Queensland
Government

AUSTRALIA'S FUTURE TAX SYSTEM

QUEENSLAND SUBMISSION

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SUMMARY

Queensland welcomes the opportunity to contribute to the Commonwealth's Review of the taxation system. A discussion on taxation reform is timely. The global financial crisis and looming national economic recession should not delay this discussion, but be more reason to engage in one. Tax reform is always difficult, even in times of economic prosperity. But in times of economic downturn, governments have a responsibility to not only soften the immediate impact on the community but to develop measures to bring forward the recovery and build a firmer foundation for the next period of prosperity. This is a time not only to take stock, but to take action.

Reform of the national taxation system should be considered a key element of the national economic reform agenda. Tax reform can strengthen the national economy by generating gains in productivity that deliver higher levels of employment and income. It can also encourage labour market participation to sustain a workforce that may otherwise be diminishing as the population ages. Furthermore, a particular challenge for all Australian governments is to reduce the immense complexity of the tax system without compromising its effectiveness or fairness.

Much of the Review will rightly focus on issues of how governments can better and more appropriately collect tax. It will raise issues of tax levels and tax mix, of tax design and tax administration. But a debate about taxation is not just a debate of how or how much governments should raise – it should also be about which level of government should undertake the taxing. Thus issues related to the national tax system are inextricably linked to the federal financial system, so that a comprehensive review of one cannot meaningfully take place without consideration of the other. They are two sides of the one coin.

The allocation of taxation powers was an issue of much debate in the development of the Australian Federation. It is fair to say that the current distribution of taxing powers between the Commonwealth and the states is not what the founders of the federation intended.

Much of the current financial imbalance evident in the Australian federal system today is a result of the erosion of state taxing powers over the last century. Revenue raising powers relating to income tax, indirect taxation and classes of stamp duties have been lost to the states over this period. This erosion of the states' taxation base has resulted in a high level of vertical fiscal imbalance (VFI), whereby the states' spending responsibilities heavily outweigh their revenue raising capacity, resulting in the need for substantial Commonwealth grants. The existence of VFI is itself not a policy problem, but an excessive level of VFI reduces the capacity of state governments to deal with budgetary pressures and meet the needs of their communities. It reduces the responsiveness of our system of government because the pressure to act is applied to one level of government and often the capacity to act lies with another.

State and territory governments, already under financial pressure, will require increased budget flexibility and revenue capacity as they seek to respond effectively to demographic change, increasing global competition in education, the need to provide infrastructure for sustainable economic growth, climate change and other 21st century social, environmental and economic challenges. A prosperous community and robust economy requires a strong federation and therefore strong states. Ultimately, governments can provide whatever the community wants to pay for. What governments require are the revenue capacity and fiscal sovereignty to do so in the most efficient manner.

This submission proposes a reform agenda that helps prepare the Australian federation for this century's challenges by strengthening the national economy and providing the governments of Australia with the financial capacity and flexibility they need to best serve their community. It directly addresses the high level of VFI in the federation and improves the revenue raising capacity of the states and territories. The proposals in this submission will improve the economic and administrative efficiency of the national taxation system. The intention of the proposed reforms is not to increase revenue per se, but to improve budget flexibility and revenue efficiency to allow states and territories to meet their obligations to the community while minimising inefficient taxation and the operational and administrative burdens that accompany current intergovernmental financial arrangements.

The proposed reform agenda is:

- **Reform of existing state taxes**, including:
    - administrative reforms, such as greater standardisation of taxes and consolidation of revenue collecting across states; and
    - consideration of the abolition of stamp duties, such as insurance duty and vehicle registration duty;
- Replacement of revenue capacity lost through tax abolitions with **access to other sources of revenue**;
- Further reform of the Commonwealth grants system, through a **reduction of States' reliance on Commonwealth grants** and an increase in the long term robustness and reliability of the remaining grants. The ultimate and longer term solution is a review and reform of Commonwealth-State roles and responsibilities, including funding arrangements;
- A review of the operation, administration and governance of the **GST**.

