



# briefing paper



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### **The tax reform debate: GST and other options**

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by Andrew Haylen

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# The tax reform debate: GST and other options

by

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## **ACRONYMS**

ABS Australian Bureau of Statistics

ACOSS Australian Council of Social Service

ANU Australian National University

ATO Australian Taxation Office

BCA Business Council of Australia

CGC Commonwealth Grants Commission

CGT Capital Gains Tax

COAG Council of Australian Governments

GDP Gross Domestic Product

GST Goods and services tax

HFE Horizontal Fiscal Equalisation

IMF International Monetary Fund

MYEFO Mid-Year Economic and Fiscal Outlook

NATSEM National Centre for Social and Economic Modelling

OECD Organisation for Economic Co-operation and Development

PBO Parliamentary Budget Office

PC Productivity Commission

PWC PriceWaterhouseCoopers

VAT Value added tax

VRR VAT revenue ratio

## SUMMARY

This paper lays out evidence for and against increasing the rate and broadening the base of the GST. It also compares the GST with other revenue raising options to assess the possible viability of tax reform to address projected structural budget deficits.

### Background and current application of the GST

In 2015-16, the Commonwealth Government is expected to raise \$376 billion in taxation revenue, \$59.8 billion (or 16%) of which will be raised from the GST. Currently all of the money raised by the GST is provided to the States and Territories. [2.1]

At 10%, the consumption tax rate in Australia is among the lowest of other OECD countries - of the 34 OECD countries that levied a VAT, 29 countries imposed a higher rate than Australia. Additionally, since 2009 21 countries raised their standard VAT rate at least once. [2.2]

Australia's tax system has been subject to major reviews or reform at least every decade since the 1970s. However, the GST was precluded from the terms of reference in the Henry Tax Review of 2010. With a chapter dedicated to the GST, the [White Paper](#) process arguably signals the first step by the Commonwealth Government to, at least, review the structure of the GST since it was introduced in 2000. [2.3]

### Criteria for evaluating the appropriateness of taxation changes

Taxation affects economic incentives and induces behavioural adjustments for individuals and firms, causing efficiency costs compared to a hypothetical situation without taxes. Consequently, the principle in determining a preferential choice of tax is how to characterize the second-best setting that implies minimum efficiency losses, among other factors, given fixed government revenue. Other key factors relate to equity and simplicity. [3]

### Evidence for a GST tax increase

The main argument in favour of a consumption tax is that it is **relatively efficient**, particularly in terms of its neutrality toward savings. The 2015 Treasury modelling of the major taxes in Australia concluded that the taxes with highest long-term costs for living standards are company income tax and stamp duties; with the GST among the lowest. [4.1]

The GST was initially implemented to provide States with a robust source of revenue and be predictable to assist States in managing their fiscal positions. However, the GST share of the **consumption base has declined** to 47% because Australian households are now saving more and spending proportionately more on GST exempt goods and services. [4.2]

The Commonwealth Government has run underlying structural deficits for 8 years and the outlook remains rather pessimistic in terms of revenue growth. For States and Territory Governments, spending on health and education and



other vital areas is growing faster than GDP. As such the GST is seen as one of the possible solutions to **address the underlying structural budget weaknesses** going forward. Raising the GST to 15% and leaving the base unchanged would result in \$24.6 billion in net annual revenue in 2015-16. **[4.3]**

Malcom Turnbull stated recently that any change in the GST would have to be justified in terms of creating economic growth and jobs. The evidence on this point is mixed, with contrasting estimates from Treasury and KPMG on the potential growth and spending implications of a GST rate increase. **[4.4]**

### **Evidence against increasing the GST**

The GST is regressive and this is at the core of arguments against increasing the GST because people on lower incomes spend a greater proportion of their income on goods and services that will be taxed. Households in the lowest income decile, on average, pay around 12% of their disposable income on GST or about three times the proportion paid by those in the highest income decile.

The National Centre for Social and Economic Modelling (NATSEM) estimated that households would spend 9.8% of their disposable income on GST if the base was broadened to include food, education and health; up from 7.4% in the current scenario.

NATSEM also showed that purchasing power is reduced most significantly for households in the lowest two income quintiles. If the GST was increased to 15% without broadening the base, \$7.9 billion of compensation would be required in the initial year of implementation. **[5.1.1]**

Others, however, argue that the GST should not be seen as a standalone policy option, but be assessed in the context of the broader tax and transfer system. This is because the combined effect of taxes and transfers in Australia is progressive and is well placed when compared to other OECD nations. **[5.1.2]**

### **Broadening the base**

The main categories of consumption that are GST-free are fresh food, health, education, childcare and financial services. The Treasury estimate that the non-applicability of the GST to the six biggest classes of exempt expenditure reduces revenues by over \$21 billion per year. The foregone revenue from these GST-exempt items is also expected to continue to erode the GST base in line with recent historical trends. As such, base broadening to include some of these items is being discussed as a means of recapturing lost revenue. **[6.1]**

A broader base is also considered to be more efficient and administratively easier to implement. This is because there are fewer 'grey lines' between exempt and non-exempt categories which reduces opportunities for tax avoidance and lobbying by rent-seekers for exclusion of particular goods. **[6.2]**

The New Zealand model is generally considered to be one of the more effective GST regimes in terms of best international tax practices and essentially limits the exemption to certain types of financial services, supply of donated goods and services by non-profit organizations and residential rental. **[7.1]**

## Options for expenditure of additional revenue

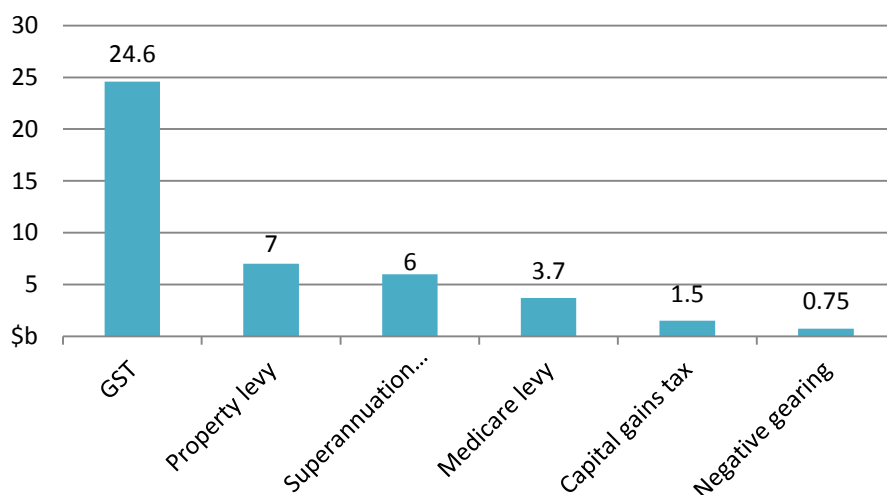
Various proposals have been put forth as to the various ways in which additional revenue could be spent. In addition to providing compensation to lower income earners (Chapter 8.1), this revenue could be used to reduce personal income taxes (Chapter 8.2) or be used to eliminate inefficient taxes like insurance levies or fund State government services like health (Chapter 8.3). Alternatively, it could be used by the Commonwealth Government to rebalance its fiscal position (Chapter 8.5).

## Alternative revenue raising options

Other reform options have been proposed, typically because they seem a more viable political proposal, particularly from an equity perspective. The main options proposed in the tax reform debate to date include: reducing the personal capital gains tax discount; increasing the Medicare levy; grandfathering negative gearing; introducing a State based property levy; and modifying superannuation contribution tax concessions. [9.1 – 9.6]

However, the other major reform options proposed in the debate thus far are, collectively and at least in the short term, unlikely to raise as much revenue as the GST would and may be associated with higher administrative costs than a single GST change.

### Alternative revenue raising options, annual gains, 2015-16



Therefore, without an unlikely and substantial improvement in the terms of trade and other external growth factors, realistically the Government is unlikely to address the substantial structural budget deficit from the revenue end, should the GST be formally removed from the tax reform agenda. As such, spending measures are most likely going to present the only other option available to Government. Spending reforms have not been addressed in this paper and is arguably the next step on the wider budget and tax reform debate.

## 1. INTRODUCTION

The Commonwealth Government has run underlying structural deficits for 8 years and the outlook remains rather pessimistic in terms of revenue growth.<sup>1</sup> For the State Governments, spending on health and education and other vital areas is growing faster than GDP; while at the same time, revenues are threatened because of reduced Commonwealth transfers.

The GST debate has consequently been brought forward, in part, to find sustainable ways to address the current and potentially worsening structural budget deficits. That being said, it is also part of a wider debate – recently initiated by the Tax Discussion Paper – about ways to examine the efficiency and sustainability of the tax base in Australia given a fixed government revenue target. However, at this stage, a revenue target is yet to be determined and remains a topic of conjecture, as emphasised recently by Paul Keating.<sup>2</sup>

The GST debate has divided political opinion. The NSW and South Australian State Premiers Mike Baird and Jay Wetherill have been firmly in favour of a GST increase; while the Victorian Premier Daniel Andrews put forward the proposal of increasing the Medicare levy to cover additional health spending. The Shorten Labor Opposition has come out in opposition to any changes to the GST, suggesting that it would impact lower income households hardest.

On 8 February 2016, Prime Minister Malcolm Turnbull identified “economic growth and jobs” as key motivations behind any tax reform; suggesting that he was yet to be convinced about suggested benefits from a direct GST and income tax swap. From this, many concluded that the GST was “off the tax reform table.”<sup>3</sup> Other tax reform and revenue options remain to be decided upon.

Bearing this in mind, this paper seeks to lay out the evidence for and against increasing the rate and broadening the base of the GST in terms of the GST’s relative efficiency, equity and revenue raising capacity. It also lays out the potential spending options if additional revenues were raised from a GST. As a prelude to that discussion this paper outlines the current application of the GST in Australia, particularly in comparison to similarly developed economies.

The final chapter of this paper will then compare the GST with other revenue raising options to assess the possible viability of tax reform to address projected structural budget deficits.

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<sup>1</sup> Treasury (2014) [Long Run Forecasts of Australia’s Terms of Trade](#), p.1

<sup>2</sup> Sydney Morning Herald, [Paul Keating slams a bigger GST as faux reform but admits hospital funding crisis](#), 3 February 2016

<sup>3</sup> Sydney Morning Herald, [Tax white paper: GST benefits small compared to those of other reforms, says Turnbull](#), 8 February 2016

## 2. BACKGROUND AND CURRENT APPLICATION OF THE GST

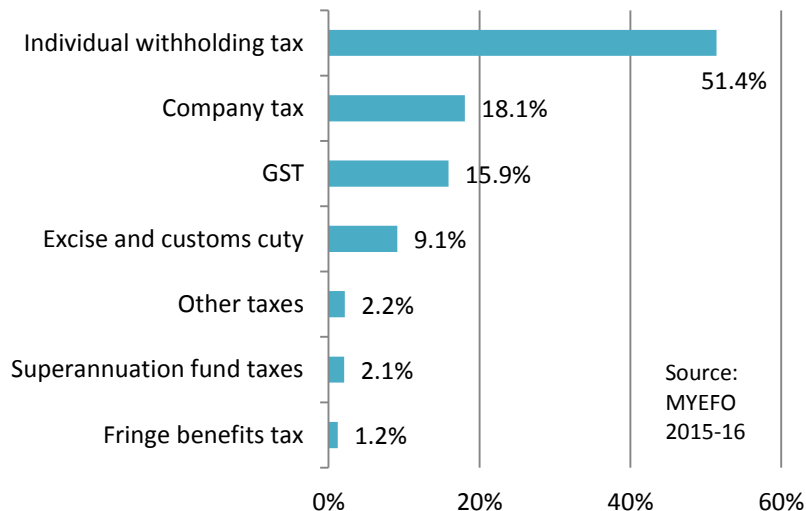
The introduction of the GST from 1 July 2000, under the *A New Tax System (Managing the GST Rate and Base) Act 1999*, was one part of a major suite of changes to taxation and federal financial arrangements, which also included the replacement of the Commonwealth Wholesale Sales Tax and<sup>4</sup>, over time, the abolition of several inefficient State taxes.<sup>5</sup> Upon introduction, the Howard Government also made reforms<sup>6</sup> to individual income tax and family payments, in part to compensate for the effect of an expected small net increase in indirect taxes.

As part of the 2008 *Intergovernmental Agreement on Federal Financial Relations*<sup>7</sup> between the States and the Commonwealth, any future change to the rate or base of the GST requires the unanimous support of the Commonwealth and every State.<sup>8</sup>

### 2.1 How the GST is currently applied

In 2015-16, the Commonwealth Government is expected to raise \$376 billion in taxation revenue, \$59.8 billion of which will be raised from the GST.<sup>9</sup>

**Figure 1: Revenue from Commonwealth Government taxes, 2015-16**



The GST is a value-added<sup>10</sup> consumption tax (VAT) applied in Australia at a

<sup>4</sup> Australian Government (2012) [GST Distribution Review – Final Report](#), p.151

<sup>5</sup> Abolished taxes included accommodation taxes, financial institutions duties, and quoted marketable securities and debits taxes.

<sup>6</sup> Australian Government (1998) [Tax Reform: Not a New Tax, A New Tax System — The Howard Government’s Plan for a New Tax System](#), Canberra

<sup>7</sup> Australian Government (2015) [Re:think - Tax discussion paper](#), p.131

<sup>8</sup> Ibid

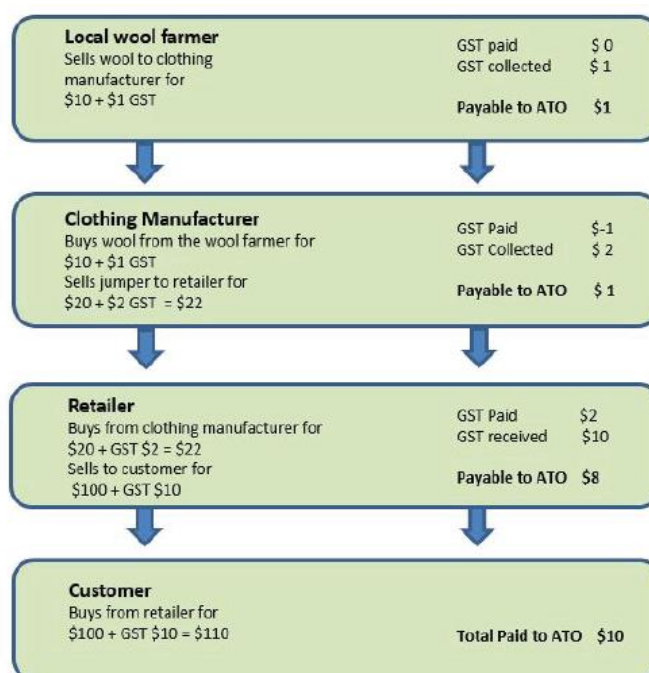
<sup>9</sup> Australian Government (2015) [Mid-Year Economic and Fiscal Outlook](#), Appendix B, p.233

<sup>10</sup> Value added can be simply measured as the difference between the value of output and the cost of inputs.

rate of 10% to a broad range of goods and services. There are, however, a considerable number of exemptions, including fresh food, health, education, and childcare. These align with what the OECD calls “standard” exemptions<sup>11</sup> and typically occur for equity<sup>12</sup> and administration reasons<sup>13</sup> (Chapter 6.1). Because of these and other exemptions, around 47% of Australia’s national consumption base is subject to GST.<sup>14</sup>

The GST, which is applied in Australia using the invoice-based credit method, is collected through a staged process on the value added at each stage of production and distribution (Figure 2).

**Figure 2: How does the GST work?**<sup>15</sup>



In other words, a firm at any stage of the production-distribution chain charges its customers the GST on its output, submits the tax to the ATO and then claims for the GST already paid on its input purchase.<sup>16</sup> This effectively means the “economic incidence” of the GST falls on the consumer.<sup>17</sup> However, as

<sup>11</sup> OECD (2015) [International VAT/GST Guidelines, Third Meeting of the OECD Global Forum on VAT](#), p.76

<sup>12</sup> Fresh food was made GST-free as part of negotiations with the Australian Democrats to secure passage of the GST legislation through the Senate.

<sup>13</sup> For example, the output may be hard to define (e.g. financial and insurance services) and/or may be justified on distributional objectives (e.g. exemptions for fresh food and health care).

<sup>14</sup> OECD (2014) [Consumption Tax Trends 2014](#), OECD, Paris.

<sup>15</sup> ATO (2014) [How GST works](#), accessed 24 November 2015

<sup>16</sup> The World Bank (2003) [Value Added Taxation: Mechanism, Design, and Policy Issues](#), p.10

<sup>17</sup> Stewart et. al (2015) [A stocktake of the tax system and directions for reform – five years after the Henry Review](#), Tax and Transfer Policy Institute, p.73

explained by the Treasury (2015):<sup>18</sup>

...the legal incidence is at each step in the supply chain, with registered entities (that is, entities carrying on an enterprise) including GST in the price of goods and services they sell. If the recipient of the supply is a registered entity, it will normally be able to claim a credit for the amount of GST in the price.

Businesses with annual turnover of less than \$75,000 do not need to register for the GST.<sup>19</sup> There are 2.73 million entities currently registered for the GST which comprises of:<sup>20</sup>

- micro enterprises (91%);
- small-to-medium enterprises (5.9%);
- non-profit organisations (2.4%);
- large businesses (0.35%); and
- government organisations (0.35%).

In keeping with the internationally accepted system for value added taxes, imported goods and services are subject to GST. Exported goods and services, including international travel purchased in Australia, are exempt from the GST as they are not consumed in Australia. This adheres to the destination principle such that the tax is ultimately levied only on the final consumption that occurs within the taxing jurisdiction.<sup>21</sup> The destination principle is the international norm and is sanctioned by World Trade Organization rules<sup>22</sup> and effectively achieves neutrality in international trade.<sup>23</sup>

A threshold of \$1000 for GST is applicable to imported goods.<sup>24</sup> As noted, by Stewart et. al (2015), “the rapid growth of online retailing has meant that this threshold is associated with increasing base erosion for the GST,” as well as concerns regarding “competitive neutrality implications” for retailers.<sup>25</sup> (Chapter 6.1.2)

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<sup>18</sup> ATO (2015) [Tax Expenditures Statement - 2014](#) ,p.140

<sup>19</sup> ATO (2013) [GST for small business](#), p.3

<sup>20</sup> Australian Taxation Office, [Compliance in focus](#), 2013-14

<sup>21</sup> OECD (2015) [International VAT/GST Guidelines, Third Meeting of the OECD Global Forum on VAT](#), p.12

<sup>22</sup> Footnote 1 of the WTO's *Agreement on Subsidies and Countervailing Measures* provides that “... the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy.”

<sup>23</sup> OECD (2014) [Consumption Tax Trends 2014](#), OECD, Paris

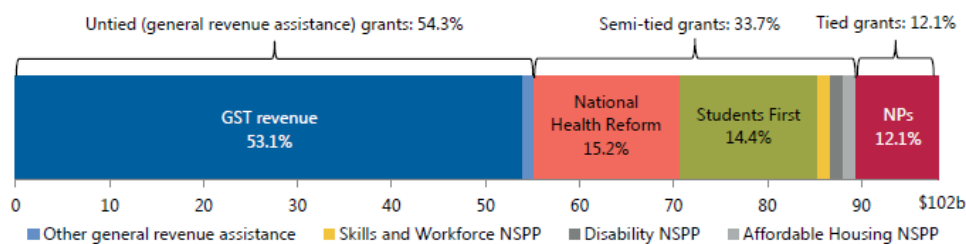
<sup>24</sup> Australian Parliamentary Library (2014) [Online shopping and potential changes to the low value threshold: costs and benefits for government, consumers and retailers](#), p.3

<sup>25</sup> Stewart et. al (2015) [A stocktake of the tax system and directions for reform – five years after the Henry Review](#), Tax and Transfer Policy Institute, p.75

### 2.1.1 Distribution of GST revenue to the States – horizontal fiscal equalisation

Currently all of the money raised by the GST is provided to the States and Territories (except for non-general interest charge penalties), accounting for more than half of all Commonwealth grants to States and Territories in 2014-15 (Figure 3). The States and Territories compensate the Commonwealth Government for the costs incurred by the ATO in administering the GST,<sup>26</sup> estimated at just under \$700 million in 2014-15.<sup>27</sup>

**Figure 3: Breakdown of Commonwealth grants to States and Territories, 2014-15<sup>28</sup>**



**Horizontal fiscal imbalance** refers “to the situation where the States have differing abilities to provide comparable levels of services through the imposition of comparable tax burdens, because of demographic and economic disparities between them.” **Fiscal equalisation** involves the transfer of payments or grants across jurisdictions to address this imbalance and is defined as **horizontal fiscal equalisation** (HFE).<sup>29</sup> As discussed by the Commonwealth Grants Commission (CGC):<sup>30</sup>

If States had the same economic, social and demographic features and Commonwealth payments were distributed uniformly among them, the Commission would recommend that the GST be distributed equally per person. Each State would be allocated the same (average) amount per resident.

However, some States are fiscally stronger than others — they have stronger tax bases, lower service delivery costs or receive above average Commonwealth payments. They need less GST revenue than other States if all States are to be fiscally equal.

Since 2000, the main mechanism used to achieve HFE has been the GST, the revenue shares of which are determined by the Commonwealth Treasurer based on independent advice from the CGC.<sup>31</sup>

<sup>26</sup> Australian Government (2015) [Re:think - Tax discussion paper](#), p.131

<sup>27</sup> Treasury (2014) [Budget Paper 3 2014-15](#), Table 3.9

<sup>28</sup> Australian Government (2015) [Reform of the Federation Discussion Paper](#), p.91

<sup>29</sup> Commonwealth Grants Commission, [What is fiscal equalisation?](#), accessed 21 January 2016

<sup>30</sup> Ibid

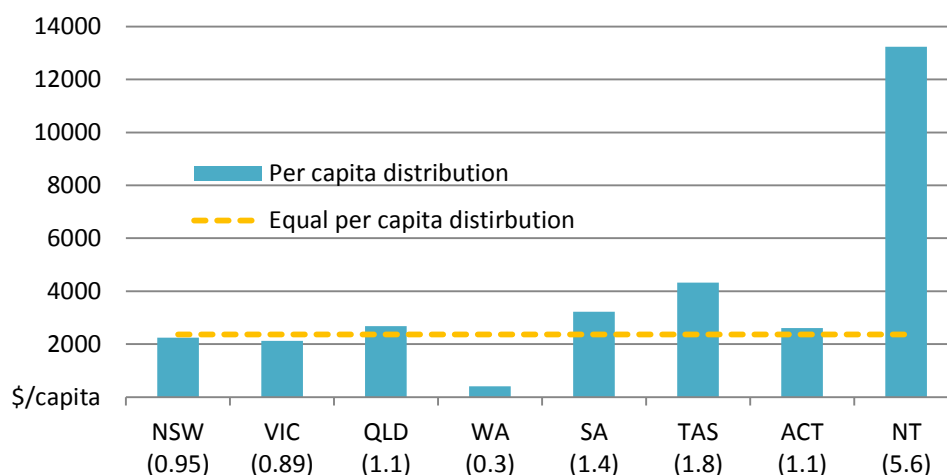
<sup>31</sup> Commonwealth Grants Commission, [Report on GST Revenue Sharing Relativities – 2015 Review](#), 2015

The CGC considers a broad range of revenue and expenditure factors in determining the formula or “relativities” for redistribution. For example:<sup>32</sup>

States and Territories with a fiscal capacity above the national average will receive a share of the GST pool that is less than their equal per capita share (making them ‘donors’), while States and Territories with a fiscal capacity below the average will receive a share greater than their equal per capita share (making them ‘recipients’).

Currently New South Wales, Victoria, and Western Australia are donors and the other jurisdictions are recipients (Figure 4). This changes over time as economies and demographic profiles evolve. The figure below compares the GST share of each State and Territory to their notional equal per capita share, as well as GST relativities for each State and Territory.

**Figure 4: GST funding per capita and GST relativities, 2015-16<sup>33</sup>**



## 2.2 Comparison with other OECD countries<sup>34</sup>

Although most international VAT systems are built on the same core principles<sup>35</sup>, there is considerable diversity in their respective structures, particularly with respect to rates, exemptions and other preferential treatments.

At 10%, the consumption tax rate in Australia is among the lowest of other OECD countries. As at January 2015, of the 34 OECD countries that levied a VAT, 29 countries imposed a higher rate than Australia. In the period since Australia introduced its GST in 2000, 23 OECD countries have increased their VAT rate (Figure 5); although it should be noted that the average increase was 2.4%. The largest increase of all the OECD nations in that period was for

<sup>32</sup> Australian Government (2015) [Reform of the Federation Discussion Paper](#), p.99

<sup>33</sup> Treasury (2015) [Budget Paper No. 3 2015-16](#), p.79

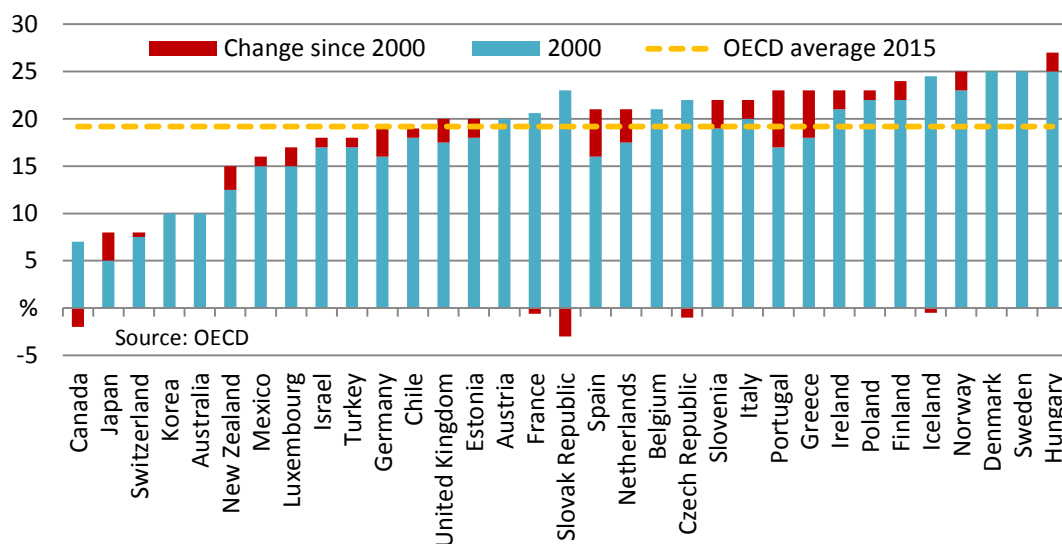
<sup>34</sup> This section only aims to provide a brief comparison of VAT rates and exemptions between Australia and other OECD countries – for more comprehensive historical analysis see the OECD (2014) [Consumption Tax Trends 2014](#), OECD, Paris.

