

Time for a progressive Medicare levy

Discussion paper

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Summary

The 2017 budget announced an increase in the Medicare levy from two to 2.5 per cent from July 2019, supposedly to fund the National Disability Insurance Scheme (NDIS). Why the NDIS in particular was targeted is unclear. When there is a deficit one could nominate anything and say it ‘needs funding’. The idea that anything needs funding is curious given expenditures are made out of consolidated revenue; receipts go into consolidated revenue and the two need not add up. However, the concern here is for the intrinsic merits of the Medicare levy. The Opposition responded to the Government’s proposal saying it would only support an increase in the levy on incomes over \$87,000. Polling by *The Australian* suggests people favour the Labor alternative.

The two contrasting positions on the levy increase raise a number of issues. The Government’s proposal involves relying more heavily on a flat tax by increasing the Medicare levy. Treasurer Scott Morrison has also flagged personal income tax cuts at about the same time as the higher Medicare levy is introduced. That reinforces our concern that the Government is undertaking a switch from progressive taxes to flat taxes.

This paper explains the concepts ‘progressive’, ‘regressive’ and ‘flat’ taxes. Progressive taxes involve redistributing resources from the rich to the poor are generally regarded as improving society’s overall wellbeing. The opposite—proportionately from the poor to the rich—is ‘regressive’ and undesirable while a ‘flat tax’ is neither one nor the other. We present a graphical analysis to show how two examples work; the progressive income tax and the flat Medicare levy.

The durability of the Medicare levy over our history suggests it is unlikely to be dropped by absorbing it into the income tax system which was one of the recommendations of the Henry Review into taxation. However, Henry did suggest an alternative of making the Medicare levy more progressive by applying it as a proportion of the income tax payable. We christen such a levy the ‘Medicare top-up’.

Given the likely collections in the 2017-18 budget papers we estimate that replacing the present Medicare levy with a 10 per cent Medicare top-up would raise additional revenue and enhance the progressivity of the overall tax system. It would be easy for taxpayers who would only need to estimate their present liabilities and add 10 per cent. But it would tilt the levy towards higher income earners with, for example, a levy reduction of \$225 for someone on \$25,000 with a levy increase of \$3,200 for someone on \$300,000. Someone on 85 per cent of average weekly earnings would break even.

Based on Tax Office figures if the Medicare top-up were introduced for 2016-17 then 61 per cent of taxpayers would be better off even though it collects more revenue.

Introduction

The purpose of this paper is to re-examine the Medicare levy in the light of recent budget announcements, in particular the planned increase in the Medicare levy. From July 2019 the Government plans to increase the Medicare levy from 2 to 2.5 per cent of taxable income 'to ensure the National Disability Insurance Scheme (NDIS) is fully funded'.¹ This measure is expected to raise over \$3.5 billion in 2019-20 and \$4.3 billion in 2020-21.²

The rationale for suggesting the NDIS is less than fully funded could equally apply to a host of other spending. For example, under the automatic defence escalations defence spending will increase by \$5.4 billion over the forward estimates. If there is a case for fully funding the NDIS there is an analogous case for bringing in additional funding to cover defence. Nevertheless In response to the Government's proposal the Labor Opposition has opted for an increase in the Medicare levy of 0.5 per cent of income for those earning \$87,000 or more.³ That would increase the progressivity of the levy at least in comparing those above and below \$87,000. Polling by *The Australian* newspaper suggest 56 per cent of respondents support the more progressive Labor option and 33 per cent saying it should apply to all taxpayers.⁴

The 2017 budget also includes a small increase in the income threshold at which the levy kicks in. For singles the threshold is increased from \$21,335 to \$21,655 for an increase of \$320 per annum. The threshold is also slightly higher for pensioners and households. At the moment for a single the levy is phased in between \$21,335 and \$26,668 until at that rate the amount of the levy is exactly equal to two per cent of income. This of course is a regular item in the budget which adjusts the bottom threshold so as to protect lower income earners from the effect of inflation.

