Tax Cuts
– Not Stimulus Spending

How Large a Tax Cut Could You Get For $97 Billion?

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Over the course of the 2008-09 financial year the Australian Government took a series of significant fiscal policy decisions which were designed to act as an economic stimulus. This paper asks the following simple hypothetical question: if those policy changes had instead been implemented as a one-off tax cut, how large would that tax cut have been? To answer this, we need to answer the following two questions. First, how large were the government's fiscal policy decisions last financial year, relative to the baseline of no policy change? Second, what is the equivalent size of the tax cut that this would have "bought"?

How Large Were the Government's Fiscal Policy Decisions, Relative to the Baseline of No Policy Change?

Relative to a baseline of no policy change, what will the policy decisions that the government actually took over the course of 2008-09 (including on Budget night, May 2009) amount to over the period to 2011-12?

Table 1 below is from this year's Budget Paper No. 1, page 3-11. It shows the Commonwealth's projected fiscal position in last year's May 2008-09 Budget, relative to the new updated projected position that was presented in this year's Budget (12 May 2009).

Table 1: The Budgetary Effect of the Government's Policy Decisions in 2008-09.

	2008-09	2009-10	2010-11	2011-12	Total
2008-09 Budget	21,703	19,669	18,996	18,870	79,238
MYEFO Policy Decisions	-11,093	-1,634	-966	-810	-14,503
MYEFO Parameter Variations	-5,244	-14,440	-15,390	-11,371	-46,445
MYEFO Bottom Line	5,365	3,595	2,640	6,689	18,289
UEFO Policy Decisions	-18,037	-18,365	-11,655	-5,435	-53,492
UEFO Parameter Variations	-9,816	-20,753	-25,314	-26,937	-82,820
UEFO Bottom Line	-22,487	-35,524	-34,330	-25,683	-118,024
2009 Budget Policy Decisions	-4,254	-11,961	-5,993	-6,952	-29,160
2009 Budget Parameter Variations	-5,373	-10,108	-16,727	-11,901	-44,109
Total Policy Decisions Since Last Budget	-33,384	-31,960	-18,614	-13,197	-97,155
Total Parameter Variations Since Last Budget	-20,433	-45,301	-57,431	-50,209	-173,374
2009-10 Budget Bottom Line	-32,114	-57,593	-57,051	-44,535	-191,293
Turnaround from 2008-09 Budget	53,817	77,262	76,047	63,405	270,531
% Turnaround Due to Policy Decisions	62.03%	41.37%	24.48%	20.81%	35.91%
% Turnaround Due to Parameter Variations	37.97%	58.63%	75.52%	79.19%	64.09%
%Deficit Due to Government Decisions	103.95%	55.49%	32.63%	29.63%	50.79%
Budget Balance Without Government Decisions	1,270	-25,633	-38,437	-31,338	-94,138

Relative to the projected position in May 2008-09, the figures show a cumulative deterioration or turnaround in the Budget bottom line of $270.5 billion over four years (see the last column in the row labelled "Turnaround from 2008-09 Budget"), relative to what was expected in May 2008.

This cumulative deterioration is a combination of deliberate "policy decisions" ($97.1 billion) that were taken over the course of 2008-09, and of expected "parameter variations" ($173.4 billion). The

latter are meant to be those changes in the fiscal situation that are not directly controlled by the government. Note, however, that a government could in principle reduce and even eliminate the size and budgetary effect of "parameter variations" by choosing not to spend and tax as highly as they do. In the extreme case, a government that decided not to tax and spend at all would face no "parameter variations". Similarly, a government that chose not to subsidise unemployment benefits (which are countercyclical) would face a different set of "parameter variations" than a government that did pay such subsidies.

Moreover, parameter variations are due to changing estimates by the Government (through Treasury) of various economic factors which may be influenced by the policies themselves. In other words, a particular spending decision might negatively (or positively) affect a parameter to amplify (or reduce) the net cost of the policy decision. Second round effects of the policies are also not costed, but appear later as parameter variations (this would in principle include the marginal excess cost of taxation). Thus, "parameter variations" are not completely outside the government's control.

