

## Early tax cuts as stimulus

***Bringing forward personal income tax cuts would see more than 50% of benefits go to the highest 10% of income earners and 79%-91% of benefits to the top 20% of earners. Just 3%-4% of the benefit would go to the lower half of all income earners. High income earners would save some or all of the tax cut making it less effective for stimulating the economy.***

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### INTRODUCTION

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With Australia in a recession brought on by the coronavirus pandemic, there have been suggestions, including from the government backbench, that the tax cuts be brought forward to help stimulate the economy.<sup>1</sup> Treasurer Josh Frydenberg has confirmed that this is being considered for the delayed budget.<sup>2</sup> Frydenberg has argued that bringing forward the tax cuts could stimulate the economy by increasing household spending.

In the 2018 and 2019 budgets the Federal Government announced large income tax cuts over a seven-year period. Together, the tax cuts are valued at \$300 billion over 10 years. The distribution of these tax cuts has been extensively examined in previous

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<sup>1</sup> Crowe D (2020) *Liberal MPs call for tax cuts in Morrison's next stimulus*, SMH, 22 July, available at <<https://www.smh.com.au/politics/federal/liberal-mps-call-for-tax-cuts-in-morrison-s-next-stimulus-20200722-p55ehz.html>>

<sup>2</sup> Crowe D (2020) 'Trickle-down fantasy': Stimulus tax cuts face fresh attack as \$28b cost revealed, SMH, 27 July, available at <<https://www.smh.com.au/politics/federal/trickle-down-fantasy-stimulus-tax-cuts-face-fresh-attack-as-28b-cost-revealed-20200726-p55fiz.html>>

Australia Institute papers.<sup>3</sup> The income tax cuts are scheduled for three stages. The stage 1 cuts came into effect in 2018-19. Stage 2 is due in 2022-23 and stage 3 in 2024-25.

Despite the discussion about bringing forward the tax cuts, there are no firm proposals for when the tax cuts should be brought forward to or what stages of the cuts should be brought forward. With the Federal Budget delayed until October, the earliest the government could easily bring the tax cuts forward to would be the 1<sup>st</sup> of July 2021 (for the 2021-22 financial year).

This paper will model two options:

1. The government brings forward stage 2 of the tax cuts by one year from 2022-23 to 2021-22.
2. The government combines stage 2 and stage 3 of the tax cuts and brings them both forward to 2021-22.

The government could bring forward the stage 3 tax cuts to 2022-23 or later instead of bringing them forward to the next financial year. The Australia Institute has not modelled this possibility as we consider it too far in the future to be plausibly considered stimulus for the current recession.

## TAX CUTS AS STIMULUS

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The effectiveness of a tax cut as stimulus depends largely on who receives the tax cut. Stimulus is effective when it is spent rather than saved, specifically when it is spent on domestically produced goods and services.

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<sup>3</sup> Grudnoff, M. (2019) *The distribution of the Government's stage 3(a) tax cuts*, The Australia Institute, 31 May, available at <<https://www.tai.org.au/content/new-analysis-over-50-stage-3a-tax-cuts-benefit-go-highest-income-earners>>

Grudnoff, M. (2019) *A bit rich: A Government plan to make tax less progressive*, The Australia Institute, 18 April, available at <<https://www.tai.org.au/sites/default/files/A%20bit%20rich%20making%20income%20tax%20less%20progressive%20-%20%255bWEB%255d.pdf>>

Grudnoff, M. (2019) *Regressing on tax*, The Australia Institute, 4 April, available at <<https://www.tai.org.au/content/analysis-54-tax-cuts-benefit-go-highest-income-earners>>

Grudnoff, M. (2018) *High income earners the big winners from scrapping 37% tax bracket*, The Australia Institute, 29 May, available at <<https://www.tai.org.au/content/high-income-earners-big-winners-scrapping-37-tax-bracket>>

Grudnoff, M. (2018) *Radical plan to increase inequality in Australia revealed in budget*, The Australia Institute, 29 May, available at <<https://www.tai.org.au/content/62-tax-cuts-benefits-go-highest-income-earners>>

Tax cuts therefore provide the most stimulus when given to those on low incomes, who spend a greater proportion of their income – mostly on the essentials of life. By contrast, higher income earners spend a lower portion of their income on the costs of living and often accumulate savings. They are more likely to save some or all of the benefit of the tax cut than lower income earners.

