# REVEALING AUSTRALIA'S REAL INCOME TAX RATES

Marginal tax rates sometimes decrease as income increases, explains **John Humphreys**

Before we can consider tax reform options, it is necessary to have accurate information about the current tax system. Unfortunately, the information provided by the government does not clearly show the exact marginal tax rates paid by Australian taxpayers.

The difference between the published and actual marginal tax rates comes from the impact of the Low Income Tax Offset (LITO) and the Medicare levy.[1] Once these policies are factored into the marginal tax rates, it becomes clear that our income tax system has a number of anomalies that need to be addressed.

The actual and published marginal income tax rates are shown in Table 1.

The published marginal rates are on the left column and show a logical step up from 0% to 15%, 30%, 40%, and 45%.

However, as shown on the right column of Table 1, the actual marginal tax rates look quite different. The first thing to notice is that instead of the five published tax brackets, there are actually nine tax brackets. Even before we consider the various tax deductions and tax offsets, our income tax system is already too complex.

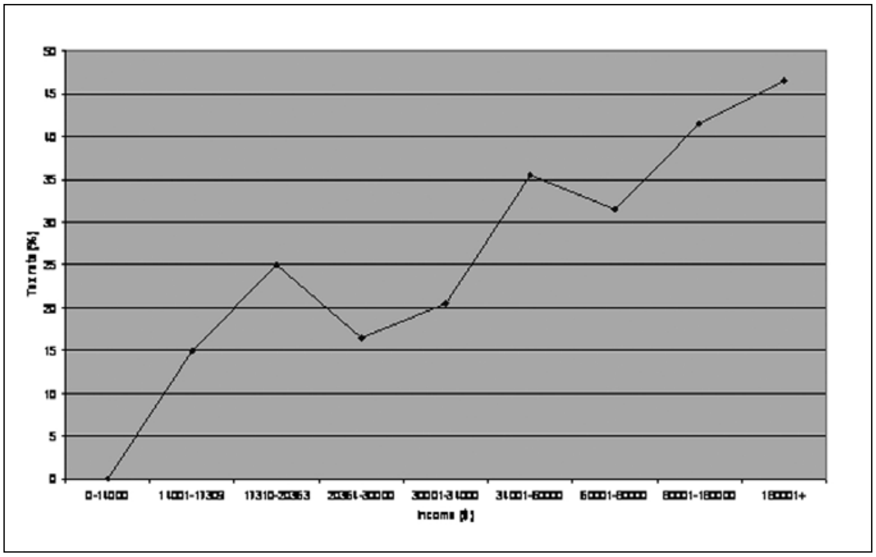
The actual tax rates show that many people are paying a higher marginal tax rate than the published data suggest. But the most significant anomaly is that the actual marginal tax rates do not follow a logical progression but instead fluctuate up and down. As shown in Chart 1, in two different places the marginal tax rate actually falls as income rises.[4]

**Table 1:** Published v actual personal income tax rate scale[2]

| Published personal income tax rate scale[3] | | Actual personal income tax rate scale | |
|---|---|---|---|
| **Income ($)** | **Tax rate (%)** | **Income ($)** | **Tax rate (%)** |
| 0 – 6,000 | 0 | 0 – 6,000 | 0 |
| 6,001 – 34,000 | 15 | 6,000 – 14,000 | 0 |
| | | 14,000 – 17,309 | 15 |
| | | 17,310 – 20,363 | 25 |
| | | 20,364 – 30,000 | 16.5 |
| | | 30,001 – 34,000 | 20.5 |
| 34,001 – 80,000 | 30 | 34,001 – 60,000 | 35.5 |
| | | 60,001 – 80,000 | 31.5 |
| 80,001 – 180,000 | 40 | 80,001 – 180,000 | 41.5 |
| 180,001 + | 45 | 180,000 + | 46.5 |

**John Humphreys** is a Research Fellow at the Centre for Independent Studies.

**Chart 1:** Real personal income tax scale[5]




The extra tax brackets, higher rates and up-and-down tax rates are caused by LITO and the Medicare levy. These impacts are reported separately in government documents. However, to properly understand the income tax system they must be considered together.

