

## Assessing the fiscal and distributional impacts of proposals to index tax brackets

Briefing note

April 2025

### Summary

In this brief we estimate the cost to government of indexing the income tax thresholds to the CPI, and who benefits the most from the resulting tax reductions. We compare this with the impacts of discretionary tax cuts implemented over past decade, and the Federal Government's recently announced cut to the lowest (16%) marginal tax rate.

The key findings are that:

- In the absence of tax increases or expenditure savings to pay for it, indexing the personal income tax thresholds to the Consumer Price Index (CPI) from 2024-25 would cost governments \$38 billion a year by 2030-31 (similar to the projected \$39 billion spend on Medicare and double the projected \$16 billion spend on unemployment payments);
- Individuals with annual incomes over \$125,000 in 2024-25 dollars (around the highest 20% of tax filers) would receive over half (54%) of the resulting tax reductions;
- Those on \$75-\$125,000 (around 30% of all tax filers) would receive approximately one fifth (22%);
- Those on \$75,000 or less (around half of all tax filers) would receive approximately one quarter (24)%;
- 60% of the resulting tax reductions would go to men and just 40% to women;
- 30% of households would get no benefit because their incomes are too low (yet they need help the most).

While it may be argued that indexation of tax thresholds is the most accurate way to 'end' tax bracket creep, tax reform has other important objectives including raising adequate public revenue and doing so in way that is fairer and more efficient:



- Compared with discretionary tax cuts, indexation does not necessarily make the tax system more progressive.
- In the absence of lasting reforms that substantially lift public revenue, indexation would undermine the capacity of future governments to provide the services and supports we need.

#### What are tax bracket creep and indexation?

Recent tax debate has focused on proposals to index the personal income tax thresholds to the Consumer Price Index (CPI) to 'eliminate tax bracket creep'.<sup>1</sup> Bracket creep occurs when rising incomes lift more of people's incomes into higher tax brackets.<sup>2</sup> Calls to index tax thresholds come in response to concerns that in recent years all or most of recent increases in people's incomes has been offset by price inflation. Consequently, people have paid more income tax at a time when they are under financial pressure from price inflation.

Indexation would require legislation to increase each income tax threshold (such as the \$18,200 threshold for the current 16% tax rate) by the CPI for each financial year. For example, the 16% tax threshold would rise by 3% to \$18,655 in 2025-26. Thresholds for the Medicare Levy and Low Income Tax Offset would also be indexed.

Far less attention has been paid to how tax indexation would be funded, who would ultimately benefit and who could lose out. The last time tax thresholds were indexed, by the Fraser government in 1976, it was reversed within five years due in part to its budgetary cost and the risk that budget deficits would increase and higher disposable incomes would fuel inflation.<sup>3</sup>

## It's unrealistic to compare the impacts of tax indexation with no tax reductions at all

A realistic assessment should compare the impact of indexation with that of the discretionary tax cuts for which it is a substitute. In the absence of indexation, it is very likely that income taxes would be cut again within around five years' time. On the other hand, discretionary tax cuts would not come as often if indexation were introduced. Analysis by the Parliamentary Budget Office (PBO) confirms the offsetting effect of discretionary tax cuts against bracket creep over time:

*`'Outside periods of budget repair, governments have periodically increased tax thresholds or lowered tax rates, with the effect of reducing or even reversing the impact* 

<sup>&</sup>lt;sup>3</sup> Kelly P (2025), *Lesson of history looms large on taxation reform.* The Australian 22/4/25.



<sup>&</sup>lt;sup>1</sup> Henry K (2025), Speech to Per Capita Conference, February, Grattan M (2025), *Peter Dutton's tax indexation 'aspiration' has merit – so why didn't we hear about it before*?; Spender A et al (2025), *Protecting working Australians from bracket creep*.; Kehoe J (2025), *Dutton urged to index income tax brackets.* AFR 26/3/25.

<sup>&</sup>lt;sup>2</sup> In addition to increasing the marginal tax rate on the next dollar of income, bracket creep also increases the share of income that attracts higher tax rates further down the scale (for example more of an individual's income is taxed at 16% rather than zero). While bracket creep refers to the impact of rising *incomes* on tax paid, indexation of tax thresholds is generally designed to redress the impact of *consumer price inflation* on taxes paid. To the extent that an individual's real (after inflation) income rises, for example due to a pay rise or higher investment returns, it is appropriate in a progressive income tax system that their overall tax rate also increases.



of bracket creep – this is referred to as 'returning' bracket creep. These regular changes have kept the overall average personal income tax rate varying between 22 and 25 per cent of income for most of the past forty years." <sup>4</sup>

## **'Unfunded' tax indexation would impact government funded services and supports**

The other practical implication of automatic tax indexation is its very substantial impact on public revenue and the ability of governments to provide the essential services and safety nets we need. In the absence of a clear commitment to tax reforms to raise more revenue, governments would be pressured to cut those programs.

