GST and personal income tax reform: the Yin and Yang of tax policy

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An incoherent tax system, in which income tax and the Goods and Services Tax (GST) do not focus on their respective strengths, diminishes both fairness and efficiency. GST is an ineffective instrument to achieve fairness objectives and will not maximise its efficiency benefits with exemptions that are wasteful and benefit, in absolute dollar terms, high income earners the most. Progressive income tax will not deliver on the community expectations of fairness if unjustifiable exemptions exist. PwC modelling suggests that Australia will forsake $8.8bn in additional revenue (net of compensation) in 2019-2020 that would be available if the GST was applied to food, education and health.

Key points

- Australia's tax system is not as coherent as it could be. While tax system reviews have sought to fashion a single system, implementation has typically been limited and uneven.
- Arguably, nowhere is this incoherence more evident than in how we tax individuals. 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.
- When we expect the GST to achieve both efficiency and fairness objectives, it achieves neither. PwC modelling shows that in 2019-2020, the top 40 per cent of income earners would pay an extra $8.8bn if the GST was applied to food, education and health. If the GST rate was raised to 12.5 per cent with this base, an additional $22.4bn would be raised. With a 15 per cent rate, the figure would be $36.0bn. This revenue could be used to reduce personal taxes, reducing Australia's economically costly reliance on this form of tax, eliminate inefficient taxes like insurance levies or fund government services like health.
- Direct compensation for low-to-middle income earners using the income tax and welfare systems is a less costly way to deal with the GST's regressive impact. PwC modelling shows that compensation is affordable. Compensation for the bottom 60 per cent of households for a GST rate or base change would cost around 40 per cent of the additional revenue raised.

The Yin and Yang of tax policy

A fragmented tax debate…

In the current tax reform debate, the GST and personal income tax are sometimes viewed as alternative revenue raising options. While 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 Federal Government, in contrast, highlights the pernicious effects of bracket creep but until recently downplayed the prospects of GST reform.

Good policy design requires us to think about how these taxes can best work together as key building blocks of our broader tax system. The personal income tax system and the GST raise two-thirds of the revenue collected by the Federal Government (the GST, on behalf of the states) and have the greatest impact on individual decisions.[1] If we want to deliver revenue for services and achieve fairness in the most efficient way possible, how can they be best deployed?

The GST is poorly-suited to achieve fairness

While GST exemptions benefit low income earners, they are enjoyed by all, regardless of their income. Exemptions are poorly-targeted and so economically-wasteful benefits. For other areas of welfare, including pensions and family payments, we apply means tests to limit access to individuals with real need. The OECD recognises Australia as having a highly targeted welfare system.[2] But this discipline is not reflected in the design of the GST.[3]

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.

Our modelling shows that in 2019-2020, the top 40 per cent of income earners would pay an extra $8.8bn if the GST was applied to food, education and health. If the rate was raised to 12.5 per cent with this broader base, an additional $22.4bn would be raised. With a 15 per cent rate and this broader base, the figure would be $36.0bn.

All these figures are net of compensation for the bottom 60 per cent of households. The compensation bill for this group would be around 40 per cent of the revenue raised in these scenarios. Of course, the actual compensation cost would be higher and net revenue gains smaller, given that necessary welfare and income tax changes would also benefit higher income earners (for example, from reductions in marginal income tax rates).[4]

Income tax should target fairness; the GST should target efficiency

Income tax and GST have distinct strengths and drawbacks, so it makes sense to have them play different roles in the tax system.

Our progressive income tax, which targets individuals' capacity to pay, is the best tax tool we have to achieve vertical equity – our desire for those individuals with higher incomes and a greater capacity to pay more tax. But this tax, compared to the GST, is complex. And for those who face high marginal tax rates, typically at both ends of the income spectrum, there can be strong disincentives to work.[5] For this reason, a progressive income tax is recognised as imposing higher economic costs than a broad based consumption tax.

The GST's strength, when levied on a broad base, is efficiency. A broad-based GST will minimise distortion of consumption decisions. While it will adversely affect work incentives (by lowering real wages), its economic costs are expected to be lower than those of a progressive income tax.

The drawback of a GST, of course, is its regressive effect in the absence of compensation. We should also recognise that some GST-free items such as education and health services

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1 In 2014-15, $181.2bn in individual income tax and $56.7bn in GST, with total Federal tax receipts amounting to $359.1bn. Federal Government, 2015-16, *Budget Paper 1*, Table 9.

2 OECD, 2014, Economic Survey of Australia, OECD, p.19.

3 The GST's exemptions fail the test of horizontal equity. At any level of income, those who spend more on exempt goods and services are taxed more lightly than others.

