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State Taxation and Fiscal Federalism

A Blueprint for Further Reform

Robert Carling

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State Taxation and Fiscal Federalism: A Blueprint for Further Reform

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Foreword

This paper by Robert Carling is the eleventh in a series of tax reform papers published by the Centre for Independent Studies. Like its predecessors, the paper identifies major structural flaws in our current taxation system and develops a set of radical proposals to put them right. Unlike previous papers, however, the flaws it identifies lie in the fiscal relation between the Commonwealth and the states, and it is this specific focus that makes Carling's contribution to the tax reform debate so distinctive and important.

Up until now, authors of CIS Tax Reform papers have tended to focus their attention on Commonwealth government taxes, and have given particular emphasis to the case for reforming personal income tax. Given that the government in Canberra raises 80 per cent of all tax revenue, and that income tax is the single biggest component of its income, this focus on federal income tax reform is certainly justifiable and will continue in future papers. Notwithstanding some welcome changes in the last two Commonwealth budgets, the case for fundamental reform of federal income tax remains compelling.

But this is not the only area where radical change is required. We should not forget that, in our federal constitution, the states too enjoy tax-raising powers, although they actually raise a lot less than they spend. As Carling points out, the states account for 40% of all public expenditure in Australia, although they only raise 16% of all tax revenues.

It is this disparity between what the states spend and what they raise that attracts Carling's particular concern, for it points to a major weakness in our federal structure. As he points out, a vibrant federal system requires that sub-central governments should enjoy a substantial degree of financial autonomy from the central authority: 'The issue is not the amount of funds per se flowing to the states; rather it is one of dependency as opposed to autonomy.' Today, taxes under the control of the states (payroll tax, stamp duties, land tax and duties on gambling and motor vehicles) generate only one-third of their budgets, and receipts from these taxes are dwarfed by the cascade of cash coming from Canberra in the form of tied grants (for schools and hospital spending) and the general purpose grant made up of GST revenues.

This dependency on cash from Canberra disempowers the state level of our federal constitution for it leads to an effective centralisation of power in the hands of the Commonwealth. As Carling puts it, the states are 'well on the way to being mere "branch offices" of the central government.'

This dependency is obvious in the case of federal tied grants, which explicitly require the states to spend the money in ways that Canberra approves. But it is also true of untied, general purpose grants. Although the Commonwealth Government likes to claim that the GST is a state rather than federal tax (because all proceeds are handed over to the states), Carling points out that the joint Commonwealth-state policy making arrangements prohibit any variation of GST rate between states and that Canberra still has the power to change the legislation whenever it likes as it sees fit. The states get the money but they lack autonomous GST-raising powers.

The states, therefore, exist in an unhealthy relationship of financial dependency and subordination with the Commonwealth. And because they raise so little of their own money, the publicly-visible chain of accountability that is so crucial in any democratic system has become hopelessly obscured. When things go wrong, Canberra blames the states and the states blame Canberra, and voters are left completely in the dark about where the fault lies and who should be doing something to rectify it.

Nor is this the only problem with the existing system of state taxation. Carling also finds that even when they raise their own money, the states are reliant on an array of taxes and levies that is desperately in need of reform.

Most state taxes exhibit one or more of the classic characteristics of 'bad taxation'. They are complex; they are inefficient (for they levy higher than necessary rates on a narrower than necessary base); they distort behaviour and therefore generate high deadweight losses; and they

are often driven more by social and political objectives than by the concern to maximise revenue raising.

What, then, should be done?

After reviewing various reform options, Carling comes up with a six-point blueprint designed to strengthen state powers in relation to the Commonwealth and thereby to enhance the accountability of state governments to their voters. He proposes (1) the abolition of all state stamp duties; (2) an increase in the GST rate from 10% to 12.5% to make up the loss of revenue this entails; (3) that 60% of GST revenues to be transferred to the states with the remaining 40% retained by the Commonwealth; (4) a one-third reduction in Commonwealth income tax; (5) the abolition of most tied (specific purpose) Commonwealth grants to the states; and (6) a new system of state income tax initially set to raise the equivalent sum to that foregone by the Commonwealth.