Queensland looks forward to discussing and developing these proposals in collaboration with the Tax Review panel, the Commonwealth and the other states and territories.

1. THE CASE FOR REFORM IN FINANCIAL RELATIONS

The Australian Federation has served the nation well, and must be kept strong

Australia was born as a nation as a federation. Our existence as a federation is not simply the result of historical accident but a deliberate choice of the founders of federation and the people of the then six colonies. This choice has served Australia well for over a century.

Australia's federal system has been flexible and adaptable. States have advanced the nation's interests individually, in cooperation and in productive competition. The basis of our federation was the creation of a carefully circumscribed central government, with plenary power residing with the states. However, at federation, at war and at many other times, the states have willingly ceded powers to the Commonwealth when in the national interest. Now, at a time of economic downturn, the Commonwealth, states and territories are also engaged in a renewed process of cooperative federalism, again in the national interest.

By being adaptable to changing circumstances, Australia's federal system has been able to maximise the advantages of both centralised and devolved responsibility. Centralised responsibility can exploit economies of scale and a national perspective; devolved responsibility engenders a closer relationship to the community to interpret and act on the regional and national interest.

It is important to keep the Australian Federation strong to sustain the structure that has sustained our nation. That means a strong Commonwealth and strong states and territories (hereafter referred to as the States). A strong federation is important to develop robust regional and national economies and to drive the national economic reform agenda needed to sustain them.

Taxation reform for a stronger national economy

Particularly at this time of national economic downturn, Australian governments must be considering measures to bring forward economic recovery and strengthen the foundation for the next period of economic prosperity.

The reform of the mix and design of Australian taxes can deliver substantial immediate and long term improvements in efficiency and equity outcomes. Improved efficiency of the national taxation system provides an important objective for the Review and should be considered a key element of the national economic reform agenda. Reducing tax inefficiencies and inequities removes the shackles from economic growth leading to:

Tax reform can deliver substantial gains in employment and income

- higher wages and profits;
- higher levels of employment; and
- lower prices for consumers.

These are worthwhile policy goals at any time; at this time of looming economic recession these are benefits which Australia cannot forego.

The tax/transfer system should promote labour market participation by rewarding work

An important feature of the taxation system is its capacity to generate incentives and disincentives. One area of particular importance is that of labour force participation. The tax system and its interaction with the transfer system should reward work and therefore encourage labour force participation, but poor design features of the existing tax/transfer system can sometimes produce high effective marginal tax rates that discourage participation. Despite the immediate circumstances, this is an important issue now, but, with the ageing of the population over coming decades, it will become a critical one as it will be increasingly important to sustain an otherwise diminishing workforce.

The impact of the tax system in this way extends beyond the labour market to investment, saving, housing, transport, pollution, access to education and health – the list is almost endless. An important objective of the Review should be to advise on the proper calibration of the national taxation system to generate desired economic, social and environment outcomes for Australia.

Of course, the impact of the tax and transfer systems on economic equity and their use as a tool for redistribution will be another important area for analysis by the Review. An equitable and fair taxation/transfer system provides a strong base on which the national economy can grow.

As the contribution of businesses, organisations and individuals to the Review indicates, the complexity of the taxation system is an area of particular concern and frustration to Australian taxpayers. There are too many taxes, too much legislation, too much administration, too many requirements, too much red tape. This generates excessive public and private bureaucracy and unnecessarily inflated levels of compliance costs for taxpayers and administrative costs for government. It is a challenge for all Australian governments – the Commonwealth with its 99 taxes, the States with 25, and local government with one – to reduce this complexity without compromising the effectiveness or fairness of the taxation system. Indeed the challenge is to enhance the system's characteristics.

It is a challenge for all governments to reduce the complexity of the tax system

A system out of balance

Much of the Review will rightly focus on issues of how governments can better and more appropriately collect tax. It will raise issues of tax levels and tax mix, of tax design and tax administration. But a debate about taxation is not just a debate of how or how much tax governments should raise – it should also be about which level of government should undertake the raising. Thus issues related to the national tax system are inextricably linked to the federal financial system, so that a comprehensive review of one cannot meaningfully take place without a review of the other.

