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Good economics or populism?

Is there an economic case for income tax cuts?

Policy Brief

Matt Grudnoff
April 2016

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Level 5, 131 City Walk
Canberra, ACT 2601
Tel: (02) 61300530
Email: mail@tai.org.au
Website: www.tai.org.au

Summary

The Treasurer Scott Morrison is a strong advocate of both cutting income taxes and reducing the budget deficit. These two goals appear contradictory, since reducing government revenue would lead to a larger budget deficit.

The Treasurer gets around this by making exaggerated claims about the economic benefits of income tax cuts. While there may be large political benefits to cutting income tax, the economic case for lower income taxes is very weak.

It is made even weaker when we look closely at the types of income tax cuts that the Treasurer is considering. The two most likely income tax cuts in the upcoming budget is allowing the budget repair levy to lapse (a cut of 2 per cent to the top income tax rate) and a cut to compensate those on high incomes for bracket creep.

Tax cuts to high income earners are highly unlikely to produce any growth dividend.

This paper looks at 5 reasons why people should be deeply suspicious of claim that income tax cuts will increase economic growth.

Reason 1 Cutting income taxes doesn't increase economic growth: Because of the budget deficit, the government is insisting that cuts to income tax must be offset with cuts to government spending or increases in other taxes. If spending is cut, or other taxes are increased by the same amount as the income tax cut, then there will be no net increase in aggregate demand and no increase in economic growth.

Reason 2 Cutting spending to cut income taxes might decrease economic growth: If the government cuts spending to fund income tax cuts that mainly go to high income earners, this is likely to reduce economic growth. Aggregate demand will decrease by the initial amount of the spending cut, but will only increase by part of the initial amount of the income tax cut. This is because people, particularly high income earners, save some of the tax cut. The result is lower aggregate demand and less economic growth.

Reason 3 A tax cut doesn't make everyone want to work more: Treasury assumes that a cut in income tax will mean people work more. But the government's plan to cut high income taxes is very unlikely to increase workforce participation. While there is some evidence that cutting low income tax rates encourages second earner to return to work, there is an absence of evidence that higher economic growth will occur from a high income tax cut.

Reason 4 Almost nobody knows their marginal tax rate: The majority of people do not know what their marginal tax rate is and so are unlikely to be motivated to work more if income taxes are cut. An Australia Institute survey shows that only 18 per cent of respondents could correctly identify their marginal tax rate.

Reason 5 Income taxes are efficient: Income tax is a relatively efficient tax. This was shown when Treasury's modelling concluded the growth dividend from an income tax/GST swap would be negligible. The government's own assessment found that the efficiency of the GST and income tax are, in operation, almost identical. Other Treasury analysis has come to the same conclusion.

Introduction

> What we're trying to achieve is high rates of growth, high rates of job growth in particular and how is the tax system actually stopping people who are actually out there backing themselves achieving the goals they want to achieve? And personal income tax rates are a blocker to that.[1]
>
> Treasurer Scott Morrison

Economic growth is the magic pudding for politicians trying to sell difficult economic narratives. Every political party claims to be able to increase it and they all claim that it will make everyone better off when it arrives. It is also used to sell difficult economic reforms and to pay for future policies. For political promises economic growth is the magical well that never runs dry.

The Treasurer has been out endlessly saying that the Coalition Government wants lower taxes and stronger economic growth. According to the Treasurer the objective of tax reform is to lower taxes. In particular the Treasurer said “if we can give personal income tax cuts at a higher level that is what has been driving us.”[2]

A lot of Australians pay income tax, so an income tax cut could benefit a large section of the population. It is not surprising that a politician would be in favour of tax relief for a large number of voters especially with an election so close. But the Treasurer goes further and claims that tax cuts, in particular income tax cuts are good for economic growth.

But what is the evidence that income tax cuts likely to have a big impact on economic growth? This report outlines five reasons to be suspicious of such a claim.

