Income tax cuts:
the implications and inequities

St Vincent de Paul Society National Council

POLICY BRIEFING | JUNE 2018

SUMMARY: Against a backdrop of rising inequality and unmet demand for essential services, the Federal Government has proposed substantial income tax cuts and a radical flattening of Australia's income tax scales. We oppose these tax cuts, which will have profound implications for inequality and the capacity of future governments to fund services and infrastructure. Modelling shows that the tax cuts overwhelmingly benefit high-income earners, with most people on low incomes receiving little or no benefit. The full package of tax cuts will widen the gap between rich and poor, undermine the progressive structure of our income tax system, and deprive governments of the revenue needed to guarantee essential services and a decent social safety net. Tax cuts will inevitably lead to more cuts to essential service and supports – an approach that is economically, socially and morally indefensible.

What are the proposed changes to income taxes?

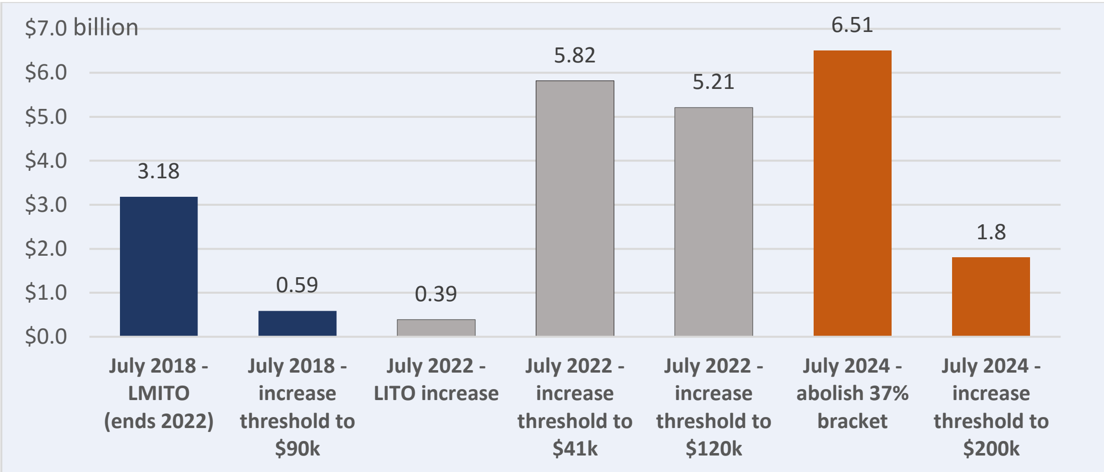
The centrepiece of the 2018 Federal Budget was a three-stage plan to reduce personal income taxes, compromising a package of measures to be phased in over seven years:[1]

STAGE ONE *from July 2018*	**Low and Middle Income Tax Offset and change in tax threshold**	People earning between $21,000 and $125,000 receive a temporary Low and Middle Income Tax Offset, worth up to $530 as a lump sum at tax time. The top income threshold for the 32.5% rate increases from $87,000 to $90,000.
STAGE TWO *from July 2022*	**Further changes to tax thresholds and Low Income Tax Offset**	The Low and Middle-Income Tax Offset ends; the annual Low Income Tax Offset increases from $445 to $645. The top threshold of the 32.5% tax bracket further increases from $90,000 to $120,000. The top income threshold for the 19% tax bracket increases from $37,000 to $41,000.
STAGE THREE *from July 2024*	**Abolition of 37% tax bracket**	The 37% tax bracket is abolished altogether and the upper threshold increased, so that people earning between $41,000 and $200,000 share the same marginal tax rate of 32.5%.

How much will the tax changes costs?

Treasury costings suggest the full package of tax cuts will cost **$144 billion** over a decade, with the final two stages comprising the most costly elements of the package (Figure 1). The third and most controversial stage, which involves removing an entire tax bracket and flattening the tax scales, will ultimately comprise around 42 per cent of the annual cost of the Personal Income Tax Plan. According to costings by the Parliamentary Budget Office, the personal income tax plan will cost **$24.6 billion a year** by the end of the decade, with the costs compounding therafter.[2] Stage three alone will cost $10.4 billion by 2028 and grow at a rate of 12 per cent per year.

Figure 1. Average annual cost of different components of the income tax plan



Source: Compiled from data from the Parliamentary Budget Office.[2]

