



Assigning State Taxes in a Federation

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A View from “Up Over”

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?

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



Benchmarks from the Literature

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

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

Benchmark 2. Decentralized Taxes



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



Benchmark 3. International Best Practice

- 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

- 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

- 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

- 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

- 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

- 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

- 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

- 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

- 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

- 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?