

The Melbourne Institute Report on the 2004 Federal Budget

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EXECUTIVE SUMMARY

Introduction

The Melbourne Institute's 2004 Budget Report, focuses on the effects of the Family Tax Benefit package and the income tax cuts, the two central features of the budget. In this budget the sum of the income tax cuts to be provided over the next two financial years is estimated at about \$3.2 billion. If you add the value of the increased family tax this increases to \$6 billion¹.

Distributional Effects

In this report we provide our analysis of the distribution of the tax cuts and family tax benefits across the Australian distribution of income. While all families with children get benefits from this budget, the benefits tend to go mostly to individuals and families with high incomes.

Labour Supply Effects

The major distinctive feature of our analysis of the budget, however, is that we also provide estimates of the labour supply effects of the tax changes. The Government has been emphasising the importance of policies to raise labour force participation and the work effort of Australians.

The effect of the increase in Family Tax Benefit Part A by \$600 per child, is estimated to reduce labour supply by about 19,000, with the largest reduction being for sole parents, which as a proportion of sole parents in work is quite high.

This effect is almost exactly offset by a positive labour supply effect from reducing the withdrawal rate of Family Tax Benefit Part A.

The most surprising finding from our modelling using the Melbourne Institute Tax and Transfer Simulator (MITTS), is that changes to Family Tax Benefit Part B, cause around 20,000 people to withdraw from the labour market. Those affected are partnered men and women. This is a result of the additional eligibility of non-working families with full Parenting Payments for Family Tax Benefit Part B. This raises net incomes at zero/low hours of work of the primary earner relative to net incomes at higher levels of labour supply.

At the same time however, modelling the effect of the raising of the top two income tax thresholds reveals that it raises labour supply by about the same amount as the Family Tax Benefit changes reduce labour supply (i.e. roughly 20,000), albeit with different workers being involved in these two effects. These positive labour supply effects of tax relief at the upper end reduce the government's net cost of raising the top two thresholds by about \$740 million. However, these savings are reduced by about \$550 million that the changes to Family Tax Benefit cost extra because of the negative labour supply effects.

¹ These dollar amounts are calculated based on a direct implementation of the tax cuts on July 1, 2004, rather than phasing them in over the next two years. The amounts here and other amounts provided in this report are based on the Survey of Income and Housing Cost 2000-2001, which is a sample from the Australian population as it was in the financial year 2000-2001. We have not updated this sample to represent demographic changes that occurred since then, but we did express all income variables in current dollars.

If the family tax benefits had been structured to increase work incentives, and the tax cut would be implemented as planned, about 94,000 jobless people could have been induced to enter the labour market, and when they move into jobs that would reduce the net cost of the changes by around \$1.5 billion due to higher tax receipts and lower welfare payments.

If the alternative policy would also include the proposed changes to Family Tax Benefit part B in addition to the proposed tax cut, it would have the same up front cost as the current budget proposal. But at the same up front cost it would still induce about 84,000 jobless people to enter the labour market, reducing the net cost of the changes by about \$1.2 billion.

The increased labour supply that is induced by the tax cuts for middle to high income earners, comes to some extent from single men and women with and without children, while the negative labour supply response to the Family Tax Benefit changes can mostly be attributed to partnered men and women. It seems likely that the induced labour supply is from (older) men and women with some non-labour income that is then supplemented by their labour market earnings, while the labour withdrawn due to the Family Tax Benefit changes would come from lower-income families with children.

Conclusions

The Government has been emphasising the importance of policies to raise labour force participation and the work effort of Australians. It is disappointing that they have committed such a large amount to reducing taxes and increasing family payments, without taking the opportunity to have a major impact on work incentives. In fact, the direct effect of the current package of budget proposals is essentially employment neutral, which is a meagre result given the enormous amount of government expenditure. If the government had structured its changes to family payments differently and introduced a “working tax benefit” aimed at rewarding the move from welfare to work, it could have increased labour supply by about 94,000.

