Restoring growth:
Tax cuts or payments and services?

June 2019

About ACOSS

The Australian Council of Social Service (ACOSS) is a national advocate for action to reduce poverty and inequality and the peak body for the community services sector in Australia. Our vision is for a fair, inclusive and sustainable Australia where all individuals and communities can participate in and benefit from social and economic life.

Summary

- The Reserve Bank of Australia (RBA) and many experts advocate more action by the Government to boost flagging growth in Gross Domestic Product (GDP) and household incomes and spending.

- Direct expenditures (especially on timely public infrastructure projects) and transfer payments generally have a stronger short-term impact on growth than income tax cuts. This is due in part to household saving patterns, with tax cuts often going to people on higher incomes who are more likely to save them rather than spend them.

- The second and third stages of the Government's proposed tax cuts are skewed towards high income-earners. In the context of high household debt, much of these tax cuts will be saved. Further, those stages are not due to be implemented until 2022 and 2024, when the state of the economy (and the Budget) is not known.

- In contrast, a $75 a week increase in Newstart and related allowances for single people and single parents would mainly go the poorest households and regions. Since they have little choice but to spend any extra dollar on essentials like food and rent, the money would be quickly spent, lifting jobs and growth in the regions that need it most.

- After 25 years of no increase in these payments beyond inflation, this is a long overdue structural reform.[1] It would ease the worst poverty and improve people's capacity to search for paid work without undermining returns from full-time employment. It would bring many other social and economic benefits including improved physical and mental health, improved well-being for children in families relying on these payments, and a greater capacity for people who are unemployed to live in regions where jobs are more readily available (where rents are usually higher).

- Other options to strengthen growth in investment and consumer demand include public investment in social housing (the most cost-effective way to resolve our homelessness crisis) and investment in renewables and energy efficiency to reduce our carbon footprint and energy bills.

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[1] Economists increasingly recognise the long-term economic benefits of social expenditures, which were previously viewed as a 'deadweight cost' for national economies. See for example, this recent speech by Christine Lagarde, Managing Director of the IMF.

Growth in incomes, consumer spending and jobs is slowing

With wages and consumer spending stalling and unemployment increasing, public concern is growing around the future of jobs and economic opportunities.

The latest GDP figures had economic growth slowing to 1.8% over the year to March 2019. In June the RBA cut interest rates for the first time in three years. The hope is that the rate cut will ease pressures on people with large mortgages, causing them to spend more money. Together with the easing of credit restrictions by the Australian Prudential Regulation Authority (APRA), this may also bring to an end the recent declines in house prices, though at the expense of housing affordability.

The RBA's growth forecasts for the next few years (published in June) are already lower than those in the 2019 Budget (published in April). The Budget forecast growth in GDP of 2.75% in 2019-20 but the RBA now expects growth of 2.5%.[2] While the budget is predicated on wages growing by 2.75% per cent in 2019-20 and 3.25% the following year, the RBA now predicts wages will rise by 2.5% next year and by just 2.6% in 2020-21.

With interest rates at historic lows, there's not much more the RBA can do through monetary policy to support stronger economic activity. As the Governor urged again on 4th June 2019, fiscal policy (budget policy) must also play its part. Government must also act.

In fact, government spending is already holding the economy above water. Public consumption (services such as the rollout of the NDIS) grew by 5.1% over the year to March while household consumption rose by just 1.8%. But over the next four years, real growth in Commonwealth expenditure is slated to fall to its lowest level in 50 years.[3]

RBA Governor (Philip Lowe) Sydney, 4/6/19

"There are certain downsides from relying just on monetary policy and there are limitations on what, realistically, can be achieved. So, as a country, we should also be looking at other options to reduce unemployment.

One option is for fiscal support, including through spending on infrastructure. This spending not only adds to demand in the economy, but it also adds to the economy's productive capacity. So it works on both the demand and supply side.

Another option is structural policies that support firms expanding, investing, innovating and employing people."

Lowe, Philip (2019): "Look beyond monetary policy for a stronger Australia" *Australian Financial Review*, Tuesday June 4, 2019. Available: https://www.afr.com/news/economy/look-beyond-monetary-policy-for-a-stronger-australia-20190604-p51ugu

[2] RBA, 'June 2019 Forecasts' at https://www.rba.gov.au/publications/smp/2019/may/economic-outlook.html
[3] ACOSS (2019), 'The uncertain future of essential services'.

The impact of different policies on GDP growth

There are a number of ways governments can boost growth in consumer demand, incomes and jobs:

- By investing directly in public infrastructure;
- By raising expenditures on government-funded services like the NDIS;
- By increasing payments to the States or local government for those purposes;
- By increasing social security payments to people with low incomes;
- By lowering personal income taxes;
- By lowering company or other business taxes.

Public consumption boosts growth directly, while payments to States, social security recipients, and tax cuts have an indirect impact. The strength of that impact depends on the degree to which the recipients spend the additional income themselves. For example, at a time like the present when household debt is high, many people are likely to save much of any increase in their incomes. Similarly, companies can either pay off debt or invest the extra income, and this depends very much on whether there is sufficient demand for their products from households (or other countries). If consumers are reducing their spending, companies are much less likely to invest.

