
10 Indexation of the Medicare Levy Surcharge income thresholds

Key points

- The Medicare Levy Surcharge (MLS) was introduced by the Australian Government in 1997 as part of a suite of measures designed to arrest the decline in private health insurance (PHI) membership, and was first applied for the 1997-98 financial year. The MLS only applies to taxpayers that do not have private patient hospital cover for themselves and all family members.
- The MLS was initially applied at a rate of 1 per cent of taxable income for singles who earned \$50 000 or more a year, and to families with one dependent child who earned \$100 000 or more a year (with the threshold increasing by \$1500 for each dependent child after the first).
- The MLS income thresholds remained unchanged until 2008-09, when the Australian Government lifted the singles threshold to \$70 000 a year and the families threshold to \$140 000 a year. These amendments also introduced annual indexation of the thresholds.
- The Australian Government lifted the thresholds and introduced indexation to 'refocus the MLS on those with higher income'.
- The terms of reference for this study ask the Commission to advise the Australian Government on the most appropriate indexation factor for the MLS thresholds. The Commission has examined four possible indexation factors: average weekly ordinary time earnings (AWOTE), average weekly total earnings, the consumer price index and the wage price index.
- To assess the merits of these options the Commission estimated and compared the proportion of single and family taxpayers that would have been subject to the MLS, had the thresholds been indexed, between 1999-2000 and 2007-08, by each of the four indexes.
- The Commission found that the proportion of taxpayers subject to the MLS would have increased under all indexation options relative to the proportion of taxpayers subject to the MLS in 1999-2000. However, the proportion of taxpayers subject to the MLS would have increased least if AWOTE was used to index the MLS thresholds.
- The Commission also investigated using an indexation measure based on high income earners, such as the ninth decile of taxable income. This was not practical. Therefore, the Commission suggests that AWOTE is the most appropriate indexation factor, because it is most likely to maintain the Australian Government's goal of keeping the MLS targeted at high income earners.

The terms of reference for this study request advice on the most appropriate indexation factor for the Medicare Levy Surcharge (MLS) income thresholds. The MLS is levied on Australian taxpayers who earn above a specified income threshold and do not have private patient hospital cover for themselves and all family members. This chapter considers four potential indexation factors for the MLS income thresholds.

10.1 Background to the Medicare Levy Surcharge

The MLS was introduced in 1997, and first applied for the 1997-98 financial year, as part of a package of measures designed to stem the decline in private health insurance (PHI) membership in the Australian community, and to maintain the private hospital system as a ‘vital complement to the long term viability of Medicare and the public hospital system’ (Wooldridge 1997). Other measures included a 30 per cent rebate on PHI premiums (introduced in January 1999) and the Lifetime Health Cover community rating scheme (introduced in July 2000).¹

The MLS first applied to taxable income in the 1997-98 financial year.² It was applied to singles who earned \$50 000 or more a year, and to families³ with one dependent child who earned \$100 000 or more a year, if they did not have appropriate private patient hospital cover.⁴ For families with more than one

¹ In 2005, the rebate was increased to 35 per cent for people aged 65–69, and to 40 per cent for those aged over 70. The 2009-10 Commonwealth Budget proposed to means test eligibility for the rebate, however legislation giving effect to this proposal is yet to be passed through parliament. The policy, if implemented, would involve the rebate being progressively reduced for higher income ranges, and totally withdrawn for the highest income range. The Lifetime Health Cover rating scheme provides for progressive increases in premiums payable by those taking up PHI after the age of 30.

² Taxpayers are defined as people who have a net tax liability greater than zero. Taxable income equals assessable income minus deductions. Income for MLS purposes equals taxable income plus reportable fringe benefits plus the net amount on which family trust distribution tax has been paid, minus any post-June 1983 component of an Employment Termination Payment where the maximum tax rate is zero. The 2008-09 Commonwealth Budget included measures to expand the MLS income definition to include salary-sacrificed superannuation contributions and net losses from financial investments.

