

## THE AUSTRALIAN

---

# Don't dream of cuts in this society of free riders

HENRY ERGAS THE AUSTRALIAN JUNE 01, 2015 12:00AM

**Oh, the poetry of economics! Exchange rates float, economies limp and tax brackets creep. No wonder the field attracts fertile minds. But it would be better if they kept their imaginations under control.**

That has clearly proved to be a struggle for John Daley, the chief executive of the Grattan Institute.

“Almost all of the (projected) return to surplus”, Daley told this paper, “is ‘drift’ — as opposed to any conscious and deliberate measures.” In particular, he says, reductions in outlays make virtually no contribution to mending the budget bottom line, with the Abbott government’s fiscal strategy instead relying on “balancing the budget by raising taxes.”

And even that is by stealth, since “bracket creep is the bulk of the reason that income-tax receipts are forecast to grow so quickly, because people’s wages are being taxed at higher rates”.

In reality, if there is the slightest chance of a surplus in our lifetimes, it is because the rate of growth of public expenditure, which (in nominal terms) averaged 7 per cent a year under Labor, has been halved. Had the trend under Labor persisted, the cumulative deficit over the period to 2018-19 would be two to three times greater than its projected level, while the return to fiscal sustainability would be postponed to the next ice age.

Daley’s claim that the government is “balancing the budget by raising taxes” therefore both misrepresents the facts and glosses over the damage Labor causes by opposing every attempt to curb increases in spending.

Nor is Daley correct in claiming that bracket creep is “the bulk of the reason” for the projected rise in income tax collections. Over the forward estimates, gross income tax withholdings are expected to rise by \$47.5 billion; depending on the estimation method used, the movement of taxpayers from lower to higher income tax brackets accounts for no more than 10 to 20 per cent of that increase.

Rather, “the bulk of the reason” for the rise in income tax receipts is economic growth, as each 1 per cent increase in nominal GDP lifts revenues from personal income tax by around 1.4 per cent. That more than proportional boost mainly occurs because when earnings increase, the share of each taxpayer’s total income in his or her top bracket rises, while the share in the lower brackets falls. As a result, taxpayers’ average tax rates rise, even if their marginal tax rates remain unchanged.

But the fact that Daley’s claims are exaggerated can’t justify complacency about the growing tax take. Bracket creep may have little effect in the budget period, but is a real issue over the longer term; and there is evidence that rising marginal tax rates undermine the incentives to work, save and invest.

Indeed, bracket creep itself provides evidence of those harms. After all, if taxpayers are bunched just below the thresholds at which higher rates cut in, that is because many people respond to the threat of higher rates by forgoing opportunities to increase their incomes. As they do that, entirely unproductive losses are inflicted on the taxpayers themselves and on government revenues.

Why those losses are so great is no mystery. The reason is the steeply progressive nature of our tax system, which imposes effective marginal tax rates that climb sharply with incomes. And adding to our problems, that progressivity has become more pronounced over time. In 1980-81, for example, the top 10 per cent of taxpayers accounted for 33 per cent of income tax paid; by 2012-13, their share had increased to 45 per cent, far outstripping the growth in the top decile's share of income earned. The greatest beneficiaries were the bottom half of income earners, whose share of income tax paid fell from an already paltry 17 per cent to barely 12 per cent.

As those changes occurred, our income tax system, far from being riddled with tax breaks which favour the wealthy, has become one of the most redistributive in the advanced economies, making it especially vulnerable to bracket creep and to the damage escalating marginal tax rates cause.

But the consequences are not merely economic. Rather, the most corrosive effect is the rise of representation without taxation. No doubt, the phenomenon is difficult to measure precisely. But under Menzies, the number of people paying income tax was aligned with the number employed; and as late as 1999-2000, there was only a 5 per cent difference between the number employed and the number of taxpayers. Now, however, nearly 20 per cent of the labour force pays no income tax at all, while the bottom 40 per cent's payments are not even a tenth of the social benefits they receive.

With free riding so pervasive, it is unsurprising that the pressures for increased public spending are overwhelming. Nor should anyone be surprised if those pressures remain overwhelming for so long as our income tax system stays as steeply progressive as it is today.

The rational solution would be to move to a much flatter tax structure, reducing the efficiency costs of rising marginal tax rates. But having entrenched representation without taxation, that reform's prospects are too poor to mention.

That makes bracket creep, whose long-run impact is to flatten the tax structure, a not entirely unattractive option. Advancing like an insidious sand dune, much of its effect would be at the lower tax brackets, where the economic losses from slightly higher tax rates are generally small. And its costs are likely to be well below those of the alternatives Labor (and Daley) prefer, such as increasing the already excessive taxes on superannuation.

But further cutting spending would be far better. Unfortunately, to think that likely demands more than imagination: it requires hallucination. And not even the poetry of economics can induce that.

×

**Share this story**

**Facebook** ([http://facebook.com/sharer.php?u=http://www.theaustralian.com.au/opinion/columnists/dont-dream-of-cuts-in-this-society-of-free-riders/story-fn7078da-1227377097107&t=Don't dream of cuts in this society of free riders](http://facebook.com/sharer.php?u=http://www.theaustralian.com.au/opinion/columnists/dont-dream-of-cuts-in-this-society-of-free-riders/story-fn7078da-1227377097107&t=Don't+dream+of+cuts+in+this+society+of+free+riders))

**Twitter** ([https://twitter.com/intent/tweet?url=http://www.theaustralian.com.au/opinion/columnists/dont-dream-of-cuts-in-this-society-of-free-riders/story-fn7078da-1227377097107&text=Don't dream of cuts in this society of free riders](https://twitter.com/intent/tweet?url=http://www.theaustralian.com.au/opinion/columnists/dont-dream-of-cuts-in-this-society-of-free-riders/story-fn7078da-1227377097107&text=Don't+dream+of+cuts+in+this+society+of+free+riders))

**LinkedIn** ([http://www.linkedin.com/shareArticle?mini=true&url=http://www.theaustralian.com.au/opinion/columnists/dont-dream-of-cuts-in-this-society-of-free-riders/story-fn7078da-1227377097107&title=Don't dream of cuts in this society of free riders](http://www.linkedin.com/shareArticle?mini=true&url=http://www.theaustralian.com.au/opinion/columnists/dont-dream-of-cuts-in-this-society-of-free-riders/story-fn7078da-1227377097107&title=Don't+dream+of+cuts+in+this+society+of+free+riders))

**Google** (<https://plus.google.com/share?url=http://www.theaustralian.com.au/opinion/columnists/dont-dream-of-cuts-in-this-society-of-free-riders/story-fn7078da-1227377097107>)

**Email** ([mailto:?body=http://www.theaustralian.com.au/opinion/columnists/dont-dream-of-cuts-in-this-society-of-free-riders/story-fn7078da-1227377097107&subject=Don't dream of cuts in this society of free riders](mailto:?body=http://www.theaustralian.com.au/opinion/columnists/dont-dream-of-cuts-in-this-society-of-free-riders/story-fn7078da-1227377097107&subject=Don't+dream+of+cuts+in+this+society+of+free+riders))