AUSTRALIA'S FUTURE TAX SYSTEM – A STATE PERSPECTIVE (COUNCIL FOR THE AUSTRALIAN FEDERATION)

SUMMARY

Australia's taxation system provides the foundation for delivery of services and investment in infrastructure. Governments provide essential investment in infrastructure and services such as health care, education, environmental protection, child support, public housing, policing and transport.

The Australia's Future Tax System Review is an opportunity to consider the tax system as a whole. The Council for the Australian Federation (CAF) believes that reform of the national taxation system must be in the interests of Australians, providing the right environment for business, support for families, and enabling services to communities and investment in infrastructure.

Reform of taxation and federal financial arrangements would contribute to greater economic efficiency, improved equity outcomes, and greater accountability and transparency. Reform will deliver benefits to the national economy and, in the long run, improve both Commonwealth and state fiscal capacity.

CAF proposes a reform agenda consisting of:

- exploration of tax sharing arrangements to secure and strengthen the funding of key services
- continued reform of the state taxation system through the rationalisation of tax design, collection and administration
- reform of Commonwealth taxation.

In this submission, CAF outlines options that could increase states' fiscal autonomy and revenue capacity. This will require governments working together to deliver reform in the interests of all Australians. It will also require states continuing with their own individual reform efforts to deliver more effective, more efficient and equitable taxation systems. These reforms will support economic growth, improve the efficiency and reduce the complexity of the tax system, increase the transparency and accountability of government expenditure, and provide a more sustainable, secure basis to provide better services for the community.

1. INTRODUCTION

CAF welcomes the Commonwealth's initiative in establishing the Australia's Future Tax System Review. This is a once-in-a-generation opportunity to contribute to a comprehensive review of the national taxation system. The tax system's impact extends beyond mere revenue raising to many facets of daily life and to the structure and operation of the Australian system of government.

The Review's central objective is to "examine and make recommendations to create a tax structure that will position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century and enhance Australia's economic and social outcomes".

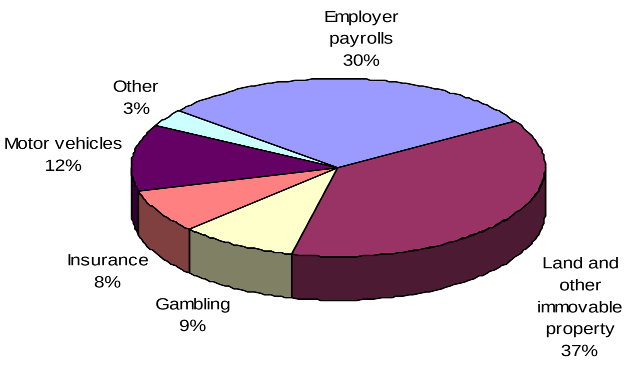
State and territory governments are providers of key community services such as health care, education, environmental protection, child support, public housing, policing and transport. Australia's taxation system is critical to supporting the delivery of community services.

Reform of the national taxation system needs to be considered in the context of providing states and territories with greater fiscal autonomy to provide greater security and sustainability of revenue to fund infrastructure investment and the delivery of services.

2. A CENTURY OF ERODING STATE REVENUE BASES

The revenue bases of the states and territories (the states) have significantly narrowed due to interpretations of the High Court, restrictions by the Commonwealth and taxation reform. As Chart 1 shows, the state tax base is essentially limited to employer payrolls[1], land and a small range of goods and services (motor vehicles, gambling and insurance). This leaves states in an increasingly difficult position from which to plan expenditure on infrastructure and services.

Chart 1. The states' tax base[1]