A tax cut that is spent on domestically produced goods and services will stimulate the economy. A tax cut that is saved or spent on imports or used to pay down debt does not stimulate the economy. The effectiveness of bringing forward the tax cut will largely depend on whether the benefit goes to those on high incomes or those on middle and low incomes. The more the tax cut goes to people on lower incomes the more effective it will be at stimulating the economy. The more the tax cut goes to those on higher incomes the less effective it will be at stimulating the economy.

Stimulus also needs to be timely. Stimulus planned years in advance risks being mismatched to the economic circumstances of the time. By the time the stimulus occurs, it might not be needed, or a different amount of stimulus might be required. Even if the tax cuts are brought forward as early as possible (to 2021-22), whatever stimulatory effect they have will not begin for nine months.

Both modelled options deal only with the impacts of bringing forward tax cuts to 2021-22. The government could make changes that bring forward tax cuts to 2022-23 or later. But this is considered to be too far in the future to be effectively targeted as stimulus.

## **BRINGING STAGE 2 FORWARD TO 2021-22**

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In order to judge the effectiveness of bringing forward stage 2 of the tax cuts by one year we need to model the distribution of the tax cuts by income. The Australia Institute model uses Australian Tax Office data to calculate the impact of bringing forward stage 2 of the tax cuts from 2022-23 to 2021-22.<sup>4</sup>

Stage 2 of the tax cut involves several changes:

- Increasing the threshold of the 32.5 cent bracket from \$37,000 to \$45,000
- Increasing the threshold of the 37 cent bracket from \$90,000 to \$120,000
- Removal of the LMITO (Low and Middle Income Tax Offset) which was introduced in stage 1

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<sup>4</sup> For an explanation of the model see Appendix A

- Increasing the maximum rate and phase out rates for the LITO (Low Income Tax Offset)

An important consideration when modelling this option is what is done with the end date of the LMITO. The LMITO is a tax refund paid to eligible taxpayers after they submit their tax return. The LMITO is currently legislated to end in 2021-22, to coincide with the stage 2 tax cuts, which begin the following year. Part of the stage 2 tax cuts is designed to compensate some taxpayers for the loss of the LMITO. Under the current legislated arrangements, no taxpayers are worse off when the LMITO is removed because of the changes made in stage 2.

If the tax cuts were brought forward, the LMITO would need to end one year earlier so that the two parts of the tax cut continue to work as planned.

Alternatively, the LMITO could continue to its currently legislated end date so that in 2021-22 taxpayers receive both the LMITO and the stage 2 tax cuts.

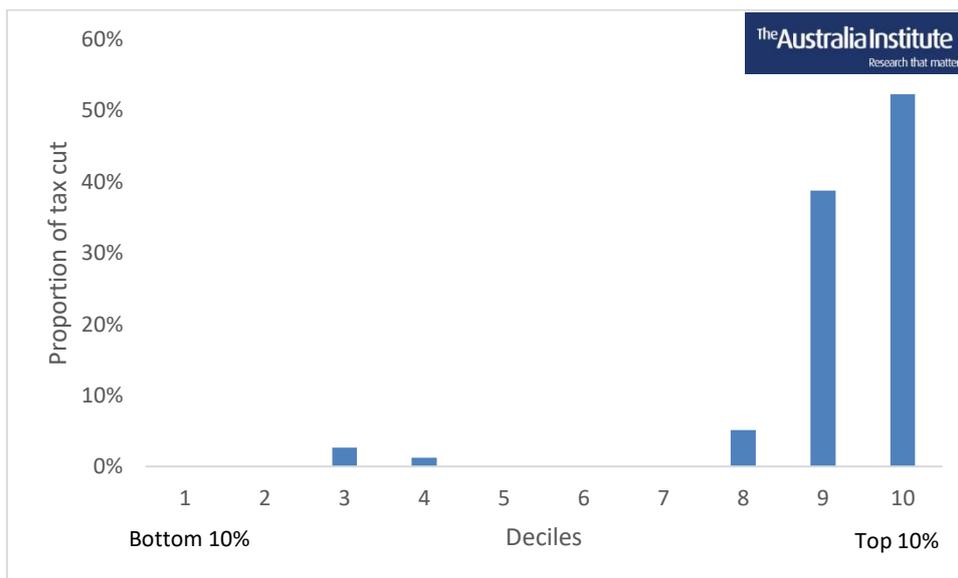
While this would increase the stimulus from the tax cuts for one year, it would mean that after the LMITO ends in June 2022 some taxpayers would face an effective tax increase of up to \$1,080. In this modeling exercise, the LMITO is removed a year early to maintain the original transition from the LMITO to the stage 2 tax cut.

