APPENDIX IV

DEPARTMENT OF THE TREASURY

SUBMISSION TO THE SENATE SELECT COMMITTEE ON A NEW TAX SYSTEM

On 3 December 1998, the Senate Select Committee on a New Tax System requested a submission from the Treasury relating to Stage One of the Committee's inquiries.

As requested, this submission deals with the specific matters set out in paragraph 2 of the Committee's Terms of Reference.

Term of Reference

2(a) the estimated levels of revenue to be generated or foregone due to the proposed changes, including the estimated level of revenue to be generated by imposing a goods and services tax (GST) on the basic necessities of life (such as food, clothing, shelter and essential services) and books;

Estimated levels of revenue due to the proposed changes in the Government's tax reform package are set out in the Government's policy document *Tax Reform: not a new tax, a new tax system* (ANTS).

Under this term of reference, estimates are also sought on the revenue that would be generated by imposing the GST on items described as the 'basic necessities of life (such as food, clothing, shelter and essential services)' and 'books'. This raises two broad issues.

First, it is impossible to generate estimates in relation to these items unless precise definitions are provided of the items which are the subject of the estimates. Second, it is also necessary to make assumptions about the other tax changes that may apply in association with imposing the GST on these items (or not imposing it, as the case may be). These issues include (i) whether other indirect taxes also change such as the wholesale sales tax on certain foods (ii) whether there are consequential changes to income tax cuts or compensation payments and (iii) whether the alternative treatment of the items in question is input taxation or GST-free.

Experience in a number of other countries, and in Australia under the Wholesale Sales Tax, illustrates the very considerable difficulties and anomalies that can arise under arrangements which seek to define so-called necessities of life.

For example, whatever definition of food is adopted, it will be controversial and the subject of expensive and time consuming dispute and litigation. Countries have attempted to approach the problem by exempting 'unprocessed foods', but few foods are completely unprocessed (rice is polished, meat is butchered, cured etc, wheat is turned to flour). It is difficult to argue that such a distinction is appropriate when it excludes basic canned, dried and frozen foods.

Attempts to list certain foods encourage 're-packaging' and create classification anomalies and significant compliance costs; for example, distinguishing between bread, buns, pastries, biscuits, cakes and confectionery. Canada zero rates basic food items but taxes snack foods, confectionery, beverages, restaurant meals and take away foods. Whereas the previous sales tax only applied to manufacturers and wholesalers, the larger retail population under GST had to apply a multitude of arbitrary and confusing classification rules.

In Canada the sale of less than 6 doughnuts is taxable but the sale of 6 or more is zero rated if the doughnuts are not for consumption on the premises. In response Canadians create ad hoc doughnut clubs at the front door of take away establishments. Vendors were required to purchase cash registers that can distinguish between sales that are subject to GST and those that are not. Traders, but most particularly small business, have incurred significant compliance costs because of the more complex calculations required on return forms.

The UK also zero rated a wide range of foodstuffs resulting in complicated and arbitrary rules. A hot meat pie is generally taxable but, based on arguments from bakeries to the effect that they only bake pies to create fresh cooked food that smells good, their pies are zero rated provided they:

- are not specifically heated at the customer's request,
- are not thrown out after being heated for a certain time, or
- have not been reheated from cold rather than cooked from raw.

In the UK hot chickens sold by supermarkets are zero rated because they are not held out to be eaten while still warm, but hot chickens sold through take away food outlets are taxed.

Under the existing WST system in Australia, chocolate coated peanuts are taxable as confectionery but chocolate coated frozen bananas are exempt; soft serve yogurt is exempt but soft serve ice cream and ice cream substitutes are taxable; chocolate coated biscuits are taxable, chocolate covered cakes are exempt.

Classification disputes continue concerning whether muesli bars, breakfast bars, health food bars and sports bars are confectionery or snack foods. These classifications also distort production and marketing choices. Frozen pizza is entirely exempt while containers for take away pizza are taxed. Chocolate 'quick' is exempt while other flavours are taxed.

There have been long running difficulties concerning the classification of milk as compared to soy and rice milk and depending upon the amount of flavouring added to the milk. Biscuits produced on retail premises are taxed differently from biscuits made in a factory.

