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Submission No.

FOR CABINET

Copy No. 54

Title

BROAD-BASED INDIRECT TAXES

Minister

John Howard, Treasurer

Purpose/Issues

To outline the main policy issues relevant to a consideration of the question of broadening the indirect tax base as a means of providing scope to reduce the burden of direct taxes.

Relation to
existing
policy

A broad-based indirect tax would facilitate progress towards reductions in direct taxation but would not, of itself, serve to produce a lower overall tax burden; progress towards that particular Government objective ultimately depends on success in reducing expenditures.

Legislation
involved

Legislation would be required if a broad-based indirect tax were to be introduced.

Urgency:
Critical/significant
dates

Early consideration of this Submission (and the related Submission on Income Tax Options) is desirable.

N/A

Consultation:
. Ministers/Depts
consulted

N/A

. Is there
agreement?

} The net budgetary impact of the different options that are available cannot be assessed in advance of decisions by Ministers.

Cost
. this fiscal year

. year 2

. year 3

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BACKGROUND

Decision No 12880(C) of 3 November, 1980 directed that I bring forward a Submission to facilitate our consideration of policy in relation to a broad-based indirect tax. In a subsequent Decision (No 12957(MP) of 19 November) the Monetary Policy Committee specified some additional aspects to be covered in the Submission, including information on other taxation options.

2. Attachment 1 to this Submission outlines in some detail the main policy issues relevant to a consideration of broad-based indirect taxes and I have lodged a separate Submission canvassing a number of options in the income tax area. These two Submissions deal, in effect, with different sides of the same coin and should be considered together.

ISSUES

3. The issues are whether we should be moving now to broaden the base of our indirect tax system and, if so, the form of that move, including with what if any action it should be accompanied in the field of direct taxes.

CONSIDERATION OF THE ISSUES

4. Before turning to these particular issues, there is one very important general point which cannot be too strongly emphasised. It is that the imposition of a new broad-based indirect tax, and the use of its proceeds to lower direct taxes, does nothing, of itself, to lower the burden of taxation overall. From this, several points follow:

- (i) The (net) proceeds of any major new indirect tax should be tied - and should be seen to be tied - unambiguously to broadly equivalent reductions in direct taxes, rather than result in increased taxation. It would be disastrous for all concerned - and not least for us as a Government - if a new tax were to mean more expenditures and more tax.
- (ii) If sufficient net revenue is to be raised to permit some reduction in direct taxes from the outset - and I believe it would be essential to

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establish our bona fides in this regard from the outset - we would need to find means of cutting back hard on expenditures at the same time if such a switch were to be accomplished in the context of a reduced overall taxation burden.

- (iii) The possibility that, on broader fiscal and monetary policy grounds, additional revenue measures could be necessary even before allowance for any reductions in direct taxes serves to underline the crucial importance of effectively containing government expenditures at this time.

The Case for a Broad-Based Indirect Tax

5. This is outlined in paragraphs 2 to 10 of Attachment 1. The main points are:

- (i) While total taxation in Australia is relatively lower than in most OECD countries we do rely more heavily on personal income taxes than most of those countries, with adverse effects on incentives and risk taking, and on the tax avoidance/evasion problem.
- (ii) Though many uncertainties are involved, the very rapid rates of growth in crude oil levy proceeds which, in recent years, have helped at least to stabilize the growing dependence upon personal income tax revenues, are unlikely to be repeated over the years ahead.

Ways to Broaden the Base

6. The main mechanisms for broadening the indirect tax base - extension of the present wholesale sales tax, a general retail sales tax and a value-added tax - are outlined in paragraphs 11 to 31 of the Attachment and some comparisons are drawn on the basis of certain criteria (numbers of taxpayers, staff requirements, lead times, policing, compatibility with a tax on services and revenue potential). A few general conclusions which emerge are:

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- (i) Extension of the present wholesale sales tax to include goods now exempt would be by far the quickest and most straight-forward method of broadening the indirect tax base. For any given rate of tax, however, it would raise less revenue than a retail sales tax or a VAT on goods; it would also be less compatible with extending the base to include services (consumption of which is very considerable) as well as goods.
- (ii) A general retail sales tax - and especially a VAT - would take much longer to implement and, because of the very much larger number of taxpayers involved, would be more costly (for businesses and the taxation authorities) to administer.
- (iii) Whatever form of tax were to be chosen, then the greater its coverage the lower (for any given revenue objective) the rate of tax to be adopted will need to be. From this viewpoint it would be important to bring as wide as possible a range of services, as well as goods, within the coverage of the tax and for the tax to embrace food and clothing as well as less essential goods.

Some Detailed Issues

7. Some detailed aspects of the nature and coverage of the alternative mechanisms are considered in paragraphs 32 to 48. I suggest that these paragraphs warrant very close reading and I limit myself here to a few brief comments:

- (i) Coverage (paras 32-40). As noted above, any really significant broadening of the indirect tax base would need to comprehend not merely a wide range of services but also food and clothing (or the bulk of those items).
- (ii) Exemptions (para 41). Purchases by producers (eg aids to manufacture, mining equipment and agricultural equipment) would need to be exempt,

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whatever the mechanism, to avoid double taxation of the finished product.