[1] Morrison (2016) *Interview with Peter Van Onselen & Paul Kelly, Sky News Australian Agenda*
[2] Morrison (2016)

Reason 1: Cutting income taxes doesn't increase economic growth

Most people probably consider that it makes sense that income tax cuts would grow the economy. A cut in income tax rates increases take home pay which in turn can be spent buying more stuff. This stuff needs to be made and more people employed to make them. This is an increase in economic growth and employment.

However, the Treasurer has demanded that the net change to the budget has to be zero.[3] That is if the government proposes a tax cuts worth $10 billion per year then spending must be cut by $10 billion or some other taxes must be increased by $10 billion.

If this is the case then income tax cuts are unlikely to lead to economic growth because the additional income people take home will be offset by spending cuts or tax increases. If the government gives you extra money to spend each pay day by cutting income tax but increases other taxes by the same amount you won't be able to buy any extra things.

Also if the government cuts its own spending and uses the money saved to increase your spending then the total amount of spending in the economy is not going to be higher since the two will at least offset each other.

For example, if the government were to cut your income tax by $100 per week and pay for that cut by increasing the GST you pay per week by $100 then you are no better off. You might get an extra $100 a week in your bank account from your employer but the stuff you buy costs an extra $100. From the point of view of economic growth, you're not able to buy more stuff.

[3] Maher (2016) *'Modest' tax cuts to counter bracket creep on the table*

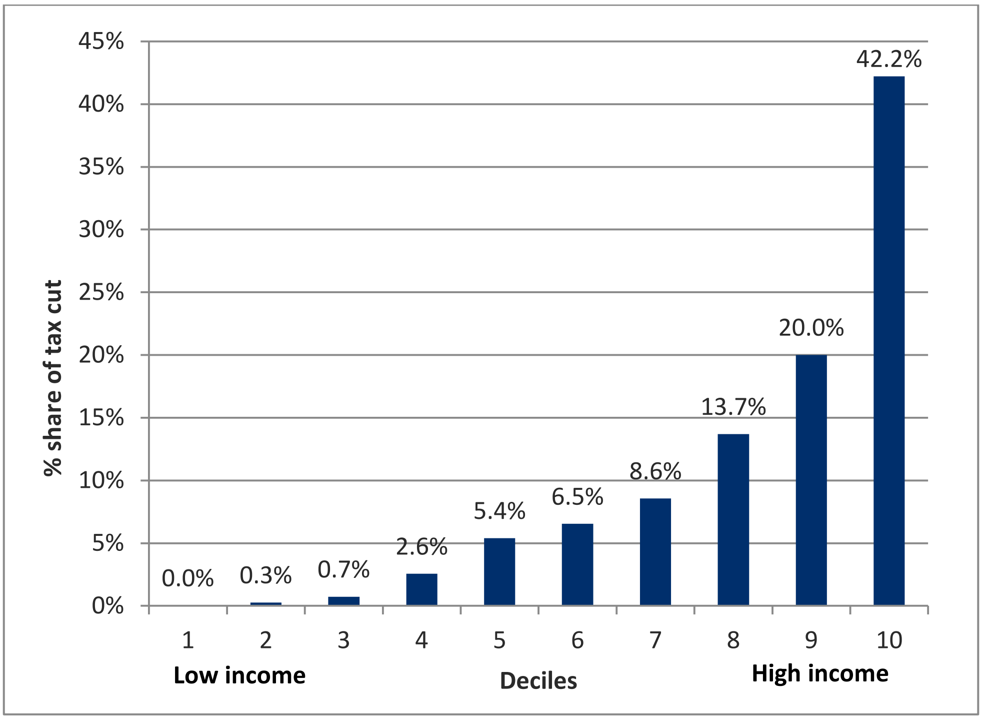
Reason 2: Cutting spending to cut income taxes might decrease economic growth

The Treasurer's preferred method is to pay for income tax cuts by reductions in government spending. If this occurs it is possible that this will lead to a fall in economic growth. This is more likely if the income tax cuts are targeted at high income earners.