It is to be hoped that the government is developing plans to increase the incentive for those on welfare to move into work for its election platform. This is the major unfinished business of this government. Unfortunately there is nowhere near as much cash available now to address this issue as there was in this week’s budget!

1. Introduction

The Melbourne Institute's 2004 Budget Report, focuses on the effects of the Family Tax Benefit package and the income tax cuts, the two central features of the budget.

Economic growth and bracket creep have been boosting government revenues substantially over the last few years. In our analysis of bracket creep for example, (Buddelmeyer et al., 2004), we estimated that the government will need to hand back about \$3.8 billion dollars to tax payers over the next two financial years, to compensate for the bracket creep since the introduction of the Australian New Tax System (ANTS) package in July 2000.

In this budget the sum of the income tax cuts to be provided over the next two financial years will take the value of about 3.2 billion. If you add the value of the increased family tax this increases to about \$6 billion².

In this report we provide an analysis of the distribution of the tax cuts and family tax benefits across the Australian distribution of income. We also provide an analysis of the labour supply effects of the tax changes. The Government has been emphasising the importance of policies to raise labour force participation and the work effort of Australians.

First, we have too many people dependent on welfare payments. In particular, about one in seven households of working age are jobless and one in seven children live in jobless households. We need policies that provide incentives to move from welfare to work.

Second, with the prospect of a rising dependency ratio, due to the ageing population, raising participation and sustaining productivity growth are the two policy imperatives for Australia to successfully manage the rising fiscal burden that we are expecting the next generation to face.

With the opportunity to make a major tax cut and raise family payments, there was a strong argument for choosing a way that increases work incentives at the same time. Therefore there were two priorities.

One was to increase the top two thresholds of the income tax system, to reduce the marginal tax rates of an increasing number of middle to high-income earners. This was done.

The second, and arguably more important priority, was to significantly reduce the effective marginal tax rates of low-wage earners in low-income families to increase the financial incentives to work. The highest effective marginal tax rates in Australia

² These dollar amounts are calculated based on a direct implementation of the tax cuts on July 1, 2004, rather than phasing them in over the next two years. The amounts here and other amounts provided in this report are based on the Survey of Income and Housing Cost 2000-2001, which is a sample from the Australian population as it was in the financial year 2000-2001. We have not updated this sample to represent demographic changes that occurred since then, but we did express all income variables in current dollars.

are faced by low-income families. This is due to the combination of the withdrawal of welfare payments, as incomes rise, and income tax paid.

2. The Effects of the Family Tax Benefit Changes

In the budget several changes are introduced to the Family Tax Benefits. First of all the maximum and the base rate of Family Tax Benefit part A are increased by 600 dollars per year per dependent child under 18 years of age.

In addition, instead of being withdrawn at 30 per cent after the income threshold has been reached, families now only face a 20 per cent withdrawal rate between the maximum and the base rate. Family Tax Benefit part B, which is targeted at sole parents and single earner families, now has an increased income threshold for the secondary earner in a family of 4000 dollars per year instead of 1825 dollars. The withdrawal rate for income above this level will be 20 per cent instead of 30 per cent. Sole parents' incomes remain untested.

2.1 "Day After" Distributional Effects

Table 1 provides details of the distribution of the benefits from the Family Tax Benefit changes. It can be seen that the benefits go to about 21 per cent of Australian "income units". "Income units" can be couples or singles with or without children. We refer to these 'income units' loosely as 'families'. There are about 9.5 million income units.

Table 1: Percentage of winners and average amount gained from the Family Tax Benefit (part A and B) changes

Income Range (Net 'family' income per week)	Income decile (Net family income)	% non-winners	% winners	Average weekly net gain (if winner)
0 – 235	1	99.47	0.53	11.54
236 – 306	2	99.37	0.63	26.70
306 – 393	3	87.98	12.02	13.89
393 – 471	4	80.21	19.79	21.97
471 – 564	5	79.17	20.83	28.51
564 – 681	6	69.29	30.71	27.39
681 – 823	7	64.12	35.88	34.27
823 – 1027	8	60.12	39.88	37.31
1027 – 1337	9	55.71	44.29	27.92
1337+	10	92.26	7.74	22.73
	Total	78.77	21.23	