If automatic indexation is not paid for by comprehensive reforms to the tax system (such as removing tax shelters and loopholes exploited by people and companies with high incomes), those most at risk are the 30% of households whose incomes are too low to pay income tax. They are unlikely to benefit from tax indexation for the foreseeable future but could be deprived of the services and supports they need.

## Indexing tax thresholds to the CPI from 2024-25 would cost the Budget \$38 billion a year by 2030-31, similar to Commonwealth spending on Medicare

The last income tax cuts were the revised 'Stage 3' tax cuts commencing in 2024-25. In the absence of tax increases or expenditure savings to pay for it, indexing the personal income tax thresholds (including the LITO and Medicare Levy) to the Consumer Price Index (CPI) from 2024-25 to 2034-35 would cost governments:

- \$38 billion in 2030-31 (similar to the projected \$39 billion spend on Medicare and double the projected \$16 billion spend on unemployment payments);
- \$81 billion in 2034-45;
- \$371 billion over the ten years from 2024-25 to 2034-35.<sup>5</sup>

## The resulting tax reductions would be skewed towards the highest 20% of personal income tax filers

- Individuals with annual incomes over \$125,000 in 2024-25 dollars (around the highest 20% of tax filers) would receive over half (54%) of the resulting tax reductions;
- Those on \$75-\$125,000 (around 30% of all tax filers) would receive approximately one fifth (22%);
- Those on \$75,000 or less (around half of all tax filers) would receive approximately one quarter (24)%;

• 60% of the resulting tax reductions would go to men and just 40% to women. Since this analysis uses data on individuals registered with the Australian Taxation Office (ATO), it leaves out many people on the lowest incomes who are not required to register. We estimate that around 30% of individuals are in households that don't pay income tax in a given year, mainly because their incomes are too low.<sup>6</sup>

<sup>&</sup>lt;sup>6</sup> Davidson P, Bradbury B & Wong M (2024), *Income inequality in Australia – who is affected?* ACOSS & UNSW Sydney.



<sup>&</sup>lt;sup>4</sup> PBO (2021), *Bracket creep and its fiscal impact*. Budget explainer No. 1.

<sup>&</sup>lt;sup>5</sup> These amounts are expressed in current (e.g. 2030-31) dollars not in 2025 values (so are higher than expenditures in the present fiscal year).



## If we treat Labor's 2026/2027 tax cuts as a *down-payment on indexation*, the *remaining* cost of indexing income tax thresholds is \$28 billion in 2030-31.

The tax cuts announced in the 2025 Budget would reduce the lowest marginal tax rate from 16% to 15% in 2026-27 and 14% from 2027-28.

If we subtract their cost from the above estimates, indexing the tax scale would cost a net \$28 billion in 2030-31, rising to \$69 billion in 2034-45 and \$288 billion over the ten years from 2024-25 to 2034-35.

## Without the 2026/2027 tax cuts, the benefits of indexation would be more skewed towards people on high incomes.

That is, the 2026 and 2027 tax cuts (lowering the first tax rate from 16% to 14%) are a less precise but more progressive response to bracket creep than indexing the tax thresholds.

If we subtract the 2025 and 2026 tax cuts from the overall tax reductions arising from indexation from 2024 to 2034:

- the highest 20% of personal income tax filers with annual incomes over around \$125,000 (in 2024-25 dollars) would secure 61% of the overall benefits from tax indexation:
- Those on \$75-\$125,000 (around 30% of all tax filers) receive one fifth (20%);
- Those on \$75,000 or less (around half of all tax filers) receive the remaining one fifth (20)%.

62% of the resulting tax reductions would go to men and just 38% to women.

#### Discretionary tax cuts can be more progressive than indexation.

For example, analysis by the E61 Institute of a decade of discretionary tax cuts from 2012 to 2022 found that average tax rates (total income tax paid as a percentage of all taxable income) rose the most for individuals with high incomes:

- The average tax rate for the highest 25% ranked by taxable income rose by 1.5 to 3.5 percentage points;
- It rose by around 1 percentage point for the middle 50%;
- It declined by 0.5% for those in the lowest 10% and rose by up to 1% among the lowest 25%.

