The Medicare levy surcharge arrangements
Tax penalty or hidden tax subsidy?

Julie Smith

Number 38
August 2001

THE AUSTRALIA INSTITUTE

The Medicare levy surcharge arrangements
Tax penalty or hidden tax subsidy?

Julie Smith
Senior Research Fellow, The Australia Institute

Discussion Paper Number 38
August 2001

ISSN 1322-5421

Acknowledgements

I am grateful to Ian McAuley (Lecturer in Public Finance at the University of Canberra) and Dr Jim Butler for helpful discussion and comments on drafts. Final responsibility for the paper rests with the author.

Table of Contents

List of Tables

Executive Summary

In July 1997, the Commonwealth government introduced an increased Medicare levy of 1.0 per cent on high-income earners without private patient hospital insurance, known as the Medicare levy surcharge. This accompanied the Private Health Insurance Incentives Scheme (PHIIS), a means tested tax rebate, later replaced with the 30 per cent rebate for private health insurance. While the 30 per cent rebate has received considerable attention in public debate, there has been less scrutiny of the policy of exempting those with private patient hospital insurance from the Medicare levy surcharge.

Since 1996, the Treasury has published annual estimates of Commonwealth tax expenditures. According to the OECD, a tax expenditure is a departure from the generally accepted ('benchmark') tax structure which produces a favourable treatment of particular types of activities or taxpayers.

Treasury's 2001 'Tax Expenditures Statement' (TES) presents the Medicare levy surcharge arrangements as a $25 million 'tax penalty'. We show in this paper that the 'tax penalty' approach to accounting for the Medicare levy surcharge arrangements is misleading, and inconsistent with international practice as well as with treatment of other similar personal exemptions. It is also contrary to Treasury's stated aims for tax expenditure reporting in Australia, which are to facilitate cost scrutiny, enable more comprehensive assessment of the size of government, and allow comparison of assistance provided to different industry sectors.

The Medicare levy surcharge arrangements should also be seen as a tax relief for the privately insured because that is the way the industry assistance scheme is implemented in practice. The relevant legislation provides for a general surcharge on the Medicare levy, and a specific exemption for a distinct class of taxpayers, those with private patient hospital cover. On conventional definitions of 'tax expenditures', the Medicare levy surcharge should thus be considered part of the benchmark tax structure, and the value of the exemption from the 1 per cent Medicare levy surcharge for those with private patient hospital insurance counted as a tax expenditure.

Furthermore, in other countries, the term 'tax penalty' generally covers denial of income tax deductions for 'proscribed activities' such as payments of bribes or fines. Reporting the Medicare levy surcharge arrangements as a 'tax penalty' on those without private health insurance, rather than as an exemption from the increased Medicare levy on higher income earners, therefore implies it is illicit for some taxpayers to rely on Australia's public health insurance scheme, Medicare. Such a use of the tax system raises the possibility of a future 'tax penalty' on taxpayers whose children attend public schools.

Viewing the Medicare levy surcharge exemption as a tax expenditure which exempts a distinct class of taxpayers from the increased Medicare levy, consistent with OECD criteria for tax expenditures, we estimate the cost of revenue forgone by the exemption to exceed $750 million annually. This adds to the already large annual cost of the 30 per cent rebate for private health insurance.

The Medicare levy surcharge arrangements are intended to assist the private health insurance industry stabilize its coverage. Excluding this assistance and reporting it as a penalty reduces scrutiny of the cost-effectiveness of this policy, and masks the extent of government activity to support private health insurance. Over the last two decades, industries receiving high rates of effective assistance such as the textiles and car industries have been subject to regular, public scrutiny and restructuring to reduce the effective rate of protection. However, the extent and financial value of industry assistance for the private health insurance industry has been grossly understated because of the misleading treatment in the TES. It also avoids any regular review.

1. Introduction

In July 1997, the Commonwealth government introduced an increased Medicare levy of 1.0 per cent on high-income earners without private patient hospital insurance, known as the Medicare levy surcharge. This accompanied the Private Health Insurance Incentives Scheme (PHIIS), a means tested tax rebate which was replaced from January 1999 with a 30% cash rebate for private health insurance.

Present policies of encouraging private health insurance are costly to public revenue. The 'tax subsidy' provided in the form of a tax rebate for private health fund membership is high compared to historical levels (Butler and Smith 1992). When introduced, the 30 per cent rebate scheme was expected to rise to $1.36 billion by 2002-03 (Senate Community Affairs Legislation Committee 1998). With population coverage reportedly rising sharply to over 40 per of the population in June 2000, the cost of the rebate was substantially revised (Senate Community Affairs Legislation Committee 2000). It is now estimated the cost could reach $2.4 billion a year (Segal 2000).

As a result of present policy, the health insurance industry receives more budgetary assistance than the mining, manufacturing and primary agricultural production industries combined (Duckett and Jackson 2000).