³ For MLS purposes a person is considered to be a member of a family if they contribute to the maintenance of a dependant, including a spouse, even if the spouse has their own income. Any parent (including a sole parent) who contributes to the maintenance of a dependent child or children is considered to be a member of a family.

⁴ An appropriate insurance policy for MLS purposes is one that does not have an excess greater than \$500 for singles or greater than \$1000 for families.

dependent child, the threshold increased by \$1500 for each dependent child after the first. The MLS applied at a rate of 1 per cent of all income. The income thresholds set in 1997 remained unadjusted until October 2008.

In 2008, a number of changes were made to the MLS. These included provision for annual increases in the thresholds by means of indexation, and an increase in the income threshold levels, which had remained unchanged since the MLS was introduced for the 1997-98 financial year (box 10.1).

Box 10.1 Recent changes to the Medicare Levy Surcharge

Amendments to the Medicare Levy Surcharge (MLS) were passed by Parliament in October 2008, and came into effect for the 2008-09 financial year. The income thresholds at which the MLS became payable in the 2008-09 financial year increased from:

- \$50 000 to \$70 000 for singles
- \$100 000 to \$140 000 for couples and families with one dependent child.

The rise in the annual income threshold for families with more than one dependent child remained unchanged at \$1500 for each dependent child after the first.

The recent amendments also introduced annual indexation. Average weekly ordinary time earnings (AWOTE) was chosen as the indexation factor. The singles threshold is now indexed annually by multiplying the 2008-09 surcharge threshold by the indexation factor and rounding the result down to the nearest multiple of \$1000 (provided that the indexation factor is greater than one). The MLS threshold for couples and families with one dependent child will continue to be set at twice the singles threshold.

The indexation factor is the index number for the quarter ending 31 December in the previous financial year, divided by the index number for the quarter ending 31 December 2006, calculated to three decimal places. The index number used for the December quarter is the estimate of full-time adult AWOTE for the middle month of the quarter (November) that is first published by the ABS.

In the 2009-10 budget, the Australian Government proposed changes that would increase the MLS for high income earners without PHI to:

- 1.25 per cent, for single people earning more than \$90 000 and for families (with less than two dependent children) earning more than \$180 000
- 1.5 per cent, for single people earning more \$120 000 and for families (with less than two dependent children) earning more than \$240 000.

Source: Tax Laws Amendment (Medicare Levy Surcharge Thresholds) Bill (no. 2) 2008; Treasury (2009a).

There has been extensive discussion regarding the appropriate approach to indexation. While the October 2008 amendments to the MLS provided for

indexation of the thresholds on the basis of changes to average weekly ordinary time earnings, the terms of reference for this study request the Commission to advise on the most appropriate indexation factor.

10.2 Why index the MLS thresholds?

When introduced in 1997, the MLS was focused on encouraging ‘high income earners who can afford to take out private health insurance to do so’, and the threshold levels at which the MLS was applied were set accordingly (Wooldridge 1996, p. 8576). When the Australian Government adjusted the MLS income thresholds in the 2008-09 Budget, it indicated that this was done in order to ‘refocus the MLS on those with higher income’ (Treasury 2008b, p. 33).

Without indexation of the income thresholds, an increasing proportion of taxpayers will be subject to the MLS over time, due to a combination of rising real incomes and wage inflation. For example, in 1997-98 around 8 per cent of single taxpayers exceeded the singles threshold. However with no indexation of the MLS thresholds, this proportion increased to approximately 33 per cent of single taxpayers by 2007-08. Therefore, without indexation, more taxpayers become liable for the MLS and the MLS is less effective over time at solely targeting high income earners.

Study participants who commented on the MLS thresholds were generally supportive of indexation, although they expressed a variety of views about the appropriate indexation factor.