Income tax cuts mean people have additional money in their bank accounts each pay day. A portion of the additional money from the tax cut is likely to be spent and the rest will be saved. The potential increase in total demand depends on how much of the tax cut is spent. Those on low incomes are likely to spend all of their income and so the whole tax cut in converted into an increase in demand for goods and services. As people's income rise the proportion they spend decreases as the proportion they save increases. The smaller the proportion of the tax cut that ends up being spent, the less it adds to demand and the less impact it has on economic growth.

The last round of tax cuts which occurred through the mid-2000s went to high income earners, with over 60 per cent of the tax cut benefit going to the top 20 per cent of households. The benefit of the tax cut going to each decile is shown in Figure 1. If the government cuts income tax to high income households and pays for those tax cuts by cutting spending, these tax cuts could actually reduce economic growth.

Figure 1 – Share of income tax cuts from 2006 to 2012 by decile



Source: Grudnoff (2013) *Tax cuts that broke the budget*

For example, imagine the government is considering two options. One is to spend $100 million on building a new hospital and the other is to cut income taxes to high income earners. The income tax cut is also expected to cost $100 million. Which of these two options leads to more economic growth?

If the government chooses to build the hospital the full $100 million is transformed into additional demand as the government's money is turned into building materials, equipment and wages. But if the government chooses to cut income tax for high income earners then some of the $100 million is spent and some is saved. If we assume that high income earners spend 70 per cent of the tax cut and save 30 per cent then this leads to $70 million being spent and transformed into additional demand and $30 million being saved.

In this example the spending on the hospital increases demand by $100 million while the tax cut only increases demand by $70 million. There is less economic growth if the income tax option is chosen.

Now imagine the government chooses to pay for the income tax cut by cutting spending on health. The decrease in spending reduces demand in the economy by $100 million but the tax cuts only increases demand in the economy by $70 million. This swap will actually lead to a fall in economic activity.

Reason 3: A tax cut doesn't make everyone want to work more

The government has been concerned at the impact income tax is having on economic growth and employment. The Assistant Treasurer Kelly O'Dwyer said;

> The government is looking at whether or not our tax system is fit for purpose, whether it is actually getting the incentives right for people who work incredibly hard; is it giving them money in their pocket at the end of the day and encouraging them to work even harder?[4]

The government's solution is to cut income taxes which Treasury assumes will boost workforce participation.[5] Workforce participation is the number of people who have a job or are actively looking for a job. If a larger percentage of the population are working, all other things being equal, the larger the economy will be.

The theory is that people look at how much benefit they might get from working an extra hour and compare that with the costs. The benefit is the money they receive from working that extra hour which is usually the wage per hour minus the tax they pay. The cost of working is usually the leisure time they have to give up.

According to the theory everyone compares the benefit of working with the costs of working. If the benefits of working are greater than the costs, then the person will work the extra hour. If the costs are greater than the benefits, they will decide not to work. If income tax is cut then the benefits go up and the theory assumes that people will want to work more.

There are a number of very serious flaws with this theory.

To begin with it assumes that extra work is available. Let's say your marginal tax rate is cut. The theory assumes that you will walk into your bosses office and say, 'Hey boss I want to work an extra hour a week'. And your boss will say 'Sure. I've been waiting for you to come and ask. I have all this extra work that I want to pay you to do.'

The reality is that we have unemployed people so if your boss had lots of extra work that he was willing and able to pay for he would go out and hire somebody to do it rather than wait for your marginal tax rate to be cut.

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[4] Maher (2015) *Taxes slashed with GST shake-up*

[5] Henry (2010) *Australia's future tax system; Final report: Detailed Analysis*

It is also important to realise that in 2014 Australian workers donated $128 billion to their bosses in unpaid overtime.[6] For full time workers this equalled on average an additional six hours of work a week. Given this, it is safer to assume that if your boss had a bit of extra work they would just give it to you and get you to do it for free.

