

STATE TAXES

IN SERIOUS NEED OF REFORM

State tax systems are inefficient, inequitable, and overly complex, says **Michael Potter**

The Federal Government raises the majority of tax revenue. Excluding the Goods and Services Tax (GST), the state, territory and local governments accounted for 18% (\$48 billion) of total taxes in 2003-04, a figure that rises to 32% (\$82 billion) if GST is included.¹ As a result, the focus has been on reforms to federal taxes, and there has been less examination of reform to state and local government taxes. However, state, territory and local government taxes represent a significant proportion of the national tax burden. No proper debate on tax reform is complete without addressing reform of state taxes.

The focus on this article is on taxes levied by states and territories (henceforth the states), more than on local government rates and taxes.

Survey of state taxes

Taxes levied directly by states include:

- Payroll taxes, which are taxes levied directly on salaries paid to employees. There are (different)

small business exemptions in each state, and some salaries are exempt.

- Stamp duties, which are payable on a large number of transactions, including mortgages and buying and selling property.
- Land taxes, which are levied on land value. Municipal rates are also levied on land value.
- Gambling taxes.
- A Fire Services Levy is imposed on some insurance premiums.

The Federal Government collects the GST on behalf of the states. While it counts the GST as a state tax, the ABS and state governments do not. This article will not discuss the merits of each position.

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Breakdown of total state taxation

	2003-04 (%)	2003-04 (\$m)
Employers payroll taxes	22.5	10820.0
Taxes on immovable property	23.9	11459.0
Stamp duties on conveyances	21.8	10470.0
Other taxes on financial and capital transactions	5.0	2410.0
Taxes on gambling	8.4	4040.0
Taxes on Insurance	6.7	3231.0
Motor vehicle taxes	10.7	5126.0
Other taxes	1.0	485.0
Total	100.0	48,028

Source: ABS, *Taxation Revenue*, Cat No. 5506.0.

Taxation principles

The generally accepted principles that a tax system needs to meet are equity, efficiency and simplicity. Most state taxes do not meet these criteria.

Efficiency

Many state taxes are levied on transactions—such as the buying and selling of assets. These taxes are generally more inefficient than other taxes. While all taxes distort economic decision making, transaction taxes can be more distortionary. They inhibit the normal transfer of assets to their highest value use, encourage assets to be held for longer than optimal and discourage restructuring of businesses.

They also can be more easily evaded or avoided than other taxes. For example, a block of land can be owned by a foreign company, which is then bought and sold rather than the underlying asset. It is much harder for Australian authorities to detect the change in ownership of a foreign company than the change in ownership of land.

Transaction taxes are not stable sources of revenue. Turnover of assets can vary substantially from one year to the next, for reasons that can have little to do with underlying economic activity. This makes it hard for state governments to make long-term budget plans.

Equity

Transaction taxes also take little account of ability to pay. Turning an asset over more often does not mean

a person is better off. For example, a poorer person who moves house often pays more stamp duty than a richer person who moves house less often.

Simplicity

State taxes are levied in an ad hoc manner with different rates, exemptions and definitions applying in different states to economically identical transactions and assets. As a result, compliance costs are raised for businesses that operate across multiple jurisdictions.

Ad hoc exemptions

An additional problem with state taxes is that several states give ad hoc exemptions to encourage new or existing businesses to move to their state. Official data on these exemptions is limited.

While these exemptions provide benefits to the particular business, the overall benefit to the state is debatable. In addition, there is nothing gained from a federal perspective from incentives for Australian businesses because the incentives merely alter the location of the business within Australia. The incentives are basically a transfer of money from the state Treasury to the business. It would be better for states to provide broader tax reductions to businesses generally.

REVIEW OF PARTICULAR STATE TAXES

Goods and Services Tax (GST)

The introduction of the GST provided a significant opportunity to reform fundamentally state taxation. However, the ultimate outcome fell short of the original plan.

In its original tax package, *A New Tax System*, the Australian Government proposed that state governments would receive all the revenue from the GST in return for the states removing a significant number of inefficient and inequitable taxes.

