Senator the Hon. Jane Hume, MP
Chair
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

7 June 2018

Dear Senator

Submission to Senate Standing Committees on Economics regarding the Personal Income Tax Plan

We are pleased to submit this letter in response to the Senate Standing Committees on Economics' (the **Committee**'s) inquiry regarding the *Treasury Laws Amendment (Personal Income Tax Plan) Bill 2018* [Provisions] (the **Bill**). The effect of this Bill is to enact the Personal Income Tax Plan (**PITP**) announced by the Government in the 2018-19 Federal Budget. We understand that submissions to the Committee regarding the Bill were due on 25 May 2018 and we apologise that our submission is late.

In short, we support all three stages of the Government's proposed PITP. Broadly, we view the combined effect of the measures introduced through the PITP as achieving a key objective of Australian tax reform: easing the growing incidence of tax borne by individual taxpayers which arises from bracket creep pressure. Importantly, the PITP delivers this relief while preserving the essential element of progressivity within the Australian personal income system.

PwC has modelled the expected cumulative impact of the three stages of the Government's proposed PITP and considered the changes to the effective rates of tax paid as well as the amount of tax contributed by particular categories of individual taxpayer (both in dollar terms and as a proportion of the Government's total tax receipts).

This modelling demonstrates that the first stage of the Government's PITP policy provides relief both in terms of effective marginal tax rate (**ETR**) and amount of tax paid directly to low and middle income taxpayers. The second stage then relieves the mounting pressure of 'bracket creep' on Australian middle income taxpayers (the negative impacts of which have been well understood and commented upon[1]). The third and last stage of the PITP then extends this relief by expanding the scope of the relief from bracket creep to those taxpayers on higher incomes (while preserving the central characteristic of progressivity within the system for top income earners).

[1] PBO, *Changes in average personal income tax rates: distributional impacts*, No 3 of 2017, 11 October 2017.

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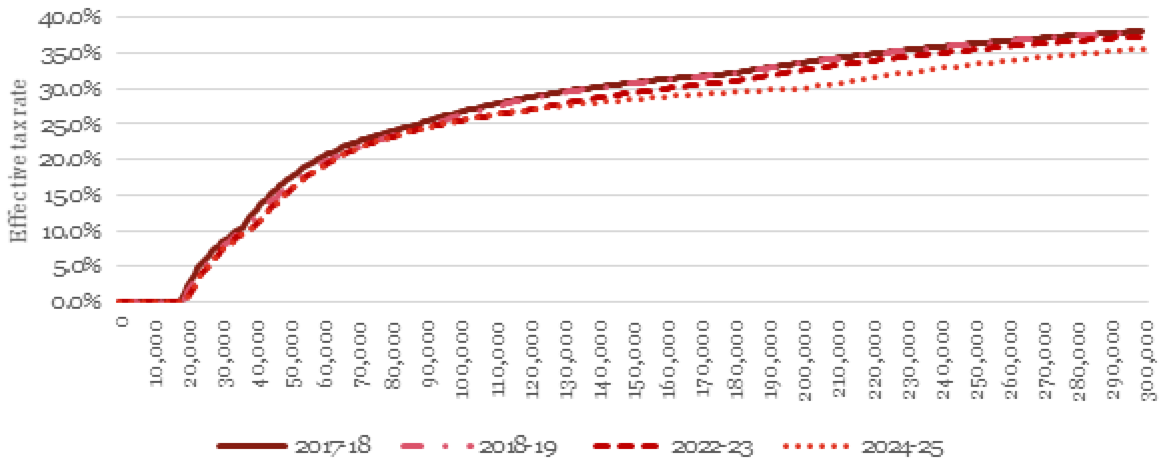
The graph below (Figure 1) shows the anticipated effective tax rates paid by individuals across a range of annual income levels for various years of income starting from when the PITP begins to take effect on 1 July 2018. This graph demonstrates the cumulative impact of all three stages of the PITP as they are gradually introduced over the period spanning the 2018-19 to 2024-25 income years.

Figure 1: Effective rates paid on individual incomes before and after budget proposals



Source: PwC modelling using unpublished ATO data (2015-16 samples files) and parameters from Budget 2018-19
Note: Effective tax rate is calculated on taxable income (after consideration of deductions) and includes income tax, medicare levy, low income tax offset and low and medium tax offset

The immediate impact of the PITP's first stage (effective from 1 July 2018) is that low and middle income taxpayers benefit from lower effective marginal rates of tax, without a discernible change for taxpayers on higher incomes. The bulk of the benefit provided to middle and higher income earners is delayed until the 2022-23 income year, when the PITP extends this relief to middle income taxpayers by easing the bracket creep pressure for these taxpayers.

