AFTS Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

I should like to make a submission for consideration in the Review of Australia's Future Tax System.

Firstly the **global financial crisis** (GFC) is likely to have long term adverse effects on both Australia's economy and government revenues - because it has disrupted arrangements that have been central to the process of economic globalization.

Thus, in designing a future tax-transfer system, it is probably necessary to: (a) give priority to the flexibility required for significant further economic adjustment; and (b) evaluate whether it is feasible to maintain the levels of net transfer payments that have been committed under past credit-driven boom conditions to offset the potential social inequalities that result from difficult economic change.

Secondly an increase and broadening of state tax sources seems necessary to **improve the operational and economic performance of state governments,** because

- **vertical fiscal imbalance** is important in contributing to the deficiencies that lead to problems in state government administrations. A tax system, under which states had own-revenue sources roughly sufficient to undertake the functions for which they are responsible, might make a major contribution to the effectiveness and efficiency of government administration in Australia (Re Question 9.1); and
- the main responsibility for stimulating **economic development** falls to state governments, yet current tax / transfer systems distorts their priorities in ways that are contrary to the community's economic interest. This is because: (a) state tax revenues tend to be based on 'transactions' rather than on value added; and (b) transfer payments from the federal government are largely based on spending 'needs', so states face no financial penalty for ineffectual economic development. Broader own-revenue sources are needed if states are to take a more committed approach to developing a productive economy in Australia (Re Question 9.2);

Details are outlined below - and are also reproduced on my website.

Regards

John Craig

Centre for Policy and Development Systems
CPDS supports leaders developing enterprise, economic, community and governance systems
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Details of Submission to the Review of Australia's Future Tax System

The Long Term Impact of the Global Financial Crisis

Rationalizing the relationship between taxes and transfer payments and between the tax-transfer system and the economy are important goals of the Review. For example, a background paper ('Architecture of Australia's tax and transfer system', August 2008) suggested that

"Australia's economic position provides an ideal opportunity for reform. The boost to national incomes from the significant increase in the terms of trade due to the resources boom, together with Australia's strong fiscal position, provides a platform on which to base a reform agenda. Given the challenges that lie ahead, it is important to have a tax-transfer system that enhances incentives and rewards effort" (p xii).

While it is now widely recognised that the global financial crisis (GFC) has complicated this optimistic view in the short term, it is less obvious that the GFC may well have adverse long term structural effects on both the economic environment and on prospective government revenue. It may (for example) make the available tax-transfer options much less attractive than the Review started out assuming.

A preliminary and simplified attempt to diagnose both the causes of the GFC and likely complications in resolving it is presented in Global Financial Crisis: The Second Test). Of most long term significance is the possibility that the past basis of economic globalization will be seriously disrupted (op cit), because (for example):

- the $US had become a global reserve currency, which allowed US monetary policy to informally stabilize global growth by counter-balancing the global business cycle, but those monetary policy methods have been discredited by their association with asset inflation. Moreover the status of the $US is no longer assured;
- the large global financial imbalances, which for decades have supported the rapid export-led development of East Asian economies (which then boosted Australia's economy and government revenue), will not be feasible in future; and
- East Asian economies face huge (perhaps insurmountable) cultural obstacles in adjusting to a new environment in which financial institutions must take profitability seriously because domestically driven growth would require external borrowing.

Moreover, while determined national (and eventually international) efforts to create a new basis for global economic expansion are likely, there are obstacles to achieving this given the diversity of understandings of the desirable social, economic and political nature of the necessarily-global new framework (eg see Obstacles to Effective Global Regulations)

The Review's December 2008 Australia's future tax system: Consultation paper suggested (amongst many other things) that: (a) Australia is operating in an increasingly globalized economy - with the crisis in financial markets showing the extent of inter-linkages (p20); and (b) the shift in the pattern of world economic growth towards China and India (which has benefited Australia) is likely to continue despite the current economic difficulties (p21).