¹ Australian Government (2017) 'Budget Measures: Budget paper no 2', *Budget 2017-18*, p 24.

² see <http://budget.gov.au/2017-18/content/bp2/download/bp2.pdf>

³ Shorten W (2017) 'Second reading: Appropriation Bill (No. 1) 2017-18', *Hansard*, 11 May at http://parlinfo.aph.gov.au/parlInfo/download/chamber/hansardr/d376893a-a137-4f4f-8358-337edb90aa4b/toc_pdf/House%20of%20Representatives_2017_05_11_5024.pdf;fileType=application%2Fpdf#search=%22Shorten%22

⁴ Morton R and Crowe D (2017) 'Fears of NDIS cost blowout and delays', *The Australian*, 29 May. The question presumed that the NDIS required additional funding through the Medicare levy.

Discussion

The Medicare levy has a rather long history. When the Whitlam Government introduced Medibank the intention was to finance it with a 1.35 per cent levy. However, that was rejected by the Senate and so Medibank was funded out of general revenue without any separate taxing arrangement.⁵ After various changes under the Fraser Government Medibank Mark II in 1976 had an associated 2.5 per cent levy on income but that was later abolished in 1978. The Hawke Government introduced a newly named Medicare in 1984 with an associated levy at one per cent of income. That levy gradually increased to 1.5 per cent in 1995 where it basically remained until it was increased to two per cent from July 2014 in association with the introduction of the NDIS. Along the way there were add-ons such as the additional levy for higher income earners who did not have private health insurance. Other levies such as the flood levy, the gun levy and Abbott's temporary deficit repair levy have come and gone.

The present Government proposal is to put more reliance on a flat levy and increasing it to 2.5 per cent. In the meantime the 'deficit repair levy' of two per cent of income over \$180,000 finishes as of 30 June this year (2017) without being replaced.

For high income earners then a two per cent levy now is to be abolished and replaced by a 0.5 per cent increase in the Medicare levy in two years' time. This makes the Medicare levy increase look like good news for the high income earners; an effective tax cut of 1.5 per cent.

A consequence of these two changes is that the proportion of individual tax paid by the flat Medicare levy component will have increased from 5.4 per cent to 6.4 per cent between 2016-17 and 2020-21 according to TAI calculations. So far that is a small amount but it reinforces the trends towards reduced progressivity by way of changing the mix towards indirect taxation and gradual changes in the progressivity of income tax over time.⁶ All that is taking place at the same time as a shift in national income to profits with one of the symptoms being wages failing to keep up with prices.

There is a perception that the Medicare levy is a 'fair' tax and is described as such by Prime Minister Malcolm Turnbull for example.⁷ Treasurer Morrison is reported as saying "If you're on a higher income, you'll pay more under our plan. If you're on a lower income, you'll pay less...But all of us will share in the responsibility of helping our mates who are living with a

⁵ Medibank itself was rejected by the Senate but passed in a subsequent joint sitting of both Houses. For the background see Biggs A (2004) *Medicare: Background brief*, Department of the Parliamentary Library, 29 October.

⁶ For example, the top marginal income tax rate was 60 per cent or more from the 1940s to 1986.

⁷ Massola J (2017) 'Malcolm Turnbull's bid to raise Medicare levy set to stall in the Senate', *Sydney Morning Herald*, 12 May.

disability”.⁸ The Prime Minister, the Treasurer and their advisors should know better. They conveniently ignore the fact that the Medicare levy as it is now is a flat tax (except of course at the bottom end of the tax scales).

