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3-stage tax cuts versus bracket creep

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3-Stage Tax Cuts versus Bracket Creep

Summary

In aggregate the 3 stages of [tax cuts](#) announced in the 2018 Budget roughly return bracket creep, but with some redistribution of the tax burden from higher income earners to lower income earners.

Bracket Creep

Australia's progressive personal income tax rate scale consists of stepped marginal tax rates, producing an upward sloping average tax rate schedule (see Figure 1b). The percentage marginal tax rates, and the dollar thresholds they cut in at, are fixed in legislation. Bracket creep describes the effect where nominal income growth pushes personal income taxpayers onto higher tax rates (average and sometimes marginal) without an increase in real income.

In aggregate this bracket creep effect from the interaction of nominal income growth with a progressive tax scale produces a growing proportion of personal income tax in total tax revenue, known as fiscal drag (see Figure 2).

Indexation of the tax rate thresholds by CPI (as was done by the Fraser government in the late 1970s) would remove this bracket creep effect. Real increases in incomes, though, would still result in tax rate increases over time under a progressive tax scale.

3 Stages of Tax Cuts

The 2018 Budget announced the then government's Personal Income Tax Plan, with personal income tax cuts to be provided in 3 stages over seven years (see Figure 1a). Stage one introduced a temporary low and middle income tax offset (LMITO). Stage two increased tax thresholds and the low income tax offset (LITO). Stage three removed the 37 per cent tax rate. Adjustments were made to stages one and two as part of the COVID stimulus packages, and stage three was legislated to take effect from 2024-25, but with a lower middle rate of 30 per cent (plus the 2 per cent Medicare Levy).

While the three stages of the tax cuts appear to have a large revenue cost, in aggregate they are largely just returning bracket creep over the seven-year period. Figure 1b compares the legislated 2024-25 personal income tax rate scale with the 2017-18 scale indexed for CPI.ⁱ The marginal tax rate (MTR) schedules include the Medicare Levy. The average tax rate (ATR) curves, which include LITO, show that compared to the 2024-25 scale, lower income earners would have paid less tax under an indexed scale (mainly due to the tax-free threshold not increasing) while higher income earners would have paid more (mainly due to the abolition of the 37 per cent rate). Middle income earners (\$70,000 to \$120,000) would have paid about the same.

Figure 1a: 2017-18 versus 2024-25 Personal Income Tax Scale

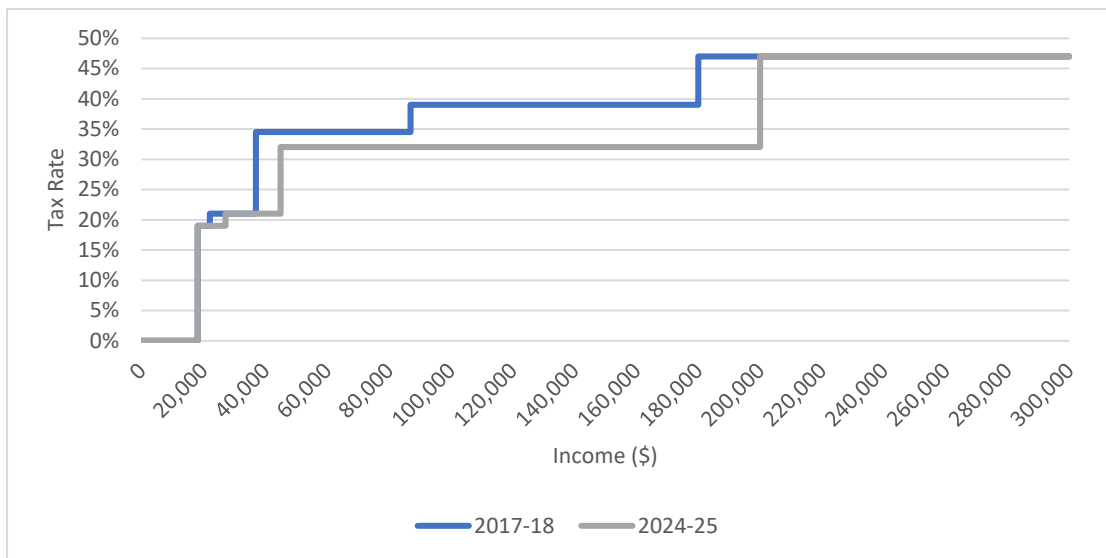
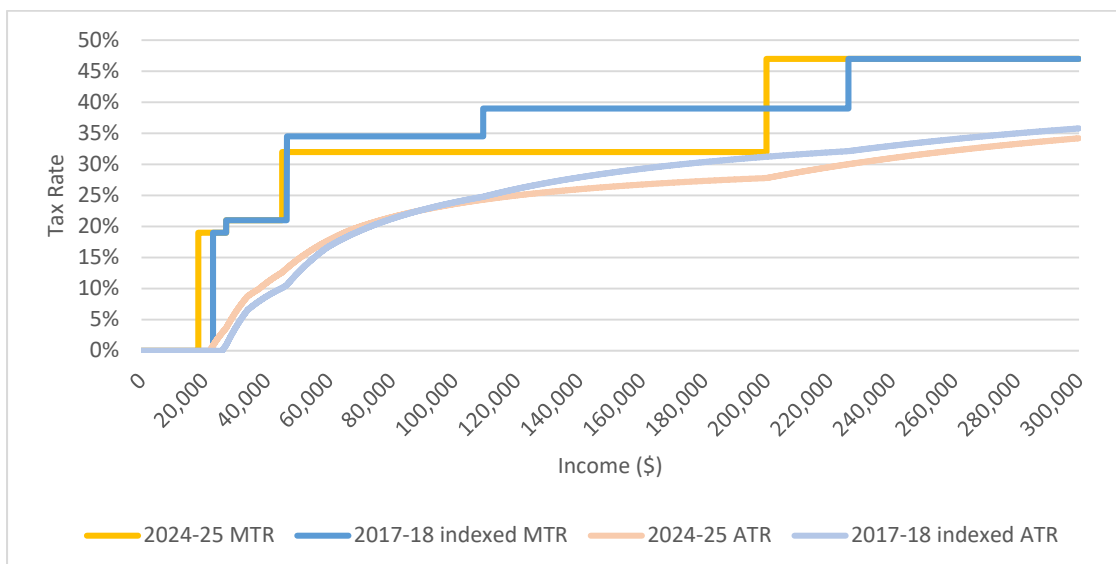


