax payable based solely on the statutory marginal tax rate schedule (Table 4). Gross tax does not include any levies (such as the Medicare levy) or any offsets.

What are average tax rates and how do they differ from marginal tax rates?

The concepts of average and marginal tax rates are often confused. This section considers the schedule of marginal rates and thresholds in Table 4 above (ignoring the impact of any levies such as the Medicare levy or offsets in the tax system).

A marginal tax rate is the additional tax an individual would need to pay if they earned another dollar of taxable income. An individual's average tax rate is the proportion of an individual's total income they will need to pay in tax. That is, their total tax obligation divided by their total taxable income.

For illustrative purposes, consider two people, Person A with $40,000 in taxable income and Person B with $80,000 in taxable income (Chart 3). Both face a marginal tax rate of 32.5 per cent (they are both in the $37,000 to $87,000 or 32.5 per cent tax bracket). They both pay tax of $3,572 on their first $37,000 of taxable income and 32.5 cents for each dollar earned above that. Person A pays tax of $4,547 with an average tax rate of 11.4 per cent. Person B pays tax of $17,547 with an average tax rate of 21.9 per cent. Person B earns twice as much as Person A, but pays almost four times as much tax, and contributes almost double the share of their income in gross tax.[2]

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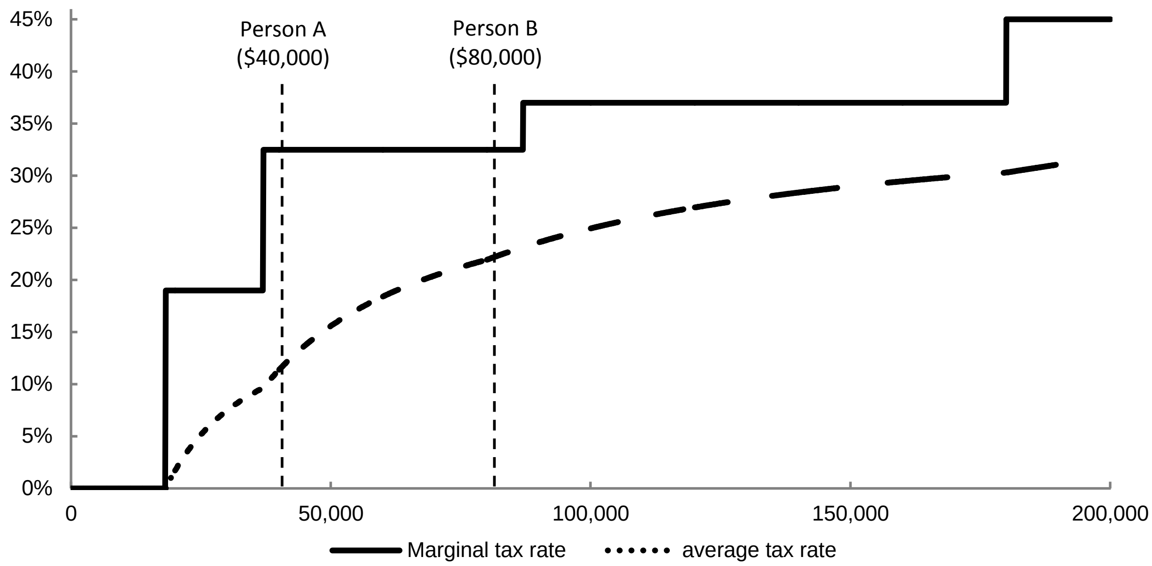
[2] References to tax paid, marginal tax rates and average tax rates in this paragraph do not take into account the impact of any levies or offsets in the tax system. They are based solely on the statutory marginal rate schedule (Table 4).

Chart 3: Marginal and average tax rates by taxable income, 2017-18



Notes: Marginal tax rates and average tax rates in this chart are based solely on the statutory marginal rate schedule (Table 4). This a simplified example of the personal income tax system and is not intended to be consistent with the estimates of personal income tax payable in 2017-18 published in the 2018-19 Budget papers. The estimates in budget papers take into account the marginal rate schedule, Medicare levy and the LITO in estimating income tax payable for individuals in 2017-18.

Because all Australian taxpayers benefit from the tax free threshold, their average tax rate will be below their marginal tax rate.

How do changes to tax thresholds and marginal rates affect taxpayers?

The tax thresholds are fixed, which means that they do not automatically keep pace with either inflation or wage growth. Bracket creep (also called fiscal drag) refers to the fact that taxpayers will face higher average, and sometimes marginal, tax rates over time even if their income has only increased by inflation.

