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The Impact of Penalty Rate Cuts on Personal Tax Revenue and Welfare

Briefing note

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INTRODUCTION

The recent decision of the Fair Work Commission to cut Sunday penalty rates, a cut that will cost individual workers between $39 and $127 for an 8 hour Sunday shift, will have a substantial impact on personal income tax revenue and, in turn, the Commonwealth budget deficit.

The link between wages growth and personal income tax revenue collection is well understood. Treasury's Mid-Year Economic and Fiscal Outlook 2016-17 states:

> "Government receipts, although growing, are expected to be affected by softer domestic prices and wages growth."

And:

> "If inflation and wage growth remain low, this would slow nominal GDP growth and in turn have adverse consequences for tax receipts, somewhat offset by a reduction in payments."[1]

Indeed, Treasurer Scott Morrison himself stated:

> "Lower wages growth and profits have an obvious impact on government revenues"[2]

In addition to the impact of cutting wages on personal tax receipts the design of the welfare system is such that as a welfare recipient's wage income rises their welfare benefit income falls. In turn, cuts to wages lead to increases in welfare payments.

As a worker's pay rises the combined impact of income tax and reductions in welfare payments is known as the 'Effective Marginal Tax Rate'. The effective marginal tax rate for many low income -earners is over 80 per cent and, in some cases, over 100 percent. This means that when the wages of low income earners are cut the cost to the government, in the form of lost tax revenue higher welfare payments, can approach $1 for every dollar lost to the employee.

While there are a number of factors that might partially offset the loss in tax revenue associated with a wage cut (such as increased employment and higher profits – discussed below) this briefing paper suggests that the cost of lost income tax revenue and increases in welfare spending associated with the decision to cut penalty rates is,

[1] http://www.budget.gov.au/2016-17/content/myefo/html/, p 2, 16

[2] http://www.afr.com/news/policy/budget/looming-budget-crunch-boosts-need-for-tax-relief-says-morrison-20161120-gsta24#ixzz4cN5W1NWZ

based on conservative assumptions, likely to be more than $650 million over the forward estimates.

BACKGROUND TO THE FWC CASE

On February 23, 2017 the Fair Work Commission handed down a decision on penalty rates that recommended a reduction in penalty rates for workers covered by 4 awards (Fast Food, Retail, Pharmacy and Retail).

As different workers are employed at different levels under each award, and each award has different base rates of pay, the impact on workers is diverse. To give a sense of the scale of the impact of the proposed cuts, however, the lowest paid casual workers covered by the retail award would lose $38.88 per Sunday for an 8 hour shift and the highest paid permanent workers covered by the Pharmacy award would be $127.09 cents worse off for an 8 hour Sunday shift.

While the number of people affected by the proposed cut is in dispute, there is no dispute that the number of people affected is significant. The Government is reported as believing that 285,000 people face a pay cut while the ACTU points out that 648,000 people are covered by the relevant awards.

To the extent that award conditions influence the conditions in non-award agreements the number of people affected by the decision is likely to be even greater than the 648,000 covered.

POTENTIAL IMPACT ON PAYE TAX COLLECTION AND WELFARE SPENDING

The potential impact of the proposed Penalty rate cut on PAYE tax revenue and welfare payments was not discussed by the Fair Work Commission and the government has released no modelling to show the likely impact of penalty rate cuts on employment creation or on the budget.

This omission is surprising given the Government's stated focus on 'budget repair' and the effort it has put into legislative efforts to secure reductions in welfare payments and other savings. As the FWC has been working on the penalty rates case for some years there is no reason for the government to have considered the potential budgetary impacts, if they were concerned with them.

While the impact of the proposed penalty rate cut on the budget accounts for only a small portion of government spending, the impact is significant relative to other measures of recent concern to the Government. For example, the Social Services Legislation Amendment Bill that recently passed the Senate included savings measures such as:

- Freezing the indexation of income thresholds for a range of entitlements
  $69m
- Automating pension data collection by DHS
  $30.2m
- Extending waiting period for a range of entitlements
  $189.4m

While a precise estimate of a cut to penalty rates on state and federal budgets is beyond the scope of this brief, as the following estimates show, the impacts are not small, are significantly larger than some of the government's recent savings measures, and, in turn, should be of concern to state and federal Governments alike.

HOW MANY PEOPLE ARE AFFECTED BY THE CHANGES?

According to newspaper reports the Department of Employment estimate that 'as few as 285,000' will be effected by the decision, with up to 460,000 under 'the most conservative estimates'. The analysis referred to in the media does not appear to have been released by the Department.[3]

The ACTU, on the other hand, has suggested that up to 648,000 people are directly covered by the 4 awards.