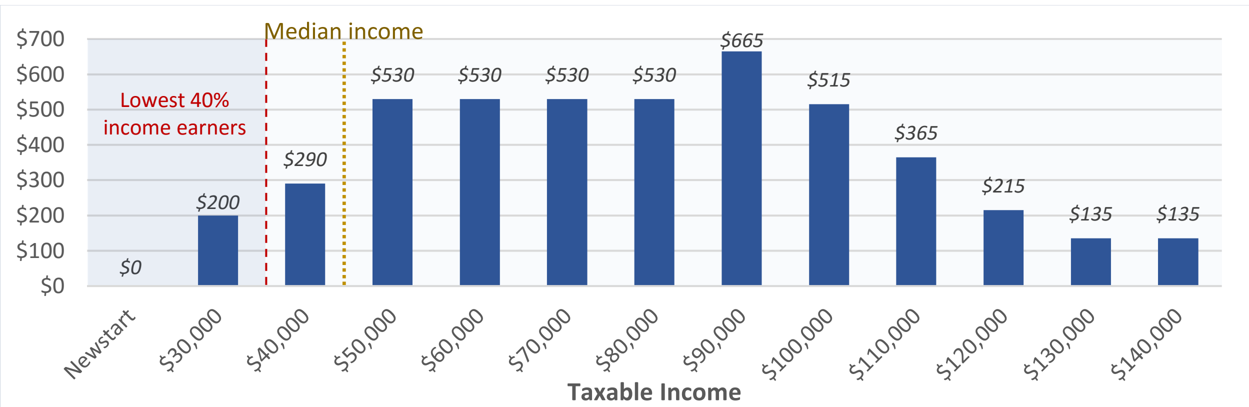
Who will benefit most from the proposed tax cuts?

Both independent modelling and Treasury costings show the tax cuts are skewed overwhelmingly toward high-income earners – both in terms of the benefits received at an individual and household level, as well as the overall distribution of forgone government revenue.[2,3,4,6,7,14,16] Individuals and families with the lowest incomes will not benefit from income tax cuts because they pay little or no income tax.

The benefits are overwhelming weighted toward high-income earners

The Government maintains that low-income earners will benefit from the 'Low and Middle Income Tax Offset' during the **first stage** of income tax cuts (2018-2022). However, the main beneficiaries will be 'upper-middle' income earners, as shown in Figure 2. **The lowest 40 per cent of income earners will get little or no benefit as their income is generally too low to pay income tax**.

Figure 2. Reduction in income tax from first stage of tax package, by income level (2018-2022)



Source: Budget Papers 2018-19.[1] Figures for the median income and income range for the lowest 40% incomes are from the latest ABS Average Weekly Earnings[10] data and the ATO's Taxation Statistics.[11]

The **final two stages** of the income tax package are the most inequitable, with the bulk of tax cuts benefitting the top 20 per cent of individuals by income, as shown in Table 1.

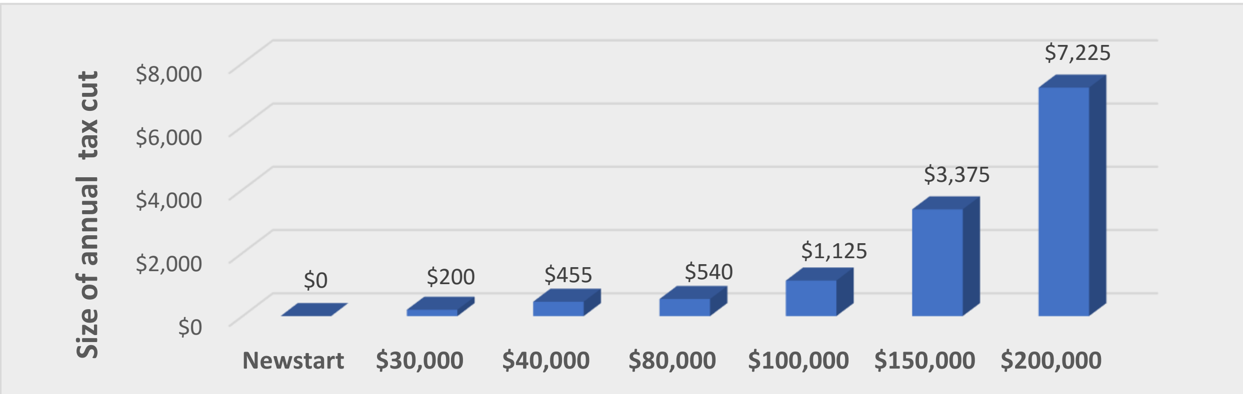
Table 1: Proposed income tax cuts by income level, for stages two and three of Government package

Individuals by income group (2017-18)	Taxable income range (2017–18) (per annum)	Before & after-tax income of average earner in each group (per annum)	SECOND STAGE (from 2022)		THIRD STAGE (from 2024)		Cumulative tax cuts 2018-2024 (per week)
			Extra tax cuts in 2022 (per week)	As a % of after-tax income	Extra tax cuts in 2024 (per week)	As a % of after-tax income	
Lowest quintile (lowest 20%)	Up to $20,000	$8,000	$0	0%	$0	0%	$0
Second quintile	$20,000 to $37,000	$28,000 ($26,000)	$0	0%	$0	0%	$27
Third quintile	$37,000 to $56,000	$46,000 ($39,000)	$0	0%	$0	0%	$61
Fourth quintile	$56,000 to $85,000	$69,000 ($54,000)	$0	0%	$0	0%	$72
Highest quintile	$85,000 and above	$156,000 ($106,000)	$39	1.9%	$69	2.3%	$160
Highest 3%	$200,000 and above	>$200,000 (>$133,000)	$39	up to 1.5%	$139	up to 5.4%	$227

Calculations are derived from distributional data released by the Parliamentary Budget Office[2]; the 2018 Budget Papers[1]; and analysis undertaken by the Australian Council of Social Service.[5] The tax cuts are modelled for individuals based on the average pre-tax income for each of the five income groups. The cumulative tax cuts show the total tax cuts over six years, expressed in 2018 dollars. Note that the stated figures do not include potential changes in the distribution of incomes from 2018 to 2024, nor do they factor in inflation and offsets from bracket creep.