The income deciles that are disproportionate winners are in the top half of the income distribution. This is because most families with children are in the fourth to the ninth highest deciles in the income distribution. There are very few families with children in

the bottom two deciles. These deciles tend to be dominated by singles without children, who do not receive family tax benefits. However, significant winners start appearing from the third decile onwards. In the top ten per cent there are very few winners because most families' incomes in this decile are too high to benefit from the increased family tax benefit. The average dollar value of the gain, that families obtain from the increase in Family Tax Benefits, ranges from \$13.89 per week for decile 3 to \$37.31 per week for those in decile 8.

2.2 Labour Supply Responses

The net effect on labour supply of the changes to the Family Tax Benefits is negative, with around 21,000 people expected to drop out, which in percentage terms is a relatively small effect. The overall average effect on working hours is negative too, but very small.

Table A.2 (in the appendix) presents our estimates of the likely effects of the changes on labour force participation. First, the payment per child for Family Tax Benefit Part A was increased by \$600. Second, the withdrawal rate of Family Tax Benefit Part A was reduced from 30 per cent to 20 per cent after the income threshold is reached. Third, Family Tax Benefit Part B has an increased income threshold before it is withdrawn and then it is to be withdrawn at 20 per cent instead of 30 per cent.

The effect of the increased in Family Tax Benefit Part A by \$600 per child, is estimated to reduce labour supply by about 19,000, with the largest reduction being expected for sole parents, which as a proportion of sole parents in work is quite high.

This effect is almost exactly offset by a positive labour supply effect from reducing the withdrawal rate of Family Tax Benefit Part A.

The most surprising finding is that the overall negative labour supply effect is caused mainly by the changes to Family Tax Benefit Part B and that a large part of the negative effect is for married men.

The negative effect on married men's labour supply as a result of the changes to Family Tax Benefit part B can be explained by the extended eligibility for this payment by their partners while receiving Parenting Payment. Before the change, a family receiving the full amount of Parenting Payment would not receive any Family Tax Benefit part B if their youngest child was over 4 years old, because the parenting payment would be more than the threshold for Family Tax Benefit part B. After the change, however, these families are partly eligible and will still receive around \$1011 in Family Tax Benefit part B. Similar families with children under 4 received around \$729 before the change and will receive about \$1894 after the change. This change is illustrated in Figure 1 for families with a youngest child between 5 and 18 years old³.

This means that across the range of incomes where the primary earner's income is not yet reducing the partner's Parenting Payment, net incomes are more than \$1000 higher after the change. This has an income effect on labour supply that is negative. In

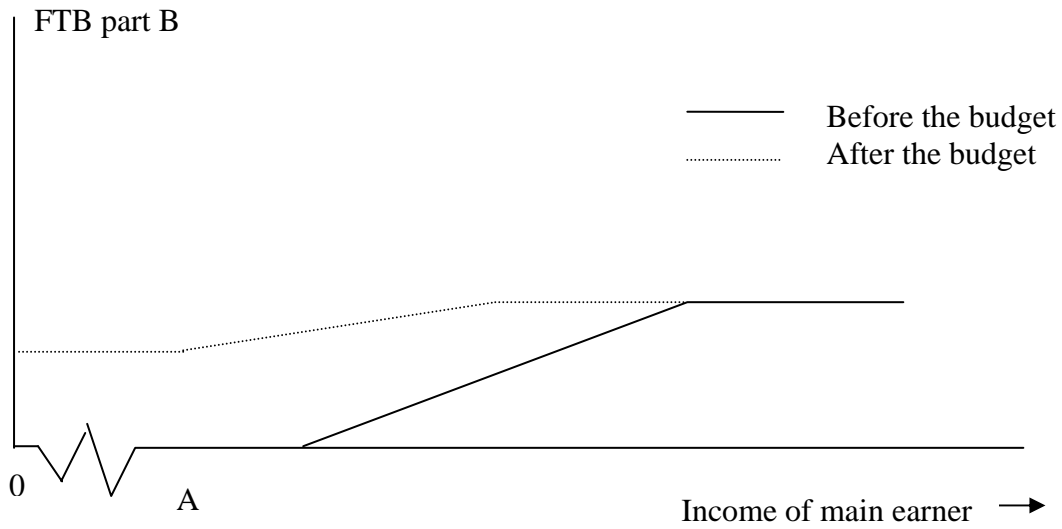
³ This figure only shows the lower end of the primary earner's income range because that is where the change to the Family Tax Benefit part B is relevant.