<sup>35</sup> OECD (2014) [Consumption Tax Trends 2014](#), OECD, Paris, p.44



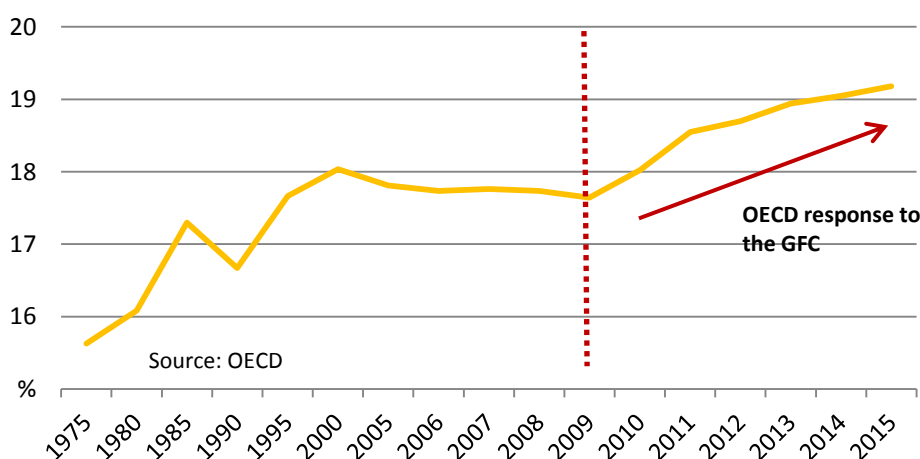
Portugal at 6%, followed by 5% increases in Spain and Greece. Additionally, the increases for these three countries were introduced incrementally rather than in a single year.

**Figure 5: Value-added tax rates, OECD nations, 2000 and 2015**



As discussed by the OECD (2014), the period since 2009 has marked a considerably increase in the average VAT rate (Figure 6), 21 countries raising their standard VAT rate at least once<sup>36</sup> in response to financial consolidation pressures caused by the economic and financial crisis.

**Figure 6: OECD VAT rate, weighted average, 1975-2015**

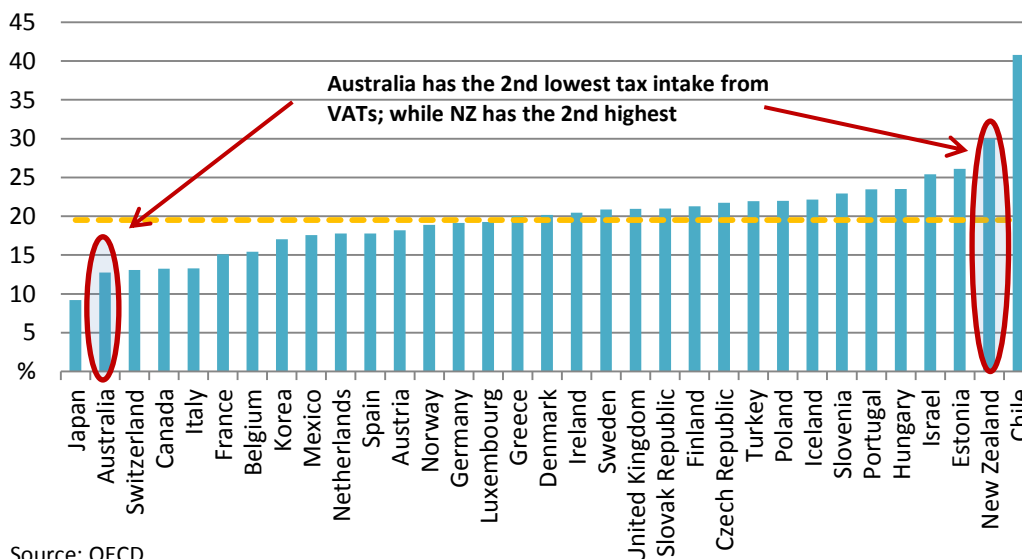


Australia relies less on consumption taxes than other comparable OECD-10 countries, with the exception of Japan and the United States (Figure 7). In addition to applying a relatively low rate of GST, a major factor explaining the shortage of consumption tax revenue in Australia is the narrowness of the base. That is, Australia exempts some large expenditure categories from the GST

<sup>36</sup> OECD (2014) [Consumption Tax Trends 2014](#), OECD, Paris, p.44

(including some food and beverage items, most health and medical expenses and some education expenses).<sup>37</sup>

**Figure 7: Value-added taxes as a % of total tax revenue, OECD nations, 2013**



Source: OECD

But note that Australia is not unique in this regard, as many OECD countries continue to apply reduced or GST-free rates to a broad range of products such as basic essentials, financial services and pharmaceuticals. These reduced rates and exemptions have typically not changed either in recent years, even though the standard VAT rates have increased.<sup>38</sup>

To compare the effects of exemptions<sup>39</sup>, the OECD has derived an index called the VAT revenue ratio (VRR) which measures the difference between the VAT revenue collected and what would be raised if a VAT was applied at the standard rate to the entire potential tax base in a “pure” VAT regime.<sup>40</sup> In 2012, the VRR for Australia was 0.47, a decline from 0.54 in 2006. This indicates that a growing proportion of consumption expenditure is going towards items exempt from the GST (Chapter 6.1).<sup>41</sup>

By comparison, the unweighted OECD VRR average is 0.55 which suggests that preferential treatments, such as reduced rates and exemptions, are still used widely in OECD countries (Figure 8). Because of this, a considerable part of the potential VAT revenue is not collected.<sup>42</sup>

<sup>37</sup> Productivity Commission (2015) [Tax and transfer incidence in Australia](#), p.28-29

<sup>38</sup> OECD (2014) [Consumption Tax Trends 2014](#), p.10

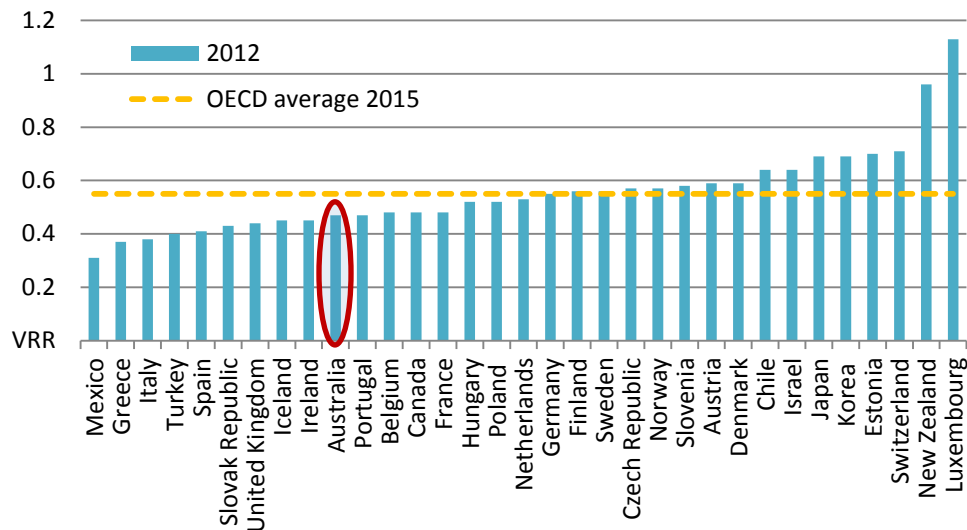
<sup>39</sup> For a complete and up to date list of exemptions across OECD countries, see Table 2.A2.4 [Consumption Tax Trends 2014](#)

<sup>40</sup> OECD (2014) [Consumption Tax Trends 2014](#)

<sup>41</sup> Productivity Commission (2015) [Tax and transfer incidence in Australia](#), p.29

<sup>42</sup> OECD (2014) [Consumption Tax Trends 2014](#), p.94

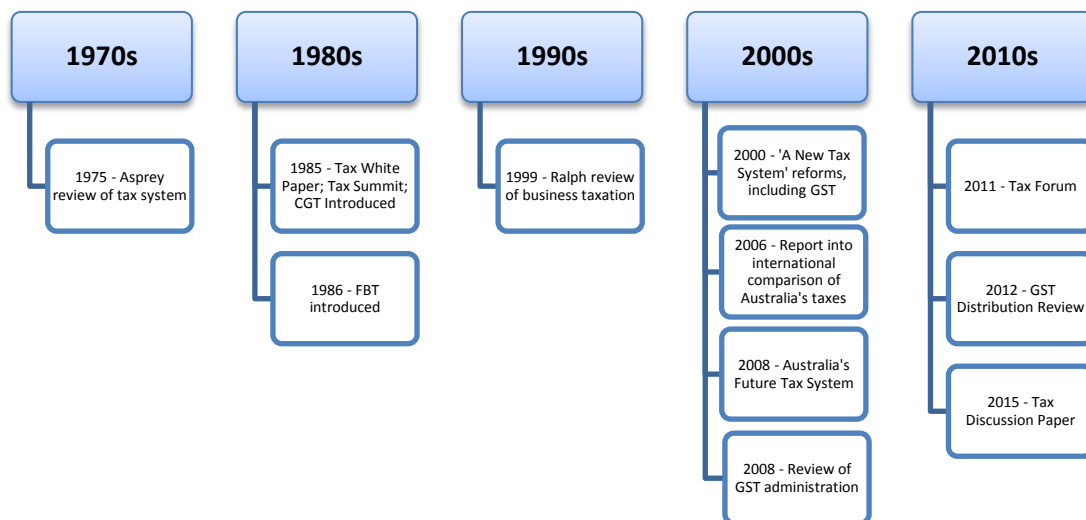
Figure 8: The GST/VAT revenue ratio in selected countries, 2012<sup>43</sup>



### 2.3 Recent Australian taxation reviews

Australia’s tax system has been subject to major reviews or reform at least every decade since the 1970s.<sup>44</sup> This section of the paper outlines key reviews in recent years as they relate to suggested changes or reforms to the GST.

Figure 9: Chronology of recent tax reviews and reform<sup>45</sup>



A key finding from this Chapter is that most of these reviews have neither discussed nor recommended any large scale changes to the GST in terms of base broadening and rates rises. The *Re:think Better Tax, Better Australia*

<sup>43</sup> OECD (2014) [Consumption Tax Trends 2014](#), p.110

<sup>44</sup> The Centre for Independent Studies (2012) [The Henry Tax Review: A Liberal Critique](#), Issues Analysis, p.3

<sup>45</sup> Adapted from: Business Council of Australia (2014) [The future of tax: Australia's current tax system](#), p.11

Discussion Paper provides the best discussion of past reviews.

### 2.3.1 Henry Tax Review (2010)

In May 2010, the Australian Treasury released its review into Australia's tax and transfer system<sup>46</sup>, [Australia's Future Tax System: Report to the Treasurer](#) (The Henry Tax Review).

The Henry Tax Review recommended the abolition of various relatively inefficient State taxes, including conveyancing duties and insurance levies. However, to maintain revenue for the Commonwealth Government, it was suggested that "other relatively more efficient taxes may need to be raised to fund the abolition of the inefficient taxes."<sup>47</sup>

Then Treasurer Wayne Swan called the Henry Review "the most comprehensive review of Australia's tax system since World War II."<sup>48</sup> However, it was precluded by its terms of reference from recommending changes to the rate or base of the GST.

The Centre of Independent Studies (2012) in their [critique](#) of the Tax Review highlighted the lack of insight regarding consumption taxes as one of the key flaws of the review.<sup>49</sup>

### 2.3.2 Tax Forum and Discussion Paper (2011)

The [Tax Forum](#) was held in October 2011 and brought together around 180 representatives of the community, business, and government, as well as academics and other tax experts to discuss priorities and directions for further tax reform. [Tax Reform: Next Steps for Australia](#) was the discussion paper released in July 2011. The forum "continued the "conversation the Government started with the release of the *Australia's Future Tax System Review* in 2010".<sup>50</sup>

By virtue of this fact, the GST – certainly in terms of adjustments to the base and rate – was left untouched in the discussion paper. The issues related to the distribution of GST between the States and Territories – by way of horizontal fiscal equalisation – are discussed briefly under the 'Session 4' section of the paper.

The [Tax Reform Road Map – A stronger, smarter and fairer tax system](#) was published by the Gillard Government in May 2013; and while it highlighted a

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<sup>46</sup> Transfer payments are defined in this paper as cash payments provided by governments to individuals and families. All cash payments are administered by the Australian Government and financed from general government revenue.

<sup>47</sup> KPMG (2011) [Economic Analysis of the Impacts of Using GST to Reform Taxes](#), Report prepared for CPA Australia, p.i

<sup>48</sup> Swan, W. (2008) [Budget Speech - Transcript](#)

<sup>49</sup> The Centre for Independent Studies (2012) [The Henry Tax Review: A Liberal Critique](#), Issues Analysis, p.5-7

<sup>50</sup> Treasury, [Tax Forum](#), accessed 14 December 2012

number of tax related issues, the GST was not discussed at any length from a reform point of view.

### 2.3.3 Tax Discussion Paper (2015)

With the Coalition in Government, then Treasurer Joe Hockey “opened the [latest] conversation on tax”<sup>51</sup> by releasing the [Re:think Better tax, better Australia](#) Discussion Paper in March 2015.

While the discussion paper does not make any specific recommendations with regard to the GST, it does highlight a number of structural issues with regard to the rate and base of the current GST and the implications that they may have for Commonwealth and State revenues going forward. These issues and evidence from the Discussion Paper will be examined at further length in later Chapters of this paper.

With a chapter dedicated to the GST, this White Paper process arguably signals the first step by the Commonwealth Government to, at least, review the structure of the GST since it was introduced in 2000.

### 2.3.4 Other GST related reports and inquiries

#### Review of the legal framework for the administration of the GST (2008)

In December 2008, the Board of Taxation submitted its [Review of the legal framework for the administration of the GST](#) to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs; it was publicly released in May 2009. Prior to this, an issues paper was published in July 2008 which provided an outline of the legal framework and the operation of the GST. The broad aim of the review was to:<sup>52</sup>

...consider reforms to the GST law that result in reductions in compliance costs, that improve the operation of the GST or remove anomalies provided the changes do not result in any changes to the scope and extent of what goods and services are subject to the GST.

This was the first formal review undertaken of the GST since its introduction in 2000.<sup>53</sup> Following the review, the Board noted that while the GST system overall is operating effectively, there were:<sup>54</sup>

...a number of opportunities exist to reduce compliance costs and to streamline and improve the operation of the legal framework for the administration of the GST and remove anomalies in its operation.

<sup>51</sup> Australian Government (2015) [Re:think - Tax discussion paper](#), accessed 1 February 2016

<sup>52</sup> Australian Government. (2008) [Review of the Legal Framework for the Administration of the Goods and Services Tax – Issues Paper](#), p.vii

<sup>53</sup> Ibid, p.v

<sup>54</sup> Ibid, p.vii

In responding to the issues raised in the Review, the Board made 36 substantive recommendations and 10 recommendations for technical amendments. Included in these were the recommendations to:

- modify the GST adjustment provisions<sup>55</sup> through a new set of rules in order to reduce compliance costs for taxpayers and encourage better compliance;
- streamline and simplify the operation of the GST grouping rules and reduce a range of current anomalies that exist; and
- achieve greater standardisation between the income tax and the GST regimes.

While important to the structure and operation of the GST, these complex administrative issues are beyond the scope of this research paper and are discussed in detail across both the issues paper and the final review from the Board of Taxation.

### **GST Distribution Review (2012)**

As outlined in Chapter 2.1, the GST is distributed to the States based on the principle of horizontal fiscal equalisation. [This Review](#), which was conducted by the Hon Nick Greiner, the Hon John Brumby and Bruce Carter considered:

...whether the distribution of the GST and the current form of horizontal fiscal equalisation will ensure that Australia is best placed to respond to long-term trends and structural change in the economy while maintaining confidence in the financial relationships within the Australian Federation.

One of the findings from the review was that South Australia, Tasmania, the Australian Capital Territory and the Northern Territory support the current equalisation system; while New South Wales, Victoria, Queensland and Western Australia see major problems with it.<sup>56</sup>

Of most relevance to this paper, Chapter 11 of the report assessed the GST revenue base itself, and its role in providing both the basis for untied grants to the States and for delivering horizontal fiscal equalisation. The report noted that:<sup>57</sup>

...States' budget stability is often more greatly affected by movements in the overall pool than they are by movements in their share of it.

The main finding from Chapter 11 of the report was that GST collections have been both less buoyant over recent times and more volatile than expected when

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<sup>55</sup> That is, where GST paid or input tax credits claimed in earlier tax periods need to be adjusted to reflect changed circumstances

<sup>56</sup> Australian Government (2012) [GST Distribution Review – Final Report](#), p.5

<sup>57</sup> Ibid, p.151

the GST was introduced (Chapter 4.2 of this paper for discussion).<sup>58</sup> The Panel identified two specific opportunities for augmenting the pool of untied funds received by the States in the short term, namely:<sup>59</sup>

- preventing the leakage of GST revenue from online imports; and
- revisiting States' obligations to fund the current First Home Owners Scheme.

### 3. CRITERIA FOR EVALUATING THE APPROPRIATENESS OF TAXATION CHANGES

The key point to emphasise prior to discussing these criteria is that tax reform should not be assessed in isolation but rather in the context of the broader tax regime in which it is implemented.

In broad terms, taxation affects economic incentives and induces behavioural adjustments for individuals and firms, causing efficiency costs compared to a hypothetical situation without taxes. Even the best and most efficient forms of taxation cause distortions. Consequently, the principle in determining a preferential choice of tax is how to characterize the second-best setting that implies minimum efficiency losses, among other factors, given *fixed government revenue*.<sup>60</sup> Other key factors relate to equity and simplicity (Figure 10).<sup>61</sup>

At this stage, a fixed government revenue target is yet to be determined. A point made by Peter Martin writing in *The Age* is that “a clear [revenue] goal” was needed before a change in the GST could be adequately assessed. To illustrate, Scott Morrison was recently stated that any change to the GST would be revenue neutral – which implies that any change would be on the grounds of efficiency gains from substituting one tax with another.<sup>62</sup> On the other hand, the States and Territories – particularly Jay Wetherill of South Australia and Mike Baird of NSW – have a clear revenue generation agenda. The contrasting perspectives are not discussed in detail in this paper which takes fixed government revenue as its analytical starting point.

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<sup>58</sup> Australian Government (2012) [GST Distribution Review – Final Report](#), p.8

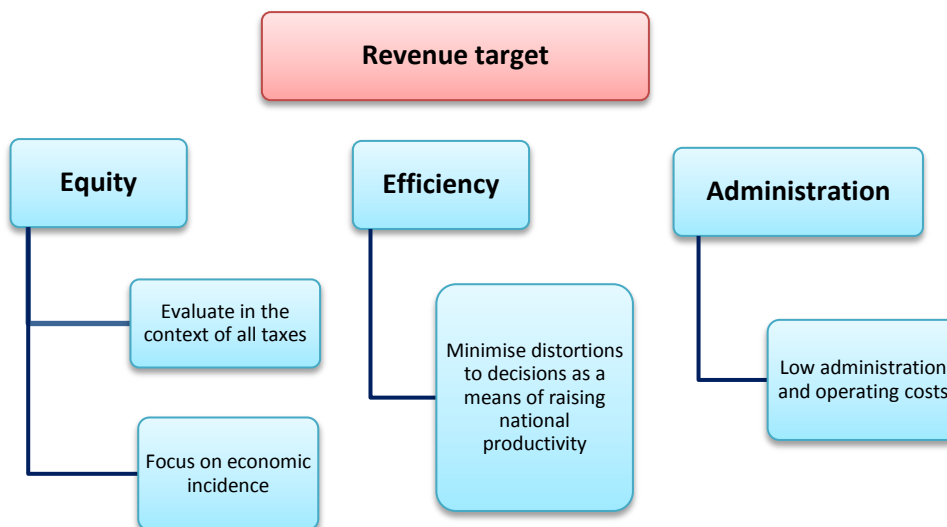
<sup>59</sup> *Ibid*, p.158

<sup>60</sup> Pestel, N, and Sommer, E. (2013) [Shifting Taxes from Labor to Consumption: Efficient, but Regressive?](#), Institute for the Study of Labor, Discussion Paper No. 7804, p.3

<sup>61</sup> OECD (2008) [Tax and economic growth](#), Economics Department Working Paper No.620, p.2

<sup>62</sup> Sydney Morning Herald (2016) [Mike Baird makes new case for 15% GST](#), 1 February 2016

Figure 10: Broad criteria for assessing tax reform given a fixed revenue target



With regard to consumption taxes, the generally accepted set of principles used, as outlined in the OECD (2015) International VAT/GST Guidelines, are as follows:<sup>63</sup>

- **Neutrality:** Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.
- **Efficiency:** Compliance costs<sup>64</sup> for businesses and administrative costs for the tax authorities should be minimised as far as possible.
- **Certainty and simplicity:** The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where, and how the tax is to be accounted.
- **Effectiveness and fairness:** Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved.
- **Flexibility:** The systems for taxation should be flexible and dynamic to

<sup>63</sup> OECD (2015) [International VAT/GST Guidelines, Third Meeting of the OECD Global Forum on VAT](#), p.13-14

<sup>64</sup> Compliance costs generally refer to the incremental burden that businesses bear in complying with regulation. Compliance costs include, but are not limited to, the costs of: acquiring the necessary knowledge of the tax system; compiling records; dealing with the Tax Office; evaluating the effectiveness of alternative transactions or methods of complying with the law; and collecting and remitting taxes.



ensure that they keep pace with technological and commercial developments.

Saul Eslake summarises the above factors succinctly, concluding that “the taxation system should ideally be equitable as between taxpayers, and certain in its impact on each of them; simple to comply with; and parsimonious in its costs of administration and collection.”<sup>65</sup>

The choice of a consumption tax base is generally seen as preferred because:<sup>66</sup>

- the tax base is robust and reliable as tax revenues grow in line with aggregate household expenditure, regardless of the type of the goods and services consumed;
- the tax can be levied to maximise the production of goods and services with minimal economic costs to the economy; and
- with a uniform rate of tax applied to the broadest range of consumption expenditure, a consumption tax will not distort relative prices.

For example, one of the factors that simplifies the collection of an indirect tax (e.g. GST) rather than a direct tax is that the tax is collected by a significantly lower number of taxpayers – there are approximately 2 million GST registrants compared to a possible population of over 20 million consumers.<sup>67</sup>

However, because the GST is a regressive tax – that is, low income earners pay relatively more than higher income earners – there are a number of equity issues that have to be reconciled with its implementation; typically through exemptions, tax cuts and/or direct transfers.

The following chapters present the core evidence for (Chapter 4) and against (Chapter 5) a GST rate increase as related to the criteria above. Chapter 6 will then examine the current issues related to a broadening of the GST base.

#### **4. EVIDENCE FOR A GST TAX INCREASE**

The GST is widely recognised as one of the more efficient taxes currently implemented in Australia,<sup>68</sup> with the Grattan Institute (2013) describing it as “attractive” and that:<sup>69</sup>

...it adds substantially to the collective budget bottom line of Australian governments. It drags relatively little on the economy as it discourages working or investing less than most other taxes.

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<sup>65</sup> Eslake, S. (2011) [Australia's tax reform challenge](#), p.1

<sup>66</sup> Evans, M. (2012) [GST Distribution Review - Options for GST taxation of imported goods and services](#), p.22

<sup>67</sup> Ibid, p.3

<sup>68</sup> KPMG (2011) [Economic Analysis of the Impacts of Using GST to Reform Taxes](#), Report prepared for CPA Australia, p.i

<sup>69</sup> Grattan Institute (2013) [Balancing budgets: tough choices we need](#), p.50

Furthermore, Australia's GST rate is amongst the lowest in all OECD countries, and given its relatively narrow base, (Chapter 2.1.2) there is possible scope for reform.

Results from various sets of modelling are presented in the next two chapters of the paper – particularly with regard to revenue generation and equity implications from an increase in the GST. It is important to note that the complexity of the GST and broader tax problem means that such modelling should be interpreted with caution. KMPG, in their submission to the latest Tax Discussion Paper, made the following point:<sup>70</sup>

Modelling produces outcomes which are dependent on assumptions. Modelling is a tool and does not present the solution. The danger with modelling and 'objective measures' is that we give them too much weight and that they act as a substitute for thinking through the issues in their multiplicity of dimensions.

Similarly, PWC noted that "the fine print [of modelling] should always be examined"<sup>71</sup> because the models are dependent entirely on the assumptions built into them and the quality of the data used.