Neither of these assumptions is certain. As far as the Review is concerned, consideration probably needs to be given to:

- the likely need for significant further change in the structure of Australia's economy - which would (for example) presumably make government actions to protect existing economic activities counter-productive; and
- the possibility of ongoing government revenue difficulties which, amongst other things, could require rethinking the level of net transfer payments.

It is understood that capital gains tax revenue (driven by property and stock-market booms) have generated most of the surpluses in Commonwealth budgets in recent years (Kehoe J., 'Capital carries a bigger load', *Financial Review*, 11/12/08). Moreover strong revenue growth associated with capital gains and sustained economic growth has, over the past decade, allowed both: (a) cuts in tax rates; and (b) large increases in transfer payments.

Despite their complex relationship with the tax system, those transfer payments have been socially and economically significant by helping to maintain a reasonable level of income equality in Australia despite the incipient emergence of an underclass of those who failed to cope with an increasingly demanding economic environment (see Social equity). Market liberalization economic strategies have thus been able to be pursued since the 1980s more vigorously than in other countries without giving rise to significant political instability. This in turn facilitated economic adjustment.

Unfortunately this 'virtuous' relationship is likely to be disrupted because the property and stock-market booms which gave rise to capital gains tax revenues as well as sustained global economic growth have directly and indirectly been products of the asset inflation that was enabled by the availability of unrealistically cheap credit in global financial markets - and the latter is unlikely to be available in the post-GFC environment.

If large transfer payments are not available in future to compensate those who are unable for various reasons to prosper in a highly competitive environment, then future policies to facilitate economic change will need to give more attention to ensuring that large numbers of potential 'losers' don't emerge. Methods to achieve this could be suggested but are well outside the scope of the Review.

Reducing the Adverse Effect of Vertical Fiscal Imbalance on Government Administration - Re Consulting Questions 8.1 and 9.1

Reducing the cost of complexity seems to be another major (and worthwhile) goal of the tax system review - as indicated in Chapter 8 of the Consultation Paper on Australia's future tax system.

However the cost of complexity applies as much to government administration as it does to the effect on citizens and businesses though only the latter received attention in the consultation paper. Rationality is a technique for problem solving that has been important to the advancement of Western societies, but this only works well in systems with fairly simple, predictable relationships. It tends to fail in complex systems - and decentralization to allow those at the coal-face of various functions to make rational decisions and take informed initiatives is vital for government administration, for the same reason that transparent market mechanisms are essential in economic affairs.

Section 10 of the Review's background paper, Architecture of Australia's tax and transfer system' (August 2008), drew attention to Australia's vertical fiscal imbalance (VFI) and to the costs and benefits of this arrangement. It referred to costs such as: a lack of clear accountability; blame shifting; and increased administrative costs. It also referred to benefits such as: more efficient tax raising; reduced compliance costs; national uniformity in services; and ability to address externalities.

It is extremely unfortunate that the most significant cost of VFI was ignored - namely the loss of practical realism and scope for initiative that results because VFI enforces a dysfunctional centralization of control within state administrations.

Though the subject has not apparently been formally studied, there is little doubt that state governments in Australia suffer from serious weaknesses in carrying out their constitutional responsibilities. This seems to be widely recognised by observers. For example, an editorial in *The Australian* of 18/11/08 implied that NSW was a 'failed state' while an earlier article (Kelly P., 'NSW is in a state of dysfunction', *Australian,* 15/11/08) implied that all states are in difficulties. Moreover public comments on general infrastructure deficiencies have circulated for years, and reforms introduced in late 2008 under the Council of Australian Government (COAG), have apparently been intended to improve the ability of states to perform their functions (eg by reducing the complexity of the constraints to which they are subject).

The present writer has been involved in strategic policy R&D for four decades with a significant focus on Queensland's government and economy, and has observed (and documented material others' published about) the dysfunctional state of Queensland Government administration and the numerous public crisis that have resulted in recent years in areas such as child protection; electricity distribution, hospitals, and water supplies (as well as a looming urban transport fiasco).

