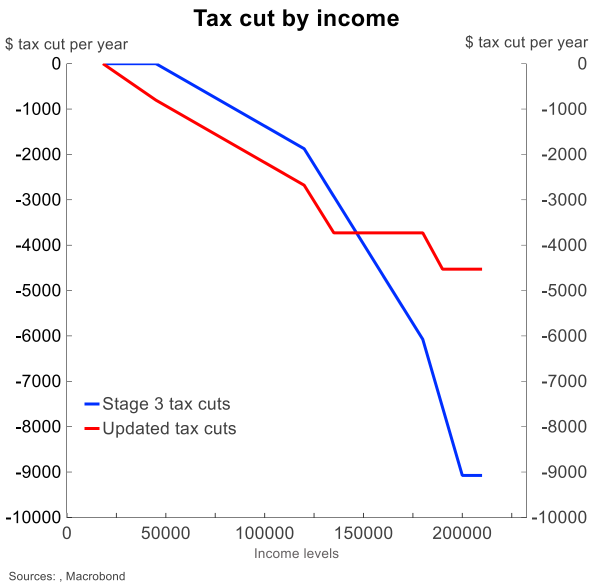
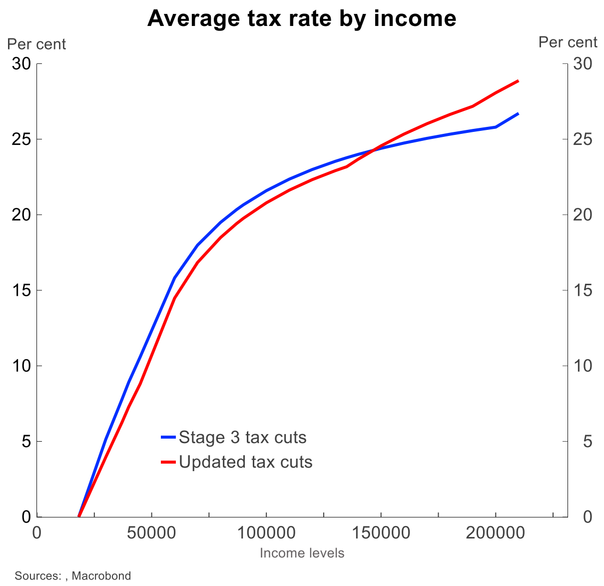
Thursday, 25 January 2024

Fiscal Insights

Stage 3 Changes Won't Derail the RBA

- **After months of speculation, the Government today announced an overhaul of the final stage of the previous Government's tax plan. From 1 July, all individuals earning less than $150k will receive a larger tax cut, while those on more than $150k will receive a smaller benefit – in some cases the benefit will be halved.**
- **Redistributing tax cuts to low and middle income earners could see a larger share of these tax cuts spent, boosting aggregate spending. At the margin this could mean inflation could fall more slowly than previously expected, but this needs to be weighed up against the fact that recent inflation reads have surprised on the downside. In net terms, we have left our inflation forecasts broadly unchanged, but are cognisant of the risks.**
- **Notwithstanding the substantial boost to income these tax cuts will deliver (estimated at around $20 billion for 2024/25), we expect the disinflationary process to continue in 2024/25.**
- **The context is important here. Household finances are under intense pressure. In the September quarter 2023 real household income declined at the fastest pace in over three decades. This occurred in part because income tax had risen to a record share of personal income. These tax cuts will help loosen the constraints on budgets but are not enough on their own to stage a sustained recovery – easing inflation and a related decline in interest rates will also be required.**
- **There are some minor risks however, particularly when it comes to the September quarter 2024. Tax cuts, coupled with another unknown but potentially significant minimum and award wage increase, could slow the expected moderation in inflation. That could in turn see a more complicated response. Notably, the recent impressive bounce in US consumer sentiment has been due to lower inflation reads not increased support measures.**





The previous Government's personal income tax plan was designed to do two things – give back bracket creep so that the average tax paid by individuals when the plan is fully implemented is broadly the same as what it was when the plan was designed, and to slow bracket creep going forward by eliminating an entire tax bracket.

Stages one and two of the plan were aimed at reducing the tax burden for low and middle income earners. By eliminating the 37 cents in the dollar tax bracket ($120,000 to $180,000), the third and final stage favoured higher income earners. To be sure, middle-income earners, that include part time workers with parental or carer responsibilities, casuals that are students and career starters, would have also benefited from the final stage of the tax plan, but to a lesser extent. Low income earners on less that $45,000 would not have received any benefit from Stage 3. The Parliamentary Budget Office expected that those earning $150,000 or more would have received around 60% of the benefit from Stage 3 tax cuts in 2024-25.

Under the original design, Stage 3 will add around $20 billion to household disposable incomes in 2024-25. Unlike the low- and middle-income tax offset, households will benefit on a week to week basis, rather than receiving a lump sum refund at the end of the financial year.

Changes to Stage 3 tax cuts

The changes to the tax cuts announced today will redistribute benefits toward low- and middle-income households. This is achieved by reducing the marginal tax rate that applies from $18,200 to $45,000 from 19 cents in the dollar to 16 cents, ensuring all taxpayers receive a tax cut – not only those on incomes above $45,000; and by maintaining the 37 cents in the dollar tax bracket between $135,000 and $190,000, which will see the benefit that flows to higher income earners decline, and in some instances halve.

