Chapter 2

Key issues

2.1 While the bill only raises the LCT *rate* and does not alter the *threshold*, most of the submissions and witnesses devoted considerable attention to arguing for an increase in the threshold or an outright abolition of the LCT. Only Mercedes-Benz suggested an alternative source of revenue, advocating a gradual replacement of the LCT by a tax on vehicle emissions, which could also fund incentives for people to replace old polluting vehicles with cleaner ones.

Increasing coverage of the LCT over time

2.2 An increasing proportion of vehicles have been captured by the Luxury tax threshold. When the wholesale sales tax on luxury vehicles was introduced in 1986, it applied to 4.5 per cent of light vehicles.[1] In 2007, the LCT applied to 12 per cent. Unsurprisingly, this was regarded as a bad thing by the importers and sellers of cars whose voices dominated the submissions and hearings. Whether it is justified could be said to depend on whether the LCT is seen as a tax on 'luxury' or 'prestige'.

2.3 There are many 'luxury' features that were formerly only available on a very select range of cars but which are now available on many other models. Features such as cruise control, sophisticated air conditioning, ABS, multiple airbags, CD players, fuel injection, satellite navigation and reversing sensors were once only found in the most expensive cars but are now more common. On this argument, as there are more cars with luxury features, it is perfectly reasonable for more cars to be subject to luxury car tax.

2.4 On the other hand, it might be said that community standards of what is a 'luxury' have increased. It might then be argued that a car is a prestige, luxury car only if it has features and specifications substantially above the norm. This argument holds that the LCT threshold should not be tied to the current method of indexation but should have a substantial increase to reflect that view.

Indexing the LCT threshold

2.5 It was commonly argued that the increased coverage was due to an inappropriate means of indexing the LCT threshold. The LCT threshold is indexed to the motor vehicle purchase component of the consumer price index (CPIMV). As with

1 Information provided by FCAI.

the rest of the CPI, the Australian Bureau of Statistics conducts surveys to determine actual prices paid for vehicles and weights them by sales to consumers.[2]

2.6 The most contentious aspect of the CPIMV involves the use of quality adjustment.[3] The Australian Bureau of Statistics explain:

> Whenever a specification change is made to a vehicle that affects its motoring performance, economy, comfort level, safety or durability… an adjustment is made to the car's reported price to allow for that portion of the price change that can be attributed to the quality change.[4]

2.7 There has been a steady increase in the features of car models (either adding entirely new features or features formerly available only as options at additional cost now being standard). As a result, although the listed price of a standard 'family 6' sedan has risen, the CPIMV has fallen.

2.8 While it is an effective measure of inflation, the CPIMV is arguably not an appropriate measure for indexing the value of a luxury car threshold, simply because it does not reflect actual prices paid by consumers. Many of the quality improvements that the CPIMV uses to discount car prices have no bearing on the luxury component of a car. Improvements in the safety features of all models have been prominent in the quality improvements since 1996, including technologies such as anti-lock brakes, airbags, seatbelt pre-tensioners and traction and stability control, however the fitting of these safety features to cheaper cars has contributed to the fall in the CPIMV. For example the recent decision to require electronic stability control on all new vehicles will result in a quality improvement across the board, however any associated cost increase will be discounted.

2.9 The CPIMV will continue to lag behind vehicle prices and this is likely to result in an increasing proportion of vehicles being subject to the tax over time. However, there is a large concession made to the industry in applying indexation. The threshold is adjusted only when the CPIMV *rises*. When the CPIMV falls, as is often the case, the threshold is not lowered.

2.10 Less discussed is whether the movements in car prices in general captured in the CPIMV are representative of those of luxury cars. Given that most luxury cars are imported, their prices have probably risen by less than those of the 'family 6' car in recent years as the Australian dollar has been appreciating.