However, the Government was forced to increase the number of GST exemptions (particularly to exempt food) in negotiations with the Australian Democrats. This decreased revenue to the states, increased complexity, reduced efficiency and had limited effect on equity (because some inequitable state taxes were not removed).²

The state governments agreed to the removal of a (smaller) list of taxes in return for the GST

in a 1999 Intergovernmental Agreement (IGA). Under this agreement, states removed bed taxes from 1 July 2000 and financial institutions duty and stamp duty on marketable securities from 1 July 2001.

In addition, state governments agreed to review the need to retain some other taxes by 1 July 2005: debits tax and stamp duty on a number of transactions, particularly the sale of business property.³ I will call this set of taxes the 'reviewable taxes'.

Progress on eliminating these reviewable taxes has been mixed.⁴ While the states did not make a commitment under the IGA to remove these taxes, it is implicit in the IGA that the preference should be for removal when possible.

On 20 April 2005, *some* of the state Treasurers proposed that they would abolish *some* of the reviewable taxes on a fairly slow timetable. While this agreement is better than nothing, it only goes part way:

- New South Wales and Western Australia did not sign up to the agreement at all.
- The timetable for abolition of the taxes is very slow. It is proposed that some taxes will not be abolished until 2010.
- It specifically excludes stamp duty on transfers of business property.

Taxes on transfer of non-residential property

Stamp duty is imposed on the transfer of non-residential property. It is therefore a transactions-based tax. Different rates apply depending on the value of the property and the jurisdiction. The tax rate is progressive in all states, so a higher-value asset attracts a higher tax rate.

As noted above, transaction-based taxes are inefficient and inequitable. They place a higher tax on businesses that sell property more often, regardless of their particular ability to pay. Stamp duties are levied on the GST inclusive value of transactions, so the effective tax rate on these transactions can be over 10%.⁵

Stamp duty on property transfer also increases the price of capital. Removing stamp duty would reduce the price of capital, producing a large economic gain, given the sensitivity of capital to changes in price.

Taxes on transfer of residential property

A stamp duty is also imposed on transfers of residential property at a progressive rate (higher-value assets attract a higher tax rate). However, if a low-income earner moves more times than a high-income earner, the aggregate amount of tax paid relative to income is less progressive.

Recent strong increases in house prices have meant that houses move into higher tax brackets (known as bracket creep). As a result, stamp duty revenue has increased sharply.

State governments have now begun to introduce exemptions for first homebuyers by raising thresholds and lowering rates. However, this has left the bracket creep problem largely unaddressed. Thresholds should be increased substantially for all homebuyers and rates should also fall. This will reduce the reliance of state budgets on this inefficient, inequitable and unstable revenue source.

Taxes on property ownership

Both state and local governments impose taxes on property ownership. They are usually levied annually on the total unimproved value of land owned.⁶ They are not transaction-based taxes, but are more akin to wealth taxes (which have different problems).

As with the majority of state taxes, land is subject to many thresholds and rates depending upon which jurisdiction the land is in.⁷ In Queensland, there are 19 different land tax rates, while the ACT uses four and the Northern Territory levies no land tax at all. Separate municipal rates are levied on land values by councils.

Generally, exemptions or concessions exist for pensioners, owner-occupied housing and land used for agricultural, charitable, religious or recreational purposes. Councils generally have fewer exemptions.

The system for valuing land varies between states. Most jurisdictions use the value for the previous year, while an average of the previous three years is used in Queensland and the ACT.

Property taxes are generally more efficient than other taxes, since land is in fixed supply. However, property can be affected by development, use and rezoning. For example, a particular house can be

taxed if it is a rental property or untaxed if it is owner-occupied. So the supply of land subject to tax is not fixed. This reduces the efficiency of the tax.

All states have a progressive scale of land tax and most have a tax-free threshold. While this increases the equity of land tax, in other ways land tax can be inequitable:

- It hits land-intensive businesses harder, although primary production is exempt.
- Land value may not be a good indicator of a taxpayer's capacity to pay. A taxpayer may have bought a property when it was worth a tiny amount compared to today's price.
- Land taxes are imposed on rental properties and not on owner-occupied properties. This means a higher tax on renters, who are generally less well off than property owners.