Term of Reference

2(b) the effects of the proposed changes on:

(i) national Gross Domestic Product,

(ii) national export performance and national debt,

(iii) the national Consumer Price Index, and

(iv) the distribution of wealth in the Australian community;

(i) Gross Domestic Product

As noted in ANTS, it can be expected that tax reform will deliver substantial long term improvements to economic efficiency, to the benefit of all Australians.

The sources of the expected increase in economic growth are outlined in ANTS (p.156) as follows:

- lower effective income tax rates, lifting incentives to work and save;
- lower, less distorted, industry input costs lifting export profitability and performance;
- abolition of distorting indirect taxes;
- a reformed business tax system, lifting capital productivity;
- lower tax compliance costs, freeing highly skilled resources for more productive endeavour; and
- more secure government finances, removing the need for ad hocery in tax design.

Determining the size of the potential gain is a difficult task. One approach is to simulate the tax reforms in a model that seeks to capture many of the complex interactions between different agents in the Australian economy.

Two specific studies were referred to in ANTS:

- A study by the Melbourne Institute of Applied Economic and Social Research in partnership with the Brotherhood of St Lawrence and the Committee for Economic Development in Australia (CEDA) found that a broad program of indirect tax reform could increase gross domestic product (GDP — a proxy for national income) by around 3.75 percentage points in the long run (around 10 years).
- A study reported by Salomon Smith Barney Stockbrokers based on estimates prepared by Econtech found that indirect tax reform could increase GDP by about two percentage points in the long run. The changes modelled were similar to but not the same as the indirect tax reforms in the Government's package.

An analysis performed by Dr Chris Murphy of Econtech was also obtained directly by Treasury, and provided similar results to those in the Salomon Smith Barney study. Again the changes modelled were similar to but not the same as the indirect tax reforms in the Government's package. A copy of this study is attached.

Since the release of the Government's package, the Melbourne Institute of Applied Economic and Social Research has reported results of its modelling of the indirect tax reforms contained in the Government's package. Those reforms were estimated to add 1.7 percentage points to GDP in the long run.

In ANTS, it has been assumed that there will be a long run increase in GDP associated with the tax package. However, this is likely to take some years to fully flow through. The revenue analysis and costings in ANTS used conservative assumptions so that it could not be argued that revenue effects were overstated. The assumption used was that GDP would increase as a result of the package by one half of a percentage point by 2002-03.

(ii) Export Performance and National Debt.

The tax package is estimated to reduce the cost of exports by 3.5 percent.

As an illustration of the increase in exports likely to flow from tax reform, the Econtech research (attached) predicts a 6.5 percent increase in exports in constant price terms. However, as noted above this did not model the actual package announced by the Government.

The effect on public debt is reflected by the overall fiscal impact of the package, as reported in ANTS. Public debt interest effects were taken into account in estimating the overall cost of the reforms.

The ANTS package is consistent with a continuing surplus right through the forward estimates period as shown in the *Pre-election Economic and Fiscal Outlook* and it also allows the Government to continue its debt retirement program. The most significant factor in reducing debt further will be the sale of the remaining equity in Telstra which on current estimates will allow the net debt to GDP ratio to fall to around 1 percent in 2001-02.

(iii) Consumer Price Index

Treasury estimates that the Government's tax package will increase the CPI, excluding tobacco allowing for the compensation provided by the First Home Owners' Scheme, by 1.9 per cent in 2001/02. As well as the impact of the GST, prices will be influenced by lower industry costs resulting from the abolition of a range of indirect taxes including the WST and stamp duty.

Treasury estimates assume full forward shifting of all taxes and charges. That is, the GST is assumed to be fully passed on to final consumers. Similarly, any cost reductions associated with the abolition of other taxes are also passed on to final consumers. The assumption of full forward shifting leads to a higher estimate of the CPI increase than any other approach based on symmetrical pass through assumptions.

