POLICY PAPER

No. 19 • April 2019

BUDGET 2019:
WHY THE LONG-TERM TAX CUTS SHOULD BE FAST-TRACKED

TARGET30
REDUCING THE BURDEN FOR FUTURE GENERATIONS

THE CENTRE FOR INDEPENDENT STUDIES

A catalogue record for this
book is available from the
National Library of Australia

Budget 2019: Why the long-term tax cuts should be fast-tracked

Dr John Humphreys

TARGET30
REDUCING THE BURDEN FOR FUTURE GENERATIONS

THE CENTRE FOR INDEPENDENT STUDIES

POLICY Paper 19

Contents

Introduction

The centrepiece of the 2019/20 budget was a proposed doubling of the income tax cuts that were legislated last year. Treasury has estimated that the cost of the new tax changes will be $19.5 billion over the next four years (until 2022/23) and $158 billion over the next eleven years (until 2029/30).[1]

These changes are scheduled to be introduced in stages. The first, short-term stage more than doubles the Low and Middle Income Tax Offset (LMITO), from $530 to $1080 per year, with the full amount going to people who earn between $48,000 and $90,000 per year. The second, longer-term stage replaces the LMITO with a higher tax threshold and lower marginal tax rate.

Both the short-run LMITO change and the long-run tax cuts will reduce tax, but the two approaches are fundamentally different. These differences are important, but they are hidden by the superficial nature of the tax debate in Australia.

The political debate too often focuses on the direct dollar benefit received by the taxpayer, and the distribution of benefits to different groups. While that is certainly important (especially to the taxpayers in question), from a national perspective the most important issue is how the tax changes impact on incentives, behaviour, economic output, and wage growth.

1 The budget documents show the annual costs for the first four years, but there is no detail for the later years. Nonetheless, by copying Treasury's assumptions within our own tax model, it's possible to recreate their estimates.

Tax cuts as microeconomic reform

Since the success of the 1980s and 1990s economic reforms, subsequent governments have attempted to drape their new policy ideas in the language of 'reform'. This is especially true with regards to tax, but not all tax changes rise to the level of reform. The purpose of microeconomic reform is to decrease economic distortions, improve productivity, and help drive higher economic growth. Not all tax policy will achieve these goals. To differentiate between superficial tax changes and meaningful tax reform, it is necessary to understand the link between taxes, incentives, and behaviour.

To properly analyse the economic consequences of tax changes, the focus needs to be on marginal tax rates. This is the tax rate paid on the next dollar earned, and therefore it is the marginal tax rate that determines people's incentive to increase or decrease their taxable income.

Higher marginal tax rates increase the incentive for people to shift from formal work into informal work, increase leisure time, downgrade their education and career plans, illegally evade tax, rearrange their financial arrangements to minimise tax, avoid difficult or risky work, shift their activity to a lower-tax jurisdiction, and decrease capital investment. These consequences won't always occur and they won't occur for everybody; but when taxes are changed, at least some people will change some of their behaviour some of the time.

By studying the behavioural changes, it is possible to analyse how a tax change will impact the broader economy, and make judgements about the efficiency and desirability of different tax policies. Behavioural changes will also impact on the underlying tax base, so they have important consequences for estimates of tax revenue. Unfortunately, the budget papers rely on a static tax model which makes the absurd assumption of zero behavioural changes from tax policy. The consequence is a counter-productive pantomime where there is a pretence of talk about tax reform when it is really talk about income distribution, while efficiency considerations are mostly ignored.

It is also important to draw a sharp distinction between the microeconomics of reform, and the macroeconomics of fiscal stimulus. Tax cuts are an example of both, but it is the microeconomic reform that creates large and lasting benefits, while the fiscal stimulus only leads to a small and short-term impact. The economic benefit of tax cuts does not come from greater consumption, but rather from better incentives leading to more production.[2]

Dynamic tax modelling

The government's proposed tax changes are a perfect example of why it is necessary to factor in changes in behaviour and conduct dynamic tax analysis. There are two main problems that come from the static tax model used by Treasury:

1. The estimated impact on the budget will be exaggerated; and
2. It's not possible to draw any conclusions about economic efficiency.

As noted above, the government claims that their proposed new tax changes will cost the budget $158 billion over the next 11 years. This estimate is based on static analysis, so it is almost certainly wrong.

We have instead used a dynamic tax model that factors in behavioural changes. This model applies an elasticity of taxable income[3] to estimate the direct link between tax rates and the tax base, which allows for more accurate estimates of revenue changes, the efficiency cost (deadweight loss) from tax, economic output, and consumer wellbeing. The model does not directly include the short-term impact of fiscal stimulus, the medium-term benefit from increased investment, or the long-term benefit from more robust market competition.[4]

2 Fiscal stimulus may increase consumption, but it also creates several feedback mechanisms that may decrease investment and/or net exports. The impact on aggregate demand is ambiguous. Further, it should be noted that economic growth comes from investment and innovation, and not from boosting consumption.

