Chapter 2

Economic issues

2.1 The Tax Laws Amendment (Personal Income Tax Reduction) Bill 2008 reduces income tax in three stages in July 2008, 2009 and 2010, increases the maximum amount of the low income tax offset and increases the income threshold at which the Medicare levy becomes payable for taxpayers eligible for the senior Australians tax offset.

2.2 The tax cuts form part of the Government's *Tax Plan for Australia's Future*.

2.3 The new tax scales envisaged in the bill are shown in the table. In addition, the low income tax offset will rise from $750 in 2007-08 to $1,500 in 2010-11. Given that the offset will continue to phase out at four cents for every dollar of income above $30 000, this implies that from July 2010 those eligible for the full low income tax offset will not incur a net income tax liability until their annual income exceeds $16 000.

2.4 The Government envisages the tax cuts as a medium-term response towards its longer-term aspirations announced in the election campaign. These are also shown in the table.

Tax thresholds ('000 dollars)

From July	untaxed	15%	30%	37%	38%	40%	45%
2007	0-6	6-30	30-75			75-150	>150
2008	0-6	6-34	34-80			80-180	>180
2009	0-6	6-35	35-80		80-180		>180
2010	0-6	6-37	37-80	80-180			>180
Aspired for 2013	0-6	6-37	37-180			>180	

Source: compiled from Explanatory Memorandum and Pulle, B; Makeham-Kirchner, A and Darby, P 2008, 'Tax Laws Amendment (Personal Income Tax Reduction) Bill 2008', Parliamentary Library Bills Digests, no. 60, 2007-08, 19 February.

2.5 The estimated costs to revenue are around $7 billion in 2008-09, $10 billion in 2009-10 and $14 billion in 2010-11.

2.6 For those earning the average weekly wage of around $56 000, the tax cuts are worth about $12 a week in 2008-09 rising to about $20 a week in 2010-11. Including the impact of the low income tax offset raises these amounts to $14 (or 1.3 per cent) and $29 (2.7 per cent). The corresponding amounts for a taxpayer on twice average earnings are about $21 and $50, higher in absolute terms but smaller in percentage terms (1 per cent and 2.2 per cent).

Should there be a more expansionary fiscal policy?

Inflationary pressures

2.7 The main concern expressed about the tax cuts when they were first announced is that they will boost aggregate demand, and so add to inflationary pressures. This is a concern when the underlying inflation rate is currently 4¼ per cent, well above the Reserve Bank's 2-3 per cent medium-term target. The latest published forecast of the Reserve Bank is for inflation to remain above 3 per cent until 2010.[1]

2.8 This argument was clearly stated by the Reserve Bank Governor, Mr Glenn Stevens:

> in the current environment an obvious cyclical case can be made for fiscal policy to be tighter … just for the moment in order to take the pressure off demand in the economy.[2]

2.9 As Treasury's Executive Director (Macroeconomic Group) put it, 'in principle, if you did not give any of the tax cuts that would be a substantially more significant tightening of fiscal policy'.[3]

2.10 Governor Stevens commented recently that 'domestic demand growth was 5.7 per cent in the latest year. It needs to be considerably lower than that'. The proposed tax cuts are worth around $10 billion per year, which if spent by households would add around 1 per cent to domestic demand.

2.11 If the tax cuts are inflationary, the Reserve Bank will need to keep interest rates higher than they would otherwise be. Governor Stevens, speaking of the task of reducing inflationary pressures, said 'I will be happy to see any support from fiscal policy we can get'.[4]

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1 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2008, p. 55. The RBA's next *Statement* will be released on 9 May.

2 Governor Glenn Stevens, *House of Representatives Economics Committee Hansard*, 4 April 2008, p. 34.

3 Dr David Gruen, *Additional Estimates Hansard*, 20 February 2008, p. 64.

4 Governor Glenn Stevens, *House of Representatives Economics Committee Hansard*, 4 April 2008, p. 34.

2.12 In line with these remarks, the Australian Workers' Union's submission comments 'there is simply no point in applying the fiscal policy accelerator to the economy if the Reserve Bank puts on the monetary policy brake'.[5]

2.13 The AWU also points out that higher interest rates mean that the exchange rate is likely to be higher than otherwise. While this makes imported goods cheaper, it makes it harder for exporters to sell their products.

2.14 Some critics of the inflationary impact of the proposed tax cuts have suggested they should be replaced by increased government spending. However, this would itself be inflationary unless it was directed into capacity building infrastructure to ease supply bottlenecks.

Could the domestic economy be slowing too much?

2.15 More recently, some commentators have suggested that an expansionary tax cut was now appropriate, given the slowing in the United States economy and the reduction in domestic consumer confidence and spending.