The ACCC will have a role in monitoring prices across the economy and preventing price exploitation with the introduction of the GST. These proposed measures have been introduced in *A New Tax System (Trade Practices Amendment) Bill 1998.*

(iv) The distribution of wealth in the Australian community

Wealth data is much less robust that income data, and for most groups increases in income imply that personal wealth will at least not deteriorate. The benefits of the tax package include:

- Personal income tax cuts totalling over $13 billion per year;
- Major increases in family assistance costing over $2 billion, including a reduction in the withdrawal rate for family benefits from 50 to 30 percent and increased child care benefits;
- An increase of 4 percent in age and service pensions, a 2.5 percent increase in income test free areas, and a reduced taper rate from 50 percent to 40 percent; and
- An increase of 4 percent in other Government income support payments.

In addition, two forms of Saving Bonus were designed to help maintain the value of the savings and retirement income of lower income older people. The income tested Aged Persons Savings Bonus, of up to $1,000, applies to each Australian aged 60 or more on 1 July 2000 and the income tested Self-Funded Retirees Supplementary Bonus, of up to $2,000, applies to each eligible Australian of aged pension age but not in receipt of a social security or service pension.

In ANTS, comprehensive information was provided showing that the tax cuts and compensation measures provided net gains across all income ranges for a range of household types. Subsequently, in November, the Treasurer tabled in Parliament Treasury analysis which sets out for each quintile of a wide range of household groups estimates of the disaggregated price increases of the tax package. The methodology used to produce these estimates is not endorsed by the Treasury. However, for those who would prefer to rely on them, they nonetheless provide no support for the proposition that, relative to the income tax and compensation benefits, the Government's tax package would have significantly different price impacts for different household groups.

Term of Reference

2(c) the effects of the package on future federal budget revenues, expenditures and surpluses, including a critical assessment of the economic assumptions underpinning the Treasury's projections in this regard;

The projected budgetary effects of the package and the key assumptions are set out in ANTS.

Term of Reference

2(d) the effects of the taxation and compensation package on disposable income and household spending power for a range of 'cameo profiles', including but not limited to those presented in the proposals, under the following scenarios:

(i) a GST extended to the necessities of life (such as food, clothing, shelter and essential services), and

(ii) a GST not extended to the necessities of life (such as food, clothing, shelter and essential services);

In the absence of other changes, the exclusion of food, clothing and shelter from a GST would result in less taxation revenue and higher disposable income across the community than would be the case if these goods were taxed. However, this would mean that the package was unsustainable as a whole, with likely highly adverse economic effects on the fiscal balance, monetary policy settings, growth and employment.

To avoid these effects, the package would need to be substantially adjusted in other ways. The distributional results then would depend on the precise definitions adopted and the nature of the adjustments to the overall package, including the compensation measures.

Term of Reference

> **2(e) with the aim of identifying families and groups who may be disadvantaged by the Government's proposals, focusing on lower and fixed income individuals, families with dependent children or adult members, groups and organisations, and those with special needs, such as people with disabilities;**

The Tax Consultative Committee made a range of recommendations that will have a favourable impact on people with disabilities. It recommended that residential care services that provide care to the aged and people with disabilities be GST-free under certain conditions. The Government accepted these recommendations, outlining the conditions in sections 38-25 and 38-40 of *A New Tax System (Goods and Services Tax) Bill 1998*.

It also recommended that community care services (ie home-based care) that provide care to the aged and people with disabilities also be GST-free provided similar criteria to those for residential services are satisfied. The Government also accepted these conditions, specifying them in section 38-30 of *A New Tax System (Goods and Services Tax) Bill 1998*.

The Government also accepted the Committee’s recommendation that a specified list of goods specifically designed for use by people with disabilities and not of a kind ordinarily used by the wider community be GST-free. GST-free medical aids and appliance are listed in Schedule 1 to *A New Tax System (Goods and Services Tax) Bill 1998*.

Term of Reference

> **2(f) the assumptions made as to consumption and saving patterns and the cost of living for the various 'cameo profiles';**

The assumed consumption pattern for every profile is that of the weights in the 12th Series Consumer Price Index. Each cameo assumes that households spend all of their disposable income – that is they neither save nor dissave. More details on both patterns appear below.

Consumption Patterns

The weights for the 12th Series CPI are listed in the table below. The consumption pattern is that for wage and salary earner households in capital cities in deciles 2 to 9 of income.