While a person earning $200,000 has an income 6.7 times more than someone earning $30,000, by 2024 they will receive a tax cut **36.1 times greater** than the tax cut someone on $30,000 gets, as illustrated in Figure 3.

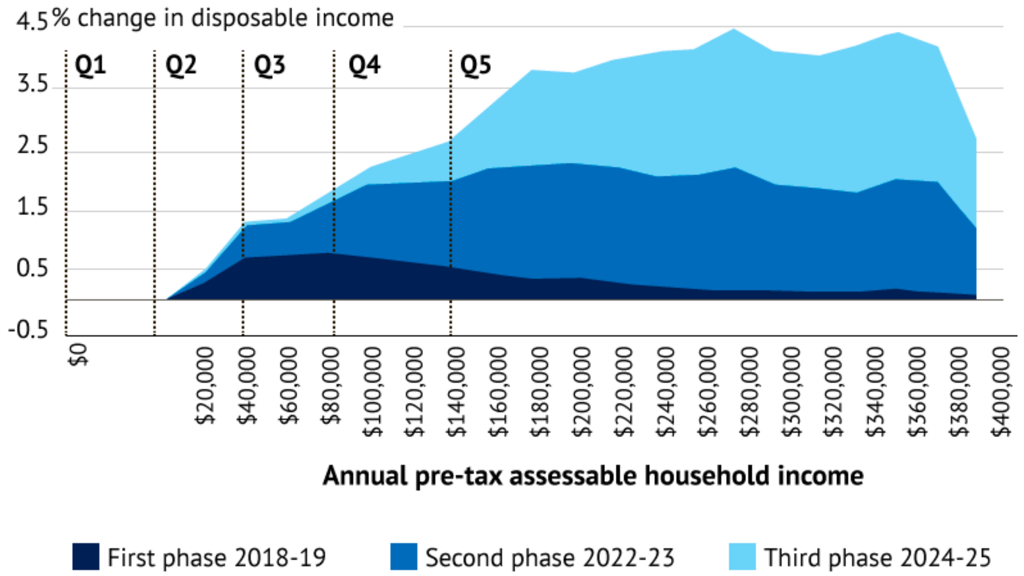
Figure 3. Phase three of income tax plan (2024-25): annual tax cut by taxable income



Source: 2018-19 Budget papers.[1]

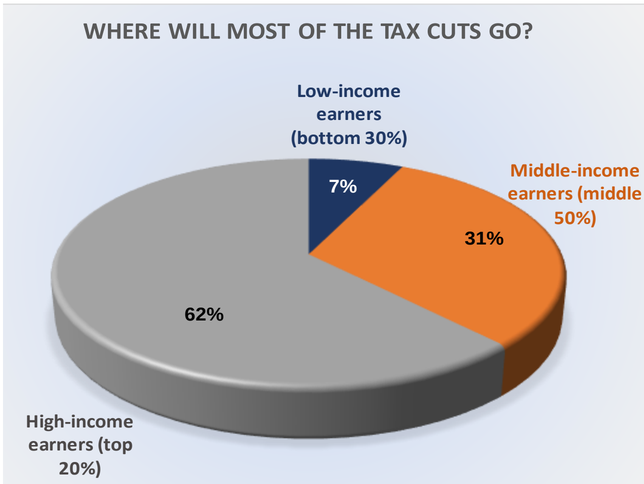
Another way to consider the impact on different income groups is at the household level. Modelling by NATSEM groups households into five groups (quintiles) based on their level of household equivalised disposable income. Figure 4 shows how the tax cuts implemented in each stage will affect the disposable income of each of these different income quintiles. While those in the lowest 40 per cent (Q1 and Q2) receive little, if any, change, the final two stages deliver a substantial percentage increase in the disposable income of those in the top 20 per cent of income earners (Q5).

Figure 4. The percentage change in household disposable income by income quintile due to tax cuts.



Source: NATSEM.[6]

Figure 5. Income distribution of tax cuts in 2024-25.



Source: The Australia Institute.[7]

When we look at the overall flow of money, significantly more of the revenue forgone to tax cuts will be redistributed to those on the highest incomes. This is illustrated by a distributional analysis undertaken by the Australia Institute, which divides taxpayers into three income groups and calculates how much each group will receive when the full plan is in place. This analysis shows that high income earners (the top 20 per cent) will receive nearly two thirds of the tax cuts, with those in the lowest 30 per cent of income earners receiving a mere seven per cent.[7]

Claims that the tax cuts target middle-income earners are wrong

Supporters of the tax plan have repeatedly tried to sell it as targeting 'ordinary middle-income Australia' and 'average Australians'.[8,9] This claim has been reiterated by sections of the media, who have insisted wage rises will push up incomes so that the main beneficiaries (those with an income of up to $200,000 a year) will be classified as middle-income earners by the time the final stages of the tax plan are delivered.