While there has been considerable attention in public debate to the 30 per cent rebate for private health insurance premiums, there has been less discussion of the policy of exempting those with private patient hospital insurance from the Medicare levy surcharge. Although the Medicare levy surcharge arrangements were was part of a package of measures aimed at stabilizing declining private health fund membership and profitability, it has hardly figured in discussion of public assistance for private health insurance or of the increased profits in the industry. Until this year, the Medicare levy surcharge arrangements were not even considered in the Commonwealth Treasury's annual estimates of tax expenditures (Treasury 2001).

Below we seek to remedy that deficiency. First of all we consider the rationale for estimating tax expenditures, and the conceptual basis for measurement. In the second section, we review broad trends in Commonwealth income tax expenditures in recent years, and outline the 'tax penalties' including the Medicare levy surcharge reported in Treasury's annual Tax Expenditures Statement (TES). We then assess the current approach to accounting for the surcharge in the TES against international practice and against the stated aims of tax expenditure reporting in Australia.

2. What are 'tax expenditures' and why do tax expenditures matter?

Tax expenditure reporting began in the late 1960s and was adopted in most industrialized countries during the 1980s (OECD 1996). A tax expenditure is a departure from the generally accepted ('benchmark') tax structure which produces a favourable treatment of particular types of activities or taxpayers (OECD 1984). Tax expenditures may take the form of exemptions (income excluded from the tax base); allowances (amounts deducted from gross income to arrive at taxable income); credits (amounts deducted from tax liability); rate reliefs (a reduced rate of tax applied to a class of taxpayers or activities); and tax deferrals (a relief which takes for the form of a delay in paying tax).

Where the tax system departs from this norm, a tax expenditure is said to exist.

Analysis of tax expenditures is important for public policy because government processes for scrutinizing tax concessions are often less rigorous than those for examining budget spending. Subsidies provided through tax relief can substitute for direct public subsidies with a similar policy objective. The distribution of benefits from tax expenditures may be quite different from the distribution of budget subsidies (Surrey and McDaniel 1985).

As a recent OECD review of tax expenditures (1996) pointed out:

> The concept of a tax expenditure was developed because accounting for the costs and benefits of tax measures is often less rigorous than for direct expenditures, despite the fact that a tax system can be used to achieve similar goals as those of public spending programmes. As governments increasingly broaden tax bases and lower tax rates, tax expenditure accounts have become an important tool in analyzing tax reform.

Expanding the use of the tax system for non-revenue social and economic goals moves in the opposite direction to the purported principle of tax reform in the last two decades because tax concessions narrow the tax base, and increase the marginal rate of taxation needed to finance any particular level of government spending.

The Treasury has published an annual set of estimates of tax expenditures of the Commonwealth government since 1986 (Treasury 1999). These Treasury estimates provide the basis for estimates of tax expenditures on health published by the Australian Institute of Health and Welfare (AIHW 2000). Official estimates of tax expenditures are compiled on a similar basis to those compiled by Butler and Smith (1992) for the period 1960-61 to 1988-89. Estimates are based on data from taxation statistics published annually by the Australian Taxation Office, derived from tax administrative processes.[1] The Commonwealth *Charter of Budget Honesty Act 1998* now requires publication of detailed information on Commonwealth tax expenditures.

According to Treasury (2001), the primary purpose of the Tax Expenditures Statement (TES) is 'to provide estimates of the value of concessions received by individuals and businesses as a result of tax expenditures', thereby permitting review and scrutiny as to

[1] The latest publication is for income year 1998-99.

'whether objectives are met at reasonable cost' comparable with that for direct expenditures.

The estimates are also to provide a more comprehensive assessment of Commonwealth government activity than direct expenditures.

> Unless both direct and tax expenditures are considered, the apparent size of government could be reduced simply by pursuing the objectives of expenditure programs through tax expenditures (2001, p.2).

The other main purpose noted by Treasury is to allow comparison of assistance provided by the Commonwealth government to different sectors:

> An examination of direct expenditures alone can present a misleading picture, particularly since the benefits derived from tax expenditures are for some sectors, greater than those derived from direct expenditures (2001, p.2).

For example, according to the TES (Treasury 2001), the mining and mineral resources, manufacturing and construction industries received direct Budget assistance of $928 million in 1999-2000, compared to over $5 billion p.a. through tax subsidies. By contrast, direct expenditures on social security of around $57 billion p.a. were considerably greater than the $17 billion annually of tax concessions aimed at 'social security and welfare', including $9.5 billion for concessional tax treatment of superannuation.

There are a number of technical issues surrounding the measurement of tax expenditures. There are also specific features of the taxation statistics that signal the need for care in their use. These issues are discussed more fully in a previous study published by The Australia Institute (Smith 2000).

