



Australian Government

The Treasury

22 April 2008

Mr John Hawkins
Committee Secretary
Senate Economics Committee
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Mr Hawkins

INQUIRY INTO THE TAX LAWS AMENDMENT (PERSONAL INCOME TAX REDUCTION) BILL 2008

Thank you for your email of 14 April 2008 seeking Treasury's response to the questions (at [Attachment C](#)) raised by the Senate Standing Committee on Economics (SSCE).

On 12 March 2008, the Senate referred the Tax Laws Amendment (Personal Income Tax Reduction) Bill 2008 (the Tax Bill) to the SSCE for report by 1 May 2008.

I understand that there are no terms of reference to instruct the Inquiry; and that Treasury will not be required to provide a written submission to the Inquiry.

In response to your request, please find attached information on the issues requested by the SSCE ([Attachment B](#)) together with a background paper to the issues ([Attachment A](#)).

I trust this information will be of assistance to the Inquiry. Please do not hesitate to contact me on 02-6263 3890 or Alix Gallo on 02-6263 4496 if you have any questions regarding any of the information provided or if we can be of any further assistance to the Committee.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Mark O'Connor', written over a horizontal line.

Mark O'Connor
Principal Adviser
Personal & Retirement Income Division

BACKGROUND

Introduction

The Tax Laws Amendment (Personal Income Tax Reduction) Bill 2008 provides for income tax cuts over three years from 1 July 2008. In assessing the impacts and appropriateness of the tax cuts, it is important to consider these in the broader fiscal policy settings. Responsible fiscal policy involves achieving a balance between competing objectives around expenditure and taxation rather than looking at each factor in isolation. In other words, it is not the tax cuts in isolation that determine the stance of fiscal policy, but the combination of taxing and spending.

Mindful of the current economic environment, such an assessment needs to be considered against the broad policy principles of:

- ensuring that government expenditure is well targeted and efficient;
- having as low a burden on Australian taxpayers as possible, that Australia's tax system is fair, simple and that it provides the right incentives to work, save and invest; and
- ensuring that current fiscal settings promote a sustainable fiscal position over the medium to longer term – and thus can assist in achieving a low-inflation environment.

This submission and our responses to the questions raised by the Committee (at [Attachment B](#)) offer information to assist the Committee in looking at some of these key elements.

Government Policy Objectives

The Government's *Tax Plan for Australia's Future* seeks to deliver assistance to working families under financial pressure, particularly those on low incomes, and to encourage those outside of the workforce to enter it. Central to its design is the aim of maximising individual incentive, enhancing labour force participation and encouraging people to work additional hours, by rewarding them for it.

The Treasurer outlined the Government's rationale for tax cuts in the Second Reading speech on this Bill:

“These tax reforms are designed to reward the hard work of Australians whose efforts are so critical to keeping the economy strong. [L]abour shortages are now widespread and employers frequently report they are the number one constraint on business expansion.

By expanding the pool of labour available to businesses they are better able to meet the high levels of demand they are facing for the goods and services they provide.

This tax reform package will significantly improve the financial incentives for second income earners and those on welfare benefits to make the transition into the workforce or increase their hours of work. [T]hese tax reforms will also enhance the incentives for taxpayers to upgrade their skills and gain higher qualifications by allowing workers to keep more of the wage gains that come with being more highly skilled and productive.”¹

¹ *Second Reading Speech Tax Laws Amendment (Personal Income Tax Reduction) Bill 2008, House of Representatives 14 February 2008.*

Macroeconomic impact

The macroeconomic impact of the tax cuts was canvassed extensively in evidence given to the Committee by senior officials of the Treasury on 20 February 2008.