#### 4.1 Replacement of distorting and inefficient taxes

Taxes are important sources of funding for government services but also affect the way the economy operates in terms of resource allocation and productivity. As acknowledged in the Treasury Working Paper [Understanding the economy-wide efficiency and incidence of major Australian taxes](#):<sup>72</sup>

The main taxes used in Australia to raise government revenue lead to losses in economic efficiency by distorting price signals and thereby changing the behaviours of individuals, firms and investors.

The more inefficient or distorting a tax is the more likely resources will be moved away from their highest value use.<sup>73</sup>

The main argument in favour of a consumption tax is that it is relatively efficient, particularly in terms of its neutrality toward savings.<sup>74</sup> By contrast, income taxes tend to deter savings by taxing the returns on those savings. Specifically, under an income tax system, individuals pay tax on their labour income (regardless of how much they save) and then again on any returns to saving that income.<sup>75</sup>

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<sup>70</sup> KMPG (2015) [Tax reform – submission to Treasury](#), p.4

<sup>71</sup> PWC (2015) [Raising GST vs Personal Income Tax: which is better for the economy?](#), TaxTalk – Insights, p.3

<sup>72</sup> Cao, L. et. al (2015) [Understanding the economy-wide efficiency and incidence of major Australian taxes](#), Treasury Working Paper 2015-01, p.1

<sup>73</sup> KPMG (2011) [Economic Analysis of the Impacts of Using GST to Reform Taxes](#), Report prepared for CPA Australia, p.1

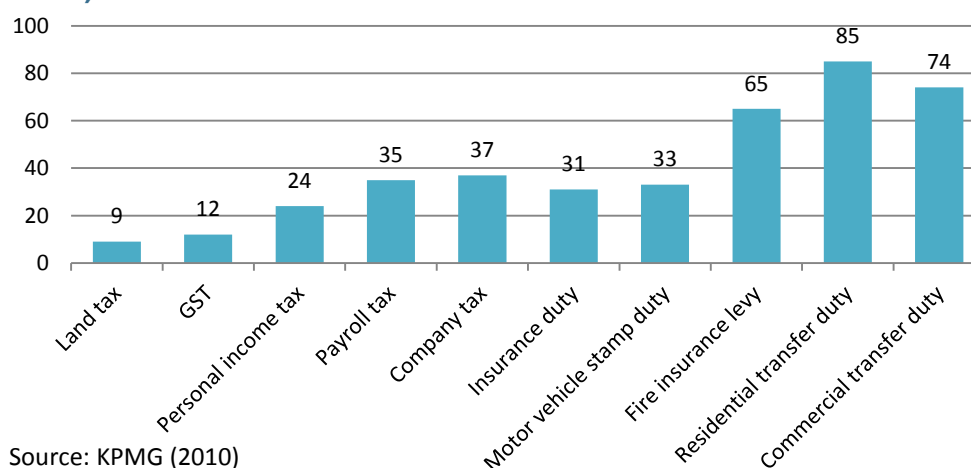
<sup>74</sup> The Centre for Independent Studies (2012) [The Henry Tax Review: A Liberal Critique](#), Issues Analysis, p.6

<sup>75</sup> Grattan Institute (2015) [A GST reform package](#), p.6

Various studies have been completed in recent years to compare the relative efficiency of different Australian taxes. Specifically they calculate the marginal welfare loss from an increase in selected Australian taxes. Welfare losses, also known as deadweight losses, are defined as burdens on people over and above their payment of tax. These burdens arise because people change their behaviour in response to taxes (e.g. substituting work for leisure).<sup>76</sup> As a general rule, the more a given tax alters individual behaviour, the greater its efficiency cost (or the higher its **excess burden**, per dollar raised).

While the specific estimates vary between models, there are some key consistencies – particularly with respect to the relative efficiencies of various State and Commonwealth taxes. For example, work commissioned for the Henry Review<sup>77</sup> estimated the marginal excess burdens of the GST at 12% (Figure 11). By comparison, the 2015 Treasury Issues Paper has estimated the marginal excess burden of GST at 19% (Figure 12).

**Figure 11: Marginal excess burden of selected Australian taxes (cents per dollar of revenue)**



Source: KPMG (2010)

The 2015 Treasury modelling of the major taxes in Australia concluded that the taxes with highest long-term costs for living standards (measured as the 'marginal excess burden'<sup>78</sup>) are company income tax and stamp duties.<sup>79</sup> As explained in the recent Tax Discussion Paper:<sup>80</sup>

Company income tax has a high marginal excess burden because of the

<sup>76</sup> The Centre for Independent Studies (2012) [The Henry Tax Review: A Liberal Critique](#), Issues Analysis, p.6

<sup>77</sup> KPMG Econtech (2010) [CGE Analysis of the Current Australian Tax System – Final Report](#), p.44

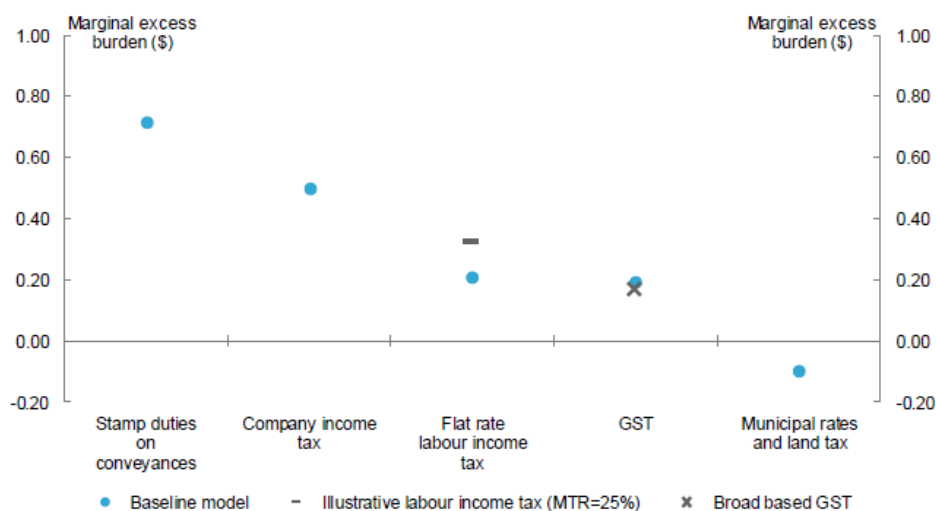
<sup>78</sup> The 'marginal excess burden' is a measure of some of the economic costs associated with a tax on the aggregate welfare of Australian households. In particular, the measure examines the impact of raising an additional \$1 of revenue on the level of consumption of goods and services by households, as well as time for leisure.

<sup>79</sup> Cao, L. et. al (2015) [Understanding the economy-wide efficiency and incidence of major Australian taxes](#), Treasury Working Paper 2015-01

<sup>80</sup> Australian Government (2015) [Re:think - Tax discussion paper](#), p.24

relatively high company tax rate of 30 per cent in Australia, combined with the high level of mobility of the underlying tax base. Conveyancing stamp duties also have a high excess burden because they discourage the exchange of residential and business properties.

**Figure 12: Long-run modelling estimates of the marginal excess burden of some of Australia's taxes<sup>81</sup>**



The OECD (2008) estimated a “tax and growth ranking” which concluded that recurrent taxes on immovable property were the least distortive tax instrument in terms of reducing long-run GDP per capita, followed by consumption taxes, personal income taxes and corporate income taxes.<sup>82</sup> The OECD (2008) in their report noted that:

A revenue neutral growth-oriented tax reform would be to shift part of the revenue base from income taxes to less distortive taxes.

Because Australia's tax mix has been gradually shifting away from a consumption base to an income base the Centre for Policy Development concluded that:<sup>83</sup>

...the overall impacts imposed by the tax system are becoming more negative over time due to the higher ‘marginal excess burden’ imposed for each dollar of revenue raised for other major tax bases such as stamp duty and income tax.

## 4.2 Shrinking GST revenue base

The GST was initially implemented to shift the tax mix toward a broader tax base such as consumption; and as outlined in the Commonwealth Government

<sup>81</sup> Cao, L. et. al (2015) [Understanding the economy-wide efficiency and incidence of major Australian taxes](#), Treasury Working Paper 2015-01, p.

<sup>82</sup> OECD (2008) [Tax and economic growth](#), Economics Department Working Paper No.620, p.7

<sup>83</sup> Centre for Policy Development (2015) [Budgeting smarter, not harder: The failure of long-term thinking in the 2015 Intergenerational Report](#), p.18

GST Distribution Review, it was widely expected that GST revenues would:<sup>84</sup>

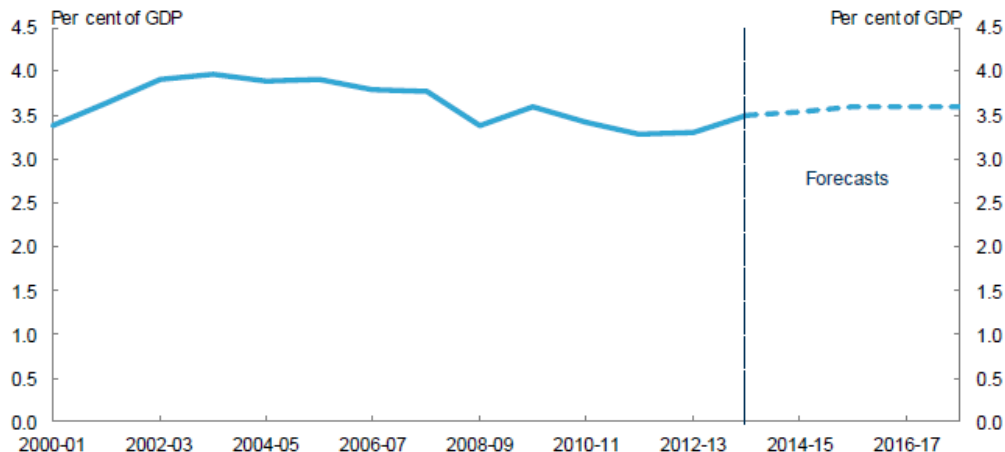
- provide States with a robust source of revenue that grew broadly in line with the national economy<sup>85</sup> to improve States' fiscal positions; and
- be predictable, so as to assist States in managing their fiscal positions and to facilitate the use of GST pool to pursue fiscal equalisation between States.

When the GST was introduced, it was anticipated to grow (on average over the medium term) by around 6% per year.<sup>86</sup> Until 2007-08, the GST grew each year by around 8.3% on average, far higher than the average 2.2% increase between 2008-09 and 2011-12. As outlined in Finding 11.1 of the *GST Distribution Review*:<sup>87</sup>

GST revenue collections have grown only modestly [since 2007-08]. Some of this softness is cyclical, but it also appears that certain structural factors will continue to dampen GST growth into the future.

By 2013-14, GST revenue covered 3.5% of gross domestic product (GDP), down from 3.9% of GDP in 2002-03.

**Figure 13: GST as a share of consumption and GDP<sup>88</sup>**



The GST share of the consumption base has declined because Australian households are now spending proportionately more on goods and services – health and education – which are exempt from the GST.<sup>89</sup>

<sup>84</sup> Australian Government (2012) [GST Distribution Review – Final Report](#), p.153

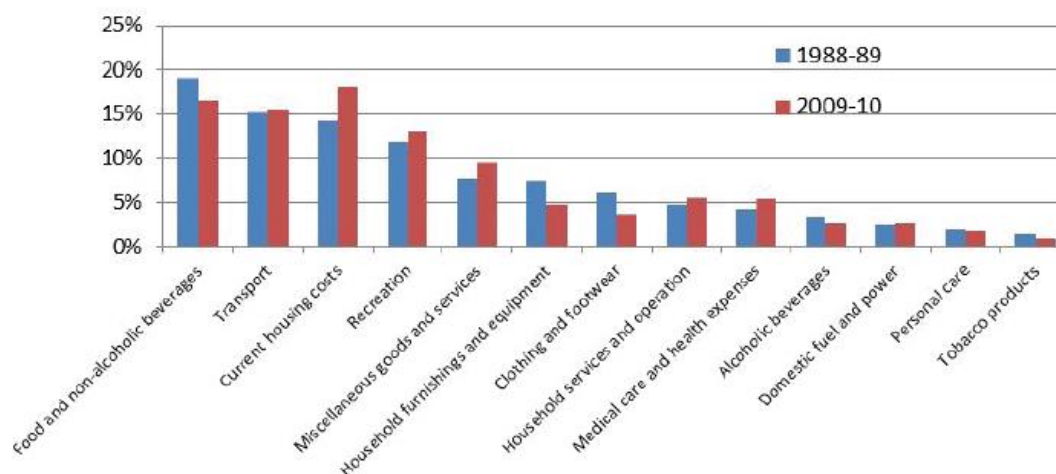
<sup>85</sup> Costello, P. (2000) [Budget Speech 2000-01](#)

<sup>86</sup> Australian Government (2012) [GST Distribution Review – Final Report](#), p.153

<sup>87</sup> *Ibid*, p.156

<sup>88</sup> Australian Government (2015) [Re:think - Tax discussion paper](#), p.141

<sup>89</sup> Stewart et. al (2015) [A stocktake of the tax system and directions for reform – five years after the Henry Review](#), Tax and Transfer Policy Institute, p.75

**Figure 14: Changing household consumption patterns<sup>90</sup>**

Because of this shift in consumption, in 2012, the VAT revenue ratio – which is an estimate for the coverage of the GST – in Australia was 0.47 and had declined from 0.54 in 2006.<sup>91</sup>

Another structural factor is that the household saving ratio (i.e. the amount that households save as a proportion of disposable income) is considerably higher now than when the GST was first introduced.<sup>92</sup> According to the Grattan Institute (2013), the low savings rates in the late 1990s and early 2000s “are looking like a historical anomaly.”<sup>93</sup>

Because the GST collections have been both less buoyant over the medium term and more volatile than expected when the GST was introduced, the panel of the GST Distribution Review recommended that:<sup>94</sup>

...the national debate around matters such as the rate and the base of the GST, and public financing arrangements more generally, needs to be ‘unfrozen’.

### 4.3 Addressing structural budget deficits

#### 4.3.1 Deteriorating Commonwealth budget position

The debate around the possibility of GST reform has been brought forward, in a large part, because of the deteriorating budget position of the Commonwealth and several State Governments. By 2016–17, combined Commonwealth and State general government net debt is estimated to exceed \$350 billion —almost

<sup>90</sup> Stewart et. al (2015) [A stocktake of the tax system and directions for reform – five years after the Henry Review](#), Tax and Transfer Policy Institute, p.76

<sup>91</sup> OECD (2014) [Consumption Tax Trends 2014](#), p.94

<sup>92</sup> Finlay, R, and Price, F. (2014) [Household Saving in Australia](#), Reserve Bank of Australia Discussion Paper, p.2

<sup>93</sup> Grattan Institute (2013) [Balancing budgets: tough choices we need](#), p.52

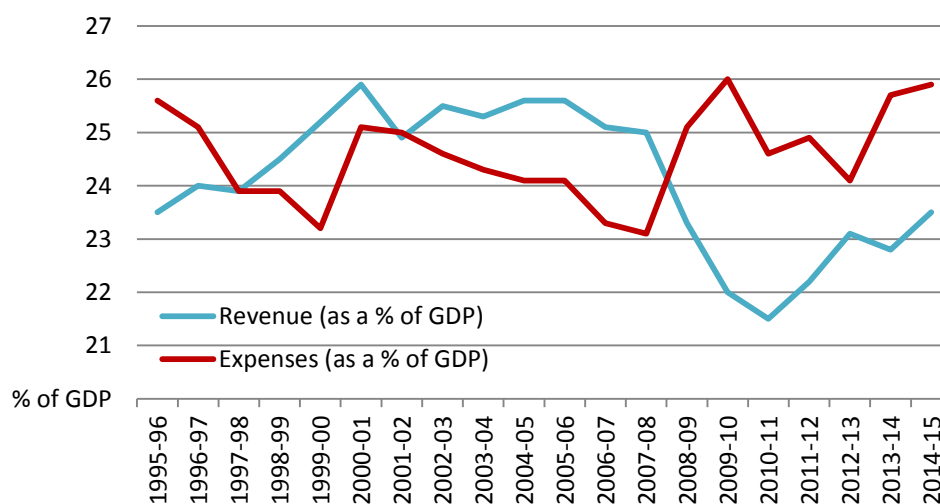
<sup>94</sup> Australian Government (2012) [GST Distribution Review – Final Report](#), p.157

20% of GDP, or more than 50% of general government revenue.<sup>95</sup> With respect to the Commonwealth Budget position, ACOSS (2015) makes the following observation:<sup>96</sup>

Australian governments face Budget pressures from the winding back of the mining boom, and the unusually high company income tax revenues that came with it, eight successive years of personal income tax cuts, and a lack of attention to repairing the personal income tax base. Those personal tax cuts were largely paid for by temporary windfall revenues from company taxes. When the revenue windfall ended after the Global Financial Crisis, the resulting drop in tax revenues was responsible for the majority of the drift from surplus to deficit.

In short, the resources boom of the past decade had a temporary impact of masking weakening Budget fundamentals, meaning that “the nation has been left with the structural burden of the policy promises.”<sup>97</sup>

**Figure 15: Commonwealth Government revenue and expenses<sup>98</sup>**



Estimates of the *structural balance* provide the best indication of the long run ‘health’ of the Budget and where it would be running at trend levels of activity. In other words, the difference between an underlying and headline budget position is a matter of removing cyclical variations from revenue and expenses estimates.<sup>99</sup>

Calculations of the structural deficit by the International Monetary Fund (IMF), the OECD, Australian Treasury (Figure 16), the Parliamentary Budget Office (PBO), Deloitte Access Economics and Grattan Institute all use slightly different methods and assumptions. But they all come to a similar conclusion: the

<sup>95</sup> Carling, R. (2014) [States of Debt](#), Centre for Independent Studies

<sup>96</sup> ACOSS (2015) [Response to the Federal Government Tax Discussion Paper](#), p.10

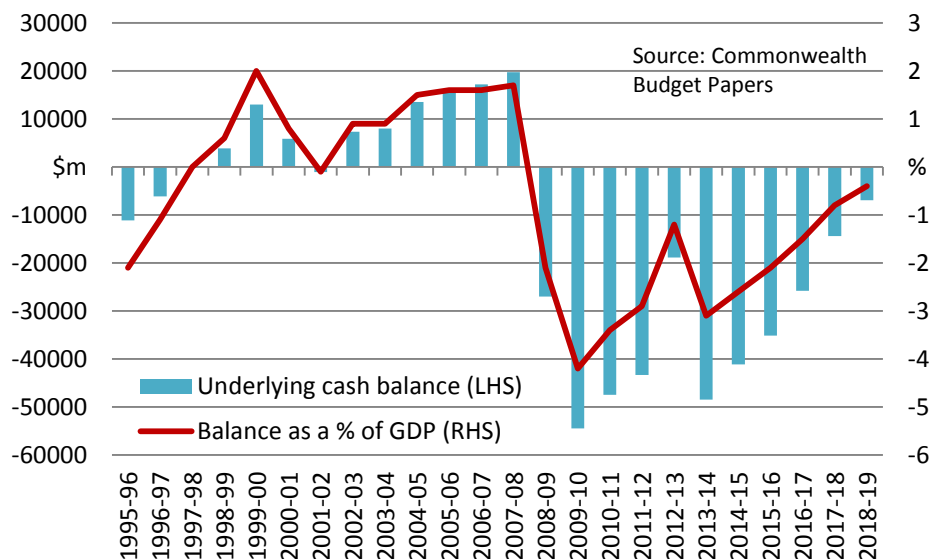
<sup>97</sup> Deloitte (2015) [Input to the BCA’s 2015-16 Budget submission](#), p.i

<sup>98</sup> Treasury (2015) [Budget 2015-16 Papers, Budget Strategy and Outlook](#), p.10-6

<sup>99</sup> Deloitte (2015) [Input to the BCA’s 2015-16 Budget submission](#), p.3

Commonwealth Government has run a substantial structural deficit for half a decade.<sup>100</sup> The Grattan Institute (2015) adds that “if current policy settings persist, both Commonwealth and State governments are likely to post significant deficits for many years.”<sup>101</sup> As can be seen in the figure below, the Treasury has estimated the underlying cash balance to improve by \$34.2 billion (from 2015-16 levels) by 2018-19.

**Figure 16: The structural underlying cash balance**



In recent history, however, assumptions underpinning modelling have proven consistently inaccurate with respect to government revenues. For example, the 2015-16 Mid-Year Economic and Fiscal Outlook (MYEFO) revealed an additional \$3.1 billion in revenue write-downs, signalling even tougher times ahead for the Commonwealth Government in trying to bring the budget back to surplus.<sup>102</sup> This follows on from the past five years in which projections have consistently overestimated the position of the budget four years out (Figure 17).

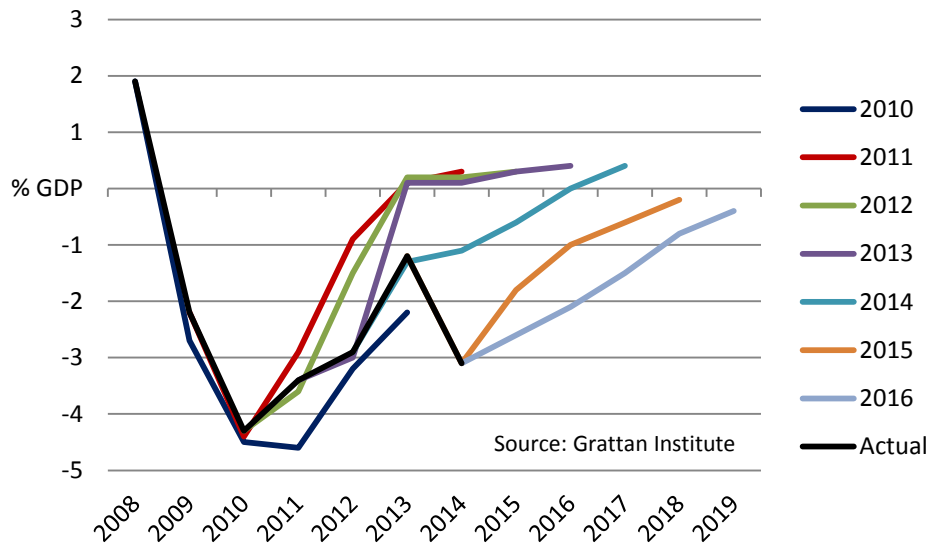
<sup>100</sup> Grattan Institute (2013) [Balancing budgets: tough choices we need](#), p.9

<sup>101</sup> Grattan Institute (2015) [Fiscal challenges for Australia](#), p.3

<sup>102</sup> Australian Government (2015) [Mid-Year Economic and Fiscal Outlook 2015-16](#), p.29

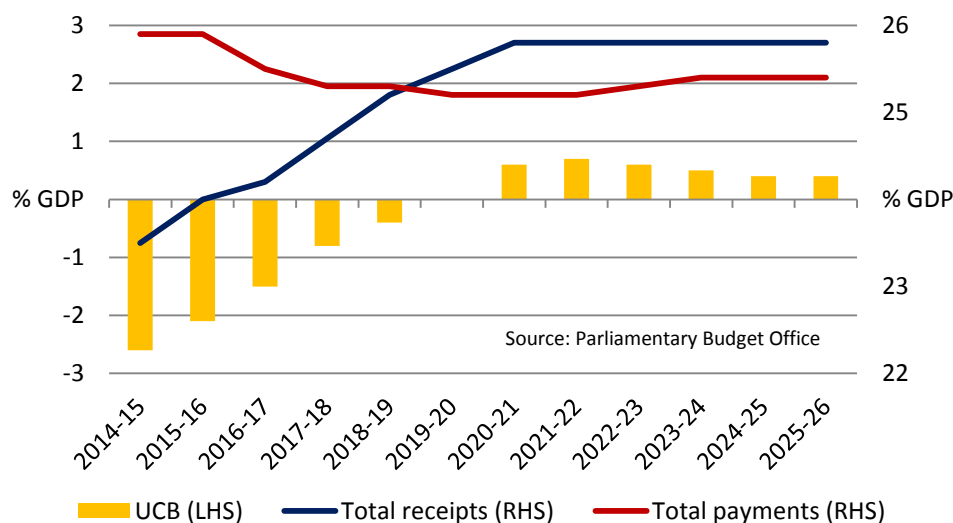


**Figure 17: Commonwealth budget balance, actual and forecast, per cent of GDP<sup>103</sup>**



Based on the policy settings and economic parameters underlying the 2015-16 Commonwealth Government Budget, the PBO projected the underlying cash balance to move from a deficit of 2.6% of GDP in 2014-15, to a peak surplus of 0.7% of GDP in 2021-22, before steadily declining to a surplus of 0.4% of GDP in 2025-26.<sup>104</sup>

**Figure 18: Underlying cash balance, total receipts and total payments**



While the structural deficit appears to improve toward the end of the projection period, this is based on a number of assumptions, including the political process

<sup>103</sup> Grattan Institute (2015) [Fiscal challenges for Australia](#), p.13

<sup>104</sup> Parliamentary Budget Office (2015) [2015-16 Budget: medium-term projections](#), Report No. 02/2015, p.1

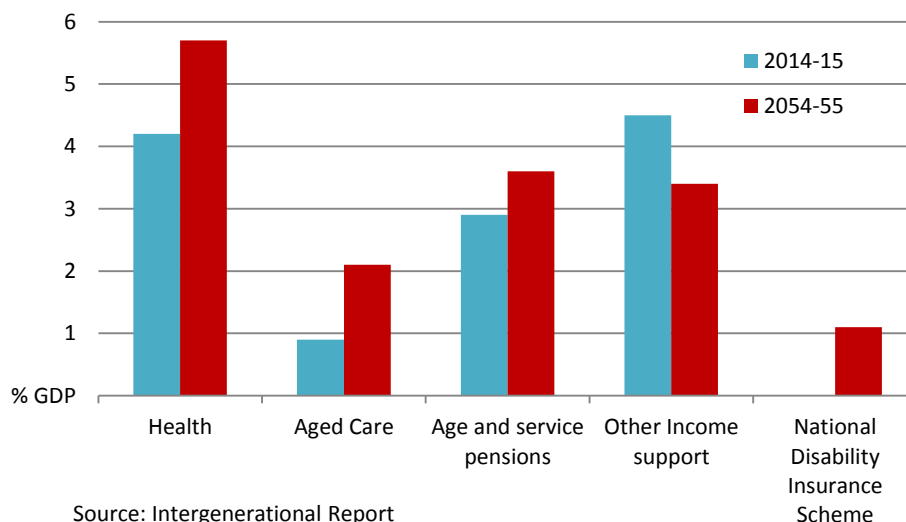
required to enable key policy savings measures to occur. As was seen following the 2014-15 Budget, [a number of measures](#) failed to pass through the Senate.