A debate about taxation is not just a debate of how or how much tax governments should raise

The Commonwealth Tax Review – "Australia's Future Tax System" – has as a central objective 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".

A Review objective is to propose a tax structure that will position Australia to deal with this century's challenges

As a federation, the Review focuses, as it should, more broadly than simply on the Commonwealth tax system.

As providers of services such as health care, education, environmental protection, child protection, policing and transport, State governments have an important role and responsibility to respond to the needs of their communities in meeting the challenges of the future.

Local government, too, has an important role to play in meeting the needs of communities, as providers of a range of important services.

Therefore, one objective of this Review must be to ensure that the national taxation system and the associated policy framework are appropriately structured to provide the different levels of government with the revenues to assist them in fulfilling this important function.

The allocation of taxation powers between the Commonwealth and the states was an issue of much debate in the development of the Australian Federation. It is fair to say that the current distribution of taxing powers, after a century of federation, is not what the founders of our federation intended.

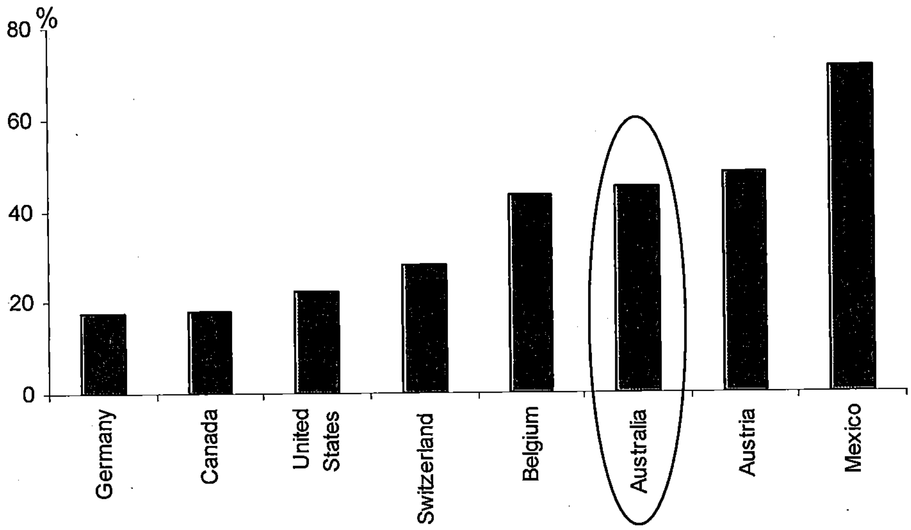
The current state of financial relations is one of imbalance...

The current state of financial relations between the Commonwealth and the States can be characterised as one of imbalance.

The Commonwealth's capacity to raise revenue is disproportionately greater than its expenditure responsibilities. Conversely, the States' expenditure responsibilities are far in excess of the revenue they raise, giving rise to a vertical fiscal imbalance (VFI) in the Australian federal system. The revenue gap of the States is closed by grants financed by the excess revenue of the Commonwealth.

The size of this imbalance is significant, with Commonwealth grants representing around 45% of total state revenue. This is around double the degree of vertical fiscal imbalance of other major federal systems such as the United States, Canada and Germany, as shown in Chart 1.

Chart 1 Australia's high level of vertical fiscal imbalance



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.

... with States strongly dependent on the Commonwealth for revenue

The level of grants to the States is predominantly at the discretion of the Commonwealth. Further, a significant proportion of these grants is tied by conditions that reflect policy preferences largely dictated by the

Commonwealth and, in some cases, require matching funding from the States. By leveraging off their financial dominance over the States, the Commonwealth can further extend its influence across an even wider range of policy fields. Thus, the States remain largely financially dependent on and policy constrained by the Commonwealth, a situation the originators of the Constitution did not intend, although foreseen as inevitable by some.

