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Tax cuts that broke the budget

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TAI

Policy Brief

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Summary

The government would have had an additional $38 billion for last year's federal government budget and would have collected an extra $169 billion over the past seven years had it not been for unsustainable income tax cuts that were made in the lead up to the GFC. Had the income tax cuts not been made, the current budget would not be in deficit and we would be having a very different discussion about funding priorities.

Budget difficulties are not something high income earners are likely to have been concerned with over the past seven years as they were the biggest beneficiaries of these tax cuts. Of the $169 billion in tax cuts, 42 per cent of them or $71 billion went to the top 10 per cent of income earners. The top 10 per cent got more in tax cuts than the bottom 80 per cent.

This sheds an entirely new light on the current debate about whether we can afford things like the NDIS or Gonski reforms. If the budget is in deficit because of income tax cuts that primarily benefited the highest income earners and that is being used as a reason not to give more money or support to the poor and disadvantaged, then political debate in Australia has reached a new low.

Using NATSEM modelling, the full extent of the tax cuts was determined by calculating the amount of revenue the government would have collected had the income tax cuts from 2005-06 to 2011-12 not taken place. These tax cuts represent a major structural change to the federal budget. In 2011-12 they slashed the amount of income tax the federal government was able to collect by a quarter.

The income tax cuts undermined the ability of the budget to generate sufficient income during more normal economic conditions. It drove the budget into structural deficit. The boom times in the lead up to the GFC increased income, spending and profit and generated large increases in revenue for the federal government.

This increase in revenue was a temporary windfall gain driven in part by the mining boom, but it was used to fund permanent cuts to income tax. The argument for the sustainability of the tax cuts at the time was that even with the cuts the budget was still in surplus. This of course ignores the fact that the boom time was hiding the long term unsustainability of the budget.

Now that the economy is growing more closely to its long run average, the structural hole left by the income tax cuts by previous governments has been exposed and has resulted in the government struggling to bring the budget into surplus.

Introduction

The economy influences the budget more than the budget influences the economy. This simple truth always seems to get lost in the political debate around the budget. At budget time the government is keen to take responsibility for the good things that happen and the opposition is keen to pin all the problems in the budget on the government. The reality is that a lot of the budget outcome (both good and bad) is dependent on things happening in the Australian and world economies, most of which are beyond the control of the government. The budget is also heavily influenced by decisions made in previous budgets.

The large surpluses in the mid-2000s were primarily driven by the booming economy, which was itself a product of a booming Chinese economy. The Australian government has no influence over the Chinese economy, but the Chinese economy has a large amount of influence over the Australian government's budget. Similarly this paper will argue the large income tax cuts made from 2005 to 2008 are having a big influence on the present federal government's budget.

What affects the budget?

The business cycle has been a feature of market economies since they first appeared with the industrial revolution. They follow a pattern of boom and bust, periods of strong growth followed by downturns, recessions and even depressions.

These regular fluctuations in economic growth also have an effect on government budgets. During a boom income, profit and spending are typically on the rise, which increases tax revenue. At the same time the number of unemployed decreases, this decreases government spending on welfare. During these times the budget, without intervention, will move towards a surplus. The opposite happens during a downturn. Income, profits and spending fall and so does tax revenue. Unemployment rises and so do government welfare payments. The budget moves naturally towards a deficit.

The regular swing in the budget outcome caused by the business cycle has led to economists dividing the budget outcome into two separate parts, a cyclical component and a structural component. The cyclical component of the budget is that part of the budget that was caused by the business cycle. The remaining part of the budget outcome is the structural component of the budget. The structural budget component can be thought of as the budget outcome if the Australian economy was growing at its long term average. Or put another way, it's the underlying part of the budget where the effects of the business cycle are removed.

The structural component is that part of the budget that policy makers have an influence over. While governments do have macroeconomic levers to exert some control over the business cycle they have not, as yet, been able to eliminate the cycle completely. Economists hoped that by dividing the budget into two components policy makers would be better able to focus on the underlying budget without being distracted by the cyclical component. If history is any guide, in Australia at least, their hopes have not been realised.

Recent history has shown that politicians either do not understand the difference between the structural and cyclical components of the budget or they choose to ignore them.