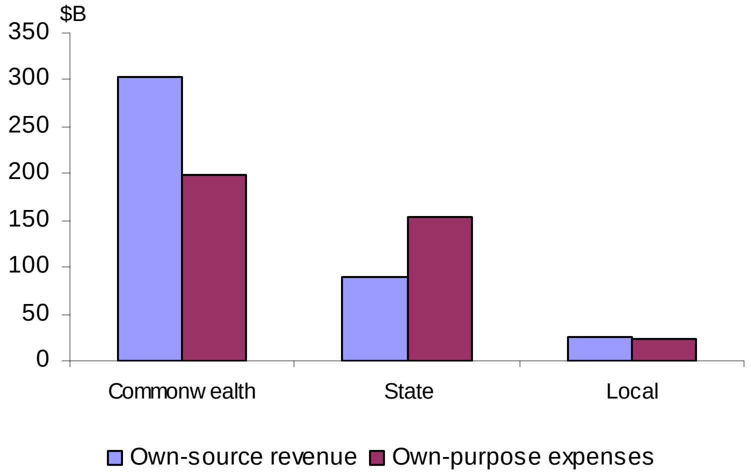


1. State taxation by economic base (2007-08).
Source: ABS 5506.0 2007-08

The progressive deterioration of states' revenue raising capacities has created a large imbalance in the finances of the Australian Federation (vertical fiscal imbalance). Commonwealth revenues far exceed their own-purpose expenses and, conversely, state own-source revenues are inadequate to fund their expenses, as shown in Chart 2.

[1] Often limited to 10-15% of employers, although covering a much larger proportion of employees.

Chart 2. A fiscal imbalance in the Federation[1,2]

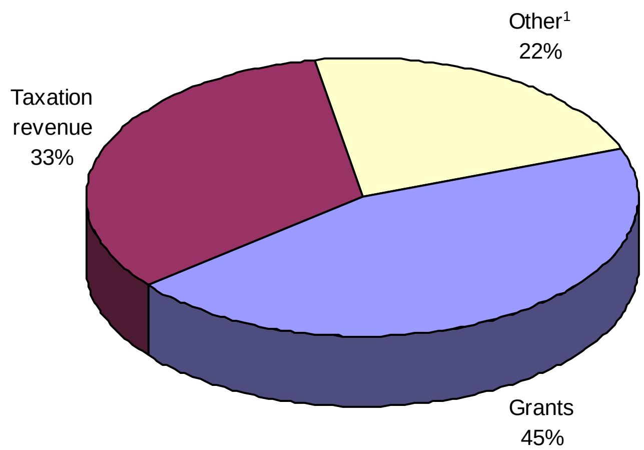


1. Multijurisdictional sector (mainly public universities) not shown.
2. Own-source revenue defined as total revenue minus grant revenue; own-purpose expenses defined as total expenses minus grants to other levels of government.

Source: ABS 5512.0 2007-08

The shortfall in funding from the narrowing of the state tax base has been filled by the Commonwealth Government through grants to the states. Commonwealth grants now represent around 45% of state revenue – a greater proportion of state revenue than state taxation, as shown in Chart 3.

Chart 3. States' strong dependence on Commonwealth grants



1. 'Other' includes sales of goods and services, interest income, royalties and dividends from public trading enterprises.

Source: ABS 5512.0 2007-08

This impact on states is exacerbated by the composition of Commonwealth grants, many of which are tied to specific purposes. Recent Specific Purpose Payments (SPP) arrangements under the new IGA negotiated by the Council of Australian Governments have relaxed some of the inflexibilities imposed by SPPs, particularly by changing the focus of agreements from input controls to the achievement of outputs and outcomes. However, the structure of SPP financial arrangements (now constituted as national agreement and national partnership payments) will continue to act as a constraint on the capacity of states and territories to plan expenditure in infrastructure and services.

3. IS VERTICAL FISCAL IMBALANCE A PROBLEM?

An excessive degree of vertical fiscal imbalance (VFI) is undesirable because it can:

- **weaken government accountability to the public** by breaking the nexus between a government's decisions on the level of service provision and the revenue raised to fund it. For every dollar spent by state governments, less than sixty cents is raised directly for those purposes
- **reduce transparency** regarding who is responsible for which government services, allowing governments to avoid responsibility by shifting blame for funding and operational shortfalls to other levels of government. Health policy has been a prime example where different levels of government responsibility, for funding, operating and regulating across different areas of the health care system, has resulted in public confusion and opportunity for blame-shifting
- **create inefficiencies**, including through bureaucratic overlap, duplication and excess and the cost of administering grants between governments
- **misallocate resources**, including the inadequate or inappropriate funding of services
- **slow the responsiveness of governments** to the needs of their communities.

All state governments are facing pressure to improve service levels in health, education and other areas, and they have responded by increasing expenditures. Table 1 shows the increase in expenses for major functions by state governments in recent years. Expenses for all major functions have increased in real per capita terms, while all but two have grown faster than the general economy.

