



Tax Facts

A knowledge-based series by the
Tax and Transfer Policy Institute

Australia's Tax Policy: Is the Low Income Tax Offset (LITO) Different to the Tax-Free Threshold?

What is the tax-free threshold?

The tax-free threshold is the level of income that can be earned tax-free. In the 2018-19 financial year, the tax-free threshold amounted to \$18,200. This means that you do not pay any income tax on income you earn up to \$18,200. For example, if you earned \$18,500, you would only pay tax on \$300.

What is the Low Income Tax Offset (LITO)?

The Low Income Tax Offset is, as the name suggests, a tax offset. Tax offsets directly reduce the amount of tax that you have to pay [see our tax fact on [tax offsets and tax deductions](#)]. For example, if you complete your tax return and find that you owe the government \$1,000 in tax, a \$200 tax offset will reduce the tax you owe to \$800. Tax offsets can reduce the tax you owe down to zero, but do not usually allow you to receive a refund from the government. If they do, they are called a refundable offset or a tax credit.

The simplest tax offsets are those with no conditions attached. For example, if the government introduced a \$200 tax offset with no conditions attached, it would reduce the tax that every individual in Australia owed to the government each year by \$200. The only exceptions would include: individuals that do not owe any tax and those who owe less than \$200 (who would only receive part of the benefit, reducing their tax liability to zero).

The Low Income Tax Offset is a \$445 tax offset, but only certain people are eligible to receive it. It is targeted at low income individuals, so only people with incomes below \$37,000 receive the full \$445 tax offset. If you earn above \$37,000, then the value of the Low Income Tax Offset is reduced by 1.5 per cent for every dollar above \$37,000 that you earn. It phases out entirely once you earn more than \$66,667. This means that only people earning below \$66,667 receive any benefit from the LITO, and only people earning below \$37,000 receive the full benefit. Individuals who do not pay any income tax, also do not benefit. As of the 2018-19 Budget, the LITO is scheduled to be phased out in 2022-23 and replaced with a different low income tax offset.

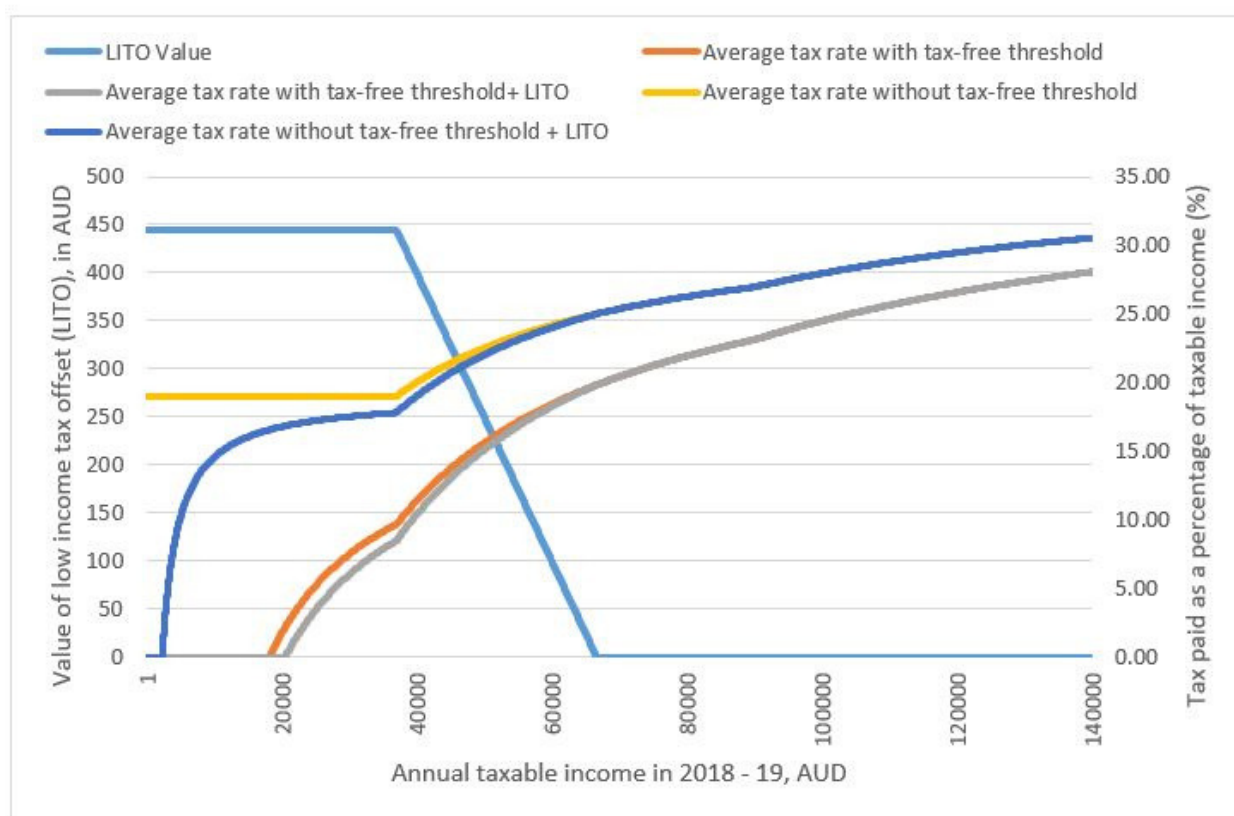
What is the difference between the LITO and the tax-free threshold?