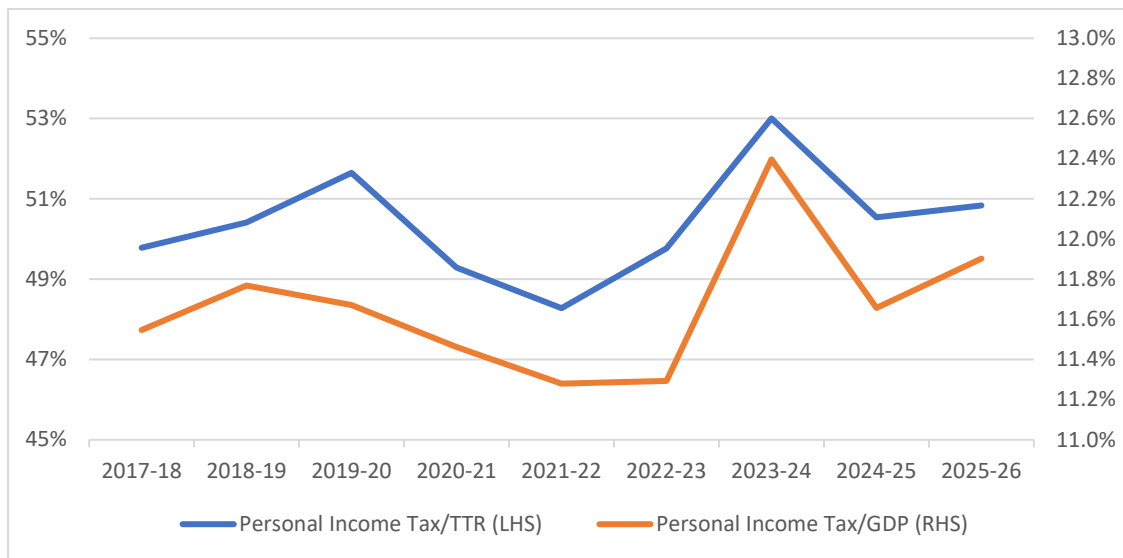
Figure 1b: 2024-25 Personal Income Tax Scale versus Bracket Creep



Personal Income Tax Share

Over this period, the personal income tax share is expected to remain broadly steady, with the impact of the three stages of the tax cuts broadly offset by the bracket creep/fiscal drag effects. Figure 2 shows that both as a share of total tax revenue (TTR) and as a share of GDP, personal income tax will be about the same in 2024-25 as in 2017-18.

Figure 2: Personal Income Tax Share with the 3-Stage Tax Cuts



Tax Review

Overall, the three stages of the tax cuts maintain personal income tax at around half of total Commonwealth tax revenue, but involve some redistribution of the tax burden from higher to lower income earners. This redistributive aspect can be looked at in the context of the current debate about the taxation of superannuation, where compared to the personal income tax scale the largest tax concessions on superannuation contributions and earnings accrue to higher income earners.

It is important to consider individual taxes and claims about costs of changes in the context of the entire tax and transfer system and the dynamic evolution of the economy. A comprehensive tax review would be an opportunity to consider these, and other issues, wholistically.

ⁱ Indexation is applied to the 2017-18 tax scale, including the Medicare Levy threshold and LITO.