Note that in 2008-09 most of the projected deterioration is due to policy decisions, not parameter variations. Indeed, if the government had taken no policy decisions, the 2008-09 Budget would have been in surplus. Putting it another way, the fact that there was a budget deficit in 2008-09 is entirely due to government policy. Most of the deficit in 2009-10 (55.5%) could also have been avoided, but for the government's decisions. It remains to be seen, of course, whether the actual parameter variations turn out to be as significant for 2008-09 as originally expected. We may get a better idea later in the year when the 2008-09 Final Budget Outcome is released.

How Much of a Tax Cut Could You Get For $97 Billion?

Suppose that instead of the policies that were actually announced and partially implemented throughout the course of 2008-09 (and which are scheduled for implementation long after the need for any kind of stimulus has passed) the government had instead decided to give Australians a one-off income tax cut in 2008-09 that "cost" the same amount as the decisions it actually took – i.e. $97 billion of foregone revenue (noting, of course that the government's actual policy decisions will be implemented over four years rather than a single year). Suppose that after this one-off cut, tax rates were then returned to their previous levels in 2009-10.

Basic economic theory suggests that as a "stimulus" measure designed to get people to spend, this may not be very effective. Consumers tend to increase consumption in response to changes in permanent income rather than temporary income. The permanent income effect of such a temporary tax cut would relatively small (although obviously it would not be trivial and the economic effect could easily be larger than the effect of an equivalent increase in government outlays). However, such a income tax cut *would* have effects on intertemporal labour supply decisions, inducing individuals to increase their labour supply in the year of the tax cut, as well as encouraging employers to hire more workers in that year as the wedge between employer willingness to pay labour and employee willingness to supply labour would fall.

Note, however, that it is the short term spending effects of policy rather than the short term supply side and efficiency effects that have been emphasised by the government. Indeed, the entire policy strategy of the government's temporary cash handouts was built around the belief that individuals would spend the money as soon as it was received.

For the purposes of this paper, we are willing to accept the government's argument on this point; thus, we assume that our temporary income tax cuts would boost spending, and we ignore the supply side effects.

Note also that the effect on government debt – around 10 per cent of GDP – would, according to the government's own logic, be relatively trivial. The government has told Australians that increases in public debt of this magnitude are easily manageable and are well below other OECD economies.

Our alternative policy involves a large budget deficit of just under 10 per cent of GDP in 2008-09, but again, according to the government's own logic this is also no problem. Indeed, large deficits during such economic circumstances are exactly what standard Keynesian theory requires (in fact, according to the Prime Minister, deliberately running large budget deficits during downturns is an integral part of "conservative" economic management). Note also, however, that our alternative policy involves much lower budget deficits after 2008-09 as economic activity recovers – again, exactly as standard textbook Keynesian theory prescribes.

In this spirit, we can also calculate the "multiplier effect" of our alternative one-off tax cut "stimulus" using the same multiplier estimates that have been used by the government. Table A on page 4-6 of Budget Paper No. 1 (reproduced below) publishes the OECD's estimates of multipliers for personal income tax cuts.[1] The government, citing the OECD's figures, says that every dollar of income tax cuts could increase economic activity (GDP) by up to $0.40 in the first year, and by up to $0.80 in the year following the tax cut.

Thus, using the government's own estimates, a one-off $97.1 billion tax cut in 2008-09 would have increased GDP by up to $38.8 billion in 2008-09, and by up to $77.7 billion in 2009-10. In other words, according to the OECD's own estimates, our alternative fiscal stimulus package would have roughly increased GDP by up to 3.5 per cent relative to the no-policy baseline in 2008-09, and by up to 7 per cent relative to the no-policy baseline in 2009-10.

