



Australian
National
University

Crawford School of Public Policy

TTPI

Tax and Transfer Policy Institute

Stage 3 tax cuts v bracket creep: Time to index the personal income tax rate scale

TTPI – Policy Brief 4/2024 March 2024

Paul Tilley

Visiting Fellow

Tax and Transfer Policy Institute

Crawford School of Public Policy, ANU

Tax and Transfer Policy Institute

Crawford School of Public Policy

College of **Asia and the Pacific**

+61 2 6125 9318

tax.policy@anu.edu.au

The Australian National University

Canberra ACT 0200 Australia

www.anu.edu.au

CRICOS Provider No. 00120C

Stage 3 Tax Cuts v Bracket Creep: Time to Index the Personal Income Tax Rate Scale

Summary

In aggregate, the previously legislated 3 stages of personal income tax cuts announced in the 2018 Budget roughly match indexation of the tax scale over the 7 years, but with some redistribution of the tax burden from higher income taxpayers to lower income taxpayers. See my 2023 paper [here](#). The newly legislated “stage 3a” tax cuts in aggregate still roughly match indexation, but with a distribution of tax cuts that more closely matches the bracket creep effects over the 7 years.

With personal income tax having been around half of total Commonwealth tax revenue for half a century and the structure of the tax rate scale having been intensely debated over recent year, now is the time to lock that in by indexing the rate scale to permanently remove bracket creep effects.

Bracket Creep

Australia’s progressive personal income tax rate scale consists of rising stepped marginal tax rates (MTRs), producing an upward-sloping average tax rate (ATR) schedule. The percentage MTRs and the dollar thresholds they cut in at are fixed in legislation.

Bracket creep describes the effect where the interaction of nominal income growth with a progressive tax rate scale pushes personal income taxpayers onto higher tax rates (average and sometimes marginal). In aggregate, these bracket creep effects cause personal income tax revenue to increase faster than personal income and produce a growing proportion of personal income tax in total tax revenue and as a percentage of GDP, known as **fiscal drag**.

These bracket creep effects could be removed by indexation of the personal income tax rate thresholds.¹ Indexation using a measure of income growth would fully remove the bracket creep effects, while indexation by a measure of price increases (as was done by the Fraser government in the late 1970s - see Attachment), would mean real increases in incomes would still result in tax rate increases under a progressive tax rate scale.

Over time, incomes can typically be expected to increase more than prices. This has not been the case recently, though, with real wages going backwards at times. Table 1 shows a comparison of CPI and two alternative income growth measures over the period that is the focus of this paper.

Table 1: Price and Income Indexes

	2017-18 to 2024-25	2012-13 to 2024-25
Consumer Price Index (CPI) (tty)	25.26%	38.01%
Wage Price Index (WPI) (tty)	19.66%	34.45%
Average Compensation per Employee (ACPE) (ya)	27.85%	38.00%

Sources: 2012/13 – 2022/23 (ABS), 2023/24 – 2024/25 (CPI and WPI (Budget), ACPE (Peter Downes, Outlook Economics))

This paper will use CPI as the price index and ACPE as the income index.² The analysis will focus on the impacts of indexation on marginal and average tax rates, rather than estimates of the \$ amounts of bracket creep, which can be found elsewhere.³

¹ In practice, indexation needs to be done using the previous year’s data.

² Noting they are, non-typically, quite similar over these time periods.

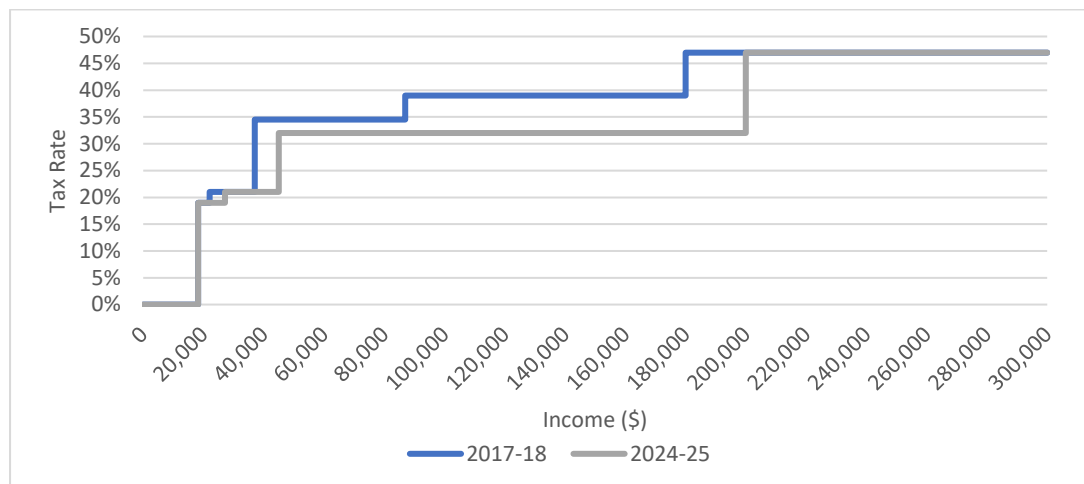
³ For example, see Peter Downes, Outlook Economics, AFR, 9 January 2024.

