

# Building Incentive

An Ai Group proposal to reduce the tax burden

 AUSTRALIAN INDUSTRY GROUP

December 2005



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The Australian Industry Group (Ai Group) has proposed to the Government a series of personal income tax changes for the 2006-07 Budget focused on lower income earners.<sup>1</sup> The tax cuts announced in the last budget concentrated on middle and upper income earners and built on significant increases to assistance to low and middle-income families over the past few years.

The new tax changes proposed by Ai Group will complement the Government's broader reform agenda and in particular its workplace relations and welfare to work measures. Ai Group's proposed tax changes will inject substantially higher incentives into the tax system for lower income earners and will reduce income tax burdens.

### **Main Measures**

Ai Group has proposed a halving of the rate of income tax faced by taxpayers earning between \$21,600 and \$30,000 from 30 cents in the dollar to 15 cents in the dollar. Ai Group has also suggested further tax relief for low income earners through a lift in the level of the Low Income Tax Offset.

#### **Ai Group's Proposals for Low Income Earners (from 1 July 2006)**

	<b>Present Situation</b>	<b>Ai Group's Proposal</b>
Low Income Tax Offset	\$235	\$435
Effective tax free threshold (for a single person)	\$7,567	\$8,900
15% Income Tax Bracket	\$6,000 - \$21,600	\$6,000 - \$30,000

- Ai Group estimates these measures will carry a full-year budgetary cost of around \$8.5 billion.
- The key economic benefit from the proposals is that the basic income tax rate faced by many low income earners will be reduced by 15 percentage points.
- This will boost incentives to work, save and invest for many lower income taxpayers.
- The measure will also reduce the effective marginal tax rates faced by many low income families and people looking to shift from welfare to work.

As a leading advocate of workplace relations reforms and of measures to reduce Australia's relatively high levels of welfare dependency, Ai Group believes an emphasis on providing tax relief and improved incentives for lower income earners will improve the effectiveness of the overall policy mix.

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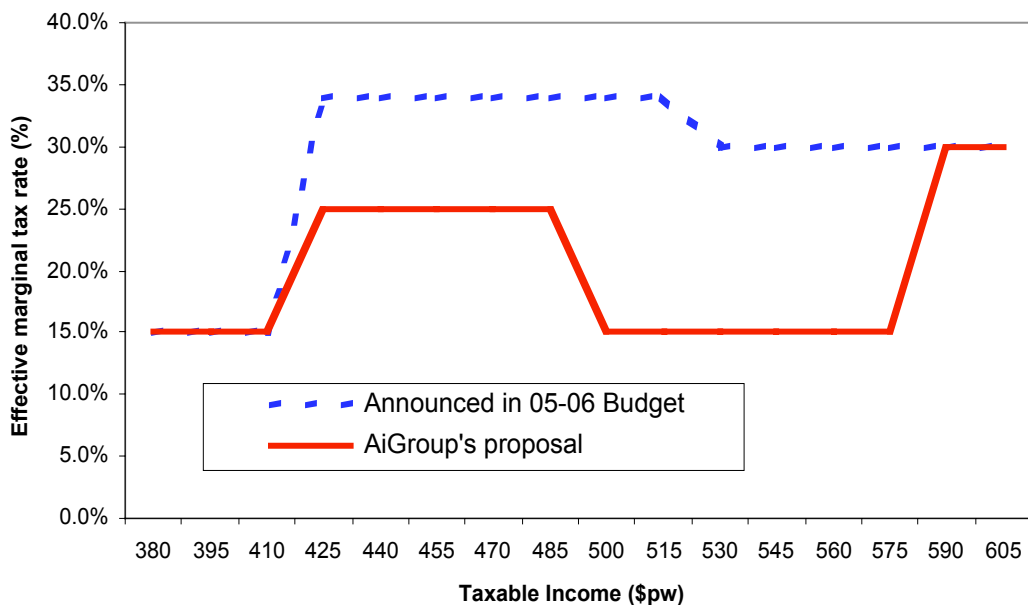
<sup>1</sup> Ai Group's Pre Budget Submission is available at [www.aigroup.asn.au](http://www.aigroup.asn.au)

*Lifting the 30% Threshold*

Raising the threshold at which the 30% rate begins to apply would represent a significant boost to incentives faced by lower-income Australians. This, together with the changes to the Low Income Tax Offset proposed by Ai Group, will slash the effective marginal tax rates faced by people with taxable incomes between \$410 per week and \$575 per week.

The chart below compares the marginal tax rates faced by low-income earners (not subject to any income support means tests) from the middle of 2006 under the income tax scale already announced by the Government with the changes proposed by Ai Group. Chart 1 incorporates changes to the Low Income Tax Offset discussed below.

**Chart 1. Low Income Earners' Effective Marginal Tax Rates (from 1 July 2006)**



*Low Income Tax Offset*

The Low Income Tax Offset (LITO) provides effective relief to very low-income taxpayers without imposing the large costs associated with raising the tax-free threshold. Ai Group's proposal would lower the tax burden for taxpayers earning below \$21,600 while substantially reducing the effective marginal tax rate over the phase-out range for the LITO.<sup>2</sup>

<sup>2</sup> Currently the LITO phases out at 4 cents in the dollar for incomes above \$21,600 and the current effective marginal tax rate over the LITO shade-out range (currently from \$21,600 to \$27,475) is 34 cents in the dollar. With the marginal tax rate above \$21,600 falling to 15 cents in the dollar, there is scope to reduce the effective marginal tax rate from 34% to 25% while simultaneously reducing both the LITO shade-out range (by around \$1,500) and the number of people affected. As a consequence the effective marginal tax rate faced by many people earning between \$26,000 and \$27,475 would fall from 34% to 15%.