Increases to tax thresholds provide a tax cut to taxpayers earning above the current threshold. For example, increasing the top threshold of the 32.5 per cent tax bracket from $87,000 to $90,000 provides tax relief of up to $135 for taxpayers earning above $90,000. Only taxpayers earning between $87,000 and $90,000 face a lower marginal tax rate (32.5 per cent instead of 37 per cent), but all taxpayers earning above $87,000 benefit, with those earning $90,000 or higher receiving the greatest benefit of $135.

Reducing marginal tax rates provides tax relief to all taxpayers in and above the tax bracket.

What are tax offsets and how do they affect tax paid?

Tax offsets reduce a person's tax liability.

A non-refundable tax offset can reduce an individual's tax liability to zero, but will not provide a benefit if their tax liability is already zero (for example, because their taxable income falls below the tax-free threshold). A non-refundable tax offset may increase the tax refund an individual would normally have received in the current system based on tax paid through the year through pay as you go (PAYG) withholding.

The main tax offset that is a structural part of the personal income tax system is the LITO. The LITO is available to Australian residents and cannot be used to reduce the Medicare levy (the low and middle-income tax offset would operate in the same manner). The ATO works out the offsets for taxpayers when they lodge their tax returns, so the offsets do not need to be specifically claimed.

The LITO provides tax relief of up to $445 for individuals with taxable income up to $37,000, with the offset then gradually withdrawn after that. Combined with the $18,200 tax-free threshold, this means that eligible recipients generally do not begin to pay income tax until their taxable income exceeds $20,542 (their *effective* tax-free threshold). The benefit of the LITO is withdrawn at a rate of 1.5 cents in the dollar from $37,000 and is fully withdrawn for people with taxable income in excess of $66,667. This means only taxpayers with taxable income less than $37,000 receive the benefit of the effective tax-free threshold of $20,542. Those with taxable income above $66,667 have a tax-free threshold of $18,200.

The Government's low and middle-income tax offset will operate in a similar way. For the 2018-19, 2019-20, 2020-21 and 2021-22 income years, the offset will provide tax relief of up to $200 for individuals earning up to $37,000. Combined with the $18,200 tax-free threshold and the LITO, the additional $200 means that eligible recipients will not begin to pay tax until their taxable income exceeds $21,595. The benefit of the low and middle-income tax offset increases and decreases depending on an individual's taxable income in a similar way to the LITO. The benefit of the low and middle-income tax offset is fully withdrawn for individuals with taxable income in excess of $125,333.

Goals for the Australian personal income tax system

The aim of the tax system is to raise revenue as simply as possible, while also being fair and efficient.

What is fair is a subjective concept, but there has been broad agreement for many years that vertical equity is a goal to be aspired to. The 1975 Asprey review said:

> *As a quality of a tax or a tax system everyone demands fairness…'vertical' equity [means] those in different situations [should be] differently treated, with those more favourably placed being required to pay more.*

A *progressive* personal income tax system has long been seen as an important part of Australia's tax (and transfer) system. The community accepts that it is 'fair' that individuals contribute more tax as their ability to pay increases. However, personal tax systems also have other objectives. Different forms of incomes may be taxed differently to facilitate policy objectives—such as investment or saving. Taxes should also be as efficient as possible. Apart from taxes designed to provide specific incentives, an efficient tax has a minimal influence on individuals' behaviour and decision-making so that the decisions individuals make are unaffected by the taxes themselves.

Progressivity raises trade-offs among the tax system objectives of equity and efficiency. For instance, higher marginal tax rates can act as a disincentive to work, save and invest so that systems with higher marginal tax rates—and a greater distance between marginal and average tax rates—tend to generate greater inefficiencies.

Progressivity of the Australian personal income tax system

A tax can apply to a taxpaying population in one of three ways:

- it is progressive if the average rate of tax increases as the base (for example income or expenditure) increases;

- it is proportional if the average rate of tax is constant; and
- it is regressive if the average rate of tax decreases as the base increases.

Charts 4a and 4b depict a progressive tax, a proportional tax and a regressive tax on an income tax base, measured by the average tax rate and tax paid. Despite the average tax rate curves (Chart 4a) having a fundamentally different character, all three can deliver a tax where actual tax paid increases as the base increases (Chart 4b).