These claims are flawed on several levels. They create a misleading impression of where the 'middle' is, relying on a definition of 'middle income' as between $120,000 and $200,000 per year. The latest ABS data shows that the **average annual income** is only **$62,000** overall ($84,700 for those working full-time).[10] The most recent figure for the ***median* annual income** – which is a more representative measure – is just over **$46,000**.[11]

Even if we assume wages will increase annually by the extremely optimistic rate of 3.5 per cent, the median income will still be just under $57,000 by 2024, and less than $65,000 by 2028 – barely half of what proponents have classified as 'middle income'. The annual pay for average income earners would rise to $76,384 in 2024, while *full-time* earners would receive on average $104,000 in 2024 – still well-below the $120,000-$200,000 range misleadingly attributed to 'middle-income' earners.

Treasury modelling only serves to reinforce how much the plan benefits higher income earners much more than those on middle incomes. As this modelling shows, in 2024-25* only one in five taxpayers will be earning more than $120,000 a year – and this will be even less if Treasury's optimistic projections for wage growth are not achieved.

The biggest losers are the most economically disadvantaged: those who do not have any income tax to cut

The biggest losers from the proposed tax cut plan are people who do not have any tax to cut: the poorest ten per cent of the community. This includes those seeking work and sole parents on Newstart, which has not been increased in the budget and is now declining in real terms.

In addition to losing out on any lift to their income, the most economically disadvantaged will bear the greatest burden from the spending cuts that will inevitably flow from the tax plan. With the tax cuts reducing government revenue by tens of billions each year, future governments will have insufficient funds to maintain the social safety net and essential services – changes that will disproportionately affect the most impoverished and vulnerable in our communities.

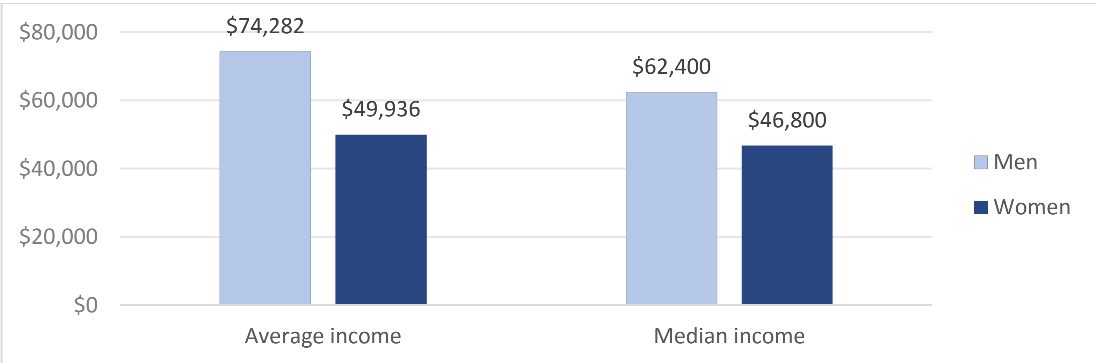
The tax cuts will widen gender disparities in income

The proposed tax plan will only compound the gender income gap in Australia.

A detailed breakdown of the gender implications of the tax package, prepared by the Parliamentary Budget Office, shows **men will receive almost twice the amount in tax cuts as women**.

This disparity reflects the entrenched gender pay gap in Australia and different working patterns between men and women. As Figure 6 indicates, women earn significantly less on average than their male counterparts, with the full-time gender pay gap currently sitting at 15.3 per cent.[12]

Figure 6. Comparison of average and median income by gender

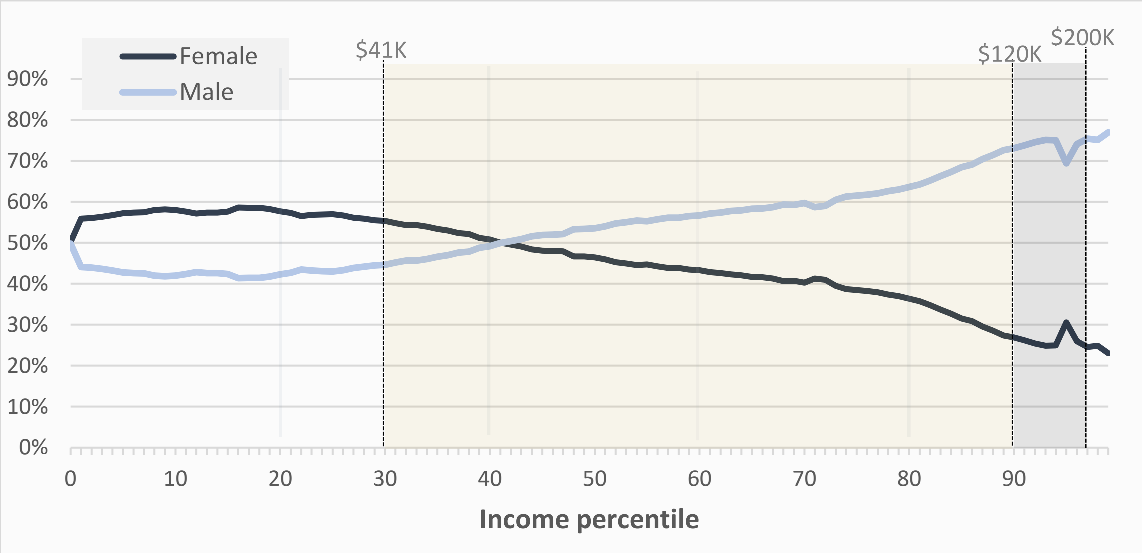


Source: ABS, Gender Indictors (2017).[13]