One reason for this disparity is the inevitable difference between the number of people covered by the relevant awards (the focus of the ACTU estimate) and the number of people covered by the relevant awards who are at work on any given Sunday (which will inevitably be smaller than the number of people covered by an award who could work on a given Sunday).

That is, given that not every employee who ever works on a Sunday will always work on every Sunday it is clear that the lower estimates of the number of people affected by the cut to penalty rates reportedly made by the Department is likely to be highly conservative. For example, if two workers took turns to work on a Sunday then they

[3] http://www.theaustralian.com.au/national-affairs/industrial-relations/labors-claims-of-penalty-rates-cut-hit-too-high/news-story/866a586bbec4e4d988bd1da5ed93bc88

would both be affected by a cut in Sunday penalty rates even though only one of them would be captured in an estimate of how many people work on any given Sunday.

Further, as the FWC decision also proposes a cut to penalty rates on public holiday a much larger pool of workers will be adversely affected than the number of people who sometimes work on Sundays.

Finally, as award wages and conditions set a floor under conditions in non-award agreements the FWC decision will likely lead to a reduction in wages well beyond the 648,000 directly covered by the Award.

HOW MUCH WILL PENALTY RATE CUTS COST AN INDIVIDUAL?

The FWC decision applies to four different awards and, within each of those awards, effects workers at different levels by different amounts. Table 1 provides a summary of the changes and the reduction in penalty rates per 8 hour day and per year.

Table 1 – Impact of FWC decision on different awards

	Base rates per hour	Current Sunday rate	Change to Sunday rate	Losses per Sunday	Losses per year
1. Fast Food (Only level 1 changed)					
Casual		175%	150%		
Fast food worker	$19.44	$34.02	$29.16	$38.88	$2,021.98
Permanent		150.00%	125%		
Fast food worker	$19.44	$29.16	$24.30	$38.88	$2,021.98
2. Retail (general)					
Casual		200.00%	175%		
Shop assistant	$19.44	$38.88	$34.02	$38.88	$2,021.76
Store manager	$23.79	$47.58	$41.63	$47.58	$2,474.16
Permanent		200.00%	150%		
Shop assistant	$19.44	$38.88	$29.16	$77.76	$4,043.52
Store manager	$23.79	$47.58	$35.69	$95.16	$4,948.32
3. Pharmacy					
Casual		200%	175%		
Pharmacy assistant	$19.44	$38.88	$34.02	$38.88	$2,021.98
Pharmacy manager	$31.77	$63.55	$55.60	$63.55	$3,304.46
Permanent		200%	150%		
Pharmacy assistant	$19.44	$38.88	$29.16	$77.77	$4,043.96
Pharmacy manager	$31.77	$63.55	$47.66	$127.09	$6,608.93
4. Hospitality (no changes to casuals)					
Permanent		175%	150%		
Food, beverage & kitchen attendant	$18.21	$31.87	$27.32	$36.42	$1,893.84
Cook - trade qualified	$22.49	$39.36	$33.74	$44.98	$2,338.96

Source: ACTU

Table 1 shows that the reduction in take home pay resulting from the cut to Sunday penalty rates for someone who works each Sunday range from $2,022 per year for a casual fast food worker to $6,609 for a permanent pharmacy manger.[4]

The impact of lower penalty rates on public holidays has not been estimated in this brief. Including the impact of a cut to public holiday penalty rates would lead to a larger estimate of the number of people affected, a larger estimate of the lost wages and, in turn, a larger reduction in the loss of Commonwealth revenue.

HOW MUCH LESS TAX WOULD BE PAID AS A RESULT OF CUTTING PENALTY RATES?

Cutting the wages of low paid workers has a significant impact on tax payable.

As Treasury points out in MYEFO:

> "If inflation and wage growth remain low, this would slow nominal GDP growth and in turn have adverse consequences for tax receipts, somewhat offset by a reduction in payments."[5]

While average tax rates for low paid workers are low (because of the existence of the tax free threshold) the tax revenue lost is 21[6] cents in the dollar for those earning over $18,201 and 34.5 cents in the dollar for those earning over $37,001 up to $87,000. The majority of people affected by the FWC recommendation to cut penalty rates are likely to be in either the 21 percent or 34.5 per cent tax brackets.

Table 2 provides estimates of the potential loss of tax revenue as a result of cutting penalty rates under a number of different scenarios. It shows that if the Government's smallest estimate of the number of affected workers (285,000) were all in the 19 percent tax bracket the reduction in tax revenue would be $164.2 million per year

If the Government's largest estimate of affected workers were all in the 34.5 per cent tax bracket the reduction in tax revenue associated with a cut in penalty rates would be $435.5 million.

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[4] As there is a lot more people employed under the Retail award than the Pharmacy award a simple average of the loss of wages across the four awards would exaggerate the size of the cut. In turn, the calculations of the economy wide reduction in wage income below are based on a weighted average of lost wages where the loss for each award is weighted by the number of people covered by that award.

