RESEARCH REPORT
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Bracket Creep: Raiding our wallets

Matthew Taylor and Robert Carling

The previous Coalition government's Stage 3 income tax cuts have been mired in controversy ever since they were announced — in their final form — in 2019. The controversy culminated in the current Labor government's January 2024 announcement the cuts will be reduced for those above $146,500 and increased for those below; the balance being approximately revenue neutral.

However, the debate surrounding the original Stage 3 tax cuts — which from some quarters included calls for their abolition — was misinformed by claims that high income earners would have been over-compensated for bracket creep. These assertions are inconsistent with the reality of personal income tax policy since the beginning of the three-stage Personal Income Tax Plan (PITP) in 2018-19.

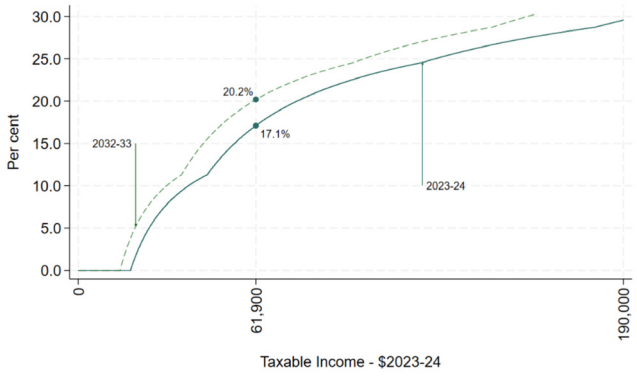
This report clarifies what bracket creep is, how it should be measured, and assesses the claims that the Stage 3 tax cuts 'more than returned bracket creep' and 'over-compensated' high income-earners. The modelling demonstrates how the benefits of income tax policy changes, relative to the year before the beginning of the PITP, have largely accrued to taxpayers on middle incomes. Had the Stage 3 tax cuts been delivered as originally intended, the highest income taxpayers would still be slightly worse off due to bracket creep over the period. The government's recently legislated revisions will further increase their cumulative tax burden.

Bracket creep: Tax increases by stealth

Every year in which there are no tax cuts, the previous year's tax thresholds are applied to the current year's taxable incomes. If income growth is merely matching that of inflation, then taxable incomes have remained the same in 'real' — adjusted for inflation — terms despite an increase in 'nominal' terms.

These nominal income increases result in higher tax rates, and greater tax payments in real terms, because of the failure of income tax brackets to increase with nominal incomes. This means higher tax rates despite taxpayers having no greater capacity to pay tax — 'bracket creep'.

Bracket creep pushes up tax rates at each level of (real) taxable income



Notes: Tax Rates in this figure reflect gross personal income tax, they do not include the impact of tax offsets or the Medicare levy. The upward shift in the curves assumes 2023-24 policy remains in place in subsequent financial years.

Source: CIS modelling.

The figure on page 1 illustrates the impact of bracket creep on the tax rate paid by a taxpayer with median wages and no other taxable income. Under 2023-24 tax rates and thresholds, a median wage earner on $61,900 would pay 17.1 per cent of their income in tax: $10,600 in $2023-24. If wages were to increase with the rate of inflation, with both growing at 2.5 per cent per annum from now until 2032-33, and there were no tax cuts over this period, their tax payment would increase by $233 (in real terms) in the first year and then increase annually; reaching $1,900 in 2032-33. Summed over the years, that's an additional $9,811 in tax, or $1,090 on average each year.

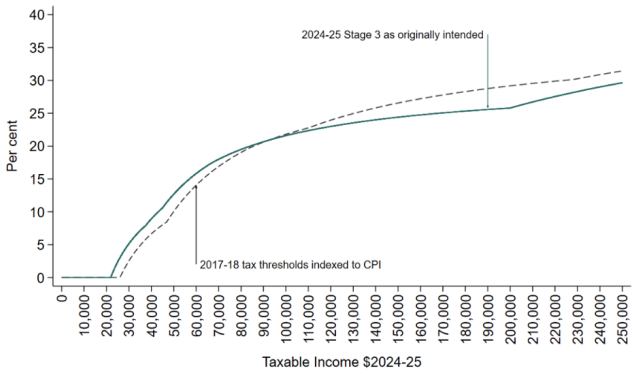
Had income tax thresholds increased in line with inflation, tax payments would have remained at $10,600 in real terms each year. Instead, bracket creep pushes tax payments up to $12,500 in 2032-33 in real terms.

Tax cuts do not necessarily compensate for bracket creep

Tax cuts are necessary, but not sufficient, to provide compensation for bracket creep. A change in tax policy that pushes tax rates — and real tax payments — below those of the previous year can only be said to be a tax cut relative to that year. For tax cuts to compensate for bracket creep accumulated in previous years, they must push tax rates below those of some benchmark financial year. The longer bracket creep is left to accumulate, the larger tax cuts must be if they are to provide compensation for past bracket creep.