> Alfred Deakin, a leader of the movement for Australian federation and second Prime Minister of Australia, predicted in 1902, "The rights of self-government of the States have been fondly supposed to be safeguarded by the Constitution. It left them legally free, but financially bound to the chariot wheels of the Central Government. Their need will be its opportunity... Our Constitution may remain unaltered, but a vital change will have taken place in the relations between the States and the Commonwealth. The Commonwealth will have acquired a general control over the States, while every extension of political power will be made by its means and go to increase its relative superiority."[1]

This financial dependency on the Commonwealth is reinforced by the limited revenue raising capacity of the States. State taxation is restricted to narrow tax bases focussed predominantly on employer payrolls, land, motor vehicles, insurance, and, in the case of mineral royalties, on mining.

The exposure of state revenues to international developments and economic downturn has recently been fully revealed. Dysfunction in financial markets has limited the credit available to finance the property and motor vehicles purchases on which much of stamp duty revenue depends. Downturns in the property and commodity markets have further diminished state revenues, principally transfer duty and royalties.

States do not have adequate access to broad based taxes

States do not have access to broad based taxes such as income and consumption taxes for revenue raising. Of course, States receive the revenue from the broadly based GST, however the GST replaces previously granted monies (Financial Assistance Grants) and abolished state taxes, and its limited capacity to meet actual needs is revealed by the reinstatement of budget balancing assistance to a number of States this year. While issues of the GST rate and application are outside the scope of this review, it is important in the context of this discussion to note that, despite agreements between the Commonwealth and the States, the setting of the rate and base of the GST remains within the constitutional and legislative authority of the Commonwealth and therefore ultimately within the Commonwealth's control to maintain or amend as it sees fit. A future Commonwealth government is constrained only by the politics of so legislating, not by any constitutional limit on its ability to unilaterally legislate to change the base or the rate.

This situation is in contrast to that in other federal systems such as the United States, Canada and Germany, where subnational governments either have direct access to broadly based income and consumption bases or have a significant say in the setting of rates of shared income and consumption taxes.

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[1] Cited in R.L. Matthew and W.R.C. Jay *Federal Finance: Australian Fiscal Federalism from Federation to McMahon*, Victoria University, 1997.

Restrictions on state taxation

The States' policy response to this situation is circumscribed by their very limited capacity to expand their taxation base. The limitations arise from a number of factors.

The States' capacity to expand their taxation base is limited by…

- **The Australian Constitution,** which precludes the States from levying customs duty or excise duty, and, because of its broad interpretation by the High Court, effectively prevents States introducing a tax based on the value of goods produced or sold – for example, a consumption or retail tax.

… the Constitution…

- **Restrictions imposed by the Commonwealth**, particularly on the levying of income tax since the Second World War. While the Constitution still allows the States to levy income tax, it essentially provides for the Commonwealth to effectively nullify this power.

… the Commonwealth…

- **Agreements with the Commonwealth.** The *Intergovernmental Agreement on Federal Financial Relations* prevents reinstatement of taxes, or similar taxes, that were abolished under the agreement associated with the introduction of the GST. These include a number of stamp duties and financial taxes, such as debits tax It also specifically precludes the States from levying stamp duties on the transfer of emission trading permits.

… and agreements with the C'wealth

With the States unable to turn to income, consumption and financial taxes, and excises and a range of stamp duties as sources of revenue, there is no effective and efficient way for the States to reduce their financial dependence on the Commonwealth. Essentially, in the absence of a commitment for reform from the Commonwealth government, VFI will remain a permanent feature of Commonwealth-State financial relations.

Why vertical fiscal imbalance is a problem

While some degree of VFI is desirable, an excessive degree of VFI will be detrimental because it can:

Excessive VFI is detrimental because it …

- 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, only around fifty-five cents is raised directly for those purposes;

… weakens government accountability…

- reduce transparency regarding who is responsible for which government services, providing the circumstances in which governments can seek to avoid responsibility by shifting blame for funding and operational shortfalls to other levels of government. Health policy in Australia has been a prime example where the responsibility across different levels of government for funding, operating and regulation in different areas of the health care system can result in a lack of transparency, an opportunity for blame-shifting and, ultimately, public confusion; and

… reduces transparency…

- create inefficiencies, duplication, misallocate resources and slow the responsiveness of governments to the needs of their communities. These problems result from bureaucratic overlap and duplication,

… creates structural inefficiencies

inadequate levels of intergovernmental transfers, and inappropriate policy interventions by one level of government in areas of responsibility of another. This inefficiency can be overcome but not without the expenditure of time and resources.

