acoss

Strengthening the Medicare Levy to secure the future of the NDIS and other essential universal services

August 2017

Who we are

ACOSS is the peak body of the community services sector and a national voice for the needs of people affected by poverty and inequality.

Our vision is for a fair, inclusive and sustainable Australia where all individuals and communities can participate in and benefit from social and economic life.

What we do

ACOSS leads and supports initiatives within the community services and welfare sector and acts as an independent non-party political voice.

By drawing on the direct experiences of people affected by poverty and inequality and the expertise of its diverse member base, ACOSS develops and promotes socially and economically responsible public policy and action by government, community and business.

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Summary

In the 2017 Budget the Government proposed to increase the Medicare Levy by 0.5% to secure funding for the NDIS, and set up a 'Medicare Guarantee' as an accounting device for Medicare benefits. The Opposition proposes a different approach: a Medicare Levy increase limited to people earning over $87,000 and keeping the deficit levy for individuals earning over $180,000.

This paper argues that the NDIS and health care services need a fair and robust revenue source to ensure they are there when people need them. It proposes four tests to assess competing revenue proposals, and applies them to six options including those from the Government and Labor. We urge the Parliament to quickly resolve funding for the NDIS [1].

We welcome the Government's shift to funding essential universal services such as the NDIS through an increase in the Medicare Levy rather than cuts to benefits and services as the 2016 Budget originally proposed. On a wider note, the best way to fund increases in the cost of essential universal services such as NDIS and health care (which will inevitably grow as a share of GDP) is through the tax system. The alternatives - service rationing and user charges - lead to greater inequality, and two-tier systems where the service people receive depends on their income, not their needs. People on lower incomes are hit harder by fixed out-of-pocket expenses. We all benefit from essential services and should contribute through the tax system to the extent that we can afford to.

As Per Capita's recent tax survey shows, almost 60% of people are prepared to pay more tax for 'better health and aged care' [2]. It is likely the NDIS would attract similar support. This support is vital and a prolonged debate over how the revenue should be raised could undermine it.

The Medicare Levy is well-suited to this purpose because as an enduring feature of our income tax system it gives people confidence that services will be supported in future. That is why it was introduced by the Hawke Government to help fund Medicare, even though it is not strictly hypothecated to those services and did not cover their full cost. It also recognises differences in people's ability to pay (though imperfectly) through the low-income Medicare Levy exemption and the high-income Medicare surcharge.

All reasonable revenue-raising options to meet future growth in NDIS, health and aged care costs should be considered, based on **4 tax principles**

1. An adequate and reliable revenue base for the NDIS and essential health services must be secured for the future.

[1] ACOSS and peak disability organisations released a statement about this last month: http://www.acoss.org.au/media-releases/?media_release=we-call-on-this-parliament-to-deliver-secure-sustainable-and-sufficient-funding-for-the-national-disability-insurance-scheme

[2] Per Capita (2017), 'Tax survey 2017.' https://percapita.org.au/research/per-capita-tax-survey-2017/

2. All should contribute according to their ability to pay (this includes middle income-earners but tax rates should be higher for those with higher incomes).
3. Opportunities to avoid contributing (whether by taking out private health insurance or using tax shelters) should be restricted.
4. The tax used for this purpose should be as simple and transparent as possible.

ACOSS welcomes both the Government's and Labor's proposals to fund the NDIS in principle. Each would raise approximately $4B in annual revenue, provided in the case of Labor's proposals the deficit levy is made permanent. However, neither proposal adequately addresses the four tax principles. With both major parties agreed that an increase in the Medicare Levy is appropriate, the Parliament is presented with an excellent opportunity to secure decent tax reform, if a compromise is pursued. We urge the Parliament to find a compromise, informed by the above principles, and get on with the job of securing an adequate and sustainable revenue base for the NDIS. It should not be a 'political football' in the next election.

The Government's increase in the Medicare Levy strengthens revenue for the long-term without raising taxes on low income-earners, but a flat rate of tax applies to middle and high income-earners. While the vast majority of households in the lowest 40% of the income distribution are exempted, most of those earning above $22,000 (or $37,000 in the case of families) would pay an extra 0.5% flat tax on all of their income.

By raising taxes on higher incomes, Labor's proposals are more progressive. Only individuals earning over $87,000 are affected and those earning over $180,000 pay the most (in proportion to their incomes). To provide the secure long-term revenue base that's needed, the deficit levy would need to be a permanent feature of our tax system linked to funding essential universal services such as health care and the NDIS.

Neither option resolves two major problems with the Medicare Levy: high income-earners can readily avoid paying it (by using tax shelters, or in the case of the Surcharge by purchasing private health insurance) and it has become too complex.

We raise **four alternative options** to reform the Medicare Levy to overcome these problems:

1. Remove the exemption from the Medicare Levy Surcharge for high income-earners who take out private health insurance (this would raise $4B a year and only affect those earning more than $90,000 if single or $180,000 for families)[3] .
2. Extend the broader definition of income used for the Surcharge to the Medicare Levy itself (this would help ensure that people who use tax shelters such as negative gearing, salary-sacrifice, and private trusts, at least pay the Medicare Levy).[4]
3. Restructure the Medicare Levy to make it more progressive as well as increasing it (one option is to replace the Levy and Surcharge with a three-tier rate scale).
4. Replace the Medicare Levy and Surcharge with a new Levy based on a In addition, the use of tax shelters that enable individuals to avoid paying both income tax and the Medicare Levy should be curbed (including negative gearing, the capital gains tax discount, superannuation, and private companies and trusts).[5]

[3] This is advocated by the Australian Greens: http://www.smh.com.au/federal-politics/political-news/high-income-earners-to-be-slugged-with-higher-medicare-costs-under-greens-plan-20170311-guw6x3.html

[4] Labor proposes substantial changes to negative gearing and the capital gains tax discount, while the Budget includes more modest changes to negative gearing. Our detailed reform proposals are in ACOSS (2017) 'Budget Priorities Statement.' http://bit.ly/2ufY6St

[5] As proposed by the 'Henry Report' on tax and transfers reform. The Australia Institute proposes a 10% income tax 'top-up' to raise an additional $2.7B.

1. Future governments will need more revenue for the NDIS and essential universal health services

Universal service guarantees and why we need them

We have a social compact with our governments: we pay taxes and receive in return health, education, welfare and other services and social security payments when we need them.

This compact works in two ways. First, it redistributes resources to those in greatest need. Second, it has an insurance role where as a community we set aside funds to meet contingencies that all of us may face: the costs of children, unemployment, a disability, a serious illness, and an inability to care for ourselves in old age.

ACOSS has called for legislated *universal service guarantees* for essential 'human' services such as health, education and disability services, which any of us may need at some stage of our lives. In our proposals published two years ago to reform the federation, we argued the Commonwealth should legislate to underwrite universal access to a range of good-quality essential services through the tax system, while States and Territories should largely determine how certain of these services will be funded and administered on the ground.[6] The NDIS, Medicare, and proposals for needs-based schools funding are all examples of universal service guarantees. The key elements include legislated individual service entitlements based on need, funding through the tax system, a robust set of service standards, the absence of means-testing, and minimal or no fees for service.