2023-24 income year		Stage 3 tax rates		Updated tax rates	
Taxable income	**Rate (%)**	**Taxable income**	**Rate (%)**	**Taxable income**	**Rate (%)**
0 – $18,200	Nil	0 – $18,200	Nil	0 – $18,200	Nil
$18,201 – $45,000	19	$18,201 – $45,000	19	$18,201 – $45,000	16
$45,001 – $120,000	32.5	$45,001 – $200,000	30	$45,001 – $135,000	30
$120,001 – $180,000	37	$200,000 and over	45	$135,001 – $190,000	37
$180,001 and over	45			$190,001 and over	45

Macroeconomic impact

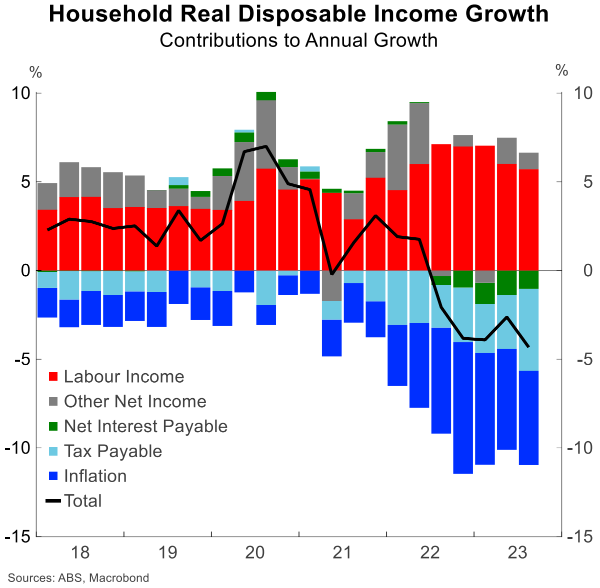
The total income boost for the household sector will remain broadly unchanged. However, given more of the benefit will flow to low- and middle-income households we could see a larger share of these tax cuts spent, boosting aggregate spending. Using upper bound empirically estimated marginal propensities to consume (MPC), the redesigned tax cuts are likely to lead to a marginal increase in consumption.

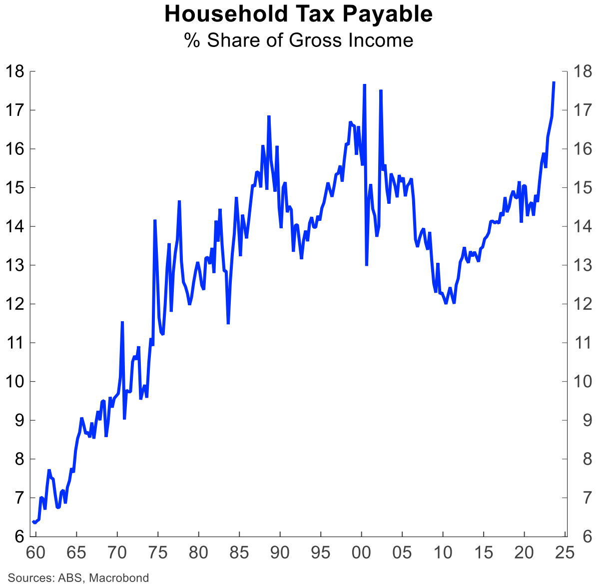
However, these are average MPC estimates and do not allow for the fact that lower-income households have seen their incomes rise faster recently than higher-income households, or that higher-income households engage in more discretionary spending that they would have scaled back recently, which could mean its more sensitive to income.

Notwithstanding the substantial boost to income these tax cuts will deliver, we expect the disinflationary process to continue in 2024/25 – we have inflation falling from 3.5% in 2023/24 to 3.1% in 2024/25.

That's because they will help loosen the constraints on household budgets but will not eliminate them – easing inflation and a related decline in interest rates will also be required.

As we have said, household finances are under intense pressure. In addition to the fall in real household disposable income in the September quarter 2023, we saw households become net borrowers for the first time since the Global Financial Crisis, spending more on consumption and investment than what they earn. Further, the RBA has also previously estimated that around 15% of households with variable rate mortgages (or more than 300k households) will have negative cash flow and become liquidity constrained with a cash rate of 3.6% - this population is likely to be larger given the cash rate is currently at 4.35%.





In addition, the tax cuts will flow when the economy is weaker and the labour market is softer. Indeed, they are an important reason we see household finances improve, and the economy stabilise before staging a recovery, in the second half 2024.

Future proofing bracket creep

By eliminating an entire tax bracket, the original design would slow bracket creep going forward. Over the past decade we have seen the number of taxpayers in the $120,000 to $180,000 income range increase from around 150,000 individuals in 2010-11 to around 1.1 million in 2020-21. Today's changes means that the pace of bracket creep could remain unchanged - given the pick-up in average wages growth, it is likely that more and more taxpayers will "creep" into higher tax brackets.

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