

The Tax Free Threshold

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THE TAX FREE THRESHOLD (TFT) is a band of income to which no individual income tax is applied. It serves a dual purpose in the tax system of reducing administrative and compliance costs for low income individuals while also enhancing the progressivity of the system. The feature was built into the Federal income tax settings as early as 1953 (when the States surrendered their income tax rights to the Commonwealth).

The reduction in **compliance burden** arises in two ways: first, by excluding low-income (<\$18,300) taxpayers from the system fewer people need to determine how the tax law applies to their circumstances and file a return with the Australian Taxation Office (ATO); and secondly, the significant administrative costs involved with handling low-Revenue interactions with taxpayers are eliminated for the ATO.

The contribution of the TFT to **progressivity**¹ is significant. As we will see later in this note, the presence of the TFT shields taxpayers of at all income levels from up to \$3,458 of additional income tax. That availability raises the question of whether the benefit could be better targetted towards lower-income taxpayers, with resulting savings potentially used to flatten the PIT structure. This note attempts to deal with the question surrounding the distribution of the TFT benefits and the cost involved in removing it while providing compensation to various categories of low-income taxpayers. We'll explore the costs and benefits in more detail, but first...

... some history.

The TFT has been a feature of the personal income tax system since it was consolidated by the federal government in 1953. While the TFT has been modified eight times since the 1983-84 income year the real value of the income exemption had been following a downward trend until 2011 (see Figure 1). The panel on the following page shows real Average Tax Rates (ATR) for every year over the period, with line colour mapped to each of the decades (browns = 80's, greens = 90's, blues = 2000's, and pinks = 2010's). The impact on ATR's over the period is clearly seen in the trending reduction in the real value of the TFT from \$12,980 in 1983-84 to \$6,550 in 2012. As the TFT was eroded by inflation, other elements of the PIT also became less progressive as marginal rates were reduced.

However, the trend to lower real TFT's was broken when the Gillard Government legislated its signature Carbon Pollution Reduction Scheme and set the current threshold amount at \$18,200². The increase in the TFT and changes

¹ A progressive tax system is defined as one where the average rate of tax increases as income increases



Figure 1: Historical TFT rate

² Clean Energy (Income Tax Rates Amendments) Bill 2011

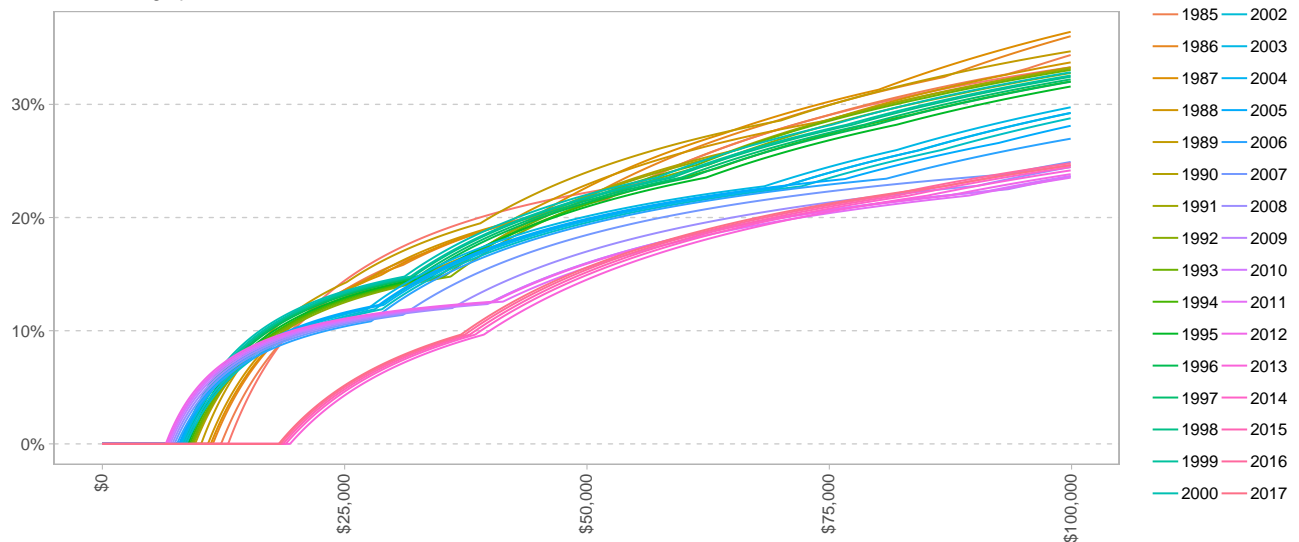
to the marginal rate schedule were part of a package of measures designed to ensure that the average low and middle-income earners were not financially disadvantaged by the introduction of the carbon pricing mechanism. The changes were also buttressed by the recommendation made by Australia's Future Tax System (AFTS) report some three years earlier:

