Tax Reform: Informing the debate

Bracket creep: Do we treat the symptoms or cure the disease?

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Key points

- Dealing with bracket creep is now firmly on the federal government's agenda. Both the Prime Minister and Treasurer have expressed concern about middle income taxpayers moving into the second highest (37 per cent marginal rate paid on incomes higher than $80,000) tax bracket.

- The immediate costs of bracket creep have been extensively canvassed. Bracket creep adversely affects incentives to work and save and is regressive, hurting those on lower incomes the most. Bracket creep also distorts our tax system. It skews our tax mix, increasing further our reliance on personal income tax, and undermines the system's progressivity. Notwithstanding these unwelcome effects, bracket creep has been the *de facto* fiscal repair strategy for both major parties, reducing the need for spending restraint.

- Governments have a clear choice when dealing with bracket creep. They can treat symptoms (by offering one-off personal income tax cuts), but not the disease itself. While the federal government has highlighted the plight of middle income earners, bracket creep affects all taxpayers with the largest burden falling on lower income earners. Tax relief which excludes the latter would be hard to defend on fairness grounds.

- Any one-off bracket creep relief will be eroded over time. At best, it is a band aid solution. To eliminate bracket creep, the only option available under a progressive rate structure is indexation of income tax thresholds to inflation or (preferably) real wages growth.

- Indexation is an unlikely solution when fiscal challenges exist. Bracket creep is a remarkably effective, if opaque and regressive, revenue raiser. As Treasury has pointed out, by the end of the forward estimates it will account for around half of the fiscal consolidation the federal government is set to achieve. If fundamental tax reform is off the table and there is no appetite to cut spending, there may be no other fiscal repair option.

- Indexation, however, would be a worthwhile tax and fiscal reform. It would slow the growth in our tax system's reliance on income tax. It would also put our fiscal debate on a more balanced footing. If the easy option of addressing bracket creep is no longer available, governments will be under greater pressure to manage their spending (and to publicly justify any tax increases). This would serve as a welcome discipline for current and future administrations.

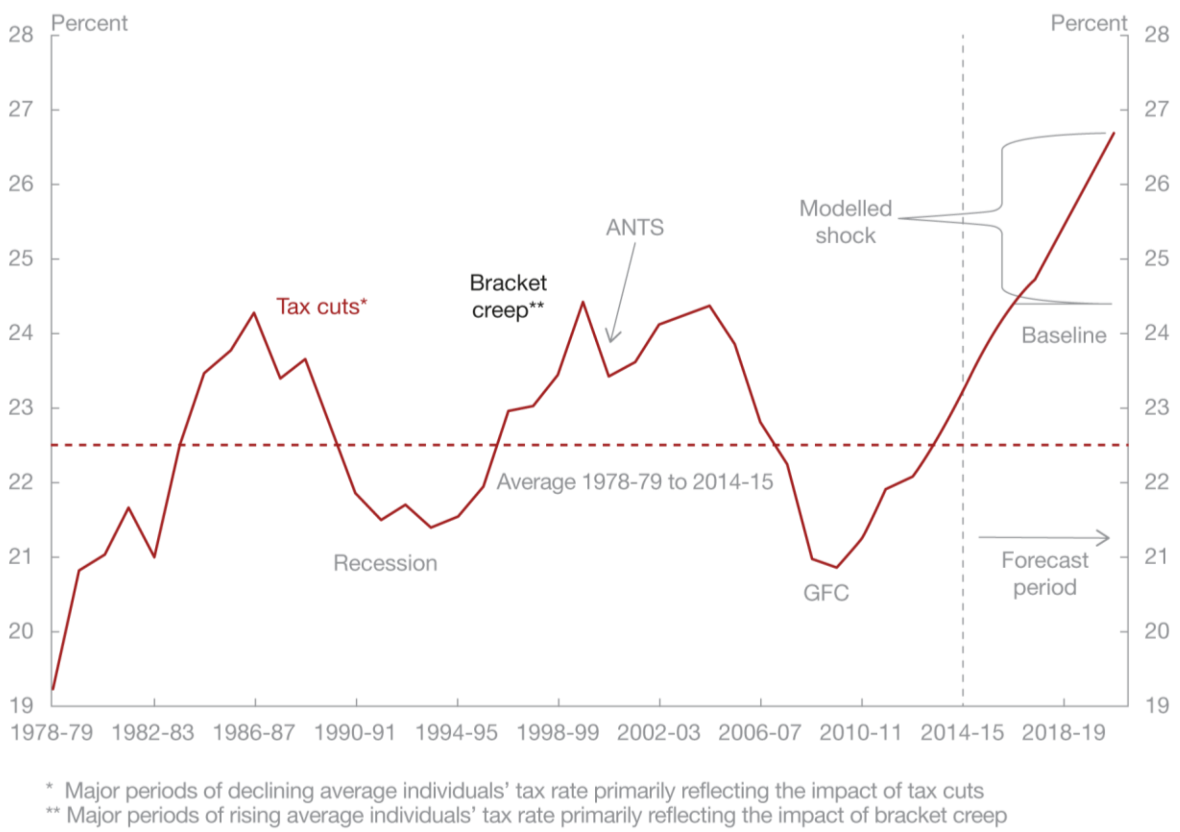
Bracket creep is now firmly on the political agenda. While the federal government is no longer planning to finance large personal income tax cuts from a 50 per cent increase in the goods and services tax (GST), it remains committed to modest income tax relief. Both the Prime Minister and Treasurer have identified bracket creep as a particular problem, expressing concern about middle income taxpayers moving into the second highest tax bracket. Treasury estimate that over 2 million more taxpayers will be in this bracket by 2024-25[1].