Paying for essential human services in this way is far better than the alternatives: service rationing and user charges. Service rationing results in many people in need missing out. User charges results in those who cannot afford to pay either missing out or a 'second tier' of inferior services reserved for people with low incomes. This is the experience of people using public dental services: those who cannot afford a private dentist often have to wait months for urgent treatment such as fillings, and as a result lose their teeth.[7]

The government has adopted the language of service guarantees with its 2017 Budget proposal for a 'Medicare Guarantee Fund', though this is an accounting device rather than a legislated protection. In a recent speech, the Treasurer went further, committing the government to:

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[6] ACOSS, COSS Network (2015), 'Fit for purpose: a federation that guarantees the services people need' Available: http://acoss.wpengine.com/wp-content/uploads/2015/10/COSS-federation-framework_FINAL.pdf

[7] Australian Institute of Health and Welfare (2016), 'Oral health and dental care in Australia: key facts and figures 2015.' Can no DEN 299. Canberra, AIHW

Guarantee the essential services that Australians rely on, like Medicare, the PBS, schools funding and disability services'.[8]

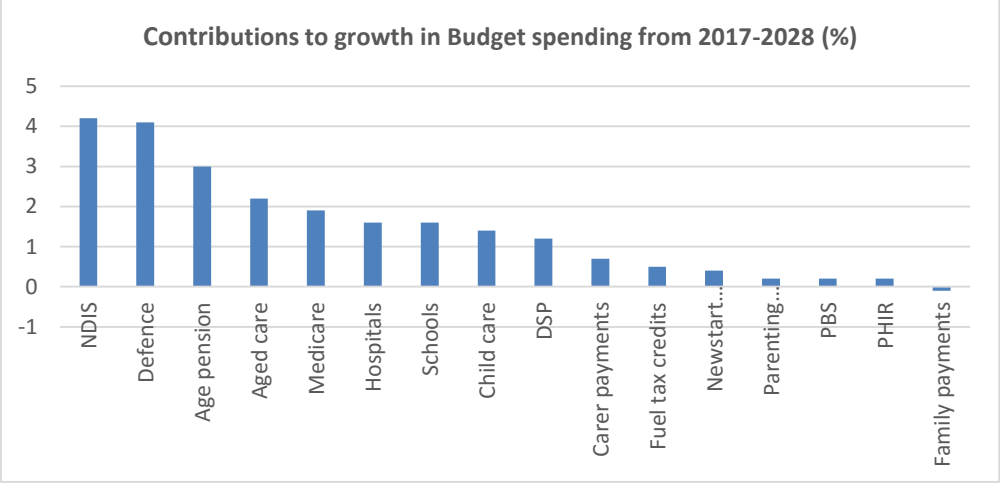
Unfortunately these service guarantees are not yet robust or widespread. For example, elements of health funding such as preventive health care and hospitals funding, which are not protected by legislation, have been cut sharply since 2014.[9] The Commonwealth and States are still in dispute over long-term funding for hospitals. Other essential services such as dental and mental health are still rationed, and people often have to pay handsomely to secure good-quality and timely services.

The gap between needs for service and public revenue is growing

In this paper we focus on the role of the Medicare Levy in funding the NDIS, but first we place this in its broader context.

The primary purpose of the Medicare Levy is to help fund essential health care services. In common with the NDIS, the cost to government of health care is likely to rise faster than most other budget expenses over the next few decades (Figure 1).

Figure 1: Looking forward: Spending on essential services is projected to rise in Australia



Source: Parliamentary Budget Office (2017), '2017-18 Budget medium term projections.'[10]

8 The Hon. Scott Morrison MP Treasurer', ''Guaranteeing the essentials - a foundation for fairness.'' Address to the Australian Industry Group, Adelaide, 27 July 2017.

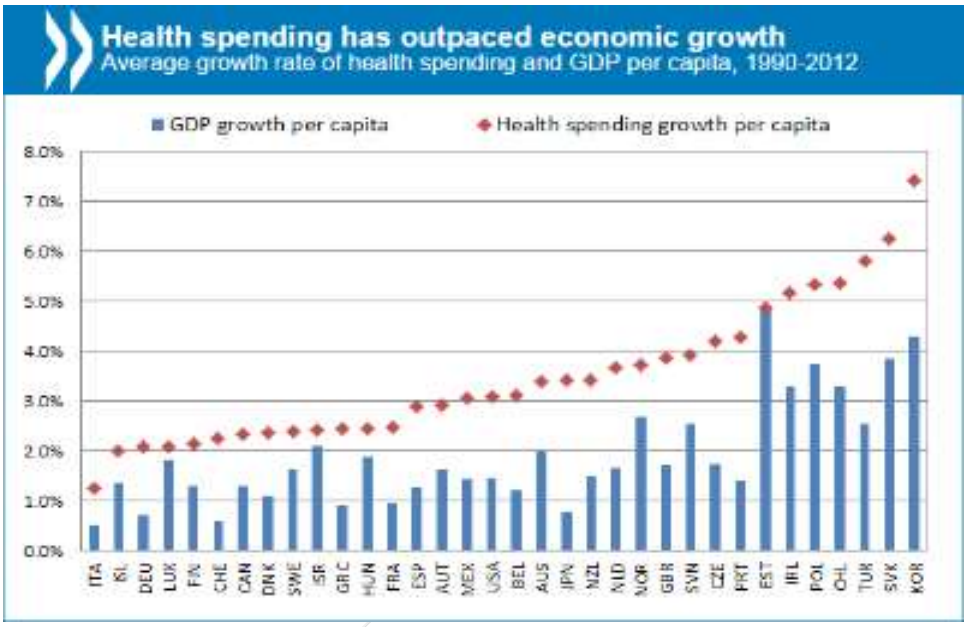
9 ACOSS (2014), 'A Budget that divides the nation: ACOSS 2014-15 Budget Analysis'. http://www.acoss.org.au/wp-content/uploads/2015/06/ACOSS_2014-15_Budget_analysis_-_WEB.pdf

10 These official projections underestimate future health care costs, since Commonwealth funding to the States for hospitals was arbitrarily cut in the 2014 Budget and this remains an area of intense dispute between governments.

Given the yawning gap between the needs of people with disabilities and services available, the cost of the NDIS to government is projected to rise substantially as the scheme is rolled out: from 0.2% of GDP in 2017 to 0.9% in 2028.[11]

Across the OECD, health care costs have also risen faster than economic growth as populations age and the range and quality of medical and aged care services improves. This is likely to continue.