Some of the punditry surrounding the purported 'over-compensation' of the original Stage 3 tax cuts presents tax rate schedules, similar to the next figure, as evidence of their claims. The figure compares the tax rates that would eventuate following the (original) Stage 3 tax cuts with those of a reference year; in this case 2017-18. While this comparison demonstrates that tax rates would be lower for those with incomes above $92,000 in 2024-25 compared to 2017-18, it fails to account for the tax paid as a result of bracket creep in the intervening years in which there were no tax cuts. All that can be concluded from this analysis is that the (original) Stage 3 tax cuts were to provide some compensation for previous bracket creep. To argue they over-compensate requires an estimate of the cumulative bracket creep they were supposed to compensate for.

Comparing tax rates in 2017-18 with those intended for 2024-25



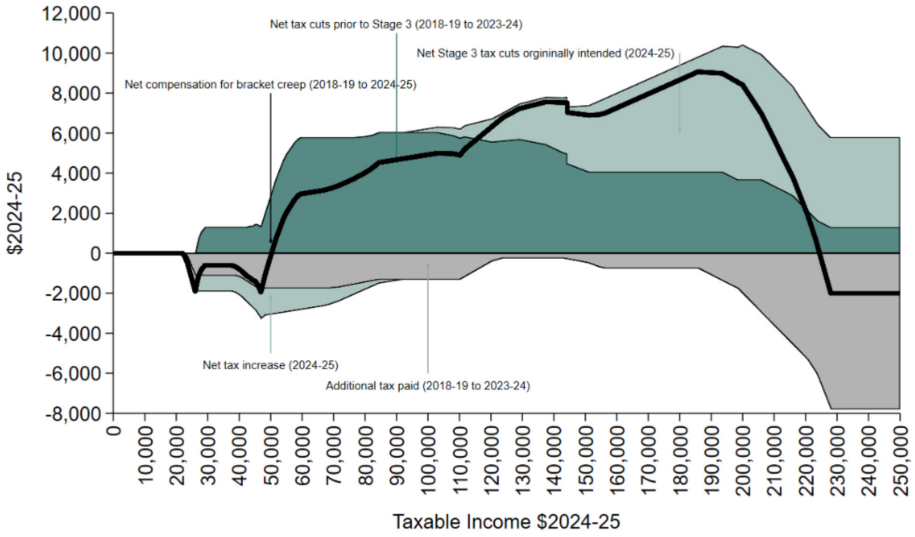
Notes: Includes the Low Income Tax Offset. Excludes the Medicare levy.

Source: CIS modelling.

High income earners have been under-compensated for bracket creep since 2017-18

The next figure presents the net position of taxpayers, taking into account tax increases that arise from bracket creep and the tax cuts received over the three-stage PITP, compared to a tax policy benchmark of 2017-18. These net benefits are provided for each level of (real) taxable income in $2024-25. Far from '$9,000 gifts for society's wealthiest', when the third stage of the PITP is placed within the context of the bracket creep of the period, it is clear that middle-income earners received the greatest benefit of the PITP. In fact, those with incomes above $224,000 would still have been worse off had the government delivered the tax cuts in the form they promised prior to January 2024.

Net compensation for bracket creep since 2017-18 under the original Stage 3 tax cuts



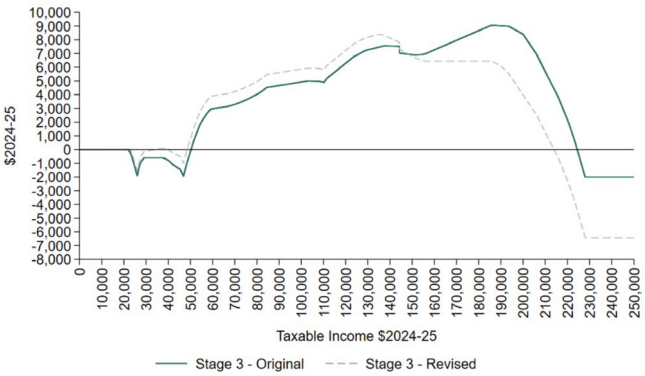
Notes: Includes the Low Income Tax Offset and the Low and Middle Income Tax Offset in the years it was in place. Excludes the Medicare levy.

Source: CIS modelling.

Stage 3 mark II: More compensation for middle income earners, less compensation for high income earners

The current government's revision of the third stage of the PITP will lower the range of incomes where over-compensation will occur to around $48,000-$214,000 — again, relative to a 2017-18 policy benchmark. The reform will also increase the extent of under-compensation for those with incomes above $214,000 by up to $6,400.

Comparing net compensation for bracket creep since 2017-18 under original and revised Stage 3 tax cuts



Notes: Includes the Low Income Tax Offset and the Low and Middle Income Tax Offset in the years it was in place. Excludes the Medicare levy.

Source: CIS modelling.

Indexation of tax thresholds to price increases will halt bracket creep and make the tax system more transparent

The lesson for future tax policy is that if tax thresholds were indexed to the CPI annually, relatively small downward adjustments to tax would be made each year; thereby avoiding the accumulation of tax revenue to fund larger but illusory discretionary 'tax cuts' every three to five years — or longer. Discretionary tax cuts in a world of indexed thresholds would be genuine. And if those in power at the time wished to change the tax burden inherent in the indexed scale, they would have no choice but to be transparent regarding their intent.

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