The Department of Economics & Melbourne Institute for Applied Economic and Social Research present the 2012 Public Policy Lecture

Tax Reform with a Larger GST

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Tax Reform with a Larger GST

• Increase GST revenue by
  – Comprehensive base, a la New Zealand
  – Increase rate to 12.5%, 15%, or more

• To fund:
  – Social security increases and income tax cuts for equity
  – Replacement of more distorting and inefficient taxes. Also, some simplicity gain.
  – Increase government revenue
Current Debate

• Changes to GST appears off the current Australian political agenda:
  – Main political parties say no

• But, logic says yes:
  – Mirrlees Review (2010 and 2011) for UK
  – Rate increases in NZ and UK in 2010
  – Grattan Institute (2012) ranks as most productive economic reform option for a country with negligible productivity growth.
  – According to Henry Review, one of the least distorting taxes

• Task this evening
  – Explore some of the reform options, and their properties
  – Restate the case for replacing some relatively inefficient taxes with a larger GST
Evaluation of Criteria for Reform Options

• Revenue collected
  – Commonwealth
  – States

• Equity
  – Evaluate in context of all taxes
  – Focus on economic incidence
  – Importance of current distribution as benchmark

• Efficiency
  – Minimise distortions to decisions as a means of raising national productivity

• Simplicity and low operating costs
Current GST

- Australia’s broad based consumption tax
- Collected by commonwealth. Then redistributed to states according to horizontal fiscal equalisation (HFE) as untied grants.
- Base about 60% of comprehensive consumption base
- Destination base (X exempt, M taxed)
- Flat 10% rate
- 2009-10 revenue of $46.6 billion, or 13% of all tax revenue
- Consensus that GST is fully passed forward to households, who bear the economic incidence
## GST Tax Base Exemptions and Revenue Loss (Treasury)

<table>
<thead>
<tr>
<th>Items Exempt</th>
<th>Revenue Cost ($ billion 2010-11)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>5.9</td>
</tr>
<tr>
<td>Water, sewage and drainage</td>
<td>0.7</td>
</tr>
<tr>
<td>Health</td>
<td>3.8</td>
</tr>
<tr>
<td>Education</td>
<td>2.6</td>
</tr>
<tr>
<td>Child care</td>
<td>0.6</td>
</tr>
<tr>
<td>Financial services</td>
<td>3.2</td>
</tr>
<tr>
<td>Imports</td>
<td>1.2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>18.3</strong></td>
</tr>
</tbody>
</table>
Arguments for a Broader Base, a la NZ (Mirrlees Review)

- **Efficiency gains**
  - Remove distortions to mix of consumer products purchased
  - Remove incentives for exempt industries (health and education) to provide in-house GST taxed inputs
  - Neutrality of treatment of private, not-for-profit and government providers
  - Reduced incentives for lobby industry

- **Greater simplicity, but involves changes to commonwealth-state financial arrangements**

- **Equity**
  - Relative to the income tax and social security systems, GST exemptions are a blunter, and less effective, redistributive system.
  - Requires that most revenue be recycled to households and government.

- **Likely more revenue integrity over time.**
### Expenditure on Food and Health by Income Quintile

<table>
<thead>
<tr>
<th></th>
<th>Bottom 20%</th>
<th>Middle 20%</th>
<th>Top 20%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food and non-alcoholic beverages /week</td>
<td>127</td>
<td>213</td>
<td>281</td>
</tr>
<tr>
<td></td>
<td>19.4</td>
<td>17.6</td>
<td>14.5</td>
</tr>
<tr>
<td>Medical and health /week</td>
<td>37</td>
<td>61</td>
<td>98</td>
</tr>
<tr>
<td></td>
<td>5.7</td>
<td>5.0</td>
<td>5.1</td>
</tr>
</tbody>
</table>

Source: ABS (2012), 6530.0
Proposals for a Higher Rate GST to Replace Other Taxes

- Much like one aspect of the Australian reforms of 2000 to fund replacement of
  - State indirect taxes
- Much like one aspect of the Australian reforms of 2000, and NZ and UK reforms of 2010, to fund lower tax rates of commonwealth
  - Personal income tax
  - Corporate income tax
### Revenue and Efficiency Costs of Selected Taxes

<table>
<thead>
<tr>
<th>Current Tax</th>
<th>Revenue, 2009-10 ($ million)</th>
<th>Marginal efficiency cost (cents/$ tax revenue)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>State taxes:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>stamp duty on insurance</td>
<td>4,597</td>
<td>31</td>
</tr>
<tr>
<td>stamp duty on property tran.</td>
<td>12,294</td>
<td>74-85</td>
</tr>
<tr>
<td>payroll tax</td>
<td>16,760</td>
<td>35</td>
</tr>
<tr>
<td><strong>Commonwealth taxes:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GST</td>
<td>46,553</td>
<td>12</td>
</tr>
<tr>
<td>personal income tax</td>
<td>124,784</td>
<td>24</td>
</tr>
<tr>
<td>corporate income tax</td>
<td>62,231</td>
<td>37</td>
</tr>
</tbody>
</table>

An increase in GST rate by one percentage point generates about $4,600 million on current base and $5,500 million on comprehensive base.