There are effective tax rate benefits that arise for taxpayers on higher incomes in the long term, however over the term of the PITP the top 20 per cent of taxpayers pay an average of 60.3 per cent of the total revenue collected from individuals (compared with 60.9 per cent in 2017-18). The amount of tax paid by the top 20 per cent of taxpayers increases year-on-year during the period of the PITP, as would be expected from a system that maintains progressive tax rates for taxpayers on high incomes.

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While Budget Paper No. 2 2018-19 seeks to describe the measures included in the PITP by their intended effect, we have opted to describe these measures by their impact on the legislative mechanics of Australia's tax laws. To that end, for the purposes of this paper we consider the PITP contemplates three distinct steps, namely:

1. Introducing the Low and Middle Income Tax Offset (**LMITO**) from 1 July 2018;
2. Adjusting the 32.5 per cent income tax bracket in the 2023-24 income year; and
3. Eliminating the 37 per cent income tax bracket from 1 July 2024.

We discuss each of these measures in turn under the headings below.

Step 1: Introducing the LMITO from 1 July 2018

The first step in the Government's PITP is introducing the LMITO, a non-refundable tax offset of up to $530 to Australian resident low and middle income taxpayers. Currently the LMITO is only available in income years ending on 30 June 2019 to 30 June 2022 and will be received as a lump sum on assessment after an individual lodges their tax return (meaning the PITP's benefit will be delivered as a single payment, rather than gradually inflating taxpayers' disposable incomes throughout the year). The LMITO will be available in addition to the existing Low Income Tax Offset (**LITO**).

The amount of the LMITO is up to $200 for taxpayers with taxable income of $37,000 or less, increasing by three cents per dollar up to $48,000 and capped at $530 for taxable incomes up to $90,000. From $90,000 to $125,333 the LMITO will be withdrawn at a rate of 1.5 cents per dollar earned above $90,000.

The modelling of effective tax rates paid before and after the introduction of the LMITO is included below at Figure 2. The same modelling in respect of proportion of total tax contributed is included below at Figure 3. This information is based on all individuals who pay an amount of tax after offsets, and therefore does not include individuals who complete a tax return but have no tax liability (after offsets).

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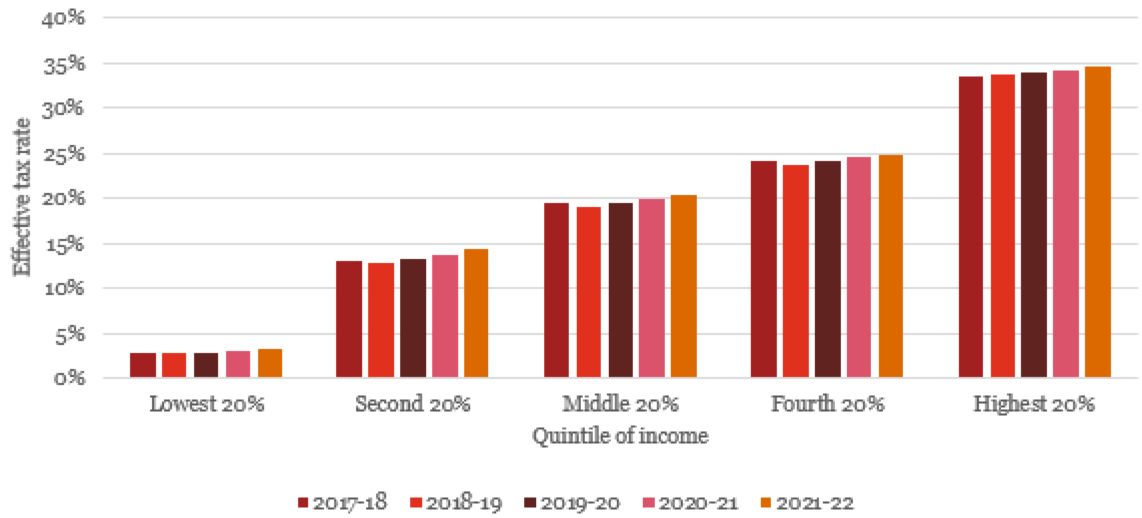
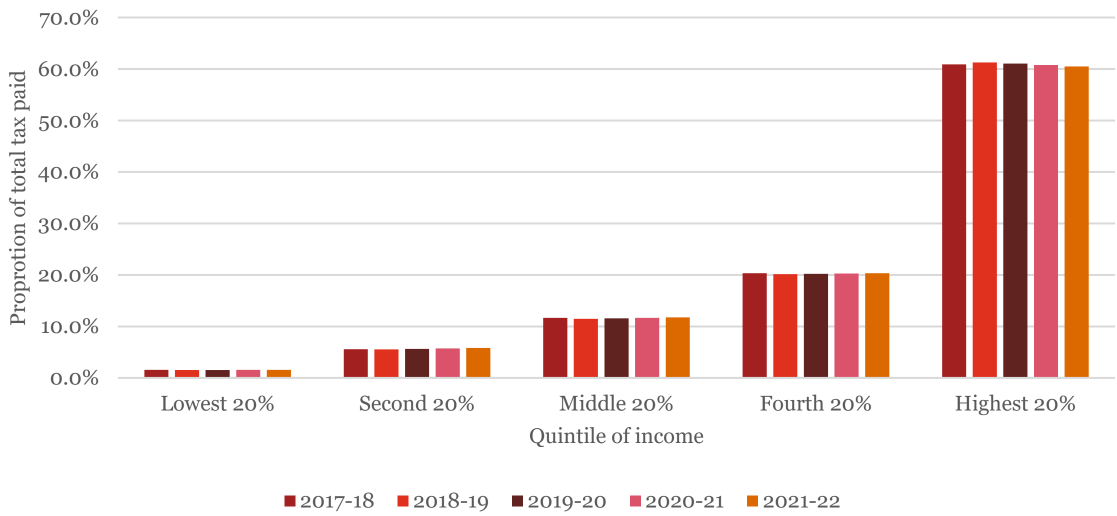
Figure 2: Effective tax rate paid by individuals in each quintile of income, before and after budget proposal