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 1).⁴

Stage One (2018-19) introduced a temporary low and middle income tax offset (LMITO) of \$1,080⁵ and increased the top threshold of the 32.5 per cent rate range from \$87,000 to \$90,000. Stage Two (2020-21) increased the top of the 19 per cent rate range from \$37,000 to \$45,000 and the top of the 32.5 per cent range from \$90,000 to \$120,000, as well as increasing the low income tax offset (LITO) from \$445 to \$700. In Stage Three (2024-25), it was proposed to remove the 37 per cent tax rate, with a new middle rate of 30 per cent to run from \$45,000 to \$200,000 (plus the 2 per cent Medicare Levy (ML)).

Figure 1: 2017-18 versus Previously Legislated 2024-25 Personal Income Tax Scale*



* Includes ML

Previously Legislated Tax Cuts (Stage 3)

While the three stages of the tax cuts appear to have a large revenue cost, **in aggregate** they are largely just matching what indexation of the tax scale would have achieved and so returning average tax rates, in real terms, to where they were seven years earlier.⁶

Figures 2a and 2b compare the previously legislated 2024-25 personal income tax rate scale with the 2017-18 rate scale indexed for prices (CPI) and incomes (ACPE) respectively. The MTR schedules include the ML. The ATR curves, which include LITO, show that compared to the 2024-25 scale, lower-income taxpayers would have paid less tax under an indexed scale (mainly due to the tax-free threshold not increasing) while higher-income taxpayers would have paid more (mainly due to the abolition of the 37 per cent rate). Middle-income taxpayers (\$70,000 to \$100,000) would have paid about the same.⁷

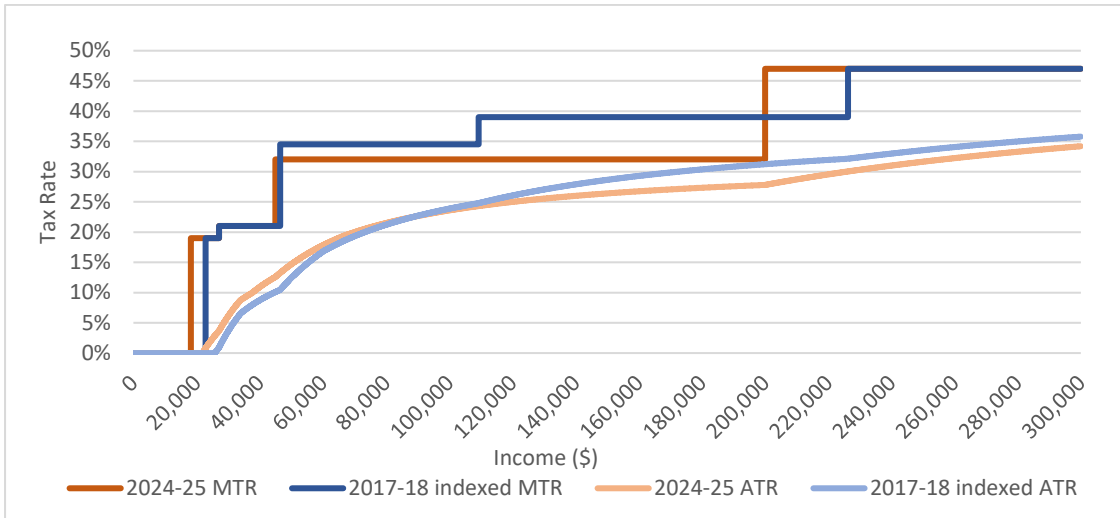
⁴ Some adjustments were made as part of the COVID stimulus packages.