Compliance costs for land taxes are likely to be low as the tax is calculated by the government and mailed to the relevant taxpayer. Only during periods where land has changed hands does the taxpayer bear costs. Avoidance opportunities are much smaller for land tax than for other taxes—in particular, land cannot be moved to another jurisdiction. In addition, most entrepreneurial land owners are trying to increase the value of land, not reduce it.

However, administration costs can be large with each state needing to assess a value for all properties. In some states, valuation is carried out each year at substantial cost. These valuations do however have additional uses, such as determining council rates. We are not aware of estimates of state administration costs.

Similar to stamp duty, land taxes can fluctuate due to changes in the value of land. Given the proportion of total state tax raised through property tax, any instability in the property market will produce instability in a state's budget. However, stamp duty is subject to an additional uncertainty—it is affected by asset turnover, while land tax is (generally) not.

Gambling taxes

Gambling taxes raise a fairly significant amount for state governments. The revenue fell after the introduction of the GST, but has climbed steadily since. Gambling taxes are levied at different rates

depending on the activity (such as horse racing, electronic machines) and on the type of bet that operates (such as lotteries and TAB).

While these taxes can be seen as transaction taxes, they are generally not levied to promote efficiency, but for other reasons, particularly discouraging what is thought to be a 'socially costly' activity. These taxes are generally inequitable, because gambling expenditure is concentrated amongst the less well off.

It is beyond the scope of this article to investigate gambling in detail. A much more detailed discussion is in the Productivity Commission's 1999 inquiry into gambling.⁸

Fire Services Levy

Most jurisdictions fund fire services out of general revenue or from land taxes. However, New South Wales, Tasmania and Victoria fund their fire services through a levy on insurance premiums. This method of collecting revenue places an unfair burden on policyholders and the insurance industry. A more efficient and equitable method of raising revenue should be implemented in these states.

Problems associated with the fire services levy (FSL) include:

- The FSL adds directly to the cost of insurance premiums, reducing the demand for insurance. This:
 - Increases the likelihood that businesses or individuals will face catastrophic loss without insurance, which is inequitable;
 - Increases the burden of the FSL on other policy holders; and
 - Encourages some businesses to insure offshore.
- The FSL interacts with the GST and state stamp duty to produce very high rates of tax. Both Victoria and NSW levy stamp duty on top of the GST, which is levied on top of the FSL, which are all levied on top of the consumer's insurance premium.
 - The tax rate was around 78% for Victorian business insurance.⁹
 - In 2003, a study found that Victoria has the highest level of taxation on insurance in the world while New South Wales was second.¹⁰
- Fire services are provided to all businesses and

individuals, not just those that pay the FSL—the uninsured businesses are ‘free riding’ on the insured businesses.

- The FSL does not vary with risk of fire, so businesses are cross subsidising each other.
- The levy does not apply to everything that could generate a fire.

The funding for fire services should be shared more equally across the community. Given that the whole community (not just those who are insured) benefits from a better equipped and prepared public fire service, funding should be raised from the general public.

Fire services should be funded either out of general revenue or out of a broad-based property tax at a low rate. Any levy could also be applied to motor vehicles and boats, as they are responsible for some component of fire responses.

Payroll tax

Payroll tax is a state tax levied on wages and salaries paid by employers, with different coverage and rates between states. Most states depend heavily on payroll tax for revenue, and revenues are growing strongly. Total payroll tax revenues were \$10.8 billion in 2003-04.

Most businesses have strong concerns about payroll tax. For example, 40% of small businesses and 45% of accountants believe payroll tax is a barrier to employment¹¹ and 46% of small businesses would prefer to see payroll tax eliminated even if it means increases in other taxes.¹²

One of the main concerns is over inconsistent definition of payrolls. For example:

- All jurisdictions except Victoria include termination payments to non-executive directors in the payroll tax base.¹³
- Commonwealth and local governments are exempt, as are those classed as self-employed.

Payroll tax imposes significant compliance costs on smaller firms (there are exemption thresholds, but they are mostly fairly low). While some state governments have recently addressed this issue by increasing the taxable wages threshold, the changes further exacerbate other distortions within the payroll tax system.