The recent political discussion in Australia has focused solely on the final budget outcome and there has been little discussion about what is happening to the underlying or structural component of the budget. This of course has been made worse by the simplistic positions both major parties have taken in which deficit and debt are seen as bad regardless of the economic context.

A dislike of deficits has reached such a point that both the government and the opposition have promised to run budget surpluses over the business cycle.[1] Most economists would suggest that balancing the budget over the business cycle should be the objective.

In order to understand why the Australian federal budget is in its current position we need to look at what has happened to the cyclical and structural components of the budget over the past decade, because the current budget outcome is largely influenced by previous budget decisions.

Tax cuts in boom time

The period from 2004-05 to the beginning of the GFC in 2008-09 was a period of strong economic growth driven in part by the mining boom. Tax receipts all grew strongly; with company tax receipts increasing over 50 per cent during this period.[2] This rise in revenue caused the budget to naturally move to a surplus.

The overall budget surpluses during this time were mainly the result of cyclical factors including increasing commodity prices and rising company tax revenue. During this period the structural budget position was also changing. Each year from 2004-05 to 2007-08, income taxes were cut. This pushed the structural component of the budget towards a deficit, although the actual budget outcome never reached a deficit because of the strong cyclical revenue collections.

In 2008-09 the GFC struck and had an immediate effect on revenues. Government revenue fell dramatically from 25 per cent of GDP in 2007-08 to 22 per cent just two years later.[3] This drove the actual budget into deficit. The structural budget, which had been pushed towards a deficit in the preceding four years because of the income tax cuts, was weakened further by the tax cuts introduced in 2008-09 and 2009-10. These tax cuts were largely a legacy of the 2007 election campaign when the Howard/Costello government promised large income tax cuts and the Labor party promised very similar cuts in response. During the GFC the structural component was also affected by the increased spending that was also part of the stimulus package. Much of the stimulus package was a temporary increase in spending and so did not have a long term impact on the structural component of the budget, but some of the increases were permanent such as the increase in pension payments.

In the past few years the economy has improved, increasing government revenue as commodity prices recovered and the stimulus package helped Australia avoid the worst of the GFC. The structural budget deficit also decreased as the stimulus package wound down, but the budget remained in deficit primarily due to the previous income tax cuts.

Current budget position

Now the government is attempting to move the actual budget position from a deficit to a surplus and is struggling to do so. The Australian economy has been growing at or just below its long term growth rate. This means the business cycle is not having a strong effect on the budget outcome. It is now the structural component of the deficit that is driving the budget outcome. With most of the spending from the stimulus package finished, government spending has fallen since 2010-11. Therefore the underlying structural budget deficit is a by-product of income tax cuts both during the last boom and in the years after the GFC.

1 Koukoulas (2013)

2 The Treasury (2012a)

3 The Treasury (2012b)

The long term effects of the income tax cuts

The importance of the income tax cuts to the structural budget deficit can be determined by looking at what the budget outcome would be in 2011-12 if we used the tax rates from 2004-05. The difference in the budget outcomes would show us how much money was given away in income tax cuts over the period. The National Centre for Social and Economic Modelling (NATSEM) produces an economic model, STINMOD, which was used to calculate the effect of the income tax cuts over the last seven years.

The tax cuts were worth $38 billion in 2011-12. This compares to a deficit for that year of $42 billion. It should be noted that the government moved $9 billion of expenditure from the 2012-13 budget to the 2011-12 budget in an attempt to bring the 2012-13 budget into surplus. It is therefore likely that the 2011-12 budget would have been in surplus if the large income tax cuts from 2005-06 had not occurred.

Over the full seven years, from 2005-06 to 2011-12 the tax cuts were worth $169 billion that is, the federal government would have collected an additional $169 billion in revenue during that period if it had not introduced the large income tax cuts. These cuts are shown in Table 1.