While average tax rates increased overall – largely due to a combination of tax bracket creep and rising real (after-inflation) incomes – the resulting increase in public revenue mainly came from the highest 25% ranked by income.<sup>7</sup>

<sup>&</sup>lt;sup>7</sup> Dwyer E (2025) <u>Who pays from bracket creep?</u> E61 Institute. The outcome would have been different if the analysis extended to 2024 and the Coalition government's Stage 3 tax cuts were implemented as planned (especially the proposed extension of a 30% tax rate up to an income of \$200,000). However, those tax cuts were restructured by the Labor government and neither party has flagged an intention to restore the originally planned tax cuts for people with the highest incomes.





### Indexing the income tax thresholds would be expensive

Table 1 and Figure 1 show the cost to revenue and the overall Budget (including public debt interest expenses) of indexing the tax scales from 2024 to 2034, and the net impact if the cost of legislated tax cuts from 2026 is subtracted from these amounts.

In the absence of tax increases or expenditure savings to pay for it, indexation costs \$38 billion in 2030-31 (close to projected \$39 billion of spending on Medicare benefits and more than \$16 billion in projected spending on unemployment payments.

	In 2030-31	In 2034-35	From 2024-2034
Impact on revenue (\$B)	-\$33B	-\$66B	-\$316B
Minus the 2026 & 2027 tax cuts (\$B)	(-\$25B)	(-\$56B)	(-\$246B)
Debt interest & other expenses(\$B)	-\$5B	-\$15B	-\$55B
Minus the 2026 & 2027 tax cuts (\$B)	(-\$2B)	(-\$3B)	-(\$15B)
Impact on underlying Budget balance (\$B)	-\$38B	-\$81B	-\$371B
Minus the 2026 & 2027 tax cuts (\$B)	(-\$28B)	(-\$69B)	(-\$288B)

#### Table 1: Impact of tax indexation on the Commonwealth Budget

Source: PBO (2025), Build Your Own Budget (2025-26 Budget version and 2024 MYEFO version).



#### Figure 1: Impact of tax indexation on the Underlying Budget Balance (\$m p.a.)

Source: PBO (2025), *Build Your Own Budget (2025-26 Budget version and 2024 MYEFO version)*. Note: The lower yellow line is the impact of tax indexation on the Underlying Budget Balance. The higher grey line is the impact of indexation minus the cost of the tax cuts scheduled for 2026.





# People on the lowest incomes stand to lose the most if government benefits and services are cut

Since they do not pay income tax and rely more on publicly funded services and income supports, people on the lowest incomes are likely to lose out if the government foregoes substantial revenue from tax indexation - that is if it is not funded by major reform elsewhere in the tax system such as removing tax shelters used by people and companies with high incomes.

Figure 2 shows that if people are divided into households ranked by their private incomes (e.g. wages and investment income), the lowest 20% paid very little income tax on average but relied substantially on social security payments (such as Age Pension and Jobseeker Payment) and government funded community services (such as health care and childcare).

We estimate the vast majority of the lowest 30% of households ranked by income do not pay income tax (noting that figure 2 shows average results which combine those who paid income and those who did not).

On the other hand, those in the highest 20% of households pay substantially more income tax and rely less on government funded services and social security payments. This is how the system is meant to work:

• Government support goes disproportionately to those who need it most and income tax raises revenue from those with greatest capacity to pay.



Figure 2:

Source: ABS (2018), <u>Government Benefits, Taxes and Household Income, Australia</u>. Note: Private income includes wages, self employment and investment income. Social security payments includes pensions, allowances and family payment. Community services includes Commonwealth-funded health, education, welfare, care and housing services. Individuals are ranked according to equivalised household private income. The lowest quintile (20%) excludes the lowest two percentiles.





# The tax savings from indexation are skewed towards people with high incomes

Figure 2 shows how the resulting tax savings over 10 years are distributed across all personal income tax filers ranked by taxable income expressed in 2025 dollars per year (from zero to \$200,000 and over).<sup>8</sup>

The yellow bars show who benefits from a combination of indexation of tax thresholds *and* the tax cuts legislated to start in 2026. The benefits are skewed toward those on high incomes:

- Individuals with incomes over \$125,000 (in 2024-25 dollars, around the highest 20% of tax filers) would receive over half (54%) of the resulting tax reductions;
- Those on \$75-\$125,000 (around 30% of all tax filers) would receive around one fifth (22%); and
- Those on \$75,000 or less (around half of all tax filers) would receive around one quarter (24)%.