## The Medicare levy

The Medicare levy has nothing to do with Medicare or health spending. According to the Mid-Year Economic and Fiscal Outlook, the Medicare levy will raise $8.6 billion in 2008–09, which goes directly to consolidated revenue.

**Table 2:** Medicare levy marginal tax rates

| Income ($) | Tax rate (%) |
|---|---|
| 0 – 17,309 | 0 |
| 17,310 – 20,363 | 10 |
| 20,364 + | 1.5 |

This money has no link to health spending. In 2008–09, the Commonwealth government will spend more than $46 billion on health (about $20 billion on Medicare), and the state governments will spend billions more. The money comes from general revenue, not the Medicare levy. The levy is nothing more than a second income tax.

While the Medicare levy is often reported as a flat rate of 1.5%, the truth is more complex. In reality, the levy has three tax brackets, as shown in Table 2.

For those earning below $17,310 there is no Medicare levy. For those earning between $17,310 and $20,363, the levy is phased in at a marginal rate of 10%. And for those earning over $20,363, the marginal rate is 1.5%.

The Medicare levy is responsible for the first anomaly in the personal income tax rates, where the marginal tax rate rises from 15% to 25% as the levy is phased in, and then falls back to 16.5%.

## Low Income Tax Offset (LITO)

The second area where the published income tax statistics are distorted is the way that the government reports the impact of the Low Income Tax Offset (LITO).

LITO does two things to the marginal tax rates. First, it increases the tax-free threshold from $6,000 per year up to $14,000 per year. This important reform improves the incentive to enter the workforce and allows low-income workers to keep more of their own money.

The second effect occurs when LITO is phased out, as people earning between $30,000 and $60,000 face an additional 4% marginal tax rate.

In effect, LITO is simply a non-transparent way of increasing the tax-free threshold and increasing marginal tax rates.

The second effect of LITO is responsible for the second anomaly in the personal income tax rates where, for example, a person earning $50,000 is paying a 35.5% marginal tax rate while a person making $70,000 is paying a lower 31.5% marginal tax rate.

In the 2008 Budget, the government committed to increasing LITO. It was quick to point out the first impact of increasing the effective tax-free threshold from $14,000 to $16,000. However, the government neglected to point out the second effect where the marginal tax rates would be increased for people earning between $60,000 and $67,500.

While many people do benefit from LITO, it is important to remember that work incentives are influenced by marginal tax rates and therefore any increase in the marginal tax rates should be a cause for concern. Consequently, it is important to have clear and transparent information about marginal tax rates and the impact of new policy on those marginal tax rates.

## The next step

The government is currently pursuing an inquiry into the Australian tax and transfer system. However, it is difficult to promote open debate when the true state of the tax system is not easily available.

To meaningfully address the income tax system, we must first have transparent information on how the system works. The government should begin to publish the real personal income tax scale, including the full impacts of both the Medicare levy and LITO.

Once people are aware of the real tax scale then it will be easier to make the case for a more equitable, efficient and simple income tax system.

One option would be to remove the Medicare levy, or at least remove the excessive 10% bracket. LITO also needs to be reconsidered. A more effective, efficient and transparent alternative to LITO is to simply increase the tax-free threshold. Both of these reforms would raise less revenue for the government and so would need to be considered in the context of broader tax and spending reform.

But whatever the solution to our tax troubles, the first step is transparency about how the system works.

## Endnotes

1 There are other programs that have an impact on the marginal income tax rates for some sections of society, such as the Mature Age Workers Tax Offset (MAWTO) and the Senior Australians Tax Offset (SATO). However, this article will deal only with the base tax rates that apply to everybody.

2 This article deals only with the marginal tax rates and does not consider the impact of withdrawal of welfare payments. The *effective* marginal tax rates in Australia (which consider both tax and loss of welfare) are even more complicated and inequitable.

3 Taken from the Commonwealth Budget, www.budget.gov.au.

4 This should not be taken to mean that I approve of a progressive income tax scale. For a discussion of a flat tax, see Peter Saunders (ed), *Taxploitation* (Sydney: CIS, 2006), especially Chapter 5, 'The Moral Case For a Flat Tax' and Chapter 9 'Rebuilding Australia's Tax and Welfare System.'

5 Note that the x-axis is not to scale. The purpose of this chart is to show the marginal tax rate anomalies.