3 Elasticity estimates were based on evidence from the US and UK, most of which suggests an elasticity of about 0.4 on average and 0.6 for high income earners. For the changes proposed in the 2019 budget the model uses an elasticity of 0.2 for the threshold increase and 0.4 for the tax rate reduction. Complete results (including sensitivity analysis) are available on request, and will be published along with more detailed analysis in the near future.

4 If these additional elements are included, then tax cuts result in larger economic benefits and a smaller cost to the budget. Some of these scenarios are considered in the sensitivity analysis.

Table A: Cost of tax changes, total from 2019/20 to 2029/30

	Static model	Dynamic model
Increase LMITO	-$14.9 billion	-$14.9 billion
Increase tax bracket to $45k	-$42.4 billion	-$39.9 billion
Decrease rate from 32.5% to 30%	-$101 billion	-$66.8 billion
TOTAL	**-$158.4 billion**	**-$121.6 billion**

Using our dynamic tax model, we estimate that the proposed tax changes will cost the budget about $122 billion over the next 11 years. The difference comes from dynamic modelling of the two long-run tax changes. Specifically, the government has proposed to increase the 32.5% threshold from $41,000 to $45,000 in 2022/23,[5] and then to decrease the 32.5% marginal tax rate down to 30% in 2024/25 (excluding the Medicare Levy). One of the consequences is that taxpayers have an increased incentive to earn and report taxable income, which helps to offset the cost of the tax cuts.

Table A highlights the difference between static and dynamic tax modelling. In particular, the static approach to tax modelling overestimates the revenue impact of cutting the marginal tax rate by as much as 50% (from $66.8 billion up to $101 billion). Dynamic analysis shows that tax cuts are actually more 'affordable' than previously understood.

Dynamic tax analysis also reveals the crucial difference between the short-run tax changes done through LMITO and the long-run tax reform. The focus of the LMITO discussion has been on the $1080 benefit received by taxpayers who earn between $48,000 and $90,000 per year, but from an economic perspective the important issue is how the LMITO impacts on marginal tax rates.

When looking at marginal tax rates, the LMITO change is a mix of good, bad, and irrelevant.

- The good news is that the marginal tax rate for people earning between $37,000 and $48,000 has been decreased by 4.5%, from 33% down to 28.5%, improving the incentives for those workers. While this is worth celebrating, it should be noted that low-income earners tend to be less responsive to tax changes; so the benefits will be small.
- The bad news is that the marginal tax rate for people earning between $90,000 and $126,000 has been increased by 1.5%, from 40.5% to 42%, creating worse incentives for those workers. These workers are relatively more responsive to tax changes, so it is possible this cost may completely offset the above benefit.
- Workers earning between $48,000 and $90,000 will receive the full benefit of $1080. While this certainly gives them a personal benefit, the LMITO policy does not actually change their marginal tax rates, which means they have no incentive to earn and/or report more income.

The net outcome is uncertain, but it's unlikely that the LMITO changes will improve the efficiency of the tax system. The recipients of the $1080 will certainly benefit from that money, but from a national perspective the LMITO changes do little to boost productivity, output, or wages. Details of the marginal tax changes from LMITO are in the Appendix, which combines the nominal tax rates, Medicare Levy, and various tax offsets to show the actual marginal tax rates.

In contrast, the long-run tax changes are an example of genuine microeconomic reform, which improves incentives, leading to higher economic productivity, output, and growth. Marginal tax rates are decreased significantly for people earning between $41,000 and $45,000 and are also decreased for people earning between $45,000 and $200,000, which unambiguously improves economic efficiency and productivity. Estimates from our dynamic tax model suggest that economic output (GDP) will increase by over $10 billion per year, which increases total wellbeing (consumer surplus)[6] by over $3 billion per year.

5 Note that the current threshold for the 32.5% tax rate is $37,000, but the government has already passed legislation to increase this threshold to $41,000 in 2022/23, as part of the 2018 tax reforms. People earning below the threshold would pay nominal income tax rates of 19%, plus the Medicare Levy.

6 While it is common to focus on the GDP results, these are not the best way to measure the benefit to society. GDP measures total (traded) output, but doesn't factor in the loss of leisure time for workers. The measure of 'total wellbeing' factors in both increased production and lost leisure to give the net benefit.

Impact of bringing the long-run tax cuts forward

Tax cuts are always welcome, but the short-run LMITO system is neither efficient nor transparent, and is one of the worst possible ways to deliver tax relief. The long-run reforms are efficient and desirable, but the benefits don't begin for at least three years, and there is a political risk that those reforms may never happen. The government should consider scrapping the LMITO system, and instead bring forward their efficient long-run tax reform to start immediately.