Additionally, there are a number of longer term risks beyond this forward estimates period which may undermine the structural cash balance for the Commonwealth Government. As reported in the 2015 Intergenerational Report, the underlying cash deficit is projected to be around 6% of GDP (\$266.7 billion in today's dollars) by 2054-55 with current policy settings.

The long term risks to the Budget appear to be the rising cost of expenditure measures associated with disability insurance, child care and paid parental leave, hospital and school funding, carer support, aged care, Medicare, disability pensions, age pensions and defence.

This was highlighted by the Commission of Audit which projected aged care expenditure to double from around \$13 billion in 2014 to \$26 billion by 2023-24.<sup>105</sup> Similarly, the Intergenerational Report released in March 2015 pointed to the increasing burden associated with an aging population base in Australia, estimating that Commonwealth Government health expenditure is projected to increase as a proportion of GDP from 4.2% in 2014-15 to 5.7% of GDP in 2054-55 (\$260 billion in today's dollars) with current policy settings.

**Figure 19: Expenditure in selected areas (2014-15 to 2054-55) – as 'currently legislated'**



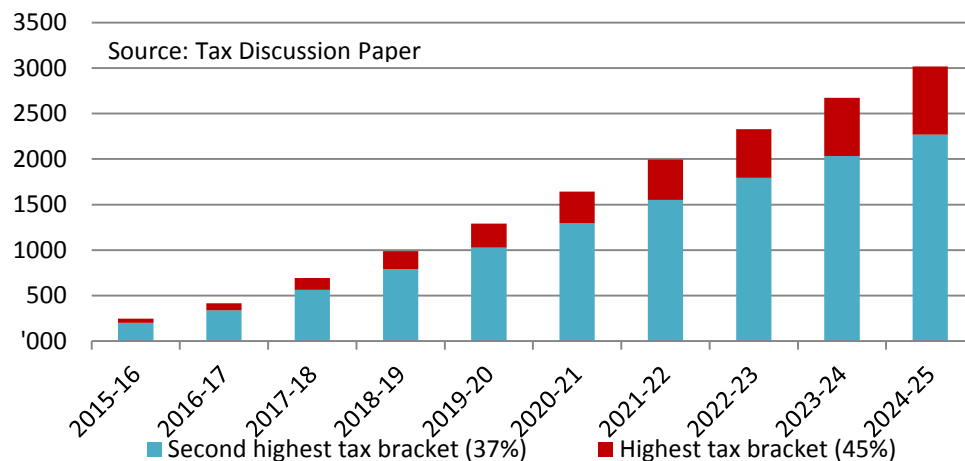
Circumstances under the existing taxation framework will go some way to offset some of these expenditure risks. For example, some structural gains will occur via fiscal drag<sup>106</sup> as wage gains push people into higher tax brackets. According to Deloitte Access Economics estimates, overall, the cumulative

<sup>105</sup> Australian Government (2014) [Towards Responsible Government – The Report of the National Commission of Audit](#), Phase One, p.viii

<sup>106</sup> Fiscal drag is the deflationary effect of a progressive taxation system on a country's economy. As wages rise, a higher proportion of income is paid in tax.

bracket creep across the five years to 2018-19 of just over \$15 billion could account for as much as one-fifth of the structural gap identified for 2014-15. Similarly, it was estimated as part of the 2015 Tax discussion Paper that over 3 million taxpayers would move to the top two tax brackets as a result of bracket creep.

**Figure 20: Estimated cumulative increase in taxpayers in the second and highest tax brackets, relative to 2014-15**



The Grattan Institute made a similar observation, commenting that “most of the revenue increase over the last four years, and the increase projected over the next four years, results from existing taxes growing faster than GDP.”<sup>107</sup> However, the Grattan Institute notes that the “government is likely to face strong pressure to return some of the fiscal drag by changing the tax scales.”<sup>108</sup>

Additionally, while recent lifts in capital gains and associated revenues from improved housing and share prices have assisted; it should be noted that both factors are highly influenced by the economic cycle and will only provide temporary relief to the structural weaknesses in the Commonwealth budget. Even wages growth isn’t certain to maintain its strong growth of the last two decades, with annual wages increasing by 2.3% to September 2015, compared with average annual growth of 3.6% in the previous decade.

The 2015-16 budget projects the terms of trade to fall by 9% in 2015-16 and then stabilise at a level about 50% higher than their long-run average.<sup>109</sup> This, according to the Grattan Institute, is “optimistic” with terms of trade worldwide typically reverting to their long run averages.<sup>110</sup>

According to Deloitte Access Economics (2015), a return to the terms of trade levels of 2002-03 would see an additional \$114 billion added to the deficit over

<sup>107</sup> Grattan Institute (2015) [Fiscal challenges for Australia](#), p.5

<sup>108</sup> Ibid, p.9

<sup>109</sup> Treasury (2015) [Budget Papers 2015-16](#), Economic Outlook, p.2-10

<sup>110</sup> Grattan Institute (2015) [Fiscal challenges for Australia](#), p.9

the next four years, with the Budget deficit being 1.8% of GDP larger than it would otherwise have been in 2017-18.<sup>111</sup> Therefore, it appears that more solutions need to be found to address the underlying structural weaknesses in the Commonwealth budget going forward.

#### 4.3.2 Estimated GST revenue gains

In the context of the need for fiscal consolidation in connection to the current revenue shortfall, consumption as a “stable tax base constitutes an attractive and reliable source for government revenues.”<sup>112</sup>

*Deloitte Access Economics* (2015) estimated that under two separate scenarios a GST increase could raise between \$112 and \$152 billion respectively over four years from 1 July 2016. After compensation, net revenue would be between \$77 and \$115 billion.

GST Scenario Modelling – Deloitte Access Economics		
	Scenario 1	Scenario 2
Tax reform	increase the rate to 15%, and broaden the base to include imported digital products and services and low value imports	increase the rate to 12.5%, and broaden the base to include fresh food, imported digital products and services and low value imports.
Revenue implications	an additional \$152 billion of revenue would be raised over four years	\$112 billion in revenue over four years
Sources of Revenue	Rate increase (\$145 b); CPI effect (\$3b); Low value goods (\$3b); Digital imports (\$1b)	Rate increase (\$72b); Fresh food (\$33b); CPI effect (\$3b); Low value goods (\$3b); Digital imports (\$1b)
Adjustments	Personal tax cuts (\$21b); Transfer payments (\$16b)	Personal tax cuts (\$19b); Transfer payments (\$16b)
Net revenue	\$115 billion	\$77 billion

*Source: Deloitte Access Economics*

The *National Centre for Social and Economic Modelling* (NATSEM) estimated the potential revenue from increasing the rate and broadening the base of the GST.<sup>113</sup> As shown in the table below, expanding the base to cover currently exempted food would increase GST revenue by \$7.1 billion followed closely by health and education at \$6 billion and \$4.5 billion respectively. Collectively, an expansion in the base to cover these and water and sewerage would increase GST revenue by \$18.6 billion for 2015-16.<sup>114</sup>

Alternatively, to raise the same amount of revenue as this expansion in the base would require an increase in the rate of GST on the current base to 13%.

<sup>111</sup> Deloitte (2015) [Input to the BCA's 2015-16 Budget submission](#), p.21

<sup>112</sup> Pestel, N, and Sommer, E. (2013) [Shifting Taxes from Labor to Consumption: Efficient, but Regressive?](#), Institute for the Study of Labor, Discussion Paper No. 7804, p.

<sup>113</sup> It should be noted that these estimates are in the absence of any changes to personal income tax.

<sup>114</sup> Phillips, B, and Taylor, M. (2015) [The Distributional Impact on the GST](#), National Centre for Social and Economic Modelling, University of Canberra, p.8

Increasing the GST further to 15% without expanding the base would increase GST revenue by an additional \$29.4 billion relative to the current rate.

Estimated GST Revenue, NATSEM Scenarios 1-7, 2015-16			
	GST Revenue (\$b)	Change in revenue (\$b)	CPI impact (%)
GST (Current)	58.9	-	
(1) Fresh Food	65.9	7.1	0.7
(2) Water and sewerage	59.9	1	0.1
(3) Health	64.9	6	0.6
(4) Education	63.4	4.5	0.4
(1) to (4)	77.5	18.6	1.8
GST 15%	88.3	29.4	2.8
GST 13 % and (5) base	77.5	18.6	1.8

Source: NATSEM (2015)

KPMG was commissioned by CPA Australia to update estimates on the potential revenue effects from raising the GST and/or broadening the base. The modelling estimated four alternative GST designs the revenue implications for 2015-16:<sup>115</sup>

1. **10% GST on a broader base** – extending the GST coverage to include fresh food, health and education is estimated to raise an additional \$12.1 billion.
2. **15% GST with current exemptions** – increasing the statutory rate of GST to 15% is estimated to raise an additional \$26.0 billion.
3. **15% GST and applied to health and education** – increasing the statutory rate of GST to 15% and extending the GST coverage to include health and education is estimated to raise an additional \$36.8 billion.
4. **15% GST on a broader base** – increasing the statutory rate of GST to 15% and extending the coverage to include fresh food, health and education is estimated to raise an additional \$42.9 billion.

By 2029-30, average annual additional revenue raised across the four KPMG scenarios is estimated to be between \$21 billion and \$76 billion.<sup>116</sup>

PWC (2015) modelled the fiscal and distributional impacts of changes to the GST, including raising its rate (to 12.5% and 15%) and broadening its base (to include items such as all food, health and education).<sup>117</sup> It found that increasing the GST with its current base to 15% would raise \$24.5 billion, net of compensation, in 2019-2020.

<sup>115</sup> CPA Australia (2015) [Tax Reform in Australia – The Facts](#), p.11

<sup>116</sup> Ibid, p.12

<sup>117</sup> PWC (2015) [GST reform packages – A baseline analysis](#), p.3

PWC scenario analysis under various GST adjustments						
Option	Baseline	Broaden (food, health and education)	Increase to 12.5%	Increase to 15%	Broaden + 12.5%	Broaden + 15%
Revenue raised 2019-20 (\$b)	75.7	85.3	88.2	100.1	99.8	113.5
Additional revenue 2019-20 (\$b)	-	9.7	15.5	24.5	24.2	37.9
Annual improvement in operating balance (% of GDP 2019-20)	-	0.5	0.6	1.2	1.1	1.8
States operating balance in surplus	2018-19	2018-20	2018-21	2018-22	2018-23	2018-24
States operating balance to remain in surplus until	2018-19	2023-24	2025-26	2039-40	2039-40	2049-50

*Source: PWC*

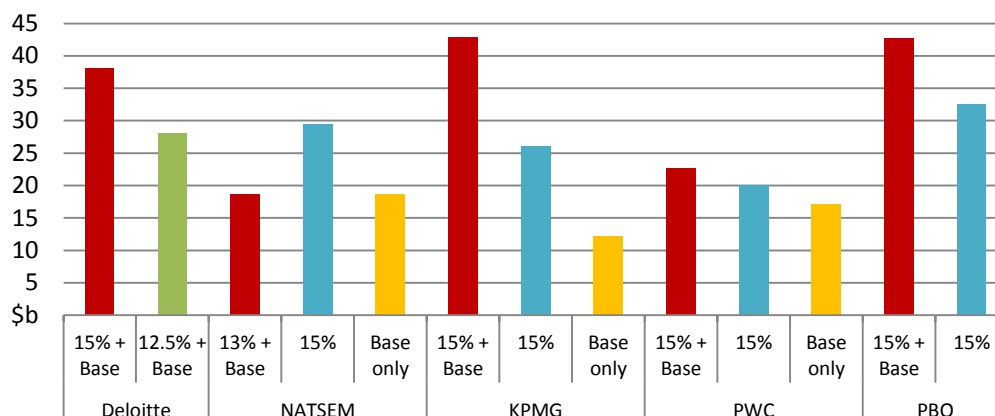
Similar GST modifications were estimated by the PBO, including changes to the base and rate of the GST. Each scenario included a compensation package that, in aggregate, would be sufficient to fully offset the impact of the changes on the bottom two quintiles by disposable income.

Summary of net GST revenue impact of scenarios – PBO, 2015-16			
	Additional GST Revenue	Compensation	Net Additional GST Revenue
(1) Basic food subject to GST	7.2	2.4	4.8
(2) Remove concession from GST base	21.6	5.6	16
(3) 15% GST	32.5	7.9	24.6
(4) 15% GST; basic food subject to GST	42.7	11.3	31.4
(5) 15% GST; remove concession	65.8	16.5	49.3

*Source: PBO (2015)*

Figure 21 compares the revenue effects of the GST based on various estimates from Deloitte, NATSEM, KPMG, as well as NATSEM and the PBO. Raising the GST to 15% and broadening the base to include fresh food, health, education and sewerage would raise between \$38 billion and \$42.9 billion in 2015-16. Raising the GST to 15% and leaving the base unchanged would result in between an additional \$20 billion and \$32.5 billion in 2015-16.

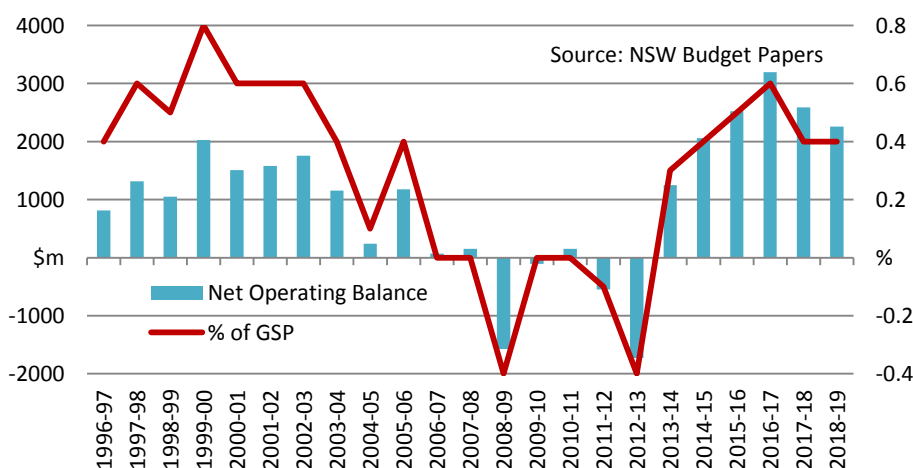
**Figure 21: Various estimates of annual GST revenues from a change in base and/or rate, 2015-16**



### 4.3.3 Implications for NSW

The NSW Government Budget is currently in a relatively healthy position having recorded surpluses for 3 consecutive years to 2015-16 (Figure 22); induced predominantly by cyclical factors, including the influx of stamp duty revenue from surging house prices over the last three years.

**Figure 22: NSW Government, net operating balance**



However, once the surge in stamp duty revenue winds down, the NSW Government - over the medium to longer term – is likely to find itself in a similar position to the other States. As outlined by ACOSS (2015):<sup>118</sup>

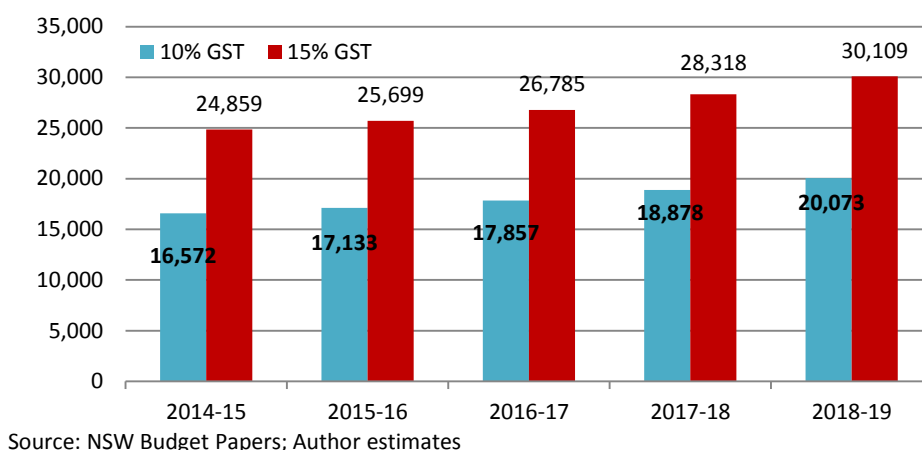
State governments are even more vulnerable to Budget pressures from population ageing and burgeoning health care costs. They also rely more on less robust, economically inefficient tax bases. Those tax bases are also, for the most part, regressive.

<sup>118</sup> ACOSS. (2015) [Response to the Federal Government Tax Discussion Paper](#), p.33

They rely too heavily on the most inefficient taxes (including Stamp Duties and insurance taxes); and on revenues from socially harmful activity (e.g. gambling); and too little on potentially efficient tax bases (including Land Tax and Payroll Tax).

NSW collects nearly 24% of its revenue from GST redistribution through Commonwealth Government grants. Based on data in the 2015-16 Commonwealth Budget Paper, NSW would stand to earn an additional \$8.3 billion in 2015-16 (or 11.5% of 2015-16 NSW general government revenue) from an increase in the GST to 15%; rising to \$10 billion in 2018-19 (13% of total revenue). These are gross figures and do not account for any potential redistributions to compensate affected stakeholders from a GST rate rise.

**Figure 23: NSW Government revenue from a GST increase to 15%**



#### 4.4 Overall economy-wide impact in Australia

Malcom Turnbull stated recently that any change in the GST would have to be justified in terms of creating economic growth and jobs.<sup>119</sup>

You have to be satisfied that it is actually going to deliver an improvement in GDP growth. Unless you can be satisfied that it's going to do that, and that it's going to be fair, of course, which is equally important, then you wouldn't do it

With broad reference to substituting a GST tax increase for income tax cuts, Prime Minister Turnbull added that:

At this stage, I remain to be convinced or be persuaded that a tax mix switch of that kind would actually give us the economic benefit that you would want in order to do such a big thing

It is not entirely clear what specific scenario is being referred to. However, Treasury modelling conducted for the 2015 Tax Discussion Paper shows the GST does roughly the same economic damage for each dollar raised as an

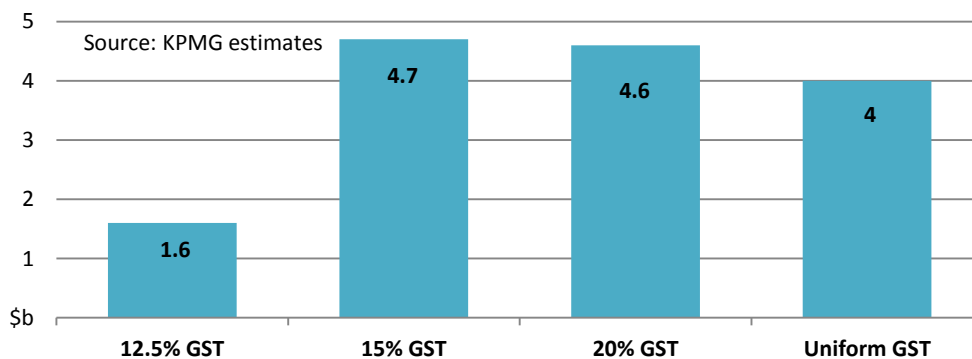
<sup>119</sup> Sydney Morning Herald, [Tax white paper: GST benefits small compared to those of other reforms, says Turnbull](#), 8 February 2016



idealised income tax, suggesting the gains from a swap would be small.<sup>120</sup> Similarly, modelling [released](#) on 12 February 2016 calculated that a 0% increase in economic growth from increasing the GST from 10% to 15%, broadening it to cover water and sewerage and funding \$30bn worth of tax cuts weighted towards middle and high-income earners.

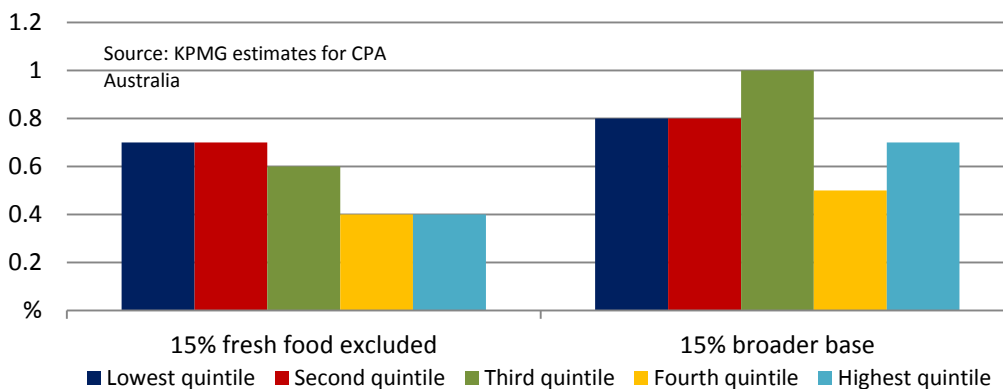
It is important to note that a direct, revenue-neutral substitution between income tax and the GST, for efficiency purposes, is not the only scenario through which GST reform may take place. For example, KPMG estimated the potential living standard gains from an increase in the GST under four different scenarios. Under each scenario, a number of other reform measures would be undertaken – specifically in the form of the abolition of insurance taxes, motor vehicle taxes, payroll tax and commercial conveyance duty. KPMG specifically found that aggregate living standards in the economy would be higher under each of the alternative tax reform scenarios.

**Figure 24: Annual impacts on living standards, deviation from baseline**



With income tax adjustments and redistribution through annual support payments, analysis by KPMG shows that all income quintiles will be better off with a higher and broader based GST (Figure 25).

**Figure 25: Change in real (after-tax) incomes by household income quintile (percentage deviation from baseline, 2015-16)**



<sup>120</sup> Cao, L. et. al (2015) [Understanding the economy-wide efficiency and incidence of major Australian taxes](#), Treasury Working Paper 2015-01, p.53

In the context of using GST reform as part of a broader package of changes to the tax system, the Business Council of Australia (2015) made the following observations:<sup>121</sup>

Australia's current tax mix is less conducive to growth than it could otherwise be. There is a strong body of evidence that changing the tax mix for a medium-sized open economy such as Australia so that it is less reliant on direct taxes and more reliant on broad-based indirect taxes would result in a more optimal tax system and increased economic growth.

Australia's ageing population and predicted decline in workforce participation will mean that personal income tax will decline relatively over time as a revenue source. Meanwhile, global competition and the desire for economic growth will place limits on the taxation of companies. Australia will need to look at increasing its reliance on indirect taxes.

## 5. EVIDENCE AGAINST INCREASING THE GST

A broad-based GST is proportional with respect to consumption but regressive with respect to income of individuals.<sup>122</sup> Because of this, the common response to GST reform is that it "hits the poor, and a wider GST base would be a double blow for the poor, as they spend a bigger share of their outlays on essentials."<sup>123</sup>

This chapter of the paper discusses some of the broader equity elements with a GST and then presents estimates related to the regressive effect of an increased and/or broadened GST on lower to middle income earners and the potential compensation required to negate such impacts. The evidence against a GST should also be considered in the context of potential revenue raising alternatives (Chapter 9).

### 5.1 Equity implications

Equity is a key consideration in the design of a tax and transfer system. As cited by the Productivity Commission (2015):<sup>124</sup>

- The principle of *horizontal equity* asserts that people in the same circumstances should be treated equally by the tax and transfer system.
- The principle of *vertical equity* asserts that people in different circumstances should be treated differently. It is often translated as the 'ability to pay', a crude measure of which is the ratio between tax paid and private income.

<sup>121</sup> Business Council of Australia (2014) [The future of tax: Australia's current system](#), p.13

<sup>122</sup> Stewart et. al (2015) [A stocktake of the tax system and directions for reform – five years after the Henry Review](#), Tax and Transfer Policy Institute, p.76

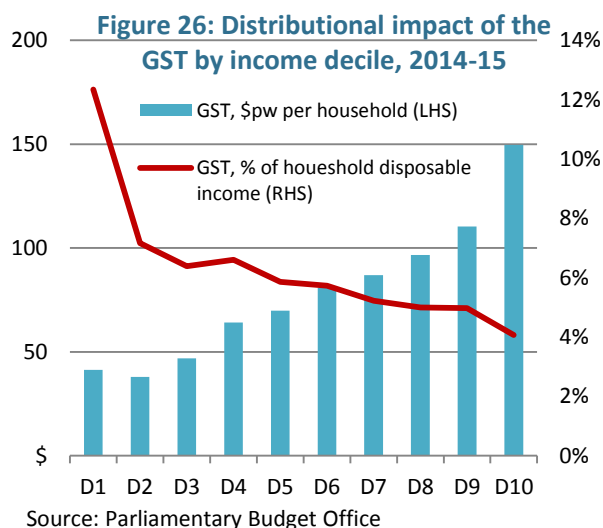
<sup>123</sup> Deloitte Access Economics. (2015) [Shedding light on the debate](#), Mythbusting Tax Reform Series Paper No.1, p.12

<sup>124</sup> Productivity Commission (2015) [Tax and transfer incidence in Australia](#), Productivity Commission Working Paper, p.14

With a **progressive tax**, the proportion of income tax paid increases as income rises. Alternatively, a tax is considered **regressive** if it impacts those on lower incomes more than those on higher incomes, as a percentage of income.

