

AUSTRALIAN CAPITAL TERRITORY

**SUBMISSION TO THE
*AUSTRALIA'S FUTURE TAX SYSTEM REVIEW***

APRIL 2009

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Executive Summary

The ACT has kept the focus of this submission to issues of particular importance or impact on the functioning of States and Territories,¹ and Local government.

In relation to State and Local taxes and transfers, the submission outlines a number of issues for consideration by the Review.

States should have access to revenue streams which:

- provide adequate revenue growth to meet growth in demand for, and unit costs of, services;
- provide a degree of stability; and
- provide for allocative and administrative efficiencies.

To the extent that vertical fiscal imbalance applies to revenue collections, transfers between levels of government should be undertaken in an efficient manner and provide maximum flexibility for States and Territories to deliver services.

To the extent possible, consideration should be given to reducing the barriers imposed by the interpretation and application of Section 90 of the Constitution. The broadening interpretation of Section 90 has reduced the States capacities to impose a range of taxes designed to discourage harmful activity or better manage the consumption of scarce resources.

Equity and efficiency considerations suggest that, where possible, the beneficiaries of services should contribute to costs. It should be recognised, however, that user charging will not be appropriate in a range of circumstances and for some services.

In addition the ACT:

- is of the view that some State revenue instruments should be viewed in the context of the broader policy objectives that they serve when considering their economical or administrative efficiency;
- supports further investigation of opportunities where State Revenue Offices and the Australian Tax Office can work together to reduce the administrative burden of the tax system; and
- addresses a number of other equity and environmental queries posed in the 2008 Consultation Paper.

¹ In this submission States and Territories are hence forth referred to as States.

Introduction

The ACT Government provides the following comments and input in response to consultation questions set out by the Review Panel. The discussion also considers the findings of the *Australia's Future Tax System Consultation Paper* (Consultation Paper) released in December 2008.

It is noted, however, that the assignment of expenditure responsibilities between the National, State, and Local governments has not been included in the scope of the Review (with the exception of welfare and other transfers). As such, by extrapolating paragraph 6 of the Terms of Reference,² it is considered that any recommendations which would in-effect reduce the aggregate level of taxation and transfer revenue available to the ACT are outside the scope of the Review.

² *"The review's recommendations should not presume a smaller general government sector and should be consistent with the Government's tax to GDP commitments."* Australia's future tax system. Terms of Reference. Paragraph 6.

State and Local Taxes and Transfers

The Constitution restricts State and Local governments' access to broad consumption based revenues, and due to past political circumstances States no longer access income based revenues. Given these circumstances, States have largely relied on revenue sources which are based on ownership and changes in ownership of financial and non-financial assets. The ACT acknowledges that, in many cases, the taxation of these revenue bases creates inefficiencies because they are narrow in nature and thereby distort economic activity.

The Review should recognise that all governments require revenue bases which give them the flexibility to fund differing levels of public service provision in line with their respective citizens' needs.

Noting the overall structure of Australia's federal financial arrangement, what changes, if any, should be made to the assignment of revenue raising powers and intergovernmental transfers in Australia?

States should not be overly dependant on growth in vertical fiscal transfers to fund their expense responsibilities and should have access to own-source revenue bases which grow at rates equivalent to these responsibilities.

States require access to revenue streams which provide revenue growth that match the growth in the demand and cost of their service delivery. While a portion of revenue streams will inevitably be based on vertical fiscal transfers, the growth in own-source revenue should at least match the increase in expenditure pressures to allow:

- States to manage their budgets without excessive reliance on increases in transfer revenue;
- reduce the need for States to undertake grant seeking behaviour and for continual changes to intergovernmental fiscal relations; and
- enhance revenue certainty and facilitate long-term planning.

The ACT contends that each level of government should have access to both cyclical and non-cyclical revenue bases.

The Consultation Paper outlines a number of principles for tax assignment which the ACT broadly supports.³ These principles, however, represent trade-offs.

This trade-off is apparent in the principle of assigning taxes for the purposes of stabilisation policy at the national level,⁴ while States receive revenue bases which are cyclically stable. In addition to the perverse incentive effects that State governments face when they have revenue bases that are unresponsive to market reform, it should be noted that both the National and State Governments face cyclical expense pressures in their provision of public services – albeit to a much lesser degree with regard to the States.

³ See Box 9.1 The theory of tax assignment. *Australia's future tax system: Consultation Paper: December 2008*

⁴ As detailed in the Consultation Paper

Nonetheless, demand for State services varies across the economic cycle and an appropriate mix of revenue bases allows for increased revenue in cyclical upturns to fund fiscal shortfalls in cyclical downturns, as is currently the case.

States should have access to tax bases which provide for administrative and allocative efficiencies, such as those which are unlikely to be eroded through horizontal tax competition.