It is important to recognise that measuring a tax expenditure depends on how the tax benchmark is defined. A number of conceptual issues arise from the problem of identifying what is a tax expenditure as distinct from a part of the benchmark tax structure.[2] The norm, or benchmark, may differ between countries and over time. Such differences in the benchmark for measuring tax expenditures include:

- how the tax base and tax-paying unit is defined;
- whether it is adjusted for inflation;
- what degree of integration between the corporate and individual taxation is considered desirable;
- which accounting period is appropriate;
- whether a realisation or accruals basis is used for assessment; and
- how tax penalties and negative tax expenditures are assessed (OECD 1984).

A recent OECD survey of tax expenditures and benchmark tax structures found that

[2] The main conceptual issues arising in estimating tax expenditures are discussed more fully in Butler and Smith (1992).

> In general the norm includes the rate structure, accounting conventions, the deductibility of compulsory payments, provisions to facilitate administration and those relating to international fiscal obligations. (1996 p. 9).

Discussing such conceptual issues in Appendix A of its 1999 TES publication, Treasury set down its approach (1999, p. 59):

> Tax expenditures are those provisions of the Australian taxation law which effectively tax certain classes of taxpayers or particular types of activity differently from a chosen benchmark. A positive tax expenditure arises where an activity or class of taxpayer is taxed preferentially with respect to a chosen benchmark. A negative tax expenditure arises where taxation is at a higher rate than implied by a chosen benchmark structure. Almost all tax expenditures identified in this Statement are positive.

Treasury continued:

> The decision as to an appropriate benchmark for determining tax expenditures is a matter for judgment: benchmarks may vary across countries and within countries over time. The principal criterion of benchmark design is that it should represent the neutral taxation treatment of similarly placed activities or classes of taxpayer (That is, neutral taxation treatment neither favors nor disadvantages similarly placed activities or classes of taxpayer).

Where it was difficult to ascertain whether a tax provision should be part of the benchmark tax structure or listed as a tax expenditure, Treasury states that its approach is that 'the Statement generally lists as tax expenditures items for which such a categorization is marginal'.[3] This should me, having regard to Treasury's stated objectives for tax expenditure reporting, that where there is doubt about whether a provision should be identified as a tax expenditure, they be listed as such. The underlying principle of providing such information is transparency (OECD 1996).

As well as considering issues surrounding the identification of the benchmark tax structure, it is also important to note that the usual approach to measuring tax expenditures excludes behavioural effects, with taxpayer behaviour assumed to be unaffected by the assumed deletion of a tax expenditure provision. This is the same approach used to determine the revenue effects of changes in the tax laws (Surrey and McDaniel 1985).

Furthermore, tax expenditure analysis ignores the issue of tax incidence, which can be important because the legal incidence of a tax subsidy may differ from the economic incidence. The benefit of a personal income tax rebate for private health insurance coverage may, for example, accrue mainly to the insurance funds who may thereby be enabled to maintain a higher level of profit than would otherwise be the case. (This problem arises in attributing direct expenditures as well as tax expenditures insofar as

[3] Australia has a very detailed formal definition of the benchmark, derived from the Haig-Simons definition of comprehensive income (that is, the change in net economic wealth between two points in time plus consumption in that period) and a principle of neutral fiscal treatment of similarly placed activities and taxpayers.

their immediate impact differs from their final incidence.) The usual practice among OECD countries is to allocate the tax subsidy to the taxpayer who immediately and directly benefits from it, even when there is a clear duality of beneficiaries (OECD 1984). Recent reports of drastically increased profitability in the private health insurance industry in Australia shows that a substantial part of the value of income tax concessions for private health insurance is passed on to the private health insurance funds.

It is generally recognized that consistency requires identification of tax penalties as well as tax expenditures (OECD 1984). Tax penalties are provisions departing from the normal tax structure that require a greater tax payment than would otherwise be due under that structure. Surrey and McDaniel (1985) concluded that such tax penalty provisions were the functional equivalents of direct government regulatory or financial penalty rules.[4] For example, in the United States businesses are denied deductions for fines paid to government entities. While court decisions and later statutes denied such deductions because they were not 'ordinary and necessary' business expenses, under normative tax and accounting principles these costs should be deductible because they are costs of earning income.

A tax penalty arises because the denial of the deduction results in taxing more than net income, and is equivalent to imposing a fine for carrying on the proscribed activity.[5]

[4] Tax penalties identified in the US Internal Revenue Code included for example, the limitation on deduction for business lobbying costs; disallowance of deduction for bad debts of political parties; disallowance of deduction for illegal bribes and kickbacks; and disallowance of deduction for business fines and penalties.

[5] While denial of deductions for the cost of producing income should be classified as tax penalties since the result is to tax more than net income, not all limitations imposed on deductions constitute tax penalties. In particular, 'limitations on tax expenditure deductions simply define the scope of eligibility for the program and do not constitute tax penalties' (Surrey and McDaniel 1985, p. 224).