Figure 7 further illustrates the gender differences across the income spectrum by grouping all taxpayers into 100 income groups (based on the size of their taxable income), with the percentage of males and females in each group plotted on the graph. As income rises, the percentage of men in each percentile rises. This means that income tax cuts that favour high income earners will disproportionately benefit men.

* Which is based on an extremely optimistic wages growth rate of 3.5 per cent.

Figure 7. Relative income distribution of taxable individuals by gender



Source: ATO, Taxation Statistics.[11]

As calculated by the Australia Institute, **around two-thirds of the benefits of the Government's proposed income tax cuts will flow to men**.[14] While the Treasurer has dismissed this gender analysis,[15] the breakdown from the Parliamentary Budget Office demonstrates the tax package is skewed towards men, who will receive three times the amount of tax cuts for the final stage of the tax plan.[17] This equates to $30 billion of the $41.6 billion costs of stage three tax cuts flowing to men over the coming decade.

While the final two stages are the most inequitable, the first stage of the tax plan will not necessarily deliver benefits to low-income women seeking to increase their participation in the workforce. During this first phase, women on low incomes and with caring responsibilities will actually face a 1.5 percent *increase* to their effective marginal tax rate.[16] This means that, even if they receive some benefit from the interim Low and Middle Income Tax Offset, this benefit will be negated by the withdrawal of social security and means-tested family payments, as well as increased costs such as childcare and means-tested levies.

In addition to widening gender disparities in income, women are likely to be disproportionately affected by the spending cuts that will inevitably arise from the huge loss in Government revenue.[16] Overall, women make greater use of government services. They were, for example, disproportionately affected by the savage funding cuts to service and the social safety net in the 2014 Federal Budget.[14]

In short, if the tax plan proceeds, men will get most of the benefits, while women will be affected most by spending cuts. This cycle of tax and spending cuts will only make gender inequality in Australia worse.

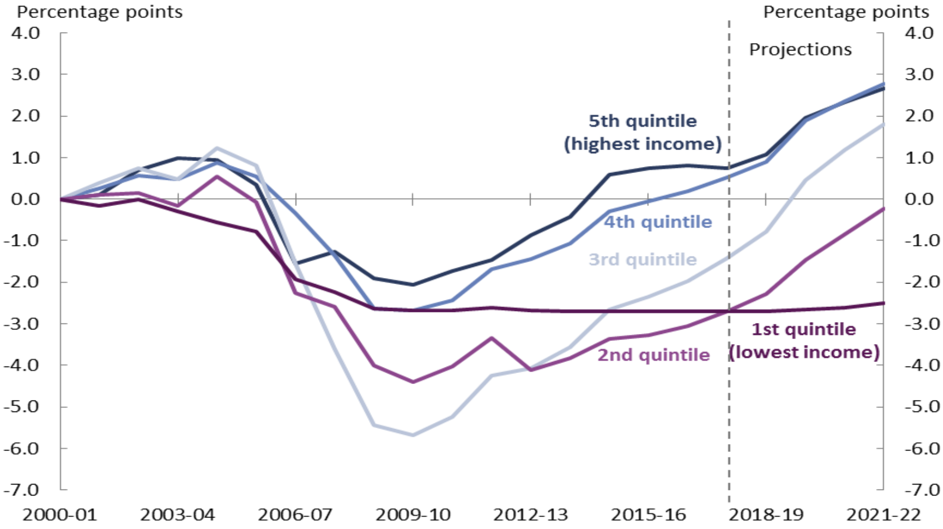
Will the tax cuts counter 'bracket creep' and disincentives to work?

The effects of 'bracket creep' have been overstated for most taxpayers

To justify the tax cuts, the Government has exaggerated the effects of bracket creep. Bracket creep occurs when average tax rates 'creep' higher over time through wages growth and inflation, pushing people into higher tax brackets or resulting in a greater share of their income being earnt in their highest tax bracket.

Despite claims that bracket creep is a growing burden for wage earners, most Australians still pay less income tax than they did fifteen years ago. This is because income taxes were cut every year between 2003 and 2011. As a result, the lowest 60 per cent of income earners currently pay less income tax than they would be paying if the 2003 tax scales had remained in place.[17] According to the Parliamentary Budget Office, the middle 20 per cent of taxpayers will only begin to 'fall behind' in 2020, and lower income earners will still be ahead at this stage.[17]

Figure 8. Impact of bracket creep for different income groups: change in average tax rates since 2000 (%)



Source: Parliamentary Budget Office (2017).[17]

For most taxpayers, low inflation and stagnant wages growth have limited bracket creep in recent years and, while much has been made of future bracket creep scenarios, we ultimately do not know how quickly wages and other incomes will grow and who will be most affected. If containing bracket creep was the key aim, then the simplest and most effective response would be to index tax bracket thresholds to inflation (including the tax-free threshold).[*] But this isn't what the proposed tax plan does.