⁵ LMITO was increased to \$1,500 in its final year (2021-22).

⁶ Bracket creep is estimated to raise the average tax rate by about 0.1 of a percentage point for every 1 per cent of wage growth, or about \$5 billion in the past year. (See Peter Downes, AFR, 9 January 2024.)

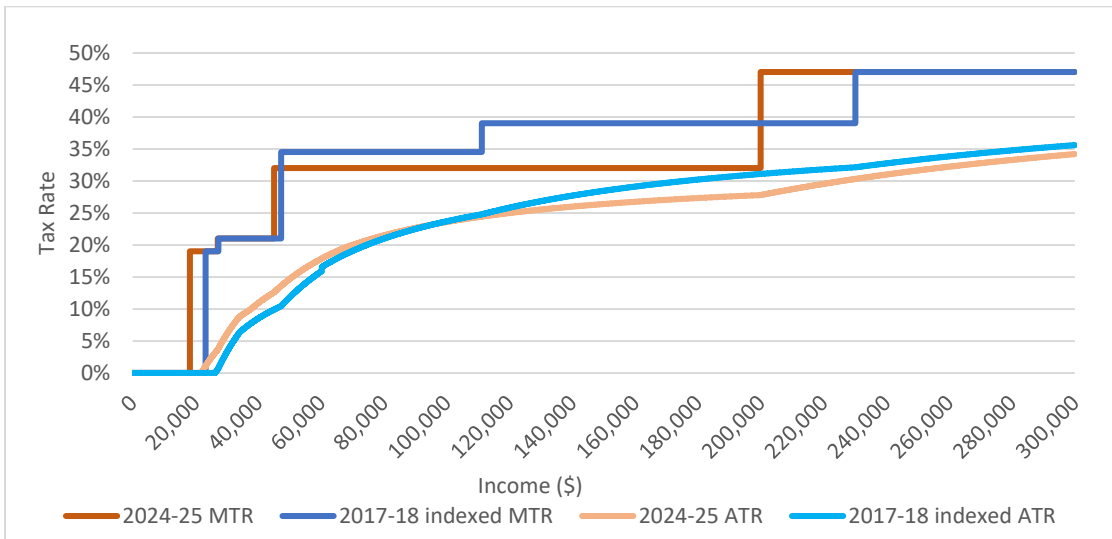
⁷ These point-to-point comparisons do not pick up the fact that low to middle income earners benefited from the temporary LMITO from 2018-19 to 2021-22.

Figure 2a: 2024-25 Previously Legislated Tax Cuts versus CPI Indexation since 2017-18*



* Includes ML and LITO

Figure 2b: 2024-25 Previously Legislated Tax Cuts versus ACPE Indexation since 2017-18*



* Includes ML and LITO

Comparing Figures 2a and 2b it can be seen that there is only a modest difference, a consequence of prices and incomes increasing at similar rates over this time.

Newly Legislated Tax Cuts (Stage 3a)

The newly legislated personal income tax cuts reconfigure the previous stage 3 tax cuts in a way that provides greater benefit for low- to middle-income taxpayers and less for high-income taxpayers (in broadly the same aggregate revenue envelope). The 37 per cent tax rate will be maintained above \$135,000, the bottom rate will be reduced from 19 to 16 per cent and the top rate will cut in from \$190,000. See Table 2.