Figure 2: Looking back - health care spending has risen strongly across the OECD



OECD (2017), ''Healthcare costs unsustainable in advanced economies without reform.''
http://www.oecd.org/health/healthcarecostsunsustainableinadvancedeconomieswithoutreform.htm

ACOSS does not see this projected rise in public spending on the NDIS and health care as a problem, as long as those services are provided in an efficient way.[12] It is good public policy for wealthy countries with ageing populations to devote a growing share of GDP to these essential services rather than luxury goods. The NDIS aims to bridge a yawning gap in the provision of

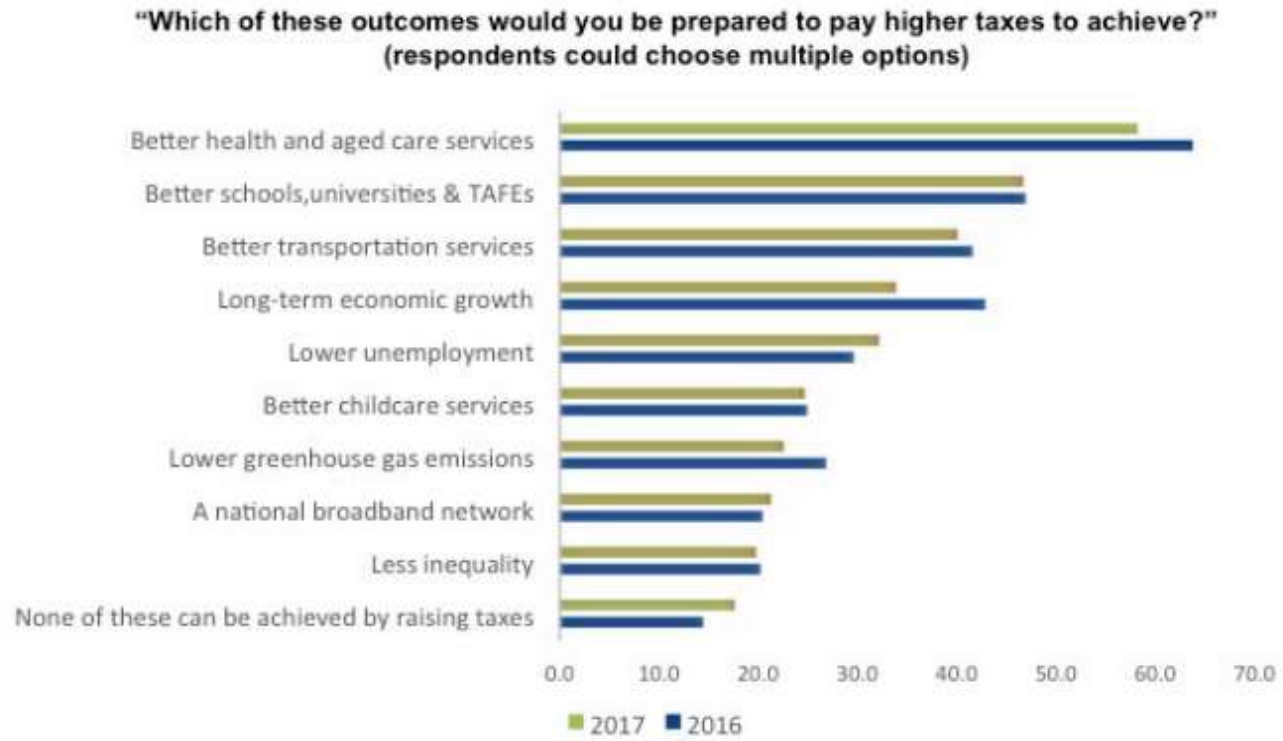
[11] Parliamentary Budget Office (2017), '2017-18 Budget medium term projections.''

[12] Cost efficiency is a long-standing issue with health services. Inflation in health costs is likely to be much higher than in a cost efficient system due to multiple purchasers in the system (government, insurers and patients), inefficient private health subsidies, an over-emphasis on acute care as distinct from preventive measures, and poor coordination of funding and provision of care for people with chronic illness. The resulting inflation in health care costs is masked by rationing of services, which disadvantages those in greatest need.

disability services. There are also unacceptable gaps in the provision of essential health services including in dental and mental health.

Therefore it is not surprising that there is broad public support for paying more tax to achieve 'better health and aged care services'. Almost 60% of respondents in recent opinion polls were prepared to do so (Figure 3).

Figure 3: Most people are prepared to pay higher taxes for better health and aged care services



Source: Per Capita (2017), 'Tax survey 2017.' http://percapita.org.au/research/per-capita-tax-survey-2017/

As discussed later, increasing public revenues to fund the NDIS has attracted similar support.

The issue we have to resolve is not whether the cost of these services will rise as a share of GDP. That is unavoidable to ensure that everyone receives the help they need. The real question is how we will pay for them. User charges penalise people with lower incomes, leaving them without assistance or second-rate assistance. Universal service guarantees underpinned by a fair tax system are the best solution.

Why use the Medicare Levy

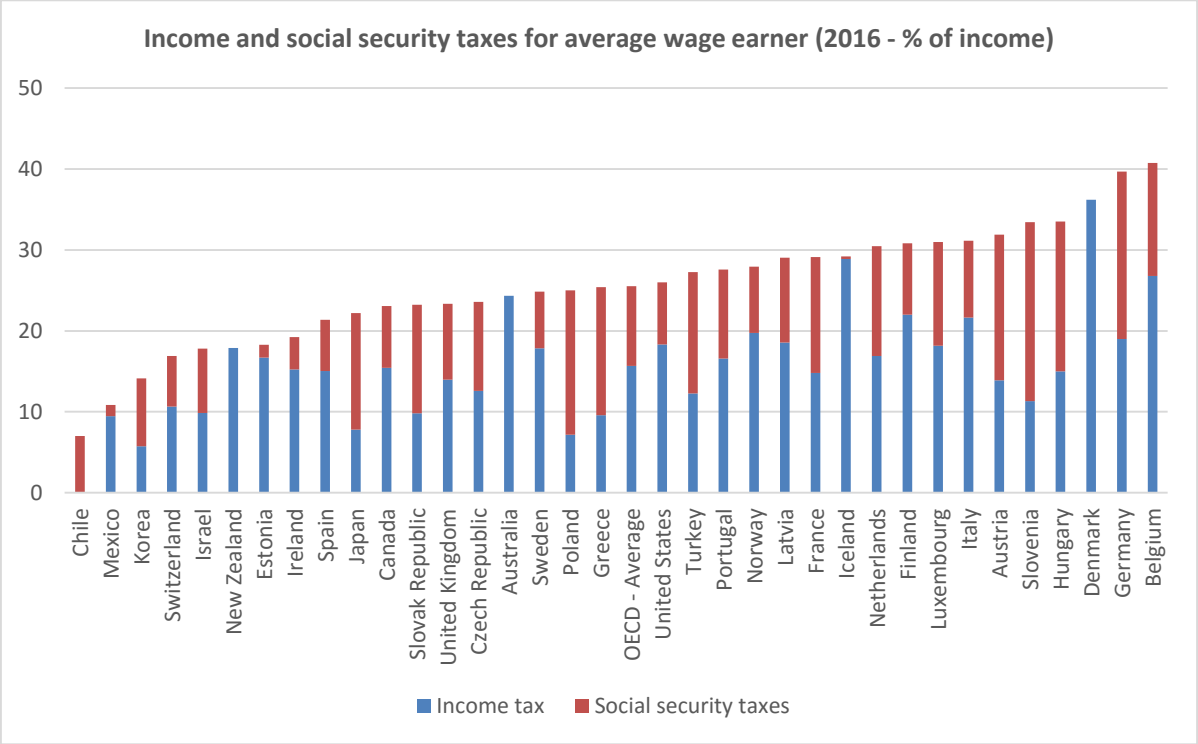
The Medicare Levy is well-suited to the role of funding a necessary expansion of essential health, aged care and disability services. It was first introduced in 1983 by the Hawke Government to cover the increase in funding required to ensure that everyone had access to a doctor or hospital when needed. Even though the Medicare Levy is not strictly hypothecated to those services and does not cover their full cost, it gives people confidence that those services will be supported in future, and helps keep governments accountable to do so. For these reasons the Levy is an enduring feature of our income tax system despite objections from some experts to the linking of taxes to particular spending programs.[13] Importantly, the Levy also recognises differences in people's ability to pay (though imperfectly) through the low-income Medicare Levy exemption and the high-income Medicare surcharge.

