www.pwc.com.au

GST reform packages

September 2015

A baseline analysis

pwc

GST reform packages: A baseline analysis

In recent weeks, the proposal of the Baird Government to fund future healthcare costs by extending the GST through the application of a 15 per cent rate to the current GST base has received considerable attention. At the last meeting of the Council of Federal Financial Relations, it was agreed that the Commonwealth Government would further develop tax reform options proposed by state premiers, including the Baird GST change and a possible increase in the Medicare Levy.

PwC has sought to determine the additional revenue that a GST change of this magnitude would generate, after providing an assumed level of compensation. We assume that the bottom three quintiles (lowest 60 per cent) of households are fully compensated and that no compensation is provided to upper quintiles (the top 40% of households). In reality, a range of possible approaches can be taken to compensation and our assumed approach is an unlikely political outcome.

Key points

- PwC has 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).
- The revenue gains from these GST changes can be used to lower other taxes, fund government programs and compensate lower income earners. The choice between these options is a political one. We assume, for illustrative purposes, that all surplus revenue, after compensation, goes to state governments to fund health care and other spending.
- We find that increasing the GST with its current base to 15 per cent would raise $24.5bn, net of compensation, in 2019-2020. If all of this money was allocated to the states, they would be able to remain in surplus (considered together) until at least 2039-40.
- As you would expect, those in the lowest income quintile will suffer the largest cut in real incomes as a result of the GST changes modelled here. This would not be the case for extension of the GST to education, given that those in the top income quintile spend more on this as a share of their income than others.
- We assume that all households in the bottom three quintiles would be fully compensated. This covers those earning up to $100,000. Under this approach, around a third of any increase in GST revenues will need to be allocated to compensation.

What does GST modelling show?

With public and political attention focussing squarely on GST reform, PwC has modelled the budgetary and distributional consequences of various changes to the rate and base of the GST.

An increase in the rate or base of the GST will generate revenues which can be put to a number of uses. State government budgets can be augmented and funding shortfalls in particular areas, including hospitals, closed. Personal income taxes can be reduced, countering the effects of bracket creep and, more broadly, boosting incentives to work and save. Other indirect taxes might be cut or eliminated. These GST changes will be reflected in higher consumer prices, necessitating compensation for those on low to middle incomes. The question of how best to 'spend' any GST dividend will be a political one and is not canvassed here.

PwC has examined how much revenue would be raised in a number of GST reform scenarios, over and above what would be required to fully compensate low to middle income earners[1]. We have assumed this money goes to state governments and look at the difference it would make to their medium-term fiscal positions. We have also examined the distributional impacts of GST reform, estimating the impact of various options on different categories of income earners. Importantly, we do not address the efficiency or complexity implications of the options considered and the modelling does not take behavioural responses into account.

How do we model?

We take the fiscal year 2019-2020 as our baseline. Using our model, we aggregate state operating balances and project them in future years, assuming no policy changes and factoring in a set of economic parameters.

To model the GST changes, we adopted the following baseline:

1 The GST, in its current form, would raise $75.7 billion in 2019-2020.

2 State operating balances reach surplus in 2018-2019, after which they move into the red and progressively deteriorate. By 2050, the aggregate deficit would amount to just over 4 per cent of GDP.

What are the outcomes?

The table below shows the fiscal impact of a number of GST reform options:

a Broadening the base of the GST to include food, health and education, but leaving the rate unchanged, would raise $9.7bn (in 2019-2020) and improve states' operating balance by 0.5 per cent of GDP.

b Increasing the rate to 12.5%, without any broadening of the base, would raise $12.5bn, improving the states' operating balance by 0.6 per cent of GDP.

c Increasing the rate to 15 per cent, without any broadening of the base, would raise $24.5bn, improving the states' operating balance by 1.2 per cent of GDP.

[1] Those in the bottom three household quintiles, or 60 per cent, of the population (based on ABS 6530.0 Household Expenditure Survey 2009-10, and 6523-0 Household Income and Income Distribution 2011-12).

d Increasing the rate to 12.5% and broadening the base ((a) and (b)) would generate $24.2 bn, which is 1.1 per cent in GDP operating balance improvement.

e Increasing the rate to 15 per cent and broadening the base ((a) and (c)) would generate $37.9bn, which is 1.8 per cent in GDP operating balance improvement.

Option	Baseline	a) Broaden (food, health & education)	b) Increase to 12.5%	c) Increase to 15%	d) Broaden + 12.5%	e) Broaden + 15%
Revenue raised 2019-20 ($bn)	75.7	85.3	88.2	100.1	99.8	113.5
Additional revenue 2019-20 ($bn)	-	9.7	12.5	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	2018-19	2018-19	2018-19	2018-19	2018-19
States' operating balance surplus remains until :	2018-19	2023-24	2025-26	2039-40	2039-40	2049-50**

**States and territories will continue to remain in surplus after 2050, the final year of fiscal projections

When considering this table, it is important to keep in mind that it only focusses on the fiscal pay-offs of possible changes. While raising the GST rate to 15 per cent with no base broadening would raise a similar amount of revenue to raising the rate to 12.5 per cent and applying it to food, education and health, the two approaches would have different impacts on efficiency and compliance burdens. The former option would exacerbate the distortionary effect of the current GST system, while the latter would significantly reduce it. A broader-based GST would also be expected to be easier for businesses to comply with.

What is the impact on households?

What about the effect of GST reform on household incomes? Given household spending and saving patterns, you would expect a rate or base increase to affect the budgets of lower income households (who save less) the most. Our modelling confirms this, as the chart and accompanying table below shows.