Table 1. Growing state government spending responsibilities[1]

Expenses	Average growth 1998-99 to 2007-08
Public order and safety	7.8%
Education	6.3%
Health	8.6%
Social security and welfare	8.4%
Housing and Community Amenities	9.9%
Transport and Communications	6.4%
Real per capita[2]	*5.4%*
GDP (current prices)	*7.2%*

1. Total state general government expenses by purpose.
2. Producer price index (final, domestic) used as inflation measure.
Source: ABS 5512.0, ABS 6427.0, ABS 3101.0, ABS 5220.0

In the longer term, the fiscal challenge facing all Australian governments can be expected to grow dramatically in the face of demographic change and rising health costs. This can be expected to progressively worsen VFI.

A recent Productivity Commission report indicates the dimension of the challenge. By 2044-45, Australian governments are projected to have a combined ageing-related fiscal gap of around 6.5% of GDP relative to 2003-04. That is, government spending is projected to increase by 6.5% of GDP more than revenue.[2] If states could not negotiate SPPs rising in line with service needs, then spending pressure on the states would treble by 2044-45.

States would be forced to increase taxation and/or ask for greater Commonwealth grants, placing added pressure on narrow state tax bases or exacerbate already high levels of VFI.

Other challenges confront state governments, such as improvements required in education and training in a competitive global environment, infrastructure development to support a more productive economy, and addressing and managing the impact of climate change.

4. REFORM OF TAXATION

Government responsiveness to community needs requires a robust funding base. Ideally, governments would have autonomy over a secure and stable revenue base to fund expenditure. This would allow governments to respond to changing economic conditions and community needs. For example, states would have greater capacity to respond to the current economic downturn if they had autonomy over revenue sources that met their expenditure needs.

However, states are constrained in finding sources of future revenue to reduce their dependence on the Commonwealth and secure a robust revenue base to plan and invest in key government services. In the absence of collaborative reform, the states' relative lack of fiscal autonomy will remain a permanent feature of Commonwealth-State financial relations.

There are significant benefits from the reform of taxation and federal financial arrangements, such as greater economic efficiency, improved equity outcomes, reduced VFI and greater accountability and transparency. These will deliver benefits to the economy and indirectly enhance fiscal capacities.

There are a limited number of ways for the states to broaden their revenue base and thus provide a more secure foundation for government services. These include:

- access to new revenue streams
- reform of the current revenue streams, possibly including Commonwealth grants.

At the same time, this is an opportunity for major administrative reform, delivering lower compliance costs for taxpayers and administrative costs for government.

The **principles to guide reform** should include the following:

- Reform should generate economic and financial benefits to be shared by all States and Territories. State Government should be better off financially from tax reform.
- Reforms should aim at improving the efficiency and equity of the taxation system.
- Reforms should improve the sustainability own-source revenue in order to meet their service and infrastructure responsibilities.
- Ensure any future reform of states taxes is offset by replacement revenue.

[2] As the Productivity Commission notes, assessing the fiscal pressures for different levels of government is complicated by grants between the various tiers, with different assumptions about the future size of those grants significantly affecting where the fiscal pressures are borne. This means that the best single measure of fiscal pressure is for all governments combined.

- Reform should increase the fiscal flexibility and autonomy of the States and Territories, which may include addressing vertical fiscal imbalance.

Consistent with these principles, CAF proposes a reform agenda with the elements in the box below.

Proposed reform agenda
A. Exploration of tax sharing arrangements to secure and strengthen the state revenue base for the funding of services
B. Continued reform of the state taxation system through the rationalisation of tax design, collection and administration
C. Reform of Commonwealth taxation

A. Tax Sharing with the Commonwealth

As previously discussed, the states are highly reliant on a narrow set of taxes. While the possibility of new taxes may arise, a more efficient way for the states to broaden their tax base is to adopt or share one or more of the existing Commonwealth taxes.

In this discussion, a difference needs to be drawn between two forms of tax sharing arrangements:

- tax revenue sharing, in which design parameters, such as rate and base, are determined by the Commonwealth with or without consultation with the states, and the revenue from the tax is then shared by some formula. The GST is an example whereby the states' share is effectively 100% and then distributed according to horizontal fiscal equalisation principles. Individual state governments have no control over the applicable rate of GST in their state
- tax base sharing, in which individual state governments have the capacity to set certain design parameters, such as the rate that applies in their state, while the Commonwealth maintains a similar capacity across the nation as a whole. For example, in Canada, the central government sets federal income tax rates and individual provincial governments set the tax rates applicable in their provinces.