A growing problem

Governments are already facing spending pressures...

Governments face increasing demand for access to improved service levels in health, education and other service and have responded in recent years by increasing expenditures. A property boom, mining boom and very strong economic conditions have until recently driven high levels of growth in property taxation, mineral royalties, GST revenue and other state revenues.

... while the global financial crisis is exposing the weakness of the States' narrow tax bases...

As discussed earlier, just as the buoyant economic conditions have evaporated in the face of the global financial crisis, so has the financial security of the States. Their essentially weak revenue position has been made starkly apparent, with the narrowness of the States' tax bases producing an intrinsic volatility in revenue and highlighting their weaknesses as sources of revenue. The effects of the global financial crisis on States' own-source revenues have reaffirmed the States' dependency on Commonwealth transfers. The inability to diversify their funding sources means the risk remains inherent.

... and demographic change and other 21st century challenges will add further pressures to State budgets

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

The Productivity Commission has indicated the dimension of the challenge. By 2044-45, Australian governments are projected to have a combined ageing-related fiscal gap of around 6½% of GDP relative to 2003-04. That is, government spending is projected to increase by 6½% of GDP more than revenue.[2]

As a major health care provider, States are likely to be impacted significantly. The preferred approach would be to close the fiscal gap through a combination of improvements in economic productivity and service delivery efficiency. However, to the extent that the gap is unable to be closed in this way, the next option contemplates States to consider increased state taxation and/or require increased Commonwealth grants. In the absence of reform of state revenue systems, such a development will either place added pressure on narrow state tax bases or exacerbate already high levels of vertical fiscal imbalance.

As well as responding to population ageing, the challenges confronting State governments, include delivering education and training in a competitive global environment, developing infrastructure to support a more productive economy, and addressing and managing the impact of climate change.

[2] [2]Economic Implications of an Ageing Australia, Productivity Commission, 2005.

2. OPTIONS FOR REFORM OF TAXATION AND VFI

There is an overall need for the States to enhance their capacity to manage their revenue bases, with two interlinked fiscal objectives for the States in the reform of their financial relations with the Commonwealth:

Reform objectives should be to:
- *reduce VFI*
- *maintain States' revenue raising capacity*

- **the reduction of vertical fiscal imbalance** – to provide greater control and greater accountability for the different levels of government in managing their finances to meet their policy responsibilities by aligning the revenue capacities and expenditure responsibilities of the different levels of government
- **maintenance of States' revenue raising capacities** – to provide the States with the revenue capacity to meet their future policy responsibilities.

At the same time, there are potentially other benefits from the reform of taxation arrangements, such as **improved economic efficiency and equity outcomes**. While not addressing directly the objectives outlined above, they will deliver benefits to the national economy and indirectly enhance fiscal capacities. The economic benefits of reform are also likely to be an area of common interest with the Commonwealth.

These objectives should be considered national objectives that will strengthen the capacity of the overall public sector in Australia to deliver the best outcomes for Australians. Similarly, the objective to improve economic and equity outcomes should be a national objective, with its pursuit being the role and responsibility of all levels of government.

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

The reform agenda proposed here has the following elements to address the issues outlined above:

Proposed reform agenda

A. Reform of the State taxation system through the rationalisation of tax administration and tax abolitions.

B. Replacement of revenue capacity lost from tax abolitions with access to other revenue sources.

C. Further reform of the Commonwealth grants system, through a reduction of States' reliance on Commonwealth grants and an increase in the long term robustness and reliability of the remaining grants. The ultimate and longer term solution is a review and reform of Commonwealth-State roles and responsibilities, including funding arrangements.