Table A: OECD and IMF estimates of fiscal multipliers

	OECD - Australia		OECD - US		IMF - G-20
	Year 1	Year 2	Year 1	Year 2	
Spending measures					
Infrastructure	0.9	1.1-1.3	0.9	1.1-1.3	0.5-1.8
Government consumption	0.6	0.7-1.0	0.7	0.8-1.1	
Transfers to households	0.4	0.7-0.8	0.5	0.8-0.9	
Revenue measures					
Personal income tax cuts	0.3-0.4	0.4-0.8	0.3-0.5	0.5-0.9	0.3-0.6
Indirect tax cuts and other	0.2-0.3	0.3-0.5	0.2-0.3	0.3-0.5	

Source: OECD 2009 and IMF 2009a.

We can also calculate the one-off tax cut which, in percentage terms, would have been equivalent to the government's actual policy decisions. Table 6 on Page 5-22 of 2009-10 Budget Paper Number 1 provides Treasury's projections of individual income and other withholding tax revenue for the same four years as the previous table. This table is reproduced below.

[1] These estimates can be found on page 138 of the OECD's March 2009 *Economic Outlook Interim Report*, in Chapter 3, entitled "The Effectiveness and Scope of Fiscal Stimulus".

Individuals income and other withholding tax revenue

Table 6: Individuals income and other withholding taxation revenue

	Actual	Estimates			Projections	
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
	$m	$m	$m	$m	$m	$m
Individuals and other withholding taxes						
Gross income tax withholding	114,700	117,680	119,000	122,630	132,590	144,075
Gross other individuals	31,036	31,210	28,350	27,690	29,440	32,180
less: Refunds	19,601	23,200	24,640	23,780	24,840	26,815
Total individuals and withholding taxation	126,135	125,690	122,710	126,540	137,190	149,440
Fringe benefits tax	3,796	3,470	3,460	3,590	3,790	4,050
Total individuals taxation	**129,931**	**129,160**	**126,170**	**130,130**	**140,980**	**153,490**

Source: Table 6, Page 5-22 of 2009-10 Budget Paper Number 1

The table shows that in 2008-09, total individual and withholding taxation (not including fringe benefits tax) was expected to be $125.7 billion. Thus, in one-off terms, the government's policy decisions of $97.1 billion over the next four years would have been roughly equivalent to a one-off reduction of 77.25 per cent of individual and withholding tax revenue in 2008-09. Note that this estimate ignores any possible labour supply effects, and is also on top of the permanent tax cuts that were passed in early 2008, some of which took effect from July 1 2008.

Suppose that this policy was implemented by reducing taxes by 77.25 per cent for every individual Australian taxpayer. What does this equate to for a taxpayer on average weekly ordinary time earnings (AWOTE) in 2008-09, which according to the ABS was $1174 (or $61,042 annually)? According to the ATO tax calculator, the annual amount of individual income tax owed by this hypothetical individual in 2008-09 (not including Medicare Levy or deductions) would have been $12,912.60, or $248.32 per week. Thus, if the government had instead implemented its 2008-09 policy decisions as a one-off tax cut and reduced the tax bill by the same amount in proportional terms for all Australian taxpayers, the average earner would have paid 77.25 per cent less than what he actually paid in taxes. This means that the average earner would have paid only $56.50 in tax per week in 2008-09 - a tax cut of $191.82 per week.

An alternative calculation is to compute the average size of the tax cut. According to ATO data there were 11.8 million individuals who lodged tax returns in 2006-07. Dividing $97.1 billion by this number of individual taxpayers, we arrive at an average tax cut of $8228.81 per individual taxpayer, which is equivalent to $158.24 per week.

Finally, there is another way that our alternative policy could have been implemented. According to the Australian Tax Office, in 2006-07 the top 3 per cent of all taxable income earners paid 24 per cent of the total personal income tax revenue. But 24 per cent of expected revenue is just about what the government would receive in revenue under our alternative stimulus plan (actually, it is slightly more than the 22.75 per cent that would be left over after our plan). Thus, an alternative stimulus package that would have been equivalent to the government's fiscal policy decisions in 2008-09 would have been to give ***all*** Australian taxpayers except the richest 3 per cent a ***100 per cent tax cut*** in 2008-09!

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