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# **How to extend the GST without hurting the poor**

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**Policy Brief**

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## Summary

"One of the most obvious steps in [reforming] the Australian tax system would be to widen the base of the GST and increase its rate, while reducing economically damaging taxes." - Burchell Wilson (Senior Economist ACCI) 2012

The Mid-Year Economic and Fiscal Outlook (MYEFO) has revealed \$28 billion in revenue write-downs, signaling even tougher times ahead for government in trying to bring the budget back to surplus.

Increasing or broadening the scope of Australia's Goods and Services Tax (GST) is an option that has long been popular with conservative politicians, business groups and economists for significantly enhancing public revenue.

While promoted by some in the conservative ranks as 'essential tax reform' for Australia, critics argue that, as a regressive tax, the GST disproportionately hurts low-income earners and families. What is clear is that any moves to change the GST would be politically fraught for the government and the subject of broad public debate.

One way of broadening the GST without enhancing the burden of the tax on low-income households, would be to extend the tax to goods and services consumed most regularly by higher income earners, such as private schools and private health insurance.

This paper looks at the potential gains and impacts involved with extending the GST to private schools and private health insurance. As the predominant consumers of private schools and private health insurance higher-income households, broadening the GST to include taxes on these services could raise \$2.3 billion per year in additional revenue without heavily impacting upon low-income earners.

Broadening the GST to private schools and private health insurance would make the tax less regressive. It would add billions of dollars per year in additional revenue without pushing the tax burden onto low income earners.

At a time when the government faces a tough challenge bringing the budget back to surplus, and an even tougher challenge of winning the public's acceptance of cost-cutting and revenue raising measures, strategic reform to the GST could be just the policy to bring to the table.

## Introduction

The Mid-Year Economic and Fiscal Outlook (MYEFO) has dealt the budget a blow in the form of \$28 billion in revenue write-downs – making the government’s struggle to bring the budget back into surplus even harder. The Abbott government’s deeply unpopular first budget focused on cutting spending, but \$10 billion in proposed savings have been rejected by the senate.

Another way the government could seek to balance the budget is to increase revenue. While the Coalition claims a philosophical preference for lower taxes, this objection to tax does not seem to extend to the goods and services tax (GST).

This paper will look at extending the GST to private schools and private health insurance. Such a broadening of the GST would impact higher income households more than low income households, since private schools and private health insurance are predominantly consumed by higher income households.

Broadening the GST to private schools and private health insurance would also raise \$2.3 billion per year of much-needed revenue for the budget.

## Budget difficulties

Australia’s federal budget is in deficit – the government is spending more money than it receives in revenue. Prior to the last election, the then-opposition leader and now Prime Minister Tony Abbott described the federal budget situation as a ‘budget emergency’.<sup>1</sup> While many economists dismiss the notion of an ‘emergency’, the Abbott government has repeatedly stated its determination to return the budget to surplus.<sup>2</sup>

A budget deficit can be addressed in two ways – by either decreasing spending or increasing revenue. The government has focused on decreasing spending:

*Without the consolidation outlined here, the budget would have remained in deficit for at least the next decade – a total of 16 years in deficits – leaving Australia vulnerable to external shocks, ill-equipped to cope with population ageing, and increasingly reliant on future generations to pay off our debt.<sup>3</sup>*

The government’s focus on spending is strange given the deficit has been caused primarily by a drop in revenue rather than an increase in spending. Revenue as a ratio of GDP is about 1.5 per cent below the long-term average, while spending is about 0.4 per cent above the long-term average.

Forecasts of government revenue have proved to be optimistic many times in recent years. The previous Labor government was confronted with consistent revenue forecast downgrades and the current government faces the same problem with the release of the MYEFO, which shows \$28 billion in revenue write-downs relative to what had earlier been predicted.<sup>4</sup>

While the government is focused on reducing spending, the recurring reductions in revenue suggest that the budget has a revenue problem, not a spending problem.

