

GST: where to next?

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Abstract

1 July 2020 marked the 20th anniversary of implementation of GST in Australia. It is not surprising that this is seen as an occasion for a review and reform of the scope and operation of GST and consideration of what reforms might be necessary. This article reflects on the objects of GST as part of the A New Tax System reform package, measures the performance of GST since its inception and concludes that Australia's GST system is not the sustainable, robust and reliable source of revenue for the States and Territories that it was intended to be.

An examination of the design features of the GST system and scope concludes that the existing GST system is unlikely to provide a reliable revenue source necessary to be the dominant source of future revenue to satisfy the spending needs of the States and Territories. Further, the analysis of the revenue estimates indicates that the robust and growing revenue stream for the States and Territories is unlikely to be achieved by broadening the base and/or increasing the rate.

However, if a number of 'policy gaps' in the GST system are addressed the revenue from GST could be restored to its initial 4 per cent of GDP. But fraud, evasion and non-compliance are inherent weaknesses of a value added tax system. By reference to the findings of the Black Economy Task Force, the article considers changes to the GST system consistent with the Task Force recommendations and the design of VAT systems internationally to limit further erosion of GST revenue.

Lastly, the article addresses whether Australia would be better off staying with a value added tax system or if there are alternatives that might better achieve the reliability, stability and sustainability that governments require.

Key words: Reform of Australia's GST; VAT policy and compliance gaps; Tax Expenditure; C-Efficiency; Black Economy; A New Tax System; GST-free goods and services; GST policy and design; horizontal fiscal equalisation; sustainability of tax revenue; intertemporal consumption; savings ratio; fraud and evasion in GST; Willie Sutton Rule; supplementary financial tax; GST reverse charge; intermediaries and disaggregation in VAT; GST treatment of peer-to-peer and or gig economy and GST; GST-free business-to-business transactions.

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1. INTRODUCTION

*'Would you tell me, please, which way I ought to go from here?
That depends a good deal on where you want to get to, said the Cat.
I don't much care where ... said Alice.
Then it doesn't matter which way you go, said the Cat.'*¹

Clearly, providing some commentary on what the future holds for GST requires a decision to be made as to 'where we want to get to'.

In addressing the question of what the future might hold for GST, it must be borne in mind that:

- GST is a part of the broader scheme of State/federal financial relations, the challenges of vertical fiscal imbalance and horizontal fiscal equalisation; and
- in theory, changes to the GST rate can be used as tools to affect aggregate consumption and growth.

Other articles in this special issue address:

- GST as a secure source of revenue for the States and Territories;
- should the GST base and rate be reformed?;
- the case for selected exemptions; and
- the case for a broad base.

Accordingly, sections 2 and 3 of this article, while covering some of the ground that is traversed in other articles, seek to identify those things about the GST system that might no longer be 'fit for purpose' after 20 years.

Sections 4 to 6 of this article discuss changes to overcome limitations of the GST system.

In classical times, a haruspex would examine the livers of sacrificed sheep and chickens to discover the will of the gods.² In the divination of what the future holds for GST, it will be necessary for the entrails of the A New Tax System (ANTS) package to be revisited:

- what objectives were held in 1998 for GST – the centrepiece of the ANTS package?³ What was the aim for the Commonwealth, States and Territories?;
- where are we now - were the objectives satisfied? If not, what went wrong?;
- which way ... ought [we] go from here?;

¹ Lewis Carroll, *Alice's Adventures in Wonderland* (Macmillan, 1865) 89.

² Wikipedia, 'Haruspex', <https://en.wikipedia.org/wiki/Haruspex>.

³ Australian Treasury (circulated by Hon Peter Costello (Treasurer)), *Tax Reform: Not a New Tax, A New Tax System: The Howard Government's Plan for a New Tax System* (1998) (ANTS White Paper).

- should Australia's indirect consumption tax revenues be preserved for the State and Territories dominant source of revenue? Or should the Commonwealth revert to general purpose grants?;
- when viewing the revenue potential of the consumption tax system, is Australia better off staying with the value added tax design?;
- are there alternatives that might better achieve the reliability, stability and sustainability that governments require?

2. WHAT WAS THE AIM OF GST AS PART OF THE NEW TAX SYSTEM REFORM?

The examination in this article of Australia's indirect taxation of household consumption begins with the context of the tax system, its scope and the purpose at which its design features are directed.

2.1 The choice of a tax on consumption

Taxation systems can be divided into two types:

- *direct taxation*, which is assessed upon the property, person, business, income of those who pay them;
- *indirect taxation*, which is levied on commodities before they reach the consumer and are paid by those upon whom they are ultimately purchased as part of the market price of the commodity.⁴

Generally, consumption taxes are levied to raise revenue for government programs⁵ whereas selective taxes are often justified on other grounds or viewed as serving a special purpose⁶ – for example, to remedy or contribute to the community cost of the consumption of particular goods and services.

2.2 Neutrality and efficiency

The choice of household consumption expenditure (HFCE) as the tax base is said to promote economic efficiency and to minimise distortions that might arise from other forms of taxation.

The choice of household consumption expenditure as the preferred⁷ tax base is because:

- the tax base is robust and reliable;
- with a tax base of HFCE, tax revenues grow in line with household expenditure, regardless of the type of the goods and services consumed;

⁴ John Bouvier, *Bouvier's Law Dictionary* (The Boston Book Company, 1897).

⁵ Sijbren Cnossen, *Theory and Practice of Excise Taxation* (Oxford University Press, 2005).

⁶ For example, the use of taxes to restrain harmful greenhouse emissions, pollution or consumption of scarce resources. The taxation of tobacco and alcohol is often justified on the basis of the health costs for which the consumption of these products is responsible.

⁷ Or so it was been thought at the time of the ANTS White Paper.

- while HFCE is linked to household and national incomes, the taxation of household consumption is less affected by variations in economic conditions than a direct tax on income.

The base is designed to allow revenue collection with *neutrality and efficiency* – the tax can be levied to maximise the production of goods and services with minimal economic costs to the economy.

With a uniform rate of tax applied to the broadest range consumption expenditure, a consumption tax will *not distort relative prices*. Because the tax does not alter relative prices, households and firms are indifferent, from a tax perspective, between:

- which goods and services to buy, produce or sell; and
- whether to consume (or produce) in the present or defer consumption (or production) for the future by means of saving – the so-called *intertemporal consumption* decision.

Furthermore, as the tax base is household final consumption expenditure, the base excludes Australian production that is consumed outside of Australia but includes foreign production that is consumed in Australia – the so-called *destination principle*.

Essentially, the preference for a tax on consumption is that it enables a secure and reliable revenue source without distorting the behaviour of firms and households. Under the destination principle, a GST is intended to be neutral in relation to decisions of consumers and producers about what goods and services they buy and produce and where – this follows from the design feature whereby GST does not alter *relative prices*.⁸

Significantly, the choice of HFCE as the tax base for GST is founded on the effect of the tax system on prices and the assumption of price elasticity of demand – *its efficiency and neutrality* is achieved because of the way *prices* affect decisions about *household expenditure and saving*.

In contrast, Treasury's *Architecture of Australia's Tax and Transfer System* paper⁹ discussed the impact of personal taxation:

All taxes and all transfers affect behaviour in some way. They change how much money people have and the incentives they face. For example, high levels of taxes on salary and wages reduce the disposable income of salary and wage earners ... it can dampen the incentive to work more to earn more money.¹⁰

The Henry Review¹¹ considered the tax base and design features of consumption taxation and commented:

⁸ This theory assumes equal price elasticity. Again, in theory, higher taxes could be applied to products with lower price elasticity without any substitution effect and hence inefficiency and distortion from the tax system.

⁹ Australian Treasury, *Architecture of Australia's Tax and Transfer System* (2008).

¹⁰ *Ibid* 3.

¹¹ Australia's Future Tax System Review Panel (Dr Ken Henry, chair), *Australia's Future Tax System: Report to the Treasurer* (2009) Pt 2, Vol 1, 273 (Henry Review).

One of the most efficient and sustainable tax bases is consumption. A tax on consumption does not tax the normal return to capital, encouraging investment and saving. From a macroeconomic perspective, consumption is generally less volatile than income or wealth, and therefore provides a more stable revenue source. As the population ages, [a broad-based] consumption tax is likely to become increasingly important, since it taxes the capital of retirees as it is spent, which might otherwise largely be untaxed under an income tax.

Further, the Henry Review noted that a consumption tax can be levied directly or indirectly. In its direct tax form, it can be designed to tax:

- personal expenditure (that is, exempting income that is saved); or
- pre-paid consumption (which taxes only labour income and exempts earnings from savings).¹²

The Henry Review concluded:

Nearly all countries pursue consumption taxation through taxes on goods and services. Personal expenditure taxes were implemented briefly in India and Sri Lanka in the 1960s and 1970s ... but the worldwide trend since then has been to tax consumption through indirect taxes such as the value added tax ... There would be few benefits and significant difficulties in implementing a direct consumption tax in Australia ...¹³

While the discussion in the Henry Review supports an indirect tax on final household consumption expenditure, there has been an ongoing debate about the design of the system to levy such a tax – in particular, the relative advantages and disadvantages of a value added tax (VAT) or a retail sales tax (RST).¹⁴

2.3 The New Tax System's aim for GST

Australia's GST is an indirect tax on final private consumption in Australia.¹⁵ It follows the design of the European Union's credit-invoice value added tax.¹⁶ The measure of private consumption is found in the Australian Bureau of Statistics (ABS) data category 'Household Final Consumption Expenditure'.¹⁷

¹² Ibid 273-274.

¹³ Ibid 274 (references omitted).

¹⁴ Alan A Tait, *Value Added Tax: International Practice and Problems* (International Monetary Fund, 1988) 18, 19; Australian Treasury, *Reform of the Australian Tax System: Draft White Paper* (1985) 131; Liam Ebrill, Michael Keen, Jean-Paul Bodin and Victoria Summers, *The Modern VAT* (International Monetary Fund, 2001) 23; George E Lent, Milka Casanegra and Michèle Guerard, 'The Value-Added Tax in Developing Countries' (1973) 20(2) *IMF Staff Papers* 318; George R Zodrow, 'The Sales Tax, the VAT and Taxes in Between – or, Is the Only Good NRST a "VAT in Drag"?' (1999) 52(3) *National Tax Journal* 429.

¹⁵ Explanatory Memorandum to the A New Tax System (Goods and Services Tax) Bill 1999, 'GST in a nutshell', ch 1, 1.

¹⁶ Alan Schenk, Victor Thuronyi and Wei Cui, *Value Added Tax: A Comparative Approach* (Cambridge University Press, 2nd ed, 2015) 15.

¹⁷ ABS, *Australian National Accounts: National Income, Expenditure and Product*, Cat. 5206.0 (4 September 2019) Table 8: Household Final Consumption Expenditure.

GST's purpose is to raise revenue for government programs¹⁸ in a way that is comprehensive, neutral and efficient.¹⁹

The ANTS White Paper emphasised the inefficiencies, distortions and flaws inherent in the disparate system of the narrowly-based State and federal indirect taxes.

The particular mischief identified in the ANTS White Paper was that the wholesale sales tax and the narrowly-based, distortionary State and Territory taxes were narrow, distorting the decisions of firms and consumers about what they produced and consumed. The selective taxes (such as tobacco, alcohol and petroleum excises) were designed to affect production and consumption decisions – at odds with the objective of a reliable and robust revenue source.²⁰

The federal wholesale sales tax, for example, was limited to goods and imposed on their wholesale value. The tax base became a lower proportion of household consumption over time.

During the 23 years prior to ANTS, the Asprey Review, the RATS Statement²¹ and *Fightback!*²² sought to place more emphasis on the broad-based taxation of household consumption expenditure and decrease the reliance on personal income tax and narrowly-based excises and sales taxes. The process in mind was a 'tax mix switch' from the economically damaging high rates of personal tax to an efficient and economically neutral consumption tax.

Conversely, the ANTS package proposed a broadening of indirect tax to provide a sustainable, reliable and stable base to the States and Territories for the long term. The ANTS White Paper contrasted this approach with earlier reform proposals as follows:

Earlier attempts at tax reform in Australia have had a *substantial 'tax mix switch'* motive - increasing indirect taxes substantially ... to fund large cuts in personal income tax rates (particularly the higher marginal rates). That *is not the objective* of this reform. *A fundamental objective of this package is to halt the erosion of indirect tax revenue ...*²³

The ANTS White Paper, while providing a 'guaranteed minimum amount' to the States up until 2002-03, envisaged that GST revenues would continue to grow thereafter such that general purpose grants would no longer be required:

... [the] introduction of the GST stabilised the process for determining the size of the pool. It also locked in the role of the CGC in determining the distribution

¹⁸ As will be shown, Australia's GST was enacted to raise revenue for the programs of the State and Territory Governments.

¹⁹ Schenk et al, above n 16, 23.

²⁰ See, eg, Taxation Review Committee (Justice Kenneth Asprey, chair), *Full Report* (1975) [3.41] (Asprey Review).

²¹ Australian Treasury, *Reform of the Australian Tax System: Draft White Paper*, above n 14.

²² Liberal Party of Australia, *Fightback! It's Your Australia: The Way to Rebuild and Reward Australia* (November 1991) (Fightback!).

²³ ANTS White Paper, above n 3, 77 (emphasis added).

of the pool among the States. At this point, the Commonwealth very clearly shed any responsibility for determining the distribution.²⁴

As a revenue source, if GST was to grow in proportion to revenue needs of the States and Territories, a failure to contribute a reliable proportion of revenue for the States and Territories would mean:

- the return to Commonwealth untied grants to make up deficiencies; and/or
- a greater emphasis placed on other less efficient taxes, with consequential impacts on savings, workforce participation and efficiency.

2.3.1 *The objectives of GST*

The ANTS White Paper described the overall objectives for GST as:

- a broad-based value added tax to provide a secure stable and growing source of revenue for the States and Territories in the long term²⁵ to remove the reliance of the States on Commonwealth grants and distorting taxes; and²⁶
- to reform the indirect tax base so that ‘the erosion of indirect tax revenue is halted permanently’.²⁷

Inherent in these twin objectives is the expectation that the GST, as designed, would provide an efficient, growth tax for the States and Territories.

The Commonwealth government maintains the position of GST as States’ revenue (and not Commonwealth). Changes to the base must have the agreement of all States and the Commonwealth governments.²⁸ The Agreement on the Reform of Commonwealth-State Financial Relations 1999 ensures that, without uniform agreement, GST cannot be used to produce the type of tax mix switch envisaged in previous tax reform reports. That is, under the IGA, GST is ‘locked in’ to its present base and rate – and hence State and Territory revenue potential.

2.4 **The benchmark**

The discussion so far has referred to GST as an indirect tax on final private consumption in Australia.²⁹ The measure of private consumption is found in the Australian Bureau of

²⁴ M Gray, *Accountability in the Australian Federation*, Background Paper for the Productivity Commission Inquiry into Horizontal Fiscal Equalisation (Analytic Outcomes, August 2017) 30, cited in Productivity Commission, *Horizontal Fiscal Equalisation*, Inquiry Report No. 88 (15 May 2018) 78 (HFE Report).