"Progressivity in the tax and transfer system should be delivered through the personal income tax rates scale and transfer payments. A high tax-free threshold with a constant marginal rate for most people should be introduced to provide greater transparency and simplicity."

– Australia's Future Tax System review, Recommendation 2

Down, down. Prices are down...

Real average personal income tax rates 1983–84 to 2016–17



Source: Tax Framework Division

The increase in the TFT to \$18,200 brought with it the highest real TFT seen in recent Australian history. Interestingly, the higher TFT setting withstood the consequential amendments resulting from [the repeal of the carbon pricing mechanism](#) in the context of the the Abbott Government's Budget austerity drive during the 2013-14 sittings of Parliament. With this example in mind it is interesting to consider the hesitance to legislate an automatic indexation of the PIT rate schedule.

The TFT reduces compliance costs...

MANY LOW-INCOME TAXPAYERS ARE CARVED OUT of the requirement to file their tax returns by virtue of the TFT. This is a key benefit of the TFT given

the associated compliance cost savings for taxpayers and the administrative savings for the Government. The [most recent release](#) of Taxation Statistics by the ATO reveals that roughly 3.4 million taxpayers reported gross income below the TFT (Figure 2). Contained in this figure are young people working part-time jobs who do not need to engage with the tax system because of the TFT. Similarly, those who are in receipt of a [tax-exempt government transfer](#) (such as ABSTUDY, Commonwealth scholarships, and certain child care benefits) whose only other income is interest income from a bank savings account with a relatively modest balance. These tax payers are shielded from the need to bear the costs involved in engagement with the system. Similarly, the associated administrative cost borne by the ATO in administering these low or negative value transactions is saved.

The number of low-income taxpayers affected by the TFT is likely to be understated by the Tax Stats data. When considering this data on the number of taxpayers earning below the TFT, it is likely that a substantial proportion of these taxpayers will have filed in order to claim an overpayment of PAYG withholding tax. Absent from these numbers are taxpayers whose gross incomes were below the TFT and chose not to engage with the system, perhaps because they believed that the PAYG installments were correct to an acceptable margin of error or they did not want to deal with the complexity associated with filing. [Any thoughts on this explanation would be appreciated]

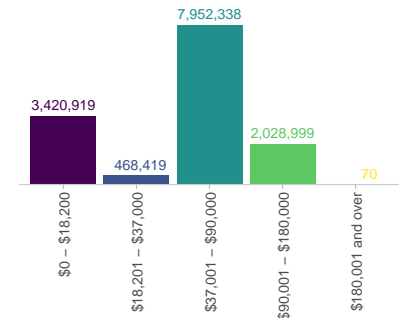
THE PRESENCE of the TFT reduces ATR's at all income levels (Figure 3). In terms of the amount of **additional tax paid**, the impact reaches its maximum in the case of an individual earning \$18,201 dollars per annum who would be liable for additional \$3,458.00 ($\$18,200 \times 19\%$) (the full value of the TFT).

If the TFT were to be removed, **the affect on average tax rates** (the measure used to assess the impact upon progressivity) would be to equate those who have earned \$1.00 with those earning \$62,701 in the presence of the TFT. [?could this be made clearer?]. Those earning an [average salary of \\$86,974.29](#) would pay an additional \$3,458 in tax in the absence of the TFT, representing an increase in total tax paid of 17.5 per cent.