2.11 Even the listed prices of cars have risen by less than the CPI as a whole and average earnings. Importers and dealers would therefore prefer that the threshold were

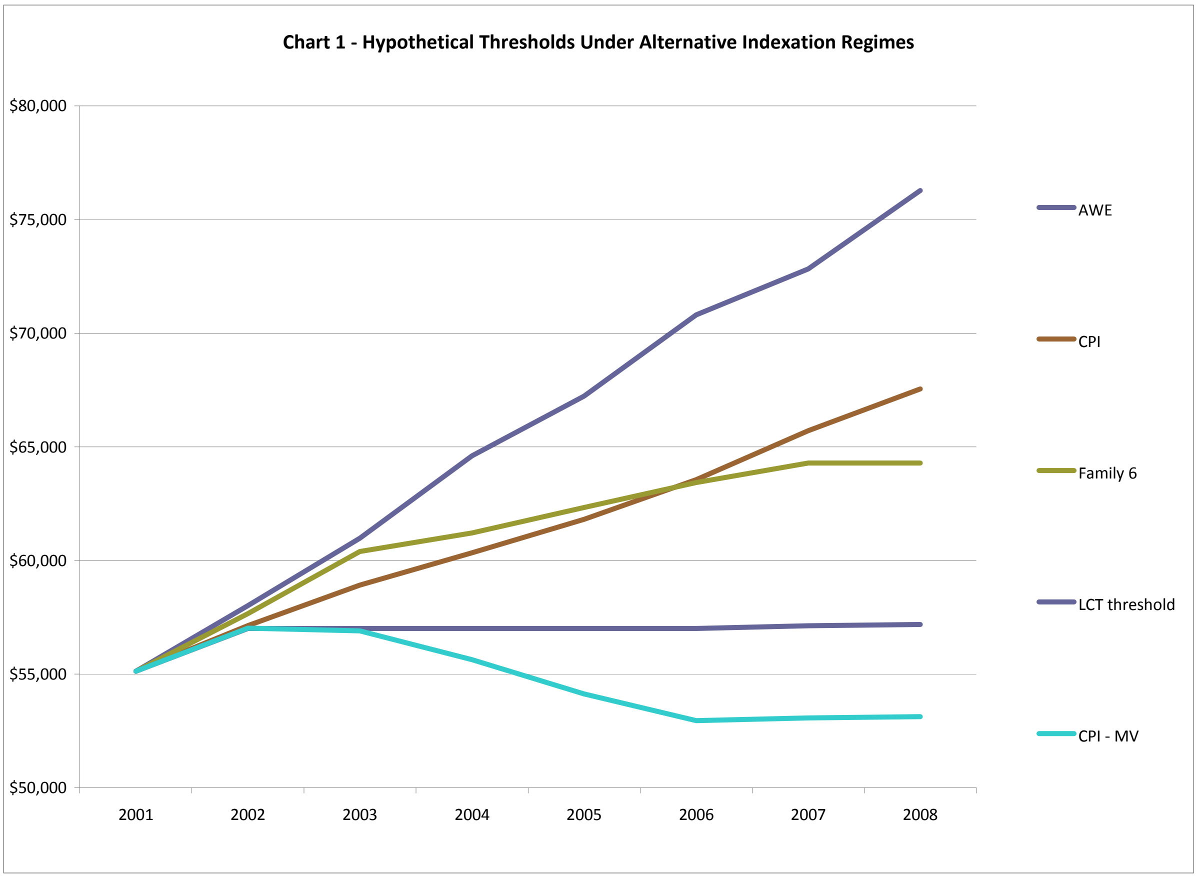
2 Accordingly, fleet sales are disregarded and luxury cars have a small weight in the basket.

3 Quality adjustments are applied in principle to all components of the CPI but are in practice more important for items such as cars and consumer electronics than for basic foodstuffs or clothing.

4 ABS, *Australian Consumer Price Index: Concepts, Sources and Methods*, 2005.

indexed to one of these measures instead, and it would be more consistent with the idea of LCT as a tax on prestige.

2.12 The actual change in the LCT threshold is compared to that under some alternative indexation regimes in Chart 1.



2.13 If the argument that the LCT threshold should have been indexed to the total CPI rather than to the pure price of luxury cars is accepted, the threshold would need to rise to around $70 000. This would lower the percentage of cars sold subject to the LCT to around 5 per cent of the market.[5]

2.14 The FCAI submission pointed out that cars priced between the current threshold and $70 000 (although being the majority of cars subject to LCT) contribute less than a fifth of the revenue raised.[6] However, not only would raising the threshold cut the number of cars subject to LCT, it would reduce the LCT raised from each of the cars still subject to the tax. Indeed, raising the threshold in this way would probably offset the additional revenue raised by increasing the LCT rate from 25 to 33 per cent.[7] (The luxury car tax threshold is equal to the car depreciation limit used to

5 Based on FCAI figures supplied in *Submission 8b*.

6 FCAI, *Submission 8b*, p.4

7 Assuming no change in demand from 2007 sales figures.

calculate depreciation deductions. Therefore raising the threshold would also affect revenue by increasing the limit unless the two were explicitly differentiated.)