3. Commonwealth tax expenditures

3.1 Broad trends in tax expenditures

Aggregate tax expenditures have grown rapidly from 1998-99, with the rising cost of the tax subsidy for private health insurance a key factor in the 6 per cent expansion of Commonwealth tax expenditures between 1998-99 and 1999-2000 (Treasury 2001). Treasury expects this high rate of growth of tax subsidies to continue due to the substantially increased cost of the private health insurance rebate.

Aggregate tax expenditures on health represented just under 5 per cent of direct expenditures on health in 1999-2000 (Treasury 2001), that is, one dollar of every twenty in the Commonwealth health budget. Most of this is accounted for by tax concessions for private health insurance (Table 1).

3.2 Tax penalties in the TES

Few tax penalties are reported in the TES. Treasury attributes a tax penalty of $80 million for the higher rate of excise imposed on leaded fuel compared to unleaded fuel and diesel,[6] with the additional revenue counted as a negative tax expenditure on health. The other such 'negative tax expenditure' items listed in the most recent TES are:

- Certain alcoholic beverages are denied the excise-fee threshold of 1.15% of alcohol which applies to beer
- Accelerated depreciation allowance for plant and equipment and for Australian trading ships and transitional arrangements for prepayments, where existing concessions are being phased out

While not specified separately as a tax expenditure, the income tax surcharge on superannuation contributions for high-income earners is effectively treated as a tax penalty by the Treasury. The revenue impact of this surcharge on high-income earners is included as an offsetting item to the estimated revenue cost of undertaxing employer contributions to superannuation funds (Treasury 2001, p. 102). It is not reported as a separate tax expenditure.

The 1 per cent increase in the Medicare levy has applied since 1 July 1997 to single individuals with taxable incomes exceeding $50,000 p.a. (and couples and families with combined taxable incomes in excess of $100,000 p.a.) without 'adequate' private health insurance (Treasury 2001, p. 53). This is included in the most recent TES as a negative tax expenditure of $25 million p.a. expected for 2001-02 and subsequent financial

[6] As the lower price for diesel for heavy vehicles is likely to damage health, its inclusion in this benchmark is questionable.

years.[7] As a 'tax penalty', its budgetary impact is represented as a cost equal to minus the revenue raised.[8]

Table 1 Tax expenditures on health

Description	2001-02, $ million
Medical expenses rebate	150
Exemption from the Medicare levy for residents with taxable income below a threshold (a)	300
Medicare levy exemption for non-residents, repatriation beneficiaries, foreign government representatives, and certain residents	50
Income tested tax offset for private health insurance	Na
30 per cent rebate for expenditure on private health insurance	310 (b)
Exemption of private health insurance rebate/benefit including expense equivalent	760
Medicare levy surcharge	-25
Employee/family travel costs associated with overseas medical treatment	<5
Benefits provided by public hospitals to their employees	135
Income tax exemption for registered health benefit organisations	50
Penalty rate of excise levied on leaded petrol	-80
Penalty rate of excise levied on cigarettes with less than 0.8 grams of tobacco	Na
Income tax exemption for public and non-profit hospitals	<1
Total tax expenditures on health (direct Commonwealth expenditures on health)	**1650 (28940)**

Source: (Treasury 2001)
(a) In the latest TES, Treasury lists for the first time the revenue cost of any refundable tax credits, including the 30 per cent rebate, being non-taxable.
(b) These estimates exclude the budgetary cost of direct payments of the 30 per cent health insurance rebate.

3.3 Treating the Medicare levy surcharge as a tax penalty

The TES treatment of the 1 per cent Medicare levy surcharge on uninsured high-income taxpayers as a 'tax penalty' raises important issues regarding the purpose and practice of tax expenditures accounting. In our previous study (Smith 2000), we argued for the inclusion of the Medicare levy surcharge arrangements in the TES, but we also argued against the 'tax penalty' approach the Treasury has now adopted. Here we show that

[7] The $25 million expected receipt of revenue from the surcharge in 2002-02 represents a substantial fall compared to the $140 million estimated to be collected from the surcharge in 1999-00 (i.e. the 1998-99 tax year).
[8] Taxation statistics indicate the number of taxpayers paying the Medicare levy surcharge in 1998-99 more than doubled to 230,000 compared to 107,276 in the previous year ((ATO) 2000).

using this approach to account for the Medicare levy surcharge arrangements is misleading and inconsistent with international practice as well as with treatment of other similar personal exemptions. It is also contrary to the stated objectives of tax expenditure reporting in Australia, of facilitating cost scrutiny, allowing more comprehensive assessment of the size of government, and comparing the level of industry assistance (Treasury 2001).