The blue bars show who benefits from indexation of tax thresholds *without* the tax cuts legislated to start in 2026. Indexation on its own skews the benefits further towards those with high incomes:

- Those with annual incomes exceeding \$125,000 receive 61% of the tax reductions;
- Those on \$75-\$125,000 receive 19%;
- Those on \$75,000 or less receive the remaining 19%.

That is, the latest legislated tax cuts, which reduce the lowest marginal tax rate from 16% to 14%, are more progressive than indexing the tax scales, though people whose incomes are too low to pay income tax do not benefit.





Source: PBO (2025), Build Your Own Budget (2025-26 Budget version and 2024 MYEFO version).

<sup>&</sup>lt;sup>8</sup> Individual taxable incomes as reported to the ATO. Not all individuals have records with the ATO. Overall, the vast majority of the lowest 30% of *households* ranked by gross household income do not pay income tax and do not benefit from income tax cuts. Most receive income support payments such as Age Pension.





Note: The yellow bars show the percentage share of overall tax reductions over the decade going to individuals on different taxable incomes (from zero to \$200,000+) from a combination of indexing income tax thresholds to the CPI and the tax cuts legislated to begin from 2026. For comparison, the blue bars remove the impact of the legislated tax cuts beginning in 2026.

Figure 3 shows how the resulting tax savings are distributed across all personal income tax filers ranked by *percentiles* of annual taxable income (from the lowest 20% to highest 20%, up to the highest 5%).

The yellow bars show who benefits from a combination of indexation of tax thresholds and the tax cuts legislated to start in 2026.:

- The highest 20% (from the 80th to 100th percentile) receive 53% of the tax cuts;
- The next highest 20% (60th to 80th percentile) receive 18%;
- The lowest 60% (from the 1st to 60th percentile) receive the remaining 28%.

The blue bars show who benefits from indexation of tax thresholds *without* the tax cuts legislated to start in 2026. Indexation *on its own* skews the benefits further towards individuals with high incomes:

- The highest 20% (from the 80th to 100th percentile) receive 61% of the tax cuts;
- The next highest 20% (60th to 80th percentile) receive 16%;
- The lowest 60% (from the 1st to 60th percentile) receive the remaining 23%.

These results correspond with those in Figure 2 above:

- The highest 20% corresponds broadly to those with incomes above \$125,000;
- The next 20% corresponds broadly to those with incomes from \$75,000-\$125,000;
- The lowest 60% corresponds broadly with those with incomes below \$75,000.



Figure 3

Source: PBO (2025), *Build Your Own Budget (2025-26 Budget version and 2024 MYEFO version)*. Note: The yellow bars show the percentage share of overall tax reductions over the 10 year period going to individuals in different taxable income percentiles (from 0-20% to 5%+) from a combination of indexing income tax thresholds to the CPI and the tax cuts legislated to begin from 2026. For comparison, the blue bars remove the impact of the legislated tax cuts beginning in 2026.





### The tax savings from indexation are skewed towards men

Figure 4 shows that at least 60% of tax reductions flowing from indexation of the tax thresholds would go to men, and only 40% to women:

• The share going to men increases to 62% if the legislated tax cuts commencing in 2026 are excluded from the analysis.

Figure 4:



Source: PBO (2025), *Build Your Own Budget (2025-26 Budget version and 2024 MYEFO version)*. Note: The yellow bars show the percentage share of overall tax reductions over the 10 year period going to women and the blue bars show the percentage going to men.





# Bracket creep (and by implication tax indexation which eliminates it) has a mixed impact on income inequality

The impact of tax bracket creep on the average (overall) tax rates faced by individuals across the income distribution varies according to the design of the tax rate scale and the distribution of taxable incomes. In Australia, its impact on the *progressivity* of the tax system (the extent to which it taxes people with higher incomes at higher average rates) depends on two factors which work in different directions:

- Bracket creep tends to reduce tax progressivity *among those who pay income tax,* since it generally increases average tax rates more for those on low and middle incomes than for people with high incomes. <sup>9</sup>
- At the same time, it tends to increase progressivity *across the entire income distribution* (income taxpayers and non-taxpayers) by raising the overall *volume or size* of income tax raised. <sup>10</sup>

Further, the impact of indexation should be measured by comparison with that of the discretionary tax cuts for which it is a substitute.