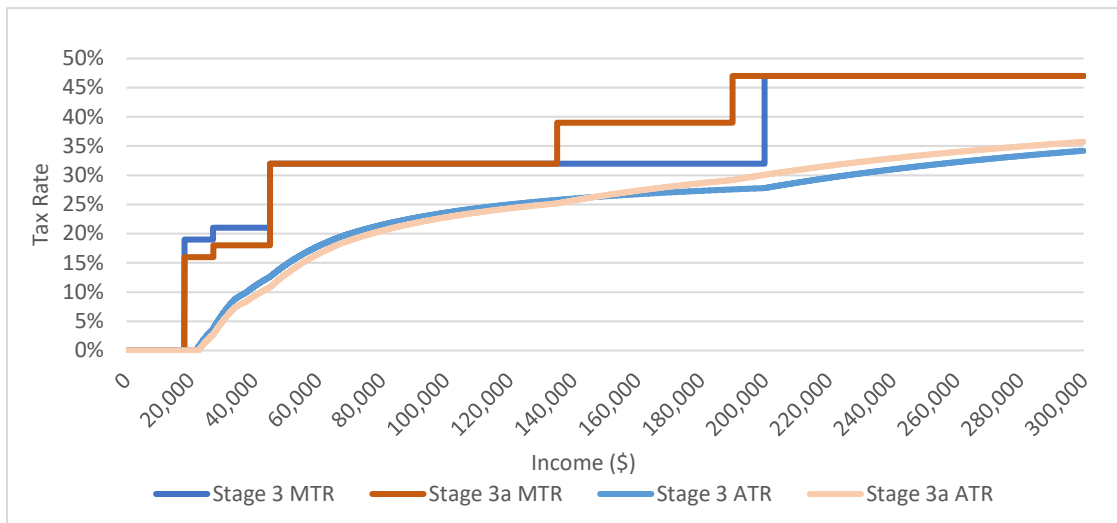
Table 2: Stage 3 Tax Rates Comparison*

Current (2023-24)		Previous Leg. (2024-25)		New Leg. (2024-25)	
\$0 - \$18,200	0%	\$0 - \$18,200	0%	\$0 - \$18,200	0%
\$18,201 – \$45,000	19%	\$18,201 – \$45,000	19%	\$18,201 – \$45,000	16%
\$45,001 – \$120,000	32.5%	\$45,001 – \$200,000	30%	\$45,001 – \$135,000	30%
\$120,001 – \$180,000	37%			\$135,001 – \$190,000	37%
\$180,001 and above	45%	\$200,001 and above	45%	\$190,001 and above	45%

* Not including ML and LITO.

Figure 3 illustrates the difference between the previously legislated and newly legislated stage 3 tax cuts. The retention of the 37 per cent tax rate and the lowering of the bottom tax rate to 16 per cent means the newly legislated schedule redistributes some of the tax cuts from higher-income taxpayers to lower-income taxpayers (see the ATR curves).

Figure 3: Previously Legislated versus Newly Legislated Stage 3 Tax Cuts*

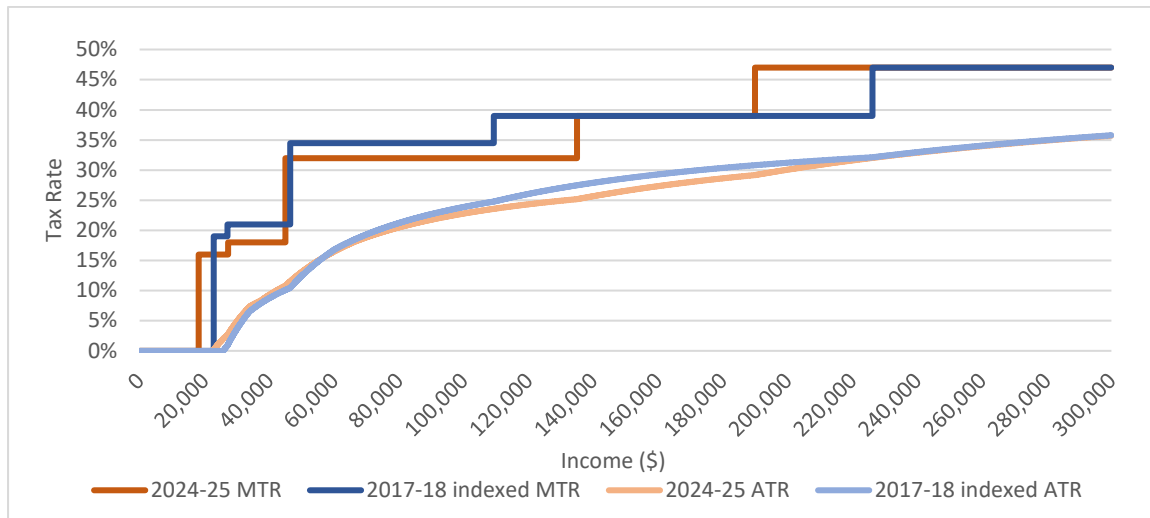


* Includes ML and LITO

Figures 4a and 4b compare the newly legislated 2024-25 income tax rate scale with the 2017-18 scale indexed for prices (CPI) and incomes (ACPE) respectively. The MTR schedules include the ML. The ATR curves, which include LITO, show that the newly legislated 2024-25 rate scale provides a reasonably close approximation to what would have been achieved under a 2017-18 indexed scale.