Based on static tax analysis, it is true that bringing forward the government's long-run tax reforms would cost the budget an additional $16.8 billion in 2019/20, with a total cost of $64 billion over the next four years. If these estimates were true, bringing forward the long-run tax cuts would cause the budget to stay in deficit for the foreseeable future.

However, the above estimates are based on the unrealistic assumption that people don't respond to changing incentives. Based on dynamic tax analysis, the cost of bringing forward the full tax reform package drops to $8.7 billion in 2019/20, and a total cost of $30.9 billion over the next four years.

The result is a series of near-zero budget balances (see Table B below), which is a small price to pay for arguably the most important piece of microeconomic reform in a generation, leading to higher productivity, giving people the double benefit of higher wages and lower taxes on those wages. While there is little economic difference between a small deficit and small surplus, if the government puts a high value on surplus projections in each year, it could easily achieve that by delaying some of their projected spending increases.[7]

Table B: Impact of bringing forward long-run tax cuts ($ billions)

	Remove LMITO	Bring forward tax cuts from 2018 budget	Bring forward tax cuts from 2019 budget	Net impact	Revised budget balance
2019/20	$7.3	-$6.3	-$9.7	-$8.7	-$1.6
2020/21	$7.6	-$6.7	-$10.4	-$9.5	$1.5
2021/22	$7.8	-$7.1	-$11.1	-$10.4	$7.4
2022/23	$8.1	-$2.9	-$7.5	-$2.2	$7.0
TOTAL	**$30.8**	-$23.0	-$38.7	-$30.9	$14.3

Conclusion

While the LMITO tax announcement achieves the political aims of a 'cash splash' direct benefit to taxpayers, it is not good tax reform. In comparison, the government's long-run tax plan will increase economic efficiency, increase taxable income (partly offsetting the cost of the tax cuts), increase GDP and investment, and lead to higher wages and more employment.

It's also worth noting that the long-run reforms improve the transparency and simplicity of the tax system. The LMITO system is not well understood, and many commentators (and voters) do not fully understand the impact of LMITO on marginal tax rates. This may have a political benefit in hiding marginal tax rate increases, but complexity and confusion should always be considered poor policy.

In all of these ways, the long-run tax reforms are preferable to their short-run plans, and the government should scrap its LMITO policy and instead bring forward the real tax cuts.

7 Note that the government policy decisions over the last year have added $6 billion of annual spending.

Appendix: Actual tax rates

The government claims their current income tax rates are as follows:

Income bracket	Marginal tax rate
0 - $18,200	0%
$18,200 - $37,000	19%
$37,001 - $90,000	32.5%
$90,001 - $180,000	37%
> $180,000	45%

This is misleading, since it does not factor in the Medicare Levy (ML), or the Low-Income Tax Offset (LITO), or the Low and Middle Income Tax Offset (LMITO). Following the 2018-19 budget, the actual tax rates were as follows:

Income bracket	Marginal tax rate
0 - $21,595	0%
$21,596 - $21,980	19%
$21,981 - $27,474	29%
$27,475 - $37,000	21%
$37,001 - $48,000	33%
$48,001 - $66,667	36%
$66,668 - $90,000	34.5%
$90,001 - $125,333	40.5%
$125,334 - $180,000	39%
> $180,000	47%

With the updated tax policy announced in the 2019-20 budget, if made into law, the actual tax rates would be as follows, with the changes highlighted in yellow.

Income bracket	Marginal tax rate
0 - $21,884	0%
$21,885 - $22,398	19%
$22,399 - $27,998	29%
$27,999 - $37,000	21%
$37,001 - $48,000	28.5%
$48,001 - $66,667	36%
$66,668 - $90,000	34.5%
$90,001 - $126,000	42%
$126,001 - $180,000	39%
> $180,000	47%

About the Author

John Humphreys

Dr John Humphreys is an economist who has worked in academia, government, consulting, and think tanks. He is an Associate Researcher at the Centre for Independent Studies and a sessional lecturer at the University of Queensland. He has also worked for the Australian Treasury, and the Centre for International Economics (including consulting jobs for the World Bank and ASEAN).

Related works

Myth vs Reality: The case against increasing Capital Gains Tax. Robert Carling. 05 March 2019 | PP18

Dividend Franking Credit Refunds: principle vs revenue. Robert Carling. 12 February 2019 | PP16

THE CENTRE FOR INDEPENDENT STUDIES

POLICY Paper 19 (PP19) • ISSN: 2209-2447 • ISBN: 978-1-925744-44-6

Published April 2019 by The Centre for Independent Studies Limited. Views expressed are those of the authors and do not necessarily reflect the views of the Centre's staff, advisors, directors or officers.

This publication is available from The Centre for Independent Studies. Visit **www.cis.org.au**.

Level 1, 131 Macquarie St, Sydney NSW 2000 • **phone:** +61 2 9438 4377 • **fax:** +61 2 9439 7310 • **email:** cis@cis.org.au