The impact on the LCT rate increase on car prices and the CPI

2.15 As the LCT only applies to the value in excess of the threshold, the price increases for cars affected by the LCT are much less than the 8 per cent increase in the tax rate (see Table 1.1). For example, if the tax increase is fully passed on to buyers the price of a $100 000 car will increase by $3 100. While car prices in Australia range up to $1.2 million for a Rolls Royce Phantom convertible, cars priced under $70 000 contribute the majority of the LCT. The additional LCT is equivalent to about 2 per cent of the average price of vehicles subject to LCT, based on 2007 sales figures.

2.16 The extent to which the tax increase is passed on will depend on the price elasticity of demand. This is likely to be considerably lower for luxury cars than for standard cars.

2.17 Around 90 per cent of new cars sold in Australia fall below the threshold, so there is no direct impact from the LCT increase. Around 95 per cent of Australian made cars sold in Australia fall below the threshold.[8] Allowing for export sales, a higher proportion of Australian made cars are not affected by the LCT.

2.18 It was suggested that the tax led to prices 'bunching' just below the threshold; 'a pricing log jam in the $50,000 to $55,000 bracket'.[9] This might suggest making the tax effect stronger would moderate prices of cars near the threshold, and that raising the threshold would increase car prices.

2.19 A simple calculation suggests the overall impact on the consumer price index will be negligible. Motor vehicle purchase has a weight of around 5 per cent in the CPI, so if the price of 10 per cent of cars sold were to increase by around 2 per cent as a result of the LCT rate increase, the total CPI might have a one-off increase of 0.01 per cent.[10]

8 Information provided by FCAI.

9 Mr Russell Scoular, Ford Australia, *Proof Committee Hansard*, 6 August 2008, p. 8.

10 ABS Cat. no. 6430.0 gives the weight of motor vehicles in the CPI as 4.9% as at June 2005. The proportion of cars affected is discussed in paragraph 1.10. Figures on revenue and volume of sales by price were provided by FCAI. A more sophisticated estimate would be likely to be even smaller. Some of the tax increase will be absorbed by manufacturers or dealers rather than passed on to consumers, and there will be a modest deflationary impact as car buyers have less money to spend on other goods and services.

The impact of the tax on sales of cars

2.20 The impact on sales will depend on the price elasticity of demand. There is general consensus that is considerably lower for luxury cars at the higher end of the market than for standard cars. Audi Australia identified their A4 models – which range from $50 000 to over $90 000 – as being price sensitive, and the company anticipates a 20 per cent reduction in overall sales, but noted that above $100 000, 'it is a different game'.[11]

2.21 A few industry spokespersons were asked for estimates of the decline they expected in sales of cars subject to LCT:

> …conservatively in the order of 18 per cent.[12]
>
> we believe, based upon our internal assumptions of price elasticity, that we will have a 20 per cent drop of cars above the luxury car threshold.[13]
>
> increasing vehicle prices in the Porsche market segments by the amount reflected with the LCT moving from 25 to 33% is likely to result in a reduction of sales of between 10 to 13% – for Porsche and its segment competitors.[14]
>
> It is very difficult to judge at this point… we have to be mindful that all of our competitors are facing the same increase.[15]

2.22 However while the market is described as price sensitive, the tax will affect all manufacturers equally, so the impact should be much lower than if just one marque increased the prices of their models. Additionally, in the price range where demand is identified as being most elastic, close to the threshold, the overall price increases will be low.

2.23 The increase in the LCT is likely to result in sales of vehicles slightly above the LCT decreasing and sales of vehicles slightly below the LCT threshold increasing. Buyers in the $65 000 - $95 000 may downgrade their purchase, or alternatively forgo optional extras. Purchasers of four wheel drives are likely to get more extra equipment fitted as aftermarket options, which will not attract the tax.

2.24 Analysis of luxury car sales provided in data sources to the Committee for July indicate that sales of vehicles subject to LCT are down compared with the same period last year. However, the results vary dramatically across market segments – with some types of vehicles showing increased sales – and sales are still higher than the

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11 Mr Joerg Hofmann, Audi Australia, *Proof Committee Hansard*, 31 July 2008, p.

