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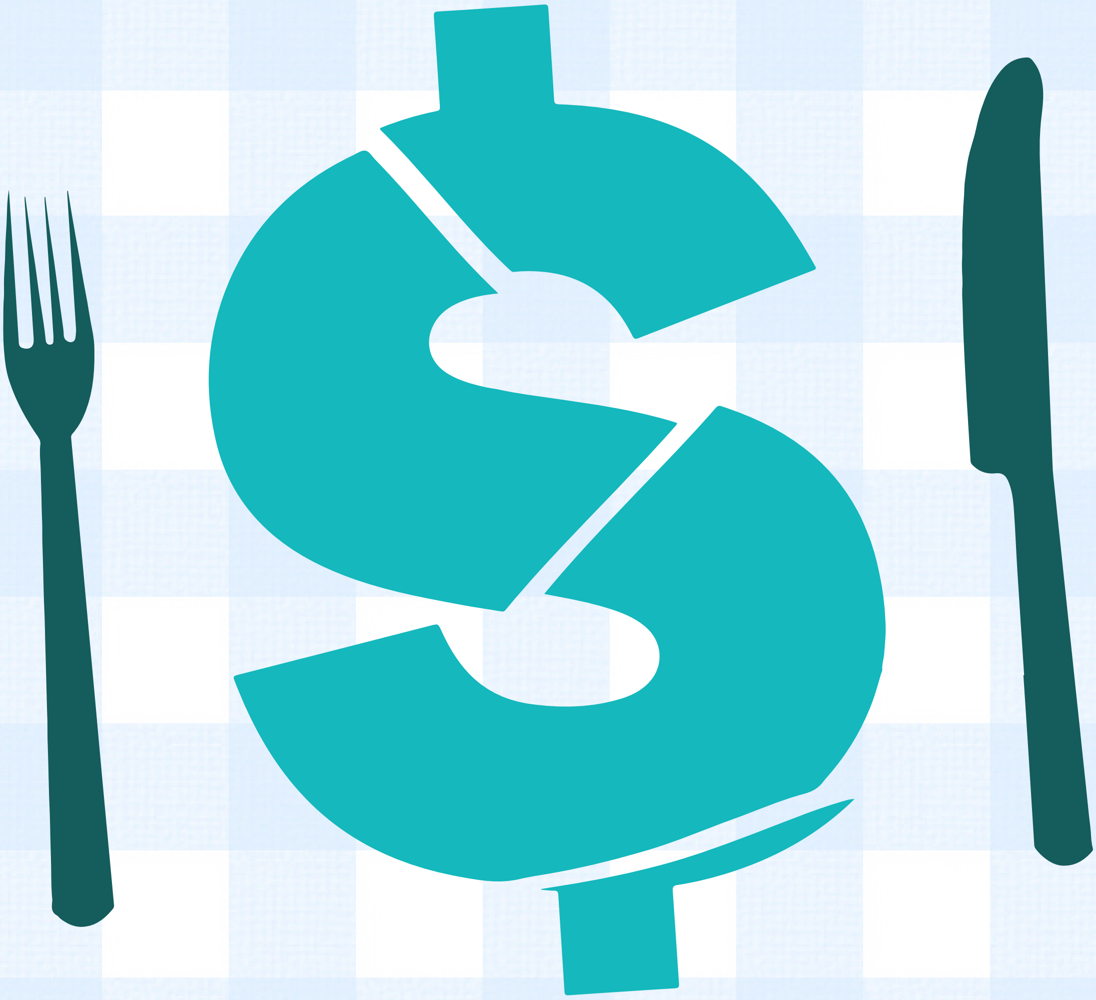

CUTTING INCOME TAX: CAN WE ADD THE BACON TO 'HAMBURGER AND MILKSHAKE' CUTS?