The Medicare Levy is our equivalent to the 'social security taxes' which most wealthy countries raise on employees and employers to pay for social security and universal health care services (Figure 4).[14]

[13] The ''Henry Review'' into the tax-transfer systems raised this objection to the Medicare Levy. Note however that the Levy is earmarked' rather than strictly 'hypothecated' to spending on health care. Australia's Future Tax System (2009), 'Report.''

[14] The OECD regularly compares the impact of personal income tax, payroll taxes, and social security taxes on employers and employees. One measure they use is the 'tax wedge'' (the difference between labour costs to the employer and net take-home pay). The overall tax wedge in Australia was 30% compared with an average of 36% across the OECD. This is mostly due to the absence of social security taxes in Australia (with the possible exception of the Superannuation Guarantee). See OECD (2017) ''Taxing wages.''

Figure 4: Most countries (but not Australia) levy social security taxes alongside income tax



Source: OECD Taxing wages data base

The current impasse over funding for the NDIS

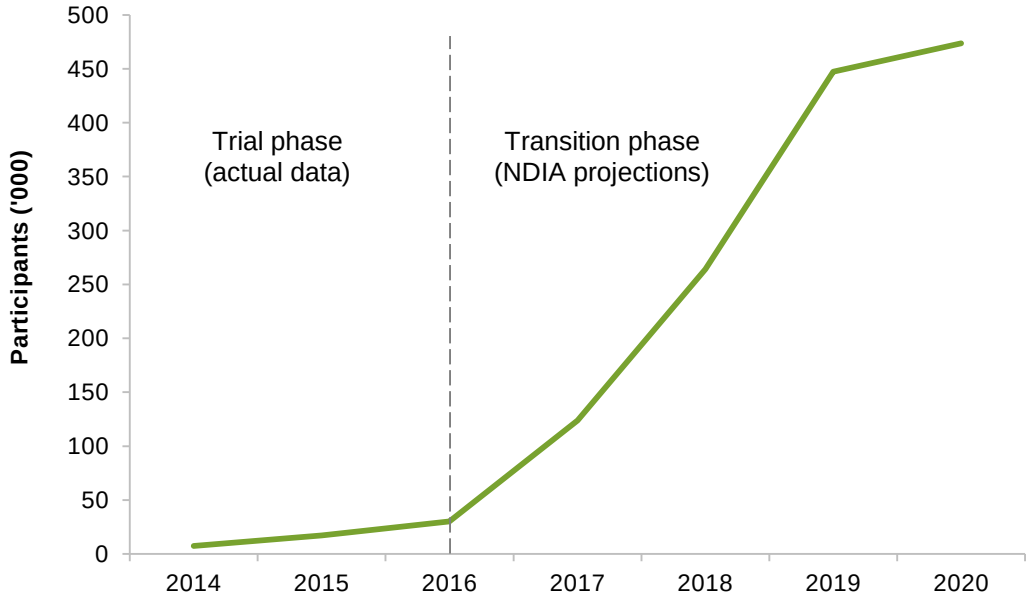
The NDIS insures us against the possibility that we or our children may experience a disability that requires a high level of care and support, which makes it much harder to carry on our usual activities such as paid work and care for children. The idea behind the NDIS is that people with disabilities are guaranteed choice and control over the services and supports they need, regardless of financial resources. The cost of this insurance is shared across the community through the tax system.

Giving people with disabilities a guarantee of control over the services they need when they need them is changing lives. The NDIS is a huge advance from the old system where services were poorly funded and rationed, so that people with disabilities and their carers had to either wait in a queue for inadequate help or pay for essential services such as attendant care and home adjustments from their own pockets.[15]

15 National People with Disabilities and Carer Council (2009), 'Shut out: the experience of people with disabilities and their families in Australia'

Implementing the NDIS is a huge task: assessing, negotiating packages of assistance, and extending new services to almost 500,000 people with disabilities within the space of four years (Figure 5).

Figure 5: Projected number of people with disabilities assisted by NDIS



Source: Productivity Commission (2017), "NDIS costs position paper."

The Productivity Commission is broadly positive about the impact of the scheme so far:

> *Early evidence suggests that the National Disability Insurance Scheme is improving the lives of many participants and their families and carers. Many participants report more choice and control over the supports they receive and an increase in the amount of support provided.*[16]

Practical challenges in negotiating and implementing assistance packages for such a large number of people, especially workforce challenges, are likely to limit the scheme's cost to the Commonwealth Budget in the early years, but it is very difficult to accurately predict the cost of the mature scheme, and vital that arbitrary spending caps are avoided. Further, as the Productivity Commission points out, the Commonwealth (rightly, given its superior revenue capacity) will bear most of the financial risk:

16 Productivity Commission (2017), 'National Disability Insurance Scheme (NDIS) Costs – Position paper' p.54

The objective of the escalation parameters is not specified in the Bilateral Agreements between the Australian Government and the State and Territory Governments at full scheme. The existing escalation parameters are unlikely to reflect the full increase in National Disability Insurance Scheme (NDIS) costs over time, which would result in the Australian Government bearing a higher share of NDIS costs over time.[17]

The NDIS was the Gillard Government's crowning social policy achievement. To help pay for it, that government announced in 2013 a 0.5% increase in the Medicare Levy:

To be implemented, DisabilityCare requires a strong and stable funding stream to provide certainty and security to the 410,000 Australians with disability, their families and carers. For this reason, the Government will increase the Medicare levy by half a percentage point from 1 July 2014. This will take the Medicare levy from 1.5 per cent of taxable income to 2 per cent.[18]

This revenue increase was widely supported, including by ACOSS.

In its 2016 Budget the Turnbull government argued that there was a $4B annual shortfall in future NDIS funding, which was disputed by the Opposition. We do not take a position on this argument over whether the NDIS is already 'fully funded'. In any event, both the government and opposition have proposed revenue-raising measures that raise $4B a year in the short-term.