The impact of these government efforts to strengthen demand depends on many factors including:[4]

- How quickly the money can be spent (a major issue with large public infrastructure projects such as highways);
- If the money goes to households, their saving patterns (generally, high income-earners are more likely than low income-earners to save any extra income);
- If money goes to other governments, their commitment and capacity to spend it quickly;
- The state of the economy (if growth is slower, a boost from the government is more likely to be have an impact because it is less likely to 'çrowd out' private sector activity);
- The impact on the currency exchange rate (an increase in economic growth or an inflow of foreign capital to Australia will, all things equal, increase the value of the dollar, which may slow the economy since exports are less competitive);
- How interest rates respond (if the RBA keeps interest rates low – as is likely now – the impact of government action is greater than where fiscal policy and interest rate policy are working against each other);
- Whether interest rates are already very low, as they are now (in which case the impact of government action is greater since there is less the RBA can do on its own).

[4] Whalen C & Reichling F (2015): "The Fiscal Multiplier and Economic Policy Analysis in the United States", Washington, Congressional Budget Office Working Paper 2015-02 Available: https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/workingpaper/49925-FiscalMultiplier_1.pdf; Coenen G et al (2010), 'Effects of Fiscal Stimulus in Structural Models', IMF Working Paper 10/73; Ramey, V (2019), 'Ten Years After the Financial Crisis: What Have We Learned from the Renaissance in Fiscal Research?' Journal of Economic Perspectives Volume 33 Number 2 pp 89–114.

There is often a trade-off between government action that can boost the economy quickly and the quality of the services or projects that are funded. This applies especially to public infrastructure. This is important, since higher government expenditure will (all things equal) increase public debt and that increase in debt is more justifiable if the services or projects have long-term economic and social benefits.

Experts have called for efficiency-boosting 'microeconomic reforms' to strengthen future productivity and growth.[5] These usually have a longer term pay-off, though some of the best short-term growth-enhancing measures (especially well-crafted public infrastructure investment) also improve future productivity. However, microeconomic reforms are unlikely on their own to boost growth in the short term, and may reduce it to the extent that they increase uncertainty for businesses and households at a time when people are risk-averse, and thus dampen investment and household consumption. Examples of this include disruptive changes to workplace relations and the ongoing uncertainty over energy policy.

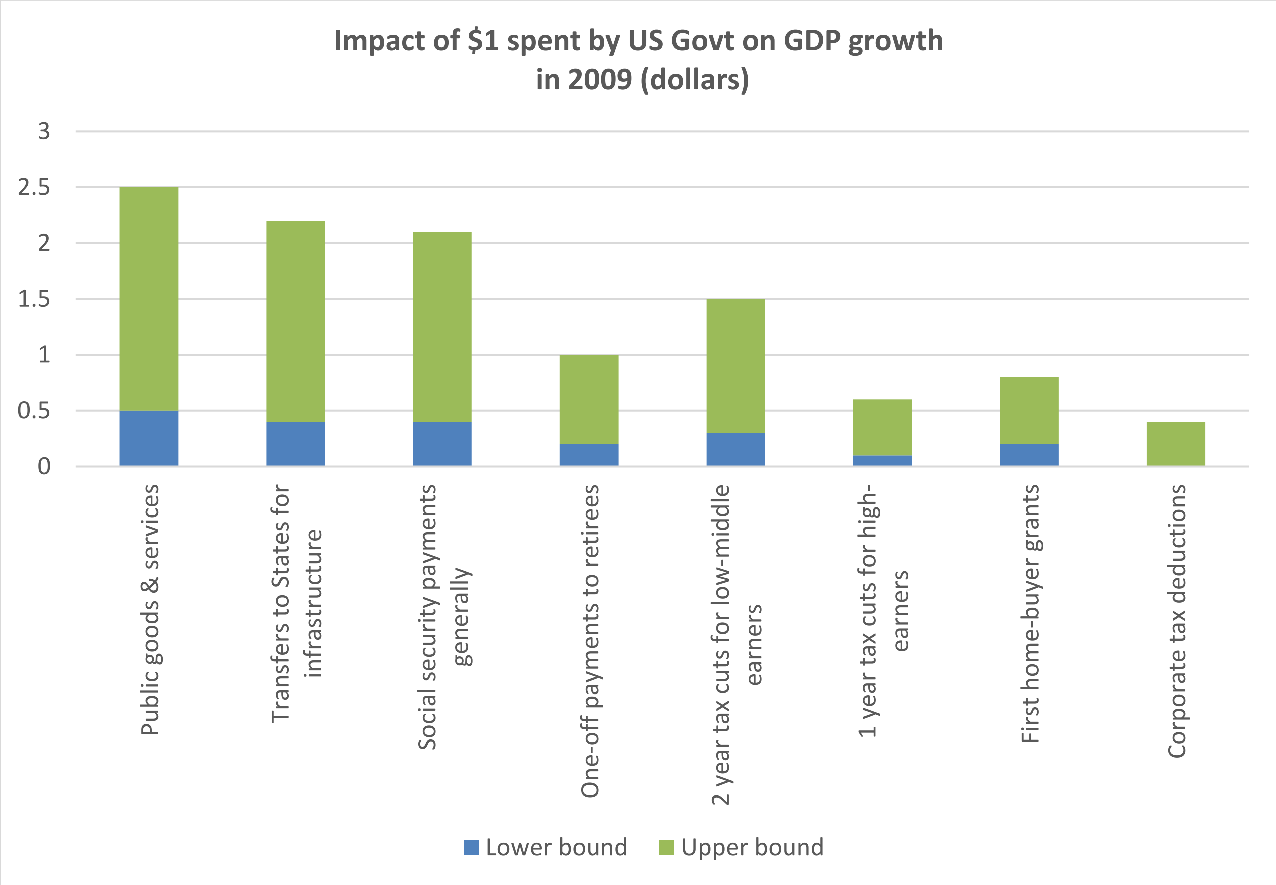
While we agree there is a need for structural reforms (for example in health, skills, tax and climate policy) to improve flagging productivity growth over the longer-term, this briefing focusses on policies to strengthen growth in incomes and consumption in the short to medium term.