2.16 Private sector employment has fallen in the US in recent months. The International Monetary Fund has lowered its forecast for US real GDP growth in 2008 from 1.5 per cent in January to only 0.5 per cent in April.[6]

2.17 In Australia retail sales fell marginally in both January and February on a seasonally adjusted basis.[7] The Westpac-Melbourne Institute index of consumer sentiment fell to its lowest level in almost 15 years in April.[8]

2.18 These factors led Westpac's chief economist to comment:

> What we're now seeing with those tax cuts is that they'll be a welcome offset to the collapse in confidence, and the collapse in spending that we're seeing at the moment. So, whereas in the past it may have been seen as adding fuel to the fire, I think now it suggests that it'll allow us to have a soft landing rather than anything more brutal.[9]

2.19 However, there are other data which suggest any slowing in the domestic economy may not be dramatic. While the outlook for the US has been marked down severely, the outlook for Australia's other trading partners has been much less affected. The IMF still expect China to grow by over 9 per cent in 2008 and forecasts for Europe and Japan have only been marginally reduced.

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5 Australian Workers' Union, *Submission. 1*, p. 3.

6 International Monetary Fund, *World Economic Outlook*, April 2008, p. 2.

7 Australian Bureau of Statistics, *Retail Trade*, February 2008, Cat no. 8501.0.

8 *The Age*, 9 April 2008.

9 Mr Bill Evans, interviewed on *7.30 Report*, ABC, 16 April 2008.

2.20 Moreover, forecasts for commodity prices have strengthened. In January the IMF had expected non-fuel commodity prices to be flat in 2008 but in April they forecast a 7 per cent increase. Higher commodity prices will inject more spending power into the Australian economy and are likely to add further to domestic demand. The Reserve Bank's latest assessment is that:

> Australia's trading partners as a group are likely to record below average growth in 2008, reflecting weak outcomes in the developed world and slower but still pretty solid, good growth in Asia. But, at the same time, higher contract prices for coal and iron ore which are about to take effect will, all other things equal, lift Australia's terms of trade by perhaps a further 15 per cent, adding two to three per cent to national income over the next year or so…most indicators of actual economic performance for the early part of 2008 have remained quite strong; employment has been very robust; and survey based measures of actual business conditions have remained strong, even if off their late 2007 highs. We do think, however, that demand growth in Australia is now in the process of moderating…for the time being policy settings should remain unchanged.[10]

2.21 This uncertainty about the economic outlook leads ACOSS to raise concerns about setting out a medium-term timetable for tax cuts. It argues that:

> by locking in three rounds of tax cuts over the next three years, it would greatly limit the Government's future fiscal flexibility. Given divergent views about the economic outlook both here and overseas, if the Parliament decides to proceed with further tax cuts then it would be prudent to legislate separately for each round.[11]

Participation effects

2.22 The translation of the tax cuts to inflationary pressures will be less if they also act to increase aggregate supply. One way that tax cuts may increase the productive capacity of the economy is if they encourage more people to look for jobs. However, as the comments above suggest, it is unlikely that these supply effects would be so great as to offset completely the demand effects. In response to questions by the Committee, Treasury reported estimates that the tax cuts could add 0.7 per cent to hours worked.

2.23 The Treasurer has placed considerable emphasis on the role of the tax cuts in encouraging labour market participation. In his second reading speech on the bill, he said:

> Labour shortages are now widespread and employers frequently report they are the number one constraint on business

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10 Governor Glenn Stevens, *House of Representatives Standing Committee on Economics Hansard*, 4 April 2008, pp 4–5.

11 ACOSS, Submission 5, p. 3.

> expansion…this tax reform package will significantly improve the financial incentives for second income earners and those on welfare benefits to make the transition into the workforce or increase their hours of work. These tax reforms will also enhance the incentives for taxpayers to upgrade their skills and gain higher qualifications by allowing workers to keep more of the wage gains that come with being more highly skilled and productive.[12]

2.24 This effect was first quantified in Treasury's *Mid-Year Economic and Fiscal Outlook*, which said of the previous government's tax cut proposals (which were similar to those proposed in the bill) that 'the estimated impact of the 2007-08 MYEFO tax cuts is to encourage around 65 000 new entrants into the workforce'.[13]

2.25 Treasury expanded on this estimate in its response to questions sent by the Committee. They explained that the estimate was derived from Treasury's version of a behavioural microsimulation model developed by the Melbourne Institute of Applied Economic and Social Research. It allows for both the 'income' effect (whereby a tax cut allows a target income to be achieved from working *fewer* hours) and the 'substitution' effect (whereby a tax cut encourages working *more* hours by increasing the return from working).

2.26 Treasury also provided an updated estimate for the tax cuts proposed in the bill. The impact was expected to be 64 000 extra entrants to the workforce, essentially the same as the previous estimate. They attributed 35 000 of the additional workers to the increase in the 30 per cent tax threshold. But almost half the impact is due to the increase in the low income tax offset, which is expected to lead to an additional 29 000 people joining the labour force. In addition, existing workers would be encouraged to work more hours. The estimated additional supply of labour from new and existing workers is around 2.5 million hours per week.

2.27 Treasury note that 'labour supply elasticity is generally much higher for those on low incomes, particularly for second-income earners' and that the impact on participation of lowering the 45 per cent marginal rate to 42 per cent 'was estimated to be very low'; contributing only 0.01 of the 0.16 increase in average hours worked per week.