It was also raised indirectly in questions put to the Governor of the Reserve Bank of Australia, Mr Glenn Stevens, by members of the House of Representatives Standing Committee on Economics on 4 April 2008. Mr Stevens also discussed this issue in remarks to the Treasury Seminar Series on 11 March 2008:

“It strikes me that in the popular discussion about fiscal policy, many participants talk past each other because they are looking at different time dimensions. It is not unreasonable to say that if the budget is perpetually in surplus, there is no debt to speak of and no other looming large unfunded liability, taxes should probably, over some long-run horizon, be lower. This, it seems to me, is the economic case for structural reductions in taxes, which some observers articulate. Others argue that such reductions should be delayed, for cyclical reasons, given that demand needs to slow to contain inflation. So there is a structural case for taxes to fall, and a cyclical case for them not to. It is no doubt difficult for any government to reconcile these two, equally valid, points of view, the more so if the same tension persists for a number of consecutive years.”²

For further information, please refer to our responses in questions 1, 2 and 4 in [Attachment B](#).

Key elements of the tax cuts affecting low- and middle-income earners

From 1 July this year, the Government will increase the 30 per cent marginal tax rate threshold so that the 15 per cent marginal tax rate will apply up to \$34,000 of income, an increase in the threshold of \$4,000. From 1 July 2009 this threshold will increase so that the 15 per cent marginal tax rate will apply up to \$35,000 of income and from 1 July 2010 this threshold will increase so that the 15 per cent marginal tax rate will apply up to \$37,000 of income.

In addition, the low income tax offset will be increased from \$750 to \$1,200 from 1 July 2008. It will continue to phase out at four cents for every dollar of income above \$30,000. This means that those eligible for the full low income tax offset will not incur a net income tax liability until their annual income exceeds \$14,000.

The low income tax offset will be increased from 1 July 2009 to \$1,350 and from 1 July 2010 to \$1,500 which means that those eligible for the full low income tax offset will not incur a net income tax liability until their annual income exceeds \$15,000 for 2009-10 and \$16,000 for 2010-11.

From 1 July 2008, low-income earners will receive half the benefit of this offset through their regular pay, rather than receiving the total as a lump sum when their income tax returns are assessed.

Impacts on families

The change to the child care tax rebate is expected to increase participation by reducing the costs that parents face in going back to work. The Government's commitment to increase the rate of the child care tax rebate from 30 per cent to 50 per cent will mean that the maximum amount that families are eligible to receive for each child will increase from \$4,354 to \$7,500 per child.

² http://www.rba.gov.au/Speeches/2008/sp_gov_140308.html

Compared to the current tax and childcare settings, a second-income earner with a partner on average earnings and two young children will have their take-home pay from part-time work of two days a week boosted by 45 per cent as a result of the tax and childcare measures taking effect from 1 July 2008.

A two-income family with two children aged two and four where one partner earns \$50,000 and the other earns \$22,500 will receive a tax reduction of \$1,450 in 2008-09 compared to 2007-08. When additional family tax benefit, child care benefit and child care tax rebate are added the family will be better off by around \$7,100 in 2008-09.

A sole parent with two children who earns \$22,500 will receive a tax reduction of \$467 in 2008-09 compared to 2007-08. When combined with increased parenting payment, family tax benefit, child care benefit and child care tax rebate the sole parent will be better off by around \$3,000 in 2008-09.

Participation impacts of the tax cuts

The labour supply response estimated by MITTS is summarised by three measures.

- The *employment effect*. This is the net change in the number of workers.
- The *change effect*. Among workers, this is the net change in the number of existing workers who change their hours. This ‘change effect’ is thus a measure of the pattern of movement in the hours of continuing workers.
- The *hours change*. This is the change in average hours per week across the population aged 15 and over. It is the bottom line of the participation impact, incorporating both the employment effect and the hours change for continuing workers covered by the change effect.

While media attention has focused on the employment effect, this does not take account of the increase in participation through existing workers increasing hours worked. A more complete measure to focus on would be the change in average hours worked.

Higher income earners are less likely to respond to tax changes by entering or exiting the workforce but can still exhibit significant changes in average hours worked.

Key results

Treasury’s modelling estimates that around 65,000 people will be encouraged to enter the workforce as a result of the tax cuts.

The increase in the 30 per cent tax threshold will encourage approximately 35,000 people to enter the workforce, while the increase in the low income tax offset will encourage around 30,000 additional workers into the labour force.

