__Briefing Note:__

Wages, Taxes, and the Budget

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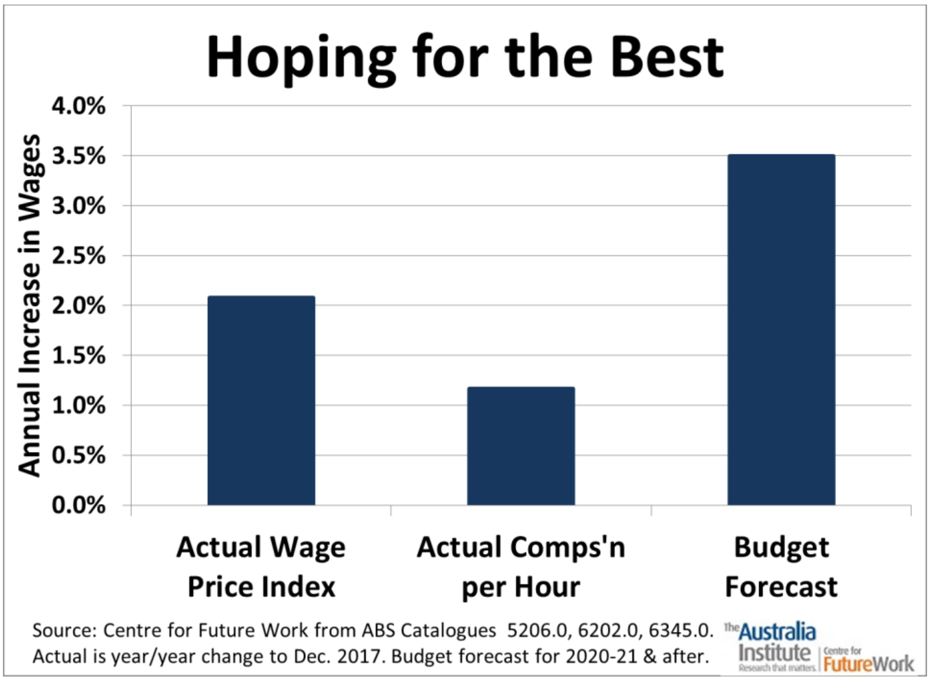
Summary

- The Coalition government's 2018 budget features a plan to cut personal income taxes for many Australians over the next several years. The government claims it wants to reward lower- and middle-income wage-earners with tax savings. However, the biggest personal tax reductions would not be experienced until 2022 and beyond (after at least two more federal elections). And the biggest savings go to those with incomes over $200,000 per year (the richest 3 percent of tax-filers).
- The boost in disposable incomes for most Australians from these changes will be miniscule, not making any measurable difference to their standard of living.
- The biggest cause of stagnating living standards in Australia has been the deceleration of wage increases since 2012. The budget assumes that wage growth will suddenly rebound in coming years to more traditional rates (of 3.5 percent per year). This assumption underpins the government's revenue forecasts – but there is no plan for achieving faster wage growth.
- To the contrary, the government's continuing labour policies will suppress future wage increases. This includes its own 2 percent cap on wage increases for federal public sector workers; the government is restraining wage growth for its own employees to barely half of what it hopes for the whole economy.
- Restoring normal wage patterns would boost disposable incomes for Australian workers many times more than tweaks to personal tax rates and thresholds.
- For example, for a worker earning $60,000 per year (higher than the median income of Australians), the Coalition tax plan will increase disposable income by $530 by the last year of the budget period (2021-22). In contrast, annual normal wage increases (of 3.5 percent per year) would boost disposable income that same year by almost $6000 – 11 times as much.
- Restoring wage increases (including by "changing the rules" of the labour market) is the best way to sustainably improve living standards for working Australians – not pre-election tweaks to the tax code.

A Rosy Forecast for Wages

Keeping with past practice, the budget continues to predict much stronger wage increases than have been realised in recent years. The budget projects a near-doubling of the annual pace of wage increases (as measured by the ABS's Wage Price Index): from around 2 percent per year at present, to 3.5 percent by 2020 and beyond. This assumption of strong wage growth is convenient for a Treasurer: the faster wages are growing, the faster tax revenues increase, helping to balance the budget and finance other government initiatives.