12 Mr Andrew McKellar, Federal Chamber of Automotive Industries, *Proof Committee Hansard*, 22 July 2008, p. 10.

13 Mr Joerg Hofmann, Audi Australia, *Proof Committee Hansard*, 31 July 2008, p. 2.

14 Porsche Australia, *Submission 5*, p. 2.

15 Ms Vesna Katic, Toyota Australia, *Proof Committee Hansard*, 6 August 2008, p. 5.

same period in 2006. Some of the July slump just represents sales being brought forward to June to beat the LCT increase. Current economic conditions, high fuel prices and uncertainty over whether the tax increase will pass the Senate, and if so, how it will be applied are further confounding factors which prevent any meaningful conclusions being drawn from July sales on the impact of the LCT rate increase.

The impact on Australian manufacturers

2.25 Some submissions claim the LCT hits a niche market in which the Australian motor vehicle manufacturing industry specialises and it will therefore reduce the viability of Australian manufacturers. Australian manufacturers concentrate largely on large family sedans and the upper ends of the model ranges for these vehicles are subject to LCT. The submissions claim manufacturing costs in Australia are relatively high and the manufacturers rely on good domestic sales to ensure the operation is viable.

2.26 However, there are only a small proportion of Australian-made cars priced above the threshold. Furthermore, the tax does not affect exports.

2.27 The Bracks *Review of the Australia's Automotive Industry* noted the existence of the LCT but did not find it had any adverse impact on Australian manufacturers. It made no recommendations for any changes to the LCT.

2.28 The LCT increase may make Australian-made cars priced below the threshold more competitive with imported models priced above the threshold, so it may provide a fillip to domestic manufacturers. Indeed, this is apparently the view of the European Commission, which 'takes… a very dim view of the luxury car tax'.[16]

Government revenue implications

2.29 The LCT generated approximately $440 million in revenue in 2007-08, or 0.14 per cent of total Australian government tax revenue. The increase in the LCT rate is expected to raise additional revenue of $130 million in 2008-09, increasing over subsequent years.[17] Any impact on sales from the LCT increase will lead to a partial offset to the revenue raised by increasing the tax rate.

2.30 An impact on sales may lead to some reduction in GST revenue from car sales.[18] However, people who decide against buying a car, or buy a cheaper car, as a result of the increase in the LCT are likely to spend the money on something else subject to the GST so total GST revenues are unlikely to be affected significantly.

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16 Mr David McCarthy, Mercedes-Benz Australia, *Proof Committee Hansard*, 6 August 2008, p. 22.

17 *Explanatory Memorandum*, p.1

18 A point made by Mr David Purchase, Victorian Automobile Chamber of Commerce, *Proof Committee Hansard*, 6 August 2008, p. 15.

The impact on rural residents and families

2.31 A number of witnesses argued that the increase in LCT will unfairly hurt rural residents:

> For those living in rural and regional areas, access to safe, reliable and convenient family transport is absolutely essential. They often need to drive on unsealed roads, particularly during flooding in the wet season, so they need enhanced vehicle stability and durability and they need long-range fuel capacity.[19]

2.32 Large and comfortable four wheel drive vehicles have been increasing in price and levels of equipment and as a result many are now priced above the threshold, especially once options such as bullbars and winches are added. Several submissions have highlighted the fact that substantially more four wheel drive, or 'SUVs', now fall above the LCT threshold, from less than 1 000 vehicles in 1979 up to 38 000 in 2007

2.33 However, there are still many four wheel drive vehicles priced below the LCT threshold (see Table 1.1 for some examples). Both the people mover and four wheel drive categories straddle the LCT threshold for most manufacturers. For example, in Toyota four wheel drives, only the Landcruiser 200 series starts its model range above the LCT threshold. As a result, the decision to purchase a vehicle subject to LCT is still discretionary for all buyers who require these vehicles.

2.34 For purchasers who do elect to buy a vehicle at the higher end of the model range, the increase in tax is not likely to represent a substantial increase in the overall purchase price. For example, a purchaser who decides to buy a top of the range Toyota Prado, or a Landcruiser VX wagon around the $80 000 mark on the new rate will incur under $2 000 additional tax, less than 2.5 per cent of the overall purchase price.

2.35 The 'people mover' class of vehicles is similar to the four wheel drive market. According to VFACTS statistics the vast majority of people movers sold are under $55 000 and very few would exceed $80 000. Only one of the five Toyota Tarago models is priced over the LCT threshold.