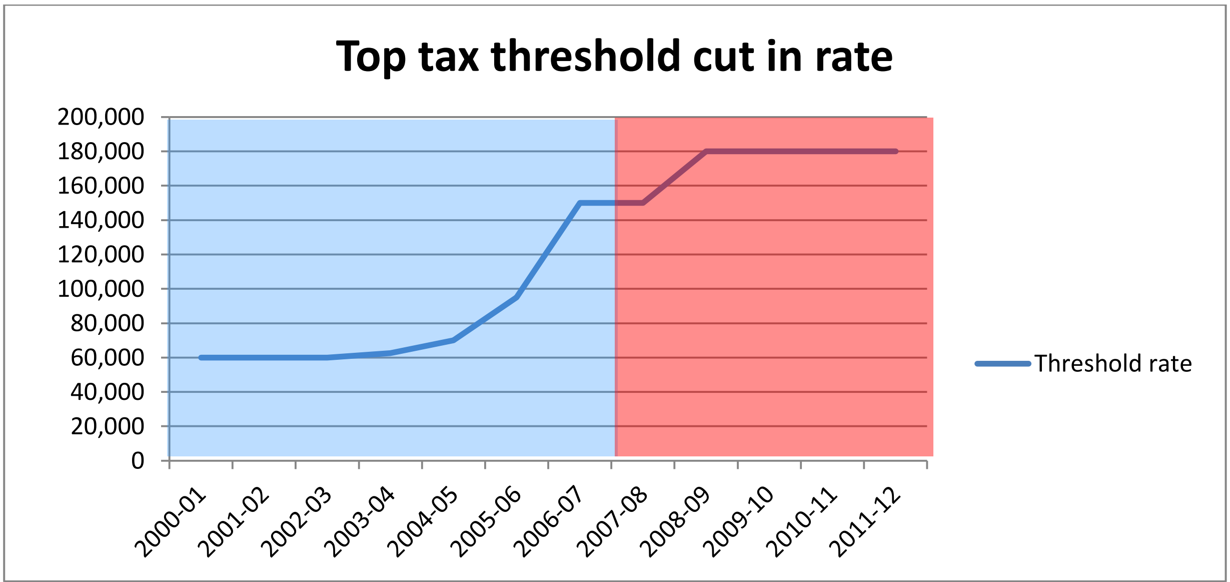
Table 1 – Size of income tax cuts ($million)

	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	Total
Income tax cut	4,819	12,142	19,549	27,914	30,938	35,932	37,584	168,878

Source: NATSEM modelling

The distribution of the tax cuts was highly skewed. Of the $169 billion in tax cuts over the seven years 42 per cent of the cuts, or $71 billion, flowed to the top ten per cent of households. The top 10 per cent received more in tax cuts than the bottom 80 per cent. This was primarily driven by an increase in the income threshold for the top tax bracket. The change in the top threshold is shown in Figure 1, with the years the Coalition was in government shown in blue and the years the ALP was in government shown in red.

Figure 1 – Rate at which top tax threshold cuts in



The top tax threshold was increased from $70,000 in 2004-05 to $180,000 in 2008-09. At the other end of the scale the tax free threshold was unchanged from 2004-05 to 2011-12. This substantially reduced the number of people in the top tax bracket. Even many years later in 2011-12 only 2.7 per cent of tax payers face the top tax rate.

To better understand how the income tax cuts favoured those on high incomes consider someone earning $35,000 over the seven years from 2005-06 to 20011-12. Over those seven years this person would have saved $11,844 from the income tax cuts. A person on $500,000 would have saved $117,534. The distribution of the tax cuts is shown in Table 2.

Table 2 – Share of income tax cuts ($million)

Deciles	Share (%)	Share ($m)
1	0.0%	53
2	0.3%	454
3	0.7%	1,241
4	2.6%	4,314
5	5.4%	9,120
6	6.5%	11,035
7	8.6%	14,456
8	13.7%	23,130
9	20.0%	33,790
10	42.2%	71,286
Total	100%	168,878

Source: NATSEM modelling

Bracket creep

As the economy grows, so do incomes and over time people find they are moved into higher income brackets even if their wages are only growing at the rate of inflation. This is commonly known as bracket creep. As part of the modelling exercise the income brackets were deflated by the Consumer Price Index (CPI) in order to remove bracket creep. These deflated income brackets are shown in Appendix 2.

When bracket creep was removed the effect of the income tax cuts was reduced. In 2011-12 the tax cuts were worth $26 billion. The total amount of the tax cuts over the seven years amounted to $125 billion when bracket creep is removed. The distribution of the tax cuts remains highly skewed to the top 10 per cent of tax payers, with 43 per cent or $54 billion flowing to the top 10 per cent.