²⁵ ANTS White Paper, above n 3.

²⁶ Under the 1999 Intergovernmental Agreement, the GST revenue would be shared between the States and Territories on HFE principles. See Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, set out as Schedule 2 to the *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999* (Cth), enacted on 10 September 1999 (IGA). The IGA provided for additional untied grants to be made until the 2002/03 financial year to maintain the States’ budget in no worse position than would have been the case prior to the ANTS reforms. But it was estimated that payments would not be required from 2003/04.

²⁷ ANTS White Paper, above n 3, 78.

²⁸ IGA, above n 26.

²⁹ Explanatory Memorandum to the *A New Tax System (Goods and Services Tax) Bill 1999* (Cth).

Statistics data category ‘Household Final Consumption Expenditure’.³⁰ The ABS measures the final consumption expenditure of Australian households.

The ‘GST Benchmark’ is a statement of the ideal economic base at which GST is directed.³¹

The *Tax Benchmarks and Variations Statement 2018* describes the tax base for the GST benchmark as:³²

... the supply of all goods and services in Australia. The definition of ‘goods and services’ is broad and includes, for example, commercial property. Other features of the benchmark tax base include:

- exports are exempt from GST;
- non-commercial activities of governments are exempt from GST;
- the supply of private residential accommodation is input-taxed (meaning rent is not subject to GST);
- the sale of pre-existing residential premises is input-taxed;
- the sale of new residential premises and the supply of alterations, additions and improvements to residential premises are subject to GST;
- goods and services supplied to oneself are not subject to GST.

Departures from the ideal base arising from legislative policy are ‘tax expenditures’. It is useful to examine both the ideal tax base and the expenditures to assess the extent to which, from a policy perspective, the GST’s tax base is sustainable and stable as a source of State and Territory revenues.

In the *Tax Expenditures Statement 2015* (and in all previous Tax Expenditures Statements) the GST benchmark was described as ‘the value of household final consumption expenditure plus the value of private dwelling investment where these are supplied in the course of an enterprise’.³³

At this point it is worth examining the treatment of housing in the GST tax base because it has important implications for the GST’s stability as a dominant revenue source for the States and Territories. The Australian treatment of housing is an adjustment to the benchmark of household consumption expenditure upon which the theory of the efficiency of value added tax is predicated.

³⁰ ABS, *Australian National Accounts: National Income, Expenditure and Product*, above n 17.

³¹ Australian Treasury, *Tax Benchmarks and Variations Statement 2018* (2019) 155 (TES 2018) states that, ‘unlike the income tax benchmark, there is no starting point such as the Schanz-Haig-Simons definition of income for determining the benchmarks for indirect taxes. Each indirect tax therefore has its own benchmark that reflects the standard features of the tax to question. Identifying the standards of a tax unavoidably involves judgment’.

³² *Ibid* 156 (footnote omitted).

³³ Australian Treasury, *Tax Expenditures Statement 2015* (2016) (TES 2015). The practice of describing the ‘ideal’ tax base in this way ceased thereafter and was replaced by the description in n 31, above.

2.4.1 Imputed rent and residential accommodation

The ABS calculation of HFCE includes actual and imputed housing rentals. Imputed and actual rent constituted 20 per cent of HFCE in 2017-18 but (as the *Tax Benchmarks and Variations Statement 2018* explains):

- actual housing rental expenditure and imputed rent from owner-occupied housing is not subject to GST;
- the sale of new residential premises and the value of alterations, additions and improvements to residential premises are subject to GST.

These structural adjustments to the HFCE benchmark mean that in any financial year:

- there is a part of HFCE upon which GST is not paid (at least entirely) – ie, actual and imputed rent; but
- there is an amount of private housing investment that is subject to GST but is not included in HFCE.

In doing so, GST collections might vary from year to year as a result of the extent of private dwelling investment.³⁴

The December 2018 national accounts show a decrease in private dwelling investment of 3.4 per cent for the quarter.³⁵

With housing investment representing a large proportion of the GST tax base, year on year variations and trends affect the reliability of GST as a dominant feature of State and Territory revenue. If the base were closer to the actual and imputed rent in the HFCE data, there would be a more stability in year on year revenue.

2.5 GST's policy gaps - under taxation of consumption expenditure

The *Tax Benchmarks and Variations Statement 2018* calculates the amount of GST revenue that, in Treasury's view, is *excluded* from the tax base through the 'policy gap'.

For the 2018-19 financial year, the *Statement* measures the 'policy gap' (in section H) as follows:

- GST-free food – \$7,300 million;
- GST-free health services, insurance, care, drugs and appliances – \$6,550 million;
- GST-free education – \$4,750 million;
- input taxation of, and reduced input tax credit (RITC) for, financial services – \$4,500 million;
- GST-free child care – \$1,540 million;

³⁴ States and Territories have experienced similar fluctuations in stamp duty revenues from real property conveyancing.

³⁵ ABS, 'Economy Grew 0.4 per cent in March Quarter', *Media Release* (8 March 2019).

- GST-free water and sewerage – \$1,009 million;
- GST-free arranging of overseas travel, accommodation and other services by travel agents – \$250 million;
- GST-free religious services – \$55 million;
- simplified accounting methodologies – \$15 million;
- GST free status to diplomats, diplomatic missions and international organisations – \$11 million.³⁶

2.5.1 ANTS' tax base

Taking the above into account, it can be seen that the tax base at which GST was directed was:

HFCE

Less: actual and imputed rent

Plus: private dwelling investment

Less: consumption expenditure on the items of 'tax expenditures' referred to above.

2.6 GST today

The 2019-20 *Mid-Year Economic and Fiscal Outlook*³⁷ forecasts for 2019-20 are:

- total GST revenues – \$65,558 million;
- GST revenue as a percentage of total Commonwealth tax revenue – 14.4 per cent;
- GST revenue as a percentage of GDP – 3.26 per cent.³⁸

While Organisation for Economic Co-operation and Development (OECD) and European Union (EU) data is not often a valid comparison with Australia's, published data of the OECD indicates that, in the 2016-17 fiscal year:

- the proportion of total Commonwealth tax to GDP (22.2 per cent) was less than the OECD average (34.3 per cent);
- VAT as a proportion of GDP in Australia was 3.4 per cent as compared with an OECD average of 6.3 per cent;

³⁶ TES 2018, above n 31, 130-140.

³⁷ Australian Treasury, *Mid-Year Economic and Fiscal Outlook 2019-20* (December 2019) (MYEFO 2019).

³⁸ Calculated from MYEFO 2019, *ibid*, Tables 3.2 and 3.9.

- in the OECD, the average VAT revenue as a percentage of total tax, was 34.5 per cent. Australia was 16.3 per cent.³⁹

3. HOW IS GST GOING AFTER 20 YEARS?

The indirect tax reforms undertaken in the ANTS package of 1998 were directed at providing:

- a neutral and efficient tax on consumption expenditure so that ‘the erosion of indirect tax revenue would be halted permanently’;
- a secure, stable and growing source of revenue for the States and Territories in lieu of general-purpose Commonwealth grants.

The objective was to remove the reliance of the States on Commonwealth grants *and narrowly based distorting taxes*.

How well has the GST performed?

3.1 A stable and sustainable source of revenue for the States and Territories

Ten years ago, the Henry Review commented on the stability of consumption taxes:

Total household consumption as a percentage of GDP has been relatively stable for a long time This suggests that a tax on consumption would provide a relatively sustainable revenue base that grows in line with the broader economy. The GST is slightly less robust because it does not cover the full consumption base. The Productivity Commission ... found that by 2044-45 GST revenues may decline slightly as a share of GDP because tax-exempt consumption such as health care is expected to grow.

... Underlying changes in consumption of specific goods and services *can be influenced by tax, as well as changing consumer preferences, new technology or government policy*. Together, these factors can affect the production and consumption of different goods.⁴⁰

But the truth of the caution expressed in the Henry Review has emerged sooner than the Review warned. Recent publications of the Parliamentary Budget Office⁴¹ and Productivity Commission⁴² have examined the stability and sustainability of our 20-year-old GST system.

Both reports have focused on the sustainability and adequacy of GST revenues for their intended purpose.

³⁹ Organisation for Economic Co-operation and Development (OECD), *Revenue Statistics: 1965-2016* (OECD Publishing, 2017).

⁴⁰ Henry Review, above n 11, Pt 2, Vol 1, 274-275 (emphasis added).

⁴¹ Parliamentary Budget Office, *Trends Affecting the Sustainability of Commonwealth Taxes*, Report No. 2/2018 (18 July 2018) (PBO Report).

⁴² HFE Report, above n 24.

3.1.1 *The HFE Report*

The HFE Report reminds us that Horizontal Fiscal Equalisation (HFE) is a product of Vertical Fiscal Imbalance (VFI). VFI arose progressively from Federation in 1901 (through the ceding of colonial customs revenues to the Commonwealth) through to the Second World War (the Commonwealth assuming sole responsibility for income tax) and, more recently, the absorption of State business franchise fees into the Commonwealth excise regime.⁴³

Under the IGA, the general revenue transfers from the Commonwealth to the States and Territories were to be satisfied by giving the States and Territories access to the total of the GST revenues.

The HFE Report comments that:

The real average annual growth rate of GST revenue⁴⁴ over the period 2000-01 to 2016-17 was approximately 3.6 per cent, roughly the same growth rate as personal income tax, but ... [t]he GST pool has grown more slowly in recent years, and is arguably not the steady and growing source of revenue for the States that was first envisaged. ...

The size of the pool distributed to the States has grown considerably since 1981. In 1981-82, approximately \$25.4 billion (in 2016-17 terms) was distributed to States on the basis of HFE. In 1985-86, the amount had grown to nearly \$28 billion (in 2016-17 terms) compared with roughly \$62.4 billion in 2017-18. Nevertheless, the growth rate of GST revenue (in real terms) approximately halved between 2000-08 and 2009-17, from 4.5 per cent to 2.1 per cent.⁴⁵

Williams⁴⁶ observed:

Tying general revenue payments to the GST was seen by the States and Commonwealth as providing a growth tax to the States. In practice, the exemptions from the GST have meant that the revenue from it is now growing at a slower rate than personal consumption expenditure.

3.1.2 *The PBO Report*

The PBO Report, from a GST perspective, foreshadows decreasing GST revenues (as a proportion of GDP) resulting from the limitations of the existing GST base. The Report identifies areas that have given rise to a decrease and concludes that the reduction is likely to continue:

⁴³ Ibid.

⁴⁴ There is a difference between the total amount of GST revenue collected, and that which is distributed to States (the GST pool) due to the fact that some GST revenue accrued during a financial year is not remitted to the Australian Taxation Office (ATO) by 30 June that year, because it is not due to be paid until Business Activity Statements are lodged the following financial year (this also applies to some GST collected by Commonwealth agencies) and because penalties owed to the ATO (other than general interest charge penalties) are not included in the GST to be paid to the States.

⁴⁵ HFE Report, above n 24, 77-78.

⁴⁶ Ross Williams, 'History of Federal-State Fiscal Relations in Australia: A Review of the Methodologies Used' (2012) 45(2) *Australian Economic Review* 145.

When the GST was introduced, GST receipts were 3.4 per cent of GDP. GST revenue peaked shortly after, in 2003-04, at 3.8 per cent of GDP, reflecting the maturing of the new tax. Since then, GST receipts have declined as a share of GDP to 3.4 per cent in 2016-17.⁴⁷

The PBO Report concluded that:

... [T]here is a likelihood that taxes on consumption will continue to trend downwards ... If these risks to tax receipts eventuate, and in the absence of other taxation reforms, maintaining Commonwealth Government revenue at recent levels as a share of GDP will lead to an increasing reliance on taxes on labour income through the personal income tax system.⁴⁸

3.2 What has been the response to date?

The Commonwealth government's response to the HFE Report is that the Commonwealth will increase the 'GST pool' by AUD 600 million in 2020-21 and a further AUD 250 million in 2024-25. The latter is to be 'indexed to grow in line with GST collections on a permanent basis'.⁴⁹

After the HFE Report, and the Commonwealth undertaking to 'top up' the GST pool, the *Mid-Year Economic and Fiscal Outlook 2018-19* (MYEFO 2018) forecasts⁵⁰ of 2018-19 GST revenues were downgraded from AUD 66,789 million to AUD 65,783 – a decrease of AUD 1 billion. The Commonwealth in its 2019-20 Budget commented:

Receipts from GST are forecast to grow by 4.0 per cent in 2018-19 (equivalent to \$2.5 billion), and by 2.4 per cent (equivalent to \$1.6 billion) in 2019-20. Compared with the 2018-19 MYEFO, receipts are expected to be around \$1.0 billion lower in 2018-19, \$1.8 billion lower in 2019-20 and \$10.3 billion lower over the four years to 2022-23. The downward revisions reflect weaker-than-expected collections, and the downward revisions to forecasts for growth in consumption and dwelling investment.⁵¹

In their 2019-20 Budget Papers,⁵² the States have highlighted the downward revision in GST revenues post-MYEFO as well as decreases in State transfer/conveyancing duties⁵³ resulting from the downturn in the property market.

⁴⁷ PBO Report, above n 41, page 4.4. MYEFO 2019, above n 37, estimates 3.26 per cent of GDP for 2019-20.

⁴⁸ PBO Report, above n 41, vii.

⁴⁹ Hon Scott Morrison (Treasurer), 'All Better Off from Fairer Way to Share the GST', *Media Release* (5 July 2018).

⁵⁰ Australian Treasury, *Mid-Year Economic and Fiscal Outlook 2018-19* (December 2018).

⁵¹ Australian Treasury, *Budget 2019-20: Budget Strategy and Outlook – Budget Paper No. 1 2019-20* (2 April 2019) 4.13.

⁵² New South Wales Treasury, *Budget Statement 2019-20* (18 June 2019); Queensland Treasury, *Budget Strategy and Outlook 2019-20* (11 June 2019); South Australian Treasury, *Budget Statement 2019-20* (18 June 2019); Tasmanian Treasury, *The Budget* (23 May 2019); Victorian Treasury, *Victorian Budget 2019/20* (27 May 2019); Western Australian Treasury, *State Budget 2019-20* (9 May 2019).

⁵³ As indicated earlier, from a real property point of view, GST is not a consumption tax but rather a tax on new dwelling investment. It is therefore a double jeopardy to the States which experience volatility in real property conveyance and transfer duties as well as GST as a result of fluctuations in property investment.

The prospect of lower GST revenue has led to the States looking to their existing revenue base to ‘plug the gap’. Measures that are to be found in many State Budgets propose to increase revenues from:

- land tax through aggregated holding and absentee landlord measures;
- waste disposal/environmental levies;
- the gambling point of consumption tax;
- increases in fines, penalties and fees and charges;
- new taxes on motor vehicles and luxury cars in particular.