[5] http://www.budget.gov.au/2016-17/content/myefo/html/, p 16

[66] Note the Medicare levy kicks in at $21,335 and is fully phased in at $26,668 but this taper has been excluded from these calculations.

And if the Government's estimate of the number of workers experiencing pay cuts were evenly distributed between the 21 per cent and 34.5 per cent tax rates then the reduction in tax revenue would range between $217 million and $350 million per year.

Table 2 – Potential reduction in personal income tax collections from FWC decision

Number of Workers Affected	285,000	460,000
Avg. Annual Wage Cut	2,744	2,744
Total cut in Wages	$782,040,000	$1,262,240,000
Lost tax at 21%	$164,228,400	$265,070,400
Lost tax at 34.5 per cent	$269,803,800	$435,472,800
Lost tax if half 21% and half 34.5	$ 217,016,100	$350,271,600

As discussed above, it is likely that not all workers who work some Sundays will work all Sundays. In turn, over the course of a year the number of people who work any Sundays or any public holidays will be larger than the number of people at work on any given Sunday or any given public holiday. This distinction is important when addressing the question of 'how many people will have their income reduced as a result of the FWC decision' but, to simplify the estimate of the impact of the FWC decision on the budget, the scenarios used assume that a smaller number of people experience all of the loss of income rather than the more realistic assumption that a larger groups of people share some of the loss of income.[7]

HOW MUCH EXTRA WILL BE SPENT ON WELFARE AS A RESULT OF LOWER PENALTY RATES?

Cutting the wages of low paid workers leads to a significant increase in welfare spending.

Welfare benefits such as Newstart, the Age pension and Austudy are available to individuals who meet income and other eligibility tests. The size of the payment declines as income rises above a threshold and the rate at which it declines is known as a 'taper rate'. The taper rate varies for different people on different benefits but the following examples give an indication of the likely budgetary cost:

- An 18 year old on Youth Allowance loses 50 cents for every dollar they earn above $437 per week and below $534 per week and 60 cents in every dollar they earn over $524. In turn, welfare spending will increase by 60 cents for

[7] The impact on the revenue estimate of this composition effect will be near zero.

every dollar lost in penalty rates by a Youth Allowance recipient earning over $534 per week. [8]

- A Newstart recipient loses 50 cents for every dollar they earn over $104 per week and 60 cents for every dollar they earn over $254 per week.

As a result of the high taper rates welfare spending will increase by 60 cents for every dollar lost in penalty rates by a Youth Allowance recipient earning over $534 per week

Table 3 shows the potential impact of a cut in penalty rates on welfare payments. It shows that if 20 percent of those affected by the penalty rate cuts were in receipt of welfare payments then the increase in welfare spending would be between $78.2 million and $126.2 million per year

Table 3 – Potential impact of FWC decision on welfare payments

Number of Workers Affected		285,000		460,000
Average annual wage cut		2,744		2,744
Total cut in wages	$	782,040,000	$	1,262,240,000
Wages bill of 20% of workforce	$	156,408,000	$	252,448,000
Cost of 50 cents in the dollar taper	$	78,204,000	$	126,224,000

If the 20 per cent of the workforce experiencing the 50 per cent taper paid no income tax then the net cost to the budget would be between $34 million and $56 million, however, as described below, it is likely that many of those who receive welfare also pay income tax which would make the cost to the budget of a wage cut even higher.

Also, if the FWC decision led to a significant increase in hours of employment, and if those hours were obtained by people who were in receipt of welfare, then there would be a reduction in expenditure on welfare. However, as discussed below, even proponents of the FWC decision have not claimed that there is likely to be a significant increase in employment.

THE INTERACTION BETWEEN THE TAX AND WELFARE SYSTEM

While the estimates above assume that if 20 percent of those who experience penalty rate cuts are on welfare the increase in their welfare payments are a substitute for any

[8] https://www.humanservices.gov.au/customer/enablers/personal-income-test-austudy-and-youth-allowance

reduction in income tax paid in reality many of those who receive welfare also pay income tax and, in turn, any reduction in their wage income would lead to them experiencing BOTH an increase in their welfare and a simultaneous reduction in income tax paid.

The interaction between marginal tax rates and welfare taper rates is a well-known phenomenon which leads to the calculation of Effective Marginal Tax Rates (EMTR's) for welfare recipients which are often over 80 per cent and can be over 100 per cent. That is, when welfare recipients earn an extra dollar they often lose between 80 and 1oo cents in combined income tax and welfare.

