



# Assigning State Taxes in a Federation

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Australia's Future Tax and Transfer Policy Conference  
Melbourne, June 18-19, 2009



## A View from “Up Over”

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1. Is this place really a federation?
2. Should it be a federation?
3. If Australia wants (or needs) to be a real federation, then it should assign some serious tax bases to the states



# Why Not Decentralize Taxes?

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1. Horizontal competition
2. Grantsmanship games
3. Vertical overlap



# Benchmarks from the Literature

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1. Centralized taxation with decentralized service provision
2. Decentralized taxation and services
3. International 'best practice'
4. Tax autonomy at the margin



# Benchmark 1. Centralized taxation Decentralized services

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- Musgrave-Oates template
- No state taxes on mobile bases to minimize fiscal externalities
- Results in large VFI
- Australia comes close

# Benchmark 2. Decentralized Taxes



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- Tiebout? Switzerland – or Bosnia?
- Neglects the fiscal externalities emphasized in Benchmark 1
- Reverse VFI – not sustainable



# Benchmark 3. International Best Practice

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- 17 federations – 17 practices
- None completely at either of previous extremes
- Usually, like Australia, closer to Benchmark 1 than to Benchmark 2
- No obvious model
- NOSFA strikes again



# Benchmark 4. Tax Autonomy at Margin

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- Second-generation literature – Oates, Weingast
- Tax assignment should depend on spending assignment
- Tax autonomy at margin critical if hard budget constraint to be effective



# Australia in International Context

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- States have significant spending assignments
- But not much taxation
- Hence large VFI
- States have some tax autonomy
- But state taxes not very good
- And unlikely to grow with spending needs



# Taxes and Transfers

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- Australia has a well-developed equalization transfer now funded by GST revenues
- Key question: How do transfers and taxes interact?
- Problem 1. Bailout - not immediate, but possible
- Problem 2. Common pool - does GST transfer solve it?



# Issue 1. Vertical Fiscal Overlapping

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- Australia (like India) has largely avoided co-occupancy
- Canada (like US) epitomizes co-occupancy
- Vertical fiscal overlapping may induce excessive state taxation



## Issue 2. Horizontal Tax Competition

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- When states tax mobile bases, horizontal fiscal externalities may lead to too low taxes
- Race to bottom less likely when equalization grants



## Issue 3. Equalization Transfers

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- Transfers in general act as disincentive to state taxes: why tax, if someone will give you the money?
- Transfers muddle accountability and lead to much gamesmanship
- But: transfers may help resolve first two issues



# The Whole Picture

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- Tax decentralization unlikely to lead to race to bottom when equalization in place
- Co-occupancy less likely to result in overly high state taxes with equalization
- Key is to have credible commitment on grants
- Transfer design and state tax assignment inextricably related.



# Giving States some Real Taxes

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- State PIT – flat tax on federal base
- State GST – flat tax on federal base
- Rates of both (or either) chosen by state
- Both (or either) administered centrally
- Wanted: a real federal GST! (and a revised equalization transfer)



# The Status Quo Revisited

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- Abolish the conveyance duty
- Personalize the payroll tax (...all the way to PIT?)
- Or: broaden its base to become a BVT
- Increase vehicle-related (and other) user charge/benefit type revenues.
- ...and...wait for the next financing crisis?