# In the absence of indexation, average tax rates have increased most for people with high incomes over the last decade

Since indexation is largely a *substitute* for a series of discretionary tax cuts, this – rather than no tax reductions at all - is the appropriate benchmark against which to assess the impact of indexation. To the extent that bracket creep increases taxes more than discretionary tax cuts reduce them, individuals would be better off if those tax cuts were replaced by system of automatic tax indexation.

Figure 5 shows results of analysis by the E61 Institute of the distributional impact of tax cuts over the decade from 2012 to 2022 – two years before the latest tax cuts in 2024. Average tax rates (total income tax paid as a percentage of *all* taxable income) rose the most for individuals with high incomes:

- The average tax rate for the highest 25% ranked by taxable income rose by 1.5-3.5 percentage points;
- It rose by around 1% for the middle 50%;
- It declined by 0.5% for those in the lowest 10% and rose by up to 1% among the lowest 25%.

While average tax rates increased overall - lifting public revenue - this mainly came from the highest 25% ranked by income.  $^{11}$ 

<sup>&</sup>lt;sup>11</sup> Average tax rates rose despite discretionary tax cuts, due in part to tax bracket creep and in part to increases in real (after inflation) incomes over the decade.



<sup>&</sup>lt;sup>9</sup> As discussed, bracket creep affects taxes paid across all tax brackets, not only each individual's *marginal* tax rate. PBO (2021), *Bracket creep and its fiscal impact*. Budget explainer No. 1, 2021

<sup>&</sup>lt;sup>10</sup> Personal income tax is generally progressive, both because tax rates increase with income and because (unlike taxes on consumption) they do not apply to those with the lowest incomes. Tran C & Zakariyya N (2021), <u>Tax progressivity in Australia – measures and estimates.</u> Economic Record Vol 97 No 316. pp45-77.



The outcome would have been different if the analysis extended to 2024 and the Coalition government's Stage 3 tax cuts were implemented as planned (especially the proposed extension of a 30% tax rate up to an income of \$200,000). However, those tax cuts were restructured by the Labor government and neither major party has indicated any intention to restore the original Stage 3 tax cuts for people with the highest incomes.<sup>12</sup> This underscores the potential – though it is by no means certain - for discretionary tax changes to strengthen revenue and improve progressivity.

#### Figure 5:



 Tax Paid/Taxable Income Sources: ATO Taxation Statistics; e61

Source: Dwyer E (2025) Who pays from bracket creep? E61 Institute

<sup>&</sup>lt;sup>12</sup> Philips B (2024), <u>Stage 3 stacks up: the rejigged tax cuts help fight bracket creep and boost</u> <u>middle and upper-middle households</u>. The Conversation, 29/1/24.





### Attachment: Modelling the impact of personal income tax indexation

Using the PBO <u>Build Your Own Budget</u> model, personal income tax thresholds were increased by estimated changes in the Consumer Price Index (CPI) for each year from 2024-25 to 2034-35.<sup>13</sup>

Thresholds for the Medicare Levy low-income reductions and the Low Income Tax Offset were adjusted in the same way.

			B 9994 95
Current tax thre	sholds	By 2030-31	By 2034-35
16% threshold	\$18,200	\$21,209	\$23,411
30% threshold	\$45,000	\$52,441	\$57,885
37% threshold	\$135,000	\$157,322	\$173,654
45% threshold	\$190,000	\$221,417	\$244,402
Low Income Tax Offset			
\$700 offset	\$37,500	\$43,701	\$48,237
\$325 offset	\$45,000	\$52,441	\$57,885
\$0 offset	\$66,667	\$77,690	\$85,756
Medicare Levy			
0% for singles below	\$27,222	\$31,723	\$35,016
2% for singles above	\$32,500	\$37,874	\$41,806

#### Projected changes to personal income tax thresholds - indexed to CPI

Source: PBO (2025), Build Your Own Budget (2025-26 Budget version); Chalmers J & Gallagher K (2025) Budget Paper No 1.

<sup>&</sup>lt;sup>13</sup> From the 2025-26 Budget Papers, the estimated increases in the CPI from 2024-25 to 2027-28 were: 2.5%, 3%, 2.5% and 2.5%. Annual increases of 2.5% were projected for later years.