10.3 Possible indexation factors

Indexation involves adjusting a dollar amount over time in line with changes in an index, with the index often based on a measure of changes in prices or wages. This is intended to provide an estimate of equivalent dollar amounts over time, adjusting for movements in measured prices or wages.

There are a number of potential price and wage measures that could be used to index the MLS income thresholds. The four measures are:

- average weekly ordinary time earnings (AWOTE)
- average weekly total earnings (AWTE)
- consumer price index (CPI)
- wage price index (WPI) (table 10.1).

Table 10.1 Possible indexation factors for the Medicare Levy Surcharge

<i>Indexation factor</i>	<i>Description</i>
Average weekly ordinary time earnings (AWOTE)	<ul style="list-style-type: none"> • Measures growth in average weekly pre-tax earnings from standard hours of full-time work for adult wage and salary earners. • Includes award, workplace and enterprise bargaining payments, penalty payments, shift allowances, commissions and retainers, bonuses, incentives, profit sharing payments, workers compensation and salary payments to directors. • Excludes amounts that are salary sacrificed, non-cash components of salary packages, overtime payments, retrospective pay, pay in advance, leave loadings, severance, termination and redundancy payments and other sources of income such as capital gains. • Does not cover a number of workers, including self-employed persons and owners of unincorporated businesses. • Index varies not only with changes in wage levels but also according to changes in average hours worked and composition of the workforce.
Average weekly total earnings	<ul style="list-style-type: none"> • Includes both AWOTE and overtime earnings.
Consumer price index	<ul style="list-style-type: none"> • Measures change over time in the price of a specified 'basket' of goods and services, which comprise a high proportion of household expenditures.
Wage price index	<ul style="list-style-type: none"> • Measures change over time in wages paid for a fixed amount of labour. • Controls for changes in income levels resulting from increases in hours worked, or changes in the composition of the workforce. • Does not cover other sources of income such as capital gains.

Source: ABS (*Average Weekly Earnings, Australia*, Cat. no. 6302.0; *Consumer Price Index, Australia*, Cat. no. 6401.0; *Labour Price Index, Australia*, Cat. no. 6345.0).

The key differences between these measures are that:

- AWOTE and AWTE both measure pre-tax weekly earnings but AWOTE includes standard hours of full-time work and AWTE includes overtime.
- WPI measures the change over time in wages paid for a fixed amount of labour and controls for changes in hours worked and the composition of the workforce.
- CPI does not measure earnings. It measures changes in a group of commonly-purchased household items.

These are all published approximately two months after the end of the quarter making each a practical option for indexing the MLS thresholds.

Study participants expressed a range of views on the most appropriate indexation factor for the MLS. The Australian Nursing Federation (sub. 17; DR57) supported AWOTE or AWTE being used, noting that these measures most accurately reflect changes in earnings. The Australian Government Department of Health and Ageing (DOHA) (sub. 32; DR69) also supported AWOTE being used as an indexation

factor for the MLS thresholds, noting that it is most relevant because it measures the ‘normal’ earnings of workers (since it excludes overtime).

Access Economics (sub. DR60) and the Australian Medical Association (sub. 28) preferred the WPI. The Australian Medical Association observed that:

[O]ther measures of earnings, such as survey-based AWE [Average Weekly Earnings] and AWOTE, are affected significantly by changes in the composition of employment. As such, the trends in AWOTE bear little relation to the experience of the typical householder. (sub. 28, p. 7)

Following the release of the Discussion Draft for this study, the Australian Medical Association (sub. DR55) also suggested the national accounts measure of average earnings — average non-farm compensation per employee — that is published by the ABS (2009a). This measure includes compensation in the form of in-kind benefits and employer contributions to superannuation and workers compensation, in conjunction with wages and salaries paid in cash. However, given that the MLS is only calculated on the basis of taxable income, this measure does not seem suitable.