Robert Carling

THE CENTRE FOR INDEPENDENT STUDIES

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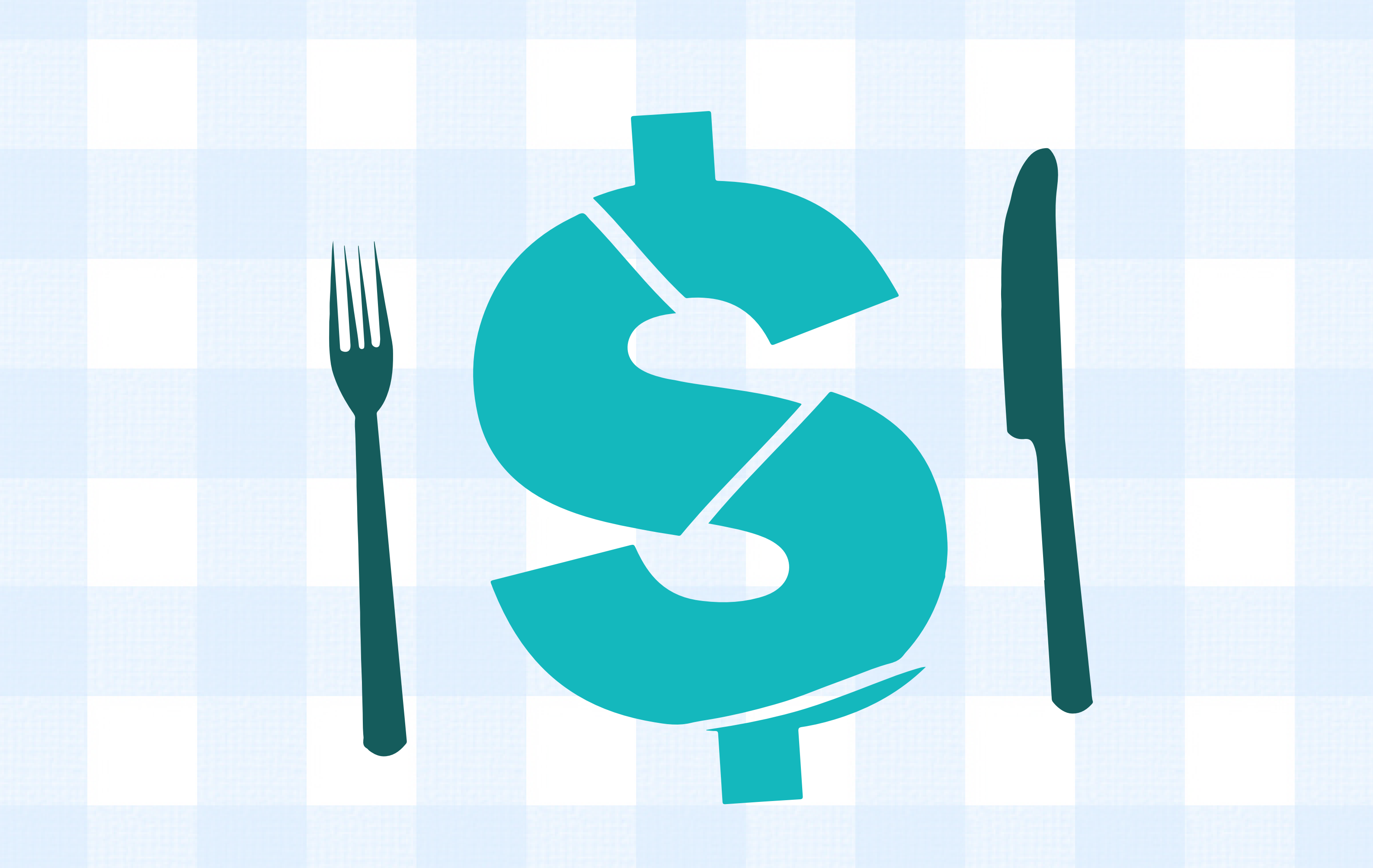
Related Works

Robert Carling, *Taming the Monster: Reforming the personal income tax*, CIS Research Report 12, April 2016.

Robert Carling and Michael Potter, *Exposing the stealth tax: the bracket creep rip-off*, CIS Research Report 8, December 2015.

Contents



Introduction

The federal government has flagged personal income tax cuts as a feature of the 2018-19 Budget to be tabled on 8 May. The only indication they have given of the form of the cuts is that they will favour low and middle income earners. The timing is also uncertain, as the government has little budgetary room to manoeuvre in the next few years.

The key problems with the current situation are that marginal rates are excessive and — with bracket creep pushing more taxable income into higher rate bands every year — the overall average rate of tax is increasing and projected to reach unprecedented levels in the next decade. These trends are being exacerbated by increases in the Medicare levy. Bracket creep has its most pernicious effects at low and middle incomes.

There has been little change in the bracket thresholds since 2012. A full-time worker on the adult minimum wage will soon be pushed from the 21% marginal rate bracket to the 34.5% bracket. At average weekly earnings, full-time workers are again approaching the second highest marginal rate of 39%. At the top, the $180,000 threshold has remained unchanged for 10 years, during which the proportion of taxpayers falling into the top bracket has more than doubled.

This paper reviews the case for personal income tax cuts; the various forms they could take; and the budgetary scope for cuts. It then suggests what the priorities should be.