- Of these additional workers from the two measures, around 25,000 will be married women and 10,000 will be single parents.

The large proportion of the estimated increases in participation may be attributable to the increase in the low income tax offset and the increase in the 30 per cent tax threshold; given that labour supply elasticity is generally much higher for those on lower incomes, particularly for second-income earners.

But it is not just new entrants to the workforce who will be encouraged to work more by the tax cuts. Workers who are already employed will be encouraged to work longer hours. The additional supply of labour from new and existing workers could mean around 2.5 million additional hours of work in the economy each week.

For further information on this, please refer to responses to questions 3 and 5 in Attachment B.

RESPONSES TO COMMITTEE QUESTIONS

Question 1

Reserve Bank Governor Stevens commented in his recent testimony that 'domestic demand growth was 5.7 per cent in the latest year. It needs to be considerably lower than that'. The proposed tax cuts are worth around \$10 billion per year which is about 1 per cent of domestic demand. How much lower might interest rates be if domestic demand were not increased by that amount? Could higher interest rates be avoided if domestic demand were not increased by that amount?

In assessing the consequences of the Budget for monetary policy, the Governor of the Reserve Bank of Australia, Mr Glenn Stevens, stated in his testimony to the House of Representatives Standing Committee on Economics on 4 April 2008 that "I do not think it would be sensible for me to sit here and nominate some hurdle that the government has to get over to get some particular outcome on interest rates."

He went on to say that "I will be happy to see any support from fiscal policy we can get, but I think we have to be realistic about how much any government will be able to do in the environment we face."

In considering the impact of the tax cuts on aggregate demand, it is relevant to note that they are unlikely to flow through fully to consumption as some could be expected to be saved.

Question 2

If the tax cuts add to aggregate demand and inflationary pressures, does this mean countervailing cuts to government spending will be required?

Assessing the impact of policy options on inflation depends on their impact on both aggregate demand and aggregate supply. The tax cuts are expected to both expand the supply potential of the economy and, to the extent that they are not saved, they will have an impact on aggregate demand. Relative to a base case of the scheduled reductions in personal income tax continuing, the impact will depend on the extent to which households would reduce their consumption and investment expenditure, compared with the extent they would reduce labour (and aggregate) supply.

Question 3

Can you give more detail on the modelling behind the statement in Treasury's Mid-Year Economic and Fiscal Outlook that the tax cuts proposed by the previous government would lead to an extra 65,000 entrants to the workforce? Would you expect about the same response to the similar tax cuts proposed in the current bill?

THE MITTS MODEL

The Melbourne Institute Tax and Transfer Simulator (MITTS) is a behavioural microsimulation model that has been developed by the Melbourne Institute of Applied Economic and Social Research (the Melbourne Institute) with funding assistance from the Commonwealth (through the then Department of Family and Community Services).

In part, MITTS is like other microsimulation models that estimate the budgetary and distributional impacts of changes in personal income tax, such as Treasury's personal income tax model and the STINMOD model developed by NATSEM. But MITTS also has the capacity to estimate the labour market impacts stemming from changes to personal income tax and income support.

MITTS has been used by the Melbourne Institute and by third parties in a number of analyses of tax and income support policy proposals.

How does the MITTS model work?

There are two components to the MITTS model:

- MITTS-A, which is a standard static microsimulation model; and
- MITTS-B, which is a behavioural component that generates estimates of labour market impacts.

MITTS-A

MITTS-A is a static microsimulation model of the tax-transfer system, providing estimates of the first-round distributional and budgetary impacts of changes in tax and income support policy.

The base dataset for MITTS-A is the detailed confidentialised data from the ABS Survey of Incomes and Housing (SIH). (STINMOD also uses SIH data as base data, while the Treasury personal income tax model uses a confidentialised sample of ATO data.)

MITTS-B

The behavioural component of MITTS (MITTS-B) uses 'discrete hours modelling' of labour supply. The basic element of this approach is a labour supply function which estimates people's preferred hours of work (choosing between a limited set of possible time points), given their net income at these time points (a function of their wage rate, tax liabilities and income support entitlements). Thus, a change in personal income tax or income support may alter the calculated net income that someone would receive at different levels of work hours, and this in turn may alter their estimated preferred hours of work.