<sup>1</sup> Abbott (2013) *Tony Abbott Budget Reply*

<sup>2</sup> Milman (2014) ‘Budget emergency’ denied by 63 leading Australian economists

<sup>3</sup> Commonwealth Government of Australia (2014a) *2014-15 Budget Paper No. 1*

<sup>4</sup> Commonwealth Government of Australia (2014b) *Mid-Year Economic and Fiscal Outlook*: Table 3.7

## Increasing revenue

The main way that governments raise revenue is through taxes. This is problematic for the Abbott government, however, as its signature policies have been removing the carbon tax and mining taxes. Mr Abbott has repeatedly stated that his government would look to lower existing taxes and not introduce new ones.<sup>5</sup>

While the government is reluctant to increase or introduce any taxes, one exception seems to be the GST.

## The goods and services tax (GST)

The GST applies a 10 per cent tax to most purchases of goods and services in Australia. Most Australians are familiar with it as it appears on receipts for purchases every day. The tax raises \$54 billion in revenue for the federal government each year.<sup>6</sup>

The Howard government introduced the GST in July 2000. It was a controversial move – a policy to introduce a GST was seen as a large factor in the electoral defeat of former Liberal leader John Hewson. When John Howard took the GST to an election in 1998 he suffered a large electoral swing against his government, losing the popular vote and only just getting enough seats to form government that year.

The GST is controversial because it is what economists call a ‘regressive tax’.

### A regressive tax

A tax is considered regressive if it impacts those on lower incomes more than those on higher incomes, as a percentage of income. The GST is regressive because people on lower incomes spend a greater proportion of their income on goods and services that will be taxed by the GST. Higher income earners save more, so proportionately less of their income is affected by the GST.

To illustrate this, if we assume the GST was universally applied to all goods and services across an economy at a rate of 10 per cent, then people who spent 100 per cent of their income would pay 10 per cent in GST. Many low income earners spend high portions of their income. But someone who spent only 80 per cent of their income – that is, they saved 20 per cent of their income – would only pay eight per cent GST.

Essential items like food, clothing and shelter make up a larger percentage of spending for those on lower incomes and they therefore have less capacity to save. On the other hand people on higher incomes are more likely to save a portion of their income, as they can meet the essentials of life with a smaller portion of their income. This means, on average, as incomes rise people pay less GST as a percentage of their income.

One way of mitigating the regressive nature of the GST is to exempt some goods and services from it. This is what happened when Australia’s GST was introduced in July 2000. A number of goods and services were exempt. These included:

- Fresh, uncooked and unprepared food
- Education, including private education
- Medical and health services, including private health insurance.

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<sup>5</sup> Fact Check (2014) *Fact file: What Tony Abbott promised on tax*

<sup>6</sup> Commonwealth Government of Australia (2014b)

In the lead up to the introduction of the GST in 2000, the Federal Parliamentary Library estimated the extent of the GST's regressive impacts. The impact of the GST on households' after tax incomes was estimated using the Australian Bureau of Statistics' (ABS) Household Expenditure Survey (HES). Table 1 shows these impacts on households of different income levels, divided into fifths or 'quintiles'. (Note that Quintile 1 represents the lowest-income households, while Quintile 5 refers to the highest-income households.)

**Table 1 – Percentage impact of GST on after-tax incomes**

Quintiles	Q1	Q2	Q3	Q4	Q5
GST burden as % of after tax incomes	4.46	2.79	2.46	2.13	1.83

Source: Richardson (1999)

Table 1 shows that households in the lowest quintile pay 4.46 per cent of their income in GST while households in the top quintile pay 1.83 per cent. Lowest-income households pay almost two and half times more, as a percentage of income, than highest income households.

## Supporters of the GST

Although consumption taxes like Australia's GST are regressive, many economists support them because they consider them to be less distorting taxes on the economy. They believe that if the GST is applied across all goods and services then it has less impact on people's purchasing behaviour than other taxes which discourage or encourage particular activities, goods or services.