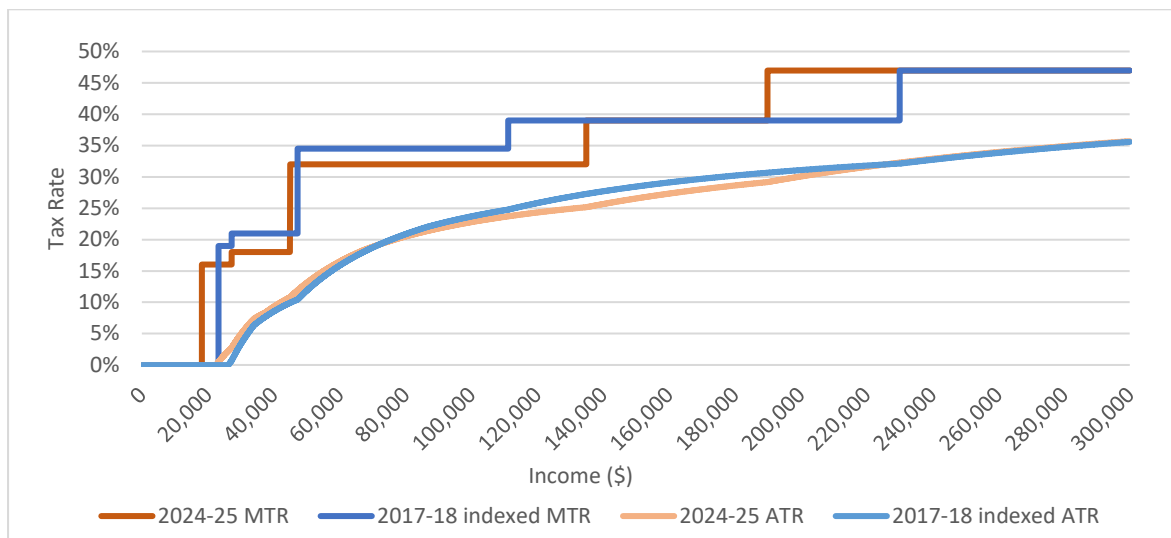
Under the newly legislated “stage 3a” tax cuts, lower-income taxpayers would have paid slightly less tax under an indexed scale (due to the tax-free threshold not increasing), mid-high-income taxpayers (\$100,000 to \$200,000) would have paid more, while higher-income taxpayers would have paid about the same.

Figure 4a: 2024-25 Newly Legislated Tax Cuts versus CPI Indexation since 2017-18*



* Includes ML and LITO

Figure 4b: 2024-25 Newly Legislated Tax Cuts versus ACPE Indexation since 2017-18*



* Includes ML and LITO

Again, comparing Figures 4a and 4b it can be seen that there is only a modest difference, a consequence of inflation and incomes/wages increasing at similar rates over this time.

2012-13 as the Base Year

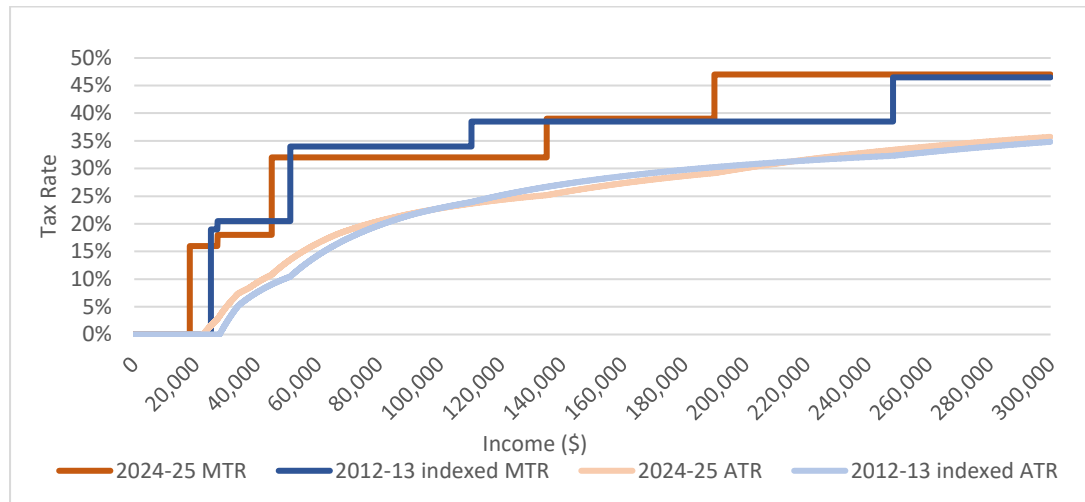
An assessment of whether a legislated tax cut has returned tax rates to a pre-bracket creep point is dependant on the choice of the base year for the calculation of the bracket creep. In the above analysis, 2017-18 (the year prior to the 7-year tax cut schedule) was chosen as that base year (for indexation in my case). There had not, however, been any substantive change in the personal income tax rate scale prior to 2018-19⁸ since the reconfiguration in 2012-13 as part of the compensation package associated with the introduction of the Gillard government’s carbon pricing

