

Indexation of tax scales: Stimuluses not wanted

The Coalition has announced a policy of indexing the personal income tax scales. If ever implemented tax indexation would pit the government against the Reserve Bank by stimulating the economy when it was inappropriate, which is why the Fraser Government abandoned tax indexation.

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INTRODUCTION

The leader of the Liberal Party, Angus Taylor, has recently announced a policy of indexing the personal income tax thresholds for inflation, a policy that dates back to an earlier initiative implemented by, and then scrapped by, the Fraser Government. The policy was announced by Angus Taylor in his budget in reply speech. As he explained it:

When your wages rise just to keep up with inflation – you’re no better off. But you pay higher taxes as though you’re better off. More of your income goes into a higher tax bracket – this is bracket creep.¹

The Opposition Leader has provided no other detail apart from a schedule for phasing in the policy.

The traditional approach to tax and spending policy (often referred to as fiscal policy) is to try to ‘time’ significant changes in taxes and spending so that they help to stimulate the economy in times of slow growth (stimulatory policy) and to constrain government and private sector spending in times of inflation (contractionary policy).

¹ Taylor A (2026) *The Tax Back Guarantee: The Coalition's Budget in Reply* at <https://angustaylor.com.au/our-budget#the-tax-back-guarantee>

However, despite repeated criticism by Angus Taylor and his colleagues that Labor’s approach to fiscal policy is inflationary, the Opposition Leader is now promising that future Liberal governments would deliver large tax cuts whenever the economy is experiencing high inflation. While Mr Taylor has made the case for such a policy on the basis of its perceived fairness, he has yet to explain the contradiction between requiring the RBA to use interest rates to slow consumer spending when inflation is rising while simultaneously requiring the ATO to cut income taxes at precisely the same time.

This paper provides estimates of how much tax revenue would have actually been returned to taxpayers under such a pro-cyclical approach to fiscal policy. The paper relies primarily on taxation statistics provided by the Australian Tax Office.

HOW WOULD INDEXING TAX THRESHOLDS WORK

Australia’s income tax system relies on the existence of a number of different ‘income thresholds’ above which different income tax rates are applied. The current thresholds and rates are spelt out in Table 1 and show that, for example, someone who earns \$19,000 per year would pay zero tax on the first \$18,200 they earn and 19% on the remaining \$800 dollars for a total tax payable of \$152.

These income tax thresholds are fixed in law and changed every few years at times, and in ways, that the government of the day thinks is both economically responsible and politically acceptable.

The Opposition Leader’s proposal, however, is to remove the ability of the Treasurer of the day to consider the appropriate timing, size and distribution of tax cuts and simple ‘automate’ the decision making. Table 1 also shows the implications of automatically indexing the income tax thresholds in 2023-24 using the previous years inflation rate which was 7.03% in 2022-23 but we have rounded down to 7% as it is not clear how many decimal places the Opposition Leader proposes to use in either selecting the inflation rate or setting the income thresholds.

Table 1: How tax indexation would have worked in 2023-24.

Scales 2022-23	Marginal tax rate	Scales in 2023-24 if indexed for 2022-23 inflation	
		range bottom \$	range top \$
0-\$18,200	0	0	19,474

\$18,200 to \$45,000	19	19,474	48,150
\$45,000 to \$120,000	32.5	48,150	128,400
\$120,000 to \$180,000	37	128,400	192,600
\$180,000 and above	45	192,600	∞

Source: Author's calculations based on Australian Tax Office (2026) ATO Tax Rates, at <https://atotaxcalculator.com.au/ato-tax-rates#tax2022>

As can be seen in Table 1, even rounding the inflation rate down to 7 percent the consequence is a new tax-free threshold of \$19,474. Over time the automation of such threshold setting will lead to increasingly awkward numbers playing a key role in our tax system leading to an increased risk of confusion and error.

Having calculated the new thresholds in Table 1 it is possible to estimate the impact on revenue and, in turn, on the amount of fiscal stimulus associated with the changes as consumers receive significant tax cuts.

As mentioned, in 2022-23 inflation was a relatively high 7.0% and that year the tax office raised \$298.0 billion in personal tax. Applying the new tax scales to the income distribution for that year generated a tax cut, and fiscal stimulus, of \$8.9 billion in 2022-23.