Both tax sharing arrangements have potential benefits for the Australian Federation. Tax revenue sharing would allow improvements in the tax system by allowing states access to more robust and efficient tax streams, perhaps in place of less efficient existing state taxes. However, states' lack of discretion over tax rates means that tax revenue sharing arrangements would at best provide stable but not independent funding for services. For example, the combined introduction of a GST and the abolition of a number of state taxes would have provided some economic benefit overall, but it also increased the dependence of states on Commonwealth revenue and weakened capacity to plan for expenditure and investment offsetting at least some of those benefits.

A potentially more effective way to broaden the states' tax base is through tax base sharing. Individual state governments would have the capacity to set a tax rate for their state with revenue raised accruing to that state. Any new revenue stream would be subject to horizontal fiscal equalisation (HFE) as is the case for all other state revenue streams.

If a base sharing approach with the Commonwealth tax base was adopted, desirable features for the tax would include:

- **broad geographic spread** of the legal and economic incidence of the tax base, so that each state and territory has a reasonable share of the tax
- **broad and deep economic base**, so that revenue can be raised without adversely impacting on the economic activity associated with the base
- **immobile,** so that different tax rates in different jurisdictions do not lead to large changes in a state's tax base through taxpayers changing the location of their residence or economic activity
- **strong and stable growth**, so that revenue grows with state expenditure responsibilities
- **revenue capacity**, so that additional revenue can constitutionally and administratively be raised
- **policy independence,** so that one level of government can adjust rates and other design parameters without undue effect on the policy and revenues of another level of government.

Income tax, principally personal income tax, is a possible candidate for tax base sharing with the Commonwealth. A number of reviews and commentaries on state tax have recommended the consideration of a shared income tax as a means of equipping states with a broader tax base.[3]

B. Reform of existing state taxes

National tax reform is an opportunity to reform existing state taxes. State and territory governments are committed to the reform of the state taxation system. State and territory governments have been undertaking substantial reform for a number of years, with major reviews, the abolition of a number of taxes and major legislative and administrative reforms having taken place in states and territories over the last decade.

However, there are further opportunities to make state tax systems more efficient and effective. These reforms can be grouped into three categories:

1. the tax mix
2. tax design
3. tax administration.

B1. The Tax Mix

As previously discussed, states currently have an over reliance on relatively narrowly based taxes, such as land, payroll, gambling and motor vehicle taxes, and less efficient taxes, such as stamp duties. Over time reform could remove reliance on narrow based taxes and have the state taxes on a broader economic bases.

Any broadening would provide states with the capacity to reduce their reliance on the more narrowly based, less efficient state taxes, such as stamp duties. It would also

[3] For example, NSW Independent Pricing and Regulatory Commission, *Review of State Taxation*, 2008; Allen Consulting Group, *A New Vision for Intergovernmental Funding Arrangements in Australia, Report to the Queensland Government* 2007; Robert Carling, The Centre for Independent Studies, *State Taxation and Fiscal Federalism*, 2006; Anne Twomey, *Australian Federalism – Options for Reform*, National IR Conference, Brisbane, 11 September 2007; Saul Eslake, *Making Federalism Work*, Australia and New Zealand School of Government Annual Conference 2008.

allow access to the revenue that may be required to meet future challenges such as population ageing, climate change, improvements in education and infrastructure provision.

Abolition of some state taxes, such as stamp duties and other administrative reforms would produce economic and administrative efficiency gains that would translate into a 'reform dividend' for governments. Access Economics has estimated that abolishing all state stamp duties and replacing them with personal income taxes could generate an increase in household consumption of up to $6.1 billion in 2005-06 prices. Access Economics also estimate that the Commonwealth could receive up to around $4 billion in additional tax revenue if the states abolished all their stamp duties (based on 2005-06 revenue data)[4].

It is noted that mineral royalties represent a financial return to the state for the right to exploit its mineral assets (i.e. they are the price paid by the producer for a community-owned resource). They are additional to the taxation of profits made by those given the right to exploit these assets and constitute a deductible expense for company tax purposes. The states consider that issues relating to the efficiency and effectiveness of existing state regimes are a matter for individual states.

