

## **Taxation and social security system reform**

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## **A. General observations**

The case for reform of the taxation and social security systems, together with reform blueprints, were provided in the Henry Review released in May 2010. To the Henry Review reform proposals should be added a more comprehensive and higher rate GST, and the option of no-bars reform of the taxation of superannuation, both of which were excluded from the review's terms of reference.

A comprehensive taxation reform package could involve any one of, or a combination of, the following:

- A comprehensive income tax base which removes current exemptions, such as the concessions for remuneration taken as fringe benefits and superannuation, and a simple progressive tax rate schedule which is automatically indexed for inflation;
- Greater neutrality of the effective tax rates on different saving and investment choice options, and a low rate on the taxation of capital income to reflect the relatively high elasticity of supply of capital to Australia;
- Increased taxation revenue from comprehensive tax bases on the economic rent earned on land, mineral and energy deposits (to replace current royalties), and other natural resources;
- Greater revenue from a comprehensive GST base along the NZ model, and at a higher tax rate;
- Reform of special taxes on selected products to correct market failures associated with motor vehicles, alcohol, and carbon and other forms of pollution;
- Remove all state stamp duties; and
- Simplify the social security system as proposed by the Henry Review.

## **B. A larger GST in a tax mix change**

*(A condensed version of a public lecture presented on 2 October 2012)*

Arguments for increasing the revenue collected from a goods and services tax (GST) with a more comprehensive tax base and a higher tax rate to fund reductions in more distorting

state stamp duties and income tax are explored. Most of the analysis is for reform packages which approximately are in aggregate revenue neutral and distribution neutral. Reform of the GST was excluded from the terms of reference for the Henry Review (2010) of taxation, and the two main political parties at the federal level state that reform of the GST is not on their agendas. On the other hand, large potential gains for national productivity are available with a shift of the mix of taxes from those with relatively high distortion costs to the GST with a much lower distortion cost (see, for example, Daley, 2012).

### **The current GST**

The GST introduced in 2000 is Australia's broad based consumption tax. It has a destination tax base which exempts exports and taxes imports. This tax base is relatively price non-responsive, or inelastic, and this property underlies the low distortion costs of the GST. The GST applies to about 60 per cent of a comprehensive consumption tax base. Exempt products include basic food, health, education, child care, water and imports valued at less than \$1000, and the input taxation of financial services provides concessional treatment for households (but over-taxation for businesses) (Table 1).

A flat GST rate of 10 per cent is applied. In 2009-10, GST revenue was \$46.4 billion, or 13 per cent of all taxation revenue.

Formally, the GST is collected by the Commonwealth government. The revenue then is redistributed to the states (and territories) as untied grants. The pattern of distribution across the states is based on principles of horizontal fiscal equalisation (HFE). HFE seeks to provide each state with a comparable ability to provide services to their constituents taking into consideration differences in their ability to collect own-source tax revenues and differences in the costs of providing services.

There is a general consensus that while business pay the GST to government, they then pass forward the extra costs to households in higher prices. That is, households pay the final or economic incidence. Given that consumption as a share of income tends to fall with income, the GST by itself has a regressive incidence. However, tax reform packages should be assessed in terms of the final incidence of the aggregate of all taxes.

Table 1: GST Base Exemptions and Revenue Loss (\$ billion in 2010-11)

Items Exempt	Revenue Cost
Food	5.9
Water, sewage and drainage	0.7
Health	3.8
Education	2.6
Child care	0.6
Financial services	3.2
Imports	1.2
Total	18.3

Source: The Treasury, Tax Expenditure Statement, 2012, Commonwealth of Australia, Canberra

### **A broader GST tax base**

The experience of NZ, and for arguments articulated in the Mirrlees Review (2010 and 2011) for the UK, recommend greater efficiency and simplicity with a comprehensive consumption base for the GST with removal of the current exemptions listed in Table 1. Restoring distributional equity, as represented by the status quo, requires recycling much of the extra GST revenue to governments and households, and changes will be sought for federal-state financial relations.

Consider efficiency and simplicity arguments for a NZ type comprehensive GST base. Distortions to household purchase decisions across different products will be removed. There is no compelling market failure argument, or equity argument, for a GST on the necessity clothing but not food, or on the utility electricity but not water. Complexity is involved for GST exempt providers of health and education and the GST treatment of business services, cleaning and other GST taxable activities they might provide. A comprehensive base provides for greater transparency and neutrality of tax treatment across government, NGO-non-profit and private-for-profit providers of health, education and child care services. Exemptions in general, and grey lines between exempt and non-exempt goods and services, invite costly and wasteful to society rent seeking lobbying activities.