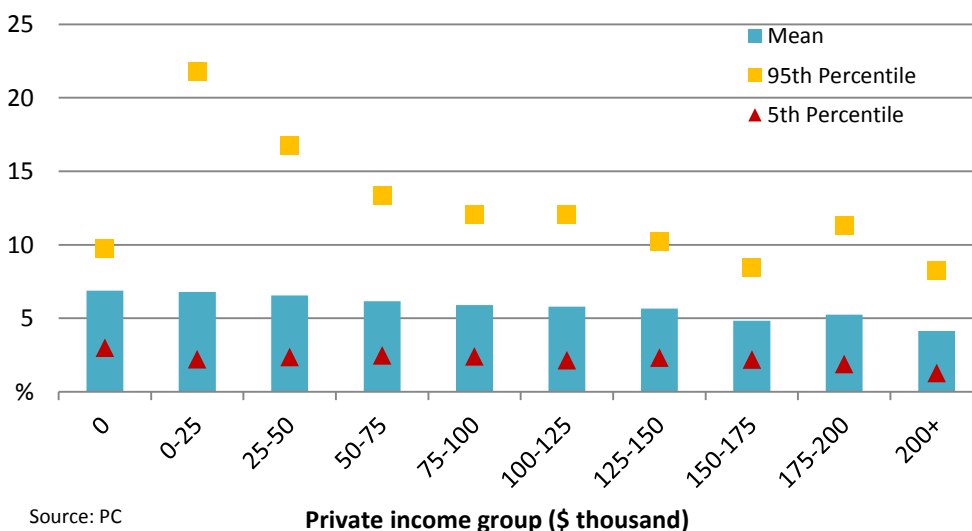
In theory, the GST is regressive because people on lower incomes spend a greater proportion of their income on goods and services that will be taxed by the GST. Higher income earners save more, so proportionately less of their income is affected by the GST.<sup>125</sup>

In Australia and according to PBO estimates, households in the lowest income decile, on average, pay around 12% of their disposable income on GST or about three times the proportion paid by those in the highest income decile.<sup>126</sup>



These estimates vary from the Productivity Commission's which show that the GST is only a slightly larger proportion of disposable income for lower-income earners compared with other income groups (Figure 27). For families with no private income, GST makes up about 7% of disposable income on average. In contrast, for families with private incomes greater than \$150 000, GST accounts for about 5% of disposable income on average.

**Figure 27: Distribution of GST as a percentage of disposable income by private income group, 2014-15**



<sup>125</sup> The Australia Institute (2014) [How to extend the GST without hurting the poor](#), p.3

<sup>126</sup> Parliamentary Budget Office (2015) [Distributional analysis of the GST](#), p.9

However, as noted by the Productivity Commission, focusing on averages does not take into account the large degree of variation in GST paid as a proportion of disposable income, particularly within some lower-income groups:<sup>127</sup>

For some families, the proportion is over 10 per cent because of debt and dissaving. Families with no private income have relatively little dispersion in the upper end of the scale, with the 75th and 95th percentiles being equal at about 10 per cent. This may be because families with no private income have difficulties getting a loan and so are unlikely to spend more than they receive in transfers. In contrast, for families with \$0 to \$25 000 in private income, there is a difference of about 12 percentage points of disposable income between the 75th and 95th percentiles. This could be due to some families having irregular incomes that were able to access credit during previous higher income periods and/or families with low regular incomes that dissave (such as retirees).

As noted by the Productivity Commission (2015), one reason why the GST may be lower as a proportion of expenditure for families with higher incomes could be because they are more likely to purchase GST-free items like private education and health services.<sup>128</sup>

### 5.1.1 Effect of a GST increase on low-income households

ACOSS commissioned NATSEM to estimate the effect of an increase in the GST from 10 to 15% which found that it would “make the overall tax system less progressive, with greater impacts on all households because more revenue would be raised.”<sup>129</sup>

The table below illustrates how changes to the base of the GST would impact households by income quintile. The final column of the table shows the percentage of after-tax household income (disposable income) that is lost in GST.

NATSEM estimated that households currently spend 7.4% of their disposable income in GST on average which differs to those estimates by the Productivity Commission. Nevertheless, using these estimates, if the base of the GST were broadened to include fresh food this would increase to 8.3% and if it were expanded to include all of the other exempted items this GST share would increase to 9.8%.<sup>130</sup>

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<sup>127</sup> Productivity Commission (2015) [Tax and transfer incidence in Australia](#), p.68

<sup>128</sup> Ibid, p.69

<sup>129</sup> ACOSS (2015) [The effects of a higher GST on households – Overview of modelling undertaken by NATSEM for ACOSS](#), p.6

<sup>130</sup> Phillips, B, and Taylor, M. (2015) [The Distributional Impact on the GST](#), National Centre for Social and Economic Modelling, University of Canberra, p.9

<b>Effects of GST changes by household income quintile</b>						
	<b>Quintile 1</b>	<b>Quintile 2</b>	<b>Quintile 3</b>	<b>Quintile 4</b>	<b>Quintile 5</b>	<b>All</b>
<b><i>GST as a share of disposable household income</i></b>						
GST (Current)	13.4%	8.5%	8.3%	7.2%	5.9%	7.4%
(1) Fresh Food	15.4%	9.8%	9.4%	8.0%	6.4%	8.3%
(2) Water and sewerage	13.7%	8.7%	8.5%	7.3%	6.0%	7.5%
(3) Health	14.9%	9.6%	9.2%	7.9%	6.4%	8.2%
(4) Education	14.1%	9.1%	8.9%	7.8%	6.4%	8.0%
(1) to (4)	17.9%	11.7%	11.0%	9.4%	7.6%	9.8%
GST 15%	20.1%	12.7%	12.5%	10.8%	8.8%	11.1%
GST 13 % and (5) base	17.6%	11.2%	11.0%	9.5%	7.8%	9.8%
<b><i>Dollar amount of GST paid per year</i></b>						
GST (Current)	\$3,576	\$4,217	\$6,296	\$7,551	\$10,154	\$6,358
(1) Fresh Food	\$4,112	\$4,887	\$7,117	\$8,422	\$11,084	\$7,124
(2) Water and sewerage	\$3,656	\$4,302	\$6,401	\$7,675	\$10,303	\$6,467
(3) Health	\$3,987	\$4,768	\$6,931	\$8,268	\$11,087	\$7,007
(4) Education	\$3,758	\$4,515	\$6,753	\$8,178	\$11,044	\$6,849
(1) to (4)	\$4,785	\$5,821	\$8,315	\$9,890	\$13,056	\$8,372
GST 15%	\$5,364	\$6,325	\$9,445	\$11,327	\$15,231	\$9,537
GST 13 % and (5) base	\$4,708	\$5,551	\$8,289	\$9,940	\$13,367	\$8,370
Average Income	\$26,131	\$49,636	\$75,931	\$105,503	\$172,638	\$85,953

Source: NATSEM

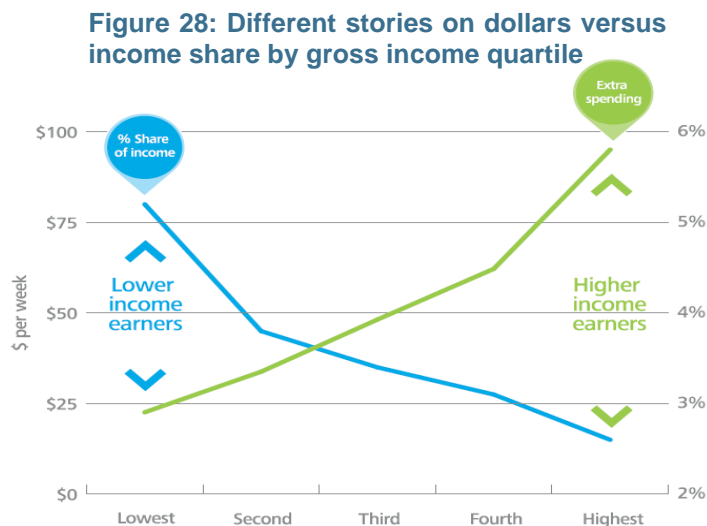
NATSEM elaborates that “while high-income households have higher levels of expenditure, and therefore pay more GST, an expansion in the base of the GST will have a greater proportional impact on the taxes paid by low-income households.” This is illustrated in the table below which shows that purchasing power is reduced most significantly for households in the lowest two income quintiles.

<b>Effect of GST changes on purchasing power</b>						
	<b>Quintile 1</b>	<b>Quintile 2</b>	<b>Quintile 3</b>	<b>Quintile 4</b>	<b>Quintile 5</b>	<b>All</b>
<b><i>Average percentage change in purchasing power</i></b>						
(1) Fresh Food	-2.0%	-1.4%	-1.0%	-0.8%	-0.6%	-0.8%
(2) Water and sewerage	-0.4%	-0.2%	-0.2%	-0.2%	0.0%	-0.2%
(3) Health	-1.6%	-1.2%	-0.8%	-0.6%	-0.6%	-0.8%
(4) Education	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%
(1) to (4)	-4.6%	-3.2%	-2.7%	-2.2%	-1.7%	-2.3%
<b><i>Average change in purchasing power (\$p.a.)</i></b>						
(1) Fresh Food	-\$537	-\$665	-\$819	-\$869	-\$937	-\$765
(2) Water and sewerage	-\$80	-\$84	-\$106	-\$124	-\$150	-\$109
(3) Health	-\$406	-\$554	-\$635	-\$718	-\$930	-\$649
(4) Education	-\$176	-\$290	-\$458	-\$631	-\$887	-\$488
(1) to (4)	-\$1,199	-\$1,593	-\$2,018	-\$2,342	-\$2,904	-\$2,011
Current GST paid	\$3,576	\$4,217	\$6,296	\$7,551	\$10,154	\$6,358
Average income	\$26,131	\$49,636	\$75,931	\$105,503	\$172,638	\$85,953

Source: NATSEM

As Deloitte Access Economics (2015) point out and estimate “any increase in the GST would indeed hit low income households harder in relative terms.”<sup>131</sup>

The figure adjacent shows that a bigger GST would cost the well-off more in terms of extra dollars a week (because they spend more than the less well-off), but less as a share of their income (because although they spend more than the less well-off, that gap is even bigger still for their income).



### 5.1.2 Broader progressivity of the Australian tax system

The Productivity Commission (2015) has argued that the tax and transfer system should be analysed collectively “because taxes are interrelated and interacting.”<sup>132</sup> Similarly, the 2015 Tax Discussion Paper concludes that:<sup>133</sup>

While it is useful to understand the distributional effects of individual taxes, it is not the progressivity of any particular tax base that ultimately matters but, rather, that the tax and transfer system as a whole delivers fair outcomes.

From this perspective, while it is clear from the evidence above that any adjustment to the GST will be regressive, some proponents argue that such the GST should not be seen as a standalone policy option. PWC (2015), for example, comments that:<sup>134</sup>

Good tax system design requires that we achieve fairness through our progressive income tax, which targets individuals' capacity to pay, allowing our consumption tax to operate in an efficient way.

The Centre of Independent Studies (2015) in their submission to the latest Tax Discussion Paper also make this point:<sup>135</sup>

Policy options for individual taxes are often criticised on the grounds they would be ‘regressive’, or insufficiently ‘progressive’. However, as pointed out in

<sup>131</sup> Deloitte Access Economics. (2015) [Shedding light on the debate](#), Mythbusting Tax Reform Series Paper No.1, p.14

<sup>132</sup> Productivity Commission (2015) [Tax and transfer incidence in Australia](#), Productivity Commission Working Paper, p.1

<sup>133</sup> Australian Government (2015) [Re:think - Tax discussion paper](#), p.136

<sup>134</sup> PWC (2015) [GST and personal income tax reform: the Yin and Yang of tax policy](#), p.1

<sup>135</sup> The Centre of Independent Studies (2015) [Submission to the Re:think Tax Discussion Paper](#), p.4

*Re:think*, judgments about the degree of redistribution should be based on the distributive effects of the tax/transfer system as a whole, not individual taxes.

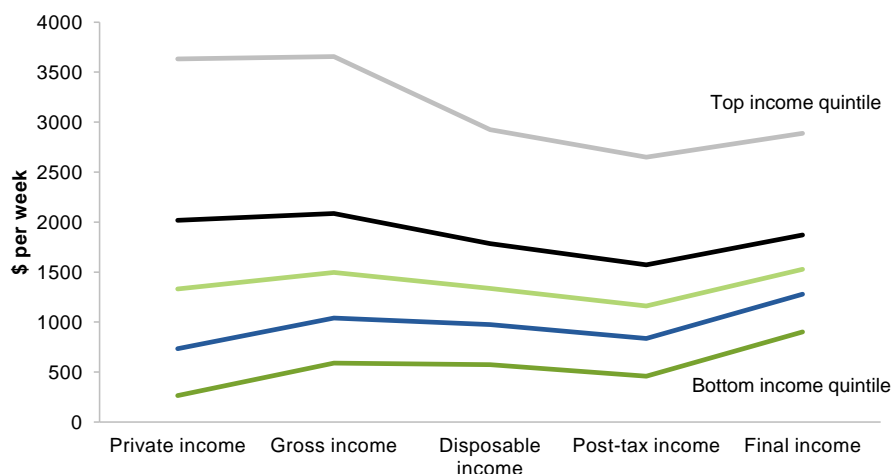
One perverse consequence of the tendency to view every individual tax through the lens of ‘progressivity’ is that some taxes have been structured with graduated rates when it makes no sense to do so.

Using data from the figure below, the Productivity Commission (2015) commented that:<sup>136</sup>

The combined effect of taxes and transfers in Australia is usually found to be progressive.

After taxes and benefits, final income is higher than private income for people in the lowest three income quintiles but lower for people in the highest two income quintiles. That is, the net impact was to redistribute income from the top 40 per cent of households to the bottom 60 per cent.

**Figure 29: Average household income by income stage and income quintile, 2009-10**<sup>137</sup>



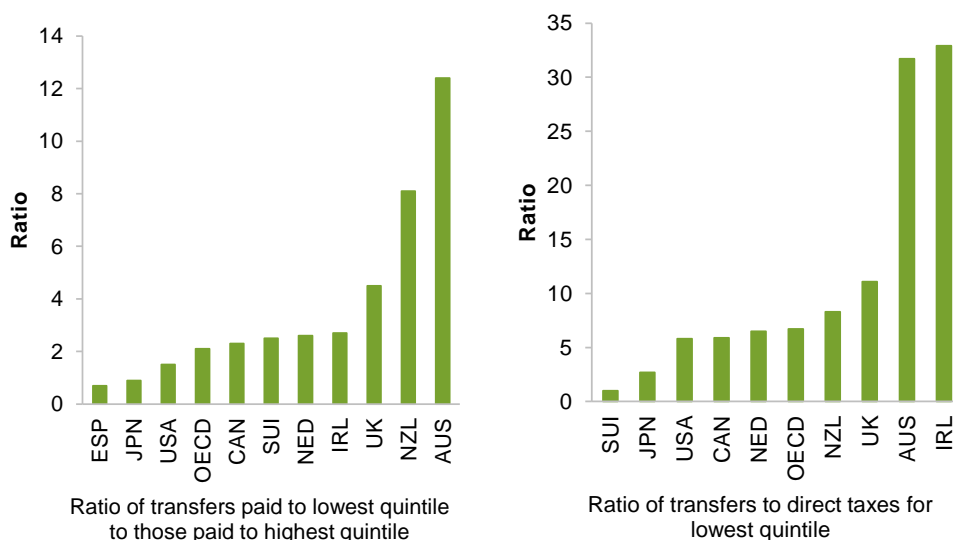
Australia’s tax system as a whole and compared with other OECD countries is progressive. Two measures are used by the OECD in determining the progressivity between countries:

1. the ratio of transfers paid to the lowest quintile compared to those paid to the highest quintile; and
2. the ratio of transfers to taxes for the lowest income quintile.

As can be seen in the figure below, Australia’s compares favourably with other OECD countries.

<sup>136</sup> Productivity Commission (2015) [Tax and transfer incidence in Australia](#), Productivity Commission Working Paper, p.33

<sup>137</sup> ABS (2012) [Government Benefits, Taxes and Household Income, Australia](#), 2009-10, Cat no. 6537.0

**Figure 30: Progressivity of tax and transfers in OECD-10 countries<sup>138</sup>**

### Life cycle perspective of taxation equity

Typically the effects of taxes in Australia are examined from a single-year perspective (Chapter 5.1.1) such that it redistributes income from people (or families) with high annual incomes to people (or families) with low annual incomes.

However, the Productivity Commission (2015) comments that taxation should also be considered on a life cycle basis. That is, as people progress through life, their income, wealth and personal circumstances change; changes which correspond with a varying degree of reliance or input into the tax and transfer system.<sup>139</sup> To illustrate, those with low incomes now may be the young or elderly who will be, or have been, amongst the high income groups at other times. With respect to consumption taxes, the Tax Discussion Paper comments that:<sup>140</sup>

...when viewed over an entire lifecycle, many individuals will ultimately incur a similar amount of tax from a broad-based consumption tax as a proportion of their lifetime income. While households that save a greater proportion of their income in any year will incur less tax as a proportion of that year's income, if and when these households eventually run down their savings they will incur more tax as a proportion of their income in those years compared to other households.

Figure 31, from the Tax Discussion Paper, shows how this can occur. It shows that when young, a typical individual's labour income is lower than their spending. This then becomes higher than their spending in middle age (when

<sup>138</sup> Whiteford, P. (2010) [The Australian Tax-Transfer System: Architecture and Outcomes](#), Economic Record, vol. 86, no. 275, pp. 528–544; Productivity Commission (2015) [Tax and transfer incidence in Australia](#), Productivity Commission Working Paper, p.35

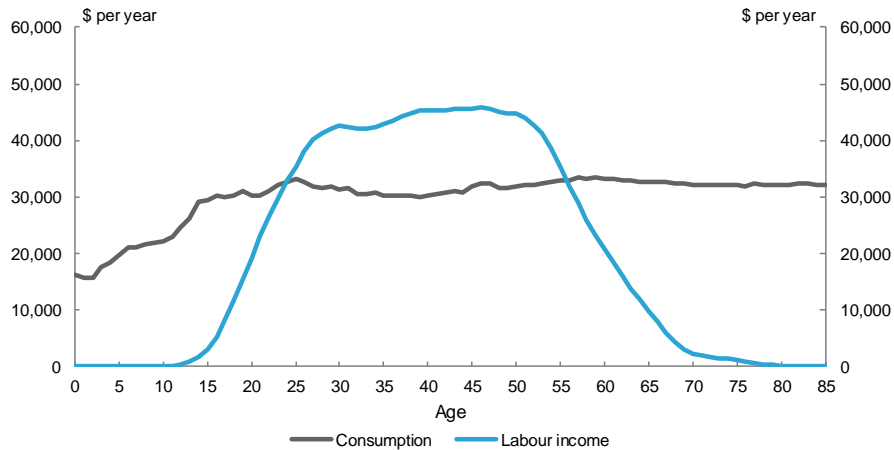
<sup>139</sup> Productivity Commission (2015) [Tax and transfer incidence in Australia](#), Productivity Commission Working Paper

<sup>140</sup> Australian Government (2015) [Re:think - Tax discussion paper](#), p.135



they have the highest incomes and are saving) and then falls, becoming lower than their spending, when they are older and are running down their savings.

**Figure 31: Estimated per capita consumption & labour income, by age, 2003-04<sup>141</sup>**



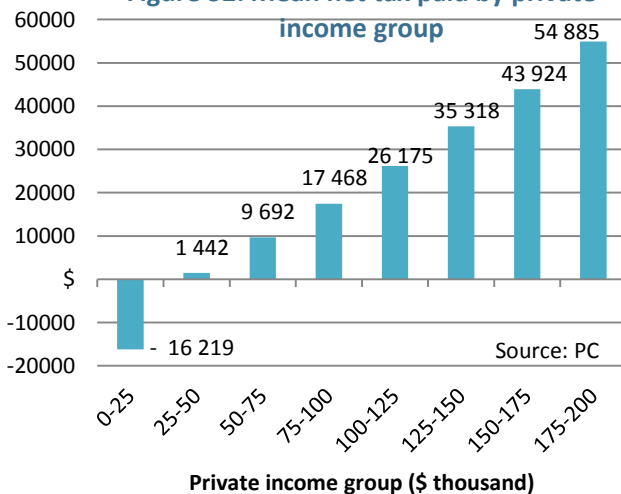
### 5.1.3 Costs of redistribution from a GST adjustment

The regressive element of the GST was initially addressed by the Howard Government in 2000 agreeing to exclude basic foods from the GST; as well as providing increases in income support payments (pensions, allowances and benefits) by 4% on the commencement of the GST.<sup>142</sup>

In the same way, Deloitte Access Economics (2015) suggests that any prospective GST reform needs to look at compensating low income households for an increase in GST via a mix of:<sup>143</sup>

- Increasing pension or benefit amounts provided to those on fixed incomes;
- Increasing the rates of support payments to families; and
- Changing the personal income tax system to cut taxes paid by low income earners. However, such a method would have limited reach in terms of its effectiveness for the lowest income earners (i.e. welfare recipients)

**Figure 32: Mean net tax paid by private income group**



<sup>141</sup> The National Transfer Accounts Project 2014, *National Transfer Accounts*, viewed 26 November 2014: [www.ntaccounts.org](http://www.ntaccounts.org); Tax Discussion Paper

<sup>142</sup> Howard, J. (1999) *Changes to the GST*, Media Release 31 May 1999

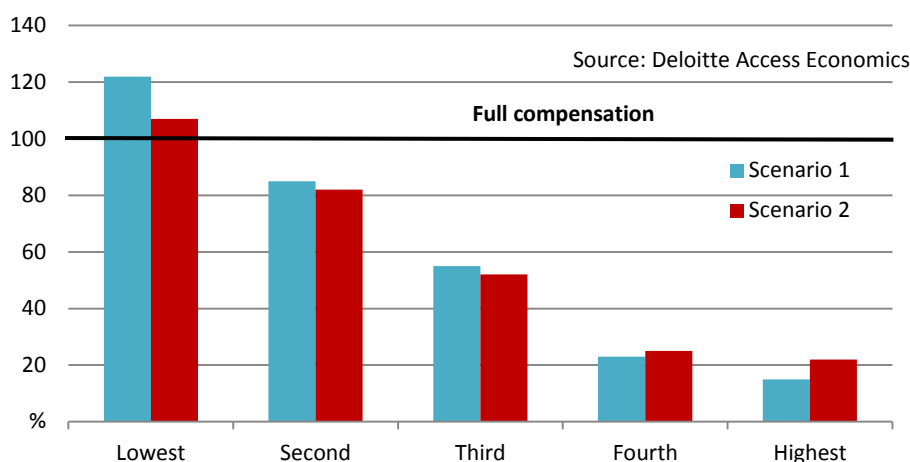
<sup>143</sup> Deloitte Access Economics. (2015) *Shedding light on the debate*, Mythbusting Tax Reform Series Paper No.1, p.14

because a significant proportion of them do not pay income tax in the first instance (Figure 32).

Deloitte Access Economics add that “the relative split between these depends on the size of the change to GST and on the goals of the compensation package.”<sup>144</sup> The amount of compensation required is estimated by Deloitte Access Economics to be in the region of \$35 and \$37 billion depending on the scheme implemented.

Figure 33, based on Deloitte estimates, illustrates that the least well-off in Australia would actually be better off with a higher GST of either 12.5 or 15% and a broader base; with average compensation greater than the additional cost of the GST reforms.

**Figure 33: Average amount of compensation provided to households by gross income quintile**



According to PwC analysis, compensating the bottom three household income quintiles would cost approximately 40 to 50% of revenue generated from the GST changes assessed. Specifically:<sup>145</sup>

- Broadening GST to food, health and education would raise an additional \$12.2 billion in 2015-16 terms – Compensation would cost \$5.2 billion (42% of revenue generated), leaving \$7.1 billion in net revenue.
- Raising the GST rate to 15% but leaving the base unchanged would raise \$30.2 billion in 2015-16 terms – Compensation would cost \$12.0 billion (40% of revenue generated), leaving \$18.2 billion in net revenue.

The chief impediment is the concern that compensatory changes to tax thresholds and transfer payments to protect the living standards of low-income earners could be wound back by future Governments, “either as a matter of

<sup>144</sup> Deloitte Access Economics. (2015) [Shedding light on the debate](#), Mythbusting Tax Reform Series Paper No.1, p.14

<sup>145</sup> PWC (2015) [We can afford fair GST reform](#), p.2

fiscal expediency or ideological malevolence.”<sup>146</sup> As outlined by PWC (2015):<sup>147</sup>

A criticism of compensation is that it might be clawed back by cash-strapped governments in the future. This goes to the question of trust, which cannot be dismissed. Any compensation strategy must address this concern, which might require legislative or other protections to be put in place.

ACOSS in their recent report [The effects of a higher GST on households](#) argues that even with compensation, the burden of risk from the reform is born by “people who are least able to bear it.”