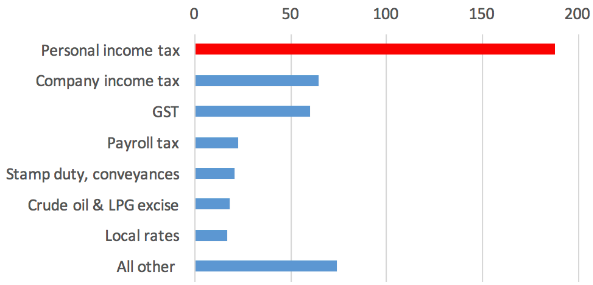
Why cut personal income tax?

It is tempting to think cynically that the government is planning income tax cuts only to enhance its electoral prospects — and there is a history of governments going to elections with income tax cuts on offer. However, there is also a sound economic case for personal income tax cuts, and a better one still for reform.

All taxes impose economic costs in the form of lower economic growth and economic well-being. This is unavoidable even though taxation funds public expenditure that may deliver offsetting benefits. However, not all taxes are equal: some do more harm than others. Personal income tax is not generally assessed to be the most damaging — an honour often bestowed on company income tax and state stamp duties on property transactions — but it is more damaging than consumption and payroll taxes.[1] Personal income tax has strong effects on people's choices between working or not working, working more or less, how much to save and in what forms, and how much to invest in self-improvement with the expectation of earning higher future incomes. As personal income tax applies to small businesses not structured as companies, it also affects business decisions.

The economic effects of personal income tax are magnified by the overall size of the tax, which dominates at 40% of all taxes at all levels of government, the next largest being company income tax at 14% (see Figure 1). As personal income tax is large, the effects at the margin are magnified. Tax system reviews in Australia have consistently identified over-reliance on personal income tax as a key problem at least since the mid-1970s. But the problem remains and is growing as a result of bracket creep, as explained below.

Figure 1: Tax Revenue, 2015–16 ($b)



Source: ABS Taxation Revenue, 2015-16 (Catalogue No. 5506.0)

The best indicator of the effects personal income tax has on peoples' decisions is the marginal rate of tax — as this is the rate that determines how much extra tax an individual pays as a result of earning an extra dollar of income. In Australia, marginal rates currently range up to 47%, as shown in Table 1. Effective marginal rates — which also measure the loss of government benefits as income increases — can be higher than shown in Table 1, particularly at low and middle incomes.

The largest benefits of tax cuts will come from lower marginal rates; but for the benefits to be maximised the cuts will need to be permanent — or at least expected by taxpayers to be permanent. People are then more likely to change their economic behaviour. To be permanent, tax cuts have to be fiscally sustainable.

In offering tax cuts, the government is likely to emphasise immediate relief from wage stagnation and cost of living pressures on households. However, the main potential benefits of tax cuts accrue with a long lag over time in the form of higher growth in the economy and real incomes, resulting from sustained cuts in marginal rates.

Table 1: Marginal Rates of Tax

EXCLUDING MEDICARE LEVY:		INCLUDING MEDICARE LEVY:	
Income range $:	Rate %:	Income range $:	Rate %:
0 – 18,200	0	0 – 18,200	0
18,201- 37,000	19	18,201 – 21,655	19
		21,656 – 27,068	29
		27,069 – 37,000	21
37,001 – 87,000	32.5	37,001 – 87,000	34.5
87,001 – 180,000	37	87,001 – 180,000	39
180,000 +	45	180,000 +	47

Source: Australian Taxation Office[2]

What scope is there for tax cuts?

The latest information available on the federal Budget outlook is from the mid-year economic and fiscal outlook (MYEFO) released in December 2017. The projected deficits and surpluses are shown in Figure 2 sourced from the MYEFO documents.

This will certainly change by 8 May as a result of changes in parameters — such as the effects of unexpected employment growth generating extra revenue — and government policy decisions. In the policy category, the government could, for example, change spending and other taxes to increase the scope for personal income tax cuts. Any projections are also subject to error, the more so the further ahead they look.

Subject to all those qualifications, the picture portrayed in MYEFO is that there is little scope for personal income tax cuts without the revenue losses breaching the government's strong commitment to return the Budget to balance or a small surplus by 2020-21. The projected surplus for that year was only $10 billion. The scope increases substantially in later years, but this is too far ahead for tax cuts taking effect then to be credible or meaningful now.

To illustrate the magnitude of effects of income tax cuts on the Budget, reducing each marginal rate by just one percentage point would reduce revenue by around $6.7 billion in 2018-19 terms, or increasing each marginal rate threshold by just $1,000 would cost $3.4 billion.[3]

These are gross revenue costs, which make no allowance for the favourable feedback effects of tax reductions on economic growth and reduced avoidance and evasion. The net effects would be lower. However, Treasury's methodology does not allow for these feedback effects in the Budget estimates.