CPI 1993-94

CPI Item Number	CPI Weight descriptor	Sub-group Wt
111	Milk and cream	0.895
112	Cheese	0.373
113	Butter	0.055
114	Other dairy products	0.14
121	Bread	0.867
122	Cakes and biscuits	0.773
123	Breakfast cereals	0.252

124	Other cereal products	0.205
131	Beef and veal	0.736
132	Lamb and mutton	0.363
133	Pork	0.177
134	Poultry	0.401
135	Bacon and ham	0.308
136	Processed meat	0.69
137	Fish	0.326
141	Fresh fruit	0.69
142	Fresh potatoes	0.121
143	Other fresh vegetables	0.606
151	Processed fruit	0.14
152	Fruit juice	0.419
153	Processed vegetables	0.27
161	Soft drinks and cordials	1.212
162	Ice cream and ice confectionery	0.354
163	Confectionery	1.324
171	Meals out	1.818
172	Take away foods	3.141
181	Eggs	0.121
182	Sugar	0.056
183	Jams, honey and sandwich spreads	0.149
184	Tea, coffee and food drinks	0.289
185	Food additives, sauces and spices	0.242
186	Margarine	0.13
187	Cooking oils and fats	0.084
188	Other food	0.597
211	Men's outer clothing	0.68
212	Men's knitwear	0.158
213	Men's shirts	0.317
214	Men's underwear, nightwear and socks	0.149
215	Boy's clothing	0.382
221	Women's outer clothing	1.64
222	Women's knitwear	0.196
223	Women's underwear, nightwear & hosiery	0.345
224	Girl's clothing	0.364
231	Fabrics and knitting wool	0.746
241	Men's footwear	0.354
242	Women's footwear	0.457
243	Children's footwear	0.252

251	Dry cleaning and shoe repairs	0.224
311	Privately-owned dwelling rents	4.483
312	Government-owned dwelling rents	0.382
321	Mortgage interest charges	6.608
322	Local government rates and charges	2.19
323	House repairs and maintenance	1.827
324	House insurance	0.41
411	Electricity	1.752
412	Gas	0.531
413	Other fuel	0.056
421	Furniture	3.505
422	Floor coverings	0.839
431	Appliances	1.538
441	Bedding	0.353
442	Towels, linen and curtains	0.401
451	Tableware, glassware and cutlery	0.261
452	Kitchen and cooking utensils	0.382
453	Cleaning utensils	0.084
454	Tools	0.485
461	Household cleaning agents	0.671
462	Household paper products	0.457
463	Other household non-durables	0.857
464	Stationery	0.429
465	Watches and clocks	0.121
466	Veterinary services	0.121
467	Pet foods	0.485
468	Travel goods	0.27
469	House contents insurance	0.382
469.5	Repairs to appliances	0.177
471	Postal services	0.168
472	Telephone services	1.547
481	Consumer credit charges	2.498
511	Motor vehicles	3.989
512	Automotive fuel	4.698
513	Vehicle insurance	2.106
514	Motoring charges	0.839
515	Tyres and tubes	0.345
516	Vehicle servicing, repairs and parts	2.778
521	Urban transport fares	1.212
611	Beer	2.927
612	Wine	1.016

613	**Spirits**	**1.118**
621	**Cigarettes and tobacco**	**2.414**
711	**Hospital and medical services**	**3.15**
712	**Optical services**	**0.177**
713	**Dental services**	**0.634**
721	**Pharmaceuticals**	**0.82**
722	**Toiletries and personal products**	**1.277**
731	**Hairdressing services**	**0.792**
811	**Books, newspapers and magazines**	**1.146**
821	**Video and sound equipment**	**0.802**
822	**Records, cassettes and tapes**	**0.308**
823	**Sports & photographic equipment & toys**	**1.454**
831	**Holiday travel and accommodation in Australia**	**1.296**
832	**Holiday travel and accommodation overseas**	**1.053**
841	**Photographic services**	**0.242**
842	**Repairs to recreational goods**	**0.112**
843	**Entertainment**	**2.498**
851	**Education fees**	**1.557**
852	**Child care fees**	**0.382**
All	**Total of weights**	**100**

Savings Patterns

For the cameos, use was not made of apparent saving rates from the Household Expenditure Survey (HES) data. The HES is not designed to produce savings ratios at all, a point noted by the ABS in its HES documents:

"HES income and expenditure estimates therefore do not balance for individual households or for groups of households and the difference between income and expenditure can not be considered to be a measure of savings" (ABS: User Guide 1993-94 Household Expenditure Survey Cat 6527.0, page 10).