⁸ Apart from a 2016-17 increase in the top of the 32.5 per cent tax rate range from \$80,000 to \$87,000.

scheme. As such, 2012-13 is another possible indexation base year to assess the 3-stage tax cuts against bracket creep effects.

Figure 5 compares the 2012-13 income tax rate scale indexed for CPI with the newly legislated 2024-25 scale. The ATR curves show that compared to a tax rate scale that had been indexed since 2012-13, the newly legislated 2024-25 scale will leave high-income earners slightly worse off, middle-income earners slightly better off and low-income earners worse off. In **aggregate**, the tax cuts over this period are not sufficient to fully return bracket creep, with the personal income tax share increasing (discussed below).

Figure 5: 2024-25 Newly Legislated Tax Cuts versus CPI Indexation since 2012-13*



* Includes ML and LITO

I have not shown separately a chart for the newly legislated tax cuts versus ACPE indexation as it is practically identical to the CPI indexation chart, with CPI and ACPE coincidentally both increasing by 38 per cent over this time (see Table 1).

Comparing Figure 5 to Figure 4a, there is only a modest difference in the results, which reflects a moderate level of inflation between 2012-13 and 2017-18.

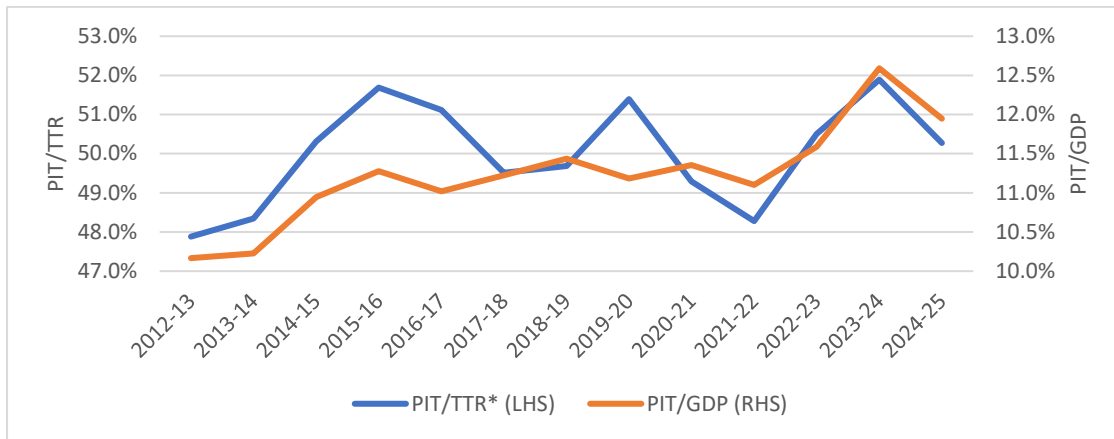
Personal Income Tax Share

Over the 7-year period of the 3-stage tax cuts schedule, the personal income tax share of total Commonwealth tax revenue is expected to remain broadly steady⁹, with the impact of the three stages of the tax cuts roughly offset in aggregate by the bracket creep/fiscal drag effects (see Figure 6a). Over the 5 years prior to that, though, the personal income tax share increased, consistent with the bracket creep effects over that time.

As a share of GDP, though, the personal income tax has been increasing across both time periods, in line with the overall tax burden increasing over the past decade (see Figure 6b) as it recovered from the fall associated with the 2008 GFC.