We have also been told that the Treasurer ‘has cleared the path for personal income tax cuts ahead of a possible 2018 federal election’.⁹ It just so happens that the Medicare levy will increase from 1 July 2019. So we are likely to see both happen at or around the same time. The result is likely to be a near revenue neutral swap of personal income tax cuts for the Medicare levy increase. That represents a partial replacement of a progressive tax with a flat tax. This should be a major concern especially given the already strong trend towards increasing inequality in Australia and the IMF warnings about the intrinsic costs of higher inequality and its consequences in lower economic growth and living standards. For example the IMF Managing Director, Christine Lagarde, has summarised a lot of the IMF research saying that lifting the share of the poor and middle classes raises living standards and economic growth while the opposite happens when inequality increases and the income share of the rich is increased.¹⁰

⁸ AAP (2017) ‘Treasurer digs in for Medicare levy fight’, *The Australian*, 13 May.

<http://www.theaustralian.com.au/budget-2017/treasurer-digs-in-for-medicare-levy-fight/news-story/0b15ccf5025df43bf85a7d43a22ba3e0>

⁹ Greber J and Tingle L (2017) ‘Good timing, as Morrison tips tax cuts in 2018’, *The Australian Financial Review*, 11 May.

¹⁰ Lagarde C (2015) ‘Lifting the small boats’, Address at Grandes Conférences Catholiques’, Brussels, 17 June at <http://www.imf.org/external/np/speeches/2015/061715.htm> accessed 14 September.

Progressive?

A tax can be described as 'progressive', 'regressive' or 'flat' with the latter meaning the tax is neither progressive nor regressive. A progressive tax is one which raises proportionately more from the rich than it raises from lower income earners. A regressive tax is one that raises proportionately more from lower income earners. If for example a tax raises one per cent from the poor and 10 per cent from the rich it is progressive in that the rich pay proportionately more as a share of their income. A regressive tax may well raise more from the rich in absolute terms but it is the proportion of the income that is critical. In Australia indirect taxes tend to be regressive; for example the GST on electricity is regressive. Low income households spend \$22.07 per week or 6.9 per cent of their income on electricity. The top 20 per cent of households by income spend more at \$43.89 per week on electricity but that amounts to just 2.4 per cent of their income.¹¹ As mentioned, a flat tax is neither progressive nor regressive but applies the same proportionate tax on all taxpayers.

For many people it is obvious that the Government should be redistributing income from higher to lower income earners. An extra dollar to a rich person is worth much less than an extra dollar to a poor person. An economist might express it 'Social welfare is larger when resources are more equally distributed'.¹² Hence if we start from a flat tax where everyone pays the same proportion of their income in tax then every extra dollar taken from a rich taxpayer and given to a poor taxpayer makes society better off.¹³

Under the present Medicare levy all taxpayers pay a flat two per cent of their income under the Medicare levy. By contrast the income tax is a progressive tax under which the higher someone's income is the higher the proportion paid in tax. For example a taxpayer with an income of \$25,000 will pay tax of \$1,292 or 5.17 per cent of income.¹⁴ As income increases to \$50,000 the tax to income ratio increases to 15.59 per cent. By contrast a taxpayer earning \$250,000 pays 34.29 per cent in personal income tax. Figure 1 plots how tax as a proportion of income increases with increases in income based on 2016-17 income tax scales: a progressive tax.