In general, confronted with the lack of growth in GST revenues, States and Territories resort to selective taxes that fall within their constitutional base. These are, by their selective nature, unstable and inefficient. Resort to plugging perceived gaps from their existing base and discovering new sources of selective taxes is an illustration of the ‘Willie Sutton Rule’⁵⁴ at work – that’s where the money is!

Ironically, it was the narrowness of the State revenue base and the distortionary effects of these taxes that the ANTS package sought to address.

What is it about the GST system that leads to low growth revenue outcomes and drives the nation backwards to the type of taxes that are neither robust nor efficient?

3.3 What’s the problem?

3.3.1 *The tax base*

The Henry Review identified that changes in consumption of goods and services can be influenced by changing consumer preferences, new technology or government policy. The Henry Review made this observation as a factor that favoured a broad over a narrowly defined consumption tax base.

The PBO and HFE Reports postulated that declining growth of GST has been due to:

1. the exemptions in the GST base such that GST revenues are not keeping pace with household consumption.⁵⁵ There are two elements that contribute to this effect:

(a) *The change in the proportion of household consumption on taxable items:*

[One] factor that has led to a decline in GST receipts as a share of GDP has been the change in the consumption mix over time. Since the GST was

⁵⁴ The ‘Willie Sutton rule’ suggests that, in activity-based costing, the focus should be on the highest costs first because that is where the largest savings can be found: see Robert S Kaplan and Robin Cooper, *Cost and Effect: Using Integrated Cost Systems to Drive Profitability and Performance* (Harvard Business Press, 1998). It derives from the response of Willie Sutton, when asked why he robbed banks: ‘Because that’s where the money is’.

⁵⁵ Williams, above n 46.

introduced, households have spent progressively more of their income on goods and services that are exempt from the GST.⁵⁶

(b) The change in the prices of taxable items vs untaxed items:

The decrease in the proportion of household consumption subject to GST has largely occurred as prices of goods and services exempt from the GST have grown faster than those goods and services subject to the GST. In fact, the volume of consumption subject to GST has remained relatively stable since the introduction of the GST ...⁵⁷

2. Changes in the savings ratio:

Although consumption expenditure tends to be relatively stable, around the time the GST was introduced the household savings ratio was at historically low levels and consumption as a share of GDP was correspondingly high. With the terms of trade boom during the 2000s, Australian real incomes rose and households largely opted to save rather than consume the gain, leading to a fall in consumption as a per cent of GDP. The global financial crisis then also led to higher saving as households rebuilt their balance sheets.

Since 2008-09, consumption as a per cent of GDP has increased as the household savings ratio has decreased from around 8 per cent to less than 3 per cent.⁵⁸

3. The increase in participation in economy by individual or small operators and suppliers who may fall under the GST registration threshold.⁵⁹

While the PBO Report identified possible diminishing GST revenues because small operators could choose not to register for GST, the Report observed that:

There are many changes occurring in the Australian labour market, including the well-established increase in part time work and an anticipated shift towards a peer-to-peer economy whereby an increasing proportion of workers are likely to be at least partially self-employed ...

Increasing self-employment could reduce the proportion of people having personal income tax deducted from their wages and remitted to the ATO by their employer and increase the proportion of people that are required to assess and remit their full tax liability to the ATO themselves. The shift towards a peer-to-peer economy also has the potential to increase participation in the black economy. However, so far the proportion of individuals who identify as self-employed for their main job has not increased ... Although the many disruptions taking place in the labour market will undoubtedly lead to

⁵⁶ PBO Report, above n 41, 5.

⁵⁷ Ibid.

⁵⁸ Ibid 4-5.

⁵⁹ Ibid 7.

challenges, the current data does not reveal negative implications for the personal income tax base so far.⁶⁰

With respect to the PBO's observation, anecdotally, employees that convert to self-employed, often disappear from the taxation system altogether.

3.3.2 *Non-compliance*

It can be observed that the PBO and HFE Reports referred to the weaknesses in Australia's GST base as the cause of the decline in GST revenue.

But the PBO Report highlights that, even with a broader base, GST revenues are affected by non-compliance. The ANTS proposals assumed 95 per cent compliance on a tax base which incorporates an Australian Taxation Office (ATO) estimate of some AUD 18 billion of cash economy activity.⁶¹

3.3.3 *Legislative, interpretive and administrative deficiencies*

While variations from the ideal and actual revenues can be explained by the weakness in the base and revenue losses through non-compliance, deficiencies in the legislative expression of the consumption tax base, its interpretation and administration can be of considerable significance to the reliability of revenue flows.

Examples of inaccuracies or inadequacies in drafting, interpretation and administration are not dealt with in this article. But some aspects of the design features that contribute to these deficiencies are given in sections 4 and 5.⁶² Whatever the cause of flagging GST revenues, in determining the future of GST, all gaps between 'ideal' and 'actual' revenue receipts need to be considered and addressed.

3.3.4 *Policy and Compliance gaps*

VRR and HFCE measures of efficiency

In reaching the conclusion that, in 2005, Australia taxed only 57 per cent of consumption, the Henry Review adopted an OECD measure called the VAT revenue ratio (VRR).⁶³ The VRR calculates a ratio of VAT/GST revenue as a proportion of total consumption. In doing so, the VRR uses 'total consumption' as the 'ideal'. Total consumption, in this sense, includes government consumption.⁶⁴ The OECD include

⁶⁰ Ibid 33.

⁶¹ ANTS White Paper, above n 3, 31.

⁶² Reference to some of the annoyances and anomalies can be found in an earlier paper of the author's presented for the Taxation Institute: see Michael Evans, 'El Condor Pasa: Is GST Change Inevitable?' (Conference Paper, TIA National GST Intensive Conference, 6 September 2012).

⁶³ $VRR = (VAT \text{ or } GST \text{ revenue}) / ([\text{consumption (including government consumption)} - VAT \text{ or } GST \text{ revenue}] \times \text{standard VAT or GST rate})$. As the Henry Review noted, an 'ideal' value added tax, which would apply at a 'single rate on all domestic consumption, would have a VAT revenue ratio of 1. A VAT revenue ratio above 1 can reflect investment in residential housing that is taxed on a prepaid basis (and rents are input taxed) but is not included in national accounts as consumption, or cascading effects of input taxation in the value chain': Henry Review, above n 11, Pt 2, Vol 1, 285, chart D2-1. The VRR is explained in more detail in OECD, *Consumption Tax Trends 2018: VAT/GST and Excise Rates, Trends and Policy Issues* (OECD Publishing, 2018) 54-59.

⁶⁴ See OECD, *Consumption Tax Trends 2018*, above n 63, 54, which explains that 'in the absence of a standard assessment of the potential VAT base for all OECD countries, the closest statistic for that base is final consumption expenditure as measured in the national accounts, VAT is indeed, ultimately a tax on

VRRs across a number of jurisdictions in the *Consumption Tax Trends* publication.⁶⁵ The 2016 Australian VRR published by OECD was 50 per cent, meaning that the GST revenue collections were 50 per cent of the ‘ideal VAT tax base’ (including government consumption).⁶⁶

However, Australia’s GST is intended to exclude government consumption from the base and is limited to household final consumption expenditure. The Australian HFCE measure (excluding government expenditure), in 2006-07 calculated that GST revenue collections was at its highest of 71.3 per cent of Australian household final consumption expenditure but had fallen to 64 per cent by 2017-18.

The VRR and HFCE ‘efficiency measures’ seek to quantify the effect of both ‘policy’ and ‘compliance’ gaps on GST revenues. Items of household consumption that are excluded, as a matter of policy, from the tax base are described as ‘policy gaps’. GST revenues that are not collected because of non-compliance with the GST law are described as ‘compliance gaps’.

It is useful to determine the extent to which the sustainability, reliability, stability and efficiency of the GST system is the result of policy, compliance or legislative design inefficiencies. Then an assessment can be made of what remedial action can be taken to address it, ie, ‘which way ... ought [we] go from here?’

First policy gaps in GST revenues are considered below.

3.4 Policy gaps in GST’s revenues

The PBO Report noted variations in savings and consumption as factors that affected the GST’s reliability as a significant revenue source for State and Territory governments. Clearly, variations in savings and consumption from one budgetary period to another are undesirable if GST revenue is a dominant part of the revenue side of the Budget.⁶⁷

However, the PBO Report focused on changes in consumption patterns where ‘undertaxed’ items of consumption were concerned. The PBO and HFE Reports conclude that, if the proportion of HFCE that is spent on GST concessionally treated items continues, GST collections are unlikely to grow at the same rate as GDP or HFCE.

The PBO attributes the declining growth in GST revenues to this shift in consumption preferences.

final consumption. Final consumption expenditure in national accounts is calculated according to a standard international norm, the System of National Accounts (SNA 2008 - except for Turkey, Chile and Japan that still use SNA 1993) under Item P3 Final consumption expenditure’. The OECD state shows the breakdown of P3 between HFCE and P3S13 (General government final consumption expenditure).

⁶⁵ Ibid Fig. 2.3.

⁶⁶ Ibid 55.

⁶⁷ In the case of the Commonwealth Budget, variations in one source of tax revenue might be offset by movements in other tax revenues – or the expenditure side of the budget. These might be described as stabilisers. The aim of the design of the tax and expenditure Budget is to seek to manage the system and its stabilisers to ensure that year by year variations can be managed.

3.4.1 *The tax expenditures*

As noted in section 2.5, the *Tax Benchmarks and Variations Statement 2018* estimates the total GST tax expenditures for the 2018-19 year as AUD 26.2 billion:

- GST-free food – \$7,300 million;
- GST-free health services, insurance, care, drugs and appliances – \$6,655 million;
- GST-free education – \$4,750 million;
- input taxation of, and RITC for, financial services – \$4,500 million;
- GST-free child care – \$1,540 million;
- GST-free water and sewerage – \$1,090 million;
- GST-free arranging of overseas travel, accommodation and other services by travel agents – \$250 million;
- GST-free religious services – \$55 million;
- boats for export – \$19 million;
- simplified accounting methodologies – \$15 million;
- GST-free status to diplomats, diplomatic missions and international organisations – \$9 million.

At 2018-19 estimates, the expenditures represent GST revenues forgone of 41.4 per cent.⁶⁸

3.4.2 *Willie Sutton rule*

The four items of concessionally taxed household expenditure that are *growing at higher rates* than household expenditure generally, are:

- water and sewerage;
- health;
- education; and
- insurance and financial services.

The PBO Report opines that the trend in these categories will continue – with the result that GST revenues as a proportion of GDP will decline into the future.

⁶⁸ Calculated from Table 5, Australian Treasury, *Budget 2019-20: Budget Strategy and Outlook – Budget Paper No. 1 2019-20*, above n 51, 4-15.

An application of the Willie Sutton rule tells us we should focus on water and sewerage, health, education, insurance and financial services to get the best bang for our buck. That is where the money is!

Happily, a broadening of the base would also produce a more neutral and efficient tax on household consumption.

But food is the largest single concession.

The reasons that these particular elements of household consumption are not fully taxed and options for reform are discussed in section 5.

3.4.3 *The rate*

Of the 37 OECD nations, only the United States does not have a value added tax. The standard rates vary from 7.7 per cent (in Switzerland) to 27 per cent in Hungary. The OECD average is 19.3 per cent.⁶⁹

At 10 per cent, only Japan and Switzerland have a lower standard rate than Australia.

Section 5 discusses increasing the Australian GST rate.

4. COMPLIANCE GAPS IN GST'S REVENUES

While the design of a value added tax promotes its 'neutrality' credentials, it is also its main weakness – it is susceptible to fraud.

In relation to GST compliance risks, the Henry Review commented:

There is an argument that tax invoices make the GST 'self-enforcing', as a business purchaser of a taxed good or service requires a valid tax invoice from their supplier in order to receive an input tax credit. While this imposes an additional compliance burden for taxpayers, it creates an additional audit trail for the ATO.

However, the inherent compliance benefits of an invoice-credit method should not be overstated. While business consumers have an incentive to ask for a tax invoice, consumers have no need for a tax invoice, as they cannot claim a tax credit. As such, tax collected at the final retail stage is not self-enforcing. Moreover, the existence of a tax invoice may assist but does not in itself ensure compliance. A false tax invoice might be used to make a claim for a credit. A missing or absent tax invoice may be used to understate sales.⁷⁰

The OECD recorded that:

Losses of VAT revenue from non-compliance can result from a number of factors. In addition to 'traditional' VAT avoidance (ie, arrangements intended to reduce the tax liability that could be strictly legal but in contradiction with the intent of the law) and evasion (illegal arrangements where liability to tax is ignored or hidden) there has been a continuous, significant and worrying trend

⁶⁹ OECD, *Consumption Tax Trends 2018*, above n 63, 66-67, Annex Table 2.A.1. Colombia, which became a member of the OECD in 2020, also has a VAT.

⁷⁰ Henry Review, above n 11, Pt 2, Vol 1, 287.

of increasing criminal attacks on the VAT system. This organised and criminal VAT fraud has been shown to have connections with other criminal activities such as terrorism and money laundering in a number of cases ...

The most common type of organised VAT fraud is the ‘missing trader’ or ‘carousel’ fraud. It arises when a business makes a purchase without paying VAT (typically a transaction for which tax self-assessment applies), then collects VAT on an onward supply and disappears without remitting the VAT collected ...

Reducing the revenue losses from VAT non-compliance remains a key challenge and a priority for countries around the world. An increasing number of tax administrations carry out research to estimate the VAT compliance gap, ie, the revenue loss due to avoidance, evasion and fraud. In the European Union, the VAT gap in the 28 member states for 2016 ... is estimated at EUR 147.1 billion. In relative terms, the VAT Gap share of the VAT total tax liability (VTTL) dropped to 12.3 percent from 13.2 percent in 2015. The smallest gaps were observed in Sweden (1.24%), Luxembourg (3.80%) and Finland (6.92%), and the largest gaps were registered in Romania (37.89%), Lithuania (35.94%) and Malta (35.32%). The United Kingdom estimated its VAT gap at GBP 13.3 billion in 2017-18, i.e. 9.6% of the estimated net VTTL ... A number of other OECD countries provide public estimates of their VAT gap. In Australia the GST gap is estimated at AUD 5.3 billion or 7.9% of VTTL ... in Canada, the multi-year average GST/HST gap for 2000-2014 is estimated at 5.6% VTTL ... and in Chile ... where the VAT gap is estimated at 16.6% VTTL.⁷¹

From a ‘compliance gap’ perspective, the ATO has published a ‘gap’ analysis. In the overview to the analysis, the ATO states:

The tax gap is an estimate of the difference between the amount the ATO collects and what we would have collected if every taxpayer was fully compliant with tax law. Tax gaps exist in all countries to some extent, and the drivers include:

- cultural and human factors
- global forces
- complexity in business and legal systems
- those who take aggressive tax positions
- genuine errors.