THE FRASER GOVERNMENT EXPERIENCE

Tax indexation was a live issue for the Whitlam Labor Government which established the Mathews Committee of Inquiry into inflation and taxation which recommended indexation.² Then Treasurer, Bill Hayden, announced that the government would not implement those recommendations on the grounds of costs among other things. Soon after the Fraser Coalition Government was elected the Treasurer, Phillip Lynch, announced full indexation of the personal income tax scales for the 1976-77 year. However, as one historian said:

These changes constituted a substantial tax cut, which was presented as a 'fistful of dollars' at the 1977 election campaign. The tax cuts, however, were regarded as not affordable, and they were partially reversed after the election with a one-off increase in the standard rate and the subsequent cessation of

² This section relies heavily on Tilley P (2024) *Mixed Fortunes: A History of Tax Reform in Australia*, Melbourne University Press.

indexation....Indexation did not... stand the test of political time and ceased in 1979–80.³

It seems that the Fraser Government regarded tax indexation as too expensive as a result of experience. Incidentally, the decision to abandon the promised indexation occurred while John Howard was Treasurer in the Fraser Government.

Tilley has also commented “In reality, governments want fiscal flexibility, including to design and announce tax cuts on a regular basis, rather than be locked into a set income tax distribution.”⁴ We might add that it has been standard orthodoxy since the 1940s that tax arrangements and fiscal strategy generally should provide stimulus when needed to boost a sluggish economy and withdraw stimulus when the rest of the economy is booming. A progressive income tax system does that automatically as surging incomes push people into higher tax brackets and falls in incomes do the opposite. However, tax indexation nullifies that process as we explain later.

HOW WOULD TAX INDEXATION HAVE WORKED IN PRACTICE?

It is possible to use historic tax thresholds, ATO data on tax collections and ABS data on inflation to answer the question ‘how would tax indexation have worked in recent decades?’ The following sections answer that question from the first Howard budget in the 1996-97 financial year.

The focus of this analysis is the impact on the size and timing of tax cuts due to the cyclical volatility of inflation. The results presented below assume that the tax thresholds for each year are determined by adjusting the tax thresholds from the previous year by the rate of inflation in the previous year. Such a lag is necessary unless the Opposition Leader proposes that tax thresholds should be indexed monthly or quarterly as the ABS releases regular data.

Figure 1 presents data on the annual tax stimulus that Angus Taylor’s automatic adjustments would deliver and charts them against inflation in the same year. This stimulus through indexation is presented in Figure 1 as a share of GDP.

³ Tilley P (2021) “1985 reform of the Australian tax system”, *Tax and Transfer Policy Institute Working Paper 7/2021* April.

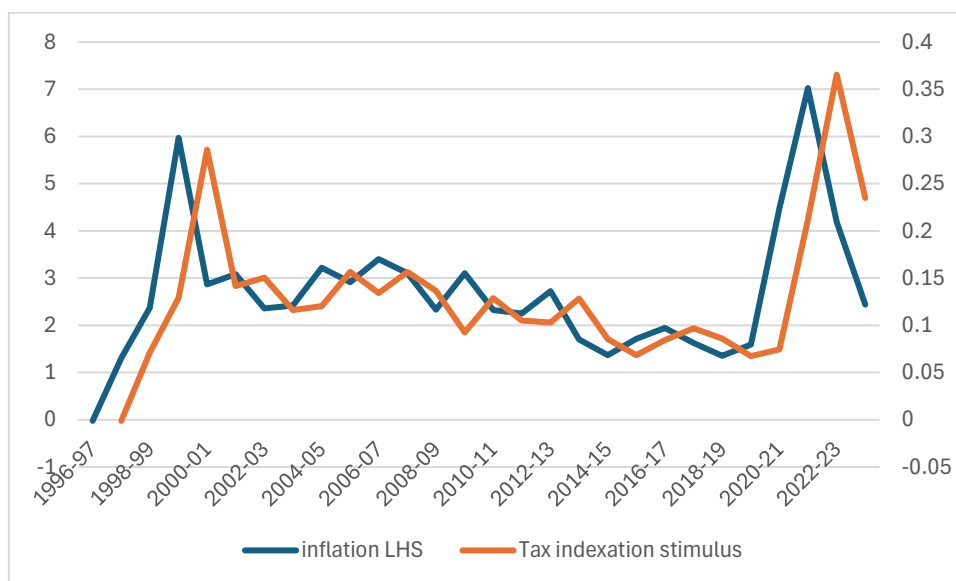
⁴ Tilley (2024) p 199.

The stimulus through tax indexation is estimated directly for 2022-23 and, for that year, we estimate the responsiveness of personal income tax to inflation. We try to explain the procedure here with more details left to the technical appendix.