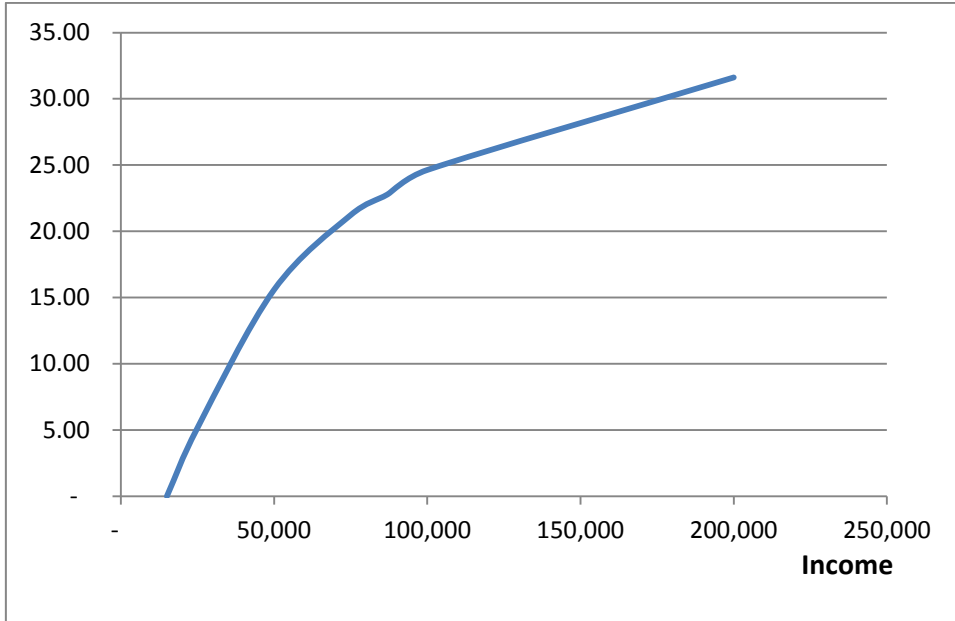
¹¹ Figures taken from ABS (2011) *Household Expenditure Survey, Australia: Summary of Results, 2009-10*, Cat no 6530.0, 6 September.

¹² Diamond PA and Saez E (2011) 'The case for a progressive tax: From basic research to policy recommendations', *CESifo working paper: Public Finance*, No. 3548.

¹³ We could modify this by including redistribution through income support payments as well as noting that different people with different needs and/or with additional dependents should also be favoured in more equal distributions.

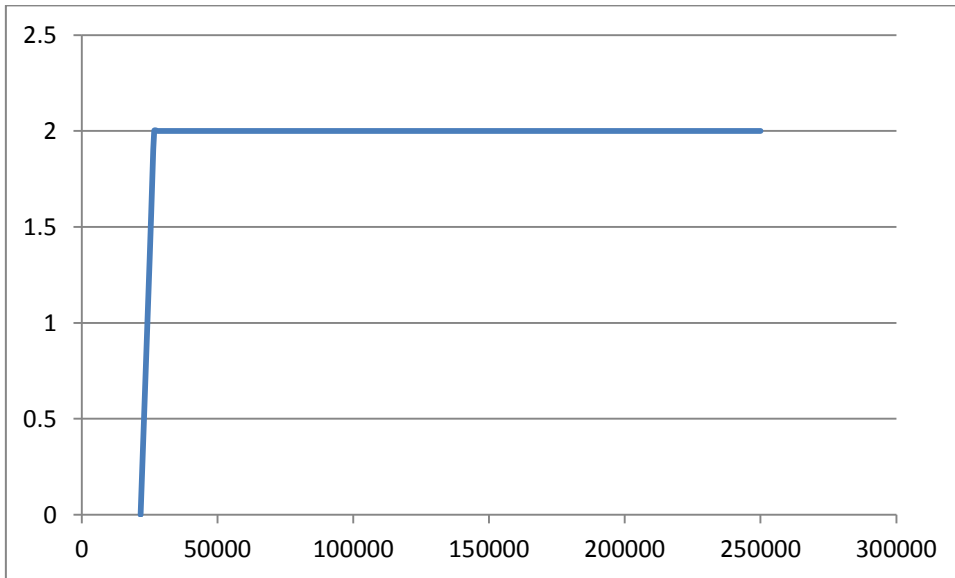
¹⁴ If we include the \$445 Low Income Tax Offset (LITO) the tax to income falls to 3.39 per cent. For simplicity we ignore the LITO in the present discussion.

Figure 1: Personal income tax as share of income (%)



As can be seen in Figure 1, the proportion of income paid as tax increases substantially as income increases. However, by contrast we mentioned that the Medicare levy is a flat tax above a certain amount. In Figure 2 the Medicare levy is plotted over the same income range.