The legislative form of the Medicare levy surcharge arrangements, the *Medicare Levy Amendment Act (No 16) 1996*, indicates clearly that the surcharge exemption is a tax relief for a distinct class of taxpayers. The legislation imposes the surcharge by a general provision for an increased Medicare levy on taxpayers with income above a threshold level, and then specifies and exemption from the increased Medicare levy for those persons covered by an insurance policy providing private patient hospital cover. It does not provide specifically for a surcharge on those without private insurance.[9] Hence the actual legislated benchmark is a progressively structured Medicare levy, with an exemption (i.e. tax relief) allowed to a distinct class of high-income earners - those with private insurance coverage. This implies it is the exemption from the surcharge – the tax relief for those with private patient hospital insurance – that represents the departure from the benchmark tax system, not the surcharge itself.

This interpretation is consistent with the Treasury's own view of the Medicare levy. Treasury considers the Medicare levy as part of the benchmark income tax system, along with the 'legislated progressive personal income tax rate scale' (Treasury 2001, p. 15).[10] (On this basis, the exemption from the Medicare levy allowed to certain groups including residents with incomes below a threshold is counted as a tax expenditure.[11])

As Treasury accepts the Medicare levy as part of the income tax benchmark, it seems logical that the increased Medicare levy on higher income taxpayers ('the Medicare levy surcharge') also be considered part of the income tax benchmark, as in other countries the norm generally includes the rate structure (OECD 1996). The surcharge is simply an instrument for increasing the progressivity of the existing proportional scale, and is therefore comparable with a graduated scale having a higher rate on higher income levels.

To classify current arrangements as a 'tax penalty' on those without 'adequate' private insurance also appears inconsistent with the practice for identifying tax penalties in other OECD countries, which generally arise from denial of deductions for carrying on a proscribed activity like offering illegal bribes, and are conceptually equivalent to the imposition of a federal government fine for carrying out the proscribed activity. Unless it is now a 'proscribed activity' in Australia for a high-income taxpayer to rely on the publicly-funded Medicare system as health insurance, it is therefore anomalous to treat

---

[9] Specifically, the *Medicare Levy Act* was amended to provide in sections 8B-8G for an increase in the Medicare levy for all individuals and certain trustees who were 'not covered by an insurance policy that provides private patient hospital cover', and was 'not a prescribed person'. The main categories of 'prescribed persons', who are fully or partly exempt from the Medicare levy, are defence personnel, persons entitled under veterans' entitlement legislation and blind pensioners and sickness beneficiaries.

[10] The benchmark adopted by the Commonwealth Treasury for estimating Australia income tax expenditures is discussed in detail in Appendix A to its annual Tax Expenditure Statements.

[11] This tax expenditure was costed at around $300 million in 2001-02. The cost of exemptions from the Medicare levy for non-residents, repatriation beneficiaries, foreign government representatives and certain residents are also treated as tax expenditures, with an estimated annual revenue cost of $50 million.

the Medicare levy surcharge as a 'tax penalty' for the purpose of tax expenditure reporting.

Furthermore, Treasury has stated that it considers 'the principal criterion of benchmark design' to be that 'it should represent neutral taxation treatment of similarly placed activities or classes of taxpayers' (1999). Treasury also notes that a criterion used to identify tax expenditures in other OECD countries is that it 'provides assistance to a distinct class of taxpayer and could be replaced by a direct outlay'. It is on these grounds that the Treasury has chosen since 1994-95 to identify the income tax rebate for low-income earners as a tax expenditure (Treasury 2001).[12]

It can thus be similarly argued regarding the Medicare levy surcharge arrangements that the exemption is not intended to be neutral in its effect on taxpayers as it represents part of the incentive structure the government has deliberately put in place to encourage the purchase of private health insurance. exemption 'provides assistance to a distinct class of taxpayers' – that is, high-income taxpayers with private patient hospital insurance.

The Medicare levy surcharge exemption also clearly could be a substitute for a direct outlay. Policy instruments that could be considered as alternative means to the same end include for example, health regulations compelling private health fund membership for high-income earners, or exclusion of high income earners from receiving Medicare benefits or treatment in a public hospital, as well as direct subsidies from the Budget.

Treating present arrangements as a 'tax penalty' shields the present policy from scrutiny for its cost-effectiveness in increasing private health insurance coverage via tax incentives compared to other more transparent policy instruments. It also has the effect of understating the extent of Commonwealth government activity and the size of government intervention in private health insurance markets.

To treat the Medicare levy surcharge arrangements as a tax penalty rather than a tax expenditure is therefore inconsistent with the criteria Treasury purports to use in identifying tax expenditures and does use for identifying tax expenditures benefitting low income taxpayers, and is inconsistent with key objectives it has set down for tax expenditures reporting in Australia.

In treating the Medicare levy surcharge as a 'tax penalty', rather than viewing the surcharge exemption as a tax relief, the Treasury apparently views these arrangements as comparable with the superannuation surcharge on high-income earners. However, the Medicare levy surcharge exemption is clearly and deliberately a device to support private health insurance, and unlike the superannuation surcharge, the Medicare levy surcharge is not intended to limit or offset the tax subsidy for private health insurance. Rather, it has the objective of providing more such assistance and encouragement. As noted earlier, that latter surcharge is intended as a claw-back of existing tax concessions for superannuation that are reported as tax expenditures in the TES.