**Benefits of Measures**

The Table below shows the impacts of Ai Group’s tax changes for low-income taxpayers.

**Table 1. Ai Group’s Proposed Income Tax Cuts for Low-Income Earners<sup>3</sup>**

<b>Taxable Income (\$pw)</b>	<b>Income Tax Cut (\$pw)</b>	<b>Increase in Disposable Income (%)</b>	<b>Reduction in Income Tax (%)</b>
150	0.73	0.5%	100.0%
200	3.84	2.0%	46.6%
250	3.84	1.6%	24.4%
300	3.84	1.4%	16.5%
350	3.84	1.2%	12.5%
400	3.84	1.1%	10.0%
450	7.05	1.8%	13.4%
500	11.78	2.7%	16.9%
550	20.36	4.4%	23.8%
600	24.17	4.8%	24.0%
650	24.17	4.5%	20.9%
700	24.17	4.2%	18.5%
750	24.17	4.0%	16.6%
800	24.17	3.8%	15.0%
850	24.17	3.6%	13.8%
900	24.17	3.4%	12.7%

**Case Study 1**

**Single Taxpayer**

For a single person earning \$550 per week, Ai Group’s proposals would:

- Improve incentives to work, save and invest by reducing the taxpayer’s marginal tax rate from its present level of 30 cents in the dollar to 15 cents in the dollar; and,
- Deliver an increase in disposable income of up to \$20.36 per week (or \$1,060 per year) for a single person. This is equivalent to a pre-tax wage increase of over \$29 per week (or \$1,516 per year).<sup>3</sup>

<sup>3</sup> The calculations do not include any entitlement to income support and they do not take into account the Medicare Levy. Ai Group does not propose any changes to these programs (other than the routine changes to reflect changes in wages and prices).

### **Case Study 2**

#### **Low Income Family with Two Children**

For a family with two children aged under 13 in which one parent worked full time for \$540 per week and the other part-time for \$270 per week (a total family private income of about \$42,200), Ai Group's proposal would:

- Improve incentives by reducing the effective marginal tax rate faced by the primary earner from the current level of 50 cents in the dollar to 35 cents in the dollar.
- Deliver an increase in family disposable income of \$22.70 per week. This would be equivalent to raising family pre-tax earnings by \$43.62 per week at existing effective marginal tax rates.

### **Case Study 3**

#### **Low Income Single Parent Family with One Child**

For a single parent household with one child aged under 13 in which the adult earned \$400 per week, (a total private family income of \$20,800), Ai Group's proposal would:

- Improve incentives by reducing the effective marginal tax rate faced by the sole parent from its current level of 65.5 cents in the dollar to 56.5 cents in the dollar.
- Deliver an increase in family disposable income of \$12.67 per week. This would be equivalent to raising pre-tax earnings by \$36.20 per week at existing effective marginal tax rates.

### **A Package of Personal Tax Changes**

In addition to the measures for low income earners, Ai Group also proposes reducing the top income tax rate in the personal tax scale from 47% to 42% from 1 July 2006.

This measure would ease the damaging 47% tax rate that currently dampens the incentives faced by higher income-earners to save, to invest and to participate in the workforce.

The reduction in the rate above \$125,000 from 47% to 42% would cost about \$0.5 billion. This estimate (and the estimates for the measures targeted to low income earners) does not factor in any revenue generating behavioural changes stemming from improvements in workforce participation, saving and investing.) In reality, Ai Group anticipates significant revenue recovery as taxpayers respond actively to the incentives.

### Income Tax Scales

2005-06 Scale			Budgeted 2006-07 Scale			Ai Group's 2006-07 Scale		
From	to	%	From	To	%	From	to	%
0	6,000	0	0	6,000	0	0	6,000	0
6,001	21,600	17	6,001	21,600	15	6,001	30,000	15
21,601	63,000	30	21,601	70,000	30	30,001	70,000	30
63,001	95,000	42	70,001	125,000	42	70,001	+	42
95,001	+	47	125,001	+	47			

### Inflationary Risk and the Longer-Term Budget Position

Ai Group believes the Government can embark on these changes while still making contributions to the Future Fund and maintaining a strong budgetary position.

The major risk to this strategy is that of adding to any additional inflationary pressures that build up over the coming months. Two factors help to offset this risk:

- In the present environment of consumer caution, a sizable share of higher disposable income will be directed to reducing existing household debt; and
- Ai Group believes that a tax cut that delivers significant increases in disposable incomes for lower-income earners will help ease some of the existing pressures on wages and business costs.

Clearly a close eye needs to be kept on inflationary pressures between now and May. If inflationary risks accumulate faster than anticipated, Ai Group would support a phased introduction of the measures put forward in this submission.

A further consideration is the degree to which the present budgetary strength is temporary and will be eroded by a return to more normal commodity prices. While commodity prices are not likely to be sustained at their current levels indefinitely, Ai Group is of the view that the ongoing impact on revenue due to fiscal drag will provide the Government with sufficient flexibility to cover any sharper-than-anticipated return to normal commodity prices.

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