These rosy wage forecasts have been made before, but not realised. And this one is unlikely to occur, either – unless the government undertakes concerted efforts to boost wages through changes in labour policies, program spending, and industrial rules.



Moreover, the Wage Price Index (WPI) is itself an overly-optimistic measure of the true pace of wage growth. The WPI uses a fixed "basket" of different jobs in the economy, to calculate an average of wage growth across different industries. But the crisis in wages has largely resulted from a deterioration in the average quality of work: the ongoing shift toward part-time, casual, and insecure jobs produces lower (and more unstable) earnings. The WPI does not take into account these changes in the composition of work, and hence it overestimates wage pressures. Other broader measures, that consider the changing composition of jobs, indicate that wage growth is even weaker than reported by the WPI. For example, the figure above portrays average labour compensation per hour worked (derived from the ABS national income statistics). It grew less than 1.2 percent over the year ending in the December 2017 quarter – barely half the 2.0 percent increase in the WPI over the same period. This makes the budget's forecast of accelerating wage growth even less believable.

There are other curious aspects to the budget's wage forecasts also worth mentioning. Strangely, the budget assumes that wages (according to the WPI) have grown 2.25 percent in the *current* fiscal year (2017-18), which ends next month. But year-over-year WPI increases were only 2.0 percent in the first two quarters of the fiscal year, and there is no indication that wage gains have suddenly accelerated. To meet its 2.25 percent 2017-18 prediction (which in turn underpins the wage path for all future years in the budget), wages must have been growing at 2.5 percent since January. So this is one prediction that is almost certainly invalid before the ink even dried on the budget papers.

Finally, in addition to forecasting wage growth (via the WPI), the budget also projects strong growth in total wages and salaries paid out. This depends on employment growth, as well as wage increases (reported in Table 4 on p. 5-9 of the main budget document). This forecast is even more expansive, suggesting growth in total wage and salary payouts of 5 percent per year by the last year of the estimates. Total nominal labour compensation has not grown that rapidly since 2012. In fact, since the Coalition was elected, average annual labour compensation (considering both expanded employment and higher wages) has grown by an average of just 3 percent per year – the slowest sustained compensation growth[1] since the Great Depression. It would certainly be a welcome outcome for wage and salary income to accelerate: to help households, as well as government, balance their budgets. But it won't happen by itself.

Do What I Say, Not What I Do

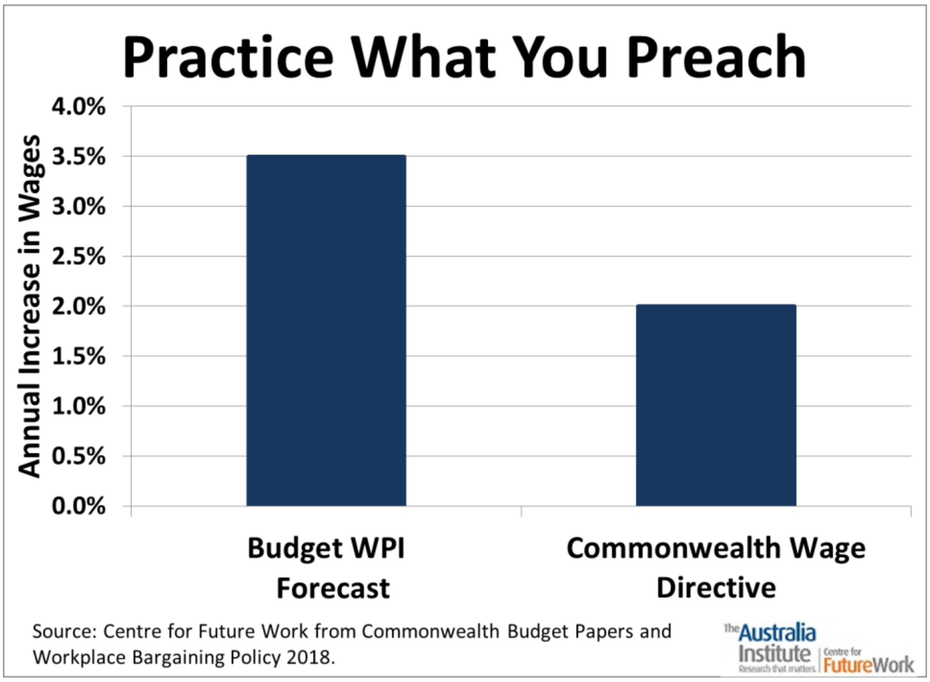
The budget's optimistic assumptions of future wage growth (so crucial to its revenue projections) are especially contradictory in light of the government's own pro-active efforts to restrain wage growth. These include continuing wage-suppressing initiatives in the areas of labour law (such as coming reductions in Sunday penalty rates for service sector workers), the failure to enforce minimum wages and other basic labour standards, the use of restrictive procurement rules to undermine wage agreements (such as the ABCC's Building Code), and more.