Estimating tax gaps is a challenging task for any jurisdiction. Tax gaps are, in effect, about measuring what is not visible – what people have *not* told us about their compliance. This might be due to a misunderstanding, by choice, or by taking a tax position that differs from the ATO view of the law. As a result, all tax gap estimates are subject to a degree of error. They can change from year to year

⁷¹ OECD, *Consumption Tax Trends 2018*, above n 63, 59.

due to improvements in the methodologies used and revisions of underlying data.

Tax gap estimates and their trends over time provide useful insights into the longer-term operation of the tax and superannuation systems. Along with other performance measures, they tell a story about the performance and integrity of the system, including levels of willing participation and significant shifts in compliance. They can guide us in determining priority risks and opportunities to better inform where we invest our resources.

Rapid changes in the economy, society and technology mean the issues driving tax gaps continue to evolve. No tax system can eliminate tax gaps, as the cost of doing so would be excessive.⁷²

In relation to GST, the analysis shows that the estimate of the ‘compliance gap’ grew from 4.9 per cent in 2009-10 to 7.3 per cent in 2017-18 (the last year for which estimates have been published to date).⁷³

The ATO estimates the ‘compliance gap’ in 2017-18 for GST, wine equalisation tax, tobacco tax and petrol and diesel excise and duty to be AUD 5.9 billion.⁷⁴

The Black Economy Taskforce Report estimated that the black economy in Australia *could have doubled* since 2012 to now represent up to AUD 50 billion in 2015-16 dollars.⁷⁵

All of this suggests that the compliance gap for GST is increasing.

4.1 The cause?

In its response to the Black Economy Taskforce Report (Taskforce Report) the government explained that the term ‘black economy’ generally refers to activities which take place outside the tax and regulatory systems.⁷⁶ The practices referred to in the Taskforce Report diminish taxation collections that are of relevance in identifying the extent of GST compliance gaps. Examples given (for both direct and indirect taxation) included:

- illegal phoenixing – liquidating and re-forming a business to avoid obligations;
- sham contracting – presenting an employment relationship as a contracting arrangement;

⁷² ATO, ‘Australian Tax Gaps – Overview’, <https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Australian-tax-gaps-overview/> (accessed 1 July 2020).

⁷³ ATO, ‘Goods and Services Tax Gap’, <https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Goods-and-services-tax-gap/> (accessed 1 July 2020); ATO, *Measuring Tax Gaps in Australia for the GST and the LCT* (2012).

⁷⁴ ATO, ‘Tax gap program summary findings’ (2016-17 for tobacco tax), <https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Australian-tax-gaps-overview/?anchor=Summaryfindings#Summaryfindings> (accessed 2 July 2020).

⁷⁵ Black Economy Taskforce (Michael Andrew, chair), *Final Report* (October 2017) 223 (Taskforce Report).

⁷⁶ Australian Treasury, *Tackling the Black Economy: Government Response to the Black Economy Taskforce Final Report* (May 2018).

- demanding or paying for work cash in hand to avoid obligations;
- not reporting or under-reporting income;
- ABN, GST, and duty fraud.⁷⁷

Recent changes to the GST law in relation to the following matters are examples of initiatives taken to address the ‘compliance gap’:

1. *Missing trader/phoenixing:*

- introduction of withholding tax on the purchase of new residential properties;⁷⁸
- a reverse charge on taxable supplies of valuable metals and limitations on relief for the second-hand acquisitions of these metals.⁷⁹

2. *Employee vs Independent Contractor Disputes:*

- extension of taxable payment reporting systems to include supplies made to couriers and cleaners and expansion of reporting foreshadowed in the 2018/19 Budget.⁸⁰

4.1.1 *Missing trader and refund fraud*

The OECD *Consumption Tax Trends 2018* refers to the inherent risk of ‘missing trader’ fraud in a value added tax system.⁸¹

Similar concerns can be found in a 2008 report of the United States Government Accountability Office⁸² and a 2008 New Zealand Discussion Paper.⁸³

The Taskforce Report refers to missing trader fraud as ‘phoenixing’. At its simplest, it involves carrying on activities or transactions giving rise to taxation liabilities where the ‘taxpayer’ liquidates or otherwise goes missing without remitting tax to the Commissioner.

Reforms to the corporations and tax laws announced in the 2018-19 Budget seek to deter and disrupt phoenix activity.⁸⁴ The Budget package included:

⁷⁷ Ibid 3.

⁷⁸ *Taxation Administration Act 1953* (Cth) Sch 1, Sub-div 14-E (TAA).

⁷⁹ *A New Tax System (Goods and Services Tax) Act 1999* (Cth) s 86-5 (GST Act), as inserted by *Treasury Laws Amendment (GST Integrity) Act 2017* (Cth).

⁸⁰ By adding items to the table in section 396-55 of Schedule 1 of the TAA to cover payments to security providers and investigation services; road freight transport; and computer system design and related services.

⁸¹ OECD, *Consumption Tax Trends 2018*, above n 63.

⁸² United States Government Accountability Office, *Value-Added Taxes: Lessons Learned from Other Countries on Compliance Risks, Administrative Costs, Compliance Burden, and Transition*, GAO-08-566 (April 2008).

⁸³ Inland Revenue Department (NZ), ‘Options for Strengthening GST Neutrality in Business-to-Business Transactions: An Officials’ Issues Paper’ (June 2008).

⁸⁴ Australian Treasury, *Budget 2018-19: Budget Measures – Budget Paper No. 2* (8 May 2018).

- introducing new phoenix offences to target those who conduct or facilitate illegal phoenixing;
- preventing directors improperly backdating resignations to avoid liability or prosecution;
- limiting the ability of directors to resign when this would leave the company with no directors;
- restricting the ability of related creditors to vote on the appointment, removal or replacement of an external administrator;
- extending the Director Penalty Regime to GST, luxury car tax and wine equalisation tax, making directors personally liable for the company's debts; and
- expanding the ATO's power to retain refunds where there are outstanding tax lodgements.

These arrangements, the author suggests, do not address, directly, the design feature of a VAT/GST system that gives rise to the revenue risks.

Domestic reverse charge

The residential premises withholding tax⁸⁵ is an example of missing trader fraud – non-compliance or evasion that is available because payment of the GST to the Commissioner is not due until (in the case of a quarterly lodger) 28 days after the end of the quarter in which the sale proceeds are received:

... an ATO submission to the 2015 Senate Inquiry on 'Insolvency in the Australian construction industry' ... reported that \$1.8 billion in GST debt had been written off as a result of phoenix activity by property developers ...⁸⁶

It appears from the Taskforce Report that these particular practices with new residential premises are part of a broader malaise.⁸⁷

The GST revenue loss of phoenixing for residential premises is the non-collection of 'output tax'.⁸⁸ The solution is to institute a collection mechanism from the 'recipient' – in the case of residential premises this will often be a consumer or other entity that is not entitled to input tax credits.

Of a similar effect to Subdivision 14-E of the *Taxation Administration Act*, amendments made to the GST law in 2017 impose a GST liability on the 'recipient' of the taxable

⁸⁵ TAA, Sch 1, Subdiv 14-E.

⁸⁶ Robyn Thomas, 'Improving the Integrity of GST on Property Transactions' (2017) 17(3) *Australian GST Journal* 164.

⁸⁷ In the 1980s, the 'bottom of the harbour schemes' involved either: (a) stripping a company of its assets before tax became payable, or (b) using another company as the entity which became liable for tax but ensuring that it never had sufficient assets to pay the money owed. The government's response at the time was to enact the *Crimes (Taxation Offences) Act 1980* (Cth), under which aiding or abetting an arrangement to make a company or trustee incapable of paying its taxation debts was a criminal offence. Penalties for a breach of the Act are currently 10 years' imprisonment or an AUD 100,000 fine.

⁸⁸ In other jurisdictions, the term 'output tax' is defined to be GST payable on taxable supplies: see, eg, *Value Added Tax Act 1994* (UK) s 24(2).

supply of valuable metals.⁸⁹ It is apparent that the arrangements at issue are another instance of ‘phoenixing’ but involve business-to-business (B2B) transactions and, instead of a withholding regime, a so-called ‘reverse charge’ has been adopted.

The Explanatory Memorandum that accompanied the Bill into Parliament explained that:

... This Bill introduces a mandatory reverse charge for taxable supplies between suppliers and purchasers of gold, silver and platinum. This removes the opportunity for fraudulent input tax credit claims by the purchaser and for the supplier to avoid paying goods and services tax (GST) to the Commissioner by liquidating ...

1.5 The objective of the announced changes is to combat ‘missing trader’ ... schemes in the gold industry, which if left unaddressed would continue to present an integrity risk to the GST system ...⁹⁰

The ‘valuable metals’ schemes exploit similar VAT/GST design features to the new residential premises withholding in Subdivision 14-E. In the case of the valuable metal schemes, refunds of input tax credits are claimed but no GST revenue is obtained. The revenue is not depleted by the non-payment of GST, but by the payment of ‘refunds’ out of government funds.

The design feature that gives rise to the revenue loss, in the case of this type of ‘missing trader fraud’, is that payments are made out of government funds for amounts that were never collected as GST revenue.

An example, similar to phoenixing, but without fraudulent intent, is where a business under financial pressure disposes of its assets, either in a fire sale to close up business or in circumstances where assets must be liquidated under pressure from financiers:

- the assets in question may be trading stock, plant and equipment or the whole of the business;
- in the present state of the law, the sale of assets will be a taxable supply (unless it qualifies for GST-free treatment at the election of both parties⁹¹). If the vendor is under financial stress, it may not have the funds to remit the GST on sale (after satisfying claims from creditors). In this situation, the purchaser will have an input tax credit but the vendor will not be able to remit the GST on sale.

To date, the government’s response to these risks is to collect the GST from the recipient of the supply rather than the supplier, but only for supplies of residential premises and valuable metals.

⁸⁹ GST Act, s 86-5 as inserted by *Treasury Laws Amendment (GST Integrity) Act 2017* (Cth).

⁹⁰ Explanatory Memorandum to the *Treasury Laws Amendment (GST Integrity) Bill 2017* (Cth).

⁹¹ To address the position where a financially distressed trader sells a business without remitting VAT from the proceeds, the UK VAT law – in section 5 of Statutory Instrument 1995 No 1268 – provides that the transfer of a business as a going concern is neither a supply of goods nor a supply of services. Unlike the Australian elective GST-free status, the UK treatment applies to any supply falling within the terms of section 5 of the SI, illustrating that it is an integrity measure rather than a concessional measure available on an election of the parties.

The New Zealand Discussion Paper of 2008 suggested that the domestic reverse charge apply to a wide range of transactions:

- going concerns;
- extremely high-value transactions – for example, supplies of goods and services when the value of the transaction exceeds, say, NZD 50 million (excluding GST); and
- improved or unimproved land irrespective of value.⁹²

The EU has authorised its Member States to apply a reverse charge mechanism in relation to domestic B2B supplies of any kind in case of sudden and massive VAT fraud. Member States can also apply the mechanism on an optional and temporary basis.⁹³

The OECD *Consumption Tax Trends 2018* includes a list of EU countries' use of domestic reverse charge under these new and expanding rules.⁹⁴

4.1.2 *Employee vs independent contractor*

ABN vs employee

The holding of an ABN has become accepted as a legitimate differentiator between employment and independent contracting.

The Black Economy Task Force observed:

Many people think the ABN creates a business, rather than it simply registering a business.

There is a widespread belief in the construction industry that having an ABN automatically confers the status of 'independent contractor', regardless of what the working arrangement is. There is also a widespread belief that quoting an ABN, whether it belongs to a hardware store or petrol station, immunises the person doing so from tax consequences or means they cannot be tracked down ...

A national cleaning company even refers job applicants to an accountant to obtain a trust package for a flat fee when incorporation wasn't feasible. ... We have observed misleading websites instructing visa holders to increase their chances of employment by applying for an ABN without consideration to the key requirement of carrying on a business.⁹⁵

For the purposes of this article, the widespread use of ABNs to avoid detection and employee status reduces GST revenue – in some cases because it allows business to assert that they are below the registration threshold and not liable to pay GST on takings – as is evidenced by *Uber BV v Commissioner of Taxation*.⁹⁶

⁹² Inland Revenue Department (NZ), above n 83.

⁹³ OECD, *Consumption Tax Trends 2018*, above n 63, 34.

⁹⁴ Ibid 112, Annex Table 2.A.12 – 'Application of domestic reverse charge and split payment mechanisms'.

⁹⁵ Taskforce Report, above n 75, 246.

⁹⁶ [2017] FCA 110; 104 ATR 901.

Given the strong authority of *ATS Pacific Pty Ltd v Commissioner of Taxation*⁹⁷ to look beyond the contractual structure, it is surprising that when the employee vs independent contractor issue comes before the Courts – eg, the cases of *Qian v Commissioner of Taxation*,⁹⁸ *Private Tutor v Commissioner of Taxation*⁹⁹ and *On Call Interpreters and Translators' Agency Pty Ltd v Commissioner of Taxation (No. 3)*¹⁰⁰ – the Commissioner's position from a GST perspective seems to be mixed.

The necessity to look past the contractual terms was emphasised in the High Court in *Hollis v Vabu Pty Ltd*¹⁰¹ where the Court emphasised that:

- the substance or reality of the relationship needed to be identified;
- the terms agreed between the parties are not of themselves determinative because parties cannot deem their relationship to be something it is not;
- the relationship is to be found not simply from the contractual terms agreed to but by the system operated thereunder and the work practices which establish the 'totality of the relationship';
- the application of a practical and realistic approach is to be adopted and viewed as 'a practical matter'.

The widespread move from 'employee' on Friday night to 'self-employed' on Monday morning would seem to be a significant weakness in the integrity of the taxation system overall.

Disaggregation/arranging

The PBO Report made specific reference to the implications of the 'peer-to-peer' or 'gig' economy.

The design feature of a value added tax that gives rise to a revenue risk from these structures is that, where supplies to households are arranged by intermediaries, if the amount paid by the consumer can be shared between the intermediary and the supplier, GST may not be payable on the part of the price paid to the supplier and/or the intermediary.

Arrangements can be put in place to achieve 'disaggregation' of the arranging function from the underlying supply. When combined with the emergence of an 'independent contractor', the integrity of an employment relationship and its withholding regime is lost.

Platforms such as Amazon, Airtasker, eBay and the Uber structure provide an illustration of how modern technology can facilitate the historical disaggregation or 'peer-to-peer' arrangements and diminish the GST collections.

Examples of the pursuit of this advantage (not always successfully) include:

⁹⁷ [2014] FCAFC 33; 98 ATR 116.

⁹⁸ [2019] AATA 14; 109 ATR 465.

⁹⁹ [2013] AATA 136; 92 ATR 686.

¹⁰⁰ [2011] FCA 366; 83 ATR 137.

¹⁰¹ (2001) 207 CLR 21; 47 ATR 559.