But the logic gets even stranger when you apply it in reverse. If the government were to increase your marginal tax rate then you would work less. The theory is that because of the tax rise the amount of money you get for working the last hour is now less so you are less likely to work.

Imagine a couple both on minimum wage who together earn $68,500 per year. They have a mortgage and kids at school to support. The theory assumes that if they got less money because of an income tax rise then they would choose to cut back their hours and earn even less money. This seems highly unlikely. Most people have financial commitments and responsibilities that need to be met. It may be that some people are in a position where they can do this but they are likely to be in the minority.

As the flaws in the theory suggest, in the real world the impact that income tax has on workforce participation is far more complex. There are some studies that show no relationship between taxes on incomes and employment rates.[7]

Other studies show some impact when income earners are grouped together with similar characteristics. For example one Meta study showed almost no impact on males while there was a larger impact on women.[8]

Studies have also shown that income tax changes had a larger impact on the decision to return to work made by second income earners in a household (mainly women deciding whether or not to work part time).[9] Income tax changes had very little impact on people's decision about how many hours to work. It has almost no impact on the decision about how many hours full time high income earners work (who are mainly men).

Treasury understands this complexity[10] but according to Professor Miranda Stewart of the Tax and Transfer Policy Institute at the ANU, in their modelling, Treasury assumes an average elasticity of Labour supply.[11] Using an average is likely to understate the impact that a change in income taxes has on women considering whether or not to

[6] Johnson (2015) *Workin' 9 to 5.30 - Unpaid overtime and work life balance*
[7] ETUI (2016) *Benchmarking Working Europe 2016*
[8] Evers et al (2008) *The Wage Elasticity of Labour Supply: A Synthesis of Empirical Estimates*
[9] Dandie et al (2007) *Australian Labour Supply Elasticities: Comparison and Critical Review*
[10] Dandie et al (2007)
[11] Stewart (2016) *Is Morrison dreaming when it comes to tax reform?*

come back to work after having children and overstate the impact on men working full time. This would then lead to overstating the value of a high income tax cut.

A more nuanced look at the impact of income tax on workforce participation also reveals that there would be a difference depending on which rates and thresholds were changed. An income tax cut that benefits low income earners would have more of an effect on women returning to part time work and therefore would have a bigger impact. An income tax cut that benefited high income earners would have more of an effect on males working full time and therefore would have less of an impact.

There has been a lot of general talk about income tax cuts from the government but beyond talk of wanting to reduce income tax the government has only talked about two possible income tax cuts in any detail. Both these cuts are for high income earners.

The first was the government's proposal to fight bracket creep by increasing the cut in rate for the second highest tax bracket which is currently set at $80,000.[12] Previous Australia Institute research has shown that most of the benefit of such a change would flow mainly to men on high incomes.[13] This is the group that are unlikely to change their workforce participation rates.

The second proposal that the Treasurer pointed too as an upcoming income tax cut was allowing the budget repair levy to lapse.[14] This would see the top rate of tax, which is paid by those earning more than $180,000, cut by two per cent. This tax cut would only benefit the top three per cent of tax payers.[15] This is again a group that are unlikely to change their workforce participation rates.

It is expected that the Treasurer will announce in this year's budget, an income tax cut by increasing the threshold of the second top tax rate.[16] The speculation is the threshold could be increased anywhere from $85,000 to $100,000. The Treasurer is also expected to cut the top tax rate by two per cent with the end of the budget repair levy in July 2017.

The income distribution impacts of these two tax cuts in July 2017 are shown in Figure 2. It assumes the second top tax threshold is increased to $90,000. All figures are in 2017 dollars.