The converse is often true. Welfare recipients who face an 80 to 100 per cent marginal tax rate cost the government between 80 and 100 cents for every dollar they lose in private income.[9]

It is important to note that some people who work on Sundays might only work on Sundays and in turn have an annual income below the tax free threshold. If those people are married to a high income earner, or are otherwise ineligible for welfare payments, then a cut in their penalty rates would lead to no loss in tax revenue and no increase in welfare payments.

SO HOW MUCH INCOME TAX WILL BE LOST AS A RESULT OF CUTTING PENALTY RATES?

If 285,000 people lost an average of $2,744 per year and they were all in the 21 per cent tax bracket then the reduction in income tax revenue would be $164.2 million per year or $656.8 million over the forward estimates.

And if 460,000 people lost an average of $2,744 per year and half were in the 21 per cent tax bracket and half were in the 34.5 per cent tax bracket then the reduction in income tax paid would be $350.2 million per year or $1.4 billion over the forward estimates.

The cost to the budget would be significantly larger if some of those who receive penalty rate cuts are in receipt of welfare benefits that rise with private income falls, that is, if the impact of the penalty rate cut is borne by a significant number of people with high EMTRs

[9] See Inglis 2016

BUT WHAT ABOUT THE INCREASE IN EMPLOYMENT?

If a cut in penalty rates led to a large increase in employment then it is possible that the total wage bill would not fall. It is even theoretically possible that the wage bill might rise. However, not even the supporters of the cut in penalty rates have argued that lower wages will lead to a large increase in the number of shifts offered to workers. For example:

- Peter Strong from COSBOA: “There will be more jobs. It might not be a lot, it might be 10,000. We don’t know how many but we’ll find out.”[10]
- James Person: “Reducing penalty rates for businesses in retail and hospitality will give them greater capacity to open their doors longer, take on more staff and give them more hours. The Restaurant and Catering Association found it could create 40,000 jobs"[11]

An analysis by Citigroup was silent on the impact of a cut in penalty rates on employment and suggested that any reduction would be passed on as increased profits or slight reductions in retail prices.[12]

It is even possible that some employers may not be able to attract skilled staff , and in turn open on Sundays, without the existing premium wages, especially if the labour market strengthens.

OTHER COMPLICATIONS

While the estimates above suggest how significant the likely loss of tax revenue and increase in welfare payments might be, these estimates do not include all of the possible economic effects, some of which include:

1) State government payroll tax revenues will decline with lower wage payments

2) If consumer spending falls in line with the cut in disposable income then GST revenue will decline

[10] http://www.news.com.au/finance/work/at-work/sunday-penalty-rates-slashed-by-fair-work-commission/news-story/debbd0c1fd8de8fe3898ca51950b4f5b

[11] http://www.smh.com.au/business/workplace-relations/penalty-rates-for-sunday-holiday-work-to-be-slashed-after-landmark-decision-by-fair-work-commission-20170222-guj8f3.html

[12] http://www.smh.com.au/business/workplace-relations/cutting-penalty-rates-would-boost-profits-for-businesses-new-report-20161130-gt0q6c.html

3) Employers will likely have to reduce staffing on, or accept lower profits from, mid-week shifts as an increase in weekend retail hours will likely lead to a reduction in trade during existing opening hours. The result of longer shop opening hours is likely to be a reduction in labour productivity. Further, economic theory suggest that a reduction in the cost of labour, relative to the cost of capital, will lead to a reduction in labour productivity.

4) Employers could take wage reductions as pure increases in profit in which case more corporate income tax would be payable. However, as not all profits will be distributed in the year they are generated, and as the average rate of corporate tax paid is well below the welfare taper rate and 34.5 per cent income tax rate any gain in corporate tax revenue is likely to be lower (and less immediate) than any reductions in income tax revenue or increases in welfare payments.

5) The estimates provided above are based on the loss of income associated with the estimated number of people affected by the penalty rate cut losing penalty rates for 8 hours on a Sunday. Some workers are likely to work shorter shifts than 8 hours and, in turn, the loss of income would be less than that descried above. However, the FWC also recommended a cut in penalty rates for public holidays. As the average state has 12 public holidays and the above figures take no account of wage reductions as a result of lower penalty rate payments on those days the figures based on the loss of an 8 hour shift (and no loss of holiday penalty rate payments) are likely to be conservative.

CONCLUSION

It is a truism that ‘the economy has a bigger impact on the budget than the budget has on the economy’. As discussed above, low wage growth is a major cause of low growth in Commonwealth revenue and, in turn, growth in the budget deficit.

While it is beyond the scope of this paper to accurately estimate the precise impact of a cut in penalty rates on the Commonwealth budget the range of estimates provided here show that the likely budget effects are significant and negative.

It seems surprising that the Commonwealth Government has not produced its own estimate of the impact of penalty rate cuts on the Commonwealth budget. It should do so as a matter of urgency.