Table 3 – Size of income tax cuts removing bracket creep ($million)

	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	Total
Income tax cut	3,258	9,689	14,848	21,771	23,319	25,900	26,374	125,159

Source: NATSEM modelling

Effect of the distribution of the tax cuts

The skewing of the income tax cuts to high income earners meant that most of the benefits of those cuts flowed through to high income earners. Of the $38 billion in tax cuts in 2011-12 the top 10 per cent of income earners gained $16 billion. This was more than the total benefit to the bottom 80 per cent of income earners.

This is an important consideration when thinking about the current debate. Some commentators have called for the Gonski reforms, which would increase funding to disadvantaged schools, to be put on hold because the budget is in deficit. They have also questioned funding the NDIS, which would also provide additional funding to disadvantaged groups, for the same reason. If the budget is in deficit because of income tax cuts that primarily benefitted the highest income earners and this is being used as a reason not to give additional funding to the poor and disadvantaged, then public debate in Australia has reached a very strange place.

Sustainability of the budget

Large income tax cuts are possible if they are accompanied by either commensurate spending cuts or increases in other tax revenue. The problem with the Howard/Costello and Rudd/Swan income tax cuts was that they were not offset in any way. They were instead, in the case of the Howard/Costello government, paid out of a temporary rise in revenue brought on by a booming economy. In the case of the Rudd/Swan government they were paid out as part of a stimulus package brought about by the GFC.

Paying for permanent income tax cuts with the temporary revenue increase from a booming economy ultimately sets the budget up to be unsustainable. When more normal economic conditions eventuate the budget no longer has the capacity to generate sufficient income. This is an important reason why the International Monetary Fund (IMF) found that between 2005 and 2007 the Howard/Costello government was responsible for the worst "fiscal profligacy" in Australian history.[4] It was not just that it spent big during that period; it was also because it set up the conditions for an unsustainable budget.

The extent of this unsustainability can be seen by looking at tax revenue growth in the boom years that saw income tax cuts. The economy boomed between 2004-05 and 2007-08, increasing company tax receipts by more than 50 per cent. GST revenues were also strong increasing 20 per cent. While income tax revenue was relatively weak increasing only 17 per cent. The relative weakness of income tax revenues can be explained by the large tax cuts the Howard/Costello government was handing out at the time.

When those tax cuts are removed income tax growth is a far healthier 35 per cent. This shows the huge impact on tax collection that the income tax cuts had. In 2011-12 the tax cuts slashed the amount of income tax the federal budget could collect by a quarter.

The argument for the sustainability of the tax cuts at the time was that even with the cuts the budget was still in surplus. This of course ignores the fact that the boom was hiding the long term unsustainability of the budget. In his final year as Treasurer in 2007, Costello announced his biggest tax cuts yet, $34 billion over four years. When asked about the sustainability of these cuts he said;

[4] Martin (2013)

> "Now, we have a situation where we have increased revenue because of a surge in employment. The Government can either hang on to that revenue or return that revenue to taxpayers."[5]

The surge caused by the business cycle could not last and so the tax cuts were creating a structural hole in the budget.

Mr Costello went on to explain his goal on income tax. He wanted 45 per cent of Australian workers paying tax of 15 cents per dollar, 85 per cent of Australian tax payers on a top marginal tax rate of 30 per cent or less, and to have 98 per cent of Australian tax payers on a top marginal tax rate of 35 per cent or less.[6]

Such large scale changes to Australia's tax structure would have been fine if Costello had planned to pay for those cuts by increasing taxes elsewhere. But instead he funded them out of a surplus created by the boom. This was simply unsustainable.

How to fix the structural problem

If the government wants to place the budget on a more sustainable footing then it will need to make some hard decisions. According to the OECD Australia is the sixth lowest taxed country in the developed world. For Australians to continue to enjoy a world class education and health system, the budget needs the capacity to generate the income to pay for it.

This does not necessarily mean that income taxes need to be increased. If there is a genuine desire to rebalance the taxation system away from income tax then this can be achieved by increases in taxation in other areas or a reduction of tax concessions and tax loop holes.

