The new GST

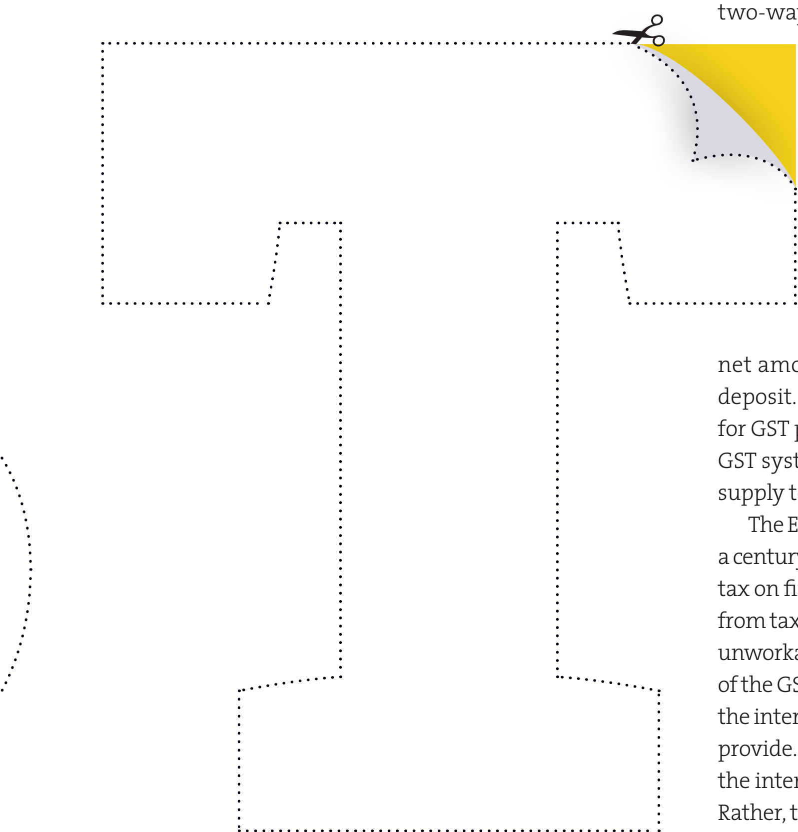
Rick Krever examines the theoretical, practical and revenue implications of reform options for GST on financial supplies.

Among the muddle of tax concessions, penalties, decreases and increases introduced by the former Coalition government, the GST stands out as a singular genuine reform and significant departure from the past. For close to seven decades, the main indirect tax imposed in Australia was the inefficient and highly distorting wholesale sales tax. While the tax nominally fell on businesses along the production chain, the cost of the tax was eventually passed on to the final consumers. The inconsistent burden of the tax across different industries and different forms of business operations imposed significant economic distortions and led to many sub-optimal commercial decisions. Australians as a whole likely paid a very large economic price for the inefficiencies caused by the tax.

In contrast to its predecessor, the GST generally acts as a non-distorting tax on final consumption only. Although it is notionally levied on all stages of the production chain, with one significant exception the tax on acquisitions is rebated back to all businesses below the final consumer. That exception is the acquisition of financial services. Like its European precedents, the Australian GST provides no relief to financial institutions for the cost of GST included in their inputs. The banks pass this GST expense on to their retail and business customers and business customers are denied any rebate for this cost.

While not ideal, the indirect imposition of GST on financial services provided to retail customers (final consumers) is not a significant departure from the fundamental principles of a GST as a consumption tax. To the extent retail customers bear some GST embedded in the cost of the financial services they acquire, the tax system maintains a rough neutrality between different forms of consumption.

By way of contrast, the indirect taxation of financial services provided to business customers is a gross violation of GST principles. Unable to recover the tax embedded in the cost of financial services they acquire, businesses must include the cost in the price of the goods and services they sell. As a result, the tax will have dramatically different impacts on different firms and different parts of the economy depending on the extent to which businesses rely on financial services. The failure to allow enterprises to recover the GST embedded in the cost of financial services generates significant distortions and biases of the very sort GST was meant



to end. Distortions between different firms and different sectors come at a cost – the consequent inefficiencies lower economic utility for all of society.

Why are financial services a problem? Why can they not be taxed like any other service and the tax rebated back to business in the same way as the GST included in all other business acquisitions?