When raw HES data is used to generate implicit savings rates, the crude rates which emerge are often unsustainably large, and the disaggregated results are unreliable since the sample sizes are often very small.

A number of commentators have proposed ways of comparing income and expenditure in distributional analysis that are dependent upon the assumption that the HES can be used as a household balance sheet.

One way of testing the reliability of this approach is to look at the measured household savings ratios for various groups. The savings ratio is the difference between measured income and expenditure, expressed as a percentage of income. The table below shows quite clearly that the measured savings ratios in the HES would be quite ludicrous as a representation of a long term position for many HES household groups.

PROJECTED HES SAVINGS RATIOS FOR 2000-01 BASE POLICY

	Quintile of Total Household Income					
	ALL	First quintile	Second quintile	Third quintile	Fourth quintile	Fifth quintile
Household Type (a) Based on Principal Income and Composition	Original HES Saving Ratio	Original HES Saving Ratio	Original HES Saving Ratio	Original HES Saving Ratio	Original HES Saving Ratio	Original HES Saving Ratio
ALL	-3.78%	-67.12%	-18.62%	-12.44%	-1.29%	11.38%
W&S Couple,two inc,no kids	5.26%	***	***	-15.03%	-2.15%	10.74%
W&S Couple,two inc,kids	0.84%	***	***	-38.03%	-3.57%	9.31%
W&S Couple,one inc,no kids	-8.05%	***	-40.32%	-16.47%	0.18%	0.32%
W&S couple,one inc, kids	-19.08%	***	-40.72%	-22.35%	-10.39%	-13.83%
W&S Single	1.69%	-69.86%	-17.29%	-4.48%	5.79%	9.71%
Self-employed	6.68%	-366.47%	-46.60%	-5.51%	-0.68%	28.08%
Unemp,Sick Allowee,AUSTUDY	-56.45%	-197.17%	-42.82%	9.33%	***	***
Married Pensioners	-11.92%	-23.49%	-6.64%	***	***	***
Single Pensioner	-6.50%	-14.48%	14.28%	***	***	***
Sole Parent or Widows Pensioners	-11.85%	-31.11%	-6.18%	***	***	***
Investment Income	-2.05%	-276.67%	-3.22%	-13.54%	-1.19%	34.82%

*** Estimate with unacceptable relative standard error
(a) Abbreviations: W&S=Wages and Salary; inc=private income(s); kids=dependent children under 18;
Unemp,Sick allowee, AUSTUDY= Unemployment or Sickness Allowance or AUSTUDY

Reasons for these anomalies in measuring the balance between income and expenditure in the HES include:

- The income sources in the HES are narrowly defined, have reference periods that differ from the expenditure data, and exclude lump sum incomes such as contract payments, termination payments, retirement payments and inheritances;

- Income data for some households reflects their statement of taxable income, rather than the money actually available for spending;

- Both the income and expenditure data in the HES is recorded for a short period of time, and the use of income from one period to finance expenditure in another is not adequately captured; in particular,

  - There is no explicit way of relating the use of savings, loans or credit cards to the expenditure data; and

  - The use of 'the acquisitions approach' which records expenditure on large capital items in a period close to the survey interview, further distorts direct comparisons of dollars of income to dollars of expenditure.

The clear conclusion is that we should not attempt to relate changes in the dollar value of income and the dollar value of expenditure based on the HES data. In the absence of a useful guide to savings rates, the cameos adopt the approach that income compensation should apply to the disposable income base.

Term of Reference

2(g) whether the stated objectives of the package can be met by using an alternative and fairer approach

The ANTS document sets out the principles, goals, strategies and plans of the Government in announcing the tax package.

Term of Reference

2(h) such other matters as the committee considers fall within the scope of this inquiry.

-

ATTACHMENT

Replacement of sales tax with a VAT, a report prepared by Dr Chris Murphy of Econtech for the Treasury.

- Main Report.
- Detailed Simulation Results.
- Technical Appendices.

The Treasury

15 December 1998