## **RESULTS OF BRINGING FORWARD STAGE 2 BY ONE YEAR TO 2021-22**

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The modeling shows that bringing forward the stage 2 tax cuts to 2021-22 will only benefit 40 per cent of taxpayers. Most taxpayers, 60 per cent, will get no benefit from the tax cut. Most of the benefit will go to those on high incomes. The top 20 per cent of taxpayers will get 91 per cent of the benefit and the top 10 per cent will get 52 per cent of the benefit. A breakdown of the benefit of the tax cut by decile is shown in Figure 1.

**Figure 1 - Benefit by decile if stage 2 is brought forward to 2021-22**



Source: Calculations by model described in Appendix A

The reason that so many taxpayers miss out completely on a tax cut is because most of the stage 2 tax changes at the lower end of the income distribution are intended only to compensate for the removal of the LMITO. Most of those on low and middle incomes will lose the LMITO but get the same amount back in changes to the tax thresholds and LITO. Because the loss and gain are identical, there is no net gain for these taxpayers.

A small group of taxpayers, those who earn between the minimum and the maximum rate of the LMITO (between \$37,000 and \$48,000), will be overcompensated for the loss of the LMITO when stage 2 comes in. This group, who are split between the 3<sup>rd</sup> and 4<sup>th</sup> decile of taxpayers, do benefit from the stage 2 tax cuts: they receive about four per cent of the total tax cut.

While the LMITO and the tax cut are precisely offset for most low- and middle-income earners, those on higher incomes gain more in the tax cut than they lose in LMITO. This is the case for two reasons:

1. While the LMITO was designed so that high income earners got limited or no benefit, the tax cut compensating for the removal of the LMITO gives high income earners the full benefit. The LMITO decreases from the maximum rate for those earning over \$90,000 and goes to zero for taxpayers earning more than \$125,333; high-income earners get the full benefit from the lift in the threshold for the 32.5 cent bracket.

2. High income earners benefit significantly from the increase in the 37 cent threshold from \$90,000 to \$120,000.

Table 1 shows the size of the stage 2 tax cuts per year and per week for someone on a very high income (\$200,000 per year), someone on the median income (\$60,000 per year), someone on the minimum full time wage (\$40,000 per year) and someone on a very low income (\$20,000 per year).

**Table 1 – Tax cut for various incomes if stage 2 was brought forward to 2021-22**

Income	Tax cut per year	Tax cut per week
<b>Very high income (\$200,000)</b>	\$2,430	\$46.61
<b>Median income (\$60,000)</b>	\$0	\$0
<b>Minimum wage (\$40,000)</b>	\$110	\$2.11
<b>Very low income (\$20,000)</b>	\$0	\$0

Source: Author's calculations

Table 1 shows those on the median wage and very low incomes get nothing. Those on the minimum wage get just over two dollars a week. Those on very high incomes get a substantial tax cut of almost \$50 per week.

## RESULTS OF BRINGING FORWARD STAGE 2 AND 3 TO 2021-22

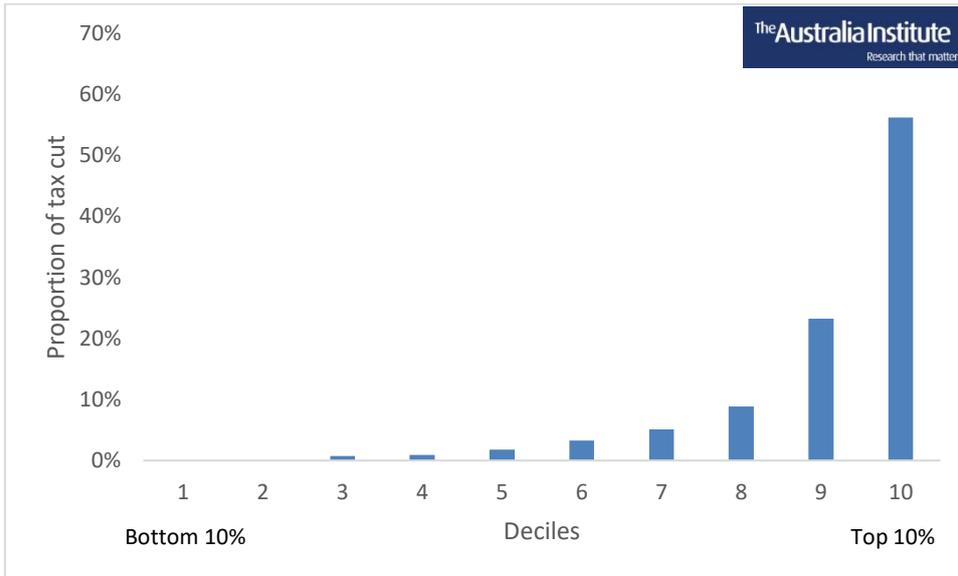
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Stage 3 of the tax cuts reduces the 32.5 cent rate to 30 cents. The threshold for this rate expands dramatically from \$45,000 to \$200,000, eliminating the 37 cent tax bracket altogether. The 45 cent threshold is increased from \$180,000 to \$200,000.