In theory, a payroll tax is fully shifted onto consumers—in which case it is identical to a

consumption tax (such as a GST).¹⁴ However, rigidities in Australia’s labour market and inefficiencies in the payroll tax mean that the tax cannot be fully shifted onto consumers. Businesses bear some of the cost, reducing employment opportunities. The OECD has argued:

Payroll taxes will raise labour costs directly insofar as employers are not able to offset them by lower wages. Such shifting of taxes into labour costs, in turn, lowers the demand for labour, as it lowers profitability and investment and encourages more capital-intensive forms of production. Thus, lowering the tax burden on labour while also reducing rigidities could lead to significant increases in both labour supply and demand, boosting output on the one hand and increasing employment on the other.¹⁵

Since payroll taxes are not based on profits, they impose the same burden whether a business is doing well or going through difficult times. However, this point applies equally to most other state taxes. If payroll taxes are not able to be passed on to either employees or consumers, then profits will be cut.

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OPTIONS FOR FUNDING REFORM OF STATE TAXES

Reducing government expenditure

The simplest way to fund a reduction in taxes is for state governments to cut expenditures to pay for the changes. However state government expenditures have been increasing strongly over recent years. Supporters of tax cuts need to be able to identify ways of containing and reducing government expenditure. The Australian Chamber of Commerce and Industry (ACCI), for example, has released a discussion paper on possible areas for reductions in Commonwealth Government spending.

Increasing other taxes

There is some enthusiasm for switching from inefficient state taxes to more efficient taxes, whether state or Commonwealth. As noted above, 46% of businesses would like payroll taxes removed even if it means higher taxes elsewhere.¹⁶

However, there are important caveats with such a proposal. It is possible that a tax switch will:

- not increase efficiency; or
- leave the net tax burden unchanged (or even increase it).¹⁷ Government revenues as a proportion of GDP should be continuously reduced.

Raising GST rate or broadening GST base

One particular proposal that has been raised is to increase the GST rate or broaden the GST base.

Most businesses would have preferred that the GST were broader when it introduced in 2000. The exemption for food in particular caused many problems for retailers, food processors and farmers.

There are important problems with such a proposal:

- While broadening the GST base to cover food in particular would reduce compliance costs in the long term, it would increase compliance costs in the transition. It is not clear that the short run costs would offset the longer run gain.
- Indirect taxes are less visible and can provide rapid increases in public revenue to divert expenditure from private purposes to government.

The GST legislation included a series of safeguards that (hopefully) have made increases in the rate and extensions of the base difficult.¹⁸ A breach of this agreement would devalue it, so that future ad hoc and inefficient changes could occur easily.

A state income tax surcharge

The states could introduce an income tax surcharge. states levied income taxes before 1942, and there have been various proposals to reintroduce state taxes (all failed so far).

A state income tax surcharge could be used to fund the removal of inefficient state taxes. The states could impose their own tax on a commonly agreed Commonwealth-state personal income tax base. The ATO would collect the tax and pass on

the state component to the relevant jurisdiction. The surcharge could apply just at the top marginal tax rate or to lower tax rates as well (because all state residents will benefit from the removal of inefficient taxes).

Some benefits of the proposal include:

- Reductions in administration and compliance costs. State revenue offices could be substantially reduced, while the increased costs to the ATO will be small.
- Income taxes are generally more efficient, flexible, predictable and equitable than state taxes.

However, there are significant barriers:

- The introduction of the GST in July 2000 reduced the need for a state income tax surcharge, because the GST replaced the general purpose payments from the Commonwealth to the states.
- There is a large risk that the proposal will mean higher, not lower, taxes.
- Most experts agree that it is a worthwhile goal to try to align the company and personal tax rates. A state income tax surcharge may make this goal harder to achieve.

Using the growth in GST revenue

The Commonwealth Government has argued that states should be using the strong growth in GST revenues to reduce other taxes. Most states are now well ahead due to tax reform. For example, it is forecast that all states and territories will be \$1.9 billion better off in 2004-05 as a result of higher than expected growth in GST revenues.