There are numerous historical, institutional and political causes of such problems - of which one attempt to provide an account is in Structural Incompetence and SE Queensland's Water Crisis. This referred to: the 'curse' of rich natural resources - which induces a community with weak public policy awareness which depends on external 'authorities'; political neglect of public administration in the 1980s; failure of amateurish reform efforts in the early 1990s; and the resulting creation of ineffectual machinery of government. However Australia's VFI is also a significant part of the problem.

Australia's VFI distorts the machinery of state government administration by centralizing control (ie in the hands of those concerned with lobbying for federal funding) and reducing the relative influence of those with practical knowledge and experience of what needs to be done in relation to particular functions and how to do it. This argument is explored in more detail as one of the themes in *Australia's Governance Crisis.* The present writer's suggestions about VFI are the result of observation and study of the effect in Queensland of the major expansion of special purpose funding by the Whitlam Government in the 1970s which led to a permanent power shift within that government from 'practitioners' to 'lobbyists', a shift that: (a) paralleled the effect that tariff protection had on manufacturers; and (b) contributed to the long-term decline in that state's effectiveness in meeting infrastructure needs.

Unfortunately, in the absence of systematic research, views publicly expressed about what is wrong can be superficial (eg see It's time to fix the failed state and Fixing State Governments which respectively commented on suggested 'solutions' involving: (a) changed political arrangements; or (b) a private sector takeover of states' non-core roles).

Similarly the 'new federalism' framework, that is now to be put in place as a result of COAG negotiations (eg see 'Rudd stamps reform mettle on COAG', *The* Australian, editorial 1/12/08), is apparently also based on a highly simplistic understanding of what is required for governments to be effective. Simplifying centralized control has no more prospect of success than the 'n' earlier schemes that federal governments have devised in their attempts to more effectively manipulate state functions, because:

- the latest 'new federalism' package has apparently done nothing to reduce states' dependence on federal funding that distorts their administration. 'New federalism' arrangements, which reduce the number of special purpose programs, will not reduce this distortion. Moreover the introduction of 'performance' measures must actually increase the centralization of power within state administrations that dis-empowers those with the knowledge and skills needed for effective performance;
- the complexity of government functions can not be adequately reflected in any finite set of 'performance' measures - see Problems in Specifying Service Outputs. Certainly whatever is specified is most likely to be emphasised - but this is equally likely to be at the expense of common sense. An instructive example involves the crisis in Queensland's electricity distribution network that resulted when 'success' for the relevant agencies was defined in terms of dividend payments to government and upgrading the distribution network was forgotten - though that necessity would have been obvious to engineers who no longer had any say. Furthermore;
- government can not be simply reduced to 'service delivery' - see Service delivery can't solve some pressing problems and Governing is not just Running a Large Business. The essence of the role of government (see Fixing State Governments) is managing real-world relationships involving: (a) creating a regulatory framework; and (b) arranging the supply of goods and services that can't be coordinated adequately through market mechanisms. There two aspects of governments' responsibilities can't be separated and promoting competitive arrangements within government machinery (as has been required under the National Competition Policy in the hope of promoting efficiency in service delivery in isolation) has impeded the ability of states to function effectively (see also Review of National Competition Policy Reforms: A Commentary).

There are institutional obstacles to identification and resolution of administrative problems associated with Australia's VFI - because of the existence of a VFI 'industry' within both federal and state governments whose participants' career prospects depend on maintaining that 'industry' and who tend to be the ones from whom advice about the subject is primarily sought (eg through COAG) without considering broader requirements. It is not in the interests of the individuals whose roles constitute a major obstacle to practical realism and initiative in state administration to identify those problems, while others find themselves confronted by a mysterious 'black box' linked to High Court judgments about the taxing powers of the federal government and they thus simply put the whole subject into the 'too hard' basket.