Figure 2 – Distribution of tax cut by income decile

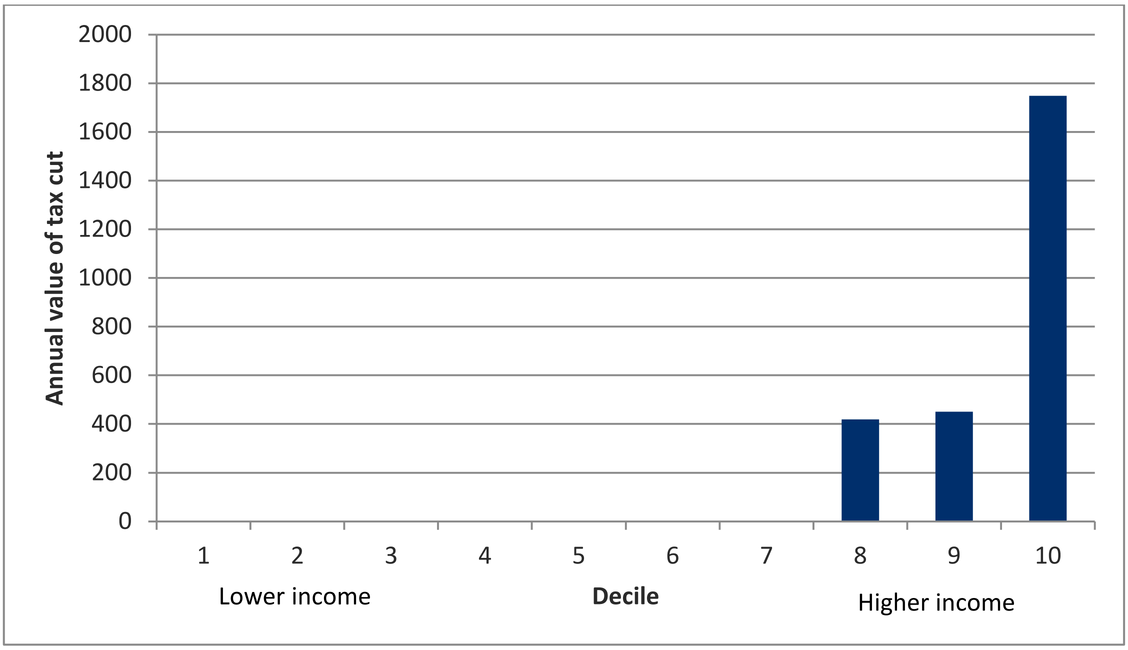
[12] Maher (2016)

[13] Grudnoff (2016) *Briefing Note: Are government plans to tackle bracket creep good for average people?*

[14] Hutchens et al (2016) *Pressure on government to make budget repair levy permanent*

[15] Hutchens et al (2016)

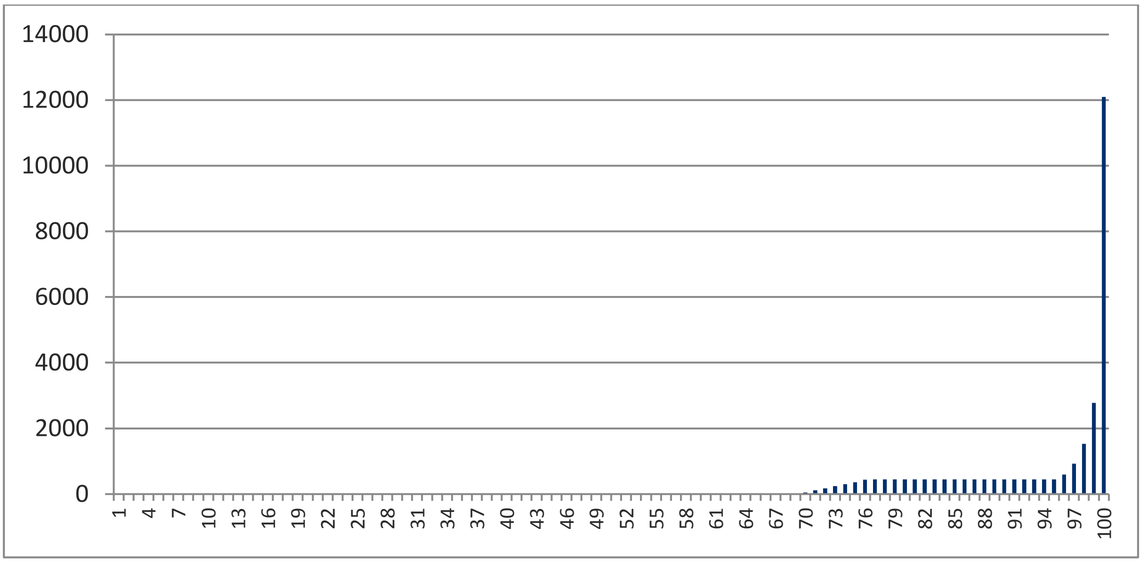
[16] Coorey P (2016) *Double tax cut for best paid in federal budget*