This modelling approach takes into account the different components of the participation impacts of policy measures which are seldom straightforward. On the one hand, a tax cut (for example) will increase the return from working and make work more attractive than leisure (the 'substitution effect'). On the other hand, it will increase the after-tax income at the current level of hours worked which will operate in the opposite direction as an incentive to reduce hours worked (the 'income effect'). The outcome will depend on the balance between these two opposing effects.

Treasury version of MITTS

Treasury maintains a version of MITTS for undertaking labour supply analysis of policy options. The Treasury and Melbourne Institute versions may produce slightly different results due to the use of different economic parameters in projections.

MITTS caveats

MITTS estimates of participation impacts are subject to a number of caveats. These include the following points.

- The behavioural elements of MITTS cover that part of the population where the Melbourne Institute believes the labour market behaviour is adequately modelled. Excluded groups include full-time students, the self-employed, people aged 65 and over, disabled people, as well as the partners of these groups. The labour supply of these groups is fixed in the model. Another group where there are questions about how well behaviour is modelled, but which is currently included in MITTS, is people in the pre-retirement 55-64 year age group.
- MITTS makes no distinction between the impact of those changes to financial incentives that are readily apparent (such as a change in tax withholding or in fortnightly income support) and those that are less visible to most (such as a change in the Low Income Tax Offset). Where the latter type of change occurs the estimated labour market response is likely to be exaggerated.
- Perhaps most importantly, it needs to be recognised that MITTS does not deal explicitly with the demand side of the labour market. It provides estimates of the potential change in labour supply. In the case of the labour market impact of tax cuts, MITTS estimates the potential increase in employment, assuming that adequate labour demand exists. Additionally, MITTS does not deal with the likely time path of adjustment.
- MITTS participation estimates are based upon sample data and econometric models that aim to predict human behaviour in response to policy or other changes. As such, the estimates have a degree of uncertainty and should be treated as indicative of the order of magnitude, rather than precise estimates, of the impact of policy.

Further information on MITTS

There are a number of publications available on the MITTS model, including both technical information and analysis of policy options, with many available on the [Melbourne Institute's website](#). Publications that may be of particular interest to the SSCE inquiry include:

- Chapter 11 of the conference proceedings from the 2004 Productivity Commission's Quantitative Tools for Microeconomic Policy Analysis conference, '[Behavioural Microsimulation Modelling with the Melbourne Institute Tax and Transfer Simulator \(MITTS\): Uses and Extensions](#)' by Creedy and Kalb
- CEDA's 2006 [Information Paper 84](#), 'Tax Cuts for Growth' (internet access for members only); and
- Melbourne Institute's [Working Paper No. 9/06](#), 'Evaluation of Policy Options to Encourage Welfare to Work by Buddelmeyer, Freebairn and Kalb.

TREASURY ANALYSIS OF THE PARTICIPATION IMPACT OF THE TAX CUTS

Analysis of the participation impacts of changes to the personal income tax scales was undertaken using the Treasury version of MITTS. The analysis covered the following changes to personal income tax to be implemented by 2010-11:

- increase in the 30 per cent threshold from \$30,001 to \$37,001;
- increase in the maximum value of the Low Income Tax Offset (LITO) from \$750 to \$1,500 per annum; and
- lowering of the 40 per cent marginal rate to 37 per cent.

Estimates from the MITTS model show that around 65,000 people will be encouraged to enter the workforce as a result of the changes. Including the effect of existing workers varying their hours, gives an overall average increase in weekly hours worked of 0.16 across the population aged 15 and over. This is roughly equivalent to an additional 2.5 million hours worked per week.

- After rounding (to the nearest 5,000), the estimated employment effect of 65,000 for these changes is the same as the number reported in the Mid-Year Economic and Fiscal Outlook from MITTS analysis of the proposed tax cuts announced by the previous government.

Those proposed tax cuts also included lowering the 45 per cent marginal rate to 42 per cent. The participation impact of that component was estimated to be very small.