- hairdressers;¹⁰²
- tourism agents;¹⁰³
- Uber;¹⁰⁴
- owner drivers;¹⁰⁵
- brothels,¹⁰⁶ and
- labour hire arrangements.¹⁰⁷

¹⁰² A quick search online shows that in the UK (where the VAT rate is 20 per cent and the registration threshold is GBP 85,000) the practice of disaggregation is widespread – at least in the hairdressing sector. Hairdressers in a salon can be self-employed (rather than employed by the salon owner) and contract in their own right with customers; but to run their business, it is necessary for them to rent the chairs in the salon from the salon owner. Each hairdresser’s turnover is likely to be beneath the turnover registration threshold and, depending on the number of chairs, the salon may also be beneath the threshold. It is merely a matter of dividing the gross takings between salon and hairdressers. The National Hairdressers’ Federation has a standard ‘Independent Contractor Chair Renting Licence Agreement’: H&H Accountants, ‘HMRC Guidelines To Rent A Chair For Hairdressers’, <https://www.handhaccountants.com/news-and-events/hmrc-guidelines-to-rent-a-chair-for-hairdressers/> (accessed 1 July 2020).

¹⁰³ *ATS Pacific Pty Ltd v Commissioner of Taxation* [2014] FCAFC 33. The Full Federal Court found that the purchase and on sale of rights to accommodation and related services by an Australian travel agent was not an ‘arranging’ service but an acquisition and resale of the rights. Edmonds J opined that ‘[i]n determining the character of a supply ... a court is not to be “handcuffed” by the terms embodied in the four corners of the contract, ... What the cases require is that the truth of the matter be sought with an eye focused on practical business affairs, rather than on nice distinctions of the law ...’.

¹⁰⁴ *Uber BV v Commissioner of Taxation* [2017] FCA 110. The case proceeded on the basis that the driver contracts with the passenger and makes the supply of the services. Uber deducts an amount from the passenger’s payment for the use of the Uber app, and pays the driver the excess. From a GST perspective the travel service is provided by the driver; Uber supplies a software package to link the passenger with the driver. Note that the London Employment Tribunal has ruled that Uber drivers are employees and entitled to be paid a minimum wage: see *Mr Y Aslam, Mr J Farrar and Others v Uber BV* [2018] EWCA Civ 2746; *Aslam, Farrar and Others v Uber BV and Others* [2016] Case 2202550/2015 (28 October 2016). An appeal by Uber was dismissed on 10 November 2017 by Her Honour Judge Eady QC: *Uber BV and Others v Mr Y Aslan and Others* [2017] UKEAT/0056/17/DA. See also *O’Connor et al v Uber Technologies, Inc., CA No. 13-03826-EMC (ND Cal.)* whether Uber drivers are employees for the purposes of the California Labor Code; *Independent Workers’ Union of Great Britain (IWGB) and RooFoods Limited T/A Deliveroo* [2017] TUR1/985(2016) in which the drivers of motorbikes and riders of bicycles were held not to be ‘workers’ within the meaning of section 296 of the *Trade Union and Labour Relations (Consolidation) Act 1992* (UK).

¹⁰⁵ *Qian v Commissioner of Taxation* [2019] AATA 14. The applicant supplied his own motor vehicle to undertake ‘subcontract’ courier services to the courier company. Senior Member Taylor commented that there ‘is a significant bias in the authorities in favour of the proposition that an arrangement where a contractor is responsible for the provision, operation and maintenance of a significant piece of equipment that is essential to the remunerated activity (as in the carriage of goods), is best characterised as one of independent contracting ...’.

¹⁰⁶ *HKYB and Commissioner of Taxation* [2018] AATA 4770; 109 ATR 435. The applicant who operated a brothel contended that it was the sex worker who supplied the sexual service to the customer and the operator only supplied the venue. The AAT found (referring with approval to ATS) that ‘the character of a supply made as a result of the performance of the terms of that contract’ was a single supply of a sexual service in a room, not two discrete supplies, sexual service and room, by the sex worker and the applicant respectively.

¹⁰⁷ *CCE v Reed Personnel Services* [1995] STC 588; *Reed Employment Ltd v HMRC* [2011] SFTD 720. The taxpayers provided nurses to hospital clients for work on a temporary basis. The Tribunals found that Reed’s activities did not amount to a supply of staff because Reed did not exercise control over the temps

The arranger as supplier

The disaggregation of services between ‘intermediaries’ and ‘service providers’ involves broader policy and industrial issues than the GST impact. Nevertheless, in GST/VAT regimes there are circumstances where there are examples of the recharacterisation of the services of intermediaries (particularly ones effected by websites and platforms) so that the intermediary is treated as the supplier and the value-added by both service providers and arrangers are brought within the normal GST system.

For example:

- the recent Netflix and low value goods amendments, provide that a supply to an Australian consumer through an electronic distribution platform is made by the operator of the platform (and not the actual supplier) for consideration and in the course or furtherance of the operator’s enterprise. This is the case notwithstanding that the actual supplier might not carry on an enterprise in its own right or might be below the turnover threshold;¹⁰⁸
- Subdivision 153 allows principals and intermediaries to agree that:

*A taxable supply that the principal makes to a third party through the intermediary is a supply that is [made] by the intermediary to the third party, and not by the principal.*¹⁰⁹

Under the UK VAT rules supplies through agents for undisclosed principals are treated as supplies to and by the agent. That is, the arranger is made the supplier;

- section 12-60 of Schedule 1 of the *Taxation Administration Act* provides for an entity that carries on the business of arranging for persons to perform work or services directly for clients to be liable to withhold an amount from payments it makes to an individual in the course of the enterprise. For GST purposes, individuals in receipt of such payments are excluded from the meaning of enterprise. Arguably, the GST law should also provide that the payer be deemed to be the supplier of the services of the individuals to the client.

The recharacterisation of ‘intermediary’ services could be broadened for GST purposes so that supplies made through intermediaries are treated as supplies made to and by the intermediary, regardless of the GST status of the principal.

at any stage, meaning that no control of the worker could pass from Reed to the client. Consequently, Reed made a more limited supply – an introductory service combined with a number of ancillary services (eg, evaluating the worker’s skills, taking references and providing a payments service for the workers). Refer also to Chris Sievers’ comments on these and other cases at <https://chrissievers.com/case-analysis-adecco-uk-ltd-v-revenue-customs-2015-ukfft-600/> (accessed 1 July 2020).

¹⁰⁸ See GST Act, s.84-55.

¹⁰⁹ GST Act, s.153-155. However, s 188-24 allows the intermediary to treat only its ‘commission’ as contributing to its registration turnover.

4.2 Fraudulent/black economy activities

The Black Economy Taskforce identified a number of practices, in addition to those referred to above, that were the cause of revenue losses from non-compliance. For GST in particular, these included:

- fraudulent or erroneous non-reporting, under-reporting or non-payment GST liabilities
- fraudulent or erroneous over-claiming of input tax credit entitlements.

In their seminal work, Professors Vann and Cooper¹¹⁰ observe that the revenue risk of a credit-invoice VAT can be twice as problematic as that under a wholesale sales tax (WST) or RST:

A registered business will always prefer to purchase *at the same price inclusive of GST* from another registered business which charges output tax and provides an invoice rather than from a business which does not charge GST and does not provide an invoice. It is possible in this case that the supplier may not charge GST but provide a fictitious invoice for GST.¹¹¹

In these cases, there is both a loss of GST revenue from the vendor and an underpayment by the purchaser in the tax period of acquisition. Evidence that this is the case can be seen from the Taskforce Report:

Too many people have ABNs although they are not entitled, including tourist visa holders and apprentices, criminal groups hide behind them (when offering illegal labour hire services, for example) and too often they are misquoted ... We have heard many instances of tradesmen who intentionally include the Bunnings' ABN when issuing invoices to customers for the work they complete.¹¹²

The PBO Report noted that:

Increasing self-employment could reduce the proportion of people having personal income tax deducted from their wages and remitted to the ATO by their employer and increase the proportion of people that are required to assess and remit their full tax liability to the ATO themselves.¹¹³

But the government's 2018 Consultation Paper on reform of the Australian Business Number System states:

In 2017, the Black Economy Taskforce ...found that *the ABN system is being used by participants in the black economy to provide a false sense of legitimacy to their business*. ... It is therefore timely to consider whether the ABN system remains fit to support the expanded range of purposes that an ABN is used for today. ...

¹¹⁰ Graeme Cooper and Richard Vann, 'Implementing the Goods and Services Tax' (1999) 21(3) *Sydney Law Review* 337.

¹¹¹ *Ibid* 356 (emphasis in original).

¹¹² Taskforce Report, above n 75, 223.

¹¹³ PBO Report, above n 41, 33.

The holding of an ABN has become an accepted and legitimate differentiator between employment and independent contracting.¹¹⁴

4.2.1 Reporting and deduction – historically speaking

For over 35 years, evasion of taxation obligations in the black/shadow/cash economy has sought to be addressed by a system of withholding and reporting by payers of transactions of specified types.

In 1988, Senior Member P M Roach explained the problem with what he referred to as the cash economy and how the government had sought to address it:

... [The problem of cash economy exists because] there are many in the community who are able to carry out their income-earning activities in such a way as to be able to easily conceal their earnings. ... Because there are a large number of persons in the community who are willing to be dishonest in tax matters, various attempts have been made over a prolonged period to limit the opportunities of the dishonest to defraud the Commissioner to the detriment of the taxpaying community ...¹¹⁵

The Senior Member went on to describe the government's 1983 response to this difficulty:

In 1983 the Commonwealth amended the [1936 Act] [and] introduced what is known as the Prescribed Payments System [PPS]: a system providing for 'collection of tax in respect of certain payments for work'. ... The Prescribed Payments System ... was intended to ensure that something on account of tax would be deducted from all payments made other than to 'employees' on 'salary or wages' so as to ensure, to that extent, funds to the Revenue and to provide some degree of disclosure as to the identity of payees.¹¹⁶

But 20 years ago, the PPS and RPS systems were replaced by the ABN initiative in the ANTS package. A broader reporting mechanism was foreshadowed *but not triggered*. The ANTS White Paper stated that 'the new reporting capability will only be activated if the Government is convinced that it is necessary and then only for a specified period ...'.¹¹⁷

Taxation Payments Reporting System (TPRS)

The 2011-12 Budget foreshadowed the specification of the building and construction industry for the purposes of reporting required under the *Taxation Administration Act*, an initiative that arose as a result of the ATO having identified significant levels of non-compliance by contractors in the building and construction industry.

The taxable payments reporting system (TPRS) commenced on 1 July 2012 for businesses in the building and construction industry which were required to report, to the ATO, all payments to suppliers/subcontractors who provide building services.

¹¹⁴ Australian Treasury, 'Tackling the Black Economy, Designing a Modern Australian Business Number System', Consultation Paper (20 July 2018) 2 (emphasis added).

¹¹⁵ *Case V158*, 88 ATC 1030.

¹¹⁶ *Ibid.*

¹¹⁷ ANTS White Paper, above n 3, 146.

The Taskforce Report provides a quantification of the success when TPRS was introduced in 2012-13 - it raised an additional AUD 2.3 billion in tax liabilities in its first year:

- AUD 265 million from outstanding returns being lodged – 249,000 contractors were found to have outstanding returns;
- AUD 506 million GST – a 6.1 per cent increase in net GST from the industry in a single year;
- AUD 1.128 million PAYG withholding – demonstrates significant under-reporting of wages and concomitant underpayment of personal income tax;
- AUD 357 million pay as you go (PAYG) instalments — an additional 50,306 taxpayers were identified as payees ...

This will not be the total increase as at the time the ATO report these results there were 76,000 contractors who had not lodged returns for that year, 53,000 who had lodged but TPRS reports indicated they had underreported, and 84,000 contractors without an active GST registration that TPRS reports indicated had received payments likely subject to GST.

Amendments made to the *Taxation Administration Act* in 2018 extended the operation of the TPRS to contractors in the courier and cleaning industries.¹¹⁸

The 2018-19 Budget announced the further extension of the TPRS:

The Government will further expand the taxable payments reporting system (TPRS) to the following industries:

- security providers and investigation services;
- road freight transport; and
- computer system design and related services.

The measure will have effect from 1 July 2019 and is estimated to have a net gain to the budget of \$605.8 million in fiscal balance terms over the forward estimates period. In underlying cash balance terms, this measure has a net gain of \$545.8 million over the forward estimates period.¹¹⁹

Despite these developments, from a GST perspective, the TPRS is limited in its application:

- it applies to payees in a limited range of services;

¹¹⁸ TAA, Sch 1, s 396-55 as amended by *Treasury Laws Amendment (Black Economy Taskforce Measures No. 1) Act 2018* (Cth).

¹¹⁹ On 8 March 2019, the Treasury released, for consultation, exposure draft legislation and an explanatory statement dealing with this measure: see *Treasury Laws Amendment (Black Economy Taskforce Measures No. 2) Bill 2018*; Explanatory Statement, *Treasury Laws Amendment (Black Economy Taskforce Measures No. 2) Bill 2018*.

- it applies to payers who derive above a minimum revenue from the same services;¹²⁰
- it does not, generally, apply to supplies of services made to consumers;
- it does not require a deduction from the payment.

The TPRS system could be extended to apply to:

- payees in a broader range of services;
- all payers regardless of whether they supply similar services – and extend to payers as agents or arrangers;¹²¹
- payers that are ‘households’ in relation to building and construction work – similar to the original PPS.

In general, the TPRS concept could be extended to a full reporting of B2B transactions as part of a broad data matching system. E-invoicing and matching is required in limited circumstances in the EU, India and China.

The 2018-19 Budget announced a number of other initiatives coming out of the Taskforce Report:

- the introduction of an economy-wide cash payment limit of AUD 10,000;¹²²
- AUD 318.5 million over four years to implement enhanced enforcement strategy, including mobile strike teams, an increased audit presence, a Black Economy Hotline, improved government data analytics, and educational activities;
- removing tax deductibility of non-compliant payments.¹²³

In addition, valid tax invoices for purchases in selected industries ought to be made mandatory with penalties for both the consumer and supplier for non-issue and non-possession.

5. WHICH WAY TO GO FROM HERE?

The previous sections have examined:

- what objectives were held for GST in 1998?;
- where are we now – were the objectives satisfied?;
- if these objectives have not been satisfied, policy and compliance gaps should be examined.

¹²⁰ Arguably, if UberEats is based on the Uber structure, the amendments will not apply because it is merely an arranger and not the entity supplying the service.

¹²¹ See n 120, above.

¹²² The Budget measure is included in the Currency (Restrictions on the Use of Cash) Bill 2019.

¹²³ The Budget measure was included in Treasury Laws Amendment (Black Economy Taskforce Measures No. 2) Bill 2018, Schedule 1.

This section addresses the ‘where to from here?’ question.