Instead, it eliminates an entire tax bracket and flattens out the tax scales so that someone earning $41,000 will pay the same marginal tax rate as someone earning $200,000 a year. The focus of the changes does not appear to be bracket creep – but rather the progressive nature of our tax system, where people on higher incomes pay a higher rate of taxation. As a result of the changes, about three per cent of the tax burden will be shifted from the top 20 per cent of income earners to those lower down by 2028.

If bracket creep *is* the core concern, then tax reform should focus on the bottom end of the income scale where bracket creep hits the hardest: where people experience the drawdown of government benefits and means-tested levies as they earn more.

The proposed tax cuts will not improve work incentives

According to the Government, current income tax arrangements are thwarting "aspiration and enterprise". As the Prime Minister recently declared:[18]

> *We have an economy, a nation that is built on aspiration and enterprise. You want people to get ahead. Now, how many times have we heard over the years – people say bracket creep is a real disincentive for people getting ahead? For getting another job, for taking a promotion, for working overtime?*

Yet the claim that flattening the tax scales will improve work incentives is spurious, with empirical evidence showing the work patterns of those on high incomes are much less responsive to marginal tax

[*] We would argue that this would need to be done at the same time as policy measures are implemented to reduce the effective marginal tax rates of low-income individuals and families.

rate changes.[19,20,21,22] And, as the latest OECD report on taxing wages concludes, Australia's 'average tax wedge' (which "measures the extent to which tax on labour income discourages employment") is lower than the OECD average, indicating that income taxes do not act to discourage work for most taxpayers.[23]

The group where changes in marginal tax rates *are* likely to affect work incentives are among those on low incomes.[24,25] Part-time workers who receive income support, for example, not only face a marginal tax rate, but also lose government support payments as their income rises. The combined impact can result in an *effective marginal tax rate* approaching 100 per cent.[24] These poverty traps are deeply inequitable and act as a disincentive to work for people on low incomes: the more they work, the less they get. Yet the Government's plan to "fix bracket creep" will do nothing to fix it where it matters.

Are the proposed tax cuts affordable?

Tax cuts will undermine the capacity of future governments to fund essential services and community infrastructure

The proposed income tax cuts are the largest ever proposed in a Federal Budget, amounting to an annual cost of **$24.6 billion** by 2028.[2] The massive dent in revenue will undermine the Government's capacity to fund essential services and infrastructure, guaranteeing future funding cuts and ultimately shifting the costs of services onto individual households.

More government revenue is needed to close gaps in our social safety net and guarantee essential services into the future

There is a large and growing gap between what the Australian Government raises in taxes, and what it needs to fund essential services and community infrastructure.

A substantial boost to spending is needed in areas that have been neglected in decades. This includes below-poverty-level unemployment and student payments, social and affordable housing, dental care and mental healthcare. Since 2014, more than $15 billion has been slashed from frontline services and the social safety net – including cuts to family payments and social security and to services supporting the most economically disadvantaged groups.

In addition to growing gaps in services and support, public revenues will need to increase to meet the future needs of an ageing population.[26] The Government's 2015 Intergenerational Report shows that total government payments are increasing faster than GDP, with essential services such as health, aged care and the NDIS being the main drivers of expenditure growth.[27]

Instead of recklessly cutting taxes, the Government should be increasing Australia's tax take in order to close gaps in services and guarantee future funding for public services and infrastructure. Ultimately, we can only create a just society if, as a community and as a nation, we make adequate provision for essential services and support, including for people who are forced to carry the burden of inequality. And, as a nation, we can only provide for those most in need if we structure our tax system to raise revenue fairly and sustainably.

Underfunding of essential services is putting pressure on living standards and household costs

Funding cuts, and a failure to grow services in line with demand, are hurting households and putting pressure on living standards. The largest price increases over the last six years were for services funded or regulated by governments. This includes a 57 per cent increase in child care costs, a 40 per cent increase in out-of-pocket medical expenses, a 40 per cent rise in energy bills, and a 33 per cent increase in the average cost of pre-school and primary education.[28] These growing everyday costs have hit low-and middle-income households hardest – precisely those who will benefit least from the government's proposed tax package.

Tax cuts now will inevitably mean harsh spending cuts later

The proposed income tax plan will lock in massive tax cuts into the future – cuts that will starve governments of future revenue and guarantee more funding is slashed from services and the social safety net.

Despite the magnitude of the proposed cuts – which are being proposed alongside substantial company tax cuts – the Government has predicted a return to surplus by 2020. However, this prediction relies on highly questionable assumptions and economic forecasts, including improbable levels of wages growth, optimistic revenue projections, and conditions of unprecedented economic stability. The budgetary forecasts also fail to take into account the underlying expenditure growth of existing services and programs – let alone making provision to reduce the current backlog of unmet needs and service gaps.