A reform agenda with:
- *rationalisation of tax administration and further abolitions*
- *replacement of abolished taxes with access to other revenue sources*
- *reform of C'wealth grants*

Further, consideration should also be given to options for reform of Commonwealth taxes that focus specifically on economic, social or community objectives and outcomes.

A. REFORM OF EXISTING STATE TAXES

Queensland has a proud record of tax reform over the past decade, with reform of its mix, design and administration.

Queensland has a proud record of tax reform over the past decade

In recent years, a large number of less efficient taxes have been abolished, including:

- marketable securities ('quoted' in 2001, and 'unquoted' in 2007);
- credit card duty (2004);
- debits tax (2005);
- lease duty (2006);
- credit business duty (2006);
- hire duty (2007);
- mortgage duty (2008); and
- duty on the transfer of core business assets (scheduled for 2012).

These abolitions will have delivered accumulated tax savings of nearly $2 billion to Queenslanders taxpayers by the end of this financial year and will deliver further savings of $755 million in 2009-10.

Over this period, insurance duty has also been cut, the payroll tax-free threshold raised, the land tax schedule reformed and transfer duty concessions for first home buyers significantly extended. At the same time, a large range of administrative reforms have simplified the state tax system for taxpayers and made tax administration more efficient.

But tax reform is an ongoing task and more can be done. National tax reform presents the opportunity to advance the reform of the state tax system, including consideration of further reform of state tax administration, design and mix.

A1. Administrative Reforms

There are administrative reforms that could be included in a package of state tax reform. These could include:

A raft of tax administration reforms should be considered

- standardisation of payroll tax legislation by building on progress to date on harmonisation of payroll tax regimes, possibly with a view to introducing mirror legislation across the States. States would only differ in relation to rates and thresholds;
- standardisation of other tax legislation (other than that relating to rates and thresholds), particularly with respect to certain aspects of business and property taxation, such as unit trusts, corporate reconstructions, and others;
- consideration of rationalisation of Commonwealth and state tax offices and/or functions. Revenue offices could coordinate more effectively, possibly specialising in particular revenue collections, consolidating tax return requirements or introducing national collections. States should also be open to consideration of linking the collection of payroll tax with that of certain Commonwealth taxes, possibly through

the business activity statement or the pay-as-you-go income tax system (PAYG), with States retaining their rights to set rates. Full integration of payroll tax with, say, PAYG is more problematic, with significant differences existing between the scope of the two tax bases;

- consideration of whether Commonwealth and state bodies should pay tax in the other's jurisdiction, allowing the removal of tax equivalent regimes to reduce administration and preserve competitive neutrality conditions; and
- further progress in e-conveyancing and standard business reporting.

A balance must be struck in considering the degree of harmonisation and consolidation of tax regimes and administration. Difference can promote comparison and competition, while uniformity can reduce the incentive to reform. Arguably, a lack of competition is one reason why aspects of the Commonwealth income tax system and administration are sometimes judged to be below international best practice.

A2. Tax abolitions

States have a number of stamp duties that have narrow bases with consequences for economic efficiency, revenue raising capacity and revenue volatility.

__A number of state taxes – mainly stamp duties – could be considered for replacement__

State taxes that could be considered for abolition include:

- **insurance duty**, including duty on general, accident and life insurance, as a relatively less efficient tax; and
- **motor vehicle registration duty**, which is also a relatively less efficient tax.

A number of submissions to the Review have already identified other state taxes and charges as desirable for reform, including the following.

- **Transfer duty**. This has been a relatively fast growing tax which, if abolished, would represent a significant reduction in the revenue raising capacity of the States.

  In considering the abolition of transfer duty, proposals to abolish components in isolation (for example, the abolition of duty on real business conveyances while maintaining duty on residential conveyances) should be resisted for reasons of administrative efficiency and tax fairness. Opportunities for avoidance are often created by partial abolitions, requiring anti-avoidance measures (such as Victoria's attempts to prevent the use of leasing arrangements to circumvent the payment of conveyance duty).