Taken in aggregate, these proposals are revenue-neutral (that is, the same amount of tax would be collected in total as is collected at the moment) but they dramatically shift the power balance between Canberra and the states in favour of the latter while simultaneously replacing an array of inefficient state taxes.

The six proposals have to be considered as an integral package, for each change involves a corresponding trade-off somewhere else. Stamp duties disappear but revenues get made up by a higher rate of GST; a big reduction of federal income tax revenues is compensated by allowing Canberra to retain a proportion of GST receipts while also scrapping specific purpose state grants; and the new state power to levy income tax is balanced by heavily reduced federal income tax.

Although the six proposals stand or fall as a package, it is undoubtedly the introduction of state income taxes that marks the most radical element in Carling's blueprint, for it is this that would enhance the fiscal autonomy of the states (which would end up funding 75% of their own spending) while also making them much more accountable to their voters. To avoid unnecessary duplication and administrative inefficiencies, Carling suggests that the states should 'piggy back' on the existing ATO tax base and should not be allowed to tamper with the structure of rates and personal thresholds. Instead, they would levy their own percentage top-up in addition to the Commonwealth's income tax demands.

This top-up would be clear and visible to every taxpayer who would know how much income tax they were paying to Canberra and how much to their own state capital. Over time, states would start to diverge in the size of their income tax levies as they differed in their spending plans, and voters could then make an informed judgement on the performance of their state governments by comparing their pattern of payments and benefits with patterns elsewhere in the country.

In this paper, Robert Carling has not only identified some crucial weaknesses in our system of funding the states, but he has also come up with an exciting yet practical set of proposals for resolving them. It is to be hoped that this paper will spark a long overdue and properly informed debate about reversing the centralisation of power in this country and reinvigorating the federal system under which we live.

Peter Saunders
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Executive Summary

The fiscal reforms that ushered in the Goods and Services Tax (GST) in 2000 had among their objectives an overhaul of the deeply flawed systems of state taxation and Commonwealth-State financial relations.

Six years on, a raft of undesirable state stamp duties has been abolished and more are set to be removed over the next six years. In Commonwealth-State relations, the allocation of GST revenue to the states has strengthened the reliability and buoyancy of state revenues and reduced the risk that states will resort to more economically harmful sources of financing.

These are significant reforms, but it is a mistake to think that all the reform work in these areas has been done. In state taxation, payroll tax and land tax are too narrowly based to function as efficiently as they could, and a number of undesirable stamp duties remain even though they suffer many of the shortcomings that led to other stamp duties being abolished.

In the arena of Commonwealth-State financial relations, while the GST is delivering more revenue to the states, it has failed to bolster their financial autonomy from the central government. The states neither individually nor collectively determine GST policy. Their dependence on GST revenue transfers from the Commonwealth, while making life easier for them, preserves the culture of state financial dependency that for decades has drained the lifeblood from Australian federalism. Reinforcing that trend is the magnitude and design of tied grants (specific purpose payments) to the states, which have blurred accountability and given the Commonwealth a growing influence on state policies in many areas of service delivery.

One approach to further reform of state taxation would be to transform payroll tax and land tax into comprehensive, low rate taxes. This would both reduce the economic distortions that accompany the existing plethora of exemptions and concessions and provide the funds to scrap the remaining stamp duties on property transfers, insurance and motor vehicles. However, state policies have eroded the payroll and land tax bases to such an extent that it is difficult to see them being reconstituted in a broad-based form in the face of fierce resistance to land tax on owner-occupied housing and payroll tax on small business.