Sources: Revenue from ABS, marginal efficiency cost from Henry Review.
Larger GST To Replace State Stamp Duties

• Reform package
  – Increase GST rate to fund
    • Replace stamp duty on insurance
    • Part of package to replace conveyance duty (together with reform to land tax)
  – Requires negotiation of federal-state financial arrangements, including different allocation formula

• Efficiency gains
• Distributional or equity effects
  – Extra GST increases costs and CPI
  – Less stamp duties reduce costs and CPI
  – Over time, package will have small net effects. But, short term winners and losers

• Simplicity with two nuisance taxes removed
• More stable revenue stream
Larger GST to Replace Other State Taxes

• Stamp duties on motor vehicles
  – Better to treat as separate reform package on charges for the use of motor vehicles. Henry Review

• Payroll tax
  – In long run, comprehensive GST and payroll tax at flat rate have similar economic effects
  – But, quite different short term effects
  – A reformed, comprehensive payroll tax would improve VFI and offer a “harder” state budget constraint
Larger GST for Income Tax Mix Change Package

• Precedents
  – A part of the ANTS package in 2000
  – NZ and UK in 2010

• Approximate revenue neutral and distribution neutral package (and for macro stability)
  – Larger GST
  – Recycle revenue to directly offset higher CPI
    • Increase social security pay rates
    • Reduce income tax, including raise tax-free threshold and reduce marginal tax rates
    • One-off compensation for self-funded retirees
  – Recycle some revenue as lower corporate income tax rate.
Efficiency Effects of GST for Income Tax Mix Change Package

1. Work verses leisure (and market verses home production) choices
   – Labour tax wedge = Ty + (1 – Ty) Tc
     With package, increase in Tc = ΔGST balanced by reduction in Ty. Negligible effects on labour supply.
   – This analysis questions
     • Estimate by Henry Review that marginal cost of GST only 12 cents/$ relative to personal income tax of 26 cents/$
     • Estimate of large gains of GST for income tax reform by Grattan Institute (2012)
Efficiency Effects of GST for Income Tax Mix Change Package

2. Reduce inter-temporal consumption and saving decision distortions of income tax.

3. Reduce magnitude of distortions to the composition of saving and investment under current hybrid tax treatment of different options.

4. GST has a destination base, compared with a production base of income tax, and more so if reducing corporate income tax
   - Shifts tax burden from internationally mobile capital inputs, and to a lesser extent skilled labour, to the much less mobile consumption
   - Optimal tax theory: The ensuing increase of capital and associated technology per worker leads to a larger economy, higher market wages and disposable incomes
Equity Effects of GST for Income Tax Mix Change Package

• First round effects
  – GST raises cost of living by revenue increase (if 100% pass through, as for ANTS 2000 reform)
  – Social security increases and personal income tax cuts raise disposable incomes
  – Can design neutral net outcome if use all revenue and careful design only for broad socio-economic groups. There will be some winners and losers within each group

• Second round and longer term effects
  – Higher market wages, and more so for reductions to corporate tax rate
  – A positive sum game from efficiency gains
  – Avoid adverse inflationary wage-price spiral via compensation and explanation
Larger GST and Smaller Corporate Income Tax Package

• Efficiency arguments (Mirrlees, Henry)
  – Optimal tax: highly elastic supply; aggregate consumption demand inelastic.
  – Maybe, as much as 20% fiscal dividend

• Redistribution and equity
  – In long run, most of reduced capital tax passed forward as higher market wages
  – Net effect on resident shareholders small with imputation system
**Bold Reform**: An Approx. Revenue Neutral and Equitable Package for Efficiency Gains

- Larger GST
  - NZ type comprehensive base
  - Lift rate to 12.5% (replace state taxes), 15% (reduce also income taxes)
- To fund
  - Replace state stamp duties on insurance
  - Together with land tax reform, replace conveyance duties
  - Increase social security rates to offset net CPI increase
  - Reduce personal income tax rates
  - Reduce corporate income tax rate
- Package requires
  - renegotiation of commonwealth-state financial relations
  - much explanation to gain general support