Figure 1 compares the impact of different government initiatives on growth in GDP in the short-term (the next few years), using 'multipliers': that is, the change in a nation's economic output generated by each dollar of additional public expenditure or tax reductions. If the value of the multiplier is one, then all of the additional public spending flows into higher growth in GDP. If less than one, some of the extra spending is absorbed, for example into household or corporate savings or imports. If greater than one, the extra spending generates stronger overall growth though positive 'feedback effects', for example due to improved consumer confidence and more employment.

These estimates for fiscal multipliers are from the stimulus package implemented in the United States in 2009. However, the ranking of different policies according to their impact on overall economic growth is generally similar in other studies.[6]

[5] Productivity Commission (2019), 'PC Productivity Bulletin', May 2019.
[6] See for example an international comparison by the IMF: Coenen G et al (2010), 'Effects of Fiscal Stimulus in Structural Models', IMF Working Paper 10/73.

Figure 1: Some government actions have more impact on growth than others



Source: CBO analysis of American Recovery & Reinvestment Act 2009 - Whalen C & Reichling F (2015): "The Fiscal Multiplier and Economic Policy Analysis in the United States", Washington, Congressional Budget Office Working Paper 2015-02 Available: https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/workingpaper/49925-FiscalMultiplier_1.pdf

Note: The 'upper and low bounds' take account of margins for error in the research.

There is a clear order of cost effectiveness here (all things equal):

- Public goods and services (especially infrastructure if the timing is right) are the most cost-effective;
- Higher social security payments are more effective than personal tax cuts;
- Personal tax cuts for low and middle income-earners are more effective than those for high income-earners;
- Personal tax cuts are more effective than business investment incentives.

The US Congressional Research Service recently published an assessment of the economic impact of the 'Trump Tax Cuts' (to personal income tax and company tax) implemented in 2017. It found that their impact on growth in GDP and consumer spending was 'small'. One reason for this was that: '*Much of the tax cut was directed at businesses and higher-income individuals who are less likely to spend*.'[7]

Congressional Research Service analysis of the Trump tax cuts

The corporate and personal tax cuts summarised

'The 2017 Tax Cuts and Jobs Act, and referred to subsequently as the Act, was estimated to reduce taxes by $1.5 trillion over 10 years. The Act permanently reduced the corporate tax rate to 21%, made a number of revisions in business tax deductions (including limits on interest deductions), and provided a major revision in the international tax rules. It also substantially revised individual income taxes, including an increase in the standard deduction and child credit largely offset by eliminating personal exemptions, along with rate cuts, limits on itemized deductions (primarily a dollar cap on the state and local tax deduction), and a 20% deduction for pass-through businesses (businesses taxed under the individual rather than the corporate tax, such as partnerships).'

Their cost

'The Congressional Budget Office (CBO) estimated in April of 2018 that the Act would result in a $65 billion reduction in individual income taxes, a $94 billion reduction in corporate taxes, and a $3 billion reduction in other taxes, for a total of $163 billion (after rounding) for the fourth quarter of 2017-18.'

Impact on GDP growth

'The tax cut in calendar year 2018 accounted for about 1.2% of GDP.
CBO projected real GDP growth for the calendar year 2018 of 3.3% (indicating a projected 3% growth rate without the tax cut). According to the National Income and Product Accounts, the actual growth rate was 2.9%, which is consistent with a *small effect of the tax revision*, perhaps even smaller than projected by most analysts.'