The challenge for governments is that its future cost – especially beyond the current four-year forward estimates period – is uncertain. It makes sense for governments to build a substantial financial buffer to ensure that those costs are covered. Future governments will need a robust, secure and growing funding source to meet their NDIS and health care commitments.

In its 2016 Budget the government proposed to bridge the claimed funding ''gap'' by cutting social security payments (including cutting access to the Disability Support Pension). ACOSS, along with peak disability organisations, rejected the idea that improved services for one group in need should be paid for by cutting payments and services to another – in the case of the DSP they were often the same people.[19]

We welcome the government's announcement in the 2017 Budget that it has abandoned that approach and proposes instead to raise the Medicare Levy by a further 0.5% from July 2019. Two

17 Ibid, p.64

18 Prime Minister, ''Locking in a fairer future for Australians with disability.'' Melbourne, 1 May 2013.

19 ACOSS (2016), 'Budget Analysis'

opinion polls shortly after the 2017 Budget found that 54% and 61% respectively of people supported that proposal.[20]

The Opposition proposes a different approach: to limit the Medicare Levy increase to those earning $87,000 or more and maintain the ''Deficit Reduction Levy'' for people earning more than $180,000.

Both Government and Opposition have signalled their commitment to the NDIS and intention to raise more revenue through the income tax system to secure its future funding. Regrettably, they have not agreed on how this should be done, so we have reached an impasse. If this impasse continues until the next federal elections, it puts at risk public support for the insurance principle underpinning the scheme: that we should all pay according to our ability.

Last month ACOSS, Disability People's Organisations Australia and the Australian Federation of Disability Organisations called on the Parliament to find a compromise to secure robust revenue source for the NDIS well before next election.[21]

ACOSS welcomes both the Government's and Opposition's commitment to the NDIS and their funding proposals, noting that it is important that the Opposition's proposed extension of the deficit levy is permanent. However, both proposals have weaknesses which we discuss below.

Given frequent changes to the Medicare Levy in recent years, and increasing demands on this source of revenue, we believe it is time to reassess how it is structured. The Levy is complex, with a separate 'Surcharge' in addition to the main Levy, individual and family income tests, and multiple rates in the case of the surcharge. It imposes high effective tax rates (especially on married women) through the phasing-out of exemptions, and can readily be avoided by taking out private health insurance (in the case of the Medicare Levy Surcharge) or by sheltering income through salary sacrifice arrangements, private trusts or negative gearing arrangements (in the case of the Medicare Levy).

20 Michelle Grattan (2017), 'Coalition two-party vote slips in post-budget Newspoll' The Conversation, http://theconversation.com/coalition-two-party-vote-slips-in-post-budget-newspoll-77691

21 ACOSS, DPOA and AFDO (2017), ''We call on this Parliament to deliver secure, sustainable and sufficient funding for the National Disability Insurance Scheme.'' 22 June 2017

2. Six options to raise revenue for the NDIS and essential health services

We present below six options to raise revenue from the Medicare Levy for the NDIS and health care (including those proposed by the Government, Labor and Australian Greens), and outline four tests for assessing them.

Four tax principles to raise revenue for the NDIS and health care

To recap, the **four tax principles** we propose for revenue proposals to fund the NDIS and essential health and aged care services are:

1. **Adequacy:** An adequate and reliable funding base for the NDIS and other essential universal services must be secured for the future.
   As it is hard to predict in advance the extent to which future governments will need extra revenue for these services, we benchmark the revenue raised by alternative proposals to the $4B a year (in 2019-20) raised by the Government's and Labor's proposals.[22]
2. **Progressivity:** All should contribute according to their ability to pay (tax rates should be progressive - higher for those with higher incomes).
   As with other universal essential services, we believe all bar those whose incomes are so low that they lack the capacity to contribute, should do so. Those with relatively high incomes should contribute a higher share of their incomes.
3. **Comprehensiveness:** Opportunities to avoid contributing (whether by taking out private health insurance or through tax shelters) should be limited.
   If some people can avoid contributing their fair share by using tax shelters such as negative gearing, private trust or salary sacrifice arrangements, that leaves the rest of us to pay more. Also, the potential of the Surcharge to inject more progressivity into the Medicare Levy is undermined by the exemption for those with private hospital insurance, which does not serve any public policy purpose.[23]
4. **Simplicity:** The taxes used for this purpose should be as simple as possible.
   Public support for a revenue-raising depends on our ability to understand what we are paying and why. It should be as simple as possible to complete a tax return and understand the basis of the assessment. Yet the Medicare Levy and Surcharge are shrouded in complexity.

[22] As indicated, this does not mean we accept the Government's argument that the NDIS was "underfunded" to that extent by the previous administration.

[23] Financial incentives for private health insurance are not justified, as there is no evidence that private insurance reduces overall public spending on health care.

We now apply the four tests to the following **six reform options**, noting that more than one solution may be needed. Our conclusions are summarised in **Table 1.**

Attachment 1 *shows how the present Medicare Levy and Surcharge work now.*

Attachment 2 *compares the impact of the Government's and Labor's proposals on households at different income levels.*

Option 1: Government - Budget proposal to increase the Medicare Levy from 2% to 2.5% from 1 July 2019

This is the 2017 Budget proposal to increase the Medicare Levy by 0.5% to help fund the NDIS.

Test 1: Adequacy

This option passes Test 1. It raises substantial revenue both in the short-term ($4B per year) and in future years.

Test 2: Progressivity

It is not clear whether this option passes Test 2. On the one hand, the vast majority of the lowest 40% of households by income are not affected due to the high Medicare Levy exemption thresholds (Attachment 2). That is, almost 40% of households earn less than $22,000 (if single, higher for Seniors – Attachment1) or $37,000 (if partnered or sole parents: again, higher for Seniors). A large share of this group are retired.

On the other hand, it is less progressive than other options because all individuals or families above the exemption thresholds face a flat 0.5% additional tax on all of their income. Although it mainly falls on the highest 60% of households by income, the extra tax varies little among those households - from an average rate of 0.4% of household income for middle quintile to 0.6% for the highest 20% ($289 to $1,185 a year respectively) (Attachment 2).

Test 3: Comprehensiveness

This proposal does not pass Test 3 as the Levy is readily avoided using tax shelters.

Test 4: Complexity

It has no impact on complexity (Test 4).

Option 2: Labor - proposal to increase the Medicare Levy from 1.5% to 2% for individuals earning above $87,000 and continue the 2% 'deficit levy' on individuals earning more $180,000

Labor proposes to restrict the 0.5% increase in the Medicare Levy to those earning over $87,000, and retain the 2% Deficit Reduction Levy.

Test 1: Adequacy

This proposal is estimated to raise $4B a year in 2019 (approximately $3B from the Medicare Levy and $1B from the Deficit Levy). It raises enough revenue to pass Test 1 (adequacy) but the Deficit Levy should be made permanent and linked to the NDIS and other essential universal services to help ensure this funding is sustained.