According to the PBO (2015), “the compensation arrangements for transfer payment recipients from the introduction of the GST [in 2000 have] remained largely in place.”<sup>148</sup>

## 5.2 Efficiency and tax churn

Apps & Rees (2013) in their ANU discussion paper, *Raise top tax rates, not the GST* argue that because of the regressive nature of the GST, and the subsequent compensation that will be required to offset these impacts, “serious losses of economic efficiency will result.”<sup>149</sup>

The technical term for this is **tax churn** which refers to the extent to which the same households both receive government payments and pay taxes. It is argued that this may involve unnecessary administrative duplication and impose compliance costs on households, and reduce choice.<sup>150</sup> For example, a GST proposal to collect increased revenue from 60% of households only to transfer it back to them as compensation either through increased transfer payments or income tax cuts would create administrative costs.

It should be noted that by OECD measures, Australia has the lowest level of tax churn. However, as noted in the International Comparison of Australia’s Taxes:

Caution should be exercised when interpreting [this observation] as the tax mix within a country can significantly affect the results. For example, countries with a high reliance on indirect taxes will have a high percentage of churn as a percentage of direct taxes.

In general terms, moving from a universal to a more narrowly targeted system would reduce churning (i.e. consumption to income base), but as the OECD

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<sup>146</sup> The Centre for Policy Development (2015) [Budgeting smarter, not harder: The failure of long-term thinking in the 2015 Intergenerational Report](#), p.21

<sup>147</sup> Ibid

<sup>148</sup> Parliamentary Budget Office (2015) [Goods and Services Tax – Distributional analysis and indicative reform scenarios](#), p.v

<sup>149</sup> Apps, P, and Rees, R. (2013) [Raise top tax rates, not the GST](#), Discussion Paper No. 684, ANU Centre for Economic Policy Research, p.7

<sup>150</sup> Whiteford, P. (2006) [The Welfare Expenditure Debate: “Economic Myths of the Left and the Right” Revisited](#), University of NSW, p.15

notes:

... for a given generosity of transfers at the low end, targeted systems need to claw back benefits more rapidly as income rises. Thus, there is a trade-off between high implicit marginal tax rates due to the tapering off of targeted benefits and high explicit tax rates due to the extra budgetary cost of maintaining universal programmes.

## 6. BROADENING THE GST BASE

The main categories of consumption that are GST-free are fresh food, health, education, childcare and financial services. However, with the consumption base for GST narrowing from 54% in 2006 to 47% in 2012, base broadening to include some of these items is being discussed as a means of recapturing lost revenue. The basic economic premise behind broadening the GST is that:<sup>151</sup>

High income earners spend more money, in absolute terms, on currently GST exempt items than low income earners. When GST is applied, therefore, additional taxes paid by the former will exceed the compensation required by the latter.

This chapter of the paper will outline key goods and services which are currently exempt and whether it is in fact feasible to broaden the base on such items – particularly financial services. The general economic and social implications of a base broadening proposal are then discussed.

### 6.1 Current exemptions

Items such as fresh food, health, education, and childcare are what the OECD calls 'standard' exemptions<sup>152</sup> and are *GST-free*. This means that: (a) they are not only subject to GST when sold; and (b) their suppliers can also claim a refund on any GST levied on the inputs they used to produce them.<sup>153</sup>

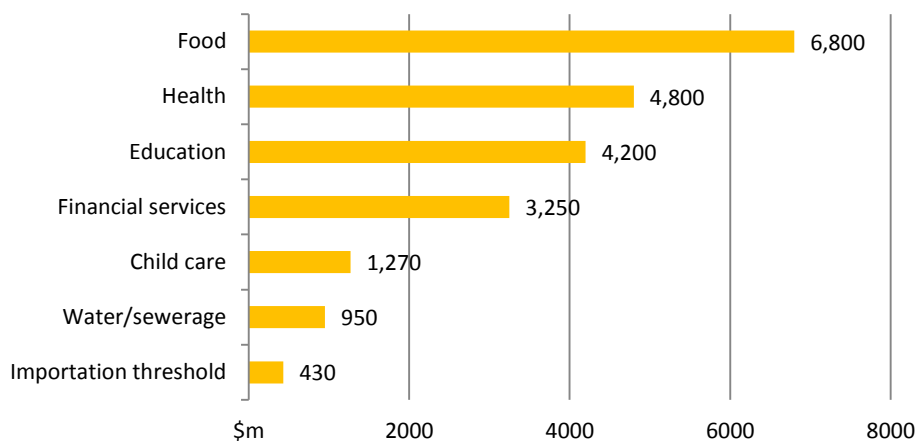
Treasury's tax expenditure data estimates reveal that the non-applicability of the GST to the six biggest classes of exempt expenditure reduces revenues by over \$21 billion per year (Figure 34) – or the equivalent of 37% of all GST revenues in 2015-16.

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<sup>151</sup> PWC (2015) [GST and personal income tax reform: the Yin and Yang of tax policy](#), p.2

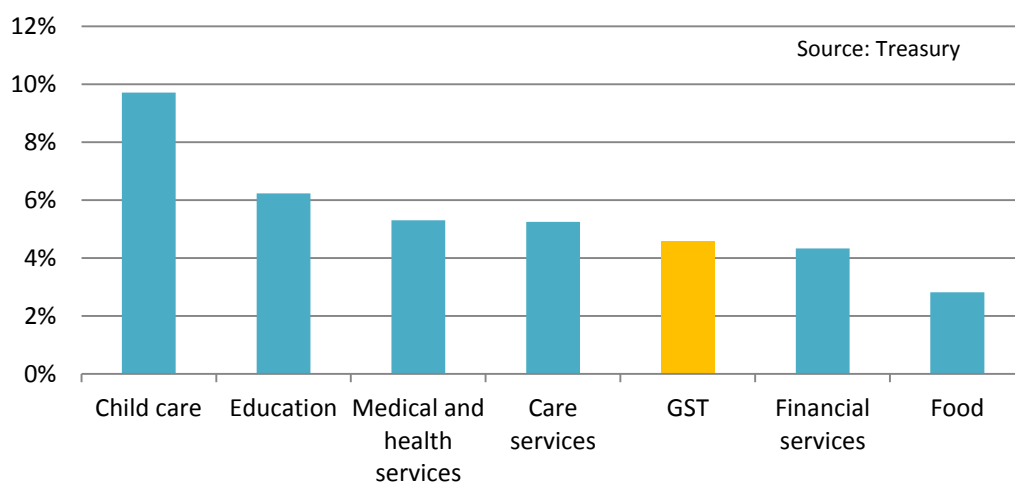
<sup>152</sup> OECD (2004) [The Application of Consumption Taxes to the Trade in International Services and Intangibles](#)

<sup>153</sup> Australian Government (2015) [Re:think - Tax discussion paper](#), p.133

**Figure 34: Foregone tax revenue from expenditure excluded from GST, 2015-16**

Source: Treasury

The foregone revenue from these GST-exempt items is expected to continue to erode the GST base in line with recent historical trends in which expenditure on GST-exempt items has increased significantly. Health and education expenditures make up a large proportion of the erosion of the GST base.<sup>154</sup>

**Figure 35: Average annual growth in GST and exempt item consumption, 2015-16 to 2018-19**

Source: Treasury

### 6.1.1 Financial services

In Australia, financial services, such as banking operations, insurance and other advisory services, are exempt from the GST and this is typically the case in virtually all the countries employing this form of broad-based consumption tax.<sup>155</sup> As discussed by the World Bank (2003):<sup>156</sup>

<sup>154</sup> Business Council of Australia (2014) [The future of tax: Australia's current tax system](#), p.16

<sup>155</sup> World Bank (2003) [Taxation of financial intermediation - Chapter 12](#), p.1

<sup>156</sup> Ibid

The decision to exempt financial services from VAT revolves around the conceptual and administrative difficulties associated with measuring the value of financial services on a transaction-by-transaction basis rather than social or economic policy reasons.

Additionally, it is conceptually and practically hard to tax the financial sector using the invoice-based credit method which the World Bank (2003) describes in the following example:<sup>157</sup>

A bank gets a deposit at 5 percent and loans out at 15 percent. Under a strict credit VAT, the bank has to divide the total 10 percent value added (i.e., 15%-5%) into two parts: one is the value added generated during the transaction between the lender and the bank; and the other is the value added attributed to the transaction between the bank and its borrower. The apportionment is next to impossible.

On the other hand, the tax revenue potential in the whole process is expected to be negligible—only the financial services to final consumers/households are taxed, whereas the services catered to firms are treated as intermediate inputs and hence are to be credited.

Crawford et. al (2010), as part of the UK Mirrlees Review, acknowledge that such practicalities require further attention if VAT were to apply to financial services. However, they emphasise that a movement to a system where financial services transactions were subject to a VAT “would not only remove distortions but likely entail a substantial net revenue gain.”<sup>158</sup>

According to estimates in the Treasury tax expenditure statement, if the financial services and supplies that are exempt were to have GST applied, it would raise around \$14 billion over the next four years and \$3.3 billion in 2015-16 alone.

### 6.1.2 GST threshold on imports

There are practical difficulties in enforcing GST obligations on suppliers that do not have a presence in the jurisdiction in which consumption takes place.<sup>159</sup> For this reason, there is a \$1,000 low-value threshold (LVT) on which the GST may apply to imported goods and services.

On 9 December 2011, the Gillard Government released the report of the Productivity Commission Inquiry into the Economic Structure and Performance of the Australian Retail Industry. The Commission considered the operation of the \$1,000 LVT and concluded:<sup>160</sup>

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<sup>157</sup> World Bank (2003) [Value Added Taxation: Mechanism, Design, and Policy Issues](#), p.26

<sup>158</sup> Crawford, I. et. al. (2010) [Value added tax and excises, Chapter 4 – Dimensions of Tax Design: the Mirrlees Review](#), p.277

<sup>159</sup> Evans, M. (2012) [GST Distribution Review – Options for GST taxation of imported goods and services](#), p.3

<sup>160</sup> Productivity Commission (2011) [Economic Structure and Performance of the Australian Retail Industry](#), p.xl

There are strong in-principle grounds for the LVT exemption for GST and duty on imported goods to be lowered significantly, to promote tax neutrality with domestic sales. However, the Government should not proceed to lower the LVT unless it can be demonstrated that it is cost-effective to do so. The cost of raising the additional revenue should be at least broadly comparable to the cost of raising other taxes, and ideally the efficiency gains from reducing the non-neutrality should outweigh the additional costs of revenue collection. ...

The Commission notes that any move to lower the level of the LVT would have no impact on the taxation of the importation of services and intangibles — for example, downloads of software, music and games. Treasury estimates that such imports currently give rise to around \$1 billion of GST revenue foregone.

The 2012 GST Distribution Review was conducted to examine the scope of practical methods to bring imported goods and services within the scope of Australia's goods and services tax. The Panel's [final report](#) to the Treasurer was published in October 2012.

The Abbot Government subsequently recently released [draft legislation](#) that proposes to amend the GST law to give effect to the 2015-16 Federal Budget measure to ensure digital products and services provided to Australian consumers receive equivalent GST treatment whether they are provided by Australian or foreign entities. July 2017 has already been flagged as the start date for GST on imported digital products and services and low value goods.<sup>161</sup>

According to PWC (2015), the new measures do not raise significant revenue but are consistent with the Government's desire to address the [Base Erosion and Profit Shifting](#) agenda in the GST space.<sup>162</sup>

## 6.2 General considerations to base broadening

There are a number of reasons to favour base broadening as part of a GST reform package. According to the Grattan Institute (2013), a broader GST is simpler and more efficient than a limited one.<sup>163</sup>

A broader based tax may have lower administrative costs as businesses which deal in both exempt and non-exempt goods simplify their accounting. Having fewer 'grey lines' between exempt and non-exempt categories reduces opportunities for tax avoidance and lobbying by rent-seekers for exclusion of particular goods.

Similarly, Saul Eslake comments that the GST is a relatively expensive tax to collect but mostly because of the 'boundary issues' that arise from the exemptions from it.<sup>164</sup>

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<sup>161</sup> Deloitte Access Economics. (2015) [Shedding light on the debate](#), Mythbusting Tax Reform Series Paper No.1, p.12

<sup>162</sup> PWC (2015) [2015-16 Australian Federal Budget - Prepare for repair](#), p.16

<sup>163</sup> Grattan Institute (2013) [Balancing budgets: tough choices we need](#), p.51

<sup>164</sup> Eslake, S. (2011) [Australia's tax reform challenge](#), p.4

The need – for example – to determine whether Italian mini ciabatta is a ‘cracker’ (and therefore subject to GST) or ‘bread’ (and therefore exempt from it). New Zealand’s GST has almost no exemptions, and it is relatively much cheaper to administer.

According to the Centre for Policy Development (2015), “imposing the GST across [exempted] expenditures would support revenues and broaden the overall tax base, as well as reducing distortions and complexities associated with only applying consumption taxes to some goods and services.”<sup>165</sup>

As the Henry Review pointed out, “a narrower GST does not make it fairer, but adds complexity.” There is evidence in a recent OECD analysis of distributional features of other VATs (excluding Australia) that a number of GST exemptions may benefit high income earners more than low income earners.<sup>166</sup> The Centre for Policy Development made a similar observation suggesting that:<sup>167</sup>

...because the wealthiest households have the highest absolute levels of expenditure on GST-exempt goods and services, most of the additional revenue raised by broadening the GST would flow from those with higher incomes. This means that even with measures to fully compensate lower income earners and to offset increase costs in public services like health and education, the revenue raised from a broader GST could make a significant contribution to strengthening the budget in the medium term.

As noted by PWC (2015), “compensation is targeted to protect those in need, whereas universal access to exemptions is both wasteful and unfair.”<sup>168</sup> This is a point that has been made by the OECD in its 2014 Economic Survey of Australia:<sup>169</sup>

A recent OECD study on the distributional effects of consumption taxes underscores that [GST exemptions] are a very poor tool for targeting support for low-income households. “At best, high-income households receive as much benefit from a reduced rate as those on low incomes, and at worst they benefit vastly more than poor households, as their consumption of tax-favoured goods and services is greater than that of low income households

In 2014, the OECD completed a survey of 20 countries on the extent to which their VAT systems were regressive. They concluded:<sup>170</sup>

A reduced rate on items such as basic foods—that account for a large share in

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<sup>165</sup> Centre for Policy Development (2015) [Budgeting smarter, not harder: The failure of long-term thinking in the 2015 Intergenerational Report](#), p.19

<sup>166</sup> OECD (2014) [The Distributional Effects of Consumption Taxes in OECD Countries](#), Organisation for Economic Cooperation and Development, Paris

<sup>167</sup> Centre for Policy Development (2015) [Budgeting smarter, not harder: The failure of long-term thinking in the 2015 Intergenerational Report](#), p.19

<sup>168</sup> PWC (2015) [We can afford fair GST reform](#), p.4

<sup>169</sup> OECD (2014) [Economic Survey of Australia](#), p.64

<sup>170</sup> OECD (2014) [The Distributional Effects of Consumption Taxes in OECD Countries](#), Organisation for Economic Cooperation and Development, Paris



total consumption of the poor—is intended to subsidize the poor, but a larger portion of the tax subsidy is, in fact, likely to be reaped by the rich.<sup>171</sup> The rich, by spending more dollar amount on the food, are expected to gain more from the subsidy, whereas the poor is to gain less simply because they spend less dollar amount on the same food items.

Crawford et. al (2010) emphasised the point that the case for using preferential rates of VAT to help the less well-off was weak and that, in the UK context in particular, there were better redistributive instruments available.<sup>172</sup> Crawford et. al (2010) add that:<sup>173</sup>

Recent international experience—including that of New Zealand—shows that many of these exemptions are unnecessary, and demonstrates the potential for a base-broadening reform of the VAT.

The standard advice by the IMF and the World Bank is that the VAT be structured with a single non-zero rate in addition to zero rate exclusively granted to exports and few selective exemptions.<sup>174</sup>

On the other hand, taxing private expenditure on **fresh food** could lead to people spending more on processed foods, leading to poorer, long-term health outcomes. However, Treasury estimates suggest that spending on these categories is relatively unresponsive, so there may not be much change in consumption.<sup>175</sup>

Likewise, higher prices for **education** could lead to parents moving children into government schools, and students choosing not to enrol in higher education. But demand for education also seems to be relatively insensitive to price: changes in private school fees and higher education contribution amounts have not significantly affected choices in the past.<sup>176</sup>

Others suggest the broadening of the GST should be more targeted at goods and services with a higher propensity of consumption among higher income earners. For example, the Australia Institute suggests that:<sup>177</sup>

One way of broadening the GST without enhancing the burden of the tax on low-income households, would be to extend the tax to goods and services consumed most regularly by higher income earners, such as private schools and private health insurance.

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<sup>171</sup> World Bank (2003) [Value Added Taxation: Mechanism, Design, and Policy Issues](#), p.37

<sup>172</sup> Crawford, I, Keen, M, and Smith, S. (2010) [Value added tax and excises](#), Chapter 4 – Dimensions of Tax Design: the Mirrlees Review, p.277

<sup>173</sup> Ibid

<sup>174</sup> Ibid,p.38

<sup>175</sup> Treasury (2013) [Tax Expenditures Statement](#), 2012

<sup>176</sup> Ibid; Jensen, B., Weidmann, B. and Farmer, J. (2013) [The myth of markets in school education](#), Grattan Institute

<sup>177</sup> The Australia Institute (2014) [How to extend the GST without hurting the poor](#),p.8

According to the Treasury's tax expenditure statement, broadening the GST to include taxes on private health insurance could raise \$1.5 billion in additional revenue per year.

## **7. COMPARATIVE INTERNATIONAL VALUE ADDED TAXATION POLICIES<sup>178</sup>**

New Zealand and the United Kingdom are two countries which have had value added taxation for a much longer period and at a higher rate than Australia. In the case of New Zealand, it also has a much broader base with their GST covering 96% of consumption. Successive reforms have also been implemented to each of their respective taxes, with such reform potentially providing a useful insight into the mechanisms Australia might use should GST reform be pursued. This section is limited to providing a relatively brief overview in each case, with additional literature provided which discusses the position of such jurisdictions at greater length.

### **7.1 New Zealand**

The GST in New Zealand was introduced on October 1, 1986 at a rate of 10%. It was subsequently raised to 12.5% in 1988 and then to 15% in 2010. The latter increase was the "cornerstone of the tax reform package [which included] a \$4.5 billion per annum reduction in income tax rates, funded by an increase in GST."<sup>179</sup> The reform package also contained measures to compensate vulnerable individuals for the increase in the rate of GST:<sup>180</sup>

Recipients of New Zealand Superannuation, Veterans Pensions, main working age benefits, Student Allowances, some Working for Families tax credits (WFF), some Government Superannuation and National Provident Fund payments, and some of the main supplementary benefits, [received] additional financial support.

Businesses with annual net-of-GST turnover exceeding NZ\$30,000 are required to register for the GST. Additionally, there are no reduced or super-reduced rates, exemptions, or zero rates—other than those necessary to define the appropriate base of the tax.<sup>181</sup> Food, children's clothing, medical care, education services, publications, energy, and other necessities of life are taxed at the same rate as other goods and services.

The New Zealand model is generally considered to be one of the more effective GST regimes in terms of best international tax practices and essentially limits the exemption to certain types of financial services, supply of donated goods and services by non-profit organizations, residential rental and finished fine

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<sup>178</sup> For a complete comparison of international GST/VAT taxation rates see the [2015 Ernst and Young Worldwide VAT, GST and Sales Tax Guide](#)

<sup>179</sup> NZ Treasury, [Reform of the Tax System – Budget 2010](#), accessed 2 February 2016

<sup>180</sup> Ibid

<sup>181</sup> In the category of 'base-defining' exemptions and zero rates, we include exports, provision of labour services, and investment capital.

metals.<sup>182</sup>

Key literature – New Zealand GST	
Report Title	Department/Organisation
Dickson, I, and White, D. (2010) <i>Commentary - Value added tax and excises, Chapter 4 – Dimensions of Tax Design: the Mirrlees Review</i> , p.387-406	Institute of Fiscal Studies
<a href="#">Successful tax reform: the experience of value added tax in the United Kingdom and goods and services tax in New Zealand</a>	University of Exeter Business School
<a href="#">Cabinet Paper – Tax reform package for Budget 2010</a>	Inland Revenue, New Zealand
<a href="#">Recent GST Reforms and Proposals in New Zealand</a>	Inland Revenue, New Zealand

## 7.2 United Kingdom

The VAT was originally introduced in 1973 at a standard rate of 10% with zero rates on selected goods and services (such as food, books, children’s clothing, and certain supplies for charities). It was also a condition of entry into the European Economic Community.<sup>183</sup>

In 1974 this was reduced to 8% but the VAT was levied from 1975 at an additional ‘luxury rate’ of 25%. However the administration of the two rates remained difficult and further revenue was required to permit reductions in the rates of income tax. In 1979 these two rates of VAT were amalgamated at 15%.<sup>184</sup> The rate was increased to 17.5% in 1991 but temporarily reduced to 15% until January 2010 in order to stimulate spending in the face of an economic downturn.

It is important to note that the UK Government considered raising the standard rate to 18.5% from 2010, to help reduce the government’s underlying budget deficit, before opting in the end to raise a similar amount of revenue from higher rates of National Insurance.<sup>185</sup>

However, the standard rate of VAT increased to 20% in January 2011 (from 17.5%) following a change of Government. As part of this, “everyday essentials such as food and children's clothing, as well as other zero-rated items like newspapers and printed books, were [still] exempt from VAT.”<sup>186</sup> Because of these exemptions, no transfer or benefit payments were made in association with the increase and it was shown by the Treasury that the additional tax

<sup>182</sup> World Bank (2003) [Value Added Taxation: Mechanism, Design, and Policy Issues](#), p.50

<sup>183</sup> Institute of Fiscal Studies (2009) [Value added tax, Chapter 10 – Green Budget](#), p.195

<sup>184</sup> James, S, and Alley, C. (2008) [Successful tax reform: the experience of value added tax in the United Kingdom and goods and services tax in New Zealand](#), University of Exeter Business School, p.37

<sup>185</sup> Institute of Fiscal Studies (2009) [Value added tax, Chapter 10 – Green Budget](#), p.194

<sup>186</sup> HC Deb 22 June 2010 c177

burden was lowest for the lower income deciles.

Key research documents – United Kingdom VAT	
Report Title	Department/Organisation
Value Added Taxation: The Experience of the United Kingdom	Prest (1980)
<a href="#">VAT/GST: The UK Experience Revisited</a>	James (2000)
<a href="#">Successful tax reform: the experience of value added tax in the United Kingdom and goods and services tax in New Zealand</a>	University of Exeter Business School
<a href="#">VAT : the new 20% standard rate</a>	House of Commons Library
<a href="#">United Kingdom – Country VAT Essentials</a>	KPMG

### 7.3 European Union VAT laws

In October 1992 the European Council agreed Directive 92/77/EEC which established new rules limiting the discretion of all States to set VAT rates. In brief, all EU Member States must apply a standard VAT rate of 15% or more, and have the option of applying one or two reduced rates, no lower than 5% to certain specified goods (this list is now consolidated in Annex III to VAT Directive 2006/112/EC).<sup>187</sup>

In December 2011 the Commission published details of a [new VAT strategy](#). As discussed by Seely (2015):

It argued that the administration of VAT should be simpler for businesses, that the tax should raise money for national governments more efficiently – through broadening the tax base and limiting the use of reduced VAT rates, and that the scale of VAT fraud should be tackled.

The Commission did not publish any proposals for amending these rules following its new VAT strategy. However, in October 2015 it confirmed that, as part of its work programme for 2016, it would present an initiative on VAT rates – though further details have not been published as yet.<sup>188</sup>

Key research documents – European Union	
Report Title	Department/Organisation
<a href="#">VAT: European law on VAT rates</a>	House of Commons Library
<a href="#">Communication: On the Future of VAT</a>	European Commission

<sup>187</sup> Seely, A. (2015) [VAT: European law on VAT rates](#), House of Commons Library, Briefing Paper 2683, p.3

<sup>188</sup> European Commission, [Commission Work Programme 2016](#), COM(2015) 610 final, 27 October 2015 p8

## 8. OPTIONS FOR EXPENDITURE OF ADDITIONAL REVENUE

Various proposals have been put forward as to why the GST should be raised, including the need to address deteriorating budget positions of the State and Commonwealth Governments.<sup>189</sup>

This chapter discusses the various ways in which this additional revenue could be spent. In addition to providing compensation to lower income earners (Chapter 8.1), this revenue could be used to reduce personal income taxes (Chapter 8.2) or be used to eliminate inefficient taxes like insurance levies or fund State government services like health (Chapter 8.3).<sup>190</sup> Alternatively, it could be used by the Commonwealth Government to rebalance its fiscal position (Chapter 8.5) – similar to the way the UK Government used their revenues following the increase in their VAT in 2011.

### 8.1 Redistribution through transfers

Opposition to increasing Australia's GST is motivated mostly by concerns about how low-income households would be affected. However, the Commonwealth Government can largely mitigate the effects of GST changes on lower income households through the welfare system. For example, when the GST was introduced in 2000, self-funded retirees received one-off cash payments – a savings bonus and a self-funded retiree bonus worth up to \$3000<sup>191</sup> – to compensate them for the higher cost of living associated with the GST.

As was outlined in Chapter 5, 40 to 50% of revenue generated from a prospective GST change would likely be redistributed through income transfers and tax cuts. Because the poorest 20% of households currently account for just over 10% of total spending on the goods and services and would contribute around 8% of extra revenue if the GST rate was increased, the Grattan Institute (2015) conclude that:<sup>192</sup>

If these households could be targeted directly, then spending 8-10 per cent of the revenues from the GST would be enough to ensure that they are no worse off on average after their higher expenses. In reality, however, compensation through higher welfare payments would not be perfectly targeted. To ensure that the poorest one fifth of households are on average no worse off, welfare benefits would have to be increased to the point where they would benefit some higher income households as well, and so would cost much more than 10 per cent of the increased GST collection.