Chart 4a. A stylised proportional, progressive and regressive tax, measured by average tax rate

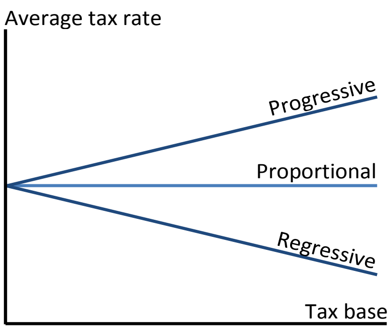
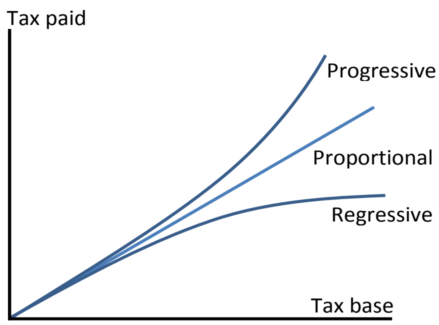


Chart 4b. A stylised proportional, progressive and regressive tax, measured by tax paid



While Australia has flat marginal tax rates over ranges of income, it has a progressive tax system because the average rate of tax increases as taxable income increases. This feature means that two individuals with different levels of income can face the same marginal tax rate, while the individual with a higher income will face a higher average tax rate (this is illustrated in Chart 3 on page 6). The average tax rate determines an individual's total return from earning income, while the marginal tax rate determines the return from earning additional income. The OECD has said that 'reducing average labour taxes could be desirable for raising participation, while lowering marginal tax rates may be preferable for increasing hours worked.'[3]

The degree of progressivity in the personal income tax system is a decision for governments, based on their judgement of societal expectations of fairness (which change over time) and their objectives for the tax system.

Effective marginal tax rates (EMTRs)

What is an EMTR?

EMTRs measure the proportion of additional private income earned that is forgone due to income taxes and the withdrawal of means tested Government cash benefits. They measure how much a marginal change in income flows on to take home pay.

[3] Johansson, A., C. Heady, J. Arnold, B. Brys and L. Vartia (2008), 'Tax and Economic Growth', OECD *Economics Department Working Paper* No. 620.

Why do EMTRs matter?

Essentially EMTRs measure the financial disincentives associated with earning additional income. In particular, high EMTRs mean individuals receive little financial benefit from undertaking additional work. This means high EMTRs can act as disincentives to labour force participation.

EMTRs themselves do not tell us how people will alter their behaviour in response to changes in the tax and transfer system. This depends on **labour supply elasticities**, which measure how much individuals will increase (or decrease) their labour supply in response to an increase (or decrease) in their after tax wage.

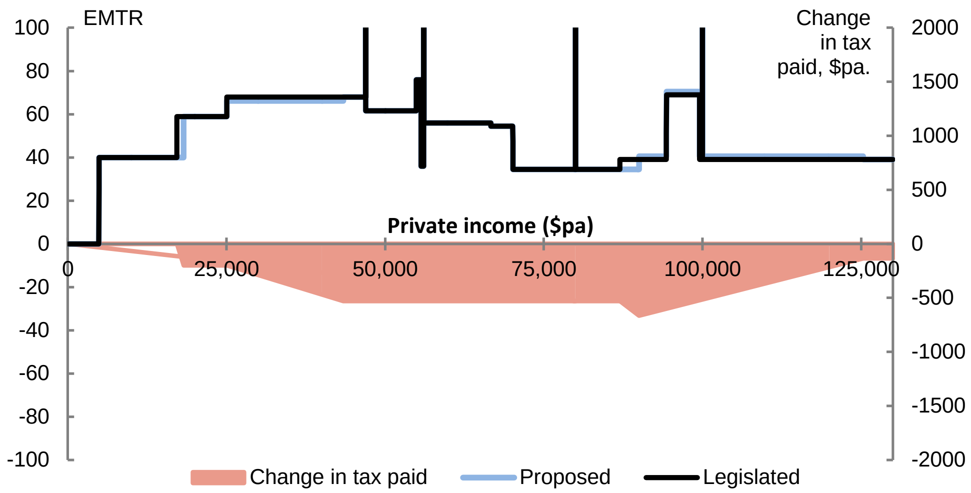
Increasing EMTRs for individuals with low labour supply elasticities may not be a problem, as these individuals are unlikely to change their behaviour in response to the change in EMTRs. Conversely, reducing EMTRs for those with elastic labour supply is more likely to see households increase their labour supply.

The Australian literature suggests that labour supply elasticities are highest for single parents, and those with relatively low wages, or low levels of educational attainment.[4]

What does the tax plan do to EMTRs in 2018-19?