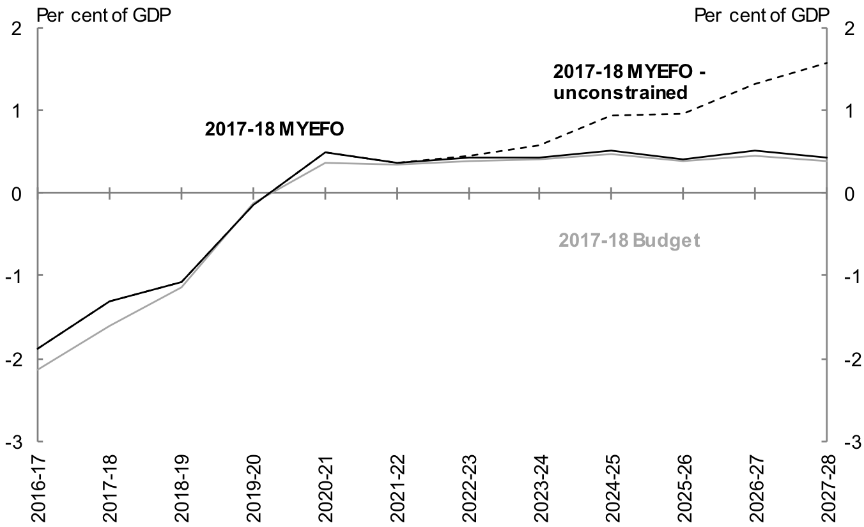
Increasing the scope for income tax cuts would require one or more of the following:

- Parameters moving substantially in favour of higher revenue or lower expenditure.
- Government decisions to reduce expenditure.
- Government decisions to increase other revenue.

The MYEFO projections include the revenue cost of the government's proposed company tax cuts. It has been suggested that the scope for personal income tax cuts could be increased substantially by abandoning the remaining company tax cuts yet to be implemented. However, the long phase-in and back-loading of the company tax cuts means the revenue cost over the next few years is not large anyway.

There has been recent media commentary, based on actual Budget results to February 2018, that the deficit for this year and perhaps later years will be revised down substantially due to positive surprises to both revenue and expenses.[4] Should this prove to be the case, there may be more scope for tax cuts than the MYEFO suggested. The conclusion is that unless that is the case or the government decides to sacrifice its Budget balance objective, the scope for personal income tax cuts is very limited in the next few years.

Figure 2: Underlying cash balance projected to 2027–28



Note: A taxtoGDP 'cap' of 23.9 per cent is applied to the 201718 MYEFO projections from 202223, as was projected at the 201718 Budget. Net Future Fund earnings are included in projections of the underlying cash balance from 202021 when drawdowns from the Future Fund are available.
Source: Treasury projections in Mid-Year Economic and Fiscal Outlook, December 2017[5]

The enduring bracket creep problem

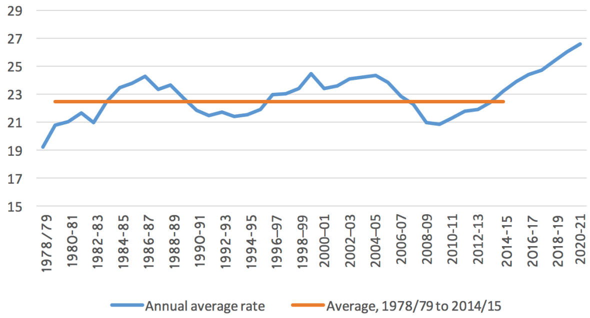
Bracket creep warrants special attention as it is an important part of the case for personal income tax relief. Bracket creep occurs as people's taxable incomes increase solely due to inflation — or on a broader definition, the increase in average incomes — in the context of unchanged marginal rates and thresholds. Thus, as incomes rise, a larger proportion becomes subject to higher marginal rates, resulting in a creeping increase in average tax rates. Bracket creep is often called a 'stealth tax' because it represents an increase in the tax burden without any change in legislation.

As illustrated in Figure 3, the overall average income tax rate has increased in recent years and is projected to increase further to unprecedented levels in the next decade. This is partly due to Medicare levy increases, but it is also due to bracket creep. In fact, the government is relying heavily on bracket creep to bring the Budget into balance. However it has set a limit to the process by imposing a cap of 23.9% of GDP on the total Commonwealth tax take — a level that is expected to be reached around 2022.

One important feature of bracket creep is that its biggest impact is felt at low to middle incomes.[6]

Tax cuts will cap the increase in the tax burden shown in Figure 3 but are unlikely to be large enough to pull it back to the levels of recent years or even to the long-term average.