What is bracket creep?

Bracket creep is caused by the fact that our income tax thresholds are not adjusted for either inflation or real wage growth[2]. This means that as incomes rise, even if only in line with inflation, individuals will be taxed at higher average, and in some cases marginal, rates[3]. This ratcheting-up of the tax burden is automatic. It does not require any legislative action from parliament.

Treasury modelling, recently released by the federal government, shows that the average personal income tax rate will rise to 26.6 per cent in 2020-21 from its forecast 24.4 per cent in 2016-17 as a result of bracket creep. Over the period 1978-79 to 2014-15, the average income tax rate has been 22.5 per cent. As Treasury points out, bracket creep has been the main factor increasing individual tax burdens over this period[4]. The chart below, taken from Treasury's brief, illustrates bracket creep's effect.

Individual's average tax rate



1 Australian Government, *Re:think Tax Reform Discussion Paper*, 2015, page 22.

2 Views differ on whether real wages growth, in addition to inflation, should be taken into account when estimating bracket creep. Some argue that bracket creep stemming from real wages growth is a 'natural feature' of a progressive income tax system. Others reject this argument, pointing out that this also raises, in an automatic and unlegislated way, average tax rates faced by individuals.

3 If taxpayer incomes are only rising with inflation, bracket creep will result in a reduction in their real after-tax incomes. If taxpayer incomes are rising in real terms, bracket creep allows the government to claim a disproportionate share of this real gain.

4 Treasurer Morrison, *Media Release*, 12 February 2016. One-off tax cuts, recessions and the global financial crisis have, at least temporarily, brought the average income tax burden down.

A fixture of our tax system

Bracket creep, with one brief historical exception (during the Fraser government), has been a fixture of Australia's personal income tax system. Governments have on occasions returned (at least part of) bracket creep through income tax cuts, but none (since Fraser) have proposed to eliminate this phenomenon altogether by indexing the personal tax thresholds (to either inflation or average wages). This might strike someone new to Australia as odd, given the legislated arrangements we have in place to index welfare payments to inflation.

The costs of bracket creep

The immediate costs of bracket creep have been extensively canvassed. Bracket creep hurts all taxpayers, not only those moving into higher tax brackets. For those who move into higher brackets, however, incentives to work and save will be adversely affected. As many have pointed out, bracket creep fails the test of fairness. Its effects are felt most heavily by those on middle and lower incomes.

Bracket creep exacerbates structural imbalances in our overall tax system. If, as most economists would argue, Australia's tax mix is skewed too heavily toward (relatively inefficient) income taxation, bracket creep will increase this dependence over time[5]. Bracket creep also erodes the progressivity of our personal tax system, compressing average tax rates faced by low, middle and higher income earners. This is starkly illustrated below.

As Treasury has showed, over the period 2013-14 to 2023-24, bracket creep will raise the average income tax rate faced by those on half average full-time earnings ($37,500 in 2013-14) by 72.8 per cent (from 10.3 per cent to 17.8 per cent), those on average full- time earnings ($75,000) by 20.7 per cent (from 22.7 per cent to 27.4 per cent), and those on twice average full-time earnings ($150,000) by only 12.5 per cent (from 30.5 per cent to 34.3 percent)[6].

It is true that bracket creep is less of a problem today than it has been in the past. When the Fraser government indexed income tax thresholds in 1976 (before abandoning this experiment in 1982), the annual inflation rate was 15 per cent. The costs of bracket creep remain substantial, however. Treasury find that if bracket creep is relied upon to reduce the budget deficit to 2020-21, GDP will contract by 0.35 per cent in the long-term[7]. Treasury point out that 'the economic cost of rising average tax rates is large because it creates distortions in all sectors of the economy.' As personal income tax rates rise, 'the economic distortion from all taxes increases.'

Why is bracket creep tolerated?