Question 4

How much would such an increase in workforce participation add to (a) the productive potential of the economy and (b) what impact would that have on inflation?

(a) MITTS modelling showed an increase in total hours worked of 2.5 million hours per week. This is equivalent to a 0.7% increase in hours worked across the population. The average hourly earnings for the increased hours are estimated to be around 80% of average hourly earnings across all workers.

(b) Inflation forecasts reflect a wide range of factors, such as the supply-demand balance in the economy and measures of wage growth and productivity.

Question 5

Would the estimated effect on workforce participation be significantly different if the tax cuts were restricted to low and middle income earners? Is there any material effect on workforce participation from tax cuts for high income earners?

The elements of the personal tax cuts have differing impacts on participation. One broad feature is that the labour supply responsiveness to changes in the tax scales (rates and thresholds) tends to decrease with income. The Government's policy provides the largest proportionate tax cuts to low and middle income earners who have the greatest labour supply response and it deferred tax cuts for those on the top marginal tax rate compared to the package included in MYEFO 2007-08. As was noted in the response to Question 3 above, deferral of the tax cuts for those on the top marginal rate made no practical difference to the estimated participation impact of the tax cuts.

The differing participation impacts of elements of the personal tax cuts are summarised in Table 1 below.

- The bulk of the participation impact is attributable to lifting the 30 per cent tax threshold to \$37,001. This stems from the large number of people affected and the higher participation elasticities of workers on lower incomes.
- The effect of the increase in low income tax offset (LITO) is a sizeable increase in the number of workers, but a net reduction in hours worked by existing workers, resulting in a small overall increase in average hours.
- The decrease in the 40 per cent marginal rate does not have a large employment effect but does produce a significant number of existing workers increasing hours of work.

Table 1: MITTS estimates of participation impacts of personal income tax changes, 2010-11

	Employment effect (net increase in number of workers) '000s	Change effect (net number of existing workers increasing or decreasing hours) '000s	Hours change (average increase in hours across population aged 15+) hours/week
Increase 30% threshold	35	10	0.11
Increase LITO	29	-23	0.03
Decrease 40% marginal rate	1	12	0.01
Impact of all changes	64	-1	0.16

Notes: For ease of exposition, the participation impacts were modelled assuming that all components commence on 1 July 2010.

Columns may not sum to totals due to rounding.

Source: Treasury version of MITTS.

MITTS output measures

Treasury analysis of the labour supply response estimated by MITTS is summarised by three measures.

- The *employment effect*. This is the net change in the number of workers; that is, the number of people moving from zero to positive hours, less the number moving from positive to zero hours.
- The *change effect*. Among workers, this is the net change in the number of existing workers who change their hours; that is the number of existing workers who increase their hours less the number who decrease their hours (excluding any who reduce their hours to zero and become non-workers). This 'change effect' is thus a measure of the pattern of movement in the hours of continuing workers. The aggregate change in hours for these workers will also depend on the distribution of the size of hour changes across those who are increasing or decreasing their hours. It is thus possible for the change effect and the associated aggregate hours to move in opposite directions.
- The *hours change*. This is the change in average hours per week across the population aged 15 and over. It is the bottom line of the participation impact, incorporating both the employment effect and the hours change for continuing workers covered by the change effect.

Two policy options may have the same overall 'hours change' but the composition of the participation impacts may vary – with different shares of the overall impact attributable to the 'employment effect' (new workers) and the change in hours of existing workers. The

attractiveness of a particular option may thus partly depend on whether there is greater concern with the hours of existing workers or with non-workers (such as jobless households).

Question 6

How much impact would you expect the tax cuts to have on wage claims and increases? Would the estimated effect on wages be significantly different if the tax cuts were restricted to low and middle income earners?

As the tax cuts will assist employees in maintaining their real incomes, it is possible that they may moderate the wage claims sought by their representatives in wage negotiations. This could be true of workers across the income spectrum.