Impact on consumption growth

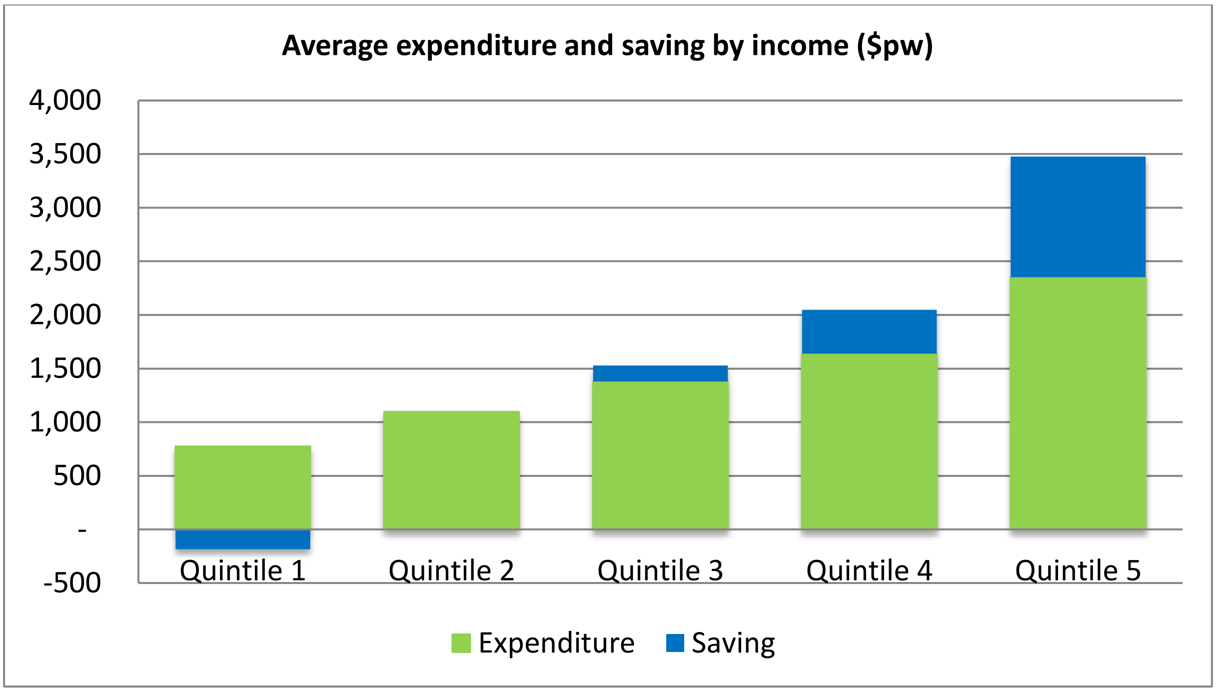
'Consumption grew at 2.6% in 2018 in real terms, about the same as 2017 (which was 2.5%) and below 2014-2016 (although higher than 2013). The initial effect of a demand side is likely to be reflected in increased consumption and the data indicate little growth in consumption in 2018. *Much of the tax cut was directed at businesses and higher-income individuals who are less likely to spend*. Fiscal stimulus is limited in an economy that is at or near full employment.'

Source: Gravelle J & Marples D (2019), The Economic Effects of the 2017 Tax Revision: Preliminary Observations, Washington DC, Congressional Research Service. *Italics added*.

[7] Gravelle J & Marples D (2019), The Economic Effects of the 2017 Tax Revision: Preliminary Observations, Washington DC, Congressional Research Service.

In Australia, income tax cuts are likely to be much less effective than increases in social security payments because the lowest 30% of households by income do not pay income tax. Low-income households have little choice but to spend every extra dollar they receive on essentials like rent and food. Thus, social security payments targeted to such households are more likely to be spent. In contrast, at a time when middle and high income-earners are heavily in debt, the temptation will be to use a tax cuts to pay down the mortgage and credit card. On average, the highest 20% of household by income save one third of their income, while the lowest 20% 'dis-save' – draw down their savings or borrow money to cover basic expenses (Figure 2).

Figure 2: High income-households save much more than those on lower incomes



Source: ABS (2018), Household Expenditure Survey. Canberra

The impact of the government's tax cuts

The government's tax cuts come in three stages commencing in 2019, 2022 and 2024 (but the impact of the second stage on the budget is not fully felt until 2023). Roughly half the tax cuts (announced in the 2018 budget) are already legislated, while the other half (announced in the 2019 budget) are not.

Stage 1 commenced in 2018 and the government proposes to extend it from July 2019 although the extension is not yet legislated. It costs $8 billion in 2019-20, of which $3.5 billion is not yet legislated.

It mainly comprises a Low and Middle Income Tax Offset worth up to $1,080 a year for taxpayers on $30,000 to $126,000 (including an increase of $550p.a. that is not yet legislated).

Overall, Stage 1 *mainly goes to middle income-earners* on $30,000 to $90,000.[8]

Stage 2 commences in 2022. It costs approximately $16.4 billion in 2023, of which approximately $6 billion is not yet legislated.

At this stage, the Low and Middle Income Tax Offset is abolished and replaced by an increased lower threshold (to $45,000) for the 32.5% tax rate and an increase in the Low Income Tax Offset.

High income-earners are the main winners from the replacement of the income-tested tax offset with a higher 32.5% tax threshold, with those on $100,000 and above gaining up to $1,080p.a. ($550 from the unlegislated changes)

High income-earners are also the main winners from an increase in the top threshold of the 32.5% tax rate from $90,000 to $120,000, which is already legislated. Those earning $90,000 or more gain up to an extra $1,350p.a. from this change.

Stage 3 commences in 2024, and costs approximately $18 billion in 2024, of which approximately $12 billion is not yet legislated.

Stage 3 would dramatically 'flatten' the tax scales by abolishing the 37% tax rate and lifting the upper threshold of the 32.5% rate to $200,000. This is already legislated.

The government now proposes to reduce the 32.5% tax rate (which would apply to incomes from $45,000 to $200,000) to 30%.

High income-earners are the main winners from Stage 3, with gains of $1,125p.a for an individual on $90,000, rising to $9,075p.a for a person on $200,000 or more. This includes an unlegislated increase worth $1,125p.a for a person on $90,000, rising to $3,875p.a for someone on $200,000 or more.