... but the TFT is costly

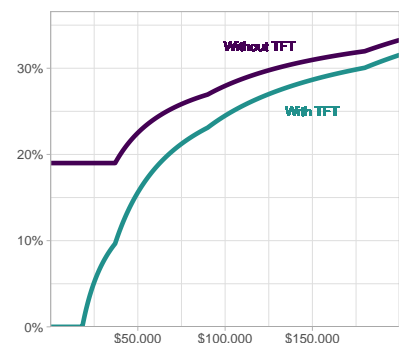
While it is clear that compliance and administrative costs would be substantially higher if the TFT were removed, so too would receipts³. Removing the TFT in the 2016-17 income year would have raised roughly \$35.5 billion. The panel below shows that the vast majority of the additional receipts are drawn from those on middle incomes which is perhaps unsurprising given the distribution of taxpayers shown in Figure 2.

If the goal of any change to the TFT was to leave poverty levels in Australia broadly undisturbed, some of these receipts may need to be passed back to low-income earners through the transfers system. The value of that transfer



Source: Tax Stats (2017) – Individuals table 2B

Figure 2: Taxpayers by bracket in 2016-17



Source: Tax Framework Division

Figure 3: Average tax rates with and without the TFT based on 2016-17 PIT rates

³ There remains a question about the extent to which the data has been modified to comply with the taxpayer secrecy provisions (primarily to be found in Div 355 of the *Taxation Administration Act 1953*). What follows will hopefully provide useful estimates of the revenue involved in such a change.

would amount to between \$5-6 billion leaving a \$30 billion addition to receipts from the policy change. This residual is perhaps a good way to think about the value that the TFT provides to middle and high-income Australian's.

The return to effort and avoidance

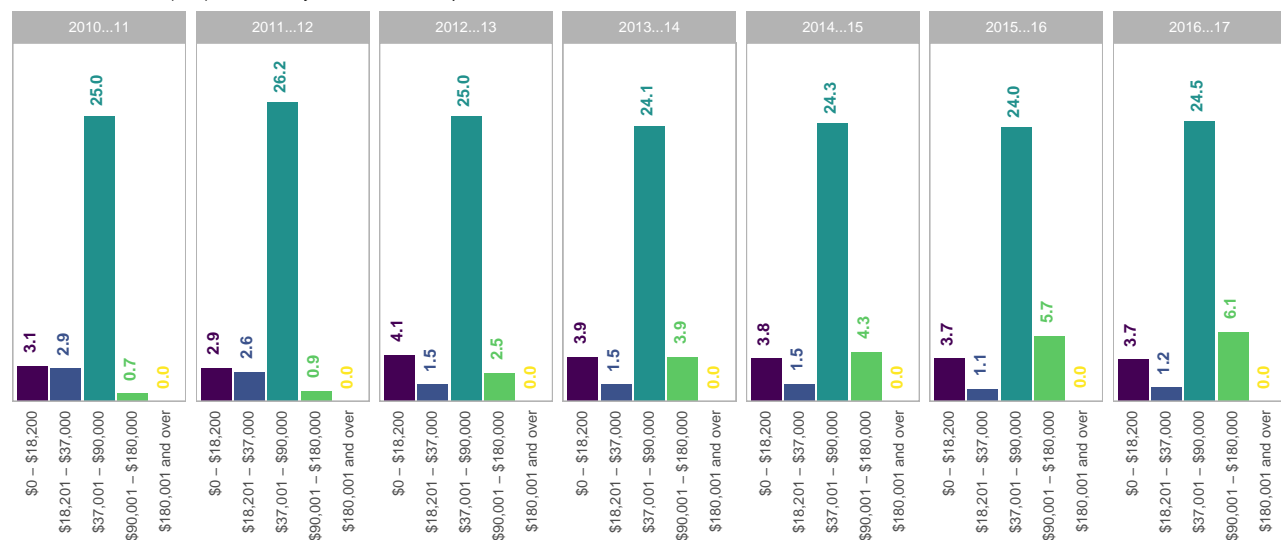
SO MIDDLE AUSTRALIA would bear the brunt of the cost involved in the removal of the TFT but perhaps a package of reform could be designed so that the **return to work** was enhanced for those paying the cost while rendering a number of common **tax planning** strategies impotent.

