INSIDE STORY

NATIONAL AFFAIRS

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The trickle-up effect

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Labor is under pressure to wave through the government's stage three tax cuts. But they'll make the tax system less progressive — and they don't stack up economically

Right:

Treasurer Josh Frydenberg (left) hasn't been entirely frank about the impact of the stage three tax cuts. Lukas Coch/AAP Image

It's not unusual to hear governments arguing that tax cuts will improve incentives to work, save or invest. Faster economic growth follows — or so the story goes — and everyone benefits.

The Morrison government certainly used that argument to defend its three-stage personal income tax cuts, which it proposed in the 2019–20 budget, took to the 2019 election and legislated shortly thereafter. For working Australians, the government declared, "rewards for effort" would increase without sacrificing "a progressive tax system in which those with the greatest ability to pay contribute a larger share of personal income tax revenue." A year later it argued that bringing forward its stage two tax cuts would "improve the incentives to work."

John Howard made similar claims about the personal income tax cuts at "the heart" of the "New Tax System" his government introduced in 2000. "Australian workers," he declared, would be given a "genuine reward for their efforts." And, lest it be thought this line of thinking is confined to one side of politics, back in 1985 Labor treasurer Paul Keating asserted that "lower marginal rates will enhance our economic performance by better rewarding initiative." Among other things, Keating was proposing a substantial reduction in the top personal tax rates from what was then 60 per cent.

Tax cuts can certainly deliver a sugar hit to economic growth, and they can be an effective part of a response to an economic downturn. And the design of tax systems — *how* taxes are collected, and *from whom* — undoubtedly has an impact on economic performance, for better or worse. But any clear correlation (let alone a causal relationship) between the *level* of taxation and and the rate of economic growth — or any other measure of economic performance — is far less obvious, as work by the OECD and the IMF has shown.

The most contentious tax cuts, of course, are those targeted at high earners. The claim that this kind of tax cut is conducive to faster rates of economic growth was recently rebutted in some detail by David Hope and Julian Limberg at the London School of Economics. The two economists analysed the impact of cuts in income and wealth taxes for high-income or high-net-worth individuals in eighteen OECD countries over more than fifty years using data on economic growth, unemployment and income inequality.

Their conclusion? While the top 1 per cent of income earners in these countries have unambiguously increased their shares of national income (by an average of 0.8 percentage points in the five years after each tax reduction), the cuts have had no statistically significant impact on real per capita GDP growth or unemployment.

Hope and Limberg's findings are consistent with other research suggesting that reductions in top marginal income tax rates have no significant impact on the amount of paid work undertaken by people who benefit from them.

But what about Australia, with its particular combination of tax rates and thresholds?

To begin with, it's important to recognise that Australia's income tax system is more progressive than generally recognised. Near-typical in some cases, unusual in others, our system's characteristics combine to do a better job of redistributing income than many people assume.

Australia's top personal rate of (in effect) 47 per cent is in the middle rank of OECD countries, with lower rates prevailing in nineteen member countries and higher rates in sixteen. But the threshold above which it applies is relatively low, with only six OECD countries having a lower threshold relative to the average wage. On the other hand, Australia's tax-free threshold is very high (twenty-six OECD countries don't have one at all); our GST rate is low compared with the OECD average of 19.2 per cent (only four of thirty-six comparable OECD countries have a lower rate); and our flat-rate Medicare levy is a lot lower than the social security contributions levied in the United States and most European countries.

Combine these factors with a tightly targeted social security system and Australia achieves a significant measure of income redistribution despite having a smaller overall tax "burden" than most OECD economies.

One thing stage three of the Morrison government's program of tax cuts *doesn't* do is lower Australia's top personal tax rate. Treasurer Josh Frydenberg is correct when he says that Australia will "retain a progressive tax system." But the system will nonetheless become less progressive once the government's tax plan is complete. In fact, an analysis by Grattan Institute suggests that 60 per cent of the plan's benefits will flow to the top 20 per cent of taxpayers, reducing the share of income tax paid by this group from 68 per cent in 2017–18 to 65 per cent by 2029–30. As a result, Australia's personal income tax system will become less progressive than in any year since at least 2003–04, and by one measure since the 1950s.

This is only partly the result of the proposed lift in the top threshold from $180,000 to $200,000 (which would still leave it relatively low by OECD standards). The reduction in progressivity mainly stems from the fact that people in the top tax bracket derive a substantial benefit from two other changes: the lifting of the threshold for the 37 per cent marginal rate from $90,000 to $120,000 from the beginning of the current financial year, and its abolition entirely from 1 July 2024; and the increase in the 32.5 per cent threshold from $37,000 to $45,000, and its reduction to 30 per cent from 1 July 2024.

Of course, shielding high-income earners from the significant benefits of reductions in tax rates or increases in thresholds below the top rate is difficult without more substantial adjustments to the rate scale. But that fact doesn't justify the pretence that the progressivity of the tax system is unaffected by changes envisaged by the Morrison government.

I'm certainly not advocating (as the opposition did at the last election) that the top marginal rate should be increased — and particularly not at the current or prospective threshold. Among other things, it would almost certainly encourage tax avoidance strategies that (legally) exploit the already large difference between the top personal income tax rate and the company tax rate (especially now that small businesses pay a company tax rate five percentage points lower than other businesses).

More generally, I don't see any compelling reason why employees who are earning wages or salaries of $200,000 or more and are not using these or other strategies to reduce their tax should be paying more of their income in tax than they currently do.

What does worry me is income from other sources — from capital gains, superannuation fund earnings, rent, "business" income routed through trusts, and so on. This income goes mainly to people whose annual pre-tax income is well in excess of $200,000 but who don't pay tax at the same rate as people whose wage or salary income exceeds that threshold. It's perhaps understandable, but nonetheless regrettable, that the federal opposition has walked away from its reforms to negative gearing and capital gains tax.

If the government truly believes that high marginal tax rates adversely affect incentives to work, save and invest — and if it also believes that Australia's tax system should be progressive — then it should be at looking how high earners unfairly benefit from features of the tax system intended to benefit low-income earners (including that very high tax-free threshold), at reforms that tax capital income at a similar rate to income from working, and at reforms that curtail the scope for high-income earners to use tax-preferred saving or investment vehicles to reduce their tax bills.

If they did this, the case would be much stronger for reducing the top marginal rate or making much larger increases in the threshold at which it becomes payable. Or the government might even use the extra revenue to better fund aged care and other worthy programs without having to raise taxes or introduce new ones. Or it might feel less need to raise taxes (or introduce new ones) when the time comes to start reducing the budget deficit. •

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