As a first approximation it might be expected that as inflation increases people’s incomes, then tax should increase in proportion as incomes increase with inflation. However, with inflation people get pushed into higher tax brackets which then increases tax collections more than in proportion to inflation. Economists call that “fiscal drag”. We estimate the income tax responsiveness to inflation as the proportionate increase in tax divided by inflation. Fiscal drag implies the ratio is greater than unity meaning that the percentage increase in tax is greater than the increase in prices. The actual figures were calculated for both 2022-23 and 2010-11. The estimate for 2022-23 came in lower at 1.47 and so was used in the calculations for the whole period shown in Figure 1, thereby adding a conservative bias to earlier years.⁵

To be clear, our estimates look at how revenue and, therefore the budget stimulus, would have been affected relative to the actual revenue in the year concerned.

Figure 1: Inflation and the stimulus through indexation



Sources: Author’s calculations based on ATO, Taxation Statistics at <https://www.ato.gov.au/about-ato/research-and-statistics/in-detail/taxation-statistics/taxation-statistics-2022-23> and Parliamentary Budget Office, Historic Fiscal Data at

⁵ Over the last 30 years the degree of progressivity has fallen so we might expect that the tax responsiveness to inflation would have lessened. The labour intensity of the calculations as well as data availability prevented similar calculations over the whole period.

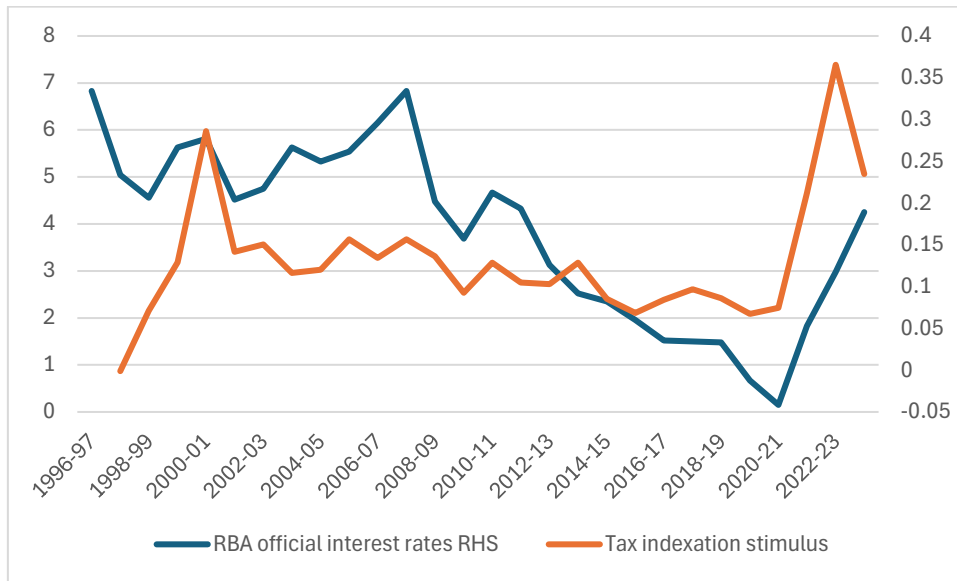
Figure 1 is striking because the peaks in the tax indexation stimulus lag behind inflation by a year. That is because any change in annual tax scales would necessarily be implemented after the inflation itself. It can also be seen that the correlation between inflation and the stimulus in Figure 1 is very close. That makes sense because it is inflation in this policy that drives the size of the economic stimulus. So a policy of tax indexation would have the stimulus to households closely follow inflation.

Figure 1 clearly shows that the Coalition's indexation plan would mean reducing revenue collections and stimulating the household sector when there is inflation. Moreover, the higher is inflation then the higher would be the stimulus to household spending. High inflation is precisely the time when the Reserve Bank is prone to increase interest rates at the expense of borrowers—especially home buyers and business borrowers. Just after the peaks in inflation would be when the Reserve Bank would be most concerned about expectations that higher inflation may continue into the future. This of course means that the tax indexation policy is likely to mean that the Reserve Bank will become even more aggressive in its interest rate movements. The Reserve Bank would anticipate that higher inflation would mean higher stimulus from tax indexation.

It should be pointed out at this stage that the role of stimulus through indexation has the effect of offsetting the main “automatic stabilisers” in the fiscal system. When the economy is booming and inflation threatens, people are temporarily pushed into higher income tax brackets which tends to dampen their spending and so offsets some of the conditions causing a booming economy. When inflation is low and the economy is sluggish automatic stabilisers kick in to help prevent further falls in economic activity. Together these effects help steer the economy between booms and busts. The Coalition's stimulus through indexation would remove most of the automatic stabilisation that would normally occur during upswings.