Choosing to account for the Medicare levy surcharge arrangements as a 'tax penalty' on those without private insurance rather than as a 'tax relief' for the privately insured prevents comparison of public assistance to the private health insurance industry with

[12] The low incomes rebate introduced with effect from the 1993-94 income year was formerly considered part of the benchmark income tax system, as part of the progressive personal income tax rate scale (OECD 1996).

that provided to other industries. This too is contrary to the stated aims of tax expenditure reporting, and treats the private health insurance industry differently from other industries, where the thrust of regulatory and public financial policy is to ensure government assistance to industry is transparent.

As noted earlier, Treasury has also stated that its approach where there is doubt about whether a provision should be identified as a tax expenditure is to include it.

The approach which is most consistent with the main principles and usual criteria for identifying tax expenditures both in Australia and overseas would therefore be to define the Medicare levy surcharge as part of the benchmark income tax system, and identify the exemption for those with private patient hospital insurance as a tax expenditure on health.

3.4 The revenue cost of the Medicare levy surcharge exemption for private health insurance

The value of the tax relief afforded by the Medicare levy surcharge exemption for those with private patient hospital insurance can be estimated in a comparable way to other tax expenditures as the 'revenue forgone' due to the exemption.

This can be estimated by calculating the per capita Medicare levy surcharge applying for those paying the surcharge in each taxable income group above $50,000 p.a. from taxation statistics ((ATO) 2000). The number of insured taxpayers benefiting from this tax relief can be approximately measured by the difference between the number of those paying the Medicare levy in each income group, and those already paying the surcharge in each income group. The value of the tax expenditure is then estimated as the sum of the per capita surcharge for each income group multiplied by the number of individuals paying the Medicare levy but not the surcharge in each income group above $50,000.

While this overstates the value of the tax expenditure because there are of a number of couples or families where the second earner has a taxable income below $50,000, who would not be liable for the surcharge, it provides a reasonable starting point for estimating the value of the tax relief afforded by the provision.

Table 2 Medicare levy surcharge, 1998-99

Grade of taxable income	Medicare levy		Medicare levy surcharge			Medicare levy payers exempted from levy surcharge	Revenue forgone by exemption from levy surcharge
	no.	$	no.	$	$ per capita	no.	$
Under $5 401	1 224	64 436	0	0	0	1 224	na
$5 401 - $9 999	1 229	140 755	0	0	0	1 229	na
$10 000 - $14 999	268 215	38 878 876	1 643	219 574	134	266 572	na
$15 000 - $20 700	968 045	256 813 008	5 680	960 383	169	962 365	na
$20 701 - $24 999	777 784	261 925 364	4 357	926 664	213	773 427	na
$25 000 - $29 999	928 783	377 379 608	4 876	1 241 386	255	923 907	na
$30 000 - $34 999	827 430	399 726 763	4 897	1 461 474	298	822 533	na
$35 000 - $38 000	456 093	248 220 438	3 391	1 130 987	334	452 702	na
$38 001 - $39 999	261 983	152 042 720	2 215	783 273	354	259 768	na
$40 000 - $50 000	987 279	657 667 895	11 835	4 818 668	407	975 444	na
$50 001 - $69 999	785 974	675 538 746	121 070	64 713 559	535	664 904	355 400 217
$70 000 - $99 999	282 334	338 615 032	45 063	32 894 271	730	237 271	173 198 779
$100 000 - $199 999	131 847	249 341 481	22 224	24 142 242	1086	109 623	119 084 998
$200 000 - $499 999	27 889	116 328 836	2 537	5 635 418	2221	25 352	56 314 197
$500 000 - $999 999	3 729	36 484 882	242	1 268 778	5243	3 487	18 281 938
$1 000 000 and over	1 171	33 653 609	71	1 190 208	16763	1 100	18 439 842
Total taxable	6 711 009	3 842 822 449	230 101	141 386 885	614	6 480 908	na
Total non-taxable	15 273	1 986 594	48	25 986	541	15 225	8 242 434
Total	**6 726 282**	**3 844 809 043**	**230 149**	**141 412 871**	614	6 496 133	**748 962 404**

Source: ATO (2000)

As can be seen in Table 2, if we correct for Treasury's misleading treatment of the exemption from the Medicare levy surcharge, then instead of a $25 million tax penalty, the Government provides a tax subsidy of up to $750 million p.a.[13]

The total cost of this hidden tax concession for high-income private health fund members will expand further in the 1999-2000 income tax year, because of the jump in fund membership around June 2000.

As a key aim of the TES is to enable a comprehensive assessment of Commonwealth activity and the size of government, it appears incongruous not to represent this magnitude of assistance to a private industry as a tax expenditure.