The development of a tax system under which various levels of government have financial capacities roughly equal to the cost of the functions for which they are responsible may be the best way to reduce such distortions - and to improve the effectiveness and efficiency of public administration overall. State governments arguably need to be allowed to take real responsibility for their constitutional functions, and be held accountable by their electorates. Presumably national coordination of activities and reform agendas can be promoted without dominant financial control, while externalities could be addressed with relatively minor amounts of discretionary federal funding.

Providing Incentives for Effective Economic Development (Consulting Question 9.2)

General responsibility for stimulating economic development in Australia falls to state governments, yet the tax revenues and transfers that have been available to them distort their priorities in doing so in ways that are contrary to the general community interest.

As the Review's Australia's future tax system: Consultation paper noted, tax systems and transfer payments affect the behaviour of individuals and businesses.

"All taxes and transfers affect the choices individuals and businesses make by altering incentives to work, save, invest or consume things that are of value to them. These changes in behaviour can ultimately leave the economy and society as a whole worse off than if the revenue were raised (or distributed) without affecting behaviour." (p34)

However taxes and transfers also affect the behaviour of state governments, and the latter can be expected to encourage activities that maximize their revenues.

As is noted in Section 10 of the Review's Architecture of Australia’s tax and transfer system:

"The current array of state taxes includes taxes which are transaction based or are levied on narrow tax bases. The opportunities for the States to introduce new forms of taxation are limited. Where States have sought to increase their taxation revenue, they have often resorted to taxes which are narrowly based or designed to realise some gain from rapidly growing areas of the economy. Other taxes such as conveyance duties have delivered increasing amounts of revenue to the States in recent years, but the tax base can be subject to fluctuations in line with the property market." (p292)

Australia's states have a relatively narrow set of revenue sources compared with the federal government. In particular, as noted above, state revenues relate to the value of transactions, rather than to the value added within the economy. The latter, however, is the base of major federal taxes such as income tax and the GST.

Moreover transfer payments under the Commonwealth Grants Commission's horizontal equalization principles have distributed federal tax revenue amongst states in accordance with their need for spending (and their revenue capacity) - irrespective of the the revenue which the federal government derives from value added by a particular states' economy (see Review of Grants Commission Arrangements, 2001). As the latter noted, this practice results in large transfers of federal revenues between states.

The overall result is that states that do not take the development of economic productivity seriously (ie are content to encourage the rapid expansion of low value-added economic activities) suffer no financial penalty.

This seems dysfunctional because:

- value added (which in simple terms is the total for all entities of: return on capital; wages and salaries paid to employees; and net payments to government) is a better measure of the community's 'wealth' than is the value of economic transactions. In fact large economic transactions can occur with no value being added to fund profits, wages and taxes;
- states are effectively encouraged to favour economic activities that maximize their transaction-based income, rather than encouraging economic activities with higher value-add which would boost: (a) the wealth of the community generally; and (b) the tax base available to the federal government.

The present writer had close involvement for a decade in attempts to formulate strategies to develop a more productive (ie higher value-added) economy in Queensland's during the 1980s and observed the resistance that arose from the Treasury whose logical concern was to: maximize (a) transaction-based state revenue (eg mineral royalties); and (b) transfers from the federal government under Grants Commission arrangements. Queensland had traditionally had a relative low per capita state product (ie about 85-90% of the national average) because of its emphasis on rapidly-growing but low value added industries. A more complete account of Queensland's 'traditional' strategy (with its emphasis on 'growth' (more economic transactions) rather than 'development' (more productive economic activities) is included in Queensland's Economic Strategy.

Though policy since then has nominally endorsed the development of a more productive economy and the situation has improved marginally - there has remained no financial incentive for the Queensland Government (or presumably any state government) to do so, Rhetoric about economic development has involved more political pretence that substantive achievement (op cit) - yet this has no financial consequences for the Queensland Government.

Australia might significantly improve its economic performance if states had financial incentives to encourage high value added economic activities - through a much broader range of own-tax sources.