Source: PwC modelling using unpublished ATO data (2015-16 samples files) and parameters from Budget 2018-19
Note: Effective tax rate is calculated on taxable income (after consideration of deductions) and includes income tax, medicare levy, low income tax offset, low and medium tax offset and seniors and pensioners tax offset. Deciles are calculated on taxable income. Quintiles are calculated by tax paid, including only individuals that pay greater than zero tax after offsets.

Figure 3: Proportion of total tax revenue contributed by quintile of income, before and after budget proposals



Source: PwC modelling using unpublished ATO data (2015-16 samples files) and parameters from Budget 2018-19
Note: Tax paid is calculated on taxable income (after consideration of deductions) and includes income tax, medicare levy, low income tax offset, low and medium tax offset and seniors and pensioners tax offset. Quintiles are calculated by tax paid, including only individuals that pay greater than zero tax after offsets.

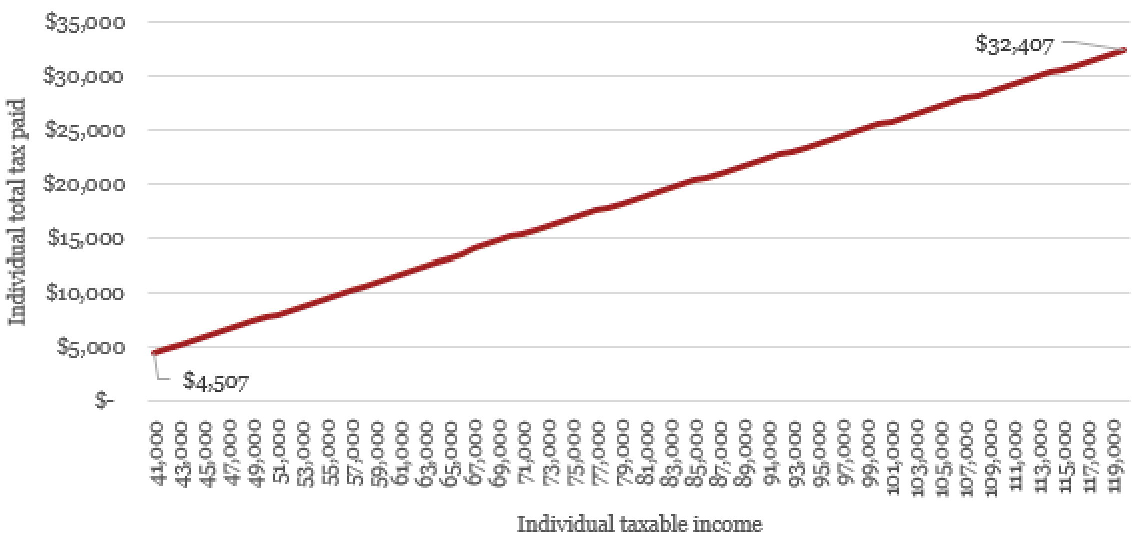
Step 2: Adjusting the 32.5 per cent income tax bracket in the 2023-24 income year