The distribution of revenue powers should provide for States to tax less mobile revenue bases, while the National government is better suited to tax mobile factors of production. This reduces the level of systemic complexity needed to protect bases from cross border leakage.

States require revenue bases which they can tax efficiently. Revenue instruments which require detailed information on cross border economic activity are not suitable for States given they tend to have access to information on the economic activities of individuals and corporations that occurs in, and are limited to, their jurisdiction. For example, as many businesses undertake activities in multiple jurisdictions the taxation of corporate profits by States would be extremely difficult and greatly increase the administrative burden on both revenue offices and business.

Where revenue bases are based on mobile factors of production (excluding labour) they tend to be eroded through inter-jurisdictional tax competition over time, leading to a sub-optimal utilisation of the revenue base. The abolition of death duties by Queensland and the consequent necessary abolition by all other jurisdictions to avoid a significant transfer of wealth and population is an example in this regard.

Allocative efficiency considerations should also be paramount to the Review. States require revenue bases that would not overly bias the location of economic activity. This will ensure that factors of production are engaged in their most economically profitable activities and reduce the incentive for firms and individuals to undertake tax avoidance activities.

As such, the ACT believes that residence-based revenue bases, such as taxes on labour and real property, are well suited to the States as they allow a better alignment of the taxation and service level preferences of citizens within a particular State and are subject to less inter-jurisdictional tax competition.

States should have greater access to revenue bases which generate a fiscal return from their own policies to increase economic growth.

The ACT believes that the assignment of revenue raising powers to Sub-National government needs to enhance the incentives for States to develop more efficient revenue bases.

The Consultation Paper has detailed a number of factors which need to be taken into account when considering the assignment of revenue raising powers between levels of government. Some of these include the incentive problems which arise when taxation and spending decisions are delinked, causing spending to deviate from efficient levels. As identified in the Consultation Paper, this relates to government accountability to its citizens and incentive effects present in the tax system which impact on the actions and effectiveness of public policy.

One key impediment to expanding economic activity in Australia is the large share of the fiscal benefits from State based economic enhancing reforms (and the provision of market enhancing public goods such as Vocational Education and Training) which accrue to the Commonwealth Government through higher levels of company and personal income taxation. The result is that the State governments tend to bear a disproportionate share of the costs of reform relative

to the potential economic benefits. Enhancing the ability of State governments to capture the fiscal benefits of reform policies should be a theme when examining State taxes in the review.

The ACT supports tax base sharing in-principle.

Tax base sharing provides an opportunity for both levels of government to access an efficient tax base, and thereby could be an effective way to reduce the reliance of the States on inefficient taxes.

It is noted that administrative arrangements for tax base sharing have the potential to be complicated. The use of the ATO as a collection agency for the States (similar to the GST arrangements) may be one way of simplifying the administration of a shared tax base.

Vertical Fiscal Imbalance (VFI) and the Assignment of Revenue Raising Powers

The high level of VFI in Australia, combined with the Constitutional assignment of revenue bases, has reduced the ability of States in the past to fund the growth in demand and price of government services.

In its Economic Survey, the OECD, highlighted potential problems resulting from structurally high levels of VFI in Australia including: "...undermining accountability to taxpayers for expenditure decisions, creating duplication and overlap in the provision of services; constraining beneficial tax competition across jurisdictions; and weakening incentives for tax and microeconomic reform."⁵ The OECD recommends a reduction in the fiscal gap in Australia.

⁵ *Economic Survey of Australia 2006: Fiscal Relations across Levels of Government*, Organisation for Economic Development and Co-operation, 31 July 2006, ch 3. pp. 1

Intergovernmental Transfers

The ACT considers that Intergovernmental Transfers should provide for equity and administrative efficiency.

The ACT supports the current institutions in place for the implementation of Horizontal Fiscal Equalisation (HFE) and the ongoing 2010 Review of State Revenue Sharing Relativities. We believe that the Commonwealth Grants Commission is the appropriate institution in which to negotiate the principles and implementation of HFE now and into the future.

The recent reforms to Specific Purpose Payments in 2008 have greatly improved the administrative efficiency and increased the flexibility of States in their delivery of services, and reduced the administrative burden. Notwithstanding these recent reforms, the States have historically been in a weaker negotiating position compared to the Commonwealth when negotiating vertical fiscal transfers. Given the level of VFI in Australia and the States' inability to access most growth taxes, where policy objectives have diverged between levels of Government the use of tied grants has proliferated. The ACT believes that the inappropriate use of tied grants impedes allocative efficiency by reducing the budget flexibility of State governments and hence their capacity to match the preferences of their citizens in the delivery of public services.