B2. Tax Design

The design of individual taxes has an important impact on their efficiency and effectiveness.

One of the main design principles for taxes is that tax rates should be kept as low as possible since the economic inefficiency of a tax increases rapidly as the rate is raised. To keep rates low, the base should be kept broad, which may also assist in increasing horizontal equity, that is, the equal treatment of taxpayers in similar positions or situations. This gives rise to a standard tax reform principle of broadening a tax base to allow the tax rate to be reduced in a revenue neutral manner.

There are trade-offs with respect to broadening or narrowing tax bases. Competing efficiency and equity considerations and particular policy goals must all be considered. Any change to the tax regime will impact taxpayers, but the key criteria should be whether the overall incidence of state taxes can be reduced as a consequence of such changes.

Where possible, the design principle of maintaining broad bases and low rates should be observed and any tax reform agenda should consider its application wherever possible.

B3. Tax Administration

The systems and procedures used to collect taxes have an important bearing on the efficiency, equity, simplicity and transparency of tax systems. Reform of the administration of state taxes and the application of best practice standards can lead to lower compliance costs for taxpayers and lower administration costs for government. This is consistent with government policies aimed at reducing red tape for businesses and the wider community.

States have shown their commitment to improved tax administration through participation in various reform initiatives. These include the Standard Business Reporting project which aims to reduce the multiple reporting requirements of business,

[4] Access Economics (2008), *Analysis of State Tax Reform*, p.x.

harmonisation of the payroll tax base, which reduces compliance cost for businesses operating across certain state boundaries, simplified legislative frameworks, and ongoing investment in information technology and data management systems.

Revenue offices at the State and Territory level compare costs on a regular basis to ensure efficiencies and best practice is adopted. Broad figures indicate that the cost of collection at the State level are lower than those for the Australian Taxation Office. Therefore, it cannot be assumed that any transfer of responsibility to the Australian Taxation Office would lead to lower costs of collection and, therefore, be available for revenue. Any governance arrangements flowing from the Henry Taxation Review should take these relative efficiencies into account to ensure maximum flow through of revenue to government services.

The states are committed to ongoing improvement in the administration of their tax systems. Initiatives going forward could include further harmonisation of states tax bases, further investment in information technology to facilitate compliance and improve client services, increased use of formal performance evaluation techniques, and increased collaboration between state revenue offices and with the Australian Taxation Office.

C. Reform of Commonwealth taxes

This submission focuses on state taxation, and on how revenue is raised and spent in the Federation as a whole. However, it is important to note that the vast majority of taxes are raised by the Commonwealth, and that a lot can be done to make Commonwealth taxation simpler and fairer.

Over time, the ad hoc evolution of the personal tax and transfer system has made the system far too complex. This complexity takes up the time and resources of taxpayers and it creates loopholes that make it easier to avoid paying taxes.

The interaction of the taxation and transfer systems also creates high effective marginal tax rates for many people on low incomes. In a lot of cases, these effective tax rates can be higher than the highest tax rate in the country, discouraging people from getting a job, or from working more. Reducing this barrier to workforce participation will help drive economic growth, improve equity, and help maintain the relative size of our workforce as our population ages.

The states encourage the Commonwealth to streamline its taxation system, and to address the high effective marginal tax rates faced by many Australians who earn low incomes.

5. CONCLUSION

Tax reform has the potential to deliver significant benefits for the Australian people. Not only can it deliver improved economic performance, a fairer distribution of taxation and lower costs for taxpayers, but it can lay the foundation for a sustained improvement in the delivery of services by providing all Australian governments with a robust revenue base from which to fund these services. For this reason, the issue of tax reform cannot be divorced from that of federal financial relations more generally.

In this submission, CAF has offered a positive reform agenda that will require a reorientation of federal finances to increase states’ fiscal autonomy and revenue capacity. The next steps in the reform of Commonwealth grants must be formulated and taken, the potential for states to access broader revenue bases must be explored, and the ongoing reform of the state tax system must be facilitated. Much of this requires governments working together to deliver reform. It will also require states continuing with their own individual reform efforts to deliver more effective, efficient and equitable taxation systems.

There is much to improve in the Commonwealth taxation system as well, which will benefit us all. There is a challenge and opportunity for all governments, to work together to reform the tax system to benefit Australians.