Source: ATO (2016) *Percentile distribution of taxable individuals, for the 2013–14 income year*, and authors calculations

This analysis shows that 70 per cent of tax payers get no tax cut while the benefit rises with the top 10 per cent getting an average tax cut of $1,748 per year. The average tax cut hides the true scale to those at the very top end with the top one per cent getting an average tax cut of over $12,000 a year or $1,000 per month. The percentile distribution is shown in Figure 3.

Figure 3 – Distribution of tax cut by income percentile



Source: ATO (2016) *Percentile distribution of taxable individuals, for the 2013–14 income year*, and authors calculations

The government's proposals on income tax cuts have all focused on high income earners and not on those who might actually change their workforce participation in response to a change in income tax. It is therefore unlikely that any income tax cuts that the government proposes will have any real impact on workforce participation.

If the government wants to increase workforce participation in order to lift economic growth there are far more effective and cheaper methods than cutting income taxes for high income earners. Apart from the fact that high income tax cuts have not been shown to have any real impact on workforce participation, they are also a very broad tool that impact on many people.

If the objective of income tax cuts is to increase participation they are not very targeted. That is they give a tax cut to people who might think about working more as well as people who have no intention of increasing their work time. The government could take a more targeted approach.

A very effective targeted approach is subsidising childcare. This has been shown to have a substantial impact on female participation rates.

Canada, which is an economically and culturally similar to Australia, has significantly higher female participation rates when compared to Australia.[17] The Grattan Institute estimated that Australia's GDP would be $25 billion higher if we had a female participation rate similar to Canada's.[18] Female participation rates increased substantially in Canada when they introduced reforms that decreased the costs of childcare and changed the way welfare payments interacted with women returning to work.

[17] Daley et al (2014) *Submission to the Productivity Commission Inquiry on Childcare and Early Childhood Learning*

[18] Daley et al (2014)

Reason 4: Almost nobody knows their marginal tax rate

Treasury's theory that lowering income tax rates will boost participation and economic growth is based heavily on the idea that people carefully look at the costs and benefits of each hour of work they choose to do. This means that people have to be able to value their leisure time in dollar terms. This is something that most people would probably have a lot of difficulty doing.

While valuing leisure time in dollar terms might seem difficult, valuing an extra hour of work in dollar terms might seem easier. All you need to do is take your wage rate and subtract your marginal tax rate, which is the amount of tax you would pay on that hour of work. To do this people would need to know their marginal tax rate.

Between 29 February and 8 March 2016 The Australia Institute conducted a national opinion poll of 1,412 people through Research Now, with nationally representative samples by gender, age and state or territory. The survey showed that the majority of respondents did not know their marginal tax rate. Only 18 per cent could correctly identify the amount of tax they would pay on an additional $100 of income.

The group least likely to be able to identify their marginal tax rate was those on incomes between $37,000 and $80,000. Only 13 per cent of these people knew their marginal tax rate. This is the same group that the government has previously been most concerned about suffering from bracket creep.[19]

Figure 4 – Proportion of people able to identify their marginal tax rate by income level

Income range	Correctly identified marginal tax rate
$0 - $18,200	26%
$18,201 - $37,000	20%
$37,001 - $80,000	13%
$80,001 - $180,000	20%
$180,001 or more	30%

Source: TAI (2016) *Australia Institute Survey – March, 1412 respondents*

[19] Grudnoff (2016)

With less than one in five people able to correctly identify their marginal tax rate it is not obvious that many people would be able to act as Treasury assumes and calculate the costs and benefits of an extra hour of work. It is therefore unlikely that changes in income tax rates are going to impact on workforce participation rates.