Under Step 2 of the PITP the Government will adjust the upper and lower bands of the 32.5 per cent income tax bracket, effectively lifting the upper range of the 19 per cent tax bracket in the process. Currently, the 32.5 per cent rate applies to taxable incomes earned in excess of $37,000 up to $87,000. From 1 July 2018 the Government will increase the top threshold of the 32.5 per cent personal income tax bracket from $87,000 to $90,000. Then, from 1 July 2022 the Government will increase the LITO from $445 to $645 and lift the upper end of the 19 per cent personal income tax bracket (or the lower end of the 32.5 per cent income tax bracket) from $37,000 to $41,000 to lock in the benefits of Step 1. 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.

From 1 July 2022, the Government will further increase the top threshold of the 32.5 per cent personal income tax bracket from $90,000 to $120,000.

Figure 4 highlights the tax contributions that arise within the 32.5 per cent tax bracket in the 2022-23 income year, with tax paid of $4,507 at the lower end of the income range and $32,407 tax paid by individuals at the high end of the income range:

Figure 4: Tax paid ($ per individual at each income rate) in the 32.5% marginal tax rate bracket, 2022-23



Source: PwC modelling using unpublished ATO data (2015-16 samples files) and parameters from Budget 2018-19
Note: Tax paid is calculated on taxable income (after consideration of deductions) and includes income tax, medicare levy, low income tax offset and low and medium tax offset.

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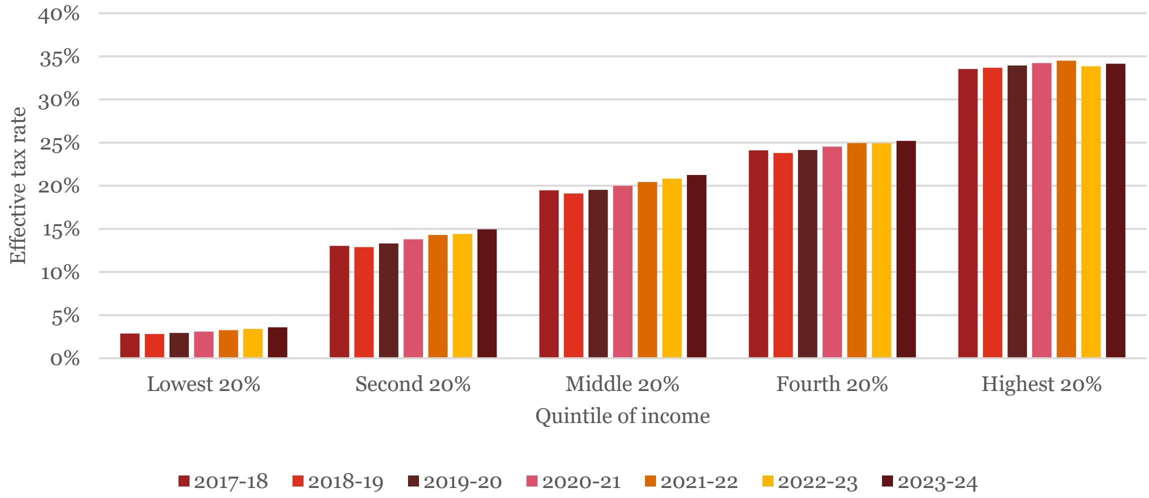
The modelling of the effective tax rate paid and the proportions of total tax collected from individuals is included below in Figure 5 and Figure 6 respectively. This information is based on all individuals who pay an amount of tax after offsets, and therefore does not include individuals who complete a tax return but have no tax liability (after offsets).

Figure 5: Effective tax rate paid by individuals in each quintile of income, before and after budget proposal



Source: PwC modelling using unpublished ATO data (2015-16 samples files) and parameters from Budget 2018-19
Note: Effective tax rate is calculated on taxable income (after consideration of deductions) and includes income tax, medicare levy, low income tax offset, low and medium tax offset and seniors and pensioners tax offset. Deciles are calculated on taxable income. Quintiles are calculated by tax paid, including only individuals that pay greater than zero tax after offsets.