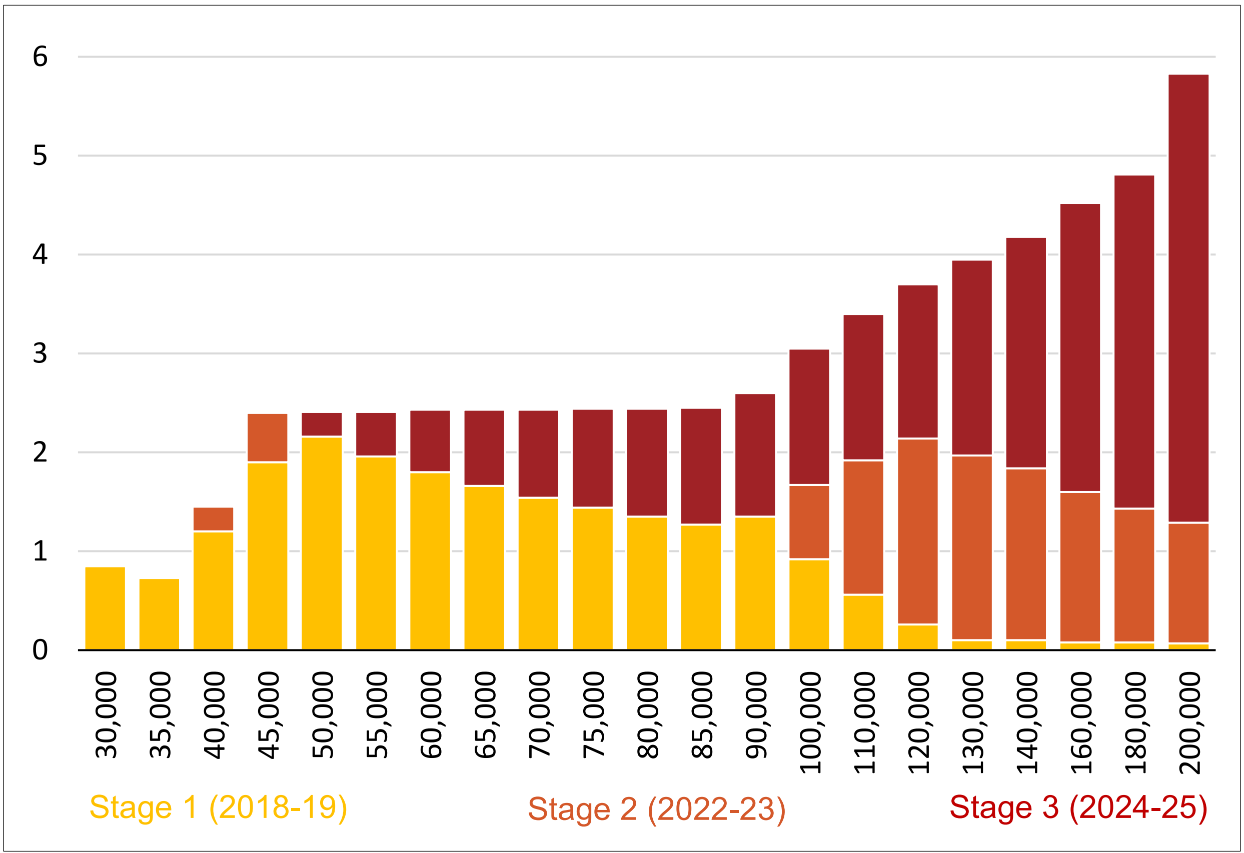
The overall package costs approximately $35.7 billion in 2024 when fully implemented, though the government has not yet released annual costs for Stages 2 or 3.

Including all stages, the tax cuts disproportionately benefit high-income individuals and households:

- Most individuals on $30,000 or less, and the lowest 30% of households, do not benefit from the tax cuts because their taxable incomes are too low to pay income tax.
- A middle income-earner on $50,000 gains $1,205.
- A high income-earner on $200,000 gains $11,640.

[8] The median (middle) taxable income for taxpayers is approx. $45,000 and the lowest income of the top 20% of taxpayers is around $90,000.

Figure 3: The impact of the three stages of the Government's tax cuts on personal incomes (% of taxable income)



Source: Wood D (2018) 'A decade of budget surpluses?' WEN Treasury post-budget event, Canberra, 8 April 2019. Grattan Institute