4 Unpublished PwC modelling undertaken for this paper.

5 Assessments of inequality must consider a number of additional questions, including wealth distribution, social mobility, inter-generational effects and other forms of government support (including education). See, Productivity Commission, 2015, *Tax and Transfer Incidence in Australia*, PC Working Paper.

are provided by public and private providers, with much of the publicly provided services not subject to a charge. While it is true low-to-middle earners who consume privately-provided services would be compensated, there is a risk of switching to public services if GST is imposed.[6]

The key point is that both fairness and efficiency can be improved if our progressive income tax and GST focus on their relative strengths.

Our progressive income tax can also be improved

Reasonable concerns exist about whether our personal tax system is sufficiently progressive.[7] These concerns underpin, in large part, calls for tax benefits associated with capital gains, negative gearing and superannuation to be scaled back. It is also reflected in support for "Buffet-style" taxes. These reforms, putting aside their policy merits, are intended to improve vertical equity and community confidence in the tax system. They are not primarily motivated by revenue considerations, but their advocates point to these benefits as well.

There is nothing inconsistent in having a more progressive personal tax system and developing a broad-based, efficient GST. Provided these taxes are focussed on their respective strengths, a wide range of efficiency and fairness outcomes can be achieved.

In his 1975 landmark tax review, Ken Asprey argued for a clear division of labour between our progressive income tax and the GST that he recommended.[8] The most influential tax policy review conducted in recent years, chaired by Nobel Prize winning economist James Mirrlees, came to the same conclusion. Mirrlees points out that:

> When indirect taxation is considered in isolation, and when there are concerns for equity, there looks to be a strong case for differentiating tax rates to help low-income households by imposing lower taxes on goods that they consume disproportionately. But indirect taxes should ***not*** be considered in isolation from the rest of the tax and welfare system. Where the government is able to levy a progressive income tax and pay welfare benefits that vary with people's needs and characteristics, this will generally prove a much more effective means of meeting its equity objectives.[9]

Compensation has always been part of reform blueprints

Compensating lower income earners for GST changes is affordable and consistent with long-established policy practice in this country.

Tax reform will impose costs on different parts of the community. If the reforms promise sufficient economic and social gains, governments have always been prepared to compensate those who are adversely affected. While views will differ on how generous compensation should be, the principle behind it is not contested. Indeed, compensation, in support of economic reform, is a staple of sound public policy in Australia.

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[6] The GST, which operates on a transaction-by-transaction basis, is not suited to margin-based financial products and so not applied to financial services. Those who advocate taxing financial services consumption have proposed different instruments, including cash flow, payroll or profit taxes. International experience in this area is very limited, reflecting the difficult tax design problems such taxes entail.

[7] See ACOSS's response to the Federal Government's Tax Discussion Paper 2015. ACOSS, 2015, *Tax Talks 3: Rethink, Reengage and Redesign*.

[8] K W Asprey, Parsons, Lloyd, Wood, 1975, *Commonwealth Taxation Review Committee*, Australian Government Publishing Service. Reprinted by Sydney University.

[9] J Mirrlees et al, 2011, *Tax by Design*, Oxford University Press, p156.

The Hawke-Keating tariff cut package provided transitional support for affected workers in vulnerable industries. The Howard-Costello GST package included substantial compensation for welfare recipients and low-income earners. And the Gillard Government's 2013 fixed price on carbon dioxide emissions introduced generous compensation for the impact on the less well-off.

The Australian approach to welfare and compensation is targeting to those in need. In comparison to most other countries, we have generally done this well. Nevertheless, many participants in the tax debate raise reasonable concerns about the effectiveness or durability of compensation for GST change. To meet these concerns, we need to consider innovative means to protect compensation outcomes.

We need to rebalance our tax system

A rebalanced, coherent tax system will use a broad based consumption tax, applying as low a rate as possible, to collect revenue in the most economically efficient manner. Its compensation challenges will be met by adjustments to income tax rates and appropriate transfer payments. The additional revenue raised can fund income tax relief, the removal of inefficient taxes or public services. Given Australia's heavy reliance on income taxes, which imposes heavy efficiency costs, and the current impact of bracket creep, a strong case can be made for income tax relief.

A coherent tax system will achieve fairness with its progressive income tax and transfer systems, which directly target individuals' capacity to pay while being mindful of minimising disincentives to work and save. A rebalanced tax system, with income tax and the GST applied to their strengths, can achieve desired economic (participation, productivity) and social objectives (fairness) in a more efficient way.

Our conversation should focus on getting the balance right between these objectives, not defending untargeted and wasteful GST exemptions and not defending income tax concessions which fail equity concerns.

Let’s talk

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