MENZIES RESEARCH CENTRE SUBMISSION

Productivity Commission

Inquiry into Creating a more dynamic and resilient economy

September 2025

Introduction

The Menzies Research Centre (MRC) welcomes the opportunity to contribute to the Productivity Commission's (PC's) Inquiry into *Creating a more dynamic and resilient economy*.

The intent of our submission is to draw attention to policies we believe the Australian Government should consider adopting to improve productivity, business investment and reward for effort that were not addressed in the PC's interim report. These policies are outlined below and in recent reports published by the MRC, which have been provided as supporting material.

Personal income tax reform

While the PC's decision to limit its focus to only some areas of policy reform is understandable, we believe the decision to exclude consideration of income tax reform is a mistake. The importance of a respected independent body such as the PC advocating for a better income tax system cannot be overstated. Ensuring that income taxes are set at an appropriate level, including in the medium to longer term, is vital to supporting the incentive to work, train and invest.

Australia is already disproportionately reliant on income tax and, without policy change, this reliance will get worse. Treasury forecasts show that, without reform, income tax will make up 54 per cent of all Commonwealth tax receipts by 2028-29 — a level not seen since the introduction of the GST.

Without reform, an average full-time worker will reach the second highest (37 cent) tax bracket in just six years in 2031-32, reaching the same position they faced in 2017-18 before the combined impact of the Stage 1-3 tax cuts. Bracket creep will return the average tax rate paid by a full-time worker to 2017-18 levels in just five years and completely erode the impact of the Albanese Government's amended Stage 3 tax cuts in seven years. Our analysis finds that the recently legislated reduction of the 16 cent tax rate to 14 cents has only delayed these outcomes by one year.

Locking in tax brackets with indexation from 2025-26 would end the cycle of tax cuts required to chase bracket creep. This would be a significant economic reform. Australia would join the majority of OECD countries (24 of 38), including the US, Canada, France and Germany, that automatically adjust tax brackets to offset bracket creep or where doing so is not automatic but is the norm each year.

By allowing Australians to keep more of what they earn, indexation would remove a disincentive to work, especially for lower and middle income earners, young people starting their careers and women. This would encourage aspiration, improve workforce participation and increase the incentive to invest in skills and education and training. In the longer term, indexation would support productivity growth by strengthening the link between productivity gains and income increases, and encouraging a more efficient allocation of labour.

Indexation would also improve fiscal transparency and act as an ongoing constraint on government spending growth. Bracket creep means the Budget's forecasts and projections are a fantasy. They account for most major transfer payments being indexed to inflation, but do not account for the fact that future governments will have no choice but to eventually cut taxes to return bracket creep to workers. This means that the Budget, which as it is doesn't show a return to surplus for a decade, is actually in much worse shape than it appears. Essentially, this allows governments to hide the true state of the books by committing to future spending and forecast that it will be paid for by income tax revenue that will never be raised.

Without the automatic windfall provided by what is effectively an annual tax increase by stealth, governments would not be able to use bracket creep as a lazy, de facto fiscal repair mechanism. This would ensure a much needed increase in the level of scrutiny on future spending commitments. Future governments would need to actually explain how to sustainably fund commitments such as the NDIS and higher defence spending. They would need to finance new spending more transparently — by seeking a mandate to enact some combination of higher taxes or reduced spending elsewhere.

A unique opportunity for reform

The conclusion of the recent wave of income tax changes, in the form of the Stage 1 to 3 income tax cuts, coupled with recent reductions in the bottom income tax rate, **presents a unique opportunity** for the Government to pursue the indexation of income tax brackets to eliminate bracket creep.

For the first time, Australia has a set of reasonable tax brackets that are bipartisan and taking effect in an election year. This unique timing differs from all recent elections, which took place when tax brackets were in a much worse relative position or in the process of being altered following years of bracket creep. In contrast, the current tax brackets, as a proportion of average full-time earnings, are in line with the most reasonable positions they have been in over the past 25 years.

The tax cuts legislated following the 2025-26 Budget (lowering the 16 cent tax rate to 14 cents) provide a window of opportunity to achieve indexation at a lower cost — by delaying the indexation of the tax-free threshold while indexing all other brackets (either immediately or phased-in over several years). This is because these tax cuts will deliver a larger benefit than indexation would have, over the three years to 2027-28, for a significant proportion of net taxpayers who are currently in the $18,000-$45,000 bracket and paying the 16 cent marginal tax rate. These taxpayers will still be better off if indexation of the tax-free threshold to CPI is delayed until 2028-29.

MRC analysis finds that the cost of indexing tax brackets to inflation is modest — between $19.8 and $33.8 billion over the forward estimates, depending on whether other brackets are indexed immediately or over several years. This is far less than the $107 billion cost of the recent Stage 3 tax cuts. The details of these reform options can be found in the additional material provided.

Policies to improve productivity

It is often argued that enacting contentious or costly productivity enhancing reforms in the modern political environment is too hard without a 'burning platform' such as a recession to create the impetus for change. Even without the clear need to reverse the recent fall in per capita incomes, we believe Australia and developed nations are already facing such a scenario in the form of global geopolitical disorder and strategic competition with the autocracies of China, Russia, Iran and North Korea.

To confront the challenges ahead, including potential economic decoupling, tariff and trade wars and the direct move of autocracies towards establishing 'war economies', it has never been more important for Australia to find ways to improve productivity and become a stronger economy.

There is no consensus on the solutions to lower productivity growth and no single lever that governments can pull to guarantee higher productivity. There are many reforms economists generally agree that governments should enact that have been put in the too hard basket for too long. They include removing stamp duty for property purchases and insurance, deregulating retail trading hours, simplifying planning and zoning restrictions, and much more sharing of public sector data.

Rather than reprosecute these well understood policies, the MRC has instead advocated for lower-cost but high-impact actions across a broad range of fronts that the Commonwealth can progress unilaterally, or at least primarily lead within the Federation. These are outlined in the supporting material provided. The low-hanging fruit that we believe the PC should recommend to the Government includes:

- **Backing business investment**
  - The Government should allow businesses to defer Capital Gains Tax when the proceeds from asset sales are reinvested into new assets, as already occurs in the United Kingdom.
- **Better government services**
  - The Commonwealth should work with states to replicate a similar shared research model to the Australian Education Research Organisation (AERO) in other areas of government services that receive substantial Commonwealth funding, such as health and hospitals, and infrastructure. Among other areas, these research institutes could be tasked with researching and vetting the most effective uses of digital technologies such as AI, as the PC has already recommended AERO be tasked with.
- **A smarter infrastructure pipeline**
  - The tools developed for governments by Infrastructure Australia to analyse the impact of construction projects and manage the infrastructure pipeline should be made publicly available.
  - All governments should manage the impact of new projects on construction market capacity across portfolios, as recommended by Infrastructure Australia. The analytical tools developed by Infrastructure Australia should be used to better plan these investments

- **An Australian DARPA**
    - To emulate the model of the US's Defense Advanced Research Projects Agency (DARPA), the Government should follow the recommendation of the Defence Strategic Review and make the Australian Strategic Capabilities Accelerator independent of the Department of Defence.

Thank you for the opportunity to contribute to this inquiry. Full copies of the recent MRC reports on Productivity and Income Tax are included as supporting material to this submission.