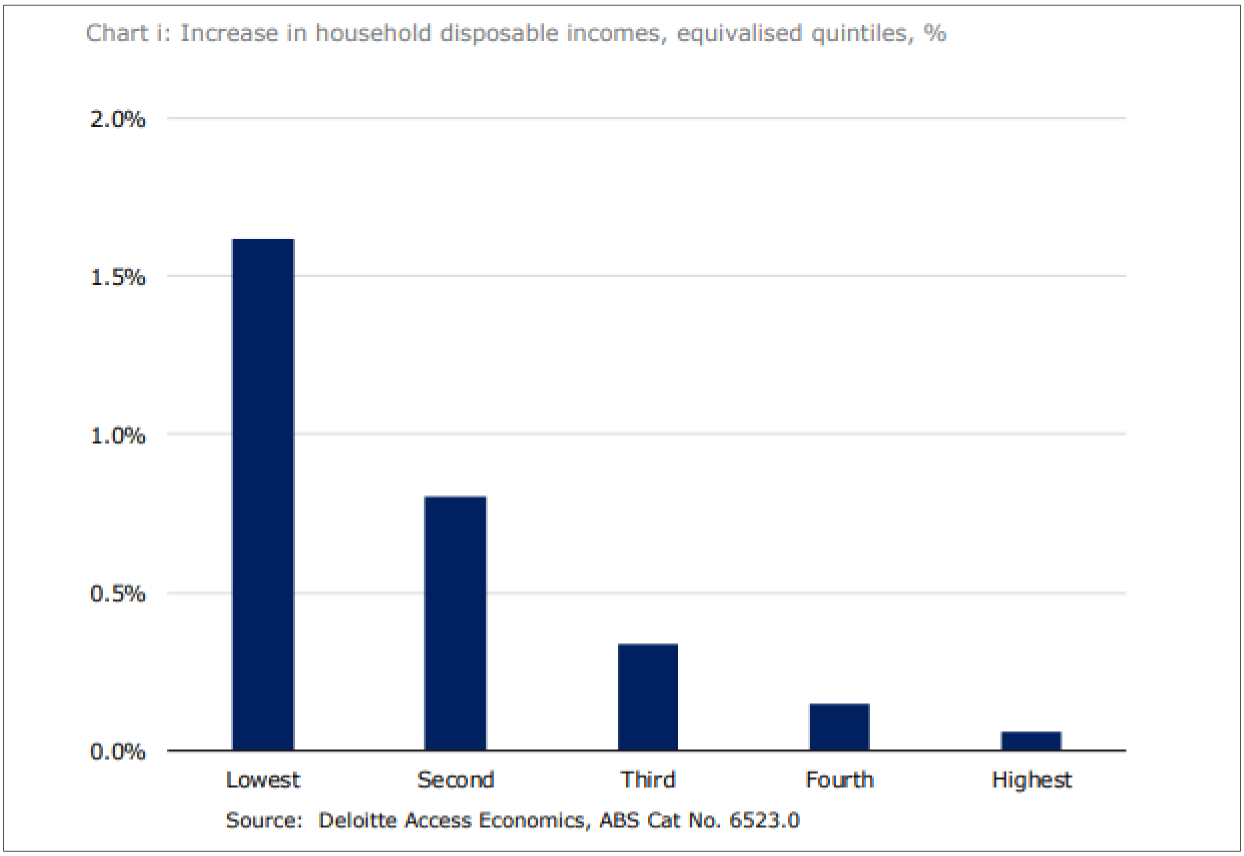
Since they predominantly go to middle income-earners and are due to be paid this year, the first stage of the proposed tax cuts is likely to boost growth in jobs and economic opportunities, though much of them will be saved by highly-indebted households.

The stage 2 and 3 tax cuts are both poorly timed (commencing 3 to 5 years away) and poorly targeted (towards high income-earners) to have a significant impact on a slowing economy.

The impact of a $75 per week increase in Newstart and related allowances

By contrast, the $75 per week increase in Newstart and related allowance payments (including Youth Allowance) for single people and single parents proposed by ACOSS would go mainly to the lowest 20% of households ranked by income (Figure 4)

Figure 4: The impact of a $75pw increase in single allowance payments (% of household disposable taxable income)