5 Farnsworth (2007)

6 Dunlevy (2007)

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Appendix 1

Historical tax tables

2004-05

Taxable income	Tax on this income
$0-$6,000	Nil
$6,001-$21,600	17 cents for each $1 over $6,000
$21,601-$58,000	$2,652 plus 30 cents for each $1 over $21,600
$58,001-$70,000	$13,572 plus 42 cents for each $1 over $58,000
$70,000 and over	$18,612 plus 47 cents for each $1 over $70,000

2005-06

Taxable income	Tax on this income
$0-$6,000	Nil
$6,001-$21,600	15c for each $1 over $6,000
$21,601-$63,000	$2,340 plus 30c for each $1 over $21,600
$63,001-$95,000	$14,760 plus 42c for each $1 over $63,000
Over $95,000	$28,200 plus 47c for each $1 over $95,000

2006-07

Taxable income	Tax on this income
$0-$6,000	Nil
$6,001-$25,000	15c for each $1 over $6,000
$25,001-$75,000	$2,850 plus 30c for each $1 over $25,000
$75,001-$150,000	$17,850 plus 40c for each $1 over $75,000
$150,001 and over	$47,850 plus 45c for each $1 over $150,000

2007-08

Taxable income	Tax on this income
$1-$6,000	Nil
$6,001-$30,000	15c for each $1 over $6,000
$30,001-$75,000	$3,600 plus 30c for each $1 over $30,000
$75,001-$150,000	$17,100 plus 40c for each $1 over $75,000
$150,001 and over	$47,100 plus 45c for each $1 over $150,000

2008-09

Taxable income	Tax on this income
$1-$6,000	Nil
$6,001-$34,000	15c for each $1 over $6,000
$34,001-$80,000	$4,200 plus 30c for each $1 over $34,000
$80,001-$180,000	$18,000 plus 40c for each $1 over $80,000
$180,001 and over	$58,000 plus 45c for each $1 over $180,000

2009-10

Taxable income	Tax on this income
$1 - $6,000	Nil
$6,001 - $35,000	15c for each $1 over $6,000
$35,001 - $80,000	$4,350 plus 30c for each $1 over $35,000
$80,001 - $180,000	$17,850 plus 38c for each $1 over $80,000
$180,001 and over	$55,850 plus 45c for each $1 over $180,000

2010-11

Taxable income	Tax on this income
1 - $6,000	Nil
$6,001 - $37,000	15c for each $1 over $6,000
$37,001 - $80,000	$4,650 plus 30c for each $1 over $37,000
$80,001 - $180,000	$17,550 plus 37c for each $1 over $80,000
$180,001 and over	$54,550 plus 45c for each $1 over $180,000

2011-12

Taxable income	Tax on this income
0 - $6,000	Nil
$6,001 - $37,000	15c for each $1 over $6,000
$37,001 - $80,000	$4,650 plus 30c for each $1 over $37,000
$80,001 - $180,000	$17,550 plus 37c for each $1 over $80,000
$180,001 and over	$54,550 plus 45c for each $1 over $180,000

Appendix 2

Historical tax tables with thresholds deflated by the CPI

2005-06

Taxable income	Tax on this income
$0-$6,240	Nil
$6,240-$22,464	17 cents
$22,464-$60,320	30 cents
$60,320-$72,800	42 cents
$72,800 and over	47 cents

2006-07

Taxable income	Tax on this income
$0-$6,371	Nil
$6,371-$22,936	17 cents
$22,936-$61,587	30 cents
$61,587-$74,329	42 cents
$74,329 and over	47 cents

2007-08

Taxable income	Tax on this income
$0-$6,645	Nil
$6,645-$23,922	17 cents
$23,922-$64,235	30 cents
$64,235-$77,525	42 cents
$77,525 and over	47 cents

2008-09

Taxable income	Tax on this income
$0-$6,738	Nil
$6,738-$24,257	17 cents
$24,257-$65,134	30 cents
$65,134-$78,610	42 cents
$78,610 and over	47 cents

2009-10

Taxable income	Tax on this income
$0-$6,947	Nil
$6,947-$25,009	17 cents
$25,009-$67,153	30 cents
$67,153-$81,047	42 cents
$81,047 and over	47 cents

2010-11

Taxable income	Tax on this income
$0-$7,183	Nil
$7,183-$25,859	17 cents
$25,859-$69,437	30 cents
$69,437-$83,803	42 cents
$83,803 and over	47 cents

2011-12

Taxable income	Tax on this income
$0-$7,269	Nil
$7,269-$26,169	17 cents
$26,169-$70,270	30 cents
$70,270-$84,808	42 cents
$84,808 and over	47 cents