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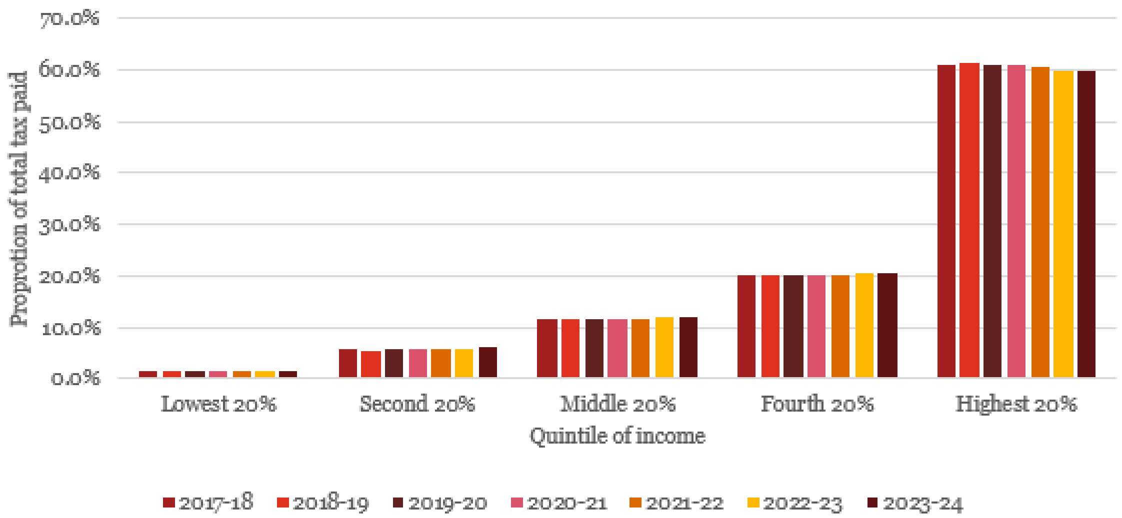
Figure 6: Proportion of total tax revenue contributed by quintile of income, before and after budget proposals



Source: PwC modelling using unpublished ATO data (2015-16 samples files) and parameters from Budget 2018-19
Note: Tax paid is calculated on taxable income (after consideration of deductions) and includes income tax, medicare levy, low income tax offset, low and medium tax offset and seniors and pensioners tax offset. Quintiles are calculated by tax paid, including only individuals that pay greater than zero tax after offsets.

Step 3: Eliminating the 37% income tax bracket from 1 July 2024

In the third step of the Personal Income Tax Plan the Government will simplify and flatten the personal tax system by removing the 37 per cent tax bracket entirely.

From 1 July 2024, the Government will extend the top threshold of the 32.5 per cent personal income tax bracket from $120,000 to $200,000, to recognise inflation and wage growth impacts. The 32.5 per cent tax bracket will apply to taxable incomes of $41,001 to $200,000.

The modelling of the effective tax rate paid and the proportions of total tax collected from individuals is included below in Figure 7 and Figure 8 respectively. This information is based on all individuals who pay an amount of tax after offsets, and therefore does not include individuals who complete a tax return but have no tax liability (after offsets).