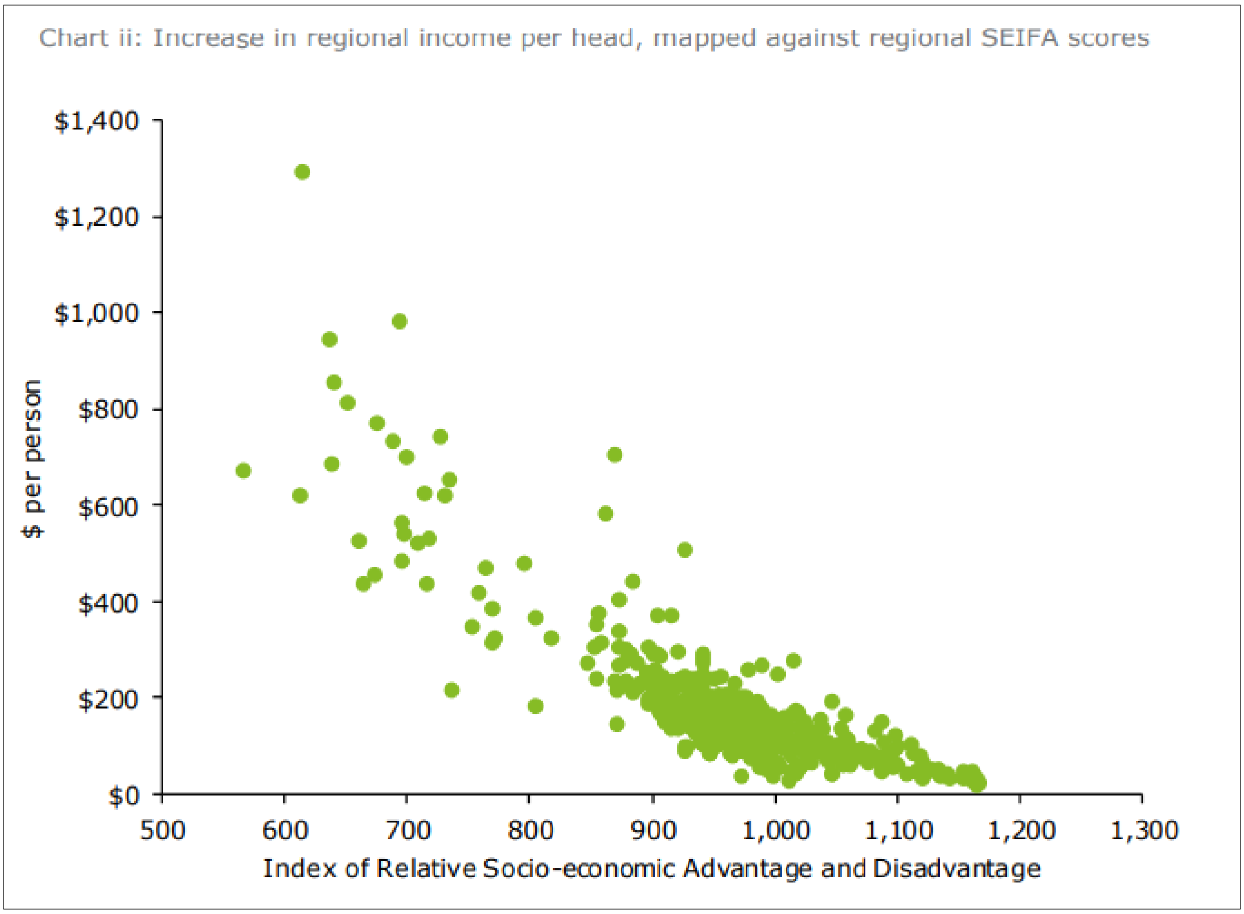


Source: Deloitte Access Economics (2018), 'Analysis of the impact of raising benefit rates for the Australian Council of Social Service.' Canberra. Available: https://www.acoss.org.au/wp-content/uploads/2018/09/DAE-Analysis-of-the-impact-of-raising-benefit-rates-FINAL-4-September-...-1.pdf

Since people relying on these payments have little choice but to spend every extra dollar on the essentials of life such as food and rent, most of any increase in those payments is likely to be quickly and regularly spent.

Further, it is likely to be spent mainly in the poorest regions – those that would otherwise be worst affected by any economic downtown. Figure 5 shows how the money is likely to be distributed across different parts of Australia ranked by the ABS SEIFA index of economic disadvantage. The lowest SEIFA scores (on the left of the graph) represent poorer regions.

Figure 5: The regional impact of a $75pw increase in single allowance payments ($ per person paid to each region)



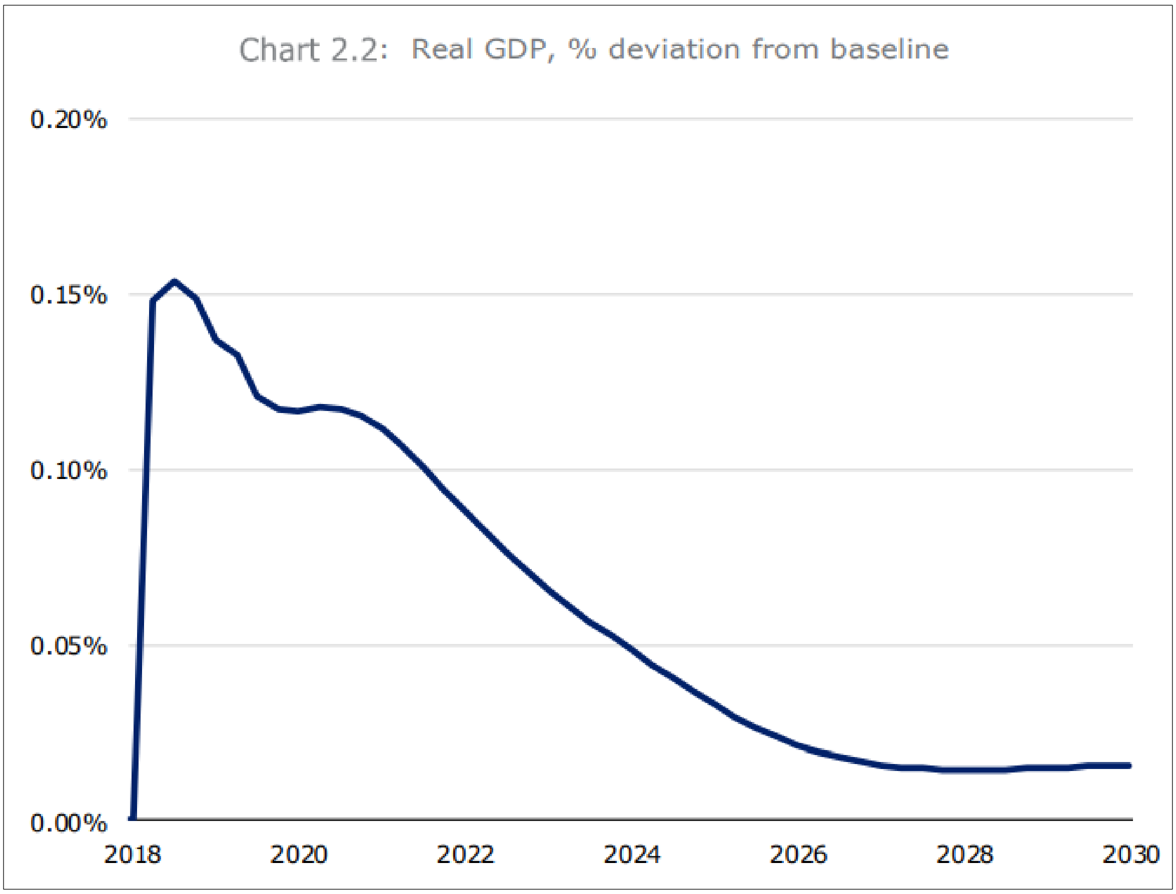
Source: Deloitte Access Economics (2018), 'Analysis of the impact of raising benefit rates for the Australian Council of Social Service.' Canberra.