addition, the lower taper rate will have a negative effect on the primary earner's labour supply as well through the indirect effect via Parenting Payments for at least part of the income range where Parenting Payments are withdrawn. Once their own benefit payment is completely withdrawn, additional income by the primary earner will impact on the Parenting Payment, reducing it by 70 cents for every dollar they earn. This reduction in Parenting Payment in turn increases the Family Tax Benefit Part B, but only by 20 cents for every dollar in Parenting Payment lost instead of by 30 cents for every dollar as was the case before the change. As a result the marginal effective tax rate of the primary earner has gone up after the change for part of the range of income which affects their partner's Parenting Payment (between B and C in Figure 2). These changes are illustrated in Figure 2 for a family with a youngest child aged between 5 and 18 years old.

Thus the effect of changes to Family Tax Benefit Part B is to reduce work incentives, for some men. This is undoubtedly a case of "unintended consequences", caused by the fact that the means test for Family Tax Benefit Part B includes income from the secondary worker's Parenting Payment which in turn is affected by the income of the primary earner. Under the new regime for example, for a couple with a child over 5, it will now be possible for them to receive the full value of NewStart, Parenting Payment and Family Tax Benefit Part A, and a part payment of Family Tax Benefit Part B. Up until now such a family would not receive any Family Tax Benefit Part B, because of the means testing of Parenting Payment. Now the means test has been relaxed and this results in eligibility for a part payment. Thus the family's income will become higher out of work than it was before the changes, thus reducing the incentive for the male to work. It should be emphasised that this is not a large effect, and of all partnered male workers only a tiny proportion is expected to move out of the labour force.

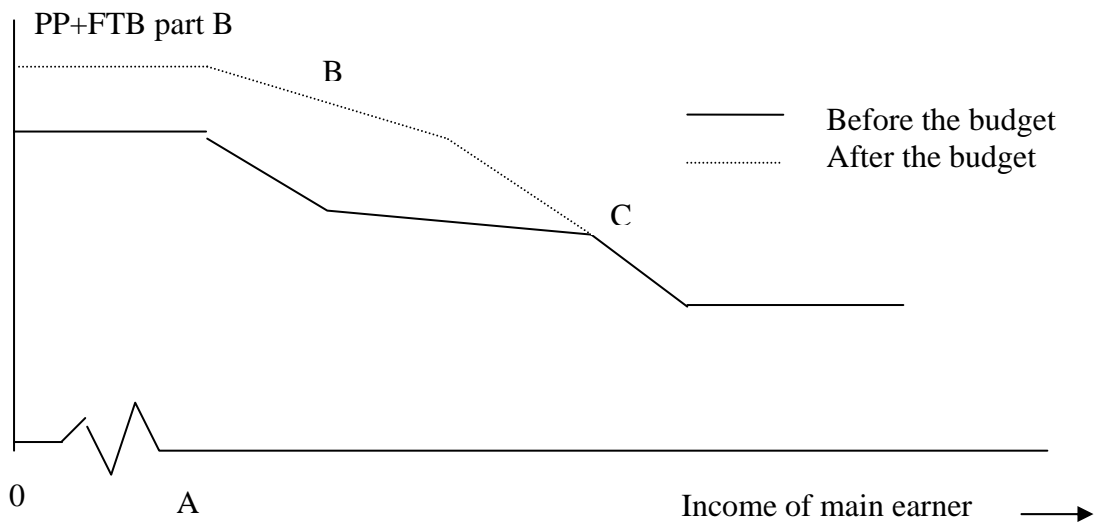
For secondary earners, there are two counteracting effects as a result of the lower taper rate. First there is the income effect because more of the secondary earner's income can be kept, resulting in higher net incomes after the change at a particular level of labour supply than before, which has a negative effect on secondary earner's labour supply. Second, there is the substitution effect which makes additional labour supply more attractive because of the lower marginal tax rate on earnings. The income effect which reduces their labour supply is found to outweigh the substitution effect, so there is also a small negative effect on female labour supply as well.