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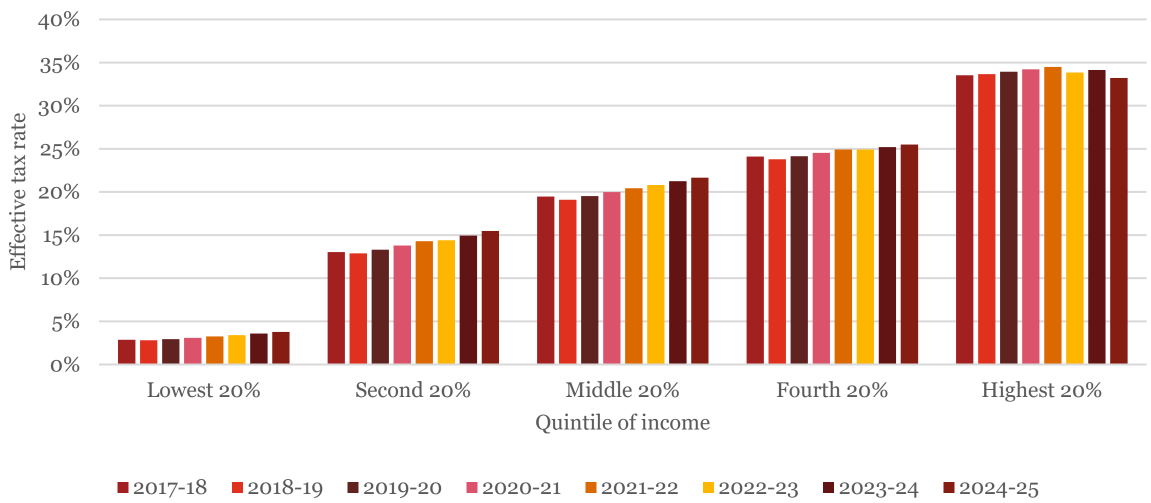
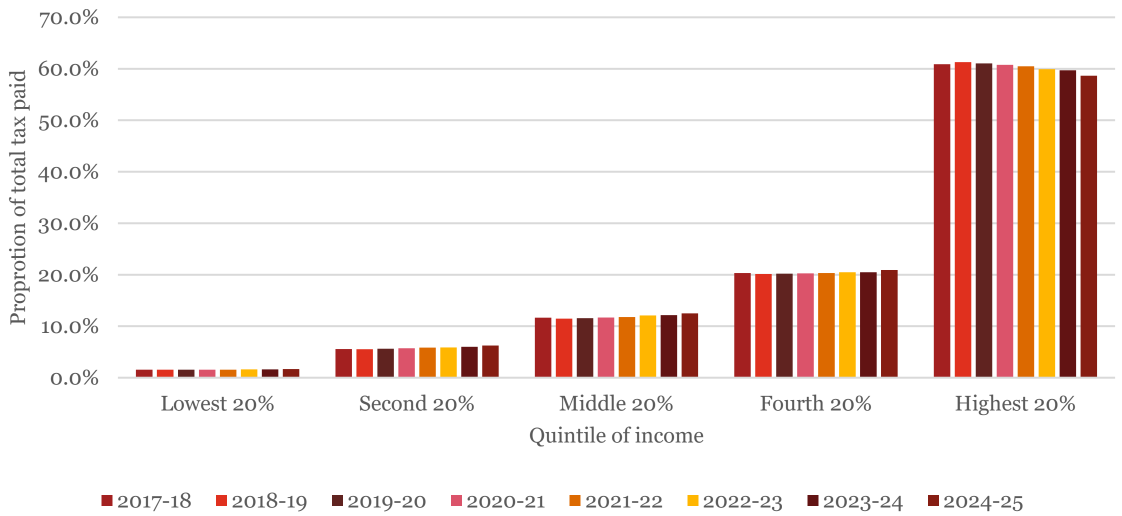
Figure 7: Effective tax rate paid by individuals in each quintile of income, before and after budget proposal



Source: PwC modelling using unpublished ATO data (2015-16 samples files) and parameters from Budget 2018-19
Note: Effective tax rate is calculated on taxable income (after consideration of deductions) and includes income tax, medicare levy, low income tax offset, low and medium tax offset and seniors and pensioners tax offset. Deciles are calculated on taxable income. Quintiles are calculated by tax paid, including only individuals that pay greater than zero tax after offsets.

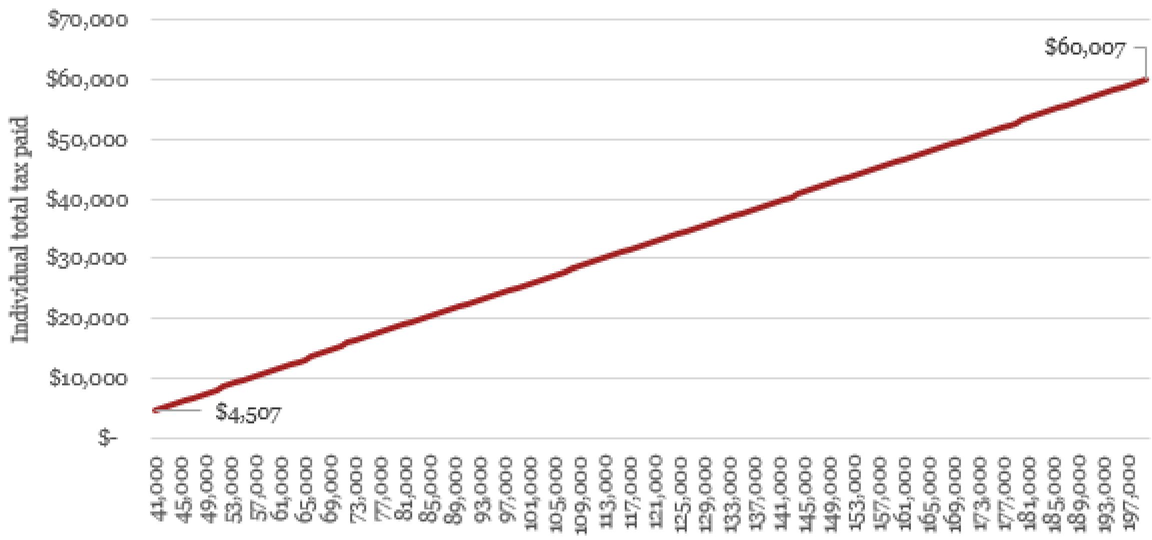
Figure 8: Proportion of total tax revenue contributed by quintile of income, before and after budget proposals