5.1 There is not enough GST revenue for its current purpose

The ANTS White Paper described the overall objectives for GST as being broad-based value added tax to replace wholesale sales tax and provide a *sustainable, reliable and stable* growth tax to the States and Territories for the long term: ‘the objective was to remove the reliance of the States on Commonwealth grants and distorting taxes’.¹²⁴

The PBO and HFE Reports suggest that the declining growth of GST has been due to:

- ‘[t]he change in the consumption mix over time. Since the GST was introduced, households have spent progressively more of their income on goods and services that are exempt from the GST’;¹²⁵
- ‘[p]rices of goods and services exempt from the GST have grown faster than those goods and services subject to the GST. In fact, the volume of consumption subject to GST has remained relatively stable since the introduction of the GST’;¹²⁶
- fluctuations in the savings ratio;¹²⁷
- the increase in participation in the economy by individual or small operators and suppliers who may fall under the GST registration threshold.¹²⁸

In addition to revenue losses from policy gaps and fluctuations in the savings ratio, section 4 identified losses in GST revenue, year on year, from ‘compliance gaps’ – fraud, evasion and deficient design features.

As noted in section 3.2, the government’s response to the HFE Report is that the Commonwealth will increase the ‘GST pool’ by AUD 600 million in 2020-21 and by a further AUD 250 million in 2024-25. The latter is to be ‘indexed to grow in line with GST collections on a permanent basis’.¹²⁹

Essentially, the Commonwealth is reverting to the topping up of the ‘pool’ for distribution between the States and Territories under HFE principles. At the same time, States and Territories are revisiting their penchant for narrowly-based, distortionary and inefficient selective taxes, fees and charges.

At the present time, it is unlikely that the pool will grow to an extent that the Commonwealth’s contributions to it will reduce or cease. And fluctuations in the savings ratio mean that the size of the pool will not be stable from one year to the next.

¹²⁴ Under the IGA, above n 26, the GST revenue would be shared between the States and Territories on HFE principles. It provided for additional untied grants to be made up until the 2002-03 financial year to maintain the States’ budget in no worse position than would have been the case prior to the ANTS reforms. But it was estimated that payments would not be required from 2003-04.

¹²⁵ PBO Report, above n 41, 5.

¹²⁶ Ibid 5.

¹²⁷ Ibid 4-5.

¹²⁸ Ibid 7.

¹²⁹ Morrison, above n 49.

Under the current settings, GST will not be sufficiently stable to sustain the lofty ambitions held for it in ANTS.

5.2 What options are available?

In considering how a future government might respond, there are two significant scenarios to ponder.

Inheriting the legacy of the Howard/Costello ANTS package, a future government must consider the extent and nature of GST's position in State/federal financial relations. Is it preferable to:

- *Scenario 1*: continue to reserve GST revenue for the benefit of the States and Territories?; or
- *Scenario 2*: abandon the reservation of GST 'for the States and Territories' and, instead, revert to funding general purpose grants from consolidated revenue or an income tax sharing arrangement?

From an adequacy of revenues perspective, both scenarios require a re-examination of the design of the GST to address policy and compliance gaps and other inefficiencies. But under scenario 1, the government can only increase the base and rate with the agreement of the States and Territories.

5.2.1 *Scenario 1: revenue for the States and Territories*

Scenario 1 assumes that the Commonwealth/State financial relations structure continues so that GST revenues are to be raised to satisfy State and Territory spending needs in lieu of general purpose grants and distortionary narrowly-based taxes.

The present position is that the Commonwealth has responded to shortfalls in the GST pool by committing to 'top up' payments – effectively general-purpose grants. But the size of the pool is determined by reference to GST revenues compared to what is necessary to achieve HFE guidelines.

This does not have the consequence, at least initially, that the Commonwealth must determine the amount of the distributions to the States and Territories – even the total amount to be distributed.

The political sensitive issue arises because the existing Commonwealth Grants Commission (GCC) process allows a comparison between the per capita proportion of GST revenue and the per capita amount of the GST pool distributed.¹³⁰

Can the prospect of diminishing GST revenues compared to State and Territory requirements be addressed by 'broadening the base' or increasing the rate?

Scenario 1: the political dimension

The date of 8 July 2019 marked 20 years since the GST Act received Assent. While the Rudd Government commissioned a Board of Taxation review of the legal and

¹³⁰ See Australian Treasury, *Budget 2019-20: Federal Financial Relations 2019 – Budget Paper No. 3* (2 April 2019) 80, Table 3.6.

administrative framework of GST, the terms of reference contained the following stark limitation:

In pursuing the reference, the Board should ensure that its consultations and recommendations focus on the legal framework for the administration of the GST as set out in the Tax Administration Act and GST Act. Whilst the Board may consider related issues to the above categories consistent with its terms of reference, its work should not extend to the rate of the GST or the scope and extent of what goods and services are subject to the GST.¹³¹

Under the IGA, changes to the base and rate must have agreement of all States and the Commonwealth Government.¹³²

That is, GST is ‘locked in’ to its present base and rate – and hence, State and Territory revenue potential.

But from a practical point of view, an increase in base or rate is of benefit only to the States and Territories and, in general, any compensation package that offsets increases in prices of items of household consumption will have to come from the Commonwealth.

The Commonwealth wears the political pain and the States the gain.

The political influence that can be marshalled to oppose GST on ‘sensitive’ items is apparent from the removal of GST from sanitary products.¹³³

Perhaps, the possibility of a tax rate and base increase can only be effected under Scenario 2.

5.2.2 Scenario 2: Commonwealth revenue

Addressing the policy gap

Section 3 showed that the top five items of GST tax expenditure in 2018-19 were:

- GST-free food – \$7,300 million;
- GST-free health services, insurance, care, drugs and appliances – \$6,655 million;
- GST-free education and child care – \$6,290 million;
- input taxation of and RITC for financial services – \$4,500 million;
- GST-free water and sewerage – \$1,090 million.

¹³¹ Board of Taxation, *Review of the Legal and Administrative Framework of the Goods and Services Tax: A Report to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs* (December 2008) 94.

¹³² IGA, above n 26, cl 13.

¹³³ A New Tax System (Goods and Services Tax) (GST-free Health Goods) Determination 2018 on 26 November 2018 makes ‘maternity pads, menstrual cups, menstrual pads and liners, menstrual underwear, tampons, and other similar products specifically designed to absorb or collect lochia, menses or vaginal discharge’ GST-free as of 1 January 2019 under s 38-47 of the GST Act.

The total additional GST revenues are AUD 25,835 million, resulting in a proportion to GDP (on 2018-19 forecasts) of 4.5 per cent.

The ABS statistics show that the four items of household expenditure that are *growing at higher rates* than household expenditure are:

- health services, insurance, care, drugs and appliances;
- education and child care;
- financial services;
- water and sewerage.

But food is the single greatest concession.

As the taxation of any or all of these categories (other than financial services) is likely to be regarded as regressive, the reform package would require compensation – no doubt from Commonwealth outlays. In all likelihood this could only be achieved by an expenditure of an equivalent amount through income tax reductions and welfare increases.

But let us consider why these particular elements of household consumption are not fully taxed.

(i) *Food*

While the GST-free treatment of food is the largest GST tax expenditure, its growth as a proportion of household consumption is reasonably stable. On present trends, its inclusion in the tax base would not improve the growth of the GST to GDP proportion of household expenditure.¹³⁴

Nevertheless, there is no technical limitation on its inclusion in the base. If the GST base is to be protected from future shifts in consumption, the GST-free treatment of food should cease.¹³⁵

(ii) *Items identified under the Willie Sutton rule*

As noted above, the four items of *concessionally taxed* household expenditure that are *growing at higher rates* than household expenditure generally, are:

- water and sewerage;
- health;
- education;
- financial services.

¹³⁴ But taxing food at the standard rate would decrease the compliance and administrative risk arising from misclassification and miscalculation (whether in error or by design).

¹³⁵ Bob Deutsch, 'Time to Wean Off the (GST-free) Milk', *Tax Institute blog* (26 July 2018), <https://insights.taxinstitute.com.au/2018/07/written-by-bob-deutsch-senior-tax.html> (accessed 2 July 2020).

The PBO Report opines that the trend on these categories will continue – with the result that GST revenues as a proportion of GDP will decline into the future.

An application of the Willie Sutton rule tells us we should focus on water and sewerage, health, education, insurance and financial services to get the best bang for our buck.

What are the limitations on including these four items in the GST base?

(a) Government provided or subsidised services (water and sewerage, health and education)

The first three areas of expenditure identified above are either government provided or government subsidised. To tax the expenditure (or inputs as is the case in the EU) may result in the increase in State and Commonwealth government outlays (to cover GST on purchases) and an equal increase in GST revenues. This could involve unproductive churning and, in the Australian situation where the GST revenue is shared amongst the States and Territories, contributions to the revenue of some States by other governments depending only upon their relative level of public expenditure.

However, while the GST-free status of subsidised or government provided services can be justified on the grounds that increasing the price may lead to greater subsidies and churning, the accepted theory is that the efficiency of a tax on household expenditure is achieved if the GST system itself does not alter ‘relative prices’.

The heavy government subsidisation of the services in question has the result that any efficiency in household consumption decisions being based on the ‘pricing signal’ has been abandoned.

The favoured model in many other VAT jurisdictions is for these services to be exempt from VAT with the result that VAT is collected on the inputs to the services but, while raising considerable revenue, it is significantly offset by increases in government outlays.

If the quest is for greater revenue, the consequential increase in outlays makes an exemption approach less attractive.

On this view, health and education should be subject to standard rate GST – even at the subsidised price. Taxation should *not* be avoided merely to achieve equal treatment between services for which a price is paid by households and those that are provided ‘free’ of explicit charges. The focus of a consumption tax is on the spending of households irrespective of the character of the item of consumption.

In *Fightback!* and the ANTS White Paper, the view taken was that, if services were provided to the public for free, then it was unfair to subject to GST the private sector provision of the same items of consumption. For health, for example, the ANTS White Paper opined:

The health sector in Australia has significant government involvement through direct subsidy and regulation. Many health services are provided to patients free of any direct charge or by means of a co-payment that is a fraction of the total cost of providing the service.

Applying taxes to health care would place the private health sector, with its heavier reliance on direct fees, at a competitive disadvantage with the public health system.¹³⁶

Taxing health and education would not appear to be a politically attractive proposition – nor would it be favoured by the States and Territories.

(b) Water and sewerage: further considerations

In addition to the ‘subsidised service’ issue discussed above, the ANTS White Paper chose GST-free treatment applying generally to taxes and charges levied at all levels of government (including local government rates and water and sewerage rates and charges).¹³⁷

(c) Financial services

The *Tax Benchmarks and Variations Statement 2018* estimates that the exemption of financial services is the fourth largest GST expenditure.

The argument for the input taxation of financial services is that it is technically difficult to include financial intermediation services in the invoice credit, transaction-based method employed by a value added tax.

The application of GST is difficult because a financial institution’s service charge is often an implicit fee, margin or spread arising from financial transactions entered into by the institution over a period of time with a number of customers.

In 2015, the then Premier of South Australia proposed that a tax equivalent to GST be collected on the household consumption of financial services— a ‘supplementary financial tax’.¹³⁸

Confronted with the prospect of the consumption of financial services increasing as a proportion of HFCE, and GST’s diminishing proportion of GDP, action to address the under taxation of financial services would be of benefit both economically and improve the security of the State and Territories’ revenue stream.

The SFT Report discussed a number of approaches to impose a ‘GST equivalent tax’ on financial intermediation services.

Essentially, the SFT Report recommended:

- retaining the existing margin-based GST approaches to gambling and insurance;
- imposing a ‘margin-based supplementary financial tax’ on margin-based financial services including fees charged for margin-based products;

¹³⁶ ANTS White Paper, above n 3, 93.

¹³⁷ *Ibid.*

¹³⁸ Taxsifu, ‘GST Equivalent Taxation of Financial Services (Supplementary Financial Tax)’, paper prepared for the South Australian Department of Premier and Cabinet [2015], <http://taxsifu.com.au/wp-content/uploads/2015/09/SADPC15-GSTfinancialservices-0914final.pdf> (SFT Report). See also Michael Evans, ‘GST Equivalent Taxation of Financial Services (Supplementary Financial Tax)’ (2017) 17(3) *Australian GST Journal* 121.

- the SFT payable under margin-based method be adjusted by either:
 - (a) reducing the aggregate margin for a period to take account of the proportion of business done with other registered taxpayers or as exports; or
 - (b) applying a reduced rate to the aggregate margin for a period to reflect the proportion of margin on B2B and exported supplies;
- the SFT charged using a margin base be accompanied by full relief under the normal GST system for input tax on purchases of goods and services. Under the present legislative structure, this might be achieved by either:
 - (a) removing ‘financial supplies’ from the definition of ‘input taxed supplies’; or
 - (b) treating ‘financial supplies’ as non-supplies.

Further, as an illustration that there are alternative taxes that can be applied for ‘difficult to tax’ items of household expenditure, Chris Murphy has modelled an economic rent tax to raise approximately equivalent revenue to the SFT suggested in the SFT Report: ‘[t]he economic assessment finds that, per dollar of revenue raised, the economic rents tax does no economic harm, with moderate harm from full taxation under the GST...’¹³⁹

As one would expect, however, the lure of collecting tax on the value added by financial institutions has not been lost on all governments.

In July 2017 the Commonwealth introduced a financial services charge under the *Major Bank Levy Act 2017*. It applies to authorised deposit-taking institutions (ADIs) with total liabilities of greater than AUD 100 billion. The levy is imposed at an annual rate of 0.06 per cent on around 75 per cent by value of the liabilities of the ADIs.

The purpose of the major bank levy is as a means of raising revenue from the financial services sector. It is estimated that the major bank levy will contribute around AUD 1.5 billion to Commonwealth revenue on an annual basis.¹⁴⁰

Nevertheless, even with the major bank levy attacking the profits of the banks, on the basis of the *Tax Benchmarks and Variations Statement 2018*, in 2018-19 there is still another AUD 3 billion in GST revenue available for the States and Territories if the input taxation of financial services was to be removed.

The rate

As noted in section 3.4.3, of the 37 OECD nations, only the United States does not have a value added tax. The standard rates vary from 7.7 per cent (in Switzerland) to 27 per cent in Hungary. The OECD average is 19.2 per cent.

At 10 per cent, only Japan and Switzerland have a lower standard rate than Australia.

But international comparisons are difficult and taxation systems vary in their taxation incidence and welfare arrangements.

¹³⁹ Chris Murphy, ‘GST and How to Tax Australian Banking’ (2017) 17(2) *Australian GST Journal* 84, 84.

¹⁴⁰ *Ibid* 94.

New Zealand increased its 12.5 per cent rate to 15 per cent from 1 October 2010.

The Inland Revenue Department explained the change as follows:

The rate of goods and services tax (GST) will increase from 12.5% to 15% from 1 October 2010, as part of a switch in the tax mix from income tax to consumption tax announced in Budget 2010. The GST rate was last increased in 1989.

