Treasury Analysis of tax mix switch

Background

Treasury analysis delivered to Treasurer Scott Morrison and Prime Minister Malcolm Turnbull on 25 January 2016 showed a tax mix switch involving income tax cuts and increasing the GST to 15 per cent would deliver negligible GDP gains.

The modelling found that increasing the GST rate would, by itself, reduce GDP. A significant portion of the revenue raised from the increase would be spent automatically, as pensions and welfare payments are indexed to inflation. This would limit the scope for cutting personal income taxes, and reduce the possibility that income tax cuts would produce enough gains to make the results of the switch GDP positive. Further measures to fully compensate low income earners would further reduce the scope for personal income tax cuts.

The Treasury work was tested against private sector modelling from two private sector firms, producing broadly similar results. Further analysis and different combinations of policy changes could be proposed and presented in advance of a future election campaign.

Receipt of the January 25 advice refocussed the Government’s current tax reform work. The Government is squarely focused on other tax reform measures that will deliver on its objectives of growth, fairness, reduced complexity and budget neutrality. While some of these reforms will not be easy, they will be necessary to ensure our future economic resilience and prosperity.

A 2015 Treasury Working Paper examines the efficiency of various taxes:

http://www.treasury.gov.au/PublicationsAndMedia/Publications/2015/working-paper-2015-01

Key findings from Treasury’s January 25 modelling and the private sector modelling are reproduced below.

Extracts of Treasury Ministerial Brief 25 January 2016

- We have undertaken additional analyses of the macroeconomic effects of Scenario involving a personal income tax to GST switch, with modest household assistance, as per Table 1 attached. We also commissioned similar analysis from KPMG and Independent Economics.

- Treasury has tested results against sensitivity to a range of key assumptions regarding the labour supply response. These show that relaxing these assumptions lead to a larger gain in GDP from a personal income tax cut but they are offset by a higher GDP loss from a GST increase, see Table 2.

- This remains consistent with [findings] published in the Government's Tax Discussion Paper in March 2015 and set out in the Treasury Working Paper released in April 2015.

- Independent Economics has estimated a new central result of a 0.18% gain in GDP in the long term. Independent Economics has also tested its central estimate to a range of assumptions and these results are shown in Table 3.

- A comparable estimate by KPMG is a 0.3% gain in GDP. KPMG has also tested its central estimate to a range of assumptions and these results are shown in Table 4.

- The estimates from the scenario testing are, of course, indicative and may change with further refinement. That said, they are all pointing to a small increase in GDP over time from personal income tax reductions that are funded largely by a GST hike. In essence, the models all suggest they are largely offsetting.

- The impact will be greater the more personal income tax cuts are combined with corporate income tax cuts.

- The case [for a tax mix switch] will need to be made forcefully using broader arguments. These include the impetus to entrepreneurial behaviour, international competitiveness and reducing incentives to channel personal income into company and other structures.

Overview of development of Treasury's model

- The model used by Treasury to estimate the effects of a tax mix switch on the economy was initially developed in 2012. During 2013 and 2014, extensions were incorporated into the model. The results from this extended model were published in a Treasury Working Paper. The working paper was reviewed by peers in September 2014, finalised in October 2014 and published in April 2015.

Table 1: Outline of Scenario 1

Tax head/transfers	Policy options	Assumed budget impact for modelling $b *
GST	GST rate to 15%, plus broaden base to water and sewerage - GST base broadened to water and sewerage from 2017-18 and rate scaled up over three years to achieve a fiscally neutral package.	35.0
GST assistance - transfer system	$6 billion total in assistance provided to households [automatically generated via indexed pension payments]	-6.0
Personal income tax cuts		-30.0

*This is not a formal costing. These are assumed Budget impacts for modelling purposes.

Table 2: Treasury estimates - Scenario 1 sensitivity analysis

Tax head/ transfer	Policy option	Indicative GDP impact %			
		Central estimates[1]	**Higher labour supply elasticity**[2]	**More working hours available**[3]	**Including additional policy changes**[4]
Personal income tax cut	Personal income tax cuts funded by a lump sum tax	1.3	1.6	1.8	1.3
GST rate	Increase rate to 15% with revenue returned to households	-1.2	-1.4	-1.6	-1.2
GST base	Broaden base to water and sewerage to fund additional personal income tax cuts	0.07	0.1	0.1	0.07
Household assistance through transfer system	Automatic CPI indexation of transfer payments and grants	-0.1	-0.2	-0.2	-0.1
Other					-0.1
		0.0	0.0	0.0	-0.1

1. Central parameters are: uncompensated labour supply elasticity of 0.15, which implies an elasticity of substitution between labour and leisure of 1.2 and a compensated labour supply elasticity of 0.4; and leisure to labour ratio of 0.5.
2. Assumes an uncompensated labour supply elasticity of 0.3, which implies an elasticity of substitution between labour and leisure of 1.6 and compensated labour supply elasticity of 0.6.
3. Assumes a leisure to labour ratio of 1 and holds the elasticity of substitution between labour and leisure at 1.2, which implies an uncompensated labour supply elasticity of 0.2 and compensated labour supply elasticity of 0.7.

Table 3: Independent Economics estimates - Scenario 1 sensitivity analysis

Tax head/transfers	Policy option	Indicative GDP impact %
Scenario 1 **GST**	GST rate to 15%, base to water and sewerage	-1.15
Household assistance	$6.0 billion total in assistance provided to households	0.00
Personal income tax cut		1.32
Total impact[1]		**0.18**
Sensitivity analysis[2]		
Household assistance		
no assistance	lower assistance package used to fund larger personal income tax cuts	0.28
assistance doubled	$12.0 billion total in assistance provided to households - higher assistance package funded by lower personal income tax cuts	-0.28

1. The GDP figure for this row is the sum of the GDP impacts for the components of Scenario 1.
2. The results of the sensitivity analysis must be added to the combined scenario 1 GDP impact to arrive at a total GDP impact.

Table 4: KPMG estimates - Scenario 1 sensitivity analysis

Tax head/transfer	Policy option	Indicative GDP impact %
Scenario 1 **GST**	GST rate to 15%, base to water and sewerage	
Household assistance **Personal income tax cut**	$6.0 billion total in assistance provided to households	
Total impact[1]		**0.30**

1. The GDP figure for this row is the sum of the GDP impacts for the components of Scenario