The Royal Australasian College of Surgeons (sub. 30, p. 4) noted that ‘the public understanding of CPI makes it the appropriate indexation methodology’. The Australian Health Insurance Association also argued in favour of the CPI because it is used to index other thresholds and payment levels:

The use of the CPI would ensure a consistent policy approach to the adjustment of Australian Government health and welfare thresholds and payments, as the CPI is also used to adjust:

- the Medicare Levy Low Income threshold;
- the Medicare Safety Net;
- the PBS Safety Net;
- the Baby Bonus; and
- Family Tax Benefits A and B. (sub. 18, p. 10)

However, not all government thresholds and payments are indexed by the CPI. As noted by DOHA:

AWOTE is the indexation measure used for a number of other income thresholds (e.g., the concessional superannuation contributions cap and the low-rate threshold for superannuation lump sum payments). (sub. 32, p. 26)

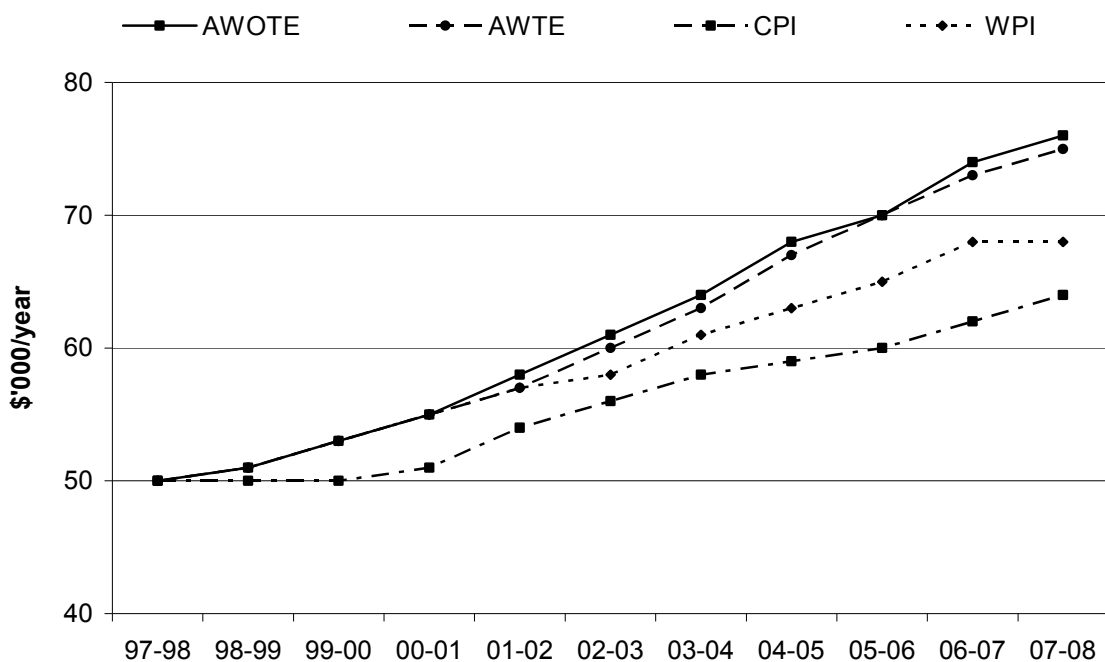
In addition, it is important that the MLS indexation factor tracks taxable income over time, given the goal of keeping the MLS targeted at high income earners. As noted by Catholic Health Australia (sub. 20, p. 2):

It is important that whatever index is chosen, it provides a reasonable representation of movements in income levels.

10.4 Assessment of potential indexation factors

To assess potential indexation factors, the Commission examined what the MLS income thresholds *would* have been if indexed between 1997-98 and 2007-08 by one of the four measures outlined above. Historically, the CPI has increased at a slower rate than wages and so it would have led to the lowest thresholds between 1997-98 and 2007-08. If the singles threshold had been indexed by AWOTE or AWTE from 1997-98 to 2007-08, it would have been around 17 per cent higher in 2007-08 than if it had been indexed by the CPI (figure 10.1).