An alternative approach is to rely on the GST to fund the removal of all the remaining stamp duties. This is an extension of the current approach, whereby a portion of the growth in GST revenue flowing to the states is replacing the revenue from various stamp duties as they are abolished. The states are not, however, committed to removing other stamp duties (those on property transfers, insurance and motor vehicles) through this mechanism and would not do so because the additional revenue foregone would be large relative to their GST revenue gains. An increase in the GST rate would be needed. An increase to 12.5% would replace most of the revenue from the remaining stamp duties, while leaving some of the cost to be met out of states' existing sources.

Reform of Commonwealth-State financial relations to strengthen federalism requires a shift from state dependence on Commonwealth grants towards wider access to broad-based taxes that the Constitution would allow the individual states to control. State control of a broad-based consumption tax would best meet the criteria for a 'good' state tax but appears unattainable given constitutional and administrative constraints. Income tax is the best choice, given those constraints. The states had their own income taxes before the Second World War and could easily have them again.

The best basic model for a state income tax is the Canadian provincial income tax system—which 'piggy-backs' on the federal income tax base with a single administration—modified to exclude the states from company income tax. To facilitate the change and avoid an increase in overall income tax, the Commonwealth needs to make room for the state tax by reducing its personal income tax rates. Over time, state income tax rates would vary, but with competition limiting any upward drift. The state income tax could take various forms but there is much to be said for a flat rate, with any progressive component being left to the Commonwealth.

This blueprint does not aim to change the overall level of government revenue, which is a separate issue. The budgetary impact on the Commonwealth would be neutralised by matching the reduction in Commonwealth personal income tax with a reduction in Commonwealth grants to the states. I suggest a one-third reduction in Commonwealth income tax, making room for a flat state income tax rate of around 10%.

For the Commonwealth, this would be offset by retaining 5 percentage points of the GST and eliminating most specific purpose payments to the states. The states would receive 7.5 percentage points of the GST and one-third of existing personal income tax revenue but forego all stamp duty revenue and most specific purpose grants from the Commonwealth. Their financial and policy autonomy would be strengthened by the power to set their personal income tax rates and the withdrawal of Commonwealth policy influence through specific purpose payments.

State taxation plays second fiddle to Commonwealth taxation but should not be overlooked in the ongoing tax reform debate. State taxes raised $42 billion in 2004–05. They have significant effects on the economy.

The decrepit condition of state taxes was one reason for the A New Tax System (ANTS) reforms that ushered in the Goods and Services Tax (GST) in July 2000. Six years later, the GST has replaced various inefficient state taxes that had raised over $3 billion a year before the GST commenced, and the states are committed to abolishing another $2 billion worth (in 2004–05 dollars) over the next six years.

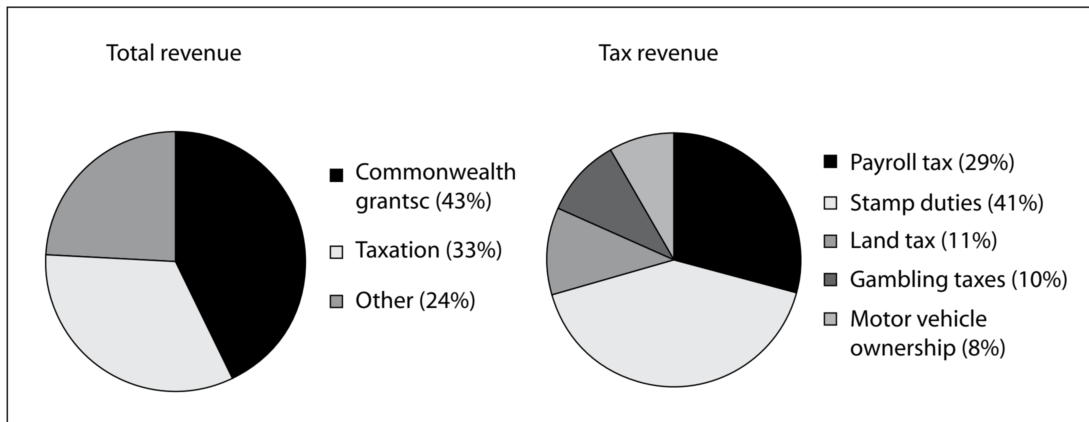
These are significant reforms but there is more to be done if the states are to have modern, efficient tax systems. Moreover, the ANTS reforms did nothing to reverse the decades of state dependence on Commonwealth grants. That dependence has drained the autonomy states must have if Australia is to reap the benefits of a federal system of government.