Enhancing the **return to work** might be achieved by flattening of the PIT rate schedule, which has the added benefit of sharpening labour force participation incentives. Ultimately the rates that received the largest reductions would be determined by government but one way to emilorate criticism of the policy change would be to ensure that those from whom the tax is collected enjoy comensurate reductions in their respective tax brackets⁴. In this way the marginal unit of labour would face a lower marginal tax rate, which is great, but the effects on horizontal equity and rent seeking activities are perhaps just as important.

⁴ It might be worth noting that the government's recent efforts to flatten the PIT rate schedule have been successful but have been estimated to cost the revenue roughly \$298 billion over the decade ahead - roughly the amount which could be raised by removing TFT

Removing the Tax Free Threshold

Additional revenue (\$bn) collected by tax bracket over period 2010...11 to 2016...17



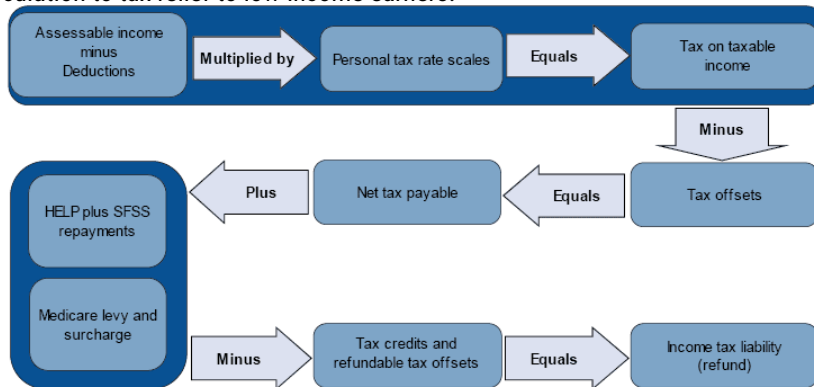
Source: Tax Stats (2017) – Individuals table 2B

THE PRESENCE of a TFT incentivises **tax planning** activities and entrenches the dead weight loss that arises as a result of the tax planning industry. Garden variety planning strategies involve income being paid to a family trust which

in turn makes distributions to family members with low or no taxable income. The after tax income of the family unit is enhanced by the presence of multiple TFT's (along with lower marginal rates). Removing the TFT would reduce the potency of these strategies while enhancing the sustainability of the PIT system.

What is everyone else doing?

BEFORE LOOKING at cross country comparisons it is worth briefly revisiting the income tax calculation as countries vary in the ways they modify that calculation to tax relief to low-income earners.



Broadly, OECD members provide relief to low-income taxpayers by:

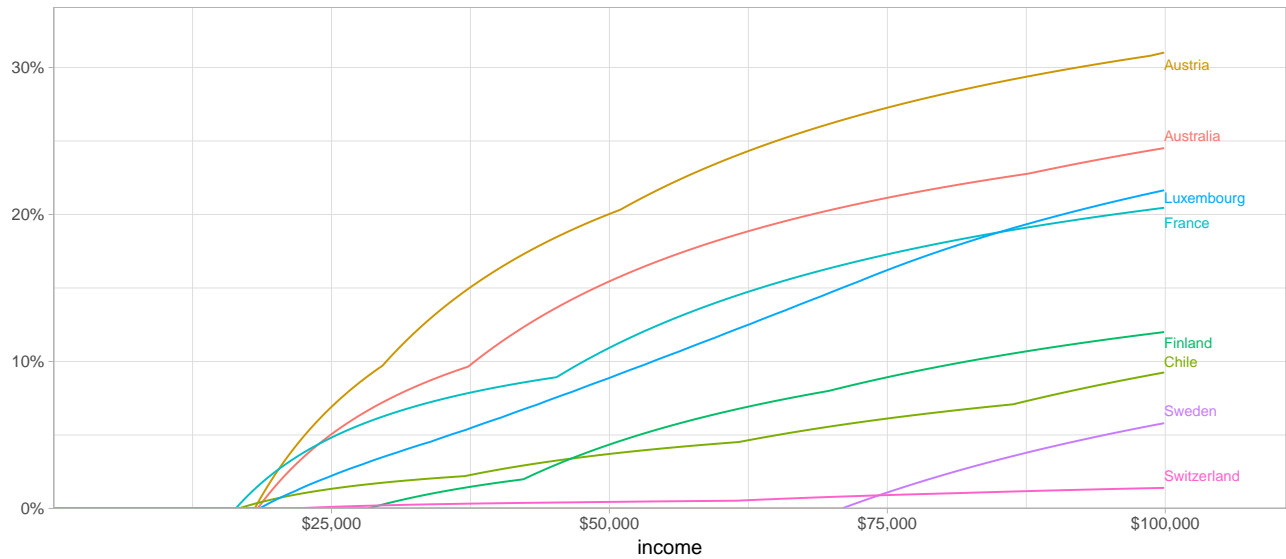
1. A basic/standard **deduction** to be applied against assessable income. Such relief is universally/automatically available and unrelated to expenditures incurred.
2. A basic/standard **tax offset** to all taxpayers.
3. A **tax free threshold**