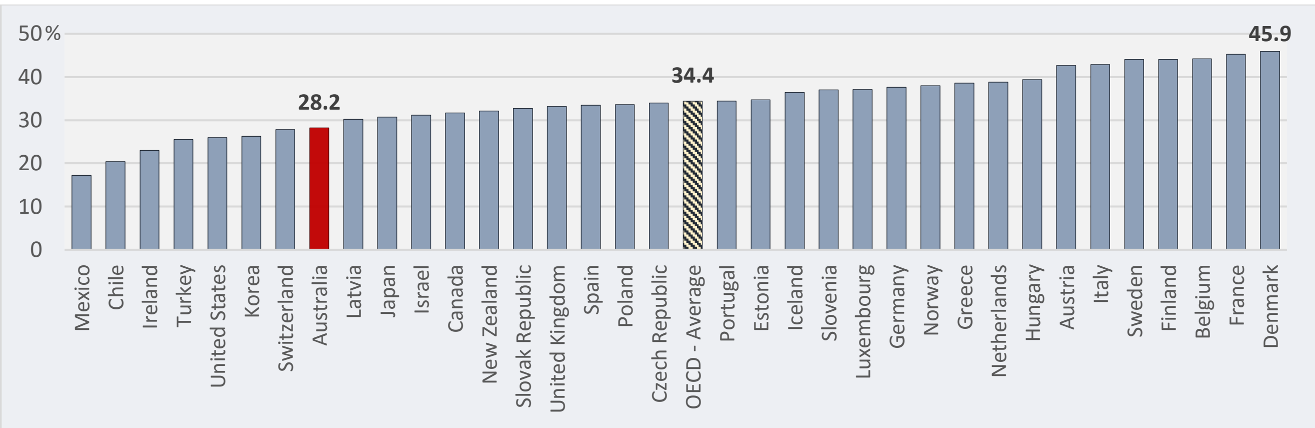
In short, the income tax cuts are not sustainable. They will lead to more future deficits and lock-in harsh spending cuts. The reduction in public expenditure will increase service gaps and user costs, reducing the quality of life for most Australians by at least at much as any marginal tax savings they may pocket under the proposed tax plan.

For those on the lowest 40 per cent of incomes, the rising out-of-pocket costs for essential services will hurt the most. They have the least to gain, and the most to lose, under the proposed tax plan.

Australia is not a high-taxing nation

Those pushing the tax cuts have maintained Australia is a high-taxing nation. Yet in comparative terms, Australia is the eighth-lowest taxing among 39 OECD countries.[29] Few developed countries raise as little tax revenue as Australia does relative to the size of the economy (Figure 9).[30]

Figure 9. Tax revenue as a share (%) of GDP in OECD nations.



Source: OECD Tax Revenue data.[29]

Despite our low overall tax take and the growing shortfall in funding for services, the Government has placed an arbitrary 'cap' on tax revenue of 23.9 per cent of GDP. They have claimed lowering taxes – both to businesses and those on higher incomers – is necessary if we are to remain under this artificial cap.

There is no doubt that there will be increasing pressure on the budget over the next few decades due to the ageing of the population, improvements in health care, unmet need for disability and mental health services, affordable housing, childcare and other essential services, as well as necessary improvements to social security to reduce poverty. To impose an arbitrary cap – without any reference to the community's unmet and growing needs – is reckless and irresponsible. It is also at odds with wider public opinion, with polling consistently showing that the Australian public would prefer higher levels of spending on public services to lower tax collection.[31,32,33]

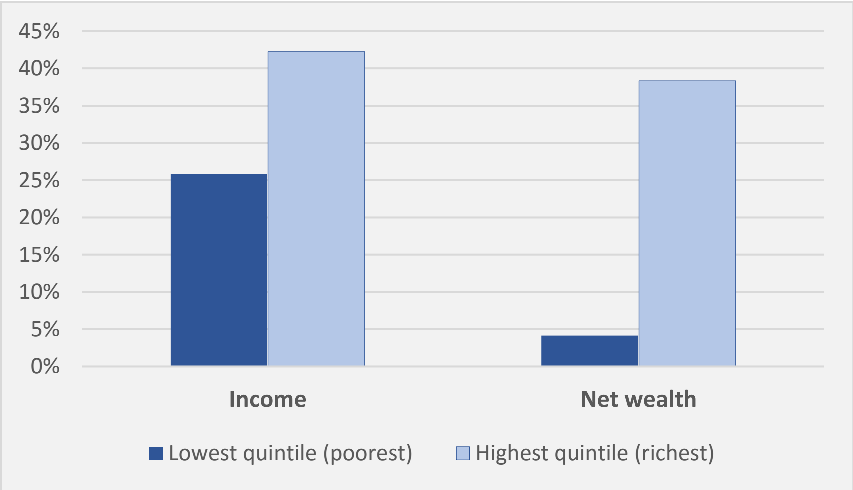
Another argument that has been made to support the proposed tax cuts is that income taxes account for a high proportion of total tax revenue on Australia. This is true in comparative terms – although Australia's overall level of tax is low, personal income taxes make up about 41 per cent of our total tax revenue – one of the highest levels in the OECD.[34] However, the main reason for this is that – unlike most other countries – our government funds social security out of general revenue rather than directly collecting social security contributions from employees and employers.[34] On average, across OECD countries, employee and employer social security contributions account for just over a quarter of total tax revenue. Claims that our overall levels of income tax are too high relative to elsewhere are, therefore, misleading and do not justify the proposed cuts. Ultimately, high-income groups in Australia do *not* face particularly high average tax rates by international standards.