APPENDIX

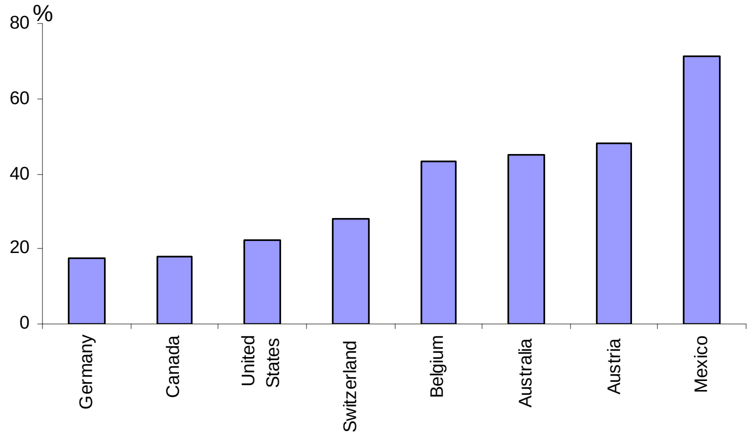
How the Australian Federation compares

International comparisons of federal fiscal relations can be problematic due to data availability and the wide diversity in cultural, economic and institutional conditions existing across the world, the most useful comparisons are those made between OECD countries. There are eight federal states in the OECD – Australia, Austria, Belgium, Canada, Germany, Mexico, Switzerland and the United States. While each of these federations is composed of three tiers of government – central, state and local – the analysis will focus on state governments.

The first point of comparison relates to the extent to which a level of government relies on transfers from other levels, or, more specifically, the proportion of state revenue represented by grants.

As Chart 4 shows, Australia lies with that group of federations with relatively high levels of reliance on grants. While states, or equivalent, in Germany, Canada and the United States have a level of funding reliance of around 20%, Australia, with Belgium and Austria, are around twice that level.

Chart 4. Australian states' relatively strong reliance on grant revenue[1]

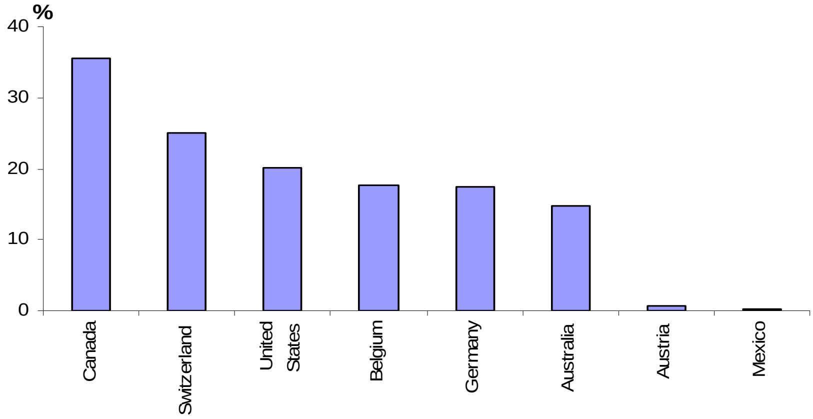


1. Measured as grants received by the states as a proportion of total state revenue.

Source: OECD Revenue Statistics 2007; ABS 5512.0 2007-08 for Australia.

Related to reliance on grant revenue is the revenue raising capacity of state governments. The limited revenue raising capacity of the Australian states is demonstrated by comparison with other federations. Chart 5 indicates the proportion of national tax revenue for which either states have discretion on the setting of rates or where rates are set with state government consent. It shows that Australian state governments have relatively weaker taxing powers than states in other federations. This is despite Australian states having major policy responsibilities in health, education, policing, environmental protection and transport.

Chart 5. Australian states' relatively low tax share[1]



1. Percentage of national revenue collected by state (or equivalent) governments, 2005

Source: OECD Revenue Statistics 2007 Table S.2

Chart 5, along with the prior discussion, exemplifies the deficiencies in the current financial arrangements of the Australian Federation, namely, an over-reliance on revenue from grants and narrowly based taxes, a limited revenue raising capacity, and restrictions on the use of its revenues. These deficiencies are related, and collectively exemplify the excess level of vertical fiscal imbalance in the Australian Federation.