Figure 10.1 **MLS income thresholds if there had been indexation, singles^a**



^a Data for WPI are only available from August 1997. Therefore, an indexation factor for 1998-99 could not be calculated. The hypothetical WPI thresholds were indexed instead by AWOTE for this year because it is also a wage measure.

Source: ABS (*Average Weekly Earnings, Australia*, Cat. no. 6302.0; *Consumer Price Index, Australia*, Cat. no. 6401.0; *Labour Price Index, Australia*, Cat. no. 6345.0), Productivity Commission estimates.

Using these hypothetical thresholds and data on the distribution of income, the Commission calculated the proportion of single taxpayers and family taxpayers who would have been subject to the MLS had indexation occurred.

If the MLS singles threshold had been indexed, the threshold would, in 2007-08, have been \$77 000 (with AWOTE indexation), \$76 000 (AWTE), \$65 000 (CPI) and \$69 000 (WPI). Similarly, if the MLS families threshold had been indexed, the threshold for families would, in 2007-08, have been \$154 000 (with AWOTE), \$152 000 (AWTE), \$130 000 (CPI) and \$138 000 (WPI).

To ensure the MLS remains focused on high income earners, the indexation factor used needs to be commensurate with the changes in their income. The Commission used data on the distribution of income to estimate the proportion of taxpayers who would have had incomes above the MLS income thresholds under each of the four indexation options from 1999-2000 to 2007-08, (box 10.2).

Box 10.2 Income distribution data used in MLS analysis

The Commission obtained data from the Australian Government Department of the Treasury on the distribution of income used from 1999-2000 to 2005-06, based on confidentialised sample unit record data extracted by the Australian Taxation Office (ATO). These samples have typically been extracted on an annual basis shortly after the publication of *Taxation Statistics*.

In the period after the sample data extraction, some tax returns continue to be lodged by 'late lodgers'. Therefore, the aggregate number of taxpayers is likely to be greater than estimated using the relevant sample data.

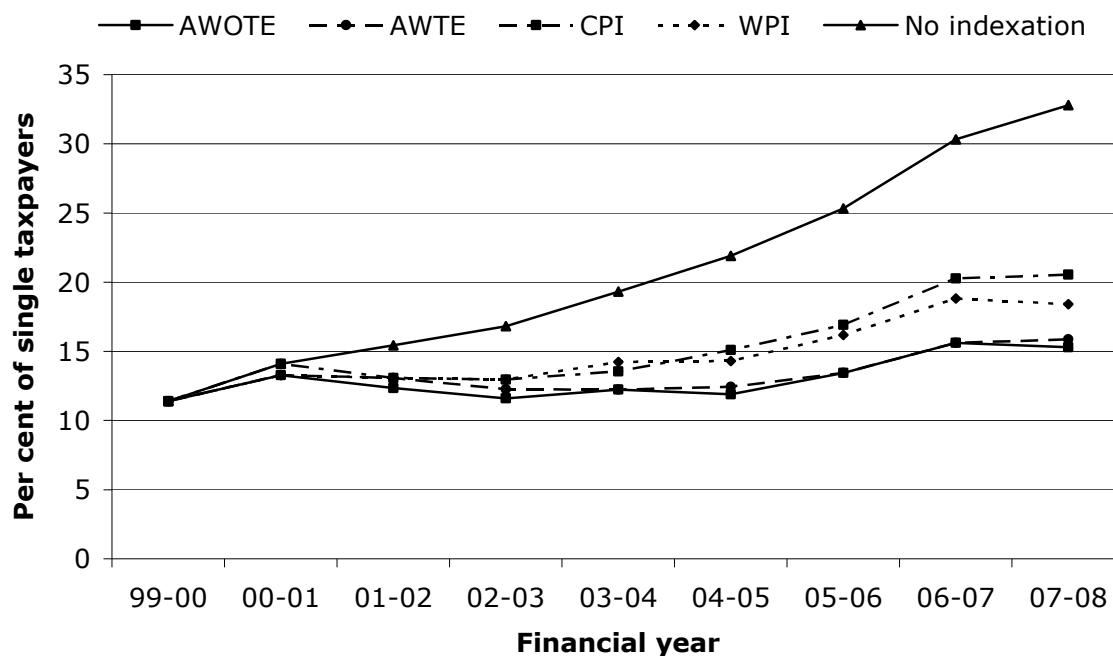
For the years 2006-07 and 2007-08, the analysis is based on data recently provided to the Treasury by the ATO. The data for 2007-08 may not be complete. However, due to the Tax Bonus, the number of returns processed for 2007-08 in a 12-month period exceeds what would be expected in a normal year.