The most obvious contradiction, however, is between the government's expansive wage forecast and its own aggressive efforts to restrain wages for its own employees. After all, the Commonwealth government is one of the largest employers in the entire country (along with major state governments). The example it sets in dealing with its own workforce sends a powerful signal to the rest of the labour market about how employers should treat wage demands from their workers.

However, despite its hopes for stronger wage growth, this budget continues with various measures to suppress wage and salary costs of the Commonwealth government. This includes staff reductions in several departments (the largest being the elimination of 1280 positions at the Department of Human Services), and the continued contracting

[1] Measured over any four-year period.

out of work to private agencies which typically pay lower wages – but ultimately cost more to the government (once all related fees and costs are taken into account). Most galling is the government's own Wage Bargaining Policy[2] which strictly limits compensation gains across the government to 2.0 percent per year. Unless other employers behave very differently than the federal government, this budget's wage forecast will be truly unattainable.



Can't Spend It If You Don't Earn It

One final internal contradiction in the government's forecasts is worth noting. The government is optimistic that wage gains will quickly accelerate to 3.5 percent per year. But its forecast for consumer spending (also a crucial determinant of tax revenues via the GST) is even more bullish. For every one of the next four years, the government anticipates GST-taxable consumer spending to increase *faster* than labour compensation (see Table 4 on p. 5-9 of the budget document). The gap between the two reaches as much as a full percentage point in 2019-20.

It is possible for households to spend more on consumer goods and services than they receive in income – but only by going into debt (or reducing savings), and only for a while. The budget thus implicitly assumes that Australian households – whose accumulated debt already equals $2.5 trillion, or 200 percent of their disposable income – will walk still further down the path of debt-fueled expenditure. The contrast between a government which pledges (on the surface, anyway) to "live within its means," and its policies producing stagnant incomes and rising debt levels for households, is another bitter pill for observers of this budget to swallow.

[2] See http://www.apsc.gov.au/priorities/workplace-relations/bargaining-policy-2018.

Wage Increases versus Tax Cuts

The centerpiece of the budget is a three-stage plan to reduce personal income taxes paid by many Australians over the coming several years. The plan is big and expensive: reducing revenues by an estimated $140 billion over the next decade. But it is end-weighted: only 10 percent of those reductions are experienced in the first four years covered by the budget projections. The biggest and most expansive changes would not take place until 2024-25: six years (and perhaps three federal elections) from now. Making expensive promises that would require a government to be re-elected three times in order to implement them, takes the politicised practice of budget-making to an entirely new and fantastical level.

Two immediate tax changes are the implementation of a new non-refundable tax offset (similar to the existing Low Income Tax Offset, or LITO) that reduces taxes owing for lower- and middle-income taxpayers by up to $530, and an increase in the second-highest tax threshold (capping the 32.5 percent marginal rate category) from $87,000 to $90,000. There are a couple of catches to the offset which limit or eliminate its value to many low-income workers: it only applies to workers who pay income tax (since it is non-refundable), and it is only refunded at the end of the year (after tax returns are filed) and hence does not reasonably affect regular household budgets. The increase in the 32.5 percent threshold provides an additional $135 per year tax reduction to people earning over $90,000.