Reason 5: Income taxes are efficient

Sometimes the call for income tax cuts is wrapped up with a call for tax swapping. This idea is to switch taxes by increasing more efficient taxes and using that money to decrease less efficient taxes. Taxes that have less negative impact on the economy are more efficient than taxes that have a larger negative impact on the economy. After swapping more efficient taxes for less efficient ones the same amount of revenue is collected but it is now collected from more efficient taxes which in turn is assumed to increase economic growth.

In the tax swap, the tax to be cut is often income tax. The unstated assumption behind this is that income tax is a particularly inefficient tax. The recent debate on tax swapping centred on increasing the GST and using the revenue to swap out other taxes, primarily income tax.

The government finally decided against the idea because the growth dividend, that is the extra growth that might arise from the tax swap, was so small that the government didn't think it was worth it. The Prime Minister said

> The work we have done demonstrates that the so-called GST tax mix switch does not give you the economic dividend, the growth dividend that would justify doing it.[20]

For many people in the tax debate this was surprising. The assumption was that the GST was a very efficient tax and income tax was very inefficient. The information that the government got from Treasury showed this was not the case.

The Treasury had earlier shown that the efficiency of the GST and income tax was almost identical.[21] When looking at the efficiency of tax Treasury attempts to measure what is calls the marginal excess burden. This is essentially a measure of the net costs that the tax has on the economy.

For example a particularly inefficient tax is stamp duty. Treasury found that the marginal excess burden for stamp duty was 0.72. This means that an additional dollar of tax collected in stamp duty cost the economy 72 cents over and above the extra dollar of tax paid.

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[20] Kenny (2016) *Michaelia Cash comments suggests light still burns inside Turnbull government for GST rise*

[21] Cao (2015) *Understanding the Economy-Wide Efficiency and Incidence of Major Australian Taxes*

Treasury calculated the marginal excess burden of the GST at 0.19. That is for every $1 in extra tax raised by the GST, 19 cents of cost is incurred across the economy. The marginal excess burden of income tax was 0.21. This means for every $1 in extra tax raised by income tax, 21 cents of costs are incurred across the economy. It should be noted that the income tax modelled by Treasury was for a single flat income tax rate.

As you can see the costs of the GST and income tax are almost identical. This was confirmed when the government decided not to proceed with a tax swap between the GST and income tax. If you swap two taxes that are almost as efficient as each other then you only reduce the cost to the economy by a tiny amount and hence you will only get a tiny economic growth dividend. This is the case for swapping between income tax and the GST. Rather than being an inefficient tax, income tax is a relatively efficient tax.

There have been recent suggestions by the Prime Minister and Treasurer that a portion of income tax should be handed to State governments. This could potentially see eight different income tax rates across the country which would increase costs of complying with the tax both for government but also for business that operate in more than one state. If this change did come into effect then the cost to the economy of income tax is likely to rise.

Conclusion

There may be good political reasons for politicians to argue for income tax cuts. A large proportion of the public could benefit from such a cut. But the economic case for income tax cuts is very weak. If politicians want to advocate for income tax cuts they should not muddy the waters by making exaggerated claims of the economic benefits that such cuts might bring.

The government has made large rhetorical claims that the budget deficit needs to be reduced. Cutting taxes is obviously counterproductive to a government trying to reduce the budget deficit. Perhaps the Treasurer hopes that if income tax cuts can be justified on economic grounds then he can overcome the contradiction of pushing for politically popular income tax cuts while simultaneously being concerned about the size of the budget deficit.

While the Treasurer might wish that doing something popular would solve his economic problems, such a situation is too good to be true. There is no strong economic case for cutting income tax. The Treasurer and government should look elsewhere for a justification to cut revenue or services.

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