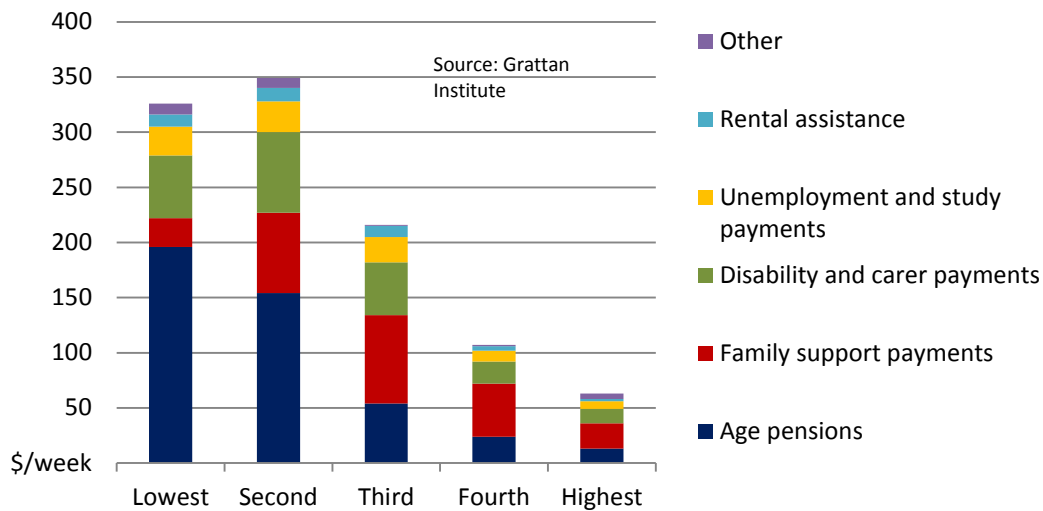
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<sup>189</sup> Grattan Institute (2015) [A GST reform package](#), p.28; If the GST is broadened or raised, governments will have additional revenue of between \$7 and \$11 billion a year after paying for the compensation package we have proposed.

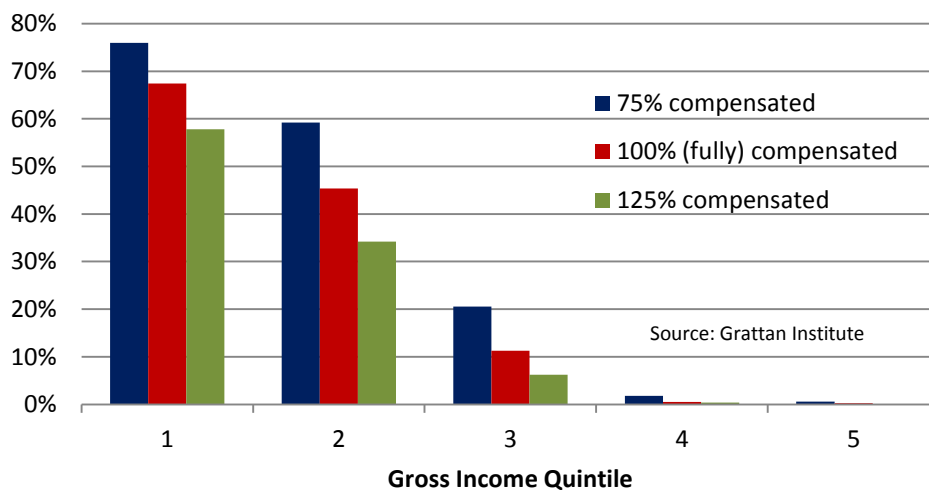
<sup>190</sup> PWC (2015) [GST and personal income tax reform: the Yin and Yang of tax policy](#), p.1

<sup>191</sup> *A New Tax System (Bonuses for Older Australians) Act 1999*

<sup>192</sup> Grattan Institute (2015) [A GST reform package](#), p.17

**Figure 36: Average weekly payments by household income quintile, \$2013-14**

The Grattan Institute (2015) estimates that higher welfare payments equivalent to 30% of revenues from increasing the GST rate to 15% would ensure that the poorest households are generally more than compensated for the higher costs (Figure 37).<sup>193</sup>

**Figure 37: Percentage of each quintile at least compensated by the amount shown after higher GST and higher welfare payments**

The main concern is not whether there is sufficient funding to compensate these householders. But rather, whether the compensation will be sustained through political cycles; with an increase in the rate or base of the GST arguably more politically permanent than an adjustment to welfare.

Previous experience in both Australia and New Zealand highlights the risk that compensation can be eroded over time. Increases in welfare benefits to

<sup>193</sup> Grattan Institute (2015) [A GST reform package](#), p.18

compensate for the introduction of New Zealand's GST were cut sharply after a change of government. In Australia, despite increases in Newstart following the introduction of the GST in 2000 and CPI indexation, the single adult Newstart rate has been eroded by cost of living increases so that it now buys less than it did before the GST was introduced.<sup>194</sup>

However, as pointed out by the PBO (2015), "the compensation arrangements for transfer payment recipients from the introduction of the GST [in 2000 have] remained largely in place."<sup>195</sup>

## 8.2 Income tax cuts

Appropriately targeted income tax cuts will help to moderate the effect of a higher GST on work incentives.<sup>196</sup> However, such a method would have limited reach in terms of its effectiveness for the lowest income earners because a significant proportion of them do not pay income tax in the first instance. As such, any income tax cuts would be targeted to compensating middle to higher income earners.

According to the OECD (2008), reducing the top marginal statutory rate on personal income can have a positive influence on productivity which may help to enhance economy-wide productivity, particularly in industries with potentially high rates of entrepreneurship.<sup>197</sup> Australia's top marginal tax rates have remained relatively unchanged over the past two decades or so.<sup>198</sup> Realistically, a cut on the top marginal tax rates is unlikely to be palatable for most voters and is an unlikely scenario from any possible increase in the GST or other such revenues. From this perspective, the Grattan Institute, in arguing that the tax system already provides numerous incentives for starting a business, propose spending 30% of additional GST revenues to allow for modest income tax cuts in the low to middle brackets.<sup>199</sup>

Proposed income tax cuts			
	Current rate	Rates with higher GST	Rates with broader GST
\$0-\$18,200	0%	0%	0%
\$18,201-\$37,000	19%	16.50%	17.50%
\$37,001-\$80,000	32.50%	30.50%	31.50%
\$80,001-\$180,000	37%	37%	37%
\$180,001 and over	45%	45%	45%
Source: Grattan Institute (2015)			

<sup>194</sup>

<sup>195</sup> Parliamentary Budget Office (2015) Goods and Services Tax – Distributional analysis and indicative reform scenarios, p.v

<sup>196</sup> Grattan Institute (2015) [A GST reform package](#), p.24

<sup>197</sup>

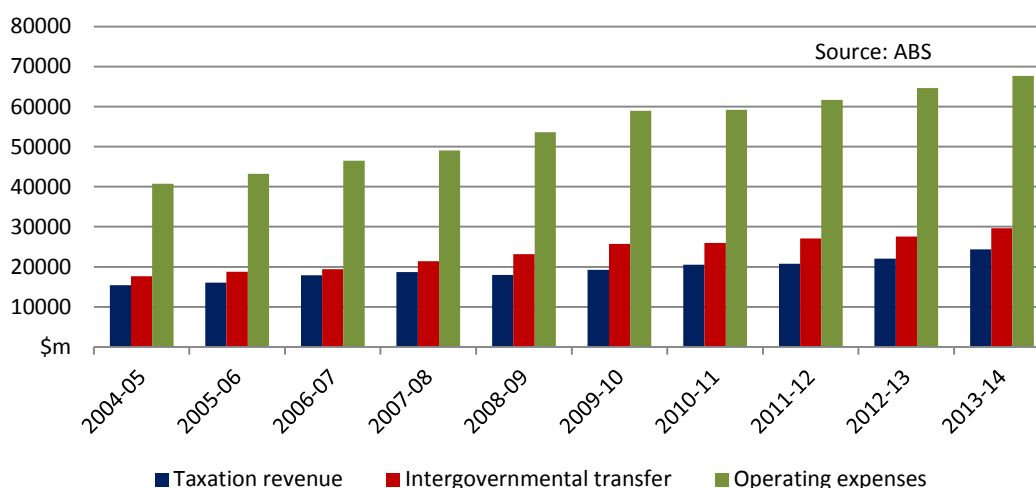
<sup>198</sup> Brys, B., S. Matthews and J. Owens (2011), *Tax Reform Trends in OECD Countries*, OECD Taxation Working Papers, No. 1, OECD Publishing

<sup>199</sup> Grattan Institute (2015) [A GST reform package](#), p.24

### 8.3 Transfers to the States

The allocation of Australia's taxation and expenditure responsibilities is highly imbalanced across different levels of government. Australia's *vertical fiscal imbalance* sees the Commonwealth collecting more tax revenue than it spends, while the States are responsible for expenditure that far outstrips their own revenues (Figure 38).

**Figure 38: NSW tax revenue, transfers and operating expenses**



Additionally, since 2010-11, health recurrent spending as a percentage of total expenses has increased from 27.2 to 28.0% in 2015-16.<sup>200</sup> Because of this, there have been a number of calls from State Premiers<sup>201</sup> for any additional revenue from a prospective change to the GST rate or base to be distributed to the States for health and education spending. This would be a continuation of the arrangements agreed to under the *Intergovernmental Agreement on Federal Financial Relations*.

The Commonwealth Government had indicated that it would not institute a change to the rate or base of the GST without the agreement of all the States and Territories. Specifically, the Tax Discussion Paper notes that:<sup>202</sup>

The [Commonwealth] Government will not support changes to the GST without a broad political consensus for change, including agreement by all state and territory governments.

Most recently, NSW Premier Mike Baird [put forth the proposal](#) of increasing the rate of the GST to 15 per cent, with no expansion to the base, a move that would raise about \$32.5 billion a year. Specifically, in the three years from 2017-18 to 2019-20, the Commonwealth Government would keep all of the revenue except for \$7 billion, which would be given to the States to make up for

<sup>200</sup> NSW Treasury (2015) [Budget Paper – Statement](#), p.5-20

<sup>201</sup> Sydney Morning Herald (2016) [Mike Baird makes new case for 15% GST](#), 1 February 2016

<sup>202</sup> Australian Government (2015) [Re:think - Tax discussion paper](#), p.129

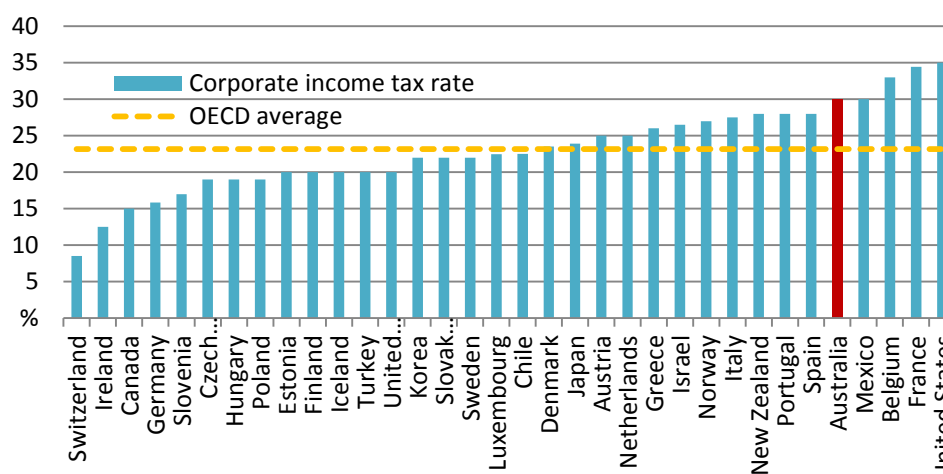


funding cuts to schools and hospitals in the 2014 federal budget – which reversed the agreements under the *National Education Agreement* and the *National Health Reform Agreement* respectively. Then, in 2020, the States and the Commonwealth Government could renegotiate the redistribution of the revenue to fund health and education over the long term.<sup>203</sup>

#### 8.4 Corporate tax cuts

Australia has a relatively high statutory corporate tax rate at 30% compared to other comparable OECD countries. The average of our competitors in the Asia-Pacific region is 23.5% and across the OECD is 23.2% (Figure 39).

**Figure 39: OECD corporate tax rates, 2015**



Source: OECD

It should be noted that as part of the 2015-16 Budget the Commonwealth Government cut the income tax rate to 28.5% for small businesses (i.e. with an aggregated annual turnover of less than \$2 million). Companies with an aggregated annual turnover of \$2 million or above are still subject to the current 30% tax rate on all their taxable income.<sup>204</sup>

Of the major taxes, corporate taxes are generally considered to be most harmful for growth, followed by personal income taxes and then consumption taxes. Specifically the OECD (2008) found that:<sup>205</sup>

...lowering statutory corporate tax rates can lead to particularly large productivity gains in firms that are dynamic and profitable, i.e. those that can make the largest contribution to GDP growth. It also appears that corporate taxes adversely influence productivity in all firms except in young and small firms since these firms are often not very profitable.

<sup>203</sup> Australian Financial Review, [NSW proposes \\$100b GST hike to mostly fund tax cuts](#), 31 January 2016

<sup>204</sup> ATO, [Growing Jobs and Small Business - tax cuts for small business](#), accessed 9 February 2016

<sup>205</sup> OECD (2008) [Tax and economic growth](#), Economics Department Working Paper No.620, p.9

In its briefing to the G20 Finance Ministers meeting last year, IMF singled out Australia's GST exemptions for reform. It specifically highlighted that reliance on direct taxation, particularly corporate tax, is the:<sup>206</sup>

...most harmful to growth, primarily because it discourages capital accumulation and productivity improvements, while introducing a bias towards the use of debt finance.

In November 2015, accounting firm PwC released details showing that a cut in the company tax from 30 to 25% would deliver the economy a \$291 billion growth dividend by 2025. In publishing its findings PwC commented that:<sup>207</sup>

...one of the best levers as part of a package of reforms is to cut our high company tax rate to attract more capital, increase productivity and lift incomes which in turn generates more government revenues.

Michael Pascoe [responding](#) directly to these forecasts by PwC, questioned whether such a cut “would attract a wave of capital that the world will suddenly rush to invest in Australia, creating more jobs and wealth.”<sup>208</sup>

Craig Emerson also [questioned](#) the premise behind such forecasts, suggesting that “insipid productivity growth in developed and emerging economies suggests the high real project returns of about 6-8 per cent required by boards are not widely available.”

The Australia Institute (2015) calculated that a reduction in company tax to 25% would give those companies a benefit of \$58,075 million over the 10 years from July 2016.<sup>209</sup> They also argue that of the top 15 companies in Australia – which collectively pay \$ \$21,742 million in company tax – “it is clear that none will be big innovators or investors in the near future.”

Even if it were proven that a broad-based reduction in the company tax rate were beneficial for the Australian economy, politically it would be a difficult proposal for voters to digest, particularly if it were paid for by an increase or broadening of the GST.

## 8.5 Budget rebalancing

As discussed in Chapter 5.4, the State and Commonwealth Budgets face precarious budget outlooks. By 2016–17, combined Commonwealth and State general government net debt will exceed \$350 billion—almost 20% of GDP, or more than 50% of general government revenue.<sup>210</sup>

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<sup>206</sup> IMF (2014) [Growth-friendly fiscal policy](#), p.1

<sup>207</sup> PriceWaterhouseCoopers, [Company Tax Cuts Help The Economy and Real Incomes Grow](#), 24 November 2015

<sup>208</sup> Australian Financial Review, [PwC and the Magic Pudding company tax cut](#), 24 November 2015

<sup>209</sup> The Australia Institute (2015) [Cutting the company tax rate](#), p.4

<sup>210</sup> Carling, R. (2014) [States of Debt](#), Centre for Independent Studies

Consequently, additional revenue from a prospective GST change may be directed to addressing the Commonwealth, and possibly the State's, budget bottom-line. The Grattan Institute suggest that half of the available additional revenue from raising the GST to 15% – \$5 billion a year – would reduce the Commonwealth's budget deficit by around 15%.

This raises broader questions about whether budget measures should be found on the revenue or expenditure side of the equation. Paul Keating, for example, came out in early February 2016 suggesting that a 50 per cent increase in the GST rate would only “feed the bad spending habits of a political system that cannot be trusted.”<sup>211</sup> He conceded that:

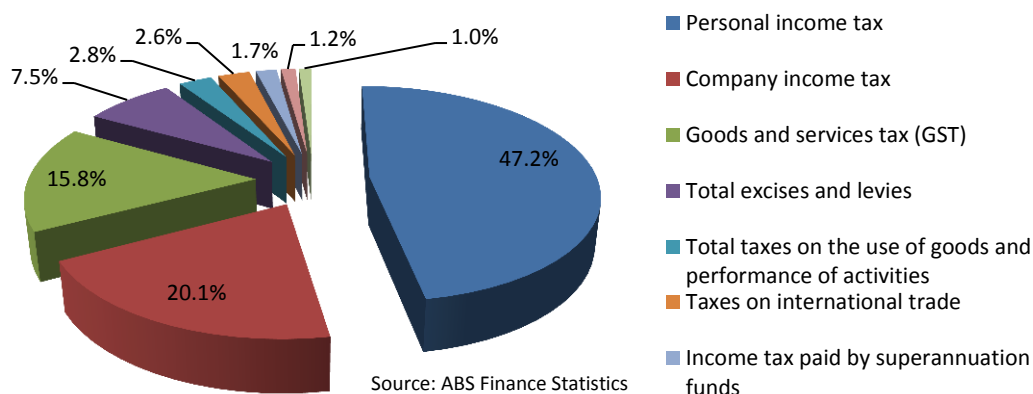
...a small increase of one or two per cent might be justified to meet burgeoning healthcare costs, as long as all of the new revenue is quarantined for that purpose alone

Examining the full scope of potential spending changes is beyond the scope of this paper but it should be considered more broadly in the context of a potential increase in GST or other alternative forms of revenue discussed in Chapter 9 of this paper.

## 9. ALTERNATIVE REVENUE RAISING OPTIONS

Australia has ‘at least 125 different taxes’, 99 of which are levied by the Commonwealth Government.<sup>212</sup> From this standpoint, the GST is part of a wider debate about ways to improve the efficiency and sustainability of the tax base in Australia. While it is beyond the scope of this paper to adequately assess all the arguments around other proposed taxation reform, it is worth noting alternative revenue raising options to the GST.

**Figure 40: Commonwealth Government tax mix, 2013-14**



Other reform options – such as Medicare Levy – have been proposed, typically because they seem a more viable political proposal, particularly from an equity

<sup>211</sup> Sydney Morning Herald, [Paul Keating slams a bigger GST as faux reform but admits hospital funding crisis](#), 3 February 2016

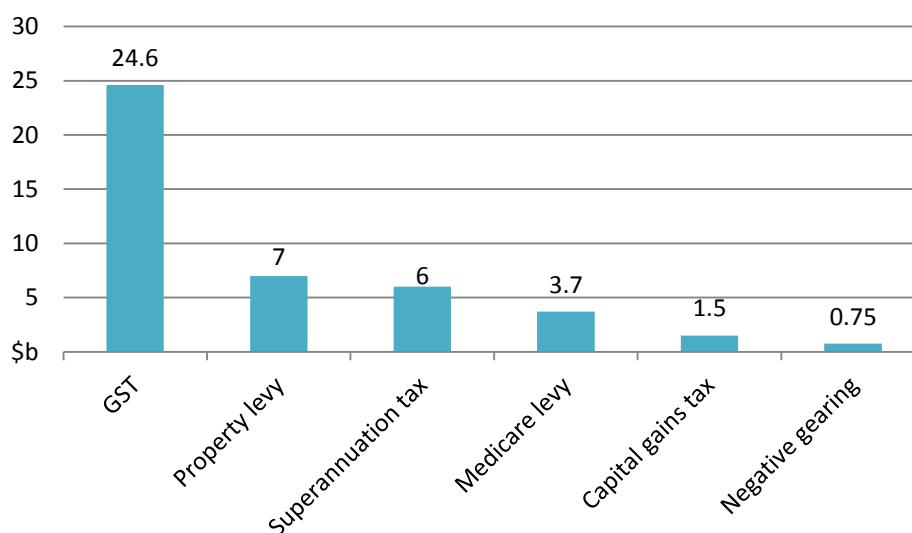
<sup>212</sup> Treasury (2008) [Architecture of Australia's Tax and Transfer System](#), p.10

perspective. PWC summarises the political aspects of the GST and broader revenue raising tax debate.<sup>213</sup>

NSW Premier Mike Baird advocates an increase in the GST to 15 per cent to meet health funding needs, his Victorian counterpart, Premier Daniel Andrews, favours raising the Medicare levy for this purpose. At the Federal political level, the Opposition focusses its attention on the GST, arguing that any change would be regressive. It is relatively silent on the subject of income tax. The [Commonwealth] Government, in contrast, highlights the pernicious effects of bracket creep but until recently downplayed the prospects of GST reform.

Based on the core proposals put forward in the debate<sup>214</sup>, none would individually have the same revenue raising capacity as the GST. As demonstrated below, raising the GST to 15% without base broadening, even after compensation, would raise an estimated additional \$24.6 billion in 2015-16. The next best option for the States would be to impose a property levy to raise around \$7 billion in 2015-16. Collectively, a GST would conservatively still be likely to raise the equivalent amount of revenue than the other options below put together.

**Figure 41: Alternative revenue raising options, annual gains, 2015-16<sup>215</sup>**



<sup>213</sup> PWC (2015) [GST and personal income tax reform: the Yin and Yang of tax policy](#)

<sup>214</sup> Specific proposals presented are: an increase in the GST to 15% without broadening the base; a property levy charged at a rate of \$2 for every \$1000 of unimproved land value; a superannuation income tax rate but with a rebate of 15 cents in the dollar; a Medicare levy increase from 2.0 to 2.5%; a reduction in the CGT discount to 25%; and grandfathering of negative gearing.

<sup>215</sup> These estimates should be treated with caution and should only provide a guide to potential revenue raising capacity of these taxation reforms. This is because they are estimated by varying methods and bodies, such that the: GST, CGT and negative gearing estimates were by the Parliamentary Budget Office; Medicare Levy estimate based on historical budget papers; property levy estimate from the Grattan Institute; and the superannuation estimate by Deloitte. For full details around assumptions see sections below and accompanying papers.

It should be noted that these are only a selection of the reform options available and have been chosen based on their individual political viability. As such, the results would be different if more substantive changes were proposed to these other measures. Additionally, their prospective application should be examined within the wider context of the whole Australian tax system – particularly in terms of spending reform which is not examined in this paper. These measures also need to be considered in the context of their respective administrative costs. For example, a broad-based GST consumption tax is likely to be administratively easier to implement than a property tax across multiple jurisdictions. Similarly, administrative changes to one tax are much less burdensome than a group of taxation reforms required to raise an equivalent amount of revenue.

### 9.1 Medicare levy

Most taxpayers pay a Medicare levy of 2% of taxable income which increased from 1.5% from 1 July 2014 to assist in funding the National Disability Insurance Scheme. The Medicare levy nominally contributes to funding the costs of public health care, but in practice it provides only a fraction of total Commonwealth Government health costs and is not hypothecated to health expenditure, instead forming part of consolidated revenue.<sup>216</sup>

An increase to the Medicare levy has been proposed, most notably by Victorian Premier Daniel Andrews, as an alternative option to raising the GST because it is more progressive and equitable for lower income earners. Specifically, a Medicare levy is reduced if a person's taxable income is below a certain threshold and, in some cases, one may not have to pay the levy at all.

- An individual does not have to pay the Medicare levy if their taxable income is equal to or less than \$20,896 (\$33,044 for seniors and pensioners).
- An individual will pay only part of the Medicare levy if their taxable income is between \$20,896 and \$26,121 (\$33,044 and \$41,306 for seniors and pensioners).

According to the 2015-16 Budget, the Commonwealth Government raised \$14.9 billion in revenue from the Medicare levy in 2015-16. However, without a detailed breakdown of tax receipts it is not possible to get a precise estimate of how much additional funding would be received from a Medicare levy increase. This is partly because revenue is also raised from the [Medicare levy surcharge](#) which is variable and based on income thresholds.

Using historical changes, however, it is possible to get an estimate of future revenue gains from a levy increase. Specifically, the *Medicare Levy Amendment (DisabilityCare Australia) Bill 2013* amended the *Medicare Levy Act 1986* to increase the Medicare levy rate from 1.5 to 2% of taxable income for

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<sup>216</sup> Stewart et. al (2015) [A stocktake of the tax system and directions for reform – five years after the Henry Review](#), Tax and Transfer Policy Institute, p.40

the 2014-15 income year and later income years.<sup>217</sup> Using estimates from the 2013-14 Budget, this roughly saw Medicare levy revenue increase by around one-third.

Medicare levy revenue, following increase from 1.5 to 2 per cent				
	2013-14	2014-15	2015-16	2016-17
Medicare levy (pre-adjustment)	10,300	10,847	11,219	11,737
Adjustment value		3,343	4,011	4,464
Medicare levy total	10,300	14,190	15,230	16,200
Adjustment value as a % of Medicare levy pre-adjustment		30.8%	35.8%	38.0%

Source: Estimates based on data from the 2013-14 Commonwealth Budget

Using these historical trends, it is estimated that revenue from a Medicare levy increase from 2.0 to 2.5% would see an increase in revenue of \$15.6 billion between 2015-16 and 2018-19.