  Because of the large magnitude of the transfer duty liability impacting on individual transactions, the comprehensive abolition of transfer duty at a single point in time may create dislocation in the property market as well as perceptions of unfairness for those forced to pay the tax in the period just prior to abolition. Therefore, the gradual phasing out of the tax could be considered.

  In considering a contemporary abolition, allowance would need to be given to the current low level of revenue attributable to the depressed state of the property market. A longer term average level of revenue may need to be used as the basis for reform arrangements.

- **Payroll tax.** Payroll tax was originally a Commonwealth tax. In recognition of the fiscal limitations facing States since their loss of income tax during World War II, the Commonwealth agreed to transfer payroll tax to the States in 1971 (albeit with a matching reduction in financial assistance grants). Today, payroll tax is a major state tax – in Queensland's case, the revenue collected from this tax is approximately equivalent to the State Government's funding of acute care services in public hospitals. Its abolition would represent a major loss of revenue for States that would need to be replaced. However, as discussed above, the opportunity exists for streamlining its administration.
- **Mineral royalties.** Mineral royalties represent a financial return to the State-level community for the exploitation of its mineral assets and the State's investment in the associated industries. There are suggestions the Commonwealth could assume responsibility for collecting mineral royalties. The transfer to the Commonwealth of this revenue stream would represent an effective loss of state sovereignty. Despite this, States should remain open to proposals on how royalties can be more efficiently and effectively levied given the constitutional limitations and various approaches applied by different levels of government.
- **Gambling taxes.** Gambling taxes, as opposed to excessive gambling per se, produce a revenue stream for state governments to use to support important community-level benefits including better health and education and the mitigation of harm arising from gambling and other addictive behaviours. Such taxes, like those imposed on alcohol and tobacco consumption, also have a policy purpose in discouraging abuse. In terms of tax design principles, gambling taxes are relatively efficient.

Redistributing the 'reform dividend'

State tax reform will deliver a 'reform dividend' that needs to be distributed in the public interest

The abolition of stamp duties and other administrative reforms would likely produce economic and administrative efficiency gains that would translate into a 'reform dividend' for governments. This windfall would largely accrue to the Commonwealth as the major recipient of national tax revenue.

This reform dividend should be shared fairly with State tax payers and State governments, as initiators of state tax reform. This windfall could be used to reduce the extent of the compensating replacement tax impost on taxpayers or fund reductions in other state taxes or improvements in services. Alternatively, the windfall could be used to support further tax reform, possibly to fund States which suffer a disproportionate loss.

B. A REPLACEMENT TAX SOURCE

Revenue from abolished state taxes will need to be replaced

The stark reality is that abolitions of some or all of stamp duties would represent a multi-billion dollar loss of revenue for the States (stamp duties raised approximately $20 billion in 2007-08). It would also represent a significant worsening of vertical fiscal imbalance and loss of revenue raising capacity.

Unless services are commensurately slashed, the loss of state taxes would have to be compensated for by access to a new and preferably broad based state revenue source.

A number of reviews and commentaries on federal financial relations have suggested states having access to income tax as a means of equipping the States with a broader revenue base.[3]

The argument for sharing of, say, the corporations tax base is not so strong. Uniformity is more critical for business operations, which are progressively becoming less state based and more nationally based (and, indeed, internationally based). This need for uniformity has been a major reason for States, which have an original constitutional responsibility for corporate law, to have transferred powers over corporations to the Commonwealth over time.

In contrast, those supporting personal income tax argue that it is a more preferable tax base for subnational governments, as tax uniformity is less crucial for individuals, who generally live and work in the one state. This makes personal income tax a more desirable tax to use to align revenue capacity with spending responsibility, and thereby align the provision of services with the wishes of their state communities. Indeed rate settings can be used as policy levers, for example in encouraging migration and growth through competitive setting or through funding the services of growing populations through settings which recognise that fiscal challenge.

The issue of the most appropriate revenue source to replace the revenue from state tax abolitions is one requiring further exploration by the Review in the first instance and ultimately by all Australian governments together.