The gains from tax reform could potentially offset some of the smaller state taxes, but not stamp duty on property or payroll taxes at this stage. However, larger reforms may be possible over the longer run.

Hand taxes over to the Commonwealth Government

The Commonwealth Government could take over some state taxes. This would enable (at the very least) harmonisation of tax rates and bases. There would be one organisation collecting the tax (the ATO) rather than individual state revenue offices and the tax could be included in the ATO's tax collection

systems (e.g., the Business Activity Statement). This would reduce costs for all businesses.

However, there are a few problems with transferring taxes to the Commonwealth and harmonising rates and bases:

- Vertical fiscal imbalance would increase. The states would become even more reliant on the Commonwealth for raising funds.
- Interstate competition would be removed. In theory at least, competition between states should encourage them to reduce taxes or make them more efficient. This has clearly worked with some taxes (estate taxes are an obvious example) but not on others (particularly taxes on less mobile assets such as land and property). Interstate competition can be inefficient, if the states are offering ad hoc exemptions for particular businesses to encourage them to locate in the state.

These problems do not mean that handing over taxes should be rejected, but that it would have to be implemented carefully.

Assessment

There has been some worthwhile reform to state taxation, particularly as a result of the GST. However, many inefficient state taxes remain. The states should:

- Abolish of *all* the state taxes included in the 1999 IGA as a priority. The proposal by the state Treasurers on 20 April does not meet this goal.
- Restrain expenditure to ensure that remaining inefficient taxes can be abolished as soon as possible.
- Abolish the Fire Services Levy, with the costs of fire services to be raised from general taxation revenue or from land taxes.
- Examine whether remaining state taxes (particularly payroll tax) could be handed back to the Commonwealth so that major reforms of the tax could occur.

At this stage, there are significant problems with proposals to broaden the GST base, raise the GST rate, or to implement a state income tax surcharge. These problems would need to be addressed before such proposals are adopted.

Reforming state taxation will be a valuable microeconomic reform, enabling Australia's growth potential to be increased. While the focus so far has been on reforms to Federal taxes, the need for state tax reform should not be ignored.

Endnotes

- ¹ Source: ABS *Taxation Revenue* Cat. No. 5506.
- ² In any case, it is much more efficient to deal with equity through the income tax and social security system.
- ³ Source: Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, available at: http://www.pm.gov.au/news/media_releases/1999/intergovernmental_agreement.htm
- ⁴ Information on which taxes have been abolished is available from the NSW Treasury's Interstate Comparison of Taxes 2004-05, available from: <http://www.treasury.nsw.gov.au/pubs/trp2004/trp04-4.pdf>
- ⁵ Access Economics, *The Economic Case for Removing Stamp Duty on Commercial Property Transfers: A Qualitative Analysis for New South Wales and Australia* (February 2003).
- ⁶ Unimproved means excluding the value of buildings and other improvements.
- ⁷ See NSW Treasury, Interstate Comparison of Taxes (2004-05), 31 and following.
- ⁸ See: <http://www.pc.gov.au/inquiry/gambling/>
- ⁹ It could be argued that the tax rate is higher. See Access Economics.
- ¹⁰ Senator Helen Coonan, Minister for Finance and the Assistant Treasurer, 'States and Territories are the Key to Reducing Household Insurance Costs' Press Release (24th February 2003).
- ¹¹ CPA Media Release (13 March 2002).
- ¹² As above.
- ¹³ NSW Budget 2003-04.
- ¹⁴ See J. Freebairn, 'The GST and Payroll Tax Abolition', in *Fightback! An Economic Assessment*, John Head, (ed.) (Sydney: Australian Tax Research Foundation, 1993).
- ¹⁵ W. Leibfritz, J. Thornton and A. Bibbee, 'Taxation and Economic Performance', OECD Economic Department Working Paper No. 176 (1997).
- ¹⁶ CPA Media Release (13 March 2002).
- ¹⁷ Recent experience is not positive—the GST has raised more revenue than expected, and company tax revenues have increased strongly after supposedly revenue-neutral changes to business tax.
- ¹⁸ In particular, under the IGA there has to be unanimous agreement of the States, Territories and Commonwealth to raise the GST rate or broaden the base.