As mentioned, the risk is that tax indexation stimulus would take place precisely when the Reserve Bank would be concerned about rising inflation expectations and so inclined to raise interest rates. Figure 2 again shows the tax indexation stimulus and this time compares it with official interest rates.

Figure 2: Taylor’s stimulus v official interest rates



Sources: Author’s calculations based on ATO and PBO historic series.

From Figure 2 we can see that the stimulus would have been fairly strong in the period leading up to the global financial crisis which began around 2008-09. Until then the Reserve Bank was keeping interest rates fairly high and the tax indexation stimulus would have worked against that. Likewise, during the pandemic, especially after around 2021-22, the indexation stimulus would have further boosted economic activity just when the Reserve Bank was trying to fight inflation with higher interest rates. On the other hand, the period leading up the pandemic was associated with quite sluggish economic growth as is evident in the Reserve Bank lowering interest rates to boost the economy following the global financial crisis. However, at that time the tax indexation was giving little or no stimulus.

Figure 2 shows that there would have been a correlation between the tax indexation stimulus and official interest rates. That observation confirms that the tax indexation stimulus would have come just at the wrong time of the Reserve Bank’s interest cycle. Further it is evident that home buyers would be hit harder if the Reserve Bank also had to take account of the extra stimulus to households when inflation is higher.

CONCLUSION

This paper has focused on the issues surrounding the Coalition’s policy of personal income tax indexation which refers to a policy of indexing the personal income tax thresholds. The mechanics of tax indexation are rather simple but as Table 1 shows, we

soon lose the elegance of round numbers which are replaced by numbers that are difficult to remember or work with. However, there are more serious problems.

It appears the Fraser Government abandoned tax indexation because the implications for revenue did not suit the economic conditions and fiscal strategies at the time. We can throw further light on the problems associated with personal tax indexation by considering how tax indexation may have worked over the last 30 years since 1996-97. Tax indexation gives a lot of revenue to taxpayers when inflation is high, indeed that is the whole purpose of it, returning so-called fiscal drag to taxpayers. The result is that the additional fiscal stimulus is highly correlated with inflation itself. The implication is that stimulus is given to households at precisely the time when further stimulus would only worsen the outlook for inflation, at least in the eyes of the Reserve Bank.

Also when we plot the hypothesised tax indexation stimulus against official interest rates we again see that the stimulus would have come just as the Reserve Bank was trying to control inflation with higher interest rates.

Technical appendix

The purpose of this appendix is to explain how the data was obtained to be used in the graphs included in this paper.

In Figure 1 we compared inflation with the tax indexation stimulus. Inflation data was derived from the ABS consumer price index series.⁶ In Figure 1 it is calculated as an increase in the inflation for the relevant financial year. To get that we calculated the average CPI for each financial year and divide by the same figure for the previous year. That gives the annual inflation rate and is expressed in percentage changes.

This brings us to the calculation of the stimulus through tax indexation. For the latest tax office data (2022-23)⁷ we were able to do a thorough calculation of how indexation of the tax scales would have affected tax receipts for that year. This allows us to calculate the responsiveness of personal income tax to inflation on the assumption that wages increase at the same rate as inflation. An economist would call this the “elasticity of tax with respect to inflation”. Having calculated that figure it can be applied to all earlier data. If the figure is above unity it means that a one per cent inflation will give a tax increase of more than one per cent. The difference is our measure of fiscal drag or the amount that would have been given back to taxpayers had there been a policy of indexing the tax thresholds, the income values above which there is a new, higher marginal tax rate. The value of the fiscal drag to be given back to households is referred to in the text as the tax indexation stimulus. In the graph the tax indexation stimulus is expressed as a share of GDP.

Because the tax scales cannot be set before the inflation is known there is an inevitable lag between inflation and the stimulus. Hence in Figure 1 there is a lag between the peak in inflation and the peak in the stimulus for the two major peaks shown in the graph.

Figure 2 shows the tax indexation stimulus together with the annual official interest rates set by the Reserve Bank of Australia. The latter series was obtained by averaging the interest rates applying over the individual years.

⁶ ABS (2026) *Consumer Price Index, Australia* at <https://www.abs.gov.au/statistics/economy/price-indexes-and-inflation/consumer-price-index-australia/latest-release>

⁷ ATO (2025) *Taxation Statistics* at <https://www.ato.gov.au/about-ato/research-and-statistics/in-detail/taxation-statistics/taxation-statistics-2022-23>