Figure 6 shows the projected impact of the increase in Newstart and related payments on economic growth (GDP). This peaks at a rise of 0.15% of GDP in the first year as the money is spent by households, and then tapers off over the next 8 years or so as the economy adjusts to the change, and income taxes gradually rise in the absence of a personal tax cut. Deloitte did not model income tax cuts over the period (though tax cuts are likely within this time-frame), since the purpose of the modelling was to estimate the impact of an increase in Newstart.

The estimated cost of the increase in allowance payments is $3.3 billion in the first year. However, this is partly offset by higher income tax collections and other fiscal outcomes from higher demand for goods and services across the economy. When those benefits to the government budget are factored in, the 'net' cost is around $2.8 billion.

The short to medium-term economic boost from a $3.3 billion increase in allowance payments is likely to be much greater than from a $3.3 billion income tax cut, for the reasons discussed above.

Figure 6: Impact of a $75pw increase in single allowance payments on growth in GDP (% change in GDP from first year of the increase)



Source: Deloitte Access Economics (2018), 'Analysis of the impact of raising benefit rates for the Australian Council of Social Service.' Canberra.

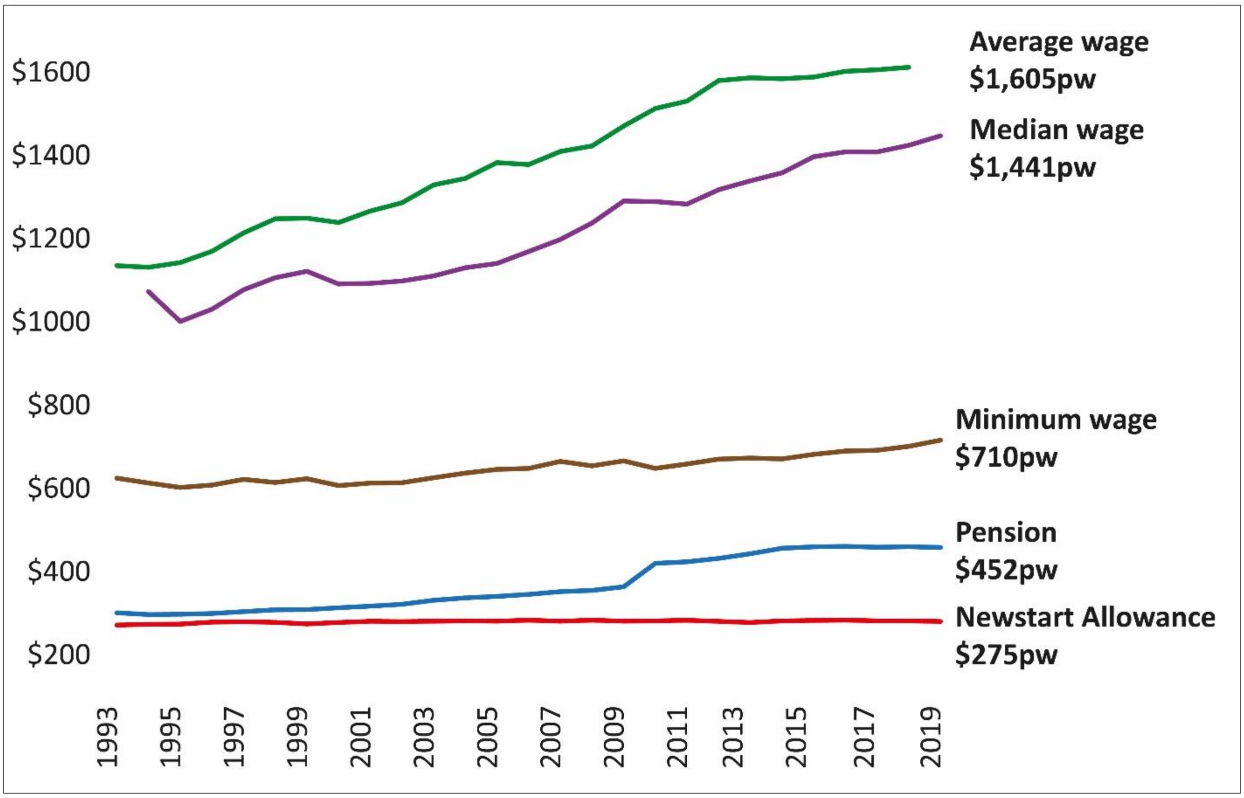
An increase in Newstart Allowance is also a structural reform, with long-term economic and social benefits.

The benefits for those who rely on these payments are clear. It is not possible to live decently on $282 a week. In addition, by easing the worst poverty, the increase would improve people's capacity to search for paid work without undermining returns from full-time employment. As Figure 7 shows, Newstart is currently less than half the value of the minimum full-time wage.

By easing the worst poverty, an increase in Newstart would bring other social and economic benefits, including improved physical and mental health, improved well-being for children in families relying on these payments, and a greater capacity for people who are unemployed to live in regions where jobs are more readily available (where rents are usually higher).

Figure 7 also shows that Newstart Allowance has not increased (when inflation is taken into account) for 25 years (since 1994), while wages, pension payments and community living standards have risen significantly over the same period. The spending capacity of people relying on these payments is the same as it was at a time when the internet was in its infancy and few people had mobile phones.

Figure 7: The value of Newstart Allowance for single adults compared with pensions and wages, over time ($ per week in 2018 values).



An increase in Newstart Allowance would make a huge difference to the lives of people who have been left behind, and would be much more effective than income tax cuts in boosting growth in consumer demand and jobs.