New Zealand relies heavily on income taxes in order to fund expenditure. Income taxes may, however, be harmful for efficiency and growth. Taxes on consumption, such as GST, tend to be less harmful to growth as, unlike income taxes, they do not apply to savings and, therefore, do not discourage this activity. A switch from income tax towards GST can, therefore, boost incentives to save and encourage economic growth.¹⁴¹

Under Scenario 1 above, because of Australia's State/Commonwealth financial relations it would seem unlikely that an increase in GST revenues could be based on a tax mix switch in the same way as in New Zealand. In any event, the lessons of 1993 illustrate that higher rates on narrow bases do not overcome the issue of shrinking revenues. The shortfall reappears later on.¹⁴²

But under Scenario 2 above, a return to untied grants from consolidated revenue would open the option for an increased reliance on GST.

It seems that, if GST revenues are to be increased, the base must first become stable and then attention can be paid to the rate.

In addition, it is likely that, under Scenario 1, only a portion of the revenue would be reserved for the States and Territories.

5.3 Broadening the base from here (policy gaps)

The recommendations from the considerations discussed in section 5.2 are:

1. the GST-free treatment of food should cease – \$7.3 billion;
2. taxing health, education and water and sewerage would not appear to be a politically acceptable proposition for the States and Territories;
3. the input taxation of financial services and the major bank levy should cease and be replaced by a supplementary financial tax – \$4.5 bn.

These reforms would, on the basis of the *Tax Benchmarks and Variations Statement 2018* numbers, raise an additional AUD 11.8 billion in GST. Using the 2018-19 estimates as a base, these reforms would increase GST to approximately 4 per cent of GDP in 2018-19.¹⁴³

¹⁴¹ Inland Revenue Department (NZ), 'Special Report: Guide to the Tax Changes Proposed in the Taxation (Budget Measures) Bill: GST Rate Increase' (May 2010), taxpolicy.ird.govt.nz/publications/2010-sr-budget2010-special-report/gst-rate-increase (accessed 2 July 2020).

¹⁴² ANTS White Paper, above n 3, 77-78.

¹⁴³ Australian Treasury, *Budget 2019-20: Budget Strategy and Outlook – Budget Paper No. 1 2019-20*, above n 51, 4-5, 4-17.

5.4 Addressing the compliance gap

Section 4 identified a number of losses in GST revenues arising from fraudulent and avoidance activities and design inefficiencies. There is no quantification of the revenue that might arise from addressing these weaknesses in the GST system. Fraudulent or avoidance activities giving rise to losses in GST revenues include:

- missing trader fraud;
- independent contractor vs employee status, including sham contracting;
- disaggregation of single supplies, eg, separating arranging from the underlying supply;
- fraudulent or erroneous non-reporting, underreporting or non-payment GST liabilities;
- fraudulent or erroneous overclaiming of input tax credit entitlements

To address these issues, GST design changes are suggested as set out below

5.4.1 *Missing trader fraud*

The revenue risk from missing trader fraud should be addressed by a mandatory domestic reverse charge to include:

- going concerns;
- high value transactions (eg, > AUD 10,000,000);
- business assets as part of a cessation of a business;
- sales of land in general;
- industry sectors where there is evidence of non-compliance sufficient for TPRS reporting to be required. For example, in many EU Member States, a domestic reverse charge applies to ‘the supply of construction work, including repair, cleaning, maintenance, alteration and demolition services in relation to immovable property’.¹⁴⁴

5.4.2 *Independent contractor vs employee*

It appears that the Commissioner is prepared to be more forceful when the matter at issue is to benefit a meritorious ‘employee’ (as in *On Call Interpreters* where superannuation guarantee charge (SGC) was at issue) but resorts to simpler solutions when the matter is mere input tax relief.

The integrity risk requires reforms to the ‘employee’ definition to ensure that in substance ‘contracts of service’ are treated consistently for all taxation and regulatory purposes.

¹⁴⁴ OECD, *Consumption Tax Trends 2018*, above n 63, 112-113, Annex Table 2.A.12.

Options worthy of consideration are:

- extension of the ‘employee’ definition to the situations covered by the ‘personal services income measures’ in Division 85 of the *Income Tax Assessment Act 1997* (Cth);
- reforming the ABN rules;
- extending the TPRS to any payer with an ABN that acquires the relevant service, including an entity that pays an affected contractor as an agent for another.

5.4.3 *Disaggregation of single supplies, eg, separating arranging from the underlying supply*

The design feature of a value added tax that gives rise to a revenue risk from these structures, where supplies to households are arranged by intermediaries, were discussed in section 4.

While the disaggregation of services between ‘intermediaries’ and ‘service providers’ involves broader policy and industrial policy issues than the GST impact, in GST/VAT regimes there are circumstances where there are examples of the recharacterisation of the services of intermediaries (particularly ones effected by websites and platforms) so that the intermediary is treated as the supplier and the value added by both service providers and arrangers are brought within the normal GST system.

For example:

- the recent Netflix and low value goods amendments provide that a supply to an Australian consumer through an electronic distribution platform is made by the operator of the platform (and not the actual supplier) for consideration and in the course or furtherance of the operator’s enterprise. This is the case notwithstanding that the actual supplier might not carry on an enterprise in its own right or might be beneath the turnover threshold.¹⁴⁵
- Division 153 allows principals and intermediaries to agree that:

*‘A taxable supply that the principal makes to a third party through the intermediary is taken to be a supply that is a taxable supply [made] by the intermediary to the third party, and not by the principal’.*¹⁴⁶

Under the United Kingdom VAT rules supplies through agents for undisclosed principals are treated as supplies to and by the agent: that is, the arranger is made the supplier.

- section 12-60 of Schedule 1 of the *Taxation Administration Act* provides for an entity that carries on the business of arranging for persons to perform work or services directly for clients to be liable to withhold an amount from payments it makes to an individual in the course of the enterprise. For GST purposes, individuals in receipt of such payments are excluded from the meaning of

¹⁴⁵ See GST Act, Divs 84-85. See n 108, above.

¹⁴⁶ GST Act, s 153-55. Cf s 188-24, which allows the intermediary to treat only its ‘commission’ as contributing to its registration turnover.

enterprise. Arguably, the GST law should also provide the payer be deemed to be the supplier of the services of the individuals to the client.

The recharacterisation of ‘intermediary’ services could be broadened for GST purposes so that supplies made through intermediaries are treated as supplies made to and by the intermediary, regardless of the GST status of the principal.

5.4.4 *Other evasion/avoidance practices*

Reporting and deduction systems

Despite being extended on three occasions to cover seven industry sectors, the TPRS is limited in its application:

- it applies to payees in a limited range of services;
- it applies to payers who derive above a minimum revenue from the same services;
- it does not, generally, apply to supplies of services made to consumers;
- it does not require a deduction from the payment;
- a domestic reverse charge is not required.

The TPRS system should be extended to apply to:

- payees in a broader range of services;
- all payers regardless of whether they supply similar services – and extend to payers as agents or arrangers;
- payers that are ‘households’ in relation to building and construction work – similar to the original PPS.

In general, the TPRS concept could be extended to a full reporting of B2B transactions as part of a broad data matching system. E-invoicing and matching is required in limited circumstances in the EU, India and China.

And, if a sector’s compliance is found to be poor enough to warrant reporting, consideration should be given to instituting a reverse charge.

As noted in section 4.2.1, the 2018-19 Budget announced a number of other initiatives coming out of the Taskforce Report:

- the introduction of an economy-wide cash payment limit of AUD 10,000;¹⁴⁷
- AUD 318.5 million over four years to implement enhanced enforcement strategy, including mobile strike teams, an increased audit presence, a Black Economy Hotline, improved government data analytics, and educational activities;

¹⁴⁷ See n 122, above.

- removing tax deductibility of non-compliant payments.¹⁴⁸

In addition, valid tax invoices for purchases in selected industries ought to be made mandatory with penalties for both the consumer and supplier for non-issue and non-possession.

6. ALTERNATIVES TO GST

The discussion in the previous sections has brought us to a question of whether a different form of consumption tax might:

- facilitate the inclusion of a more complete measure of household consumption to be subject to tax; and
- be less susceptible to fraud and evasion.

The Henry Review explains the choice of a tax on consumption as follows:

For the tax system to support Australia in making the most of the opportunities and meeting the challenges of the 21st century, it needs to raise revenue from efficient and sustainable tax bases. One of the most efficient and sustainable tax bases is consumption. A tax on consumption does not tax the normal return to capital, encouraging investment and saving. From a macroeconomic perspective, consumption is generally less volatile than income or wealth, and therefore provides a more stable revenue source. As the population ages, an indirect broad-based consumption tax is likely to become increasingly important, since it taxes the capital income of retirees as it is spent, which might otherwise largely be untaxed under an income tax ...

A broad-based consumption tax is one of the most efficient taxes available to governments ... For a small open economy, investment is likely to be more mobile than consumption, suggesting economic growth is likely to be higher by shifting away from taxes levied on investment. Further, a single-rate consumption tax does not distort the timing preferences of consumption for individuals. The same tax is paid regardless of whether a person consumes now or in the future, imparting no bias for or against saving.¹⁴⁹

The consumption taxes that are discussed in this section are:

- a direct expenditure tax;
- a value added tax;
- a retail sales tax;
- a hybrid GST;
- a cash flow tax

¹⁴⁸ See Treasury Laws Amendment (Black Economy Taskforce Measures No. 2) Bill 2018 (Cth), Schedule 1.

¹⁴⁹ Henry Review, above n 11, Pt 2, Vol 1, 273-274 (emphasis added).

6.1 Direct expenditure tax

The Henry Review discussed the direct expenditure tax and concluded that there would be few benefits and significant difficulties in implementing a direct consumption tax in Australia:

While consumption taxes are usually levied indirectly on the sale of goods and services, a consumption tax can also be levied as a direct tax. This can be achieved by taxing personal expenditure (that is, exempting income that is saved) or through a pre-paid consumption tax (which taxes only labour income, and exempts earnings from savings).

Nearly all countries pursue consumption taxation through taxes on goods and services. Personal expenditure taxes were implemented briefly in India and Sri Lanka in the 1960s and 1970s ... but the worldwide trend since then has been to tax consumption through indirect taxes such as the value-added tax ...¹⁵⁰

6.2 Retail sales tax (RST) vs value added tax (VAT)

There is debate in the literature about the superiority of a VAT over an RST. Much of it focuses on compliance costs and advantages.

The reference to an RST in the discussion below relates to a tax on turnover (whether on a transaction-by-transaction basis or aggregated). The difference from a VAT is that:

- under an RST, a B2B sale is not taxed; but
- under a VAT it is taxed but the business purchaser is entitled to a credit for the VAT paid on the purchase.

A New Zealand paper on goods and services tax of March 1985 stated:

The main options which deserve consideration as a means of reforming present indirect taxes are broadly:

1. *Retail sales tax*, which is used predominantly in North America ...
2. *Value-added tax*, which operates at each stage of production and distribution, using a *credit-invoice* system. GST is a tax of this type. The tax is comprehensive, well suited to taxing consumption expenditure without the economic disadvantages inherent in other tax systems.¹⁵¹

Compliance and administration costs and integrity

The discussion of the relative merits of an RST or VAT involves measures of integrity and compliance and administration costs.

In theory, the breadth of the base – and hence the policy gap – is not altered. The New Zealand, *Reform of the Australian Tax System* and ANTS discussion papers did not distinguish a value added tax from an RST from the perspective of the breadth of the

¹⁵⁰ Ibid 274.

¹⁵¹ Office of the GST Launch Co-ordinator (NZ), *GST, the Key to Lower Income Tax* (March 1985).

base – although Ebrill et al expressed the view that ‘in practice, it is hard to ensure that RST does not fall on business inputs’.¹⁵²

In both an RST and VAT, a system of ‘private use’¹⁵³ adjustments is necessary for purchases for which quotation has been given or credit has been claimed.

(i) *VAT is collected along the way*

The preference (in 1985) in the New Zealand GST was for a value added tax, predominantly because of the concern of the integrity of a single stage tax at the retail level. However, the identical nature of the tax base – being private final domestic consumption expenditure - is evident from comments made in the 2008 New Zealand Discussion Paper:

1.8 The ideal consumption tax system would ensure perfect neutrality for both businesses and the government in business-to-business transactions. Perfect neutrality would be achievable in practice if GST did not apply at every stage of production and distribution but applied only at the point of final consumption, as happens with retail sales taxes.¹⁵⁴ However, retail sales taxes are more likely to be exposed to evasion than is GST because of the opportunity for goods and services to be untaxed if acquired by consumers from wholesalers, importers or other providers who are not identified as ‘retailers’.

1.9 The trade-off associated with the government preferring GST over a retail sales tax is the challenge of ensuring that business neutrality is achieved to the greatest extent possible ...¹⁵⁵

The conclusion in the New Zealand Discussion Paper is in keeping with the general view that *a value added tax is superior because, in a retail sales tax, all the revenue is lost if the retailer does not account for the tax on sale*. It is argued that, because tax on the value-added is collected at each step of the production and distribution chain, it is only tax on the retail margin that is lost.

(ii) *But is it?*

Both Tait¹⁵⁶ and the *Reform of the Australian Tax System* Draft White Paper counter that a retailer might claim credits on all purchases and not remit the tax on sale (as is the case with the phoenix arrangements).

The *Reform of the Australian Tax System* Draft White Paper preferred a broad-based consumption tax (BBCT) – a retail sales tax and not a value added tax – essentially covering the same base as the value added tax (GST) implemented 15 years later:

The situation is more complicated than this. It is true that the net liability which the retailer faces under a VAT is significantly lower than his liability under an equal rate BBCT. However, the possible tax evaded at the retail stage could be the same under either tax. Under either a VAT or BBCT the evader is likely to

¹⁵² Ebrill et al, above n 14, ch 3.

¹⁵³ Including input taxed use such as financial services and residential rent.

¹⁵⁴ GST and sales taxes are generally economically equivalent when they function perfectly.

¹⁵⁵ Inland Revenue Department (NZ), ‘Options for Strengthening GST Neutrality’, above n 83.

¹⁵⁶ Tait, above n 14, 19.

obtain his purchases tax free (by refund under the former and quotation under the latter) and understate his sales ...

Under a VAT, business may be able to marginally overstate claims for credit for purchases and marginally understate tax liabilities without arousing suspicion; as this can be done at every link in the production and distribution chain, the overall effect could be significant. It is possible that the opportunities for tax evasion under a VAT are greater than under a BBCT simply because more taxpayers are involved.¹⁵⁷

The authors of *The Modern VAT*¹⁵⁸ are moderate in their assertions about the strength of the value added tax credit-invoice system.