Figure 2: Medicare levy share of income (%)



From Figure 2 it can be appreciated that any taxpayer over approximately \$27,100 pays a Medicare levy of two per cent and so do all taxpayers with income above that amount. Of course Morrison and others are correct when they say higher income earners pay more under the Medicare levy, two per cent of a big number is always going to be bigger than two per cent of a smaller number. A flat tax has that property. However, governments have generally accepted the principle that income tax should be progressive such that the proportion of the

income paid in tax increases with income. The principle that income tax should be progressive is firmly embedded in Australia's personal income tax system¹⁵ and it seems strange that the levies applying over the years have been applied in a flat manner. However, the Opposition position makes it clear that the Medicare levy need not be flat and we think other progressive options should be explored.

¹⁵ Progressivity is also enhanced by Australia's income support and family assistance programs.

Progressive options for the Medicare levy

Before outlining specific options it is important to remember that the Henry Review into Australia's tax system recommended abolition of the a number of items that were also based on income and that they be absorbed into a new and simpler personal income tax. Hence recommendation 5 of the final report of the Henry Review was:

The Medicare levy and structural tax offsets — the low income, senior Australians, pensioner and beneficiary tax offsets — should be removed as separate components of the system and incorporated into the personal income tax rates scale. If a health levy is to be retained, it could be applied as a proportion of the net tax payable by an individual.¹⁶

In relation specifically to the Medicare levy there are two main options:

1. Abolish the Medicare levy and absorb it into the personal income tax system, or
2. Impose a new progressive Medicare levy.

The second option is particularly interesting; the suggestion that the Medicare levy be applied as a fixed proportion of the income tax payable.

The Henry report makes it clear that its concerns revolved around three arguments:

1. The phasing arrangements of the Medicare levy increases taxpayers' effective marginal tax rates are increased in complex ways and over relatively low income ranges,
2. Many people are now exempt from the Medicare levy such as non-residents and ADF [Australian Defence Force] members,
3. The Medicare levy gives a misleading impression of the amount spent on health (being only a tenth of total health spending).

We are more concerned here with the distributional impact. Inequality and distributional analyses are difficult for public servants to deal with because they involve dealing in values which might be seen as the preserve of the political system. Nevertheless we would add a fourth argument in the above list and that would relate to enhancing the progressivity of the tax system.

¹⁶ Australia's future tax system (2009) *Australia's future tax system; Report to the Treasurer, Part One Overview*, p 81

OPTION ONE: ABOLISH THE MEDICARE LEVY AND ABSORB INTO THE PERSONAL TAX SYSTEM.

This is the preference expressed by the Henry Review. In the first instance the two taxes could be simply merged so that over most of the range the 19 per cent becomes 21 and so on. In addition the new personal income tax scales might be tweaked to enhance its progressivity. While this might be the best outcome in terms of simplicity, progressivity can also be addressed with a progressive levy. The Medicare levy has proved very durable having been basically unchanged since 1984. Hence reforming the levy itself may be the way to go and we consider that as option two.

OPTION TWO: IMPOSE A NEW PROGRESSIVE MEDICARE LEVY

We noted above the Labor Opposition has opted for an increase in the Medicare levy of 0.5 per cent of income for those earning \$87,000 or more which would increase the progressivity of the Medicare levy somewhat. There is a sort of precedent here with the Flood levy in 2011-12 year; a 0.5 per cent from \$50,000 to \$100,000 and \$250 plus one per cent for incomes above \$100,000. That was a much more progressive levy than the existing Medicare levy.

Recall the Henry recommendation cited above that suggested the Medicare levy 'be applied as a proportion of the net tax payable by an individual'. The benefit of that is that it would work with rather than against the progressivity of the present income tax scales. On our own estimates we think a Medicare levy as an 8.5 per cent increase in the income tax assessment should produce a roughly revenue neutral outcome. However, for simplicity we are suggesting a 10 per cent figure. Someone who pays income tax at 10 per cent of their income would have the Medicare levy changed from two per cent to one per cent while someone taxed at 40 per cent of their income would be charged a Medicare levy of four per cent. The change would also be simple: the existing two per cent levy is simply replaced by a levy calculated by calculating someone's tax liability and adding 10 per cent. Incidentally, using 10 per cent instead of 8.5 per cent would raise an additional revenue of \$2.7 billion per annum if it applied in 2017-18.