What will be the effects on inequality?

Inequality is a problem in Australia and is getting worse

The cuts to income taxes are being proposed against a backdrop of growing disparities in income and wealth (Figure 10). Wealth inequality in Australia has been on the rise over the past two decades, with the gulf between the wealth held by the top one per cent and the bottom 50 per cent now the greatest at any time over this period. Income inequality has also steadily climbed over time, despite some fluctuations. Australia's income inequality compares poorly to other OECD member countries, with the latest OECD data showing Australia's Gini coefficient (a commonly used measure of inequality) was 0.33 in 2014, ranking 22nd – behind most of the 35 OECD countries.[35]

Figure 10. Real percentage increase of household income and wealth, 2004-2014



Source: ABS, Household Income and Wealth, Australia, 2015-16; and OECD Economic Survey.

In addition to the growing gap in income and wealth, inequality in Australia is manifested in growing disparities in access to housing, increasing educational inequalities, and the inequitable access to public services and infrastructure.

These widening inequalities have major social, economic and political implications, and Australia cannot afford to go any further down this path. If the Government continues down the pathway of more tax cuts and spending cuts it is inevitable that the gaps in income, wealth and opportunity will only increase and become further entrenched.

The tax cuts erode our progressive taxation system

Australia has long relied on a progressive tax system to help fund the services most of us need and to reduce income inequality. Our progressive income tax system means higher income earners pay a greater share of their income in taxes. This ensures revenue is raised from those most able to pay and distributes it to those least able to support themselves and their families.

The progressive nature of our income tax system plays a broader role in Australia's overall tax system. Most other taxes are proportional or regressive in nature, including most tariffs and excise, the Goods and Services Tax (GST), fees and charges, and most state taxes.[36] The progressive rate structure of our income tax system, combined with social security payments that target those on the lowest incomes, is critical to ensure our tax and transfer system is progressive and helps to reduce poverty and inequality.

The proposed tax plan, however, undermines the fundamental principle of our progressive income tax system. It moves away from a progressive system toward a flatter tax structure, delivering a big cut for those at the top and very little for those at the bottom of the income scale. If the full package of proposed tax cuts is implemented, the average tax rate will increase more at the lower and middle end of the income scale, with those on low incomes ultimately paying a bigger share of total income tax, while those at the top will be paying a smaller share.

The proposed tax cuts will increase inequality

The tax cuts will increase inequality not simply because they are overwhelmingly skewed towards those on higher incomes. In the longer run, the most profound distributional effects may be through the massive reduction in government revenue and the inevitable cuts to spending.

Accessible public services and our social safety net have a powerful redistributive effect, making them essential tools in the fight against inequality and poverty. Public services make up one-quarter of all goods and services consumed by Australians – and for households on low incomes, the reliance on these services is even greater. As a recent study of OECD countries found, the value of public programs – such as education, healthcare, and early childhood education – represents 76 per cent of the disposable income of low-income households, compared to 34 per cent among middle-income households, and 14 per cent among high-income households.[37]

Cuts to public spending will exacerbate economic inequality and undermine public services. The lack of adequate funding to public services such as healthcare and education is already resulting in greater out-of-pocket costs for households, with increased user fees and a trend toward privatising services. More tax cuts will lead to further funding cuts, increased fees and more privatisation – putting more pressure on living standards and household costs, and hurting most those who have the least.

What are the dangers of a tax cut bidding war?

With both major parties promising substantial income tax cuts, there is a real risk of a race to the bottom that will jeopardise future funding for services and community infrastructure and deliver little or no benefits to those on the lowest incomes. We believe Australia needs to strengthen public revenue to secure vital community services and supports into the future, rather than embarking on a reckless tax bidding war that will squander billions on unjustified tax cuts.

Ultimately, the choices we make about tax have major impacts on the services we fund and the society we want to have. While people who rely on social security and part-time workers on low wages are the people with the most to lose in a tax-cut bidding war, the adverse effects will ripple across communities, contributing to greater inequality and undermining social cohesion and trust.

Against a backdrop of persistent and rising inequality, the stakes are high. Securing sufficient government revenue and retaining our progressive income tax system are vital to narrow inequalities and fund services and our social safety net. Cutting taxes for short-term political gain will have long-term social and economic costs – costs that will hurt those on the lowest incomes most, but which will ultimately damage us all.

[1] *Budget Papers 2018-19*, (2018). Commonwealth of Australia: Canberra. https://www.budget.gov.au/2018-19/content/documents.html
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