Projected Medicare levy revenue						
	15-16	16-17	17-18	18-19	Total revenue 15-16 to 18-19	Additional revenue 15-16 to 18-19
Revenue (2.0%)	14,870	15,570	16,290	17,100		
2.5%	18,588	19,463	20,363	21,375	79,788	15,958
3.0%	22,305	23,355	24,435	25,650	95,745	31,915
3.5%	26,023	27,248	28,508	29,925	111,703	47,873
4.0%	29,740	31,140	32,580	34,200	127,660	63,830

Source: Estimates based on data from the 2015-16 Commonwealth Budget

In terms of economic arguments for and against a Medicare levy, consideration should also be given to which tax method is the most efficient – in terms of administrative costs and foregone revenue to operate. GST is generally perceived to be an **efficient form of taxation**, as was acknowledged by the Henry Tax Review (see Chapter 4.1). It is, however, beyond the scope of this paper to make an assessment on whether the Medicare levy or GST rise is more efficient.

## 9.2 Expansion of State and Territory own-source revenue

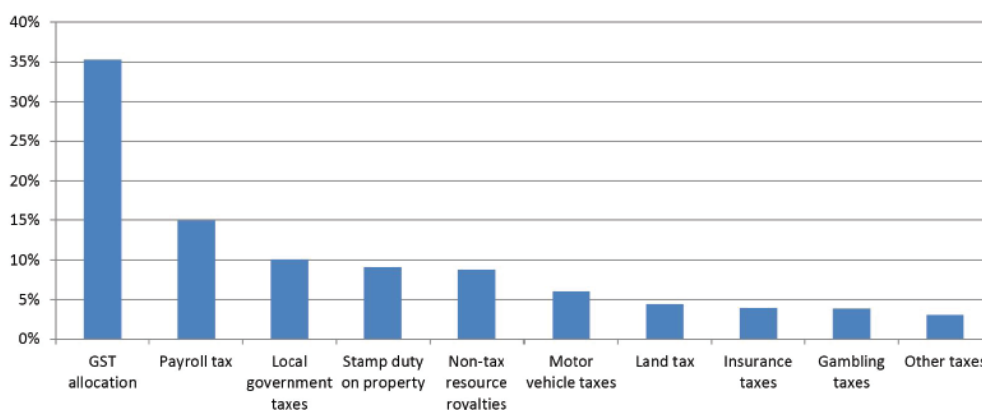
State and Territory governments have broad power to tax but raise only about 18 per cent of total tax revenue in Australia.<sup>218</sup> Of this, the payroll tax, stamp duties and property taxes raise most revenue for States and Territories.

<sup>217</sup> For more discussion around this, see the House of Representatives [explanatory memorandum](#).

<sup>218</sup> 5512.0 - Government Finance Statistics, Australia, 2013-14

In terms of land taxes, State and Territory governments levy a stamp duty on transfers of land. All except the Northern Territory, levy land tax on the aggregate holding of unimproved land value that is owned by a taxpayer; although there is a threshold under which tax is not applicable.<sup>219</sup>

**Figure 42: Types of tax as a percentage of total State and local tax revenue, 2012-13**



A broadening or deepening of States and Territories' revenue capacity could occur through reform of the land tax which, according to the Grattan Institute, is the most efficient tax available to the States. This is because if applied and designed correctly, the land tax does "little to change incentives to work, save and invest."<sup>220</sup> The IMF also recommended increasing property taxes "especially recurrent charges on residential properties; while scaling back transaction taxes." This is because:<sup>221</sup>

Property taxes appear to be relatively growth-friendly and can serve equity and accountability aims; transaction taxes impede efficient trades.

The Henry Review recommended that stamp duties be replaced over time by more efficient annual land taxes, a policy approach that has been taken up by the ACT government.<sup>222</sup>

Such reforms could be part of a wider tax reform package. However, as noted in the Reform of the Federation Green Paper:<sup>223</sup>

...any broadening of State and Territory taxes could be offset by a reduction in Commonwealth tax revenue and Commonwealth tied grants, or other changes to roles and responsibilities.

<sup>219</sup> Stewart et. al (2015) [A stocktake of the tax system and directions for reform – five years after the Henry Review](#), Tax and Transfer Policy Institute, p.71

<sup>220</sup> Daley, J, and Coates, B. (2015) [Property Taxes](#), Grattan Institute, p.1

<sup>221</sup> IMF (2013) [Fiscal monitor: taxing times](#), p.24

<sup>222</sup> Treasury (2010) [Australia's Future Tax System: Report to the Treasurer](#), Recommendations 51-54

<sup>223</sup> Australian Government (2015) [Reform of the Federation Discussion Paper](#), p.96

Under this option, the States and Territories would have more control over their own revenue and flexibility to adjust tax policy to finance their own expenditure decisions.<sup>224</sup> However, unlike the current horizontal fiscal equalisation arrangement for GST revenues, the capacity of States and Territories to broaden their overall revenue would be limited in some cases, varying by jurisdiction. States such as NSW and Victoria – given the strength of their property markets – would stand to benefit most from such a reform.

Based on Grattan Institute estimates, a low-rate, broad based property levy using the council rates base could raise about \$7 billion a year for State and Territory governments through an annual levy of just \$2 for every \$1000 of unimproved land value, or \$1 for every \$1000 of capital improved property value.<sup>225</sup>

Key research documents – Own-source revenue		
Report Title	Date	Organisation
<a href="#">Property Taxes</a>	2015	Grattan Institute
<a href="#">A stocktake of the tax system and directions for reform – five years after the Henry Review (Chapter 6)</a>	2015	Australian National University

### 9.3 Capital gains tax discount

Capital gains tax (CGT) is levied as a component of income tax on realised gains made on the sale of assets such as shares or property.<sup>226</sup> When introduced, capital gains were taxed at the marginal tax rate with an adjustment for inflation. From 1999, CPI indexation was replaced with a 50% CGT discount for gains on assets that have been held for longer than 12 months.<sup>227</sup> As shown in the Table below:

- Individual taxpayers pay taxation on capital gains at half their marginal personal income tax rate;
- Super funds pay taxation on capital gains at two-thirds their income tax rate; and
- Companies get no discount on their capital gains.

Anecdotally, Peter Martin (Economics Editor of The Age), describes the CGT discounts as a “system that taxes wages at twice the rate of profits.”<sup>228</sup>

<sup>224</sup> Australian Government (2015) [Reform of the Federation Discussion Paper](#), p.97

<sup>225</sup> Daley, J, and Coates, B. (2015) [Property Taxes](#), Grattan Institute, p.4

<sup>226</sup> Stewart et. al (2015) [A stocktake of the tax system and directions for reform – five years after the Henry Review](#), Tax and Transfer Policy Institute, p.54

<sup>227</sup> Australian Government (1999) [Review of Business Taxation: A tax system redesigned](#), Canberra

<sup>228</sup> Martin, P. (2015) [Easy tax reform: axe capital gains](#), Comment – The Age



CGT discount rates by type of taxpayer			
Entity	Discount	Entity tax rate	Effective tax rate on capital gain
Complying superannuation fund	33.3%	15%	10%
Company	0%	30%	30%
Individual – at top marginal tax rate	50%	47%	23.5%
Individual - \$37k-\$80k	50%	32.5%	16.25%
Individual - \$18.k-37k	50%	19%	9.5%

Source: Deloitte (2015)

Deloitte, in their analysis of the CGT, argue that – in principle – the basic idea of providing a more generous taxation treatment to capital gains as compared to income is justified; but the discount is too generous in its current form.<sup>229</sup>

Evans et. al (2015) of the Universities of NSW and Tasmania in a submission to the Tax Discussion Paper argue that on grounds of equity, efficiency and simplicity – and, importantly, on the grounds of fiscal sustainability – existing preferences for individuals in the CGT regime should be reformed. Evans et. al (2015) specifically propose substituting the 50% discount with a CGT-free threshold. It is argued that this system would direct preference to “lower-income taxpayers with capital gains, rather than being heavily skewed towards higher-income taxpayers.”<sup>230</sup>

The 2009 Henry Review recommended that the CGT discount be reduced from 50 to 40%.<sup>231</sup> Deloitte recently went further, proposing that the discount be cut to 33.33% which “would help tackle the difference in tax rates applied to income and capital gains from different sources.”<sup>232</sup>

In May 2015, the PBO provided the Greens with [costings](#) to reduce the CGT discount for individuals and trusts, applied to all assets sold on or after 1 July 2015. It estimated that:

- removing the CGT discount entirely would generate \$10.2 billion over the 2014-15 forward estimates;
- reducing the CGT discount to 25% would generate \$5.7 billion over the 2014-15 forward estimates; and
- reducing the CGT discount to 40% would increase revenue by \$2.4

<sup>229</sup> Deloitte Access Economics. (2015) [Shedding light on the debate](#), Mythbusting Tax Reform Series Paper No.2, p.19

<sup>230</sup> Evans, C, Minas, J, and Lim, Y. (2015) [Taxing personal capital gains in Australia: An alternative way forward](#), Submission to Tax Discussion Paper, p.5

<sup>231</sup> Treasury (2010) [Australia's Future Tax System: Final Report](#), Chapter 12: List of Recommendations

<sup>232</sup> Deloitte Access Economics. (2015) [Shedding light on the debate](#), Mythbusting Tax Reform Series Paper No.2, p.22

billion over the 2014-15 forward estimates.

Key research documents – Capital gains tax discount		
Report Title	Date	Organisation
<a href="#">Australian Housing Investment – Analysis of Negative Gearing and CGT Discount for Residential Property</a>	2015	ACIL Allen
<a href="#">Taxing personal capital gains in Australia: An alternative way forward</a>	2015	University of NSW; University of Tasmania
<a href="#">Should capital income be taxed? And if so, how?</a>	2015	Crawford School of Public Policy

#### 9.4 Income tax thresholds

Personal income tax is the largest single source of government revenue in Australia. It comprises (including fringe benefits tax and tax on superannuation contributions) more than 10% of GDP and nearly half of Commonwealth Government taxes.<sup>233</sup>

Australia's statutory personal income tax rates and thresholds are shown in the table below. The rate specified at each tax bracket is the 'marginal' tax rate, which is the amount of tax payable on a taxpayer's next dollar of taxable income, not the 'average' tax rate on that person's entire taxable income.<sup>234</sup>

##### 2014-15 Resident personal marginal income tax rates

Taxable income	Tax on this income
\$0—\$18,200	Nil
\$18,201—\$37,000	19 cents for each \$1 over \$18,200
\$37,001—\$80,000	\$3,572 plus 32.5 cents for each \$1 over \$37,000
\$80,001—\$180,000	\$17,547 plus 37 cents for each \$1 over \$80,000
\$180,001 and over	\$54,547 plus 45 cents for each \$1 over \$180,000
The maximum low-income tax offset (LITO) of \$445 is available for individuals with income below \$37,000. These people have an 'effective tax-free threshold' of \$20,542.	
The Medicare levy of 2 per cent also separately applies to most taxpayers' total taxable income.	
The Temporary Budget Repair Levy is payable at a rate of 2 per cent on taxable income over \$180,000 between the years 2014-15 and 2016-17.	

One of the proposals put forth to raise revenue has been to increase the marginal rates of tax in the top personal income tax brackets. The premise behind such a proposal is that reforms and changes to the personal income tax system have resulted in an increasing share of the tax burden being borne by middle income earners.<sup>235</sup>

Using ABS household expenditure survey data to estimate average tax rates by primary income quintile, Apps & Rees (2013) show that in relative terms the

<sup>233</sup> 5512.0 - Government Finance Statistics, Australia, 2013-14

<sup>234</sup> Australian Government (2015) [Re:think - Tax discussion paper](#), p.36

<sup>235</sup> Apps, P, and Rees, R. (2013) [Raise top tax rates, not the GST](#), Discussion Paper No. 684, ANU Centre for Economic Policy Research, p.4-7

highest income quintile has realised the equal highest percentage point cut in the average tax rate between 2003-04 and 2009-10 at 3.73%. This is compared to income earners in the middle primary income quintile which have only realised a 0.88% cut in the average tax rate.

Income taxed by primary income: HES 2003-04 and 2009-10					
Primary income quintile	1	2	3	4	5
2009-10 Tax \$pa	4,242	9,096	13,915	20,363	48,067
2003-04 Tax \$pa	4,405	7,992	10,839	15,619	36,475
2009-10 ATR %	11.4	17.0	20.4	23.0	28.9
2003-04 ATR %	15.2	19.4	21.2	24.5	32.6
Percentage point cut in ATR	3.7	1.6	0.9	1.6	3.7
Nominal tax cut \$pa	1,391	866	602	1,411	6,215

Source: Apps, P, and Rees, R. (2013)

Because of this trend, Apps & Rees (2013) consider that, as opposed to a higher and broader GST, top income tax rates should be raised – with a particular policy focus on restricting tax evasion and avoidance.<sup>236</sup>

Having developed estimates showing that raising the GST would reduce the progressivity of the tax system, ACOSS (2015) similarly recommended that:<sup>237</sup>

The best place to start is concerted action to limit the ability of taxpayers to avoid paying their fair share of personal income tax by using tax shelters such as superannuation, capital gains concessions, negative gearing and private trusts and companies.

The traditional economic argument behind limiting the top tax bracket increases is that it has the potential to undermine the efficiency of an economy.<sup>238</sup> From that point of view, it is important to determine whether the increase in the tax share of the top quintile in Australia has exceeded that of their income share. This would mean an increase in progressivity of the personal income tax and social contributions at the very top of the income distribution or not.

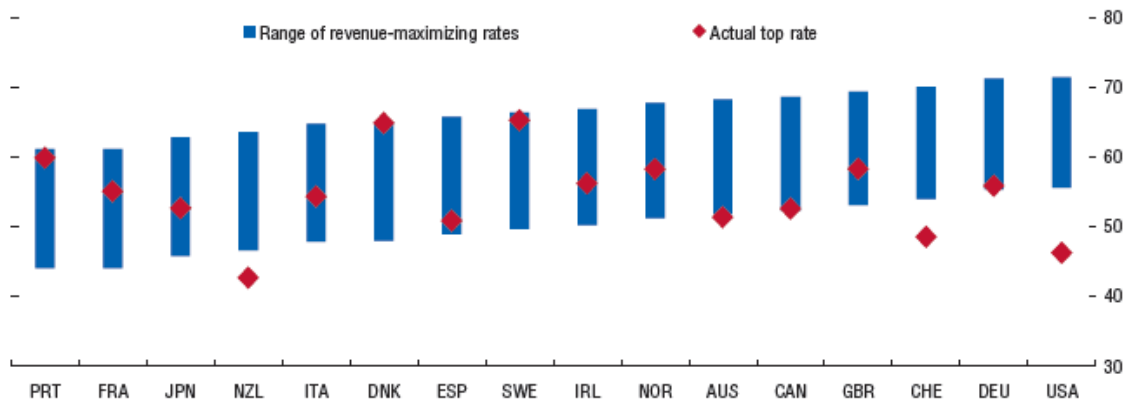
In assessing whether there is untapped revenue potential at the top of the income distribution, the IMF compared the current top marginal income tax rate with the marginal tax rate that would maximize the amount of tax paid by top income earners.<sup>239</sup> The IMF estimated that the current top marginal rate in Australia is toward the lower end of the range, implying that there is the possibility of raising more from those with the highest incomes.

<sup>236</sup> Apps, P, and Rees, R. (2013) [Raise top tax rates, not the GST](#), Discussion Paper No. 684, ANU Centre for Economic Policy Research, p.12

<sup>237</sup> ACOSS (2015) [The effects of a higher GST on households – Overview of modelling undertaken by NATSEM for ACOSS](#), p.9

<sup>238</sup> IMF (2013) [Fiscal monitor: taxing times](#), p.34

<sup>239</sup> Ibid, p.35

Figure 43: Top Marginal Rates and Revenue-Maximizing Rates, Late 2000s<sup>240</sup>

Key research documents – Income tax		
Report Title	Date	Organisation
<a href="#">Raise Top Tax Rates, Not the GST</a>	2013	Australian National University – Centre for Economic Policy Research
<a href="#">Optimal Taxation, Inequality and Top Incomes</a>	2014	University of Sydney
<a href="#">How much income tax do we really pay? An analysis of 2011–12 individual income tax data</a>	2015	Australian Parliamentary Library

## 9.5 Negative gearing

Negative gearing refers to a form of financing whereby an investor borrows money to buy an asset, but the income generated by that asset (net of other expenses) does not cover the interest on the loan. The loss is then deducted against other sources of income, for example labour income.<sup>241</sup>

More than 1.2 million Australian taxpayers own a negatively geared property; a figure which has risen considerably over the past few decades.<sup>242</sup> The Commonwealth tax discussion paper notes that “investment properties constitute a substantial proportion of the total value of negatively geared assets.”<sup>243</sup> The end result of this trend in negative gearing is an increasing cost, through foregone revenue, on the Commonwealth Budget. As noted by the Grattan Institute’s John Daley and Danielle Wood (2015):

...negative gearing is expensive, inefficient, inequitable, and it reduces home ownership. For governments under severe budgetary pressure it should be near the top of the reform list.

<sup>240</sup> IMF (2013) [Fiscal monitor: taxing times](#)

<sup>241</sup> The McKell Institute (2015) [Switching gears – Reforming negative gearing to solve our housing affordability crisis](#), p.10

<sup>242</sup> Daley, J, and Wood, D. (2015) [Negative gearing: the economic reasons why government must kill this sacred cow](#), The Age – Comment

<sup>243</sup> Australian Government (2015) [Re:think - Tax discussion paper](#), p.64

Daley and Wood (2015) add that the alternative mechanism would be “to allow investors to write off their losses only against capital gains.”<sup>244</sup>

The Treasury’s Tax Expenditure Statement does not include any estimates in relation to negative gearing, because negative gearing is not considered to be a tax expenditure under the benchmarks used for the Statement.<sup>245</sup>

According to estimates produced by the PBO, however, the Government could save \$3 billion in four years by abolishing negative gearing. The PBO estimated the proposal would increase Government revenue by \$42.5 billion over the period to 2024-25.<sup>246</sup>

Key research documents – Negative Gearing		
Report Title	Date	Organisation
<a href="#">Switching Gears – Reforming negative gearing</a>	2015	McKell Institute
<a href="#">Australian Housing Investment – Analysis of Negative Gearing and CGT Discount for Residential Property</a>	2015	ACIL Allen

## 9.6 Superannuation taxation

At present, taxes cover all income generally paid by superannuation funds on behalf of their members on their contributions and earnings. Complying funds are currently subject to a 15% tax rate in relation to taxable contributions received, realised capital gains and investment income. Only two-thirds of a capital gain is included in assessable income if the asset is held for at least 12 months.<sup>247</sup> As acknowledged in the Financial System Inquiry final report, “superannuation is seen as an attractive savings and wealth management vehicle for middle- and higher-income earners due to the highly concessional tax treatment of contributions and earnings.”<sup>248</sup>

Because of these concessions, the Government foregoes a significant amount of income tax revenue. The Treasury’s yearly Tax Expenditures Statement shows that tax breaks that are provided to support superannuation are one of the most costly of Australia’s extensive array of tax expenditures. Additionally, the share of superannuation concessions is accounted for mostly by earners in the top income quintile.<sup>249</sup> The Murray financial system inquiry found that only \$1 in every \$200 of super concessions went to the bottom 20% of income

<sup>244</sup> Daley, J, and Wood, D. (2015) [Negative gearing: the economic reasons why government must kill this sacred cow](#), The Age – Comment

<sup>245</sup> Australian Parliamentary Library (2015) [Budget impacts of negative gearing](#), FlagPost Blog

<sup>246</sup> Australian Greens (2015) [Reforming Negative Gearing – A fairer housing market for all Australians](#); Modelling by the Australian Parliamentary Budget Office.

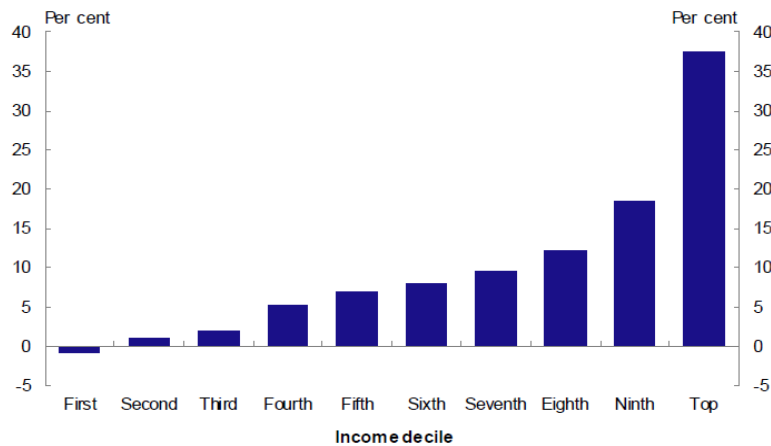
<sup>247</sup> Treasury (2013) [Pocket guide to the Australian Taxation System 2012-13](#), Appendix A, p.12

<sup>248</sup> Treasury (2014) [Financial System Inquiry - Final Report](#), p.137

<sup>249</sup> Centre for Policy Development (2015) [Budgeting smarter, not harder: The failure of long-term thinking in the 2015 Intergenerational Report](#), p.16-17

earners while more than half went to the top 20%.

**Figure 44: Share of total superannuation tax concessions by income decile<sup>250</sup>**



Additionally, individuals with very large superannuation balances are able to benefit from tax concessions on funds that are likely to be used for purposes other than providing retirement income, such as tax-effective wealth management and estate planning.<sup>251</sup>

For this reason, “superannuation tax concessions are not well targeted towards improving retirement incomes for those most likely to rely on government support.”<sup>252</sup> Additionally:<sup>253</sup>

Giving high-income individuals larger concessions than are required to achieve the objectives of the system also increases the inefficiencies that arise from higher taxation elsewhere in the economy.

The Grattan Institute has estimated that reducing the threshold for concessional taxation of contributions to \$10,000 per year and taxing super income streams at 15% in the withdrawal phase would increase revenue by up to \$9 billion per year.<sup>254</sup>

Alternatively, Deloitte have proposed changes, in line with those proposed by the Henry Tax Review<sup>255</sup> under which every worker would pay tax on the income they paid into super but then receive a rebate of 15 cents in the dollar. Specifically:

For high earners on the 45¢ marginal tax rate, the rebate would leave them paying 30¢ in the dollar. For low earners on the 19¢ cent rate, the rebate would

<sup>250</sup> Treasury (2014) [Financial System Inquiry - Final Report](#), p.138

<sup>251</sup> Treasury (2014) [Financial System Inquiry – Interim Report](#), p. 2-126

<sup>252</sup> Treasury (2014) [Financial System Inquiry - Final Report](#), p.137

<sup>253</sup> Ibid, p.139

<sup>254</sup> Grattan Institute (2013) [Balancing budgets: tough choices we need](#)

<sup>255</sup> The Henry Review recommended abolishing the 15 per cent contributions tax and instead taxing contributions at marginal tax rates with a tax credit of 20 per cent so the majority of taxpayers do not pay more than 15 per cent tax on contributions

pay just 4 per cent. Earners below the tax-free threshold would receive a payment from the government of 15¢ in the dollar.

These changes proposed by Deloitte are estimated to save the Budget \$6 billion per year which is for the 2016-17 financial year alone.<sup>256</sup>

Key research documents – Superannuation		
Report Title	Date	Organisation
<a href="#">Building super on a fair foundation: Reform of the taxation of superannuation contributions</a>	2012	ACOSS
<a href="#">Super tax targeting</a>	2015	Grattan Institute
<a href="#">Shedding light on the debate, Mythbusting Tax Reform Series Paper No.2</a>	2015	Deloitte Australia

## 10. CONCLUSION

Based on the evidence presented in this report, an increase and or broadening of the GST will generate significant revenue for the Commonwealth and potentially the States, depending how that revenue is distributed.

The major concern from such changes is that because of its regressive nature lower income earners will be relatively worse off under proposed changes. However, there is a body of evidence to suggest that the revenue will be sufficient enough to adequately compensate low and middle income earners; although other stakeholders have raised concerns that compensation packages may be retracted or eroded over time.

Even with guarantees against a retraction through political cycles and with possible compensation to lower income households, the GST has been described in segments as a “political grenade” or “the Lord Voldemort of any conversation about tax reform.”<sup>257</sup> This was evidenced through the failure to assess it in the last major tax review and even more recently when the Prime Minister Malcom Turnbull appeared to distance himself from such a reform.

A number of stakeholders have suggested that there are more equitable and possibly more efficient ways of generating the equivalent revenue that would have been raised from the GST. Most notably, changes to the Medicare levy, superannuation taxation, capital gains tax discounts and negative gearing. However, based on the scenarios in Figure 41 above, the other major reform options proposed in the debate thus far are, collectively and at least in the short term, unlikely to raise as much revenue as the GST would and may be associated with higher administrative costs than a single GST change.

<sup>256</sup> Deloitte Access Economics. (2015) [Shedding light on the debate](#), Mythbusting Tax Reform Series Paper No.2

<sup>257</sup> Eslake, S. (2011) [Australia’s tax reform challenge](#)

Therefore, without an unlikely and substantial improvement in the terms of trade and other external growth factors, realistically the Government is unlikely to address the substantial structural budget deficit from the revenue end, should the GST be formally removed from the tax reform agenda. As such, spending measures are most likely going to present the only other option available to Government. Spending reforms have not been addressed in this paper and is arguably the next stop on the wider budget and tax reform debate.

Irrespective of the final policy decision regarding the GST, the key point to make is that any taxation changes should be examined within the wider context of the entire tax system and that taxes should be used, in combination, to maximise their respective efficiency and equity strengths.<sup>258</sup>

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<sup>258</sup> PWC (2015) [GST and personal income tax reform: the Yin and Yang of tax policy](#), p.5