Source: PwC modelling using unpublished ATO data (2015-16 samples files) and parameters from Budget 2018-19
Note: Tax paid is calculated on taxable income (after consideration of deductions) and includes income tax, medicare levy, low income tax offset, low and medium tax offset and seniors and pensioners tax offset. Quintiles are calculated by tax paid, including only individuals that pay greater than zero tax after offsets.

Figure 9 highlights the tax contributions that arise within the 32.5 per cent tax bracket in the 2024-25 income year, with tax paid of $4,507 at the lower end of the income range and $60,007 tax paid by individuals at the high end of the income range:

Figure 9: Tax paid ($ per individual at each income rate) in the 32.5% marginal tax rate bracket, 2024-25



Source: PwC modelling using unpublished ATO data (2015-16 samples files) and parameters from Budget 2018-19
Note: Tax paid is calculated on taxable income (after consideration of deductions) and includes income tax, medicare levy, low income tax offset and low and medium tax offset.

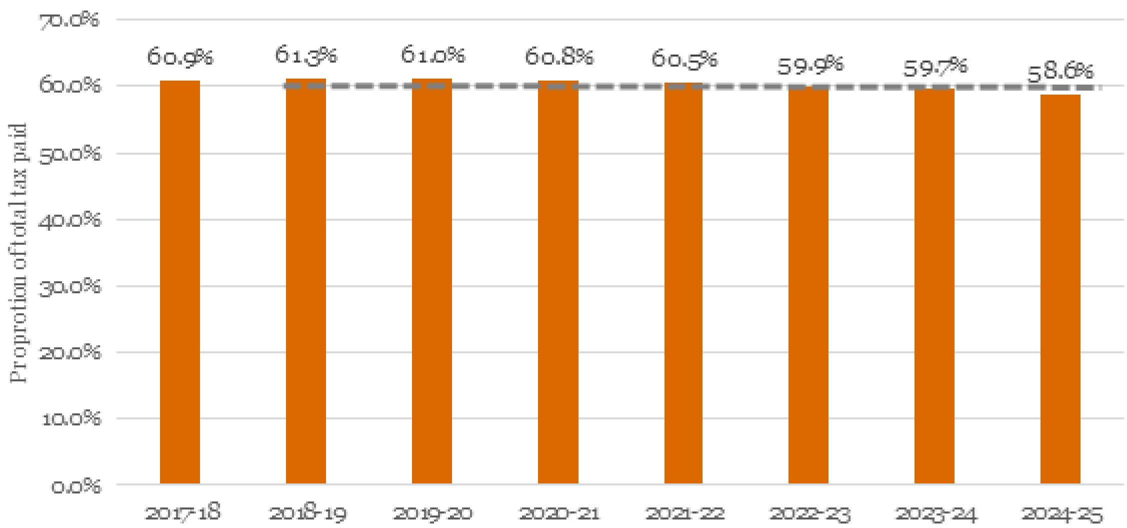
We have analysed the implications of the 2019 Budget proposals for the top 20 per cent of taxpayers (see Figure 10), and make the following observations:

- the top 20 per cent of taxpayers currently pay 60.9 per cent of the total personal income tax paid in Australia (with reference to 2017-18);
- if the 2018-19 Budget proposals are introduced in their entirety, then over the next 7 years the top 20 per cent of taxpayers would pay an average of 60.3 per cent of the total personal income tax paid; and
- in the early years (2018-19 and 2019-20) our analysis indicates that the top 20 per cent of taxpayers will pay a higher proportion of total personal income tax paid than the current 60.9 per cent of total personal income taxes.

While the total proportion of tax paid by the top 20 per cent of all taxpayers falls to 58.6 per cent by the 2024-25 income year, this does not prejudice the progressive nature of Australia's income tax system. Broadly, the shift in the proportion of total personal income tax away from the top 20 per cent of Australian taxpayers is driven by:

- non-tax paying income earners entering the tax system (where their incomes have grown to a level sufficient to attract a liability to tax);
- low income taxpayers moving to higher income brackets due to growth in real wages; and
- relief from bracket creep, being extended for taxpayers on higher income levels in later income years (i.e. 2023-24 and 2024-25).