[13] This was estimated using taxable income categories. Estimating the forgone revenue for the surcharge exemption using gross incomes increases the result to $820 million.

4. Conclusion

The Medicare levy surcharge arrangements represent a substantial tax benefit that has attracted virtually no comment or analysis because of its lack of transparency and its previous omission from the Treasury's annual *Tax Expenditures Statement*.

Unlike for other industries receiving assistance through the tax system, the value of assistance to the health insurance industry has been grossly understated because the tax benefit represented by the Medicare levy surcharge arrangements has been excluded from the TES.

The inclusion of the Medicare levy surcharge in the latest TES as a 'tax penalty' is misleading and inappropriate, and contrary to the stated aims of tax expenditure reporting. On conventional definitions of 'tax expenditures', the Medicare levy surcharge should be considered part of the benchmark tax structure, and the value of the exemption from the 1 per cent Medicare levy surcharge for those with private patient hospital insurance should be counted as a tax expenditure. To treat it as a tax penalty wrongly implies that it is a 'proscribed activity' in Australia for high income taxpayers to rely on Medicare.

Presenting the Medicare levy surcharge arrangements as a tax relief for the privately insured is also be consistent with its actual legislative form, which legislates for a general surcharge, and specifically exempts a distinct class of taxpayers with private patient hospital cover.

The Medicare levy surcharge exemption for those purchasing private health insurance adds substantially to the existing large budgetary cost of tax rebates and direct subsidies aimed at supporting private health insurance, with this tax relief for private patient hospital cover costing over $750 million annually in forgone revenue, in addition to the cost of the 30 per cent rebate for private health insurance.

Even if a case can be made for the 'tax penalty' interpretation of the arrangements, it is inconsistent with the objective of tax expenditures reporting to treat these arrangements as a tax relief. In keeping with the conservative approach Treasury supposedly adheres to in identifying 'marginal' tax expenditures, the Medicare levy surcharge exemption should be identified as a tax expenditure.

The use of the Commonwealth's constitutional taxation powers to impose a discriminatory tax on individuals choosing not to purchase a commercial product has wider implications. The power to tax is a coercive power of government, and is traditionally subject to close scrutiny to protect against its abuse. The only comparable use of this tax power seems to be the compulsory superannuation levy.

Even aside from its lack of transparency in the TES about the use of tax power for other purposes, the Medicare levy surcharge arrangements for encouraging private health fund membership sets a disturbing precedent for governments to impose discriminatory income taxes based on other questionable criteria.

For example, at present, Commonwealth funding for education is met from general revenue without notional hypothecation such as from the Medicare levy. It is open to the Commonwealth government to introduce an earmarked personal income tax levy, for example, to fund the public education system.[14] Would this anticipate a tax surcharge on high-income taxpayers whose children attend public schools, with an exemption for those attending private schools?

Alternatively, would the Commonwealth government ever consider legislating for comparable arrangements on personal taxpayers without building insurance, in order to support the general insurance industry through difficulties associated with the HIH collapse?

While the Medicare levy surcharge exemption raises disturbing questions about the limits of the Commonwealth's use of taxation powers, the surcharge itself represents an untapped opportunity for expanding a progressive funding base for the public health system. Extending the Medicare levy surcharge to all high-income taxpayers by abolishing the exemption for those with insurance would be a simple legislative change that could substantially expand available revenues system by around $750 million for the public health care system. It would at the same time meet the objective of making health care financing more progressive by making all high-income earners contribute proportionately more to health care costs.

[14] The Timor levy is a recent example of such earmarked levies on high-income earners.

References

(AIHW) Australian Institute of Health and Welfare 2000, *Health expenditure bulletin*, Australian Institute of Health and Welfare, Canberra.

(ATO), Australian Taxation Office 2000, *Taxation statistics*, Commonwealth of Australia, Canberra.

Butler, J., and Smith, J. 1992, 'Tax expenditures on health in Australia: 1960-61 to 1988-9', *Australian Economic Review*,, no.3, pp. 43-58.

Duckett, S., and Jackson, T. 2000, 'The new health insurance rebate: an inefficient way of assisting public hospitals', *Medical Journal of Australia*, vol. 172, pp. 439-42.

OECD 1984, *Tax expenditures: a review of the issues and country practices*, OECD, Paris.

— 1996, *Tax expenditures: recent experiences*, OECD, Paris.

Segal, L. 2000, *Submission to Senate Community Affairs References Committee re First Report - Public Hospital Funding and Options for Reform*, Health Economics Unit, Centre for Health Program Evaluation, Monash University.

Senate Community Affairs Legislation Committee 1998, 'Private Health Insurance Incentives Bill 1998 Private Health Insurance Incentives Amendment Bill 1998 Taxation Laws Amendment (Private Health Insurance) Bill 1998.' http://www.aph.gov.au/senate/committee/clac_ctte/Ptehealth/index.htm. December.