Consistent data for the years 1997-98 and 1998-99 were not available.

If the MLS singles threshold had been indexed between 1999-2000 and 2007-08, the proportion of single taxpayers subject to the MLS would have been most stable had AWOTE been used (figure 10.2). Therefore, indexing the MLS by AWOTE would have gone closest to achieving the Australian Government's objective of keeping the MLS focused on high income earners among singles.

Nevertheless, even with AWOTE indexation, the proportion of single taxpayers that would have been subject to the MLS would have increased from 11.4 to 15.3 per cent between 1999-2000 and 2007-08.

Figure 10.2 Proportion of single taxpayers subject to the MLS under alternative indexation options



Source: Australian Government Department of the Treasury (unpublished); ABS (*Average Weekly Earnings, Australia*, Cat. no. 6302.0; *Consumer Price Index, Australia*, Cat. no. 6401.0; *Labour Price Index, Australia*, Cat. no. 6345.0); Productivity Commission estimates.

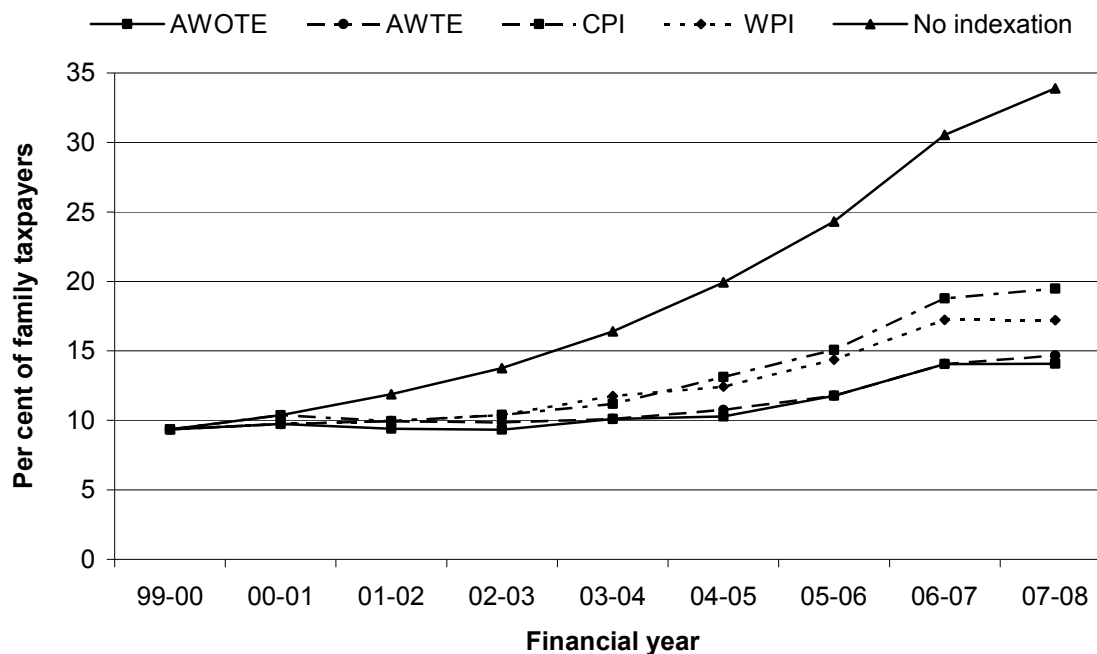
In contrast, the proportion of single taxpayers subject to the MLS would have increased significantly if the CPI (from 11.4 to 20.5 per cent) or WPI (from 11.4 to 18.4 per cent) were used. Therefore, the CPI and WPI are clearly unsuitable if the intention of the Government is for the MLS to target high income earners among singles.