At the time of the introduction of the GST, key reasons for the exemptions of what are considered necessities of life and higher shares of expenditures for those on low incomes

were the regressive effects of a GST. These concerns are real and supported by available data. However, in the context of the total tax system, exempting some “necessity of life” items from the GST is a very blunt and ineffective way of meeting society equity goals when compared with a progressive income tax and means tested social security system. For example, while the better-off spend a smaller share of their income on food than those on lower incomes, the percentage difference is not large, and more importantly, the better-off spend twice as many dollars per week on food (Table 2). To maintain the current redistributive effects of the tax system as an aggregate, some of the revenue windfall of removal of current exemptions for food, health, water, and so on will need to be recycled in a progressive fashion to households via increases in social security rates and reductions in marginal income tax rates.

Table 2: Expenditure on Food and Health by Households by Income Quintile

	Bottom 20%	Middle 20%	Top 20%
Food and non-alcoholic beverages	127	213	281
\$/week	19.4	17.6	14.5
% of total outlays			
Medical and health			
\$/week	37	61	98
% of total outlays	5.7	5.0	5.1

Source: Australian Bureau of Statistics, Catalogue No 6530.0.

In the cases of health, education and child care, governments at both the federal and state levels fund a proportion, but not all, of these services for reasons of external benefits and equity. Bringing these services into the GST net for the efficiency and simplicity reasons noted above will require a similar proportion of the extra GST revenue to be recycled to the two tiers of government. Importantly, these subsidies will be more transparent, direct and better targeted at meeting the correction of external benefits and equity of opportunity reasons for government intervention.

### **A higher GST rate**

Another set of reform package options is to raise the current GST rate of 10 per cent to, say, 12.5 or 15 per cent, either on the current GST base or on a more comprehensive base, and to

use the revenue gained to replace or reduce other more distorting taxes. Relative high distorting taxes to be replaced (or reduced) include the state stamp duties on insurance and property transfers, and federal income taxation. This reform idea is similar to the philosophy behind the introduction of the GST in Australia in 2000, the rate increases in NZ and the UK in 2010, and increases in VAT rates in other countries.

Table 3 provides a list of the taxes high on the list to be replaced, or reduced, with the revenue from a higher rate GST. Details are given of the revenue collected in 2009-10 and of the Henry Review (2010) estimates of the marginal efficiency costs of the different taxes. An increase in the GST rate by one percentage point would generate about \$4.6 billion a year on the current base, and \$5.5 billion on a comprehensive base. Taxation involves a transfer of revenue (and ultimately of labour and other resources) from the private sector to the public sector. But also, taxation changes decisions in the private sector, such as shifting from market employment which is income taxed to leisure and home work which are not taxed. The changed decisions involve a loss of private sector welfare greater than the dollar for dollar transfer. The above one dollar transfer loss to the private sector is referred to as the marginal efficiency cost of the tax. For example, in Table 3, the last dollar of stamp duty on insurance involves a total loss of welfare to the private sector of \$1.31, with \$1 being a transfer to government and 31 cents being the marginal efficiency cost.

Table 3: Revenue and Efficiency Costs of Selected Taxes

Tax	Revenue, 2009-10 (\$ billion)	Marginal Efficiency Cost (cents/\$ tax revenue)
State taxes:		
Stamp duty on insurance	4.6	31
Conveyance duty on property	12.3	74-85
Commonwealth taxes:		
GST	46.6	12
Personal income	124.8	24
Corporate income	62.2	37

Sources: Revenue from ABS, Catalogue No 5506.0; marginal efficiency cost from Henry Review, 2010, page 13.

Differences in the marginal efficiency cost of different taxes provide one measure of the efficiency benefits, or increases in national productivity, of increasing the GST rate to fund reductions of more distorting taxes. For example, using the Henry Review (2010) numbers in

Table 3, another dollar of GST to replace a dollar of stamp duty on insurance involves an additional cost of 12 cents but saves a cost of 31 cents for a net gain of 19 cents per dollar tax mix change. Of course, there are legitimate arguments about the estimated magnitudes of the efficiency costs of different taxes (including my concerns with the Henry Review numbers). However, few doubt the ranking of these costs, and then that a tax mix change involving a larger GST to replace taxes listed in Table 3 offers very large gains in national productivity.

### **A larger GST to replace state stamp duties**

State stamp duties on insurance and on the conveyance of property are among the most distorting taxes, and their removal would bring important gains in simplicity; stamp duties on motor vehicles also deserve removal, but as argued by the Henry Review (2010) as part of a separate tax reform package for the taxation of motor vehicles for road funding, pollution and congestion. In the case of conveyance duty, a reform package would involve a broader base and higher rate land tax, roughly to fund the unimproved land value component, and a higher GST to fund the improvements component of property value transfers.