The impact of the change towards a progressive Medicare levy as outlined here is illustrated in Figure 3.

Figure 3: The existing income tax plus proportional Medicare levy

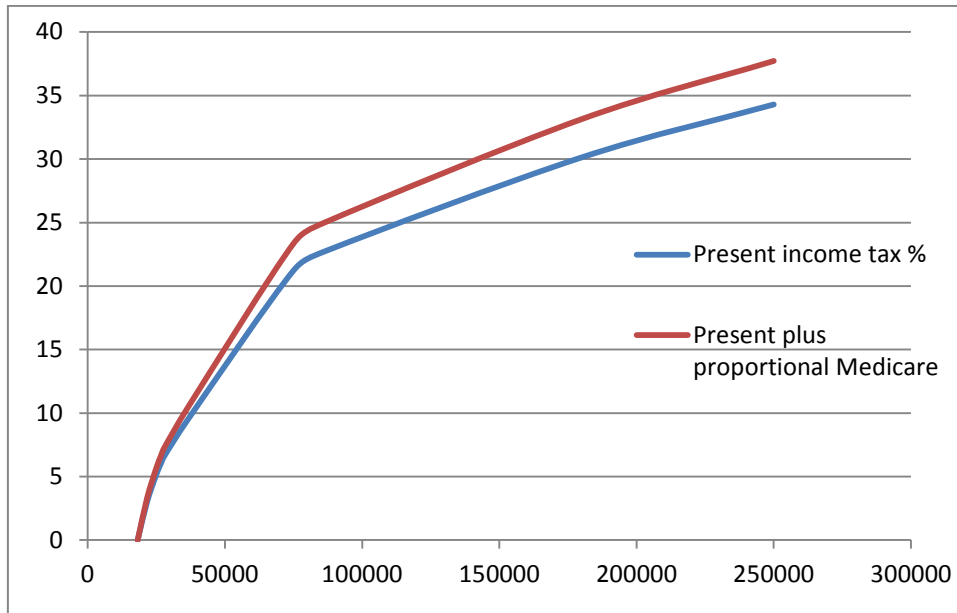


Figure 3 clearly shows that the proportional Medicare model suggested by Henry would preserve if not enhance the progressivity of the tax system. Indeed for the bulk of taxpayers there should be a reduction in the levy while those at the top would experience an increase in the levy. Table 1 gives some examples of the winners and losers. Average weekly earnings (AWE) are currently \$1,533.1 per week or an annual \$79,721. That figure is included in Table 1.

Table 1: Switch to a progressive Medicare levy; winners and losers.

Income \$	Gain(+)/loss (-) \$
25,000	205
50,000	220
AWE 79,721	-151
150,000	-1,313
300,000	-4,823

Source: TAI calculations

These results clearly show that a proportional Medicare levy would improve the progressivity of the system. Someone on average weekly earnings would pay an additional \$151 per annum but anyone with a taxable income below \$67,625 would be a net gainer. That is about 85 per cent of average weekly earnings. Higher income earners would pay extra of course as is shown in Table 1.

Overall a more progressive Medicare levy would improve the progressivity of the Australian taxation system and so should be considered as an alternative to the present flat Medicare levy. We might call it a 'Medicare top-up' because the levy would simply be a proportional top-up on income tax liabilities.

We can also examine the impact on different income earners of the proposal here and compare it with the Government’s proposal along with the compromise suggested by the Opposition. Those comparisons are made in Table 2.