If AWTE had been used, a slightly higher proportion of single taxpayers would have been subject to the MLS in some years than if AWOTE had been used.

Given that no indexation actually took place between 1999-2000 and 2007-08, 33 per cent of single taxpayers were potentially subject to the MLS in 2007-08.

As discussed above, when the MLS was introduced, the threshold for families was set at twice the singles threshold. If the MLS families threshold had been indexed, between 1999-2000 and 2007-08, the proportion of families subject to the MLS would have been most stable had AWOTE been used (figure 10.3). Therefore, indexing the MLS income thresholds by AWOTE would also have best met the Australian Government's objective of keeping the MLS focused on high income earners of families.

Figure 10.3 Proportion of taxpayers who were members of a family subject to the MLS under alternative indexation options^a



^a For purposes of simplicity, the \$1500 threshold increase for a second and each additional child is not taken into account in this analysis. Therefore, these estimates slightly overstate the proportion of family taxpayers who would have been subject to the MLS.

Source: Australian Government Department of the Treasury (unpublished); ABS Source: ABS (*Average Weekly Earnings, Australia*, Cat. no. 6302.0; *Consumer Price Index, Australia*, Cat. no. 6401.0; *Labour Price Index, Australia*, Cat. no. 6345.0); Productivity Commission estimates.

Nevertheless, with AWOTE, the proportion of family taxpayers that would have been subject to the MLS would still have increased, from 9.4 per cent in 1999-2000 to 14.1 per cent in 2007-08.

The proportion of family taxpayers subject to the MLS would have increased by much more had the CPI (from 9.4 to 19.5 per cent) or WPI (from 9.4 to 17.2 per cent) been used as the indexation factor. Hence the CPI and WPI are unsuitable if the intention of the Government is for the MLS to target high income families.

If AWTE had been used, a slightly higher proportion of family taxpayers would have been subject to the MLS in some years than if AWOTE had been used.

The analysis in this chapter shows that if the MLS income thresholds had been indexed, the proportion of single and family taxpayers subject to the MLS would

each have increased even if AWOTE had been used. The other indexation factors would have had led to more people being within the scope of the MLS.

The Government's objective is for the MLS to target high income earners. But the four indexation options examined above would not have held the proportion of taxpayers subject to the MLS constant.

The Commission investigated using an indexation factor that specifically measured income changes for high income earners, rather than average earnings. Since 8 per cent of single taxpayers were subject to the MLS when it was introduced, the Commission considered the feasibility of indexing the thresholds based on movement in the ninth decile (ninetieth percentile) of incomes for singles.⁵ The Commission could not find data published annually by income decile. Thus, at this point in time this option is not feasible. However, this option could be considered in the future if data were available in a robust and timely manner.

In light of the above, the Commission considers that AWOTE is the most appropriate indexation factor for the MLS thresholds, and is more likely to meet the Australian Government's goal of the MLS being targeted at high income earners than if other indexation factors were used.

FINDING 10.1

Average weekly ordinary time earnings is the most appropriate indexation factor for the Medicare Levy Surcharge income thresholds.

⁵ An alternative option would be to index the thresholds based on movements in the eighty-fifth percentile of incomes for singles, as around 85 per cent of single taxpayers were below the MLS income threshold for singles after it was increased in 2008-09.