C. REFORM OF THE COMMONWEALTH GRANTS SYSTEM

C'wealth grants include:
- ***GST***
- ***five major SPPs***
- ***national partnerships***

The current system of Commonwealth grants is predominantly built around:

- the Goods and Services Tax (GST);
- five major specific purpose payments (SPPs) – health, schools, disabilities, housing and skills – associated with national agreements in those areas; and
- a number of national partnerships and minor SPPs, which relate to specific reforms, projects and financial arrangements with the States.

[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,* 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.

The GST represents a significant revenue source for the States and is the main vehicle for redistribution between the States to equalise financial capacity and service needs.

National partnerships represent the main vehicle for direct Commonwealth financial intervention in policy areas usually managed by the States. Provided the States are not pressured to agreeing to partner with the Commonwealth on these projects, there is little benefit in seeking to limit the capacity of the Commonwealth (or the States) to offer these partnerships.

While recent SPP reform is to be welcomed, there is more to be done

Last year, there were significant reforms to SPPs that saw the broadbanding of SPPs and a shift to a greater emphasis on policy outcomes and service outputs. Although these reforms are to be welcomed, there would appear further scope for reform of the resultant five major SPPs in health, schools, disabilities, housing and skills.

SPPs have the potential to provide the States with a stable source of funding directly correlated with growth in their expenditure responsibilities. However, as they currently have no grounding in an assessment of the Commonwealth's appropriate policy role and funding relationship to the States in these areas, determination of the base funding and escalation for these SPPs are effectively at the discretion of the Commonwealth. This provides States with no long term funding certainty and leaves the funding of state government services vulnerable to changes to Commonwealth policy priorities.

C1. Review and reform of Commonwealth-State roles and responsibilities

Review and reform of C'wealth-State roles and responsibilities is the preferred approach to reform

The preferred approach to reform is a comprehensive review to determine the most appropriate allocation of policy, expenditure and regulatory responsibilities, as well as funding arrangements, between the Commonwealth and States, with a view to reducing the extent of overlap, duplication and opportunity for blame shifting, and increasing accountability to the public.

Such reviews have taken place previously. In 2006, Germany undertook to reallocate many responsibilities shared between levels of government to one or other level.[4]

The terms of reference of the review could include:

- the most appropriate allocation of service policy and delivery responsibilities to ensure service delivery is efficient, effective and responsive to community needs (for example, early childhood learning and vocational education and training);
- where responsibilities are shared, the appropriate allocation of roles and establishment of mechanisms and institutions to ensure the delivery is efficient and responsive to community needs; and

[4] Anne Twomey, *Australian Federalism – Options for Reform*, National IR Conference, Brisbane, 11 September 2007.

- appropriate funding arrangements, including the establishment of mechanisms and institutions to ensure funding is shared fairly and maintained in the long term.

C2. Review of the operation, administration and governance of the GST

After a decade in operation, a review of the GST would be timely

While acknowledging the Review's terms of reference require it to reflect the Commonwealth Government's policy "not to increase the rate or broaden the base of the GST", it would be timely, after nearly a decade in operation, to review the operation, administration and governance of the GST. One particular issue for review is the multi-stage structure of the GST. A GST with fewer stages could result in taxpayer compliance savings, provided changes did not result in excessive administrative burdens or revenue leakage. As the Commonwealth directs GST revenue to the States, any changes to the GST will need to take into consideration the revenue implications for States.

D. TAX AND OTHER REFORMS FOR ECONOMIC AND COMMUNITY OBJECTIVES

The Review should also consider tax reforms to achieve economic, social and environmental objectives

The Terms of Reference for the Review provides for recommendations to enhance overall economic, social and environmental wellbeing, with a particular focus on ensuring there are appropriate incentives for:

- workforce participation and skill formation;
- individuals to save and provide for their future, including access to affordable housing;
- investment and the promotion of efficient resource allocation to enhance productivity and international competitiveness; and
- reducing tax system complexity and compliance costs.

There may be an opportunity for reforms to Commonwealth taxation to support State policy objectives, for example, affordable housing, reduced road congestion and optimal infrastructure provision. The proposal of such reforms should be in the context of efficient tax design and effective budget management.