A financial service is an intermediation service. The financial service provider sits between two groups, lenders and borrowers, and brings them together for a relatively small intermediation fee, the spread between the interest paid to lenders and that charged to borrowers. Both the lender and the borrower share the cost of the bank's intermediation services: the lender pays something to the bank for its services in finding a borrower for the funds it wishes to lend and the borrower pays something to the bank for its services in finding a source of loan funds. Because the value of the service provided is not explicitly separated from the gross flow of funds, it is difficult to find the proper base to tax.

From a policy perspective, the difficulty of finding the appropriate base is exacerbated by the unique two-way element of financial services. If I deposit money in my bank account, I provide a service to the bank. In effect, I rent the bank my money and they pay me a rental fee called 'interest'. At the same time, the bank provides me with a service by looking after my money for me. It is much safer sitting in the bank than under my mattress and I'm willing to pay something for this service. The relative values of these two services are offset against each other and the net amount is reflected in the interest paid on the deposit. But since one party (the bank) is registered for GST purposes and the other party (me) is not, the GST system cannot correctly tax the net value of the supply to each party.

The European originators of the GST concluded half a century ago that the correct tax treatment (imposing tax on final consumers and providing complete relief from taxation for business customers) was inherently unworkable for financial supplies given the structure of the GST and the difficulty of measuring the value of the intermediation services that financial institutions provide. The cost of the intermediation service is not the interest paid by borrowers or remitted to lenders. Rather, the cost, shared between borrowers and lenders, is the spread between those two amounts. There is no direct way of measuring the value of financial intermediation services and indirect surrogate mechanisms for estimating it can be complex.

And so, the first full European GST, adopted in Denmark in 1967, established the precedent for all European GST systems and the Australian system: financial institutions would pass on to both business and retail customers the cost of tax included in their acquisitions without relief for business customers. At the same time, there would be no GST charged on the further value added by financial service providers.

As a result, business customers were over taxed (they received no relief for the tax borne by the financial institutions and included in the price of the services the institutions provided) and retail customers were under taxed (they paid tax on the value of supplies up to the financial institutions but not on the additional service provided by the institutions).

The result was clearly a second best outcome, though the designers of the first GST laws may have been right in concluding that was the best outcome possible at the time. But the world has moved on in the 40 years since and the case for Australia copying the approach developed four decades ago in Europe rather than newer systems being adopted by our competitors has become increasingly difficult to justify.

To be fair, Australia has not slavishly adopted the original GST model as it stood in the 1960s. In an attempt to ameliorate the distorting effects of the tax imposed on intermediate businesses by the traditional approach, Australia adopted a special rule which provides banks with a partial rebate of GST they pay for a limited number of specialised services commonly purchased from third parties. However, since this measure only applies to a very small number of inputs acquired by banks, it can actually complicate the tax picture. There is no rule requiring banks to pass on the benefit of these limited tax rebates to the customers that actually use services related to the qualifying inputs. The tax savings could instead be passed on to preferred customers. While all business customers will be overtaxed on the financial services they acquire, some will be only slightly overtaxed and others greatly overtaxed.

Two of Australia's closest neighbours (and competitors!) have moved well beyond this piecemeal and somewhat ad hoc response to the problems of applying traditional GST rules to financial supplies. They have instead adopted a completely new model for the taxation of financial supplies much more attuned to the goals of the GST and the reality of business operations in the 21st century.

Using slightly different technical mechanisms, Singapore and New Zealand have developed ways to completely eliminate tax on financial supplies to business customers. In the case of supplies to registered businesses, financial institutions recover all the tax imposed on their acquisitions while charging no tax on their services. There is thus no GST explicitly charged on financial supplies acquired by business customers or embedded in the price they pay for those services.

This approach is the ideal from an economic theory perspective as it eliminates any tax distortions and economic inefficiencies, strengthening the economic environment in which New Zealand and Singaporean companies operate. It also gives firms in both jurisdictions a competitive edge over counterparts in Australia.

The ease with which both jurisdictions moved from the old model of GST to this modern treatment raises the obvious question of what is holding back Australia. No doubt state governments are concerned that modernising the GST as it applies to financial supplies acquired by businesses carries a risk to their respective shares of GST tax revenues. There is also the inevitable political constraint caused by the need to obtain agreement by all States and Territories before the Commonwealth GST legislation can be amended. The problems are not insurmountable, however. And down the road, the costs of failure to reform while Australia's competitors did so may prove to be significant. It's time to give serious consideration to the reform option.

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