Test 2: Progressivity

It passes Test 2 and would be much more progressive than the Government's general increase in the Medicare Levy.

While it makes little difference to taxes paid by the lowest 40% of households, compared with the Government's proposal those in the middle and second-highest quintiles would pay significantly less: 0.1% and 0.2% of income ($67 and $253 a year) respectively compared with 0.4% and 0.6% ($289 and $572 a year) respectively in the government's proposal (Attachment 2). On the other hand, compared with the government's proposal, the average tax increase for the highest 20% of households would increase by almost half - from 0.6% of income to 0.9% (from $1,105 to $1,735 per year).

Test 3: Comprehensiveness

It does not pass Test 3 as there is no change to the treatment of tax shelters. This is an important consideration if the aim is to shift more of the cost to high-income earners.

Test 4: Simplicity

It would not pass Test 4 (simplicity) as it would increase the complexity of the Medicare Levy (the Deficit Levy is, in effect, absorbed into the ordinary income tax scale).

Option 3: Greens - proposal to remove the Medicare Levy Surcharge exemption for holders of private health insurance

This proposal is intended to increase the overall progressivity of the Medicare levy by converting the Medicare Levy Surcharge into a general surcharge for high-income earners.

Test 1: Adequacy

This proposal passes Test 1 as it raises substantial revenue ($4B a year in the short-term, increasing more substantially than the other proposals over time).

Test 2: Progressivity

It passes Test 2 (progressivity) as only individuals earning over $90,000 and families earning over $180,000 would pay. These individuals would mainly fall within the highest 20% of household incomes.

Test 3: Comprehensiveness

It passes Test 3 as it strengthens the tax base by removing a major exemption.

Test 4: Simplicity

It passes Test 4 as people would no longer be required to include health insurance details in their tax returns.

Option 4: ACOSS - broaden the 'base' of the Medicare Levy from taxable income to 'Medicare Levy Surcharge taxable income', the income definition used for the surcharge

This is the first of three alternative proposals advanced by ACOSS for structural reform of the Medicare Levy and Surcharge to make the system simpler, more comprehensive, and more progressive.

The proposal would change the income base, or definition, for the Medicare Levy to that currently used to determine whether an individual or family must pay the Medicare Surcharge, termed 'medicare surcharge taxable income'. The difference is that the latter disallows certain tax shelters: negative gearing, salary sacrifice, and (to a degree) private trusts. This is an integrity measure to ensure that people cannot use those tax shelters to avoid the Surcharge. The proposal would extend this income definition to the Medicare Levy.

Test 1: Adequacy

It is not clear whether, on its own, it passes Test 1 as we lack estimates of the revenue it would raise, though this is likely to be substantial (of the order of $1 to $2B per year) . This

option could be considered alongside an increase in Medicare Levy rates, to offset any increase in tax avoidance that might otherwise occur.

Test 2: Progressivity

It passes Test 2 (progressivity) as these tax shelters disproportionately benefit high-income earners.

Test 3: Comprehensiveness

It passes Test 3 because it prevents people from using tax shelters to avoid the Levy.

Test 4: Simplicity

It does not pass Test 4 as calculating income for Medicare Levy purposes would be more complex, though the relevant information is already provided in tax returns.

While beyond the scope of this report, a better alternative is to close these tax shelters so that they cannot be used to avoid personal income tax generally. ACOSS has detailed proposals in its Budget Submission to deal with negative gearing, private trusts and companies, and further reform of the taxation of superannuation.[24] Both the Labor Party and the Greens advocate major reform of the tax treatment of negatively-geared investments and private trusts and the Government proposed in the 2017 Budget to reduce the scope of deductions for property investments.

Option 5: ACOSS - Replace the Medicare Levy and Surcharge with a simpler, three-tier Medicare Levy

Our second alternative proposal would replace the Levy and Surcharge with a new Medicare Levy with a three-tier progressive rate scale (zero for low-income earners in lieu of the exemption, a standard marginal rate for middle income-earners, and a higher marginal rate for high-income earners). There would be no exemption for holders of private health insurance. This could be combined with Option 4 above by using 'medicare surcharge taxable income' as the income base for the new Levy.

The existing income-tested exemptions for low-income earners would be replaced by either a set of tax free thresholds that vary according to family size, or rebates along the lines of those that currently remove people with the lowest incomes from paying personal income tax.[25]

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24 ACOSS (2017), 'Budget submission.'

25 For example, the individual tax-free threshold for the new Medicare Levy could be equal to the current Medicare Levy exemption threshold. In the case of couples and families, this threshold could be increased by the difference between that threshold and the higher exemption thresholds for couples and families. These tax free thresholds would not be income-tested.

Test 1: Adequacy

This option could be designed to pass Test 1 by setting the rates and thresholds so that it raises at least $4B in extra annual revenue. Given the removal of the health insurance exemption, this would not be difficult (see Option 4 above).

Test 2: Progressivity

Whether it passes Test 2 depends on the rates and thresholds. If low income households continue to be exempted, the health insurance exemption for high-income earners is removed, and the broader income definition is used, this would not be difficult.

Test 2: Comprehensiveness

The proposal passes Test 3 as the ability for people to avoid contributing their fair share through the health insurance exemption. If this was combined with Option 4, then the ability to do so using tax shelters would also be reduced.

Test 3: Simplicity

It is very likely to pass Test 4 as the two parts of the Medicare Levy are rolled into one, people would only need to declare their partner's income in order to claim a higher tax free threshold, and the tax scale would be more transparent.[26]

Option 6: ACOSS - Replace the Medicare Levy and Surcharge with a new Medicare Levy calculated as a fixed percentage (such as 12%) of personal income tax payable each year

The Henry Report on tax and transfer reform proposed a simplified Medicare calculated as a fixed proportion of personal income tax paid each year.[27] This was recently advocated by the Australia Institute, with the proportion set at 10%.[28] Our proposal goes a step further and replaces the Medicare Levy Surcharge as well (as does Option 5 above).

Test 1: Adequacy

The proportion of income tax applied would be fixed to raise at least an extra $4B a year in

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[26] One implication of the greater transparency of this proposal is that the marginal tax rates required to raise the same revenue as the present "flat tax" applying to all income for those not exempted from the Medicare Levy would be higher. This is because the new tax rates would only apply to "slices" of income above each of the three thresholds in the three-tier rate scale, not the whole of a person's income as is the case now. How much higher the proposed standard and high-income tax rates would need to be (above the current 2% for the Levy plus 1-1.5% for the Surcharge) depends on the revenue gains from removal of the health insurance exemption and the broader income definition.

[27] Australia's Future Tax System (2009), "Report."

[28] At http://www.tai.org.au/content/progressive-medicare-levy

order to pass Test 1. This would need to be modelled. The Australia Institute estimated that its 10% rate would raise $2.7B per annum in the short term, so the rate may need to be slightly higher than 10% to raise another $1.3B and replace the approximately $0.3B currently raised by the Surcharge.[29]

Test 2: Progressivity

It passes Test 2 as it mimics the progressivity of the personal income tax.