These approaches can provide the same ends but vary consider

Conclusion

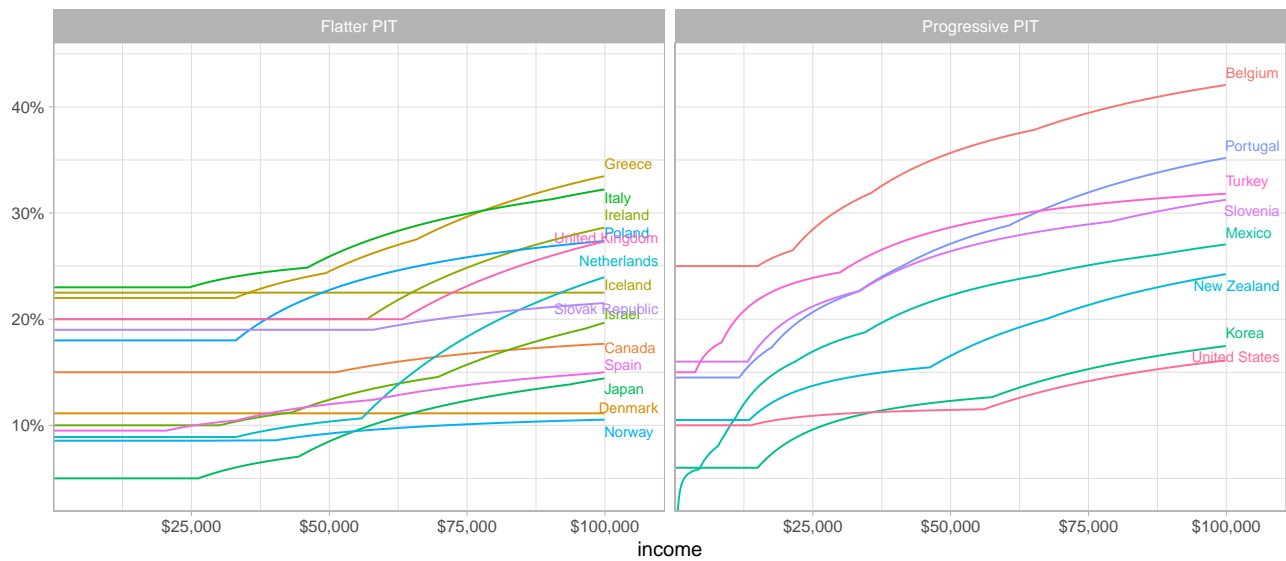
The TFT serves a dual purpose of enhancing progressivity and carving out a significant number of low income earners from the need to engage with the tax system. While it achieves both of those aims a significant amount of the benefit accrues to taxpayers on middle and high incomes. Additionally, the presence of the TFT incentivises income streaming among related parties (families). If the TFT were to be removed it would come with a significant boost to revenue, in the 2016-17 income year that amount would equate to roughly \$35.5 billion. However, such a change would likely result in millions of additional people being drawn into the tax system and the need to compensate

OECD TFT club members
Average Tax Rates (AUD terms)



Source: Tax Framework Division

No TFT for us... OECD countries without TFT's
Average Tax Rates – AUD terms



Source: Tax Framework Division

low-income taxpayers to ensure that rates of poverty were not undisturbed. It may be appropriate to look to the transfers system as a way to administer a compensating adjustment for those taxpayers.