2.28 Further tax reforms were called for in the submission from the Shop, Distributive and Allied Employees' Association. It drew attention to the impact of high 'effective marginal tax rates' (which capture both additional income tax paid and reduced benefits received[14] when income rises) for many working families on labour force participation. It claims that in 2006:

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12 *House of Representatives Hansard*, 14 February 2008.

13 *MYEFO*, 2007-08, p. 8.

14 Notably the family tax benefits.

> 7.1 per cent of working age Australians faced an EMTR of over 50 per cent; this represented 910,000 Australians. Almost two-thirds of these were couples with children.[15]

2.29 Its recommendations are:

> The introduction of earned income tax credits would overcome the problem of high effective marginal tax rates. The imposition of a wealth tax on those with substantial wealth is justified on equity grounds… closing down tax loopholes must be a priority.[16]

2.30 The SDA also advocates changes to the structure of family tax benefits.

Relief for working families

2.31 It has been argued that the tax cuts are needed to compensate working families for the extra expenses caused by higher interest rates and higher petrol and food prices. From this perspective, and given the need to limit inflationary pressures, some argue that the tax cuts could be restricted to low and middle income earners.

2.32 Some argue the proposed tax cuts do not go far enough. The Shop, Distributive and Allied Employees' Association has stated 'tax rates for low and middle income earners should be cut further'.[17]

2.33 In the longer term, once inflation is back within its target, there is scope to provide tax relief for working families. In the same comments quoted above, Reserve Bank Governor Stevens stated a case for a medium-term reduction in taxation.

> In an economy like ours, where we have no debt and the budget is continually in surplus, it seems to me there is an obvious structural case that can be made for lower taxes.[18]

2.34 The Australian Council of Social Service takes a different view about helping low income and disadvantaged people. Its submission argues:

> well targeted investment in community services would deliver more cost effective and longer lasting improvements in the living standards of low and middle income Australians than further tax cuts at this time.[19]

2.35 Among programmes they would like to see given more funding are community care, dental health, job training and social housing. They argue that

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15 SDA, *Submission 3*, p. 8. Confusingly, they claim later on the same page that the number of affected workers is 1.9 million.

16 SDA, *Submission 3*, p. 10.

17 SDA, *Submission 3*, p. 7.

18 Governor Glenn Stevens, *House of Representatives Standing Committee on Economics Hansard*, 4 April 2008, p. 4.

19 ACOSS, *Submission 5*, p. 1.

opinion polls suggest that more Australians would prefer more spending on community services than would prefer tax cuts. They also note that 'over one third of Australian households do not benefit from income tax cuts because their incomes are too low to pay tax'.[20]

Wage pressures

2.36 Another argument for the tax cuts is that by boosting disposable income, they may avert higher wage claims, which would in themselves be inflationary. Treasury give some guarded credence to this idea, remarking in their response to the Committee's questions that 'as the tax cuts will assist employees in maintaining their real incomes, it is possible that they may moderate the wage claims sought by their representatives in wage negotiations'.

2.37 However, unlike under the 'Accord' of the 1980s, there is no scope in the decentralised wages system to make a 'deal' for such a trade-off.

2.38 As with the participation argument, it might be argued that any impact on wages growth is most likely to occur at the lower and middle income ranges. However, Treasury opine that the impact 'could be true of workers across the income spectrum'.

Superannuation as an alternative

2.39 A suggestion to moderate the inflationary impact and address the challenge of an aging population is to give the tax cuts, at least in part, in the form of contributions to superannuation. The Australian Workers' Union stated:

> The AWU supports raising private savings by providing half of Labor's $31 billion tax cut as a contribution to a nominated taxpayer superannuation fund. This funding will be available to invest in productive investments aimed at building capacity and productivity growth.[21]

2.40 Treasury has been asked whether paying the tax cuts into superannuation would be less inflationary. Its Executive Director (Macroeconomic Group) replied:

> If the money went into compulsory superannuation, it would have less impact on aggregate demand; yes, I suspect that is right.[22]

2.41 Paying the tax cuts in the form of superannuation, thereby raising private saving, would also be associated with a smaller current account deficit than if they are allowed to add to current consumption.

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20 ACOSS, *Submission 5*, p. 2.

21 Australian Workers' Union, *Submission 1,* p. 5.

22 *Additional Estimates*, 20 February 2008, p. 64.

2.42 A variant on this proposal, which is more consistent with keeping the election promise, is to allow people to 'opt out' of the superannuation contribution and receive the tax cut if they choose. Dr Nicholas Gruen of Lateral Economics described his idea as follows:

> Many people who might actually be well disposed to increasing their super contribution but don't ever get around to doing so. So what would happen if their employers deposited the proceeds of their tax cuts into their super accounts, but also allowed them to opt out and receive the tax cuts in their pockets if they chose? … Prime Minister Kevin Rudd would be inviting employees to join him in a fiscal conservatism that would do the country good in the short term and themselves and their children good in the long run. And those who don't like it – well they just tick the box, opt out and that's it.[23]

2.43 This might be particularly helpful for those earning less than $450 a month, and so not receiving compulsory superannuation contributions.

23 Dr Nicholas Gruen, *Australian Financial Review*, 5 February 2008, p. 71.