Test 3: Comprehensiveness

It passes Test 3 (comprehensiveness) in part, as people could no longer avoid paying part of the Levy (the Surcharge) by taking out private health insurance. On the other hand, it would make it difficult to broaden the definition of income for Medicare Levy purposes beyond 'taxable income' as in Option 4.

Test 4: Simplicity

It passes Test 4 and would be the simplest of all of the reform options discussed here.

[29] Based on 2014 Australian Taxation Office statistics, revenue from the Surcharge in that year was $219m.

Table 1: Six options to raise revenue for the NDIS and essential health services

Option	Test 1: Adequacy	Test 2: Progressivity	Test 3: Comprehensiveness	Test 4: Simplicity
1. Increase the Medicare Levy from 2%-2.5% (Government proposal)	YES: Permanent measure Raises $3.6B in 2019 ($8.2B over next 4 years)	UNCERTAIN: Most of lowest 40% of households exempt but a flat tax rate applies to the rest [1.]	NO: Levy can still be avoided using tax shelters	Neutral: No change in complexity
2. Increase the Medicare Levy to 2.5% for those earning >$87,000 and retain the 2% deficit levy for high-income earners (Labor proposal)	UNCERTAIN: Raises enough in short-term ($4.1B) but could end once Budget is in surplus unless deficit levy is made permanent	YES: Strongly progressive: Most of lowest 60% are exempt and tax rate is highest for top 20%	NO: Could increase avoidance without preventive action	Neutral: Slight increase in complexity of Medicare Levy

Option	Test 1: Adequacy	Test 2: Progressivity	Test 3: Comprehensiveness	Test 4: Simplicity
3. Extend the 1-1.5% Medicare Levy high-income surcharge to individuals with private health insurance (Australian Greens proposal)	YES: Raises $4B in 2019 (>$16B over next 4 years)	YES: Impact largely restricted to top 20% of households	YES: Widens 'base' of surcharge [2.]	YES: Simplifies tax returns
4. Extend the Medicare Levy to tax-sheltered income by applying the income definition used for the Medicare Surcharge [3.]	UNCERTAIN: Revenue estimate not available but likely to be substantial (in the range of $1B-$2B in 2019)	YES: Includes tax-sheltered income (from salary-sacrifice, negative-gearing, trusts) disproportionately going to high-earners	YES: Levy is harder to avoid using these tax shelters	NO: Extra calculation of tax-sheltered income needed (but does not require more info in tax returns)
5. Replace Medicare Levy & Surcharge with a Medicare Levy with a three-tier rate scale, with sheltered income included in the tax base [4.]	YES: Rates and threshold could be set to raise >$4B in 2019	YES: More progressive than increasing existing Levy, due to its 3-tier tax scale and removal of health insurance exemption	YES: Includes tax-sheltered income, so Levy is harder to avoid	YES: Overall this simplifies tax returns and improves transparency

Option	Test 1: Adequacy	Test 2: Progressivity	Test 3: Comprehensiveness	Test 4: Simplicity
6. Replace Medicare Levy & Surcharge with a new Medicare Levy set at a fixed % of income tax [5.]	YES: Rates and threshold could be set to raise >$4B in 2019	YES: More progressive than increasing existing Levy, due to the progressivity of the personal income tax and removal of health insurance exemption	UNCERTAIN: The health insurance exemption would be removed but the income base for the Levy would be no broader than 'taxable income'	YES: Greatly simplifies tax returns and improves transparency

1. Currently, individuals with incomes $21,655-$27.068 and families on up to $36,541-$45,676 (plus $3,356 per child) pay a partial Medicare Levy and those below these thresholds do not pay the Levy. Similarly, Seniors with incomes of $34,244-$42,805 (single) or $47,670-$59,587 (couples) pay a partial Medicare Levy. Although these thresholds appear to be low, the vast majority of households in the lowest 40% of the disposable income distribution do not pay the Levy (Attachment 2). However, above these thresholds the Levy is paid at a flat rate of 2% of *all* taxable income, not just income above the thresholds.
2. This would extend it to the majority of high-income earners who are currently exempted since they hold private health insurance. There is no evidence that increased use of private insurance lowers overall public health costs.
3. This refers to 'income for Medicare Levy Surcharge purposes' which is the definition of income used to assess whether the Surcharge should be paid. It includes and reportable fringe benefits, deductions for negatively-geared investments, non-compulsory super contributions, and certain income from private trusts: https://www.ato.gov.au/Individuals/Medicare-levy/Medicare-levy-surcharge/Income-for-Medicare-levy-surcharge-purposes/. This would extend to the Medicare Levy.
4. This would replace the income-tested exemption and 2% Medicare Levy, together with the 1-1.5% Surcharge, with a graduated individual tax scale more like personal income tax (where only income *above* each threshold is taxed at the marginal tax rate). Currently, most taxpayers with income above the exemption thresholds pay the flat 2% Levy on *all* of their income. In this proposal, the first tax rate (which would be zero to replace the current low-income exemption) would apply to low-income earners, the second tax rate would apply to middle income-earners, and the third tax rate to high-income earners. The tax free threshold would be supplemented by add-ons for couples and families so that households with low incomes are still exempted.

5. The Medicare Levy would be calculated annually in tax returns as a fixed percentage of the personal income tax payable by each individual. It would 'piggy-back' the progressive income tax system.
6. The Australia Institute proposes a 10% rate to replace the Medicare Levy only (not the Surcharge). They estimate this would raise an additional $2.7B a year in the short term. To raise at least $4B and replace the revenue raised by the Surcharge, approximately $2B more would be needed, so the rate may have to be slightly higher, for example 12%.

3. Conclusion

The NDIS, along with health and aged care, are essential services we could all need at some stage of our lives. The Government should guarantee universal access to these services and we should all contribute to their cost according to our ability to pay.

Their cost will rise as the population ages and historic gaps in the services available to people are redressed – including disability services, mental and dental health.

Almost 60% of people would be willing to pay more tax to fund better health and aged care services and it is likely that this would also apply to the NDIS. We welcome the apparent consensus among the major parties that at least another $4B a year should be raised in the short term to finance the NDIS and other essential services. The Medicare Levy is well suited to raising additional revenue this purpose.

ACOSS welcomes both the Government's and Labor's proposals to raise revenue to help fund the NDIS, but to date they have not agreed on a common position; and both proposals have weaknesses. We raise four alternative options to assist the Parliament in reaching agreement on a fair and robust revenue source for the NDIS: removing the health insurance exemption from the Surcharge (as proposed by the Australian Greens); broadening the income 'base' of the Levy to include tax-sheltered income; replacing the Levy and Surcharge with a Levy with a three-tier tax scale; and replacing them with a Levy based on a proportion of personal income tax paid each year.

Resolving this issue is both vital and urgent.

Attachment 1: How the Medicare Levy and Surcharge work

The Medicare Levy has two components: the Levy itself and the Medicare Levy Surcharge (MLS) for high-income earners without private health insurance.