The alleged 'self-enforcing' feature of the invoice-credit VAT – the notion that the purchasers will help enforce the VAT as a consequence of their interest in obtaining a proper invoice from their suppliers – is not as important in practice as sometimes has been argued: purchasers do not care, for instance, whether tax has been paid by their suppliers, only about the acceptability to the authorities of the invoices they hold. There is evidently a potential problem in the claiming on the basis of fraudulent invoices.¹⁵⁹

Nevertheless, Ebrill et al, having canvassed both opinions, conclude in favour of a value added tax – at least at rates above 10 per cent:

The collection of revenue at many points under the VAT rather than simply at the final stage under the RST renders the RST much more vulnerable to evasion – while the RST may work at low rates (5-10%) at higher rates it proves too vulnerable. ... There are of course those who argue for the superiority of the RST over the invoice-credit VAT.¹⁶⁰

The ANTS White Paper preferred a value added tax approach:

In supporting an international preference for a value-added tax it is contended that the multi-stage, credit offset approach of the value-added tax creates an audit trail by attaching the tax liability to each transaction, 'making it legally and technically ... superior'.¹⁶¹

But the prevalence of missing trader fraud in value added tax systems and the increasing use of the reverse charge mechanism would indicate that the much-lauded advantage of VAT's audit trail and multiple collections is, in the modern economy, becoming its Achilles' heel.

At the commencement of GST, Professors Vann and Cooper made the following observations about the ability of a value added tax to deal with the black economy:

¹⁵⁷ Australian Treasury, *Reform of the Australian Tax System: Draft White Paper*, above n 14, 131.

¹⁵⁸ Ebrill et al, above n 14, 23.

¹⁵⁹ See Lent et al, above n 14, which provides early recognition of the limits of self-enforcement.

¹⁶⁰ Zodrow, above n 14, 435, states that '... although ... some of the advantages of the VAT have been exaggerated by its proponents, it seems difficult to argue that the VAT is not, on balance, superior to the standard RST'.

¹⁶¹ Tait, above n 14, 18-19.

... A moment's thought will make it clear that the GST is potentially more prone, not less, to evasion than a WST or RST. The latter taxes involve only one cash flow of tax, and this cash flow is deferred until a single transaction occurs. Thus the usual form of evasion under a RST or WST is that the seller of goods will charge the tax to the buyer ... and not remit the tax ... to the government. The GST on the other hand, involves two cash flows – the refund of input tax credits, as well as the charging of tax on sales. This makes GST vulnerable to a further kind of evasion – the claiming of input credits for tax on fictitious acquisitions. The analogy with the income tax is evident – income tax taxpayers, like GST taxpayers, but unlike WST or RST taxpayers, can cheat by overstating their deductions as well as under-reporting their sales income. And, again unlike the WST or RST, the GST puts this temptation in the face of every commercial firm and for every transaction they undertake (or do not undertake), not just a few.¹⁶²

And, as for the refund of surplus input tax:

Where the tax credits in a tax period exceed the GST on the taxable supply of goods and services in that period by a registered person, the excess tax credits give rise to a refund ... This refund system is particularly important in the case of capital goods if the integrity of the tax as a consumption-type is to be maintained, but equally, it is one of the major weak points from an administrative viewpoint. It assists fraudulent claims that are only detected after the horse, in the form of the refund, has bolted. New Zealand is said to have suffered in this way at the hands of a number of UK criminals in the early days of its GST. What is clear is that whatever level of compliance with the GST is achieved, is brought about through the skill and diligence of the tax administration in conducting the usual processes of audit, document checking and so on, aided (or perhaps hindered) by a mountain of additional paper created by the tax.¹⁶³

And the 'self-enforcing' argument:

On the other hand, a claim is often made for the superiority of the GST over RST and WST, because each business will be looking over the shoulder of every other business to ensure that they pay their GST, so that a purchaser from the business can get GST credits on its inputs (often referred to as the 'self-enforcing nature' of the GST). Again these assertions depend very much on the assumptions about pricing, and parties to transactions that underlie them. A registered business will always prefer to purchase *at the same price inclusive of GST* from another registered business which charges output tax and provides an invoice rather than from a business which does not charge GST and does not provide an invoice. It is possible in this case that the supplier may not charge GST but provide a fictitious invoice for GST as just noticed. But such behaviour will be difficult to sustain over a long period for ordinary sales, if regular audits of on-going businesses are in place as is intended in Australia. This is why such fraud is likely to arise around large one-off transactions such as purchase of large capital items, since a single fraudulent invoice can generate a large tax

¹⁶² Cooper and Vann, above n 110, 356 (footnote omitted).

¹⁶³ Ibid.

refund, and in the early stage of implementation of the GST before audit coverage is fully in place. In this case it is more likely, however, that no actual transaction at all occurs, but a fraudulent invoice for a non-existent sale is used to claim a refund.

If the GST evading supplier discounts the GST-inclusive market price by the amount of the GST, the registered business purchaser will generally be indifferent. So too the ATO may not be overly concerned as the tax lost on this purchase will be made up for on the next sale in the chain. If, however, the GST evader is supplying to a consumer and not to another registered business, the evaded tax is lost forever. If the evader uses few taxed inputs (as is common in the services sector), there is little incentive to register to recover input tax. Hence the GST is as prone to evasion in household services (cleaning, plumbing, electrical, repairs etc) as other taxes. It may also lead to evaders specialising in this area and not making supplies to registered businesses, or alternatively charging tax on supplies to registered businesses but not households and seeking to allocate all input tax to the supplies to businesses.¹⁶⁴

The value added tax system design makes it susceptible to fraud but can the design rules be improved to address its weaknesses?

6.3 Hybrid GST

It is worth considering why a value added tax is designed as a tax paid by the merchant on the price paid to him/her by the consumer.

The explanation, no doubt, is that to require the consumer to remit tax on their own expenditure is not likely to be:

- politically acceptable; and
- practically workable.

But, as discussed in section 4, a value added tax is merely a collection mechanism for tax payable on household consumption expenditure. A lesser number of tax collectors is a good thing from a compliance and administration point of view.

It is, in effect, a withholding tax collected by the merchant for the tax burden intended to be suffered by his or her customer.

Can the GST system be modified to manage the risks described by the Professors Cooper and Vann consistent with the concept that GST is merely a tax collected by a payee on expenditure incurred by a payer?

6.3.1 Reverse charge

While GST was not within its terms of reference, the Henry Review found:

An alternative proposal would be to allow businesses to agree to reverse charge a greater number of transactions Making greater use of reverse charging would have cash flow benefits for the purchasing business. However, the

¹⁶⁴ Ibid 356-357.

reverse charge approach would not remove the compliance costs associated with identifying business-to-business transactions.

Reverse charging would be similar in effect to a retail sales tax, as some transactions within the supply chain would be excluded from GST, provided that the recipient is registered for GST ...

This approach might reduce some compliance costs associated with the current GST system. It also reduces the risk to revenue of paying input tax credits where no GST has been paid. ... This would be of particular benefit in relation to large, infrequent transactions.¹⁶⁵

The Henry Review recommended:

The government should consider making greater use of GST-free business-to-business transactions or reverse charging, provided the potential compliance cost savings outweigh the additional complexity costs and risks to revenue.¹⁶⁶

The discussion in earlier sections illustrates that the increasing use of the reverse charge on B2B transactions is a less risky way of ensuring that GST liabilities and credits are offset in the reporting obligations of the one entity – the payer. This avoids the risk of unfunded refunds.

And the Subdivision 14-E residential premises withholding tax is a mechanism to put the GST obligation on the party on which it is intended that the tax burden lies.

As discussed above, a broadening of the reverse charge mechanism should be undertaken.

6.3.2 *Employee/arranger provisions*

The discussion of intermediaries in previous sections and the tendency to adopt Friday night and Monday morning contractor arrangements supports the view that the GST liability for supplies that are arranged (or subcontracted) should fall on the entity ‘arranging’ for the supply to be made to the customer and managing the payment from the customer.

In *Asociación Profesional Elite Taxi v Uber Systems Spain, SL* (Case C-434/15), the Advocate General recommended that:

Uber’s activity must be viewed as a whole encompassing both the service of connecting passengers and drivers with one another by means of the smartphone application and the supply of transport itself, which constitutes, from an economic perspective, the main component. This activity cannot therefore be split into two, for the purpose of classifying a part of the service as an information society service. Consequently, the service must be classified as a ‘service in the field of transport’.¹⁶⁷

In Australia’s own *ATS case*, the Full Federal Court stated:

¹⁶⁵ Henry Review, above n 11, Pt 2, Vol 1, 290.

¹⁶⁶ *Ibid* 291.

¹⁶⁷ Case C-434/15, Opinion of Advocate General Szpunar, ECLI:EU:C:2017:364 (11 May 2017).

In determining the character of a supply – what was really supplied? – pursuant to performance of an executory contract, a court is not to be ‘handcuffed’ by the terms embodied in the four corners of the contract, the more so if those terms and conditions do not represent all the terms and conditions of the contract; or where the contract is but one link in a chain of contracts, the performance of each being related to, if not dependent on, performance of the immediately preceding contract; or where, by reference to the factual matrix of the entirety of the arrangements, the commercial or practical reality points to the conferral or provision of a supply which goes beyond the conclusion that might otherwise be drawn from a confined analysis of the terms and conditions of one contract in that chain ...¹⁶⁸

And referring to Burdett J in *Thorpe Nominees Pty Ltd v Federal Commissioner of Taxation*,¹⁶⁹ it was stated that:

Practical reality is not a test so much as an attitude of mind in which the court should approach the task of judgment. Reality, like beauty, is often in the eye of the beholder What the cases require is that the truth of the matter be sought with an eye focused on practical business affairs, rather than on nice distinctions of the law. So the exactness which the lawyer is prone to seek must be consciously set aside; indeed, with respect to a choice between various contributing factors, it cannot be attained. The substance of the matter, metaphorically conveyed when we speak of the source of income, is a large view of the origin of the income – where it came from – as a businessman would perceive it.¹⁷⁰

The legal distinction between subcontractor, employee and arranging/labour hire is a weakness in the indirect tax system which has as its central design feature the identification of the ‘entity’, ‘enterprise’ and ‘supply’ concepts.

In the consideration of the reforms to GST in section 5, broad amendments to treat an ‘arranger’ as a supplier have been suggested.

A ‘hybrid’ GST could involve reshaping these core concepts to strengthen the collection mechanisms.

6.3.3 *Difficult to tax items*

Residential property and financial intermediation are difficult to tax under the transaction-based invoice credit VAT scheme.

But as the discussion above in relation to financial services suggests, a supplementary tax can be applied to the same ‘price’ without the complexities of the value added tax regime.

A land tax, for example, could be applied to the improved value of owner-occupied housing to collect the equivalent of GST on imputed rent.

¹⁶⁸ *ATS Pacific Pty Ltd v Commissioner of Taxation* [2014] FCAFC 33.

¹⁶⁹ (1988) 19 ATR 1834.

¹⁷⁰ *Ibid* 1846.

6.4 Cash flow tax – the direct subtraction method

The main complexity and risk with the VAT and RST are that they are transaction-based, with a mechanism to relieve tax cost of intermediate production on a transaction by transaction basis.

A cash flow tax (suggested in the Henry Review) ‘focuses on taxing entities, rather than outputs’.¹⁷¹

The Henry Review suggested a direct subtraction tax:

- consumption is potentially an efficient and sustainable tax base;
- consumption taxes can be levied directly on individuals by taxing only wages or allowing deductions under income tax for savings, or indirectly by taxing sales of goods and services that individuals buy;
- while Australia’s main consumption tax – the indirect invoice-credit GST – is an efficient tax relative to most other taxes levied in Australia, its design is complex;
- another means of taxing consumption would be to tax the difference between businesses’ cash inflows and outflows (excluding wages from outflows; that is, the value-add of labour would be taxed).¹⁷²

The Henry Review suggested that an alternative to the credit-invoice value added tax should be considered:

- under the ‘direct subtraction’ method ... the tax applies to cash receipts after payments (excluding payments for the labour services of employees) are subtracted;
- the direct subtraction method is the simplest and likely to be the most consistent with the needs of a modern economy, as it can run off standard business cash flow management practices;
- unlike the transaction-based GST that taxes goods and services, the CFT is based on accounts. ... Rather than adding up tax payable or refundable for each individual sale or acquisition (as necessary for an invoice-credit GST), a taxpayer would apply a single rate of tax to their net cash flow position. The broader the cash flows included in the base, the simpler the tax is for those in the system.¹⁷³

Some adjustments would be made in calculating the ‘net amount’ for a period that is subject to tax. For example:

- removing cash flows associated with financial services;¹⁷⁴

¹⁷¹ Henry Review, above n 11, Pt 2, Vol 1, 273.

¹⁷² Ibid.

¹⁷³ Ibid 279.

¹⁷⁴ The consumption of financial services would be separately taxed under an additive method.

- removing cash receipts from exports.

The Henry Review suggested refunds would be paid where there was a negative cash flow in any period.

The inference is that a cash flow tax could be adopted on a broader base than the GST. Accordingly, business and government operating in ‘sensitive areas’ could be brought within the same ‘cash flow tax’ system without overtly placing a tax liability on the items produced.

Removing the transaction-by-transaction reporting would simplify compliance and administration because the focus would shift to aggregates in the accounts – much the same as income tax.

Limitations

While not covered in the Henry Review, it is possible that sales from offshore would not be brought within the cash flow tax system. The regime instituted in July 2017 and 2018 might not be able to be utilised for suppliers that are not established in Australia.

The ‘cash flow’ approach would not calculate the appropriate ‘value added’ for financial services and rents – two of the ‘difficult to tax’ areas in VAT or RST. But other ways of raising equivalent amounts of tax through alternative mechanisms can be adopted.

In addition, while the ‘self-enforcing’ character of a value added tax may be exaggerated, the cash flow method, of itself, is a self-assessment and declaration regime. As such it is susceptible to fraud in both overstatement of outlays and receipts.

A cash flow consumption tax has the potential to overcome the policy gap by focusing on ‘entities’ rather than goods and services; but under the cash flow system the common difficulties of consumption taxation persist:

- *government subsidised services*: it would appear that the cash flow tax would require both subsidies as well as explicit fees to be brought to account as revenue against which all costs can be claimed. Given the large value of grants and subsidies in the education and health sectors, there are considerable cash flow and churning inefficiencies in the ‘full tax’ approach. The alternative would be to exclude subsidies and grants from the calculation – giving rise to large and ongoing refunds, as is the case under the GST;
- *the proper taxpayer*: the stated advantage of the cash flow approach is that it focuses on entities rather than transactions. But the identification and opportunity to manipulate the correct entity under GST is mirrored in the cash flow approach. A discussion of this weakness in the GST system is beyond the scope of this article;
- *employee/independent contractor/arranging*: it is not clear whether the cash flow approach would address the inherent difficulty in ensuring that tax is collected on the value added by ‘Friday night/Monday morning’ arrangements and ‘intermediaries’ discussed in section 4;
- *phoenix and missing trader fraud*: the cash flow mechanism suggested in the Henry Review would result in a refund of the tax component of purchases if not accounted for by the supplier;

- *Demanding or paying for work cash in hand to avoid obligations;*
- *Not reporting or under-reporting income.*

Further, the cashflow system would seem to suffer from fluctuations in the savings ratio, making it (perhaps) unsuitable as a tax base for the States and Territories.