Figure 3: Personal Income Tax as % of Taxable Income



Source: ATO Taxation Statistics to 2014-15; Treasury Ministerial Brief, 'Economic and Fiscal Effects of Rising Average Tax Rates', 1 February 2016 for projections.

Tax cut options

The Budget will emphasise tax cuts as dollars-per-week amounts but there are various different ways to reach a given dollars-per-week cut.

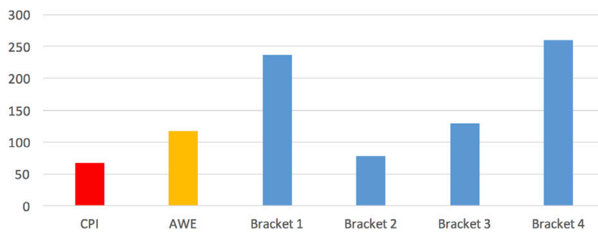
The traditional ways of delivering income tax cuts have been to: raise the thresholds for tax brackets; cut marginal rates; or increase the low income tax offset. A special case of increasing thresholds is to automatically index the thresholds for CPI inflation or average wage growth.

All these methods have been used in the past, although automatic indexation of thresholds only applied for a brief period in the 1970s before it was abandoned.

One-off increases in thresholds

One-off increases in thresholds have probably been the most common form of delivery of tax cuts but also provide the most limited economic benefits. They are usually a way of returning the proceeds of accumulated bracket creep to taxpayers — and in that sense are more fiscal smoke-and-mirrors than genuine tax cuts. Moreover, any increase in thresholds is subject to renewed erosion by bracket creep which, if allowed to run unchecked, will eventually fully offset the initial relief — for the process to start all over again, like a dog chasing its tail. Taxpayers whose incomes fall in a range between the previous and new thresholds have their marginal rates reduced, but only until their income growth once again takes them above the new threshold and their marginal rate is back to where it was.

Figure 4: Increases in Marginal Rate Thresholds Compared with CPI and AWE, 1997–2017 (%)



Source: ATO; ABS Average Weekly Earnings (Catalogue No. 6302.0) and Consumer Price Index (Catalogue No. 6401.0).

The marginal rate at average weekly earnings has always been a politically sensitive benchmark, and this is why the government increased the $80,000 threshold at which the 39% marginal rate applied to $87,000 in the 2016 Budget. Another critical threshold now is the $37,000 threshold at which the 21% rate becomes 34.5%. The income of a full-time worker on the minimum wage is approaching and may soon go above $37,000.[7] As Figure 4 shows, the increase in this threshold over the long-term has lagged other thresholds and average weekly earnings. This can be considered an egregious case for a one-off threshold adjustment.

The estimated revenue cost of a $1,000 increase in each threshold in 2018-19 terms is as follows:

The $18,200 threshold:	$2.1 billion per $1,000
The $37,000 threshold:	$1.2 billion per $1,000
The $87,000 threshold:	$0.1 billion per $1,000
The $180,000 threshold:	Rounds to zero per $1,000

Source: Deloitte Access Economics, Budget Monitor, November 2017.[8]

Automatic indexation of thresholds

Automatic indexation of thresholds is a much more satisfactory solution to bracket creep — by stopping it from happening in the first place. It takes the discretion away from government and ensures that the tax burden does not increase automatically just because of inflation. At current and projected rates of inflation, the revenue cost of indexation would be $2–3 billion a year cumulating. The saving to taxpayers compared with an unindexed tax scale would be small in any one year but substantial after several years of indexation.

Reductions in marginal rates

Reductions in marginal rates are a more satisfactory form of tax cut than one-off increases in thresholds because their effects are more permanent. However, they are also very costly to revenue, as the following shows for a 1 percentage point cut in each of the marginal rates:

The 19% rate: $1.9 billion per 1 percentage point

The 32.5% rate: $2.7 billion per 1 percentage point

The 37% rate: $1.0 billion per 1 percentage point

The 45% rate: $1.1 billion per 1 percentage point

Source: Deloitte Access Economics Budget Monitor, November 2017[9]

Under current government policy (but not yet legislation) marginal rates are due to *increase* by 0.5 percentage point in 2019. The fact that this takes the form of an increase in the Medicare levy does not alter the fact that it is an increase in all marginal rates. The new marginal rate scale including Medicare levy will then be 21.5%, 35%, 39.5% and 47.5%. Although it makes no sense to be increasing marginal rates and reducing them at the same time, if the Medicare levy increase goes ahead then all the economic harm of high marginal rates will increase and the economic case for reducing them will be stronger!