The Medicare Levy

The Medicare Levy is a 2% tax on all taxable income for individuals not exempted. In this way it is very different to the income tax rate scale, where the tax rates only apply to the slice of income above each tax threshold (including the tax free threshold).

Exemptions apply to individuals earning less than $21,655 and couples or families earning less than $34,244 (higher for Seniors). These thresholds are indexed each year. The tax rates that effectively apply to individuals and families at different income levels are shown in Table 1.

Table 1: Medicare Levy rates and thresholds (2016-17)

	Taxable income ($ per year)	Tax rate (%)
Singles (<65 years)		
	0-21,655	0%
	21,656- $27,068	10% [2.]
	> $27,068	2% of *all* income
Singles (>64 years)		
	0-34,244	0%
	34,245-42,805	10% [2.]
	>42,805	2% of *all* income
Couples and families with children (<65 years) Combined income: [1.]		

	Taxable income ($ per year)	Tax rate (%)
	0-36,541	0%
	36,542-45,676	10% [2.]
	>45,676	2% of *all* income
Couples and families with children (>64 years) Combined income: [1.]		
	0-47,670	0%
	47,671-59,587	10% [2.]
	>59,587	2% of *all* income

1. Exemption is based on the combined taxable income of partners, plus $3,356 per child.
2. This is the effect off the income test, which phases out the Medicare Levy low-income exemption by 10 cents for each additional dollar earned.

The exemptions and income tests are designed to ensure that those on the lowest incomes, including people who rely on social security for their income, do not need to pay. In the personal tax scale, this role is played by the tax free threshold and series of tax rebates for social security recipients and others.

It is clear from the table that the Medicare Levy is much more complex that a tax of 2% on everyone's incomes.

A further complication is the 10% tax rate that effectively applies to individuals and couples whose incomes are just above the exemption thresholds. Since this applies to family as well as individual income it has a significant impact on the tax paid by lower income-earners in married couples, the vast majority of whom are women.

Medicare Levy Surcharge

The Surcharge was introduced by the Howard Government to encourage high-income earners to take out private hospital insurance.

The Surcharge is potentially a progressive element of the Medicare Levy since it adds up to an extra 1.5% to the personal tax paid by people with high incomes. It is currently levied at rates from 1% to 1.5% on all income of individuals and families earning above certain thresholds who have not taken out private hospital insurance, as shown in table 2.

Table 2: Medicare Levy Surcharge rates and thresholds (2016-17)

	Income thresholds			
Singles	$90,000 or less	$90,001–$105,000	$105,001–$140,000	$140,001 or more
Families [1]	$180,000 or less	$180,001–$210,000	$210,001–$280,000	$280,001 or more
Rates [2]	0.0%	1.0%	1.25%	1.5%

1. Plus $1,500 for each dependent child after the first.

2. Applies to all income of those not exempted.

Like the Medicare Levy the Surcharge also takes family income into account, which impacts on the tax paid by many married women with low or modest incomes

A special definition of income called ''income for medicare levy surcharge purposes' is used to determine whether an individual or couple has to pay the surcharge. Unlike the 'taxable income' base used for the Medicare Levy, this includes income that has been sheltered from tax using a number of common tax shelters; including negative gearing, salary sacrifice, and (to a lesser degree) private trusts. This is intended to prevent high-income earners from avoiding the Surcharge by diverting their income into those shelters. However, once it is determined that the Surcharge applies, it is applied to the individual's taxable income plus reportable fringe benefits (see box below).

Income for medicare levy surcharge purposes includes the total of:

- taxable income (including the net amount on which family trust distribution tax has been paid and your spouse's share of trust income on which the trustee is assessed under section 98, and which has not been included in your spouse's taxable income),
- total reportable fringe benefits,
- total net investment loss,
- reportable super contributions,
- less: if you are aged 55 – 59 years old, any taxed element of a superannuation lump sum, other than a death benefit, which you received that does not exceed your low rate cap.

If you exceed the threshold, this means you are liable to pay the Medicare Levy Surcharge, but the total is not used to calculate how much surcharge you pay. The surcharge payable is based on the sum of taxable income and reportable fringe benefits.

Attachment **2: Impact of the Government's and Labor's proposals on households**

The data below, from Australian National University's Centre for Social Research and Methods, compares the impact on different households of the Government's and Labor's proposals to raise approximately $4B a year, that is:

- The Government's proposed 0.5% increase in the Medicare Levy; and
- Labor's proposals to increase the Medicare levy by 0.5% for individuals earning over $87,000 and retain the 2% Deficit Levy for those earning more than $180,000.

The key findings (shown in Tables 1 and 2 below) are that:

- These two proposals raise similar revenue in the short-term – close to $4 billion - in 2019-20

- The Government's proposal is mildly progressive:
  For example, the average increase in tax for households in the lowest 40% by income is 0.07% of their income (an average $30 a year), compared with 0.4% ($289) for the middle 20%, and 0.6% ($1,100 a year) for those in the highest 20%.
  This is due to the exemption of the vast majority of the lowest 40% (most of whom, including many retirees, rely on social security for their income) from the Medicare Levy.

- Labor's proposal is more progressive:
  Compared to the Government's proposal, those in the middle and second-highest quintiles would pay significantly less: 0.1% and 0.2% of income ($67 and $253 a year) respectively compared with 0.4% and 0.6% ($289 and $572 a year) respectively in the Government's proposal.
  On the other hand, the average tax increase for the highest 20% of households would be almost 50% higher - from 0.6% of income in the Government's proposal to 0.9% ($1,105 to $1,735 per year).
  This is due to the exemption of the vast majority of the lowest 60% of households from any tax increase, with this revenue loss recouped from people drawn from the highest 20% of households.

Table 1: Impact of the Government's 2017 Budget proposal

Average impact on households of Budget proposals in 2019-20*

Average impact	Lowest	2	3	4	Highest	All
($pa)	-$3	-$57	-$289	-$572	-$1105	-$401
(% of income)	-0.01%	-0.13%	-0.41%	-0.55%	-0.6%	-0.2%

Source: Australian National University's Centre for Social Research and Methods and ACOSS calculations
Note: * Increase Medicare levy by 0.5%, raising $3.6B in 2019-20
Few households in the lowest 40% (approximately 13%) would be impacted as their income falls below the exemption thresholds.

Table 2: Impact of Labor's alternative proposals

Average impact on households of Labor proposals in 2019-20*

Average impact	Lowest	2	3	4	Highest	All
($pa)	-$0	-$7	-$67	-$253	-$1,735	-$408
(% of income)	0%	-0.01%	-0.1%	-0.22%	-0.88%	-0.2%

Source: Australian National University's Centre for Social Research and Methods and ACOSS calculations
Note: * retain 2% Deficit Levy and increase Medicare levy for those earning over $87,000 only; raising $4.1B in 2019-20
Few households in the lowest 60% (approximately 5%) would be impacted as only individuals earning over $87,000 would pay more.

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