The changes in EMTRs associated with the first phase of the Personal Income Tax Plan are minor, compared with the overall EMTRs that households face. For illustrative purposes, Chart 5 below compares the EMTRs of a single parent household in 2018-19 under legislated policy (in black) with the Personal Income Tax Plan (blue). While the private incomes at which EMTRs change and the size of the changes are dependent on household characteristics, the pattern described below for the single parent household, is broadly illustrative of the effect of the tax plan on EMTRs for all individuals.

Chart 5: EMTR in 2018-19, Sole parent eligible for parenting payment, with one child



Source: Treasury.

The introduction of low and middle-income tax offset will extend the current effective tax free threshold (equal to the benefit provided by the statutory tax free threshold of $18,200 and

[4] Dandie, S. and Mercante, J. (2007), *Australian Labour Supply Elasticities: Comparison and Critical Review*, Treasury Working Paper 2007-04 (October 2007).

reduction in tax paid from both the LITO of $445 and the Seniors and Pensioners Tax Offset (SAPTO) of $2,230) for a single parenting payment recipient from a taxable income of $32,279 to $32,914, reducing EMTRs over this income range by 19.8 percentage points. This corresponds with private incomes between around $17,200 and $18,250.

For the single parenting payment recipient, there is then a small decrease in EMTRs of 1.8 percentage points over the range of taxable income from $37,000 to $48,000 as the low and middle-income tax offset is increased incrementally from its base rate of $200 to its maximum value of $530. This corresponds with private incomes between around $25,060 and $43,400.

In 2018-19, the threshold at which the 37 per cent tax rate applies is increased from $87,000 to $90,000, resulting in a decrease in EMTRs of 4.5 percentage points over this income range.

There is a small increase in EMTRs (of 1.5 percentage points) over the period the low and middle-income tax offset phases out for taxable incomes between $90,000 and $125,334. Given the small magnitude of this increase, this is likely to have a negligible impact on participation incentives.

While EMTRs will be slightly higher over some income ranges, the tax cut received by taxpayers means that they are still better off financially under the changes.

From 2022-23, the plan will cause EMTRs to be lower or unchanged when compared with the EMTRs that would apply without the plan.

Budget impact of the Personal Income Tax Plan

The introduction of the Personal Income Tax Plan has a cost to revenue of $13.4 billion over the period of 2018-19 to 2021-22 (the forward estimates period), of which around $11.65 billion is associated with the introduction of the low and middle-income tax offset, while around $1.75 billion is due to extending the top threshold of the 32.5 per cent tax bracket from $87,000 to $90,000. This is outlined in the table below.

Table 5: Cost of the Personal Income Tax Plan to 2021-22

	Costing				
Revenue/receipts ($m)	**2018-19**	**2019-20**	**2020-21**	**2021-22**	**Total to 2021-22**
Total - Personal Income Tax Plan	**-360**	**-4,120**	**-4,420**	**-4,500**	**-13,400**
Introduce the low and middle-income tax offset*	-	-3,700	-3,950	-4,000	-11,650
Increase the top threshold of the 32.5% tax bracket from $87,000 to $90,000	-360	-420	-470	-500	-1,750

*This offset will be available for the 2018-19, 2019-20, 2020-21, and 2021-22 income years, and will be received as a lump sum on assessment.

On 29 May 2018, the Treasury provided to the Senate Economics Legislation Committee (at the Senate Estimates hearing) a range of information, including material on the medium term costing of the Personal Income Tax Plan. A copy of this information can be found here: https://static.treasury.gov.au/uploads/sites/1/2018/05/Senate-Estimates-May-2018-Attachment-1.pdf

Estimates beyond 2018-19 to 2021-22 (the forward estimates period) incorporate a range of medium term assumptions that carry a higher amount of uncertainty. These projections include assumptions regarding income levels and distributions, demographics and economic conditions.

Estimates made further into the future become increasingly sensitive to the underlying projections and are subject to heightened uncertainty. As such, rather than providing year by year estimates we have provided results aggregated over the medium term as a guide to the estimated cost of the plan.

These estimates are prepared before considering the tax-GDP cap. As shown in Chart 2 in Box 2 in Budget Statement 3 of Budget Paper No. 1, under the Personal Income Tax Plan tax receipts are projected to be below 23.9 per cent of GDP until 2026-27, while without the Personal Income Tax Plan receipts would exceed 23.9 per cent of GDP from 2021-22.