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NATSEM at the University of Canberra

NATSEM Policy Insight 2020/2

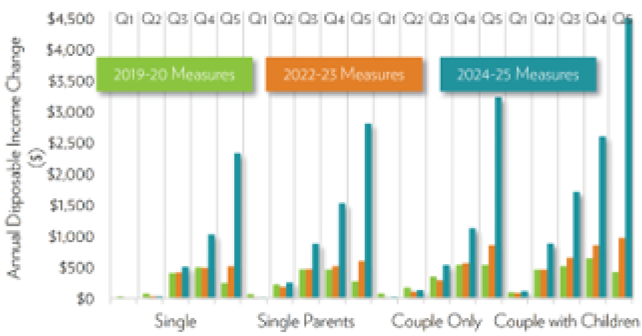
Who benefits from tax cuts?

The Government has announced in the Budget this week tax cuts as a stimulus to the Australian economy. But what is the evidence that tax cuts will stimulate the economy? This policy insight looks at the Australian and international literature on whether tax cuts stimulate the economy.

A series of tax cuts were announced in the 2019 budget, some of which applied in 2019/20; and then two additional stages designed to return additional revenue due to bracket creep to middle and high income earners. Bracket creep occurs when incomes rise and the tax thresholds stay the same; over time, workers pay more in tax, so the tax thresholds need adjusting to keep pace with wage increases.

In this budget, the Government has announced they will bring forward the tax cuts planned for 2022-23. These tax cuts increased the top threshold of the 19 per cent tax bracket from $41,000 to $45,000; and increased the low Income tax offset by $55, from $645 to $700. Despite this targeting of middle and low income earners, NATSEM's analysis from the 2019 budget showed that because high income earners also benefit from the tax rate changes, they still benefited the most from the tax cuts – see Figure 1.

Figure 1: Increase in incomes from the 2022-23 tax cut, as modelled by NATSEM for the 2019 Budget



The Government's argument is that they have brought forward the tax cut because it will stimulate the economy – people will spend more. But is there any evidence that this is true?

There has certainly been research in Australia and overseas on how people react to an increase in income. In Australia, the Reserve Bank published research in 2009 (Berger-Thomson et al., 2009) that used the Household Income and Labour Dynamics in Australia (HILDA) survey to estimate what is called by economists the "marginal propensity to consume" between 2005 and 2007 from changes to income tax rates; and lump sum transfers to households. They looked at this by income level, and concluded that "Lower income households tend to consume a greater share of extra income".

In the US, two papers from the National Bureau of Economic Research, one in 2004; and one in 2017, found similar results. The first looked at rebates provided to taxpayers in the US, and found that "households spent about 20 – 40 per cent of their rebates on non-durable goods … The estimated responses are largest for households with relatively low liquid wealth and low income" (Johnson et al., 2004).

Analysis of tax cuts in the US using a model from the NBER called TAXSIM (a microsimulation model similar to NATSEM's STINMOD+ model) in the US found that "the positive relationship between tax cuts and employment growth is largely driven by tax cuts for lower-income groups, and that the effect of tax cuts for the top 10% on employment growth is small" (Zidar, 2017).

All these approaches use some fairly complicated statistical modelling techniques to identify what will be spent from an increase in incomes. All find low income earners are more likely to spend any increase in income

The justification of the tax cuts (negating bracket creep) might have been valid in 2019 when we were looking at a surplus in a few years, but COVID has changed all that. We now need to be looking at how we can stimulate the economy. The evidence from Australia and overseas shows that bringing the tax cuts forward won't be as effective as putting money into the pockets of low income households (eg, increasing/keeping jobseeker). This is what will stimulate the economy as the money feeds directly back into the economy as low income families are more likely to spend this money, creating more employment. Further, tax cuts only go to those employed, and due to COVID, many are now unemployed, so won't be spending their tax cut; but would be spending higher Jobseeker benefits.

A mix of targeted tax cuts (which are a valid fiscal policy) and higher payments to unemployed workers would target low income families better than just tax cuts.

References

Berger-Thomson, L., Chung, E., McKibbin, R., 2009. Estimating marginal propensities to consume in Australia using micro data. *RBA Research Discussion Paper 2009-07.*

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NATSEM's policy insights aim to be short pieces using readily available data to inform policy.

MORE INFORMATION

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