As a result of the budget's revenue problems and the potentially non-distorting nature of the GST, there are currently calls to expand it to a higher rate, or to cover current exemptions. The hope is that a higher or broader GST will improve efficiency and revenue collection.

Supporters of this idea include former Prime Minister John Howard, who recently lamented that the GST did not include food:

*I'd say that it's a great pity that the Labor Party and the Democrats in the Senate in 1999 hadn't voted for the GST that the Australian people voted for which then included food.<sup>7</sup>*

Senior Coalition senator Ian Macdonald in May 2014 also called for the GST to be broadened to include food.<sup>8</sup>

Business groups regularly call for a higher rate or broadening of the GST. The Business Council of Australia (BCA) has suggested that increases in the GST "would have a significant and positive impact on the key drivers of growth and productivity".<sup>9</sup>

The Australian Chamber of Commerce and Industry (ACCI) was strongly in favour of both increasing the rate and broadening the GST:

<sup>7</sup> Massola (2012) *Revive IR reform: Howard*

<sup>8</sup> Griffiths (2014) *Tony Abbott brushes aside call from Coalition backbencher for broadening of GST base to fresh food*

<sup>9</sup> Business Council of Australia (2008) *Unrealised gains: The competitive possibilities of tax reform*

*From an efficiency perspective, one of the most obvious steps in terms of reform of the Australian tax system would be to widen the base of the GST and increase its rate while reducing or removing economically damaging taxes.<sup>10</sup>*

Business groups' calls for a higher rate and broader GST are usually accompanied by calls for lower rates of company tax. This is not surprising. A broad GST is paid by consumers, whereas company tax is paid by businesses. Businesses are keen for the tax burden to be placed on other parts of the economy rather than on themselves.

## Changing the GST

Although some economists, politicians and business groups support changes to the GST, its regressive nature means that changing it is a divisive issue in Australian politics. This has particularly been the case since the Abbott government's first budget was heavily criticised as being unfair. While many in the Coalition are in favour of broadening and/or increasing the GST, they are reluctant to call for any changes that would be seen as being unfair on low income earners.

This begs the question – if more revenue is to be raised through the GST, how can it be done fairly?

### A fair GST increase through compensation

A common proposal for overcoming the regressive nature of the GST is to provide compensation for lower- and middle-income earners. The most common suggestion for how to provide this compensation is through income tax cuts to lower-income earners. This doesn't work for lower-income earners because many already pay little or no income tax.

Another common suggestion for compensating low-income earners is through increases in government payments such as pensions, unemployment benefits and family tax benefits. This form of compensation is problematic as it can be taken away in subsequent years.

Furthermore, both the Coalition and Labor governments have reduced these benefits by various methods. The most common method has been to change the indexing methods of these payments to the Consumer Price Index (CPI) rather than to Average Weekly Earnings (AWE). The most recent federal budget included plans to freeze the indexation of some benefits all together. Over time this has the effect of reducing these government benefits in comparison to wages.

With little firm commitment from either side of politics to protect these benefits there is no guarantee that any GST compensation that is added to these benefits will not be stripped away over time, leaving lower-income households worse off.

### Raising GST revenue fairly

While providing compensation for the impacts of a higher or broader GST are problematic, there are opportunities for broadening the GST and at the same time making the GST less regressive. This could be achieved by removing GST exemptions for services that are more likely to be consumed by higher-income households. The two prime candidates for consideration are private schools and private health insurance.

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<sup>10</sup> Wilson B (2012) *Revisiting the GST*

The amount and distributional effect of exempting private schools and private health insurance was calculated using the National Centre for Social and Economic Modelling (NATSEM) economic model STINMOD. These results show that the government could raise an additional \$2.3 billion per year if the GST was extended to private schools and private health insurance.

This includes raising \$790 million from extending the GST to private schools and \$1.53 billion from extending the GST to private health insurance.