— 2000, Hansard, CA77, *Senate Community Affairs Legislation Committee*, Canberra.

Smith, J. 2000, 'Tax expenditures and public health financing choices', Discussion Paper no. 33, Canberra.

Surrey, S., and McDaniel, S. 1985, *Tax expenditures*, Harvard University Press, Cambridge MA.

Treasury 1999, *Tax Expenditures Statement*, AGPS, Canberra.

— 2001, *Tax Expenditures Statement 2000*, AGPS, Canberra.

The Australia Institute promotes a more just, sustainable and peaceful society through research, publication and vigorous participation in public debate.

The Australia Institute is an independent non-profit public policy research centre. It carries out research and policy analysis and participates in public debates on economic, social and environmental issues. It undertakes research commissioned and paid for by philanthropic trusts, governments, business, unions and community organisations.

The Institute is wholly independent and not affiliated with any other organisation. As an Approved Research Institute, donations to its Research Fund are tax deductible for the donor.

Philosophy

The Institute was established in 1994 by a number of individuals from various sections of the community. They share a deep concern about the impact on Australian society of the priority given to a narrow definition of economic efficiency over community, environmental and ethical considerations in public and private decision making. A better balance is urgently needed.

The Directors, while sharing a broad set of values, do not have a fixed view of the policies that the Institute should advocate. Unconstrained by ideologies of the past, the purpose of the Institute is to help create a vision of a more just, sustainable and peaceful Australian society and to develop and promote that vision in a pragmatic and effective way.

Membership

Membership is a valuable means of contributing to the objectives of the Institute. The annual fee is $80 (with a discount for low-income earners). Members receive the *Newsletter*, published four times a year, and are entitled to Institute papers free of charge on request. They also receive discounted admission to some Institute functions.

If you would like to purchase our publications or support The Australia Institute through membership or donation please contact:

Garden Wing, University House, ANU, ACT 0200
Tel: (02) 6249 6221 Fax: (02) 6249 6448
Email: mail@tai.org.au
Website: www.tai.org.au

Discussion papers available from the Australia Institute
$21 per copy including GST and postage

37. Kayrooz, C., Kinnear, P., Preston, P., *Academic Freedom and Commercialisation of Australian Universities: Perceptions and experiences of social scientists*, March 2001
36. Dennis, R., *Measuring Employment in the 21st Century: New measures of underemployment and overwork*, February 2001
35. Hamilton, C. and Denniss, R., *Tracking Well-being in Australia: The Genuine Progress Indicator 2000*, December 2000
34. Baragwanath, C. and Howe J., *Corporate Welfare: Public Accountability for Industry Assistance*, October 2000
33. Smith, J., *Tax expenditures and public health financing in Australia*, September 2000
32. Kinnear, P., *Mutual Obligation: Ethical and social implications* August 2000
31. Denniss, R, *Taxing Concern? The Performance of the Green Power Scheme in Australia*

    August 2000
30. Toyne, P. and Farley, R, *The Decade of Landcare: Looking Backward – Looking Forward* July 2000
29. Chapman, B. and Kapuscinski, C., *Avoiding Recessions and Australian Long Term Unemployment* June 2000
28. *Indicators of a Sustainable Community: Improving quality of life in Newcastle* May 2000
27. Smith, J., *The Implications of the GST for Charities* February 2000
26. Turton, H. & Hamilton, C., *Population Growth and Greenhouse Gas Emissions* December 1999
25. Wensing, E., *Comparing Native Title an Anglo-Australian Land Law* November 1999
24. Neutze, M., Sanders, W., Jones, G., *Public Expenditure on Services for Indigenous People* September 1999
23. Eckersley, R., *Quality of Life in Australia: An analysis of public perceptions* September 1999
22. Hamilton, C. & Turton, H., *Business Tax Reform and the Environment: Emissions trading as a tax reform option* August 1999
21. Nevile, A., *Competing Interests: Competition policy in the welfare sector* June 1999
20. Quiggin, J., Saddler, H., Neutze, M., Hamilton, C., Turton, H., *The Privatisation of ACTEW: The fiscal, efficiency and service quality implications of the proposed sale of ACT Electricity and Water* December 1998
19. Turton, H. and Hamilton, C., *The GST Package and Air Pollution: The impact of proposed indirect tax changes on atmospheric emissions* September 1998
18. Disney, J., Nevile, J., Quiggin, J. and Smith, J., *Perspectives on the GST Package* September 1998
17. Sheehan, J. and Wensing, E., *Indigenous Property Rights: New developments for planning and valuation* March 1998
16. Smith, J., *Gambling Taxation in Australia* March 1998
15. Hamilton, C. and Quiggin, J., *Economic Analysis of Greenhouse Policy: A layperson's guide to the perils of economic modelling* December 1997