The Henry tax review recommended that the Medicare levy be abolished and the revenue foregone be taken into account in setting the standard marginal tax rates. This would be simpler and also more honest, as the current levy covers only a fraction of the actual cost of Medicare.[10] However, government policy is clearly going in the opposite direction, with the Medicare levy being increased by 0.5 percentage points twice since the Henry review recommendation was made: once by the Gillard government and once by the current government. Cancelling the next increase is an option, but would be hard to sell as a 'cut' when it hasn't even taken effect.

Current marginal rates present substantial disincentive effects and there is a strong case for reducing them. There is a good case for a scale of 15%, 27% and 35%.[11] Clearly such large cuts in marginal rates are unaffordable in the current Budget situation and can only be viewed as a long-term or even 'aspirational' goal. However, it is important that any tax cuts made or planned now represent moves in the direction of a lower marginal rate scale. While there may be a pressing need to correct for bracket creep now, the main thrust of future tax cuts should be cuts in marginal rates rather than increases in thresholds.

Increasing the Low Income Tax Offset

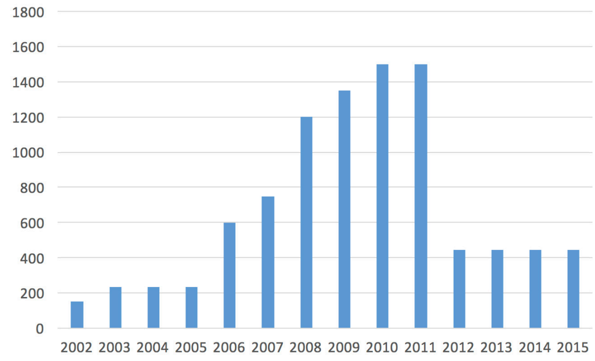
Increasing the Low Income Tax Offset (LITO) is another form that tax cuts could take independently of any other threshold or marginal rate adjustments. As illustrated in Figure 5, the LITO was frequently increased by the Howard government as an alternative to increasing the tax-free threshold.

By 2010, even though the tax-free threshold remained at $6,000, the LITO had been raised so much that the effective threshold for low income earners was $16,000. These levels changed radically when the Gillard government increased the actual tax-free threshold to $18,200 in 2012 and cut the LITO to $445, which gave an effective low-income earners' threshold of $20,500. Increasing the LITO now would be a way of delivering a tax cut confined to low and middle income earners, because the LITO is gradually clawed back as incomes rise above $37,000. For example, doubling the LITO from $445 to $890 a year would lift the effective low-income earners' tax-free threshold to around $23,000, deliver a tax cut of around $8.50 a week from that level to $37,000, and gradually taper tax cuts up to $66,667.

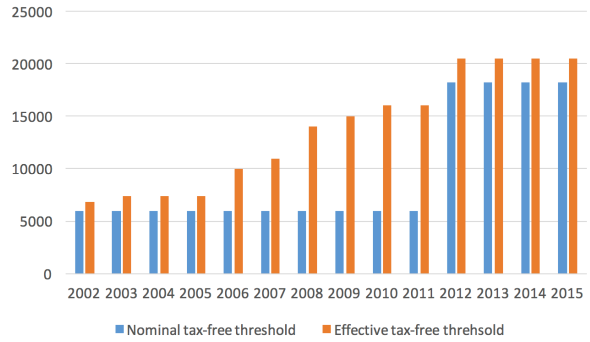
However, the LITO is not without its own problems. As it is targeted to benefit only low income earners, it has to taper off above a certain income level. Currently, the taper rate is 1.5 cents in the dollar of income above $37,000, which means the LITO declines gradually from a maximum of $445 to zero at an income level of $66,667. It is important to understand that this claw-back mechanism represents a 1.5 percentage point addition to effective marginal rates over the income range $37,000–$66,666.

Any increase in the LITO would increase the effective tax-free threshold for low income earners and give them a tax cut, but would also require an increase in the taper rate (and therefore an increase in the effective marginal rate) above $37,000 or an extension of the taper range above $66,667, which would increase effective marginal rates above that level. These increases in effective marginal rates for a large number of taxpayers would be a high price to pay for reducing the effective marginal rate (to zero) for a small number of additional taxpayers at the bottom. For this reason, increasing the LITO should not be the favoured option.

Figure 5: Low Income Tax Offset Since 2002



........and the Nominal and Effective Tax-free Thresholds



Source: ATO; Commonwealth Budget papers, various.

Preferred options for tax cuts

For the reasons discussed above, personal income tax relief should favour:

Priority 1: Automatic indexation of all thresholds.

Priority 2: A start to reductions in marginal rates.