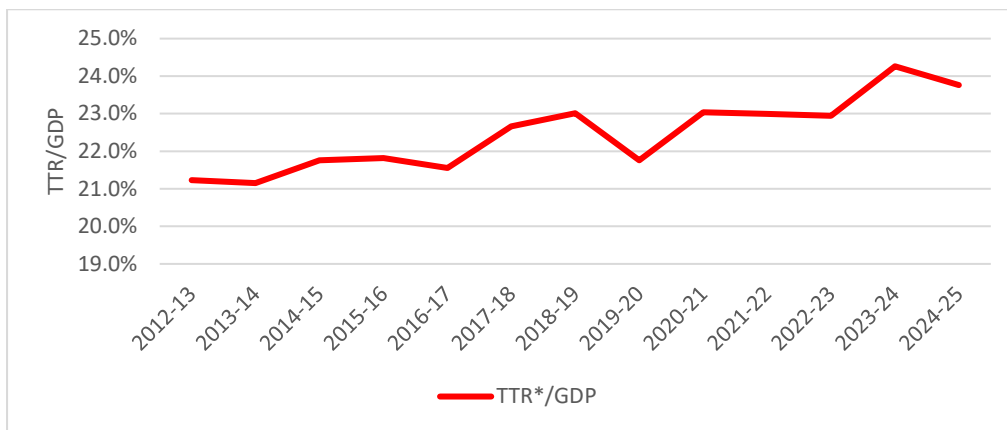
⁹ The yearly volatility is largely driven by the impact of changes in company income tax revenues on total Commonwealth tax revenues (the denominator).

Figure 6a: Personal Income Tax Share (2012-13 to 2024-25)



* Total Commonwealth tax revenue

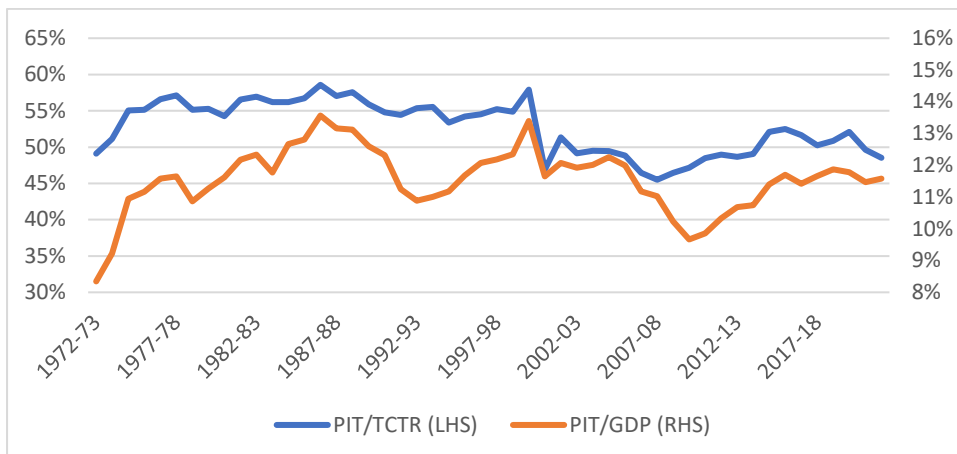
Figure 6b: Tax Burden (Commonwealth) (2012-13 to 2024-25)



* Total Commonwealth tax revenue

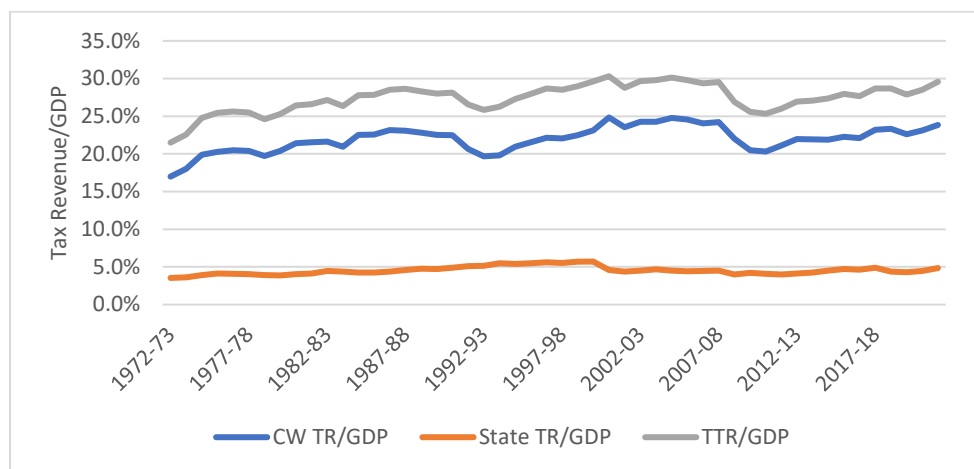
These recent movements in the personal income tax share, though, need to be seen in an historical context. Personal income tax has made up around half of total Commonwealth tax revenue for the past half a century (see Figure 7), although with a noticeable step down at the time of the introduction of the GST in 2000.