By removing private schools and private health insurance from the list of goods and services that are currently exempt from the GST, we make the GST less regressive. This is because these services make up more of the average high-income earners' expenditure than that of low-income earners.

The distributional impacts of including private schools and private health insurance are shown in Table 2.

**Table 2 – Distributional effects of private schools and private health insurance**

	Q1	Q2	Q3	Q4	Q5	Total
<b>Private schools</b>						
GST \$Million	51.5	82.7	159.1	199.6	297	790
% of total revenue	6.5	10.5	20.1	25.3	37.6	100
<b>Private health insurance</b>						
GST \$Million	157.3	202.1	291.9	378.8	501	1,531.2
% of total revenue	10.3	13.2	19.1	24.7	32.7	100
<b>Total</b>						
GST \$Million	208.8	284.8	451	578.4	798	2,321.2
% of total revenue	9	12.3	19.4	24.9	34.4	100

Source: NATSEM

As Table 2 shows, private schools and private health insurance impact least on the poorest 20 per cent of households. Only nine per cent of revenue comes from those households, while more than a third of total revenue (34%) comes from the richest 20 per cent of households. About 60 per cent comes from the top 40 per cent of income earners.

The regional impacts of these changes were also modelled. These are presented in Table 3.

**Table 3 – Regional impacts of private schools and private health insurance**

State	Location	GST \$Million
NSW	Sydney	493
	Rest of NSW	249
VIC	Melbourne	452
	Rest of VIC	123

QLD	Brisbane	239
	Rest of QLD	206
SA	Adelaide	153
	Rest of SA	29
WA	Perth	228
	Rest of WA	43
TAS	Hobart	30
	Rest of TAS	17
NT		11
ACT		48
	Total state capitals	1,595
	Total states	667
	% Capital	70.5

Source: NATSEM

As Table 3 shows, the majority of the revenue (71%) would be raised from the capital cities. There is far less impact on regional areas than on capital cities. This is not surprising given that the majority of private hospitals and schools are located in capital cities.

## **Advantages of broadening the GST to include private health insurance and private schools**

### **Revenue**

With the MYEFO showing large revenue write-downs and the government keen to reduce the budget deficit, the \$2.3 billion could be a valuable contribution to the budget.

### **Efficiency**

Such a broadening of the base of the GST has other advantages. The GST is seen by economists, conservative political parties and business groups as a far more efficient way to raise tax revenue. When the Coalition side of politics has talked about raising revenue from taxation they have mainly focused on raising or broadening the GST. There should therefore be little concern from these groups about such a change.

### **Fairness**

The fact that the broadening is mainly targeted at services predominantly used by high-income earners should also make the change more palatable to those who have concerns about the regressive nature of the GST.

The criticism of the Abbott government's first budget was that it was unfair. Analysis of the budget from a number of different sources, including Treasury, showed that the budget savings were built on taking money from those on lower incomes far more than those on higher incomes.

A broadening of the GST to include private schools and private health insurance is less likely to be subject to similar criticism, since most of the tax revenue will come from higher-income earners.

## Conclusion

The major problem with a consumption tax like the GST is that it is a regressive tax. Ways to overcome its regressive nature usually involve one-off increases to government benefits. This seems to have done little to alleviate the voting public's concerns about the tax. This could be in part because any increase in government payments to offset the change in GST could be clawed back by the government in subsequent years.

A way to overcome this problem would be to broaden the GST to services predominantly consumed by higher-income earners. By doing this the government could raise revenue without significantly impacting the poor.

By extending the GST to private schools and private health insurance the government could raise a much-needed \$2.3 billion in revenue, 60 per cent of which would come from the top 40 per cent of income earners, at a time when revenue is being written down.

As the revenue base in Australia is continually downgraded, the government needs to find ways of increasing revenue. The alternative – cutting spending – has been rejected not only by the Senate but also by the general public. The budget has a revenue problem and broadening the GST to private schools and private health insurance is a first step towards plugging the revenue hole.

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