Ideally, tied grants should only be used to correct horizontal externalities which could not otherwise be internalised through a general purpose grant. However, where they are used they should be limited to those areas which are primarily the responsibility of the national government and should not be used in a way that:

- directs a large proportion of sub-national resources;
- encourages cost shifting behaviour by one or more levels of government;
- shifts service delivery risks inappropriately; and
- leads to administrative complexities and/or duplication and overlap.

Changes to state, territorial, and local government own source revenue instruments

What changes should be made to state and local government own source revenue instruments? What scope is there for greater use of user charging to bring social, environmental or economic benefits?

The ACT Government believes that all governments should, where practicable, rely on revenue generation instruments which minimise market distortions and have a low administrative burden.

The use of exemptions and thresholds generally reduces the efficiency of revenue instruments by concentrating the tax burden on those who do not qualify for exemptions. This reduces economic activity in the non-exempt part of the revenue base. Where exemptions and thresholds are low the burden is shared across the revenue base and the distortionary effects are likely to be lower.

However, in many cases, exemptions and thresholds are used to encourage activity to achieve a socially optimal outcome or for equity considerations.

For example, Stamp duty on motor vehicles in the ACT is based on a combination of the price of the vehicle and the fuel efficiency or carbon emissions of the vehicle. This effectively provides a partial exemption to the purchase of low polluting vehicles and increases the tax burden on higher polluting vehicles. This is in line with the social objective of increasing the number of low polluting vehicles relative to high polluting vehicles on ACT roads.

The ACT believes that while State revenue instruments have scope for improvement, the review should acknowledge that some revenue instruments have policy objectives beyond revenue-raising and that where possible the ability of States to encourage a reduction in harmful behaviour through the application of taxes should be considered.

Scope for Greater Use of User Charging

The ACT Government agrees in-principle that user charging has the potential to better align service provision with citizens' preferences. However, the opportunities for increased application of user charges are restricted by Section 90 of the Constitution.⁶ The increasingly broad interpretation taken by the courts has heightened the level of restriction placed on this form of revenue raising.

While it is agreed in-principle that service users should contribute to the cost of the provision of services, user charging will not be appropriate in a range of circumstances and for some services, such as where:

- non-excludable public goods are involved, the beneficiaries cannot be identified or are so numerous as to justify charging the whole community;
- benefits are not readily attributable to individuals, charges may need to be levied against classes of 'users';
- positive externalities exist, the full cost should not be passed to users but rather some element should be more broadly charged (e.g. public transport fares);
- negative externalities exist, the charge should exceed the direct cost of the services (motor vehicle charges);
and
- the services provided are such a fundamental right that no person should be excluded on the basis of financial capacity (e.g. education and health services).

In the case of social services, such as public schools and hospitals, the ACT does not support the use of user charges on equity grounds, as an extensive concessional scheme would be required in order to ensure appropriate service coverage, significantly adding to the complexity of funding service delivery, and in practice, restricting the range of user charges that can be implemented.

⁶ Commonwealth of Australia – Section 90, 'Exclusive power over customs, excise and bounties'

The use of the tax system to achieve income redistribution objectives

What is the appropriate allocation of roles of the Australian and State governments in income redistribution?

The ACT suggests the assignment of income redistribution responsibility should not be solely determined by access to a particular tax base. A range of other considerations are relevant as discussed below.

The ACT considers that there is a role for both tax expenditure and purposive expenditure programs in achieving policy goals, including income redistribution goals. Incorporating income redistribution roles in a tax system invariably increases its complexity, and introduces anomalies and opportunities for avoidance. On the other hand, expenditure programs, although more transparent, incur additional administrative costs.

In this context, the ACT suggests the overall efficiency and effectiveness should be the basis of achieving a balance between tax expenditure and purposive programs as a means of income redistribution.

Allocation of roles for income redistribution

Both the Commonwealth and the States have a role in income redistribution and welfare services.

State Governments participate in income redistribution through the provision of welfare and housing services to individuals and families as well as through providing a range of concessions to pensioner and concession card holders.

The ACT Government recognises the potential benefits that may result from the centralisation of income redistribution responsibilities. Possible benefits include:

- increases in the effectiveness of a common transfer approach;
- administrative benefits resulting from reduced levels asymmetric information (as the Commonwealth has sole access to personal income information of residents); and
- reductions in the level of fragmentation of the current personal transfer system that have the potential to create a more targeted system.

However, the centralisation of income redistribution represents a trade-off, namely the reduced scope of the welfare and transfer system to cater for unique community needs where it is delivered at a State level. As such, the ACT believes that there is scope for shared responsibility between levels of government in the area of income redistribution.

What opportunities could be pursued to deliver more seamless administrative arrangements of the tax-transfer system across the federation?

The Review is encouraged to actively consider opportunities in the area of more seamless administrative arrangements of the tax-transfer system.

It should also be noted that States are currently undertaking a project to standardise the administration of payroll tax, this could form the basis for any harmonisation of other taxes in the future.