Figure 7: Personal Income Tax Share (1972-73 to 2021-22)



Total tax revenue has also been broadly stable as a share of GDP over the past 40 years, averaging around 22.5 per cent for the Commonwealth and 28 per cent for Australia as a whole (see Figure 8).

Figure 8: Tax Burden (1972-73 to 2021-22)



Time to Index the Personal Income Tax Rate Scale

Australia has had an extensive deliberation in recent years over the level of personal income tax revenue in our tax system and the appropriate degree of progressivity in its rate scale. While it is unrealistic to think we can ever reach a point where everyone agrees, personal income tax has been fairly steady at around half of total Commonwealth revenues for several decades and the parliament has now voted for the current rate scale after an intensive debate.

As such, now would be a good time to broadly lock that in. Now is the time to again index the personal income tax rate scale to permanently remove the bracket creep effects going forward. This would represent a decisive reform of the personal income tax scale, enabling the tax debate to move to more substantive tax reform issues.

There are, of course, a significant number of design issues that would need to be settled to implement such a policy. Key to that is the question of what index to use, most significantly whether to use a price or incomes index.

If an incomes index is chosen, WPI is readily measurable, but a broader index of incomes such as ACPE may be more appropriate. Use of an incomes index most completely removes bracket creep effects.

If a price index is chosen, CPI is most obvious. It may, though, be desirable to detract from large short-term fluctuations. A rolling average of recent years could be used.¹⁰ Use of a price index leaves room for announcing “tax cuts” where income growth is greater than price growth.

The main downside for a government (or potential government) that makes such a bold reform is that it reduces future opportunities to announce “tax cuts” that return or partially return bracket creep. Use of a price index, though, would mean that real increases in income will still generate additional revenue with a progressive tax scale.

¹⁰ Another possibility, suggested to me by Peter Downes, would be to use the mid-point of the RBA inflation target range, which would provide a stable average and have the added benefit of providing an anchor to inflation expectations.

And Time for a Tax Review

Settling the design issues with implementing indexation of the personal income tax scale would be best done following a review of the relevant issues (as was the case with the 1975 Mathews review – see Attachment).

More broadly, the more important tax policy issues at stake relate not to bracket creep and minor variations in the overall weight of personal income tax in the Australian tax system, but to the design issues of the income tax base, such as the inconsistent and inequitable approaches to the taxation of savings and the interactions with entity structures such as companies and trusts.

Indexing the personal income tax rate scale would permanently remove the bracket creep effects, enabling a greater focus on these more fundamental tax base issues. These issues should be considered 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, holistically.

Attachment

1975 Mathews Review: The Committee of Inquiry into Inflation and Taxation

In December 1974, the Whitlam government commissioned a specific inquiry into the effects of inflation on the tax system, with ANU academic Russell Mathews as chair. (The Asprey report touched on these issues in its preliminary report, but the government wanted some specific advice.) The committee report was in two parts.¹¹

Personal Income Tax Rates and Deductions

The committee examined the interactions of inflation with the progressive personal income tax rate scale and tax deductions set in dollar amounts. It argued that these interactions pushed up average tax rates and resulted in a different tax distribution from that which was intended by the legislation, with low-income earners and families affected disproportionately. To neutralise these unintended effects the committee recommended indexing the personal income tax rate scale and deduction amounts. It favoured indexation by prices, rather than incomes, accepting that real income increases would still result in tax rate increases.

Business Income Tax Base

The interaction of historical cost accounting with inflation meant that for expenses such as trading stock and fixed assets, when revenue and expense were measured to assess profit in a later period they would be expressed in different prices. To counter this the committee recommended adjustments to stock valuations and depreciation to account for the effects of inflation.

Government Response

The committee reported in May 1975, but the Whitlam government did not implement its indexation recommendations. At the December 1975 election, though, the Coalition promised that it would. The incoming Fraser government then introduced full indexation of the personal income tax rate scale and some rebates from the 1976-77 income year. These indexation arrangements ran until 1979-80.

¹¹ I cover the Mathews report in more detail in *Mixed Fortunes: A History of Tax Reform in Australia*.