Figure 1 Family with a non-working secondary earner (youngest child aged 5-18)



A = Amount of income at which the partner's Parenting Payment starts to be withdrawn

Figure 2 Family with a non-working secondary earner (youngest child aged 5-18)



A = Amount of income at which the partner's Parenting Payment starts to be withdrawn

3. The “Full Effect” including the Tax Cuts

In addition to the more generous family payments, the budget contains an increase in the two top tax thresholds in two stages. In 2004-2005 the 42c threshold will be raised to \$58,000 and the top threshold will be raised to \$70,000. In 2005-2006 these two thresholds will be raised to \$63,000 and \$80,000 respectively. The calculations in this section are based on the thresholds for the later year.

3.1 Day After Distributional Effects

Tables 3a and 3b provide details of the distribution of the benefits resulting from the raising of the top two tax thresholds and the combination of the Family Tax Benefit and income tax changes, respectively.

Table 3a: Percentage of winners and average amount gained from the Income Tax Threshold changes

Income Range (Net family income per week)	Income decile (Net family income)	% non-winners	% winners	Average weekly net gain (if winner)
0 – 681	1 to 6	100.00	0.00	-
681 – 823	7	82.72	17.28	7.61
823 – 1027	8	49.29	50.71	23.98
1027 – 1337	9	48.69	51.31	30.33
1337+	10	7.38	92.62	39.54
	Total	78.80	21.20	

Table 3b: Percentage of winners and average amount gained from the Family Tax Benefit and Income Tax Threshold changes

Income Range (Net family income per week)	Income decile (Net family income)	% non-winners	% winners	Average weekly net gain (if winner)
0 – 235	1	99.47	0.53	11.54
236 – 306	2	99.37	0.63	26.90
306 – 393	3	87.98	12.02	13.89
393 – 471	4	80.21	19.79	21.97
471 – 564	5	79.17	20.83	28.51
564 – 681	6	69.29	30.71	27.39
681 – 823	7	47.08	52.92	25.72
823 – 1027	8	23.81	76.19	35.49
1027 – 1337	9	27.74	72.26	38.64
1337+	10	5.24	94.76	40.50
	Total	61.93	38.07	

Clearly the benefits are further skewed towards the top of the income distribution for this component of the budget. The large majority of income units in the bottom half of the distribution do not receive any additional income, while the large majority in the top half of the distribution benefit from the change.

The mean gain for the 95 per cent of income units in the top decile, who are winners, is \$40 a week. The mean gain for the 21 per cent in the fifth decile, who are winners, is \$28.50 a week. The mean gain for the 12 per cent of winners in the third decile is \$14 a week. Barely anyone in the bottom two deciles, dominated by low-income singles without children or age pensioner couples, gains anything from the budget.

3.2 Labour Supply Responses

The tax cut, produced by raising the thresholds, almost exactly cancels out the negative labour supply effects induced by the Family Tax Benefits changes. In aggregate, the resulting effect on labour supply is a negligible gain of about 2,000 jobs (see Table A.2 in the Appendix).

The labour supply that is induced by the tax cuts for middle to high-income earners, can to some extent be attributed to single men and women with and without children, while the negative labour supply response of the Family Tax Benefit changes is mostly from partnered men and women. It seems likely that the induced labour supply is from (older) men and women with some non-labour income that is then supplemented by their labour market earnings, while the labour withdrawn due to the Family Tax Benefit changes would come from lower income families with children.