Table 2: Impact on different income groups (\$) : Medicare levy under different proposals

Income	Medicare top-up	Government changes	Opposition
25,000	-205	0	0
50,000	-220	250	0
AWE 79,721	151	399	0
150,000	1,313	750	750
300,000	4,823	1,500	1,500

Source: TAI calculations.

Table 2 shows that our proposals involve lower taxes on people with incomes at \$25,000 and \$50,000 but increases for those on average weekly earnings or above. At average weekly earnings the Government’s proposal involves a bigger tax increase than the Medicare top-up but at higher incomes the Medicare top-up raises more revenue than the Government proposal. The Opposition proposal has no impact on taxpayers under \$87,000 and is the same as the Government proposal thereafter.

Of course average weekly earnings figures do not tell us much about taxable incomes as assessed by the Australian Taxation Office (ATO). Based on ATO figures¹⁷ if our proposal were introduced for 2016-17 then 61 per cent of taxpayers would be better off. People earning above that would be somewhat worse off. The breakeven figure is obtained by noting that our proposal benefits lower income and middle earners up to \$67,934 where there is no change. The ATO figures relate to the 2014-15 financial year. Based on the official forecast for the wage growth index in 2016-17 and the actual for 2015-16¹⁸ the breakeven figure is worth \$64,934 in 2014-15. From the percentile distribution of taxable incomes and we find that \$64,934 is just below the amount that 61 per cent of the population earn. Hence we claim that 61 per cent would be better off¹⁹ even though the Medicare top-up will raise more revenue than the existing Medicare levy. Of course in future years the collections and the distribution of collections will depend on the behaviour of incomes themselves as well as any changes to the personal income tax scales.

The impact on other taxpayers is given in Table 3. Single taxpayers only are shown in this table. Note too that this just compares the existing Medicare levy with the proposed Medicare top-up.

¹⁷ Australian Taxation Office (2017) *Taxation Statistics*.

¹⁸ Both are included in Australian Government (2017) ‘2017-18 Budget Paper No 1’, *Budget 2017-18*.

¹⁹ The calculation gives 60.694 per cent which is rounded to two significant figures.

Table 3: Existing Medicare levy and Medicare top-up compared

Taxable income	Existing Medicare levy	Medicare top-up	Change
\$	\$	\$	\$
25,000	334.50	129.20	205.30
50,000	1,000.00	779.70	220.30
Breakeven point 67,624	1,352.48	1,352.48	0.00
75,000	1,500.00	1,592.20	-92.20
100,000	2,000.00	2,463.20	-463.20
150,000	3,000.00	4,313.20	-1,313.20

Source: TAI calculations

Table 3 shows that someone on \$25,000 would get tax relief of \$205.30 a year or \$3.95 a week. By contrast a taxpayer with a taxable income of \$100,000 would lose \$463.20 a year. We noted above that the Medicare top-up at 10 per cent would raise slightly more revenue—an additional \$2.7 billion per annum if it were applied in 2017-18. So even though it raises more revenue the Medicare top-up gives a tax cut to almost 61 per cent of taxpayers.

If the Medicare top-up were accepted then at any time governments could increase or reduce the 10 per cent but without affecting the progressivity of the tax system as a whole.

Conclusions

A 'little' levy on taxpayers may seem like a good idea to fund certain spending initiatives or simply to raise revenue. However, increasing levies or raising new ones may involve dealing with flat taxes and displacing good, old progressive taxes. That works against the ideal of a progressive tax system.

The Henry tax review recommended abolishing the Medicare levy and absorbing it into the personal income tax. As a fall-back it suggested a Medicare levy as a proportion of income tax paid. We think that is a good idea and suggest calling it the 'Medicare top-up'. We have shown in the above discussion that the Medicare top-up would involve savings for taxpayers up to about 85 per cent of average earnings with generally higher savings the lower is the income. Those savings are financed by tax increases on those with high and very high incomes.

Based on Tax Office figures if our proposal were introduced for 2016-17 then 61 per cent of taxpayers would be better off.