2.36 The increase in the number of four wheel drives above the LCT threshold partly reflects a cultural shift in the perception of four wheel drive vehicles and a concomitant shift in their equipment and pricing. Four wheel drive sales have risen dramatically, while the rural population has been shrinking. Four wheel drive manufacturers increasingly target a more affluent demographic and differentiate their vehicles by equipment, rather than off-road performance or price. This shift in the purchasing demographic means that any attempt to differentiate four wheel drive vehicles from other luxury cars is likely to benefit more urban than rural residents.

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19 Mr Andrew McKellar, Federal Chamber of Automotive Industries, *Proof Committee Hansard*, 22 July 2008, p. 2. A similar point was made by Mr Mark Coulton MP, *Submission 17*.

The rationale for taxing luxury cars at a higher rate than other goods and services

2.37 A number of submissions and witnesses point out there is no distinguishing feature which would single vehicles out from other luxury or 'status' goods – such as private yachts, or jewellery – which do not attract a similar tax.[20] As Audi Australia argued; 'Australia is one of very few countries in the world which has something like the luxury car tax'.[21]

2.38 The replacement of sales tax with the GST was partly motivated by a desire to have a (more) uniform rate of indirect taxation which it was argued would lessen the extent to which the taxation system distorts consumption decisions. On this logic, equity considerations would be managed through the broader tax-transfer system, not through differential taxes on specific categories of goods preferred by low-income or high-income households.[22]

2.39 Some witnesses argued there are no other products subject to a tax when the price exceeds a threshold.[23] While not an exact analogy, stamp duties could be seen as a form of 'luxury home tax' as in many states (first home) purchases of cheaper houses are not taxed and the tax rate increases with the price.

2.40 In its favour, the LCT is a progressive tax which is relatively easy to collect. It is equitable in that it taxes those most able to afford it.

2.41 The LCT falls almost entirely on discretionary purchases, although views differ about whether this is a good or bad feature of a tax.

2.42 The main theoretical arguments for deviations from uniform tax rates on goods and services is addressing 'externalities' or raising revenue for the benefit of specific sectors of the community. These are the rationales underlying other deviations from uniform taxation such as the excises on fuel, tobacco and alcohol (and the future impost on carbon emissions) and various agricultural levies.

2.43 The original 1986 wholesale sales tax appears to have been a protectionist measure, designed to increase the price of European imports, while the 2000 LCT was

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20 For example, Mr John Chapman, Motor Trade Association of South Australia, *Proof Committee Hansard*, 22 July 2008, p. 16; Mr David Purchase, Victorian Automobile Chamber of Commerce, *Proof Committee Hansard*, 6 August 2008, p. 14; and Mr McCarthy, Mercedes-Benz Australia, *Proof Committee Hansard*, 6 August 2008, p. 22.

21 Mr Joerg Hofmann, Audi Australia, *Proof Committee Hansard*, 31 July 2008, p. 3. Ms Vesna Katic from Toyota reported the Philippines has a luxury car tax; *Proof Committee Hansard*, 6 August 2008, p. 5.

22 Treasury [Henry Review], *Architecture of Australia's Tax and Transfer System*, p.281.

23 For example, Mr Peter Griffin, Toyota Australia, *Proof Committee Hansard*, 6 August 2008, p. 2.

introduced to ensure the introduction of GST did not result in a sudden reduction in the price of luxury vehicles, apparently because this might erode support for the GST.

2.44 The European Union, and some importers, have criticised the LCT as a disguised form of protection for the Australian car industry. According to the European Commission, 90 per cent of vehicles subject to the LCT are imported and 50 per cent are from Europe.[24]

The effect of the LCT and the proposed increase in the LCT rate on the adoption of vehicle safety features and environmental technologies.

2.45 Because safety and environmentally friendly technologies appear first as optional equipment, they usually appear on luxury vehicles first, but gradually diffuse to standard models.[25] Some submissions and witnesses argued that the LCT discourages innovation by taxing these technologies:

> The luxury car tax is a 33 per cent tax on safety features and low-emission technologies. If a customer seeks the fitting of airbags to a vehicle priced over the luxury car tax threshold then the customer will incur a 33 per cent additional tax.[26]

2.46 It is possible that at the margin fewer buyers of luxury cars will buy these features as the price of these options has increased. It was suggested that in some cases dealers would not import models with superior safety features as the LCT increase led to buyer resistance.[27]

2.47 However, the development and production of these types of advanced technologies represents part of the core business for luxury car manufacturers and they are unlikely to remove features from more than a small fraction of their models. Mercedes stated that they never de-specify their vehicles and summarised their reason:

> This is our core value of our brand and we are very aggressive and have been over the last years to bring down the pricing as best as we can but we never take any technology, whether it is safety or environmental technology, out of our cars.[28]

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24 VACC, *Submission 11*, attachment C; European Commission's submission to Bracks review.