Stamp duties are a form of indirect tax, similar to the GST, in terms of an additional cost and with much of the extra cost past forward to buyers as higher prices. But, stamp duties fall on business activities with extra distortions relative to a GST with its final incidence on household consumption. Conveyance duty as a transaction tax also reduces transfers of ownership of property from less productive to more productive owners and uses. There is no market failure reason to impose a higher indirect tax burden of stamp duty plus GST on insurance relative to the flat GST burden on most other products. These additional distortions lie behind the higher marginal efficiency cost of stamp duties relative to the GST shown in Table 3.

A larger GST to replace stamp duties tax reform package, as a change in the composition of indirect taxation, will have a negligible effect on the aggregate cost of living. However, in the short run, some winners and losers seem inevitable, but these will decline over time and with net gains in productivity.

Aggregate revenue neutrality across the different government jurisdictions could be maintained by a corresponding reduction in commonwealth special purpose payments. The states would benefit from more stable revenues.

### **A larger GST to replace payroll tax**

The arguments for replacing state payroll taxes with a larger GST, or other taxes for that matter, are not compelling. The long run effects of a comprehensive GST (which taxes income consumed and exempts income saved) and a comprehensive payroll tax (which taxes labour income and exempts capital income or the return on income saved), both with flat rates of tax, are similar. Both have a long run incidence on employees and not employers; payroll tax reduces the market wage, and the GST reduces what can be purchased with take-home wages. As argue in the Henry Review, with a highly elastic supply of capital relative to labour, shifting the tax mix from capital to labour provides for greater efficiency (optimal tax literature), and most of the benefits go to labour as higher market wages (because of more investment per worker).

There are important short term and transition differences with mixed efficiency and equity effects which can be argued to favour the GST over payroll, and vice-versa.

Reality is that both the GST and payroll taxes, as currently administered, have narrow bases, coincidentally each about 60% of their potential.

In terms of commonwealth-state financial relations, payroll tax (along with land tax) is an important state tax. Reform would be better addressed to broadening the payroll tax base than its removal. Here, one should argue that while less than 10% of employers pay payroll tax, about 50% of employees are directly affected, and the costs are in part passed on to employees of small and medium firms not subject to payroll tax.

### **A larger GST to reduce income taxation**

A tax reform package involving a larger GST to fund reductions in income taxation would raise national productivity. At the same time, with careful design the package can be approximately aggregate revenue neutral, revenue neutral between the commonwealth and the states, and roughly distributional neutral across broad demographic and income categories. Of course, these later constraints could be relaxed.

The efficiency case for replacing an income tax with a broad based consumption tax is as follows. Both taxes fall on labour market decisions to join the workforce, to invest in skills, and on hours of work. For a given market wage, income taxation reduces disposable income, while the GST (and indirect taxes more generally which are passed on as higher prices to households) reduce the quantity of goods and services which can be purchased from the

disposable income. So, labour market distortions are similar with a revenue and equity neutral larger GST and smaller income tax mix change.

By contrast, while income taxation falls on capital income as well as labour income, albeit as a hybrid mess of different tax rates (Henry Review, 2010), and distorts both the aggregate levels of saving and investment and the composition of different saving and investment options, such as housing, business plant and equipment, and superannuation, the GST with its consumption base lowers the tax burden on saving and investment. In the context of Australia as a net capital importer and a small open economy, the price sensitivity or elasticity of the supply of capital, and especially from non-residents, is high, and much higher than for labour. As argued in more detail in the Henry Review (2010), the Mirrlees Review (2010 and 2011) and the NZ Tax Working Group (2010), given these differences in factor supply elasticities, a GST for income tax mix change in time results in an increase in capital inflow, a larger capital stock (and associated better technology), higher labour productivity, and increases in market wages. Lower, but still positive income tax rates reduce the dispersion of effective tax rates on different saving and investment choice options, which, in turn, reduces tax distortions to the mix of the larger capital stock and increases productivity.

For households, the higher average cost of living with a larger GST would be offset with a recycling of the additional GST revenue as higher social security rates and lower marginal income tax rates. The income tax rate schedule would become more progressive. In the longer run, the productivity gains of a GST for income tax mix change provide a net gain in national income. Under an aggregate revenue constraint, while the current distribution of the aggregate tax burden can be maintained for households across broad demographic and income groups, in a particular year there will be some losers, as well as winners, within each group.

The first round increase in GST revenue for the states and fall in income tax revenue (and increase in social security outlays) for the commonwealth changes commonwealth-state financial relations. The current balance could be restored with a commensurate reduction of commonwealth special purpose payments to the states.

## References

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