The tax savings from these two measures will be very small, relative to the benefits that workers would get from a restoration of normal annual wage increases. There are four major reasons why ongoing wage increases are far more powerful than tweaks to the tax rules in lifting living standards for workers over time:

1. Wage increases can and should occur every year, and exert a compounding impact on incomes (since wage increases in any given year build on previous years' increases). Tax rates cannot be cut year after year.
2. Wage increases deliver benefit to any employed person, even if their income was so low that they did not have to pay income tax. Non-refundable tax cuts offer no benefits to very low-income workers.
3. The distribution of savings from tax cuts is more concentrated among higher-income households (since they are the ones who currently pay tax at higher rates).
4. Tax cuts are not "free." Taxes are collected in order to pay for the whole range of public goods and services (from health care to education to safety to infrastructure). Reductions in taxes must inevitably lead to reductions in the provision and consumption of public goods and services – and that in turn will reduce the quality of life for most Australians by at least as much as the marginal tax savings they pocketed.

Wage Increases are Better

	Boost to Annual Disposable Income in 2021-22 From:	
Current Earnings	Coalition Tax Plan	Annual 3.5% Wage Increases
$20,000	$0	$2,950
$40,000	$290	$4,780
$60,000	$530	$5,975
$80,000	$530	$7,435
$100,000	$515	$9,294
$125,000	$135	$11,617

Source: Centre for Future Work calculations from Budget 2018 Chart 1 and Table 3 (pp. 1-13, 1-14).

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The preceding table compares the small incremental changes in disposable income for wage-earners at different levels of income under the Coalition tax plan, with increases in disposable income (after deducting taxes at the relevant marginal rates) that would prevail over the budget period if wages were growing at traditional “normal” rates. The simulation assumes annual wage increases of 3.5 percent per year: this reflects traditional experience in Australia (until wages sharply decelerated after 2012), and is equal to the sum of long-run price inflation (as per the RBA’s 2.5 percent annual target) plus annual labour productivity growth (which typically grows by 1 percent or more per year). RBA Governor Philip Lowe recently confirmed his own view that 3.5 percent is a normal pace of wage growth consistent with his bank’s monetary policy.[3]

Restoring normal wage growth (through a combination of labour, macroeconomic, and fiscal measures) would do far more to lift the incomes of working Australians than incremental reductions in personal income taxes. For example, an Australian worker with annual wages of $60,000 would have almost $6000 in extra disposable income in the last year of the budget forecast thanks to ongoing normal wage increases – 11 times what they would pocket through the Coalition government’s tax plan. Very low-income workers receive nothing from the tax plan, but they would benefit directly from the restoration of normal wage increases. For example, a worker with $20,000 in current annual wages would enjoy a near-$3000 increase in disposable income by 2021-22.

[3] Dr. Lowe told the Standing Committee on Economics of the House of Representatives on February 16, 2018 that “If we're going to deliver average inflation of 2½ per cent we should probably have average wage increases over long periods of time at 3½ per cent.” See Hansard at http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;db=COMMITTEES;id=committees%2Fcommrep%2Faf4a01ce-cf3b-4e4e-a214-3522214a8e01%2F0000;query=Id%3A%22committees%2Fcommrep%2Faf4a01ce-cf3b-4e4e-a214-3522214a8e01%2F0001%22.

Public Services, Living Standards, and Taxes

The importance of public services to quality of life must always be kept front and centre in any discussion about tax cuts as a strategy for "supporting workers." After all, the total material standard of living of Australians depends both on the *private* consumption they purchase with their personal incomes, and on the *collective* consumption which they can access via publicly-provided goods and services. Those public services make up a significant portion of total consumption – all the more so for lower-income Australians (whose private consumption is limited by their incomes).

In Australia in 2017, total household personal consumption was slightly more than $1 trillion. That consumption was concentrated disproportionately among high-income households due to their greater purchasing power. Consumption of public services at all levels of government, meanwhile, equaled $332 billion. And consumption of public services is distributed relatively equally across society; if anything, lower-income households may receive a slightly greater-than-proportional share of public health care, education, and other services. Public consumption – or what is sometimes called the "social wage" – thus represents one-third of the value of private consumption. And for lower-income households, that proportion is greater.