Priority 3: A one-off increase in the current $37,000 bracket threshold.

Automatic indexation of all thresholds

Automatic annual indexation of all thresholds is the first priority. It would put a stop to future bracket creep. The tax saving and annual Budget costs obviously depend on the size of the indexation adjustments. There is a choice between indexing to the CPI and indexing to average wages (which normally grow faster than the CPI, although this has not been the recent experience).

There is a strong case for using average wages, otherwise any future increase in real wages would trigger bracket creep. Both the CPI and average wages have recently been increasing at around 2% a year, but are expected to pick up pace. If we use 2.5% for illustrative purposes, this would cost the Budget around $2.4 billion in the first year — a figure that would then cumulate each year as new indexation adjustments are made. For taxpayers, the first year saving would be around $4 a week from $40,000 to $87,000, $6 a week up to $180,000, and $13 a week above $180,000.

A start to reductions in marginal rates

Cuts to marginal rates should be the second priority for tax cuts. Shaving one percentage point from each marginal rate would have a Budget cost of around

$6.7 billion in 2018-19 terms. However, as the 30% marginal rate was increased to 32.5% in 2012 to offset the cost of increasing the tax-free threshold at that time, and as this rate is the one faced by the largest number of taxpayers, arguably the top priority should be reversing that increase and reinstating the 30% rate. Coincidentally, this also would have a Budget cost of around $6.7 billion in 2018-19 terms. At the current threshold of $87,000 and above, this would deliver the maximum tax cut of $24 a week and smaller amounts at incomes in the $37,000 to $87,000 range. In the middle, for example, the saving would be $13 a week at $65,000.

Beyond this measure, the government should aim to cut marginal rates further. However, its ability to do this responsibly will depend on the Budget situation in the future. Attempting to lock in further cuts beyond (say) 2020 now would be neither responsible nor credible.

A one-off increase in the current $37,000 bracket threshold

A one-off increase in the current $37,000 threshold should be the third priority. As illustrated in Figure 4, this is the threshold that has been increased least over the past 20 years. It is where the marginal rate currently jumps sharply from 21% to 34.5%. The income of a full-time worker on the minimum wage is already close to this threshold and may exceed it after the next minimum wage increase, which means that minimum wage workers will face a marginal rate (including LITO taper) of 36% instead of 21% currently. An increase to $40,000 from 1 July 2018 would have a full-year Budget cost of $3.7 billion and deliver a tax cut of about $9 a week above $40,000 income and smaller amounts between $37,000 and $40,000.[12]

Bringing the three elements together, Table 2 shows the approximate Budget costs and per week tax savings at various income levels.

Table 2: Summary of Priority Personal Income Tax Changes

	Budget cost $b	Tax cut $ pw at income level of:			
		$40,000	$65,000	$90,000	$190,000
Priority 1: Index thresholds annually*	2.4	4	4	6	13
Priority 2: Cut 32.5% rate to 30%	6.7	1	13	24	24
Priority 3: Raise $37 K threshold to $40 K	3.7	9	9	9	9
Totals**	$11.6 b	$11 pw	$23 pw	$36 pw	$43 pw
Per cent cut	5.2%	11.6%	8.6%	8.2%	3.6%

*First year only.
**Components do not sum to these totals as double-counting is eliminated.

Reconciling tax cuts with Budget responsibility

Successive federal governments have displayed insufficient resolve in restoring Budget balance since the global financial crisis and the waning of the mining boom; a balanced or surplus budget is now overdue. The current government has pinned its credibility to achieving a small surplus in 2020-21. This is an unambitious goal, but adherence to achieving at least that modicum of fiscal discipline is important to Australia's fiscal sustainability, not to mention credibility.

Given that, and the last published Budget projections (in the December 2017 MYEFO), there is little room for tax cuts in the next few years. The outlook may change in the forthcoming Budget as a result of favourable revisions to Budget parameters or policy measures to enlarge the scope for tax cuts. All that can be said at this stage is that the government should only use fiscal headroom for tax cuts as it becomes available, and should phase the cuts following the priorities set out above.

The fiscal constraints the government faces in formulating tax cuts are in large part a consequence of the failure of federal governments to wind back expenditure from the bloated levels of 10 years ago. Expenditure as a proportion of GDP has declined to some extent but is now stuck at around 25%. Even a small reduction from that level over the next few years — which could be achieved simply by slowing the rate of growth of expenditure — would create significant additional space for tax cuts.

More radical reform options

This paper has reviewed the options for tax cuts within the framework of the current broad structure of the personal income tax system. The priorities identified merely tinker with a flawed system — although automatic indexation of thresholds would be a genuine and valuable reform. However, there are more radical reform options worth considering, should the government be so minded.