4. Comment and Conclusions

4.1. Reversing the Work Incentive Effects of the Family Tax Benefit Changes

In our opinion, a very important priority is to significantly reduce the effective marginal tax rates of low-wage earners in low-income families to increase the financial incentives to work. The highest effective marginal tax rates, in Australia, are faced by low-income families. This is due to the combination of the withdrawal of welfare payments as incomes rise, and tax paid.

As mentioned in the introduction, with the opportunity to make a major tax cut and raise family payments, it would be strategic to choose a way that increases work incentives at the same time.

The tax cuts established by raising the top two thresholds raise the work incentives slightly. This is evident from a positive effect on participation for all subgroups (see Table A.2 in the Appendix) as well as an increase in the average number of hours worked. However, the negative effect of the changes to the Family Tax Benefit scheme cancels out the positive labour supply effect from the tax cuts. This is mainly caused by the income effect resulting from the increase in the family's net income due to the higher Family Tax Benefit payments. With regards to Family Tax Benefit part B, a classic example of an unintended consequence arises. The withdrawal rate on the Family Tax Benefit part B is reduced from 30 to 20 cents in the dollar and the free

area is increased from \$1825 to \$4000 per year to increase the secondary earners' work incentives. Unfortunately, this results in an increase of the effective marginal tax rate for primary earners with a non-working spouse in part of the range where each dollar they earn affects their spouse's receipt of Parenting Payment. This is in addition to the income effect resulting from an increase in the amount of Family Tax Benefit B for which a family is eligible when both partners are not working or when the primary earner is on low income. For some primary earners there is thus not only the negative income effect, but an additional reduction in work incentives through the substitution effect.

The effect of the Family Tax Benefit part A can also be decomposed in an income effect from the increase of \$600 per year per child and a work incentive effect from the reduction in the withdrawal rate from the current 30 to 20 per cent. With respect to partnered women the income effect dominates. For sole parents, the two opposite effects keep each other in balance, but both effects are relatively strong. The increase with \$600 per child per year in itself would significantly reduce the labour supply of sole parents if it was not counteracted by the reduced taper rate.

However, the work incentives for sole parents could have been increased much more while at the same time addressing the work incentives for all low income families, including singles and couples without children. Apart from work incentives being one of the policy directives, the latter two groups currently also miss out on benefits from the government's \$6 billion outlay.

Table 4 shows the distribution of winners and the average amount of net gain over the 10 income deciles for this alternative policy of providing working tax credits. The type of working tax credits that have been modelled have been outlined recently in Buddelmeyer et al. (2004). It is clear that for this alternative policy the additional expenditure benefits a larger proportion of families than the policy in the budget.

Table 4: Percentage of winners and average amount gained from the Working Tax Credit, Family Tax Benefit part B and Full Tax Changes

Income Range (Net family income per week)	Income decile (Net family income)	% non-winners	% winners	Average weekly net gain (if winner)
0 – 235	1	82.92	17.08	6.70
236 – 306	2	85.23	14.77	11.63
306 – 393	3	74.76	25.24	17.67
393 – 471	4	59.24	40.76	22.66
471 – 564	5	30.00	70.00	19.13
564 – 681	6	65.71	34.29	23.01
681 – 823	7	49.11	50.89	21.05
823 – 1027	8	30.83	69.17	25.77
1027 – 1337	9	45.83	54.17	32.29
1337+	10	7.02	92.98	40.17
	Total	53.14	46.86	

The labour supply effects and cost of this alternative are compared to the full policy and to components of the policy set out in the budget in Tables A.1 and A.2 in the Appendix. It is clear from this that the cost of the alternative policy is similar to the cost of the policy presented in the budget. However, since the expected labour supply effects are positive at around 84,000 additional persons in the labour force, the expected cost after taking the effect of labour supply responses into account is lower for this alternative policy. Excluding the Family Tax Benefit part B changes from the working tax credit package is expected to increase the labour supply effect of the working tax credit to about 94,000 additional labour force participants.