Bracket creep is an effective funding tool for governments. It ensures that income tax collections rise more rapidly than real incomes, increasing the tax to GDP ratio over time. This has implications for medium-term budget repair. If spending cuts or legislated tax increases are not politically feasible, bracket creep can be relied upon to help close the fiscal gap. It does this without requiring action by parliament. It is no exaggeration to say that bracket creep is an important, if unstated, part of both major parties' budget strategies.

As Treasury has pointed out, 'by the end of the forward estimates, around half of the fiscal consolidation [the federal government will achieve] relies on increases in average tax rates due to the non-indexation of the tax scales'[8] - in other words, bracket creep.

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5 The narrowing of our consumption tax base as exempt activities (particularly health and education) account for a larger share of spending is another factor behind this adverse tax mix change.

6 *Re:think Tax Reform Discussion Paper*, page 22.

7 Treasurer Morrison, Media Release, 12 February 2016. Bracket creep reduces GDP by 0.55 per cent, but additional government spending is assumed to offset this by 0.2 per cent.

8 *Ibid.*

What to do about bracket creep?

The Turnbull government has signalled that it will take action on bracket creep. It has two choices. It can deal with the symptoms of the problem, most clearly illustrated by (but not limited to) taxpayers moving into higher tax thresholds. Or it can tackle its underlying cause; the non-indexation of the thresholds themselves.

A symptomatic solution would be to offer one-off income tax cuts to (at least some of) those who are affected by bracket creep. Thresholds could be set at higher income levels (to stop people moving into higher tax brackets) and marginal tax rates could be reduced. With the GST increase off the table, any income tax relief will necessarily be limited.

The key point, however, is that any one-off change to thresholds and rates will offer only temporary relief. If the new thresholds are not indexed (to either inflation or average wages growth) the tax cuts will be eroded over time.

If one-off income tax cuts were funded by higher income taxes elsewhere (for example, higher taxation of superannuation contributions, capping negative gearing or limiting other deductions), the result would eventually be a higher overall income tax burden[9].

The Prime Minister and Treasurer have spoken publicly about middle income earners moving into the second highest tax bracket ($80,000, where they would be subject to a marginal tax rate of 37 per cent).

Bracket creep affects all taxpayers, however, and hurts those on lower incomes the most. At $80,000, individuals face a 4.5 percentage point increase in their marginal tax rate (from 32.5 per cent to 37 per cent). At $37,000, they are confronted with a 13.5 percentage point increase (from 19 per cent to 32.5 per cent).

On fairness grounds, it is hard to justify limiting bracket creep relief to middle income earners. Indeed, an upward adjustment of the $80,000 threshold would deliver a tax cut to all those earning above $80,000, with no benefit to those earning less. One possible defence of this option, according to media reports, is that it would compensate middle and high income earners for possible tax increases in other areas (superannuation contributions, negative gearing).

This argument is not a compelling one. It suggests a degree of tax churn for middle income earners (giving with one hand, taking with another) with no relief for those most heavily affected by bracket creep.

Treating the disease itself: indexation of income tax thresholds

If the government wants to eliminate bracket creep it must deal with the underlying cause of the problem. The only way to do this is to index income tax thresholds to either inflation or average wages. This is done by a number of other OECD countries, including the UK, Canada and the US. As others have pointed out, this can be achieved in a variety of ways[10].

Indexation would constitute modest, but nevertheless real, tax and fiscal reform. It would slow, but not entirely arrest, our increasing dependence on income tax over consumption tax[11]. It would also prevent the progressivity of our personal tax system being further eroded.

Perhaps most critically, indexation would bring greater balance to our current budget debate. Given the hidden nature of bracket creep, it is not surprising that it is relied upon for fiscal repair. This is not a healthy situation. Views will always differ on the role that spending restraint and tax increases should play in reducing deficits. It is far better that this debate takes place in the open. We expect spending cuts, if proposed, to be clearly outlined and explained. The same should apply to tax increases. A budget debate conducted along these lines will allow the public to make informed decisions.

Conclusion

We are not predicting that governments will give up the easy revenue that bracket creep generates; at least not any time soon. Indeed, if governments have no appetite to cut spending, bracket creep will play an important role in budget repair. The public do not appear to be especially concerned about this. But as argued in this paper, bracket creep lacks transparency, is inefficient and regressive. Over time, its economic costs will escalate. One-off tax relief will be eroded over time. At some point, the public might demand a stronger, lasting policy response.

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9 Indeed, if limits and caps applying to superannuation contributions, negative gearing and other deductions are not indexed, their real value will also be eroded overtime (as nominal and real wages rise), increasing effective tax rates.

10 R Carling and M Potter, *Exposing the stealth tax: the bracket creep rip off*, CIS Research Report, December 2015, page 20.

11 Other factors can lift the income tax share of overall revenues, including the natural growth of the labour force. As mentioned earlier, the narrowing of our consumption tax base is also affecting our tax mix.

Let’s talk

PwC wants to encourage and stimulate debate on tax reform. For further information, please contact:

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