The modeling shows that if both stage 2 and stage 3 are brought forward to 2021-22, then the bottom quarter of taxpayers (23 per cent) will get no benefit. Most of the benefits go to high income taxpayers. The top 10 per cent get more than half of the benefit (56 per cent) and the top 20 per cent get 79 per cent of the benefit.

A breakdown of the benefit of the tax cut by decile is shown in Figure 2.

**Figure 2 – Benefit by decile if stage 2 and 3 are brought forward to 2021-22**



Source: Calculations by model described in Appendix A

Table 2 shows the size of the tax cut per year and per week for people on various incomes including very high income (\$200,000), median income (\$60,000), minimum wage (\$40,000) and very low income (\$20,000).

**Table 2 - Tax cut for various incomes if stage 2 & 3 was brought forward to 2021-22**

Income	Tax cut per year	Tax cut per week
<b>Very high income (\$200,000)</b>	\$11,505	\$220.66
<b>Median income (\$60,000)</b>	\$380	\$7.30
<b>Minimum wage (\$40,000)</b>	\$110	\$2.11
<b>Very low income (\$20,000)</b>	\$0	\$0

Source: Author’s calculations

Those on very low incomes get nothing, while those on the minimum wage get no greater benefit than if only stage 2 was brought forward. Those on the median income get \$7.30 per week while those on a very high income get \$220.66 per week.

## EFFECTIVENESS OF BRINGING TAX CUTS FORWARD AS STIMULUS

Table 3 summarizes the distribution of both options.

**Table 3 - Summary of the distribution of both tax cut options**

<b>Tax cut proposal</b>	<b>Top 10%</b>	<b>Top 20%</b>	<b>Bottom half</b>	<b>Bottom 30%</b>	<b>Bottom 20%</b>
<b>Bringing forward stage 2</b>	52%	91%	4%	3%	0%
<b>Bringing forward stage 2 &amp; 3</b>	56%	79%	3%	1%	0%

Source: Calculations by model described in Appendix A

Both proposals to bring forward the tax cuts overwhelmingly benefit taxpayers on high incomes, the least effective targets of stimulus. If just stage 2 were brought forward to 2021-22, the top 10 per cent of taxpayers would get 52 per cent of the tax cut and the top 20 per cent would get 91 per cent of the tax cut. If both stage 2 and stage 3 are brought forward to 2021-22 then the top 10 per cent would get 56 per cent of the tax cut and the top 20 per cent would get 79 per cent of the tax cut.

Low income taxpayers get very little of the tax cut, despite being the most effective targets of stimulus. Both proposals to bring forward the tax cuts give nothing to the bottom 20 per cent. Bringing forward stage 2 to 2021-22 will see the bottom 30 per cent get less than three per cent and the bottom half of taxpayers get four per cent of the total benefit. If both stage 2 and stage 3 are brought forward to 2021-22 then the bottom 30 per cent get less than one per cent and the bottom half of taxpayers get three per cent of the total benefit.

## CONCLUSION

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Stages 2 and 3 or the government's tax cut plan are designed to mainly benefit those on high incomes. Those on low incomes get little to none of the tax cut. Bringing these stages forward to 2021-22 will simply mean high income taxpayers get a large tax cut earlier. This is ineffective stimulus.

The billions of dollars that it will cost to bring forward the tax cuts could be spent more effectively by the government. Direct employment, labour intensive projects and grants to low income earners would stimulate the economy much more than tax cuts to high income taxpayers. For example, a permanent increase in the rate of JobSeeker would see all the extra funds go to those on very low incomes, which would be a much more cost-effective stimulus.

## APPENDIX A

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The Australia Institute has constructed a model of Australia's tax system using the latest taxation statistics. The model breaks down all taxpayers into 100 groups from the lowest income earners to the highest. By inflating income by nominal GDP and calculating how much tax each group pays as each stage of the tax cut is brought forward to 2021-22, we calculated how much of the tax cut would go to each income decile.