4.2 Conclusions

The estimates presented in this report suggest that the family tax benefit changes as they are set out in the budget are expected to cause about 21,000 workers to withdraw from the labour market. In turn, this will add an extra \$550 million to the cost of the package due to lower tax receipts and higher welfare payments. This effect, incidentally will eventually be offset by a roughly equivalent positive behavioural effect on tax revenues from the raising of the top two tax thresholds over the next two financial years.

If the family tax benefits had been structured to increase work incentives, at no extra up front cost keeping the changes to Family Tax Benefit part B, about 84,000 jobless people could have been induced to enter the labour market, and when they move into jobs that would reduce the net cost of the changes by \$1.2 billion due to higher tax receipts and lower welfare payments. Excluding the changes to Family Tax Benefits part B, an additional 10,000 persons are expected to enter the labour force. This includes the positive labour supply effect of the tax cut. As a result of the lifting of the income tax thresholds alone, about 20,000 people are expected to move into jobs.

It is to be hoped that the government is developing plans for its election platform to increase the incentive for those on welfare to move into work, not by the use of a stick but by rewarding work. This is the major unfinished business of this government. Unfortunately there is nowhere near as much cash available now to address this issue as there was in this week's budget!

References

Buddelmeyer, H., P. Dawkins, J. Freebairn, and G. Kalb (2004), "Bracket Creep, Effective Marginal Tax Rates and Alternative Tax Packages", *Quarterly Bulletin of Economic Trends*, 1.04, pp. 17-28, Mercer – Melbourne Institute.

A more extended version is available on the web under 2004 MITTS projects:

Buddelmeyer, H., P. Dawkins, J. Freebairn, and G. Kalb (2004), "Bracket Creep, Effective Marginal Tax Rates and Alternative Tax Packages" <http://128.250.230.133/counter/bracketp.cfm> .

Appendix Tables on the Effect of Labour Responses

Table A.1 The costings of the different packages (in \$ million)

	Before labour supply responses	After labour supply responses	Difference in cost
July 2004 no change	base	base	
FTB part A \$600+ ONLY (taper rate is fixed)	1,984.9	2,437.2	452.3
FTB part A reduced taper ONLY	439.0	236.5	-202.5
FTB part A change ONLY	2,423.9	2,569.5	145.6
FTB part B change ONLY	379.3	856.3	477.0
FTB changes only	2,803.2	3,356.4	553.2
Increase the tax thresholds ONLY	3,208.3	2,468.7	-739.6
FTB changes + maximum tax cut	6,011.5	5,776.4	-235.1
Tax credit + FTB part B change	2,817.1	2,417.1	-400.0
Tax credit + FTB part B change + maximum tax cut	6,025.4	4,801.7	-1,223.7
Tax credit + maximum tax cut	5,646.1	4,120.0	-1,526.1

Table A.2 The employment effects of the different packages (actual numbers)

	couple men	couple women	single men	single women	single parents	Total	Singles ("jobless families")
July 2004 no change	base	base	base	base	base	base	base
FTB part A \$600+ ONLY (keep taper fixed)	-6,599	-5,719	0	0	-6,659	-18,977	-6,659
FTB part A reduced taper only	2,200	0	0	0	5,893	8,092	5,893
FTB part A change ONLY	0	-4,839	0	0	236	-4,603	236
FTB part B change ONLY	-13,637	-4,839	0	0	0	-18,477	0
FTB changes only	-12,318	-8,798	0	0	236	-20,880	236
Increase tax thresholds ONLY	6,159	7,039	6,422	524	707	20,851	7,653
FTB changes + maximum tax cut	-3,959	-1,760	6,422	524	707	1,934	7,653
Tax credit + FTB part B change	-1,760	-6,159	16,930	19,406	31,291	59,708	67,627
Tax credit + FTB part B change + maximum tax cut	6,159	2,200	23,351	20,193	31,880	83,783	75,424
Tax credit + maximum tax cut	17,157	1,320	23,351	20,193	31,880	93,901	75,424
Weighted number in sample	4399183	4399183	2918898	2622433	589287	14928984	