- *Targeting:* By its nature, the tax-free threshold applies to everyone's first \$18,200 of income, irrespective of how much they earn overall each year. You could earn \$1 million and would still benefit from the tax-free threshold. In contrast, the LITO only provides a benefit if you meet the eligibility criteria by having an income above \$18,200 and below \$66,667.
- *Value:* A tax offset is more valuable to a taxpayer than a tax-free threshold equal to the same dollar amount. For example, the tax-free threshold reduces the portion of income on which you need to pay tax. If you earned \$30,000 dollars, the \$18,200 tax-free threshold implies you only pay tax on \$11,800. With a 19 per cent tax rate applied to \$11,800, tax owed amounts to \$2,242. In contrast, a tax offset directly reduces the tax you pay. If you earned \$30,000 dollars and the tax-free threshold applied, you would owe \$2,242 in tax. However, if you were eligible for a \$5,000 tax offset, the tax owed would be directly reduced by \$5,000, resulting in tax due amounting to zero (since the LITO is not refundable).

Which is better policy?

The tax-free threshold and LITO inject progressivity into the tax system in different ways. Figure 1 presents the value of LITO and the average tax rate, with and without LITO and the tax-free threshold, by taxable income level. The yellow line shows the average tax that would be paid if the tax-free threshold and LITO did not exist. For example, an individual earning \$10,000 would pay 19 per cent of their income (\$1,900) in tax. The dark blue line allows for LITO, in the absence of the tax-free threshold, shifting the average tax paid downwards. As a result, the tax burden of an individual earning \$10,000 is reduced to 14.6 per cent (\$1,455). The blue and yellow lines eventually converge where the value of the LITO (represented by the light blue line) falls to zero. In this example, the LITO injects more progressivity for low-income earners by reducing their tax payable, without impacting the amount paid by higher income earners.

Figure 1. Average tax rates with and without LITO and the tax-free income threshold



Source: TTPI.

The orange line and grey lines incorporate the impact of the tax-free threshold. The orange line represents the average tax rates applicable with the tax-free threshold in effect. Compared to the yellow line, the addition of the tax-free threshold has two effects. First, it introduces an extra, zero tax bracket and by doing so, further increases the progressivity of the income tax system (because low income individuals pay even less tax). For example, an individual earning \$10,000 would now pay zero tax. Second, it decreases the average tax rates paid by all individuals (since the entire orange line falls below the yellow line). The incorporation of the LITO, represented by the grey line, further increases the progressivity of the system since low-income individuals pay even less tax, while the average tax rates of high income individuals remains the same.

In conclusion, the tax-free threshold injects progressivity into the tax system by adding a zero tax bracket, and the LITO enhances this progressivity by targeting low income individuals explicitly. The tax-free threshold also serves as a way of reducing the number of Australians that need to complete a tax return. If an individual earns less than \$18,200, then no tax will be deducted, and they do not need to complete a tax return. Deciding which is better policy requires a complex analysis of the different policies' impacts on the income distribution, workforce participation, productivity, administrative burden and government revenue. It also requires a value judgement regarding the purpose of the tax policies. Finally, it requires examining the tax and transfer system in its entirety. For example, refundability of franking credits has very different effects in the absence of a tax-free threshold.



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