Ultimately, of course, governments must collect taxes to pay for those public services.[4] When governments deliberately undermine the revenue base for the delivery of those services – even if done through measures which are promoted as "helpful" to working people – the necessary trade-off will be a reduction in consumption of public services that will match or exceed the seeming "savings" delivered through a tax cut.

Strangest 3 Reasons for Cutting High-Income Taxes

The Coalition government has advertised its personal tax plan as being helpful for low- and middle-income Australians, and we have challenged that claim. An even harder sell is to justify the much bigger personal tax cuts flowing to those with incomes of $200,000 or more per year under the third stage of the Coalition plan (eliminating the 37 percent tax category altogether, and lifting the top threshold to $200,000). Treasurer Scott Morrison made several attempts at this in his budget, none of which succeeded. Here are the three strangest arguments he made for tax cuts for high-income Australians:

1. "*Protecting what Australians earn from bracket creep*" (budget speech). The principle of progressive taxation suggests that the marginal rate of tax should increase as income increases, so that taxes are collected more fairly on the basis of ability to pay. "Bracket creep" is a term that is often manipulated to justify tax cuts. True bracket creep refers to the situation in which an individual's marginal tax rate increases

[4] We are not implying that budgets must be strictly balanced in any particular year, only that taxes and public services must remain in broad proportion over the long-term.

despite no increase in real income; instead, they were "pushed" into a higher bracket purely because of inflation. This problem is easily addressed by automatically indexing all thresholds to consumer price rises (as is done in many countries). The changes announced in this budget are much different, however. The government plans (if it is re-elected three times) to *eliminate* a major bracket altogether, leaving the whole tax system with just four taxable income classes (fewer than most other countries). In the guise of addressing "bracket creep" (a modest issue in tax design), the government is moving toward a flat tax system in which a full-time minimum wage worker (at $41,000 per year) would pay the same marginal tax rate as someone earning $200,000 per year.[5] This is a major change in the principles of Australia's tax system, but neither the cost nor the rationale for such an historical change are being adequately discussed by the government.

2. "*Ensuring more Australians pay less tax by making personal taxes simpler*" (budget speech). Simplicity is another misleading descriptor for the sort of changes contained in this budget. If the final, third stage of the Coalition's plan was ever implemented, someone with $200,000 taxable income would experience savings of $7725 per year, representing an 11 percent reduction in their total taxes. But will their tax return be "simpler" under that system? Not exactly. At any rate, most people with $200,000 incomes don't have too much trouble filling out tax forms – or else they hire someone to do it for them! Their tax owing is calculated by adding the lump sum owing from the top of the next-highest threshold, to the product of their income above that threshold times the relevant marginal tax rate. That simple calculation is no less complicated under a 4-category tax system than under a 5-category tax system. Treasurer Morrison is not making the Australian tax system any simpler. But he would certainly make it a loss less fair.

3. Page 1-14 of the budget document contains the winner for most far-fetched justification for a high-income tax cut: "*Australia's top marginal tax rate currently cuts in at about 2.2 times average full-time earnings. This compares with 4 times average full-time earnings in Canada and the UK and 8 times in the US. Without change, Australia's ratio is projected to drop to about 1.7 times average full-time earnings in 2024–25, reducing our international competitiveness and ability to attract and retain talent and skills.*" This argument is extraordinary on several levels. First, coming from a government that has expended so much effort trying to keep (certain) people out of Australia, it is interesting that they justify tax cuts for high-income earners on the basis of attracting more (high-income) people to come here. More importantly, if it is indeed a problem that the highest marginal tax rate kicks in at a threshold that is only 2 times higher than average full-time earnings (rather than 4 times or 8 times), the solution is obvious: introduce new marginal tax thresholds for those earning very high incomes. Instead, this budget would move Australia the other direction: toward a system with fewer tax brackets, and less progressivity.

[5] In a totally flat tax system, with a uniform tax rate applied to all taxpayers regardless of income, "bracket creep" disappears. But the goal of such a system is to redistribute taxes away from high-income earners, not to solve "bracket creep."