25 Examples include airbags, anti-lock brakes and stability control.

26 Mr Tim Reardon, Federal Chamber of Automotive Industries, *Proof Committee Hansard*, 22 July 2008, p.2.

27 This point was made in general by Mr Tim Reardon, Federal Chamber of Automotive Industries, *Proof Committee Hansard*, 22 July 2008, p.5.

28 Mr Horst Van Sanden, Mercedes Benz, *Proof Committee Hansard*, 6 August 2008, p.23

2.48 In some cases buyers may be able to avoid the LCT by having additional safety features fitted after the car is bought rather than paying for them as an option from the manufacturer.

2.49 The Australian market represents too small a segment of the overall global car market – probably less than 2 per cent – to affect major manufacturers' research and development budgets. This point was conceded by Toyota:

> The tax would not impact on Toyota’s global research and development activity.[29]

2.50 There are concerns that the faster increase in listed car prices than in the threshold of the LCT may have a negative impact on sales for any future hybrid vehicles larger and more capable than those currently on the market. The Toyota Prius currently falls below the LCT threshold, while the Lexus Hybrids are above it. Future hybrids targeting the gap between these models are likely to fall around the LCT threshold in price. Toyota has argued on environmental grounds that hybrid cars should be exempt from the LCT.[30]

2.51 It has also been argued that luxury cars are safer and more fuel efficient than other vehicles and so the LCT effectively represents a tax on these features. While some luxury vehicles may be more efficient in terms of fuel used per kilowatt generated than some below the threshold, the size of the engines fitted to these vehicles, and their generally larger weight, means that very few actually burn less fuel per kilometre. The median fuel consumption for cars under the LCT threshold is under 9 litres of fuel to travel 100 kms, while the median for models subject to the LCT is over 10 litres.[31] A similar point can be seen from the examples in Table 1.1.

2.52 The fitting of vehicle safety features such as traction control to luxury vehicles is largely a marketing decision, rather than an economic one in most cases. While the technologies do increase the costs of a vehicle and will take time to appear on low end vehicles, the cost is small in comparison to model markups at the luxury end. These features are fitted to luxury vehicles rather than midrange cars in order to differentiate them from lower specification models. The LCT does not represent a tax on safety technologies, it represents a tax on a marketing decision by manufacturers.

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29 Mr Peter Griffin, Toyota Australia, *Proof Committee Hansard*, 6 August 2008, p. 7.

30 Toyota Australia, *Submission 7*, pp 5-6.

31 Secretariat calculation based on fuel economy data from *Top Gear Australia*, July 2008, and median of car models selling more than 100 vehicles in 2008, based on VFACTS sales data.

The impact on corrective services

2.53 One example cited in a submission to the inquiry is the use by the ACT Department of Justice and Community Safety of specially modified vehicles to transport persons in custody. While the baseline cost of these vehicles is below the LCT threshold, the cost of the modifications required to render the vehicles fit for their intended purpose raises them above the threshold. While emergency vehicles are exempt from the LCT, these vehicles do not qualify.

The impact on historic vehicles

2.54 While it is a tiny segment of the market, there is an anomaly in the way historic vehicles are handled. Vehicles over two years old or imported over two years ago are exempt from LCT. Some classic and vintage car enthusiasts have drawn attention to the fact that a classic or vintage car which would be exempt if purchased within Australia attracts the LCT if it is imported for sale. There is no tax on selling the cars outside Australia. Over time this may lead to a loss of Australia's motoring heritage.[32]

2.55 There may be a case to provide an exemption for vehicles over a certain age, such as more than 30 years old. Such an exemption would address the imbalance and the tiny proportion of such vehicles likely to be imported is unlikely to have any significant impact on the economic effect of the tax or revenue generated.

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32 Mr John Burt, Sporting Car Club SA, *Proof Committee Hansard*, 22 July 2008, p. 13; Association of Motoring Clubs, *Submission 14*.