Abolishing the tax-free threshold

Abolishing the tax-free threshold would make much more revenue available for large cuts in marginal rates. However there would still need to be some form of low income tax offset — with the attendant drawbacks discussed above — to protect the genuinely needy from large increases in tax bills.

Abolition of the tax-free band could be combined with a *flat tax*. Although this move away from a graduated tax scale would go against the grain of current concerns about inequality, tax policy should never lose sight of the case for a flat — or at least less steeply graduated — income tax.[13] The redistributive objectives of government can be better pursued through the targeting of expenditure programs.

Abolishing deductions, offsets and rebates

Abolishing deductions, offsets and rebates such as deductions for work-related expenses would generate extra revenue for marginal rate cuts and remove opportunities for rorting the system. However, many deductions and offsets are grounded firmly in tax principles and getting rid of them is not as easy or compelling as it may seem.

Removing distortions in taxation of saving and investment

There are many distortions in the taxation of saving and investment — such as interest income being more heavily taxed than investor housing, and foreign dividends more than domestic franked dividends. Ironing out these distortions could both simplify the system and make people's saving and investment choices less tax-driven, while recognising the principle that saving should be taxed at lower rates than labour income. One option would be to apply a low, flat rate of tax to all forms of saving with no tax-free band for this form of income. While this in itself would be an advance, it is not clear that such a system — which would involve revenue pluses and minuses — would free up money for cuts in marginal rates on labour income.

Conclusion

The personal income tax burden is at historically high levels and rising. There is a strong case for relief. This can take different forms, but the priorities should be first to initiate a system of automatic annual indexation of thresholds to average weekly earnings; second, to cut marginal rates; and third, to make a one-off increase in the $37,000 threshold to $40,000.

The cut in marginal rates should start with the current 32.5% rate, and extend to all marginal rates when Budget conditions permit. Significant income tax cuts are very costly to revenue, and the scope for cuts is severely constrained by the Budget outlook, which may necessitate a phased approach.

It remains to be seen whether the upcoming Budget revises the outlook for the better and provides scope for anything more than modest income tax cuts in the next few years. The key to substantial tax cuts is stronger government expenditure restraint, which would see expenditure as a proportion of GDP fall below the level of 25% at which it has settled.

Endnotes

1 Rankings of the marginal deadweight cost of taxes can be found, for example, in Chris Murphy, Modelling Australian Corporate Tax Reforms, Tax and Transfer Policy Institute Working Paper 2/2018, ANU, Canberra, February 2018. However, these estimates typically understate the economic costs of personal income tax because of the modelling assumptions made and the failure to capture long-term effects on investment in human capital.

2 Australian Taxation Office, *Individual Income Tax Rates,* https://www.ato.gov.au/Rates/Individual-income-tax-rates/

3 Deloitte Access Economics Budget Monitor, November 2017.

4 Christopher Joye, 'Turnbull on track for early budget surplus', The Australian Financial Review, 29 March – 2 April 2018.

5 Treasury projections in Mid-Year Economic and Fiscal Outlook, Commonwealth Treasury, December 2017.

6 This and other aspects of bracket creep are explored more fully in Robert Carling and Michael Potter, Exposing the Stealth Tax: The Bracket Creep Rip-off, CIS Research Report 8, The Centre for Independent Studies, Sydney, December 2015.

7 The Fair Work Commission is currently considering an application for an increase. An increase of 2.4% would take the minimum wage to $37,000 expressed as an annual income.

8 Deloitte Access Economics Budget Monitor, November 2017

9 Deloitte Access Economics Budget Monitor, November 2017

10 Jeremy Sammut, Fiscal Fiction: The Real Medicare Levy, CIS Research Report 27, The Centre for Independent Studies, Sydney, May 2017.

11 Robert Carling, The Unfinished Business of Australian Income Tax Reform, CIS Policy Monograph 108, The Centre for Independent Studies, Sydney, 2010.

12 This figuring assumes the starting point for LITO taper is also increased to $40,000.

13 This case is made in Taxploitation – The Case for Income Tax Reform, CIS Readings 11, The Centre for Independent Studies, Sydney, 2006.

About the Author

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Robert Carling is a Senior Fellow at The Centre for Independent Studies, an independent public policy research and educational institute based in Sydney. He undertakes research into a wide range of public finance issues, writes papers for publication, and regularly comments in the media on taxation and other budget issues. His most recent publication under the CIS banner was 'From Reform to Retreat: 30 years of Australian fiscal policy'. Before joining the CIS, he was a senior official with the New South Wales Treasury, and prior to that, with the Commonwealth Treasury.

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