For each of the GST reform scenarios we look at, income earners in the lowest quintile suffer the largest fall as a share of income.

a. Broadening the GST base to include food, health and education would lower the real incomes of the lowest quintile, absent compensation, by 1.3 per cent. Real incomes of those in the highest quintile would be reduced by only 0.7 per cent.

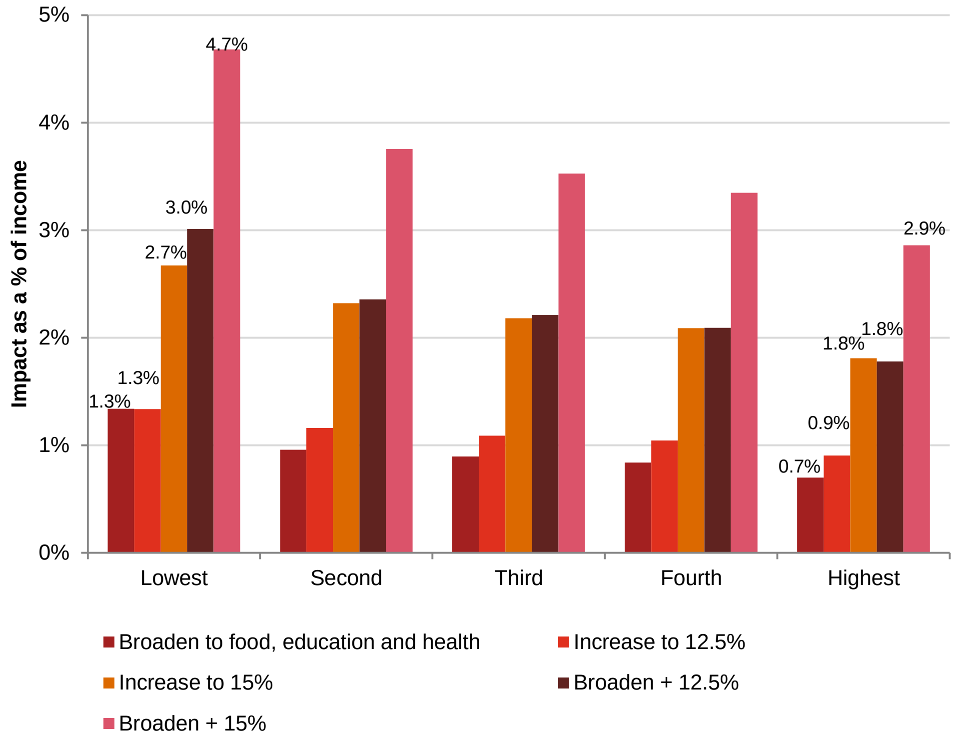
b. Increasing the rate to 12.5 per cent, with the GST's current base, would lower real incomes of those in the bottom quintile by 1.3 per cent and those in the top quintile by 0.9 per cent.

c. Increasing the rate to 15 per cent, with the GST's current base, would cut first quintile incomes by 2.7 per cent and top quintile incomes by 1.8 per cent.

d. Increasing the rate to 12.5 per cent and broadening the base reduces first quintile incomes by 3 per cent and top quintile incomes by 1.8 per cent.

e. Increasing the rate to 15 per cent and broadening the base reduces first quintile incomes by 4.7 per cent and top income quintiles by 2.9 per cent.

These overall results mask important differences. While lower income households spend more, as a share of income, on food and health than higher income households, this does not apply to education. Applying the GST to the latter would have the largest impact on those in the top income quintile.



GST distributional Impacts 2014-15, per person per year	Lowest	Second	Third	Fourth	Highest	Average
Broaden GST to food, education and health	$232	$219	$289	$387	$618	**$349**
Increase to 12.5%, no broadening	$232	$266	$351	$482	$800	**$426**
Increase to 15%, no broadening	$464	$532	$702	$963	$1,600	**$852**
Broaden GST food, education and health and increase rate to 12.5%	$522	$540	$712	$966	$1,573	**$863**
Broaden GST food, education and health and increase rate to 15%	$812	$861	$1,135	$1,544	$2,527	**$1,376**

So what about compensation?

The GST compensation package adopted in the modelling above is the assumed elimination of any burden for the bottom three quintiles of the household income distribution. If the bottom three quintiles are fully compensated for the one-off price impacts of a GST change, the compensation bill in 2019-20 would be: $3.9bn for Option (a), no rate change, but including food, education and health; $4.6bn for Option (b), a rate increase to 12.5 per cent with no base broadening; $9.1bn for Option (c), a rate increase to 15 per cent with no broadening; $9.6bn for Option (d), a rate increase to 12.5 per cent and including food, education and health; and $15.1bn for Option (e), a rate increase to 15 per cent, but including food, education and health.

Close to one-third of the additional revenue raised by these options would have to be spent on compensation, assuming the bottom three quintiles are fully compensated.

This compensation approach has been included for illustrative purposes only. The size, targeting and means of delivering any actual compensation package will reflect a range of political, fiscal and fairness considerations. Low to middle income earners, however, are likely to be compensated in any scenario, although defining the cut-off point for the latter will always be contentious.

Let’s talk

PwC wants to encourage and stimulate debate on tax reform. For further information, please contact:

Tom Seymour
Brisbane
Managing Partner,
Tax & Legal
+61 (7) 3257 8623
tom.seymour@au.pwc.com

Paul Abbey
Melbourne
Partner, Corporate Tax
+61 3 8603 6733
paul.abbey@au.pwc.com

Jeremy Thorpe
Sydney
Partner, Economics
+61 (2) 8266 4611
jeremy.thorpe@au.pwc.com

David Pearl
Canberra
Director, Corporate Tax
+61 (2) 6271 3328
david.pearl@au.pwc.com