- (iii) Single and multiple rates (paras 42-44). Multiple rates (like exemptions) have attractions from some viewpoints but they also involve costs not merely in terms of revenue potential but also, in the case of taxes at the retail level, in terms of administrative difficulties, particularly for the taxpayers involved.
- (iv) Relationship to existing indirect taxes (paras 45-48). Two issues for consideration here are whether any new indirect tax should replace or supplement the existing wholesale sales tax, and whether it should apply to (that is, "on top of") excisable goods.

Revenue Implications

8. It will be apparent from the foregoing that, apart from data problems, there are a great many questions to be answered before any firm estimates of revenue yields can be prepared. Paragraphs 49 to 55 are relevant here and Table 5 provides some illustrative figures. In very broad terms it can be said that:

- (i) Extension of the present wholesales sales tax would raise an additional amount of roughly \$300 million for each 1 per cent of tax if it were to apply to all goods (including excisable items) but only about \$30 million for each 1 per cent of tax if food and clothing and (as I am inclined to think would be necessary) excisable items were excluded. Extension of the present wholesale sales tax to selected services (which would not be without its difficulties, particularly if multiple rates were involved) might raise about \$100 million for each 1 per cent of tax.
- (ii) A retail sales tax applicable to all goods and selected services would yield about \$540 million for each 1 per cent of tax, but only half this amount if food and clothing and excisable items were excluded. With the

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former coverage a rate a little under 4 per cent would be necessary to achieve a "revenue neutral" effect - that is, to raise the revenue equivalent of the present wholesale sales tax (an estimated \$2060 million in 1980-81). (It should be noted that the illustrative figures in Table 5 for the retail sales tax relate largely to private consumption sales and that the revenue yields would be somewhat higher if the tax were applied - as it would have to be in respect of some goods - to sales to businesses and governments.)

- (iii) The illustrative revenue yields in Table 5 are gross in that they do not allow for the effects of resultant increases in the CPI on budget outlays on indexed pensions and benefits (see below).

Other Implications

9. Other implications of broad-based indirect taxes which we would need to consider carefully are:

- (i) CPI effects (paras 56-58). Table 6 suggests that, as well as having a less distorting effect on consumer demand, a broad-based indirect tax would be more efficient than measures involving the existing excises in terms of its impact on the CPI (for a given amount of revenue).
- (ii) Regressivity. Action would need to be taken to protect the needy from the impact of price increases occasioned by any new indirect tax. This issue is addressed in paragraphs 59 to 62 of the Attachment while the choice from among the options canvassed in my accompanying Submission on Income Tax Options would also need to bear this problem in mind.
- (iii) Implications for Wage Determination. Some points relevant to the consideration of these implications are presented in paragraphs 63 to 68.

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CONCLUSIONS

10. This Submission is intended to facilitate our consideration of whether or not to move now to introduce a broad-based indirect tax. From the point of view of the long-term effectiveness of our taxation system as a whole, I think that there should be less reliance on income tax. It follows that, the question of expenditure levels aside, I see it as essential that we place more reliance on broadly-based indirect taxes. At the same time, I recognise that there are other factors, of a political and social nature, that need to be put in the balance in any consideration of the matter as a whole. The information presented in the Submission and the accompanying Attachment is sufficiently detailed for such consideration and for arriving at an "in principle" decision. I submit the issue for consideration on the basis that:

- (i) if the change of emphasis in the tax mix were to be seen merely as an alternative to vigorously pursuing expenditure cuts, I would prefer no change at all;
- (ii) the change of emphasis should be generally understood to be effected in the context of a lower - not higher - tax burden;
- (iii) the change would be made in a way that
 - (a) really did result in significant broadening of the tax base; but
 - (b) did not significantly inhibit our endeavours to reduce inflationary expectations; and
 - (c) was associated with measures designed to ensure that, as far as practicable, needy persons (social welfare pensioners, low income earners) did not suffer detriment from the change.

11. As to the form such a move might take, there are clearly many issues to be considered in reaching a view on that. Again, however, I think the Attachment

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to this Submission provides a good basis for some hard thinking on many of the relevant issues. Key considerations include timing and the inevitable trade-offs involved between (for example) simplicity and administrative ease on the one hand and revenue potential on the other.

12. If Ministers generally are of a like mind, I suggest that we endeavour to clarify our own thinking as far as we can on the basis of the present documentation and, of possible, arrive at a decision "in principle". When we have done that I propose that Treasury and the Taxation Office be requested to prepare, in the light of our guidance, a detailed proposal and plan of implementation for our further consideration as soon as possible in the new year.

(John Howard)

Treasurer

15 December 1980

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