Question 7

What would be the impact on (i) aggregate demand, (ii) workforce participation, and hence (iii) inflation and (iv) interest rates, of replacing the tax cuts with superannuation contributions? Would this be particularly helpful for those earning less than \$450 a month, and so not receiving compulsory superannuation contributions?

(i) The impact of this alternative on aggregate demand depends on the extent to which households would reduce their consumption and investment expenditure (compared to base case of the scheduled reductions in personal income tax continuing).

This can be affected by the design of measures: whether they are temporary or permanent; provide a lump-sum or regular payment; and are compulsory or optional.

It also varies considerably depending on the circumstances of each household. For example, households under financial stress are more likely to consume an additional dollar of income.

(ii) This alternative would be expected to have a lower impact on labour force participation, with the nature of this impact affected by the design of the contribution policy. In the case of contribution amounts that are equivalent in size to each individual's tax cut entitlement, how much lower would depend on the extent to which individuals regard superannuation contributions (with benefits to be received some time in the future) as the equivalent of tax cuts (with benefits received more immediately).

(iii) In assessing the impact of the alternative on inflationary pressures, consideration would also need to be given to the extent to which they would have a lower impact on labour (and aggregate) supply than the base case.

(iv) In assessing the consequences of the Budget for monetary policy, the Governor of the Reserve Bank of Australia, Mr Glenn Stevens, stated in his testimony to the House of Representatives Standing Committee on Economics on 4 April 2008 that "I do not think it would be sensible for me to sit here and nominate some hurdle that the government has to get over to get some particular outcome on interest rates."

In relation to whether replacing tax cuts with superannuation contributions would be particularly helpful for those earning less than \$450 a month, and so not receiving compulsory superannuation contributions, while paying any amounts into superannuation would clearly have some impact on the superannuation savings of the individual, the impact would be limited by the amount of the payment and whether it was one-off or ongoing. Whether it was the

optimal consumption/savings decision for the individual would depend on the individual's circumstances, needs and preferences.

Question 8

How much impact do you expect the slowing in the world economy to have on the growth of demand in the Australian economy in the coming year, and hence on inflationary pressures? If the Australian economy slows too rapidly, what impact will these tax cuts have?

The Government will provide an updated assessment of the economic outlook for both the world and Australia in the 2008-09 Budget papers.

Questions to Treasury on the Tax Laws Amendment (Personal Income Tax Reduction) Bill 2008

Reserve Bank Governor Stevens commented in his recent testimony that 'domestic demand growth was 5.7 per cent in the latest year. It needs to be considerably lower than that'.¹ The proposed tax cuts are worth around \$10 billion per year which is about 1 per cent of domestic demand. How much lower might interest rates be if domestic demand were not increased by that amount? Could higher interest rates be avoided if domestic demand were not increased by that amount?

If the tax cuts add to aggregate demand and inflationary pressures, does this mean countervailing cuts to government spending will be required?

Can you give more detail on the modelling behind the statement in Treasury's *Mid-Year Economic and Fiscal Outlook* that the tax cuts proposed by the previous government would lead to an extra 65,000 entrants to the workforce? Would you expect about the same response to the similar tax cuts proposed in the current bill?

How much would such an increase in workforce participation add to the productive potential of the economy and what impact would that have on inflation?

Would the estimated effect on workforce participation be significantly different if the tax cuts were restricted to low and middle income earners? Is there any material effect on workforce participation from tax cuts for high income earners?

How much impact would you expect the tax cuts to have on wage claims and increases? Would the estimated effect on wages be significantly different if the tax cuts were restricted to low and middle income earners?

What would be the impact on (i) aggregate demand, (ii) workforce participation, and hence (iii) inflation and (iv) interest rates, of replacing the tax cuts with superannuation contributions? Would this be particularly helpful for those earning less than \$450 a month, and so not receiving compulsory superannuation contributions?

How much impact do you expect the slowing in the world economy to have on the growth of demand in the Australian economy in the coming year, and hence on inflationary pressures? If the Australian economy slows too rapidly, what impact will these tax cuts have?

1 Transcript of House Economics Committee Public Hearing, 4 April 2008, p. 34.