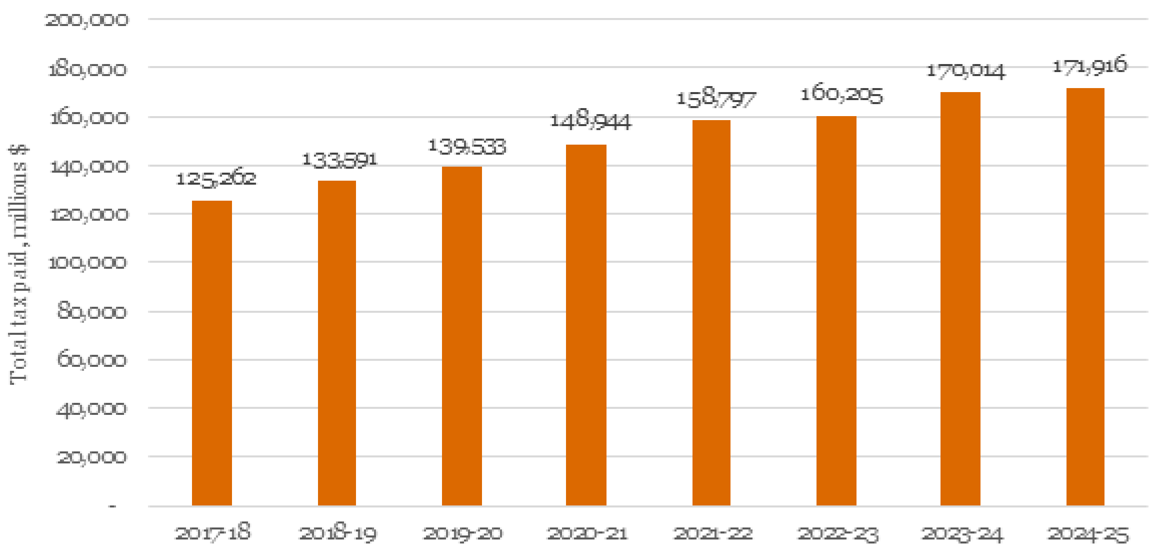
Figure 10: Proportion of total tax revenue paid by the highest 20% of taxpayers, before and after budget proposals



Source: PwC modelling using unpublished ATO data (2015-16 samples files) and parameters from Budget 2018-19
Note: Tax paid is calculated on taxable income (after consideration of deductions) and includes income tax, medicare levy, low income tax offset, low and medium tax offset and seniors and pensioners tax offset. Quintiles are calculated by tax paid, including only individuals that pay greater than zero tax after offsets.

As a final observation from our analysis, the top 20 per cent of taxpayers pay an increasing amount of tax revenue every year to 2024-25, as shown in Figure 11 below.

Figure 11: Amount of total tax revenue paid by the highest 20% of taxpayers, before and after budget proposals



Source: PwC modelling using unpublished ATO data (2015-16 samples files) and parameters from Budget 2018-19
Note: Tax paid is calculated on taxable income (after consideration of deductions) and includes income tax, medicare levy, low income tax offset and low and medium tax offset. Quintiles are calculated by tax paid, including only individuals that pay greater than zero tax after offsets.

Conclusion

Our modelling shows that the Government's proposed PITP provides much-needed relief from the pressures of bracket creep to Australian taxpayers and it does so in a way which retains the central character of progressivity in Australia's income tax system. For these reasons, we support the PITP as an appropriate response to these issues.

However, we note that the highest earning taxpayers in Australia will pay a top marginal rate of tax which is relatively high when compared with other national comparables (45 per cent for taxable incomes exceeding $200,000). For example, Australia's rate is equal top in the following list of federal taxes for individuals:

- **Australia - 45.0% (proposed)**
- United Kingdom - 45.0%
- United States - 37%
- New Zealand - 33%
- Canada - 33%

Further efforts to reform Australia's tax system should consider the international competitiveness of Australia's personal income tax regime (and the flow-on effects for skilled migration and labour force participation incentives) alongside further seeking to alleviate the burden of bracket creep.
An essential element of all Australian tax reform efforts should be the preservation of the system's essentially progressive nature.

In addition to our comments on personal income tax reforms in this letter, there continues to be a need for comprehensive tax reform in order to support Australia's future prosperity.

Yours faithfully,

[redacted]

Pete Calleja
Australian Tax Leader
PwC

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