In this paper I review the ANTS reforms of state finances and look at ways to further reduce the economic efficiency burden of state taxation and rearrange the states' revenues so as to reduce their dependence on Commonwealth grants.

1. An overview of state revenue

Tax revenue accounts for around one-third of total state revenue. As shown in Figure 1, the rest comes from Commonwealth grants (43%) and an assortment of other sources (24%) such as sales of goods and services and distributions from government business enterprises. These proportions vary from state to state, but that is another story; here I am concerned only with the aggregates.

Figure 1: Composition of State Revenue, 2004–05



Source: ABS, *Government Finance Statistics*, 2004–05, ABS Cat No 5512.0 (Canberra: ABS, 2006).

Consistent with the Australian Bureau of Statistics (ABS) treatment, this presentation is based on GST revenue being classified as Commonwealth tax revenue that is transferred to the states as general purpose grants. The Commonwealth Government classifies it as state tax revenue on the grounds that all GST revenue is paid to the states. The ABS treatment is valid for the following reasons:

- The states cannot determine the rate or base of the GST, either collectively or individually. Under the 1999 Intergovernmental Agreement on Reform of Commonwealth-State Financial Relations (IGA) they have the ability to veto any proposal to vary the rate or base, but this is a very different power from that to change the rate or base.
- The powers bestowed on the states by the IGA are not legally enforceable and the Commonwealth Parliament could at any time amend the GST legislation without the states' agreement. This fact is based on the constitutional reality that the GST can *only* be imposed under Commonwealth statute.
- There is no possibility of the rate of GST varying from state to state. This is obvious given

the first and second points, but worth stating given that a strengthening of federalism would require individual states to have greater fiscal autonomy and capacity to set their own tax policies unilaterally.

Given this treatment of GST revenue, the tax slice of the state revenue pie comprises five major components: payroll tax (29%); stamp duties on various transactions (41%), especially property; land tax (11%); gambling taxes (also 10%); and motor vehicle ownership and operation (8%).

Commonwealth grants can be broken down into untied, general purpose grants (two-thirds) and tied, specific purpose grants (one-third) such as for state operation of public hospitals and schools. General purpose grants nowadays are fully accounted for by the transfer of GST revenue from the Commonwealth to the states, but until 2005–06 they also included a small component based on state implementation of agreed National Competition Policy reforms.

2. State taxation before the GST

Widespread dissatisfaction with state taxation was one factor in the build-up to the national tax review announced by the Prime Minister in August 1997. There were various reasons for that dissatisfaction, but at the core was the belief that some state taxes—stamp duties in particular—imposed high deadweight economic costs by distorting economic activity. They had narrow bases, were levied on turnover and became imbedded in the business cost structure. While deadweight costs are by their nature difficult to measure, the attempts that have been made placed stamp duties high on the scale of economic efficiency costs.[1]

Other issues included the heavy dependence of the states on Commonwealth grants to finance their expenditures (the so-called vertical fiscal imbalance); the low buoyancy of state tax revenue (failure to generate revenue growth in line with the economy); and the volatility of some tax bases.

In addition, the business community was and remains vociferous in its criticism of payroll tax and wanted it abolished as part of the GST reforms. Criticism of payroll tax as a 'tax on jobs' is generally given short shrift by tax experts and its abolition was never likely in the 1997 review, although the anti-payroll tax lobby remains an influence on state tax policy.

The structure of state tax revenue in 1999–2000, the last pre-GST year, is shown in Table 1. Payroll tax was the largest single revenue source but the various stamp duties in total generated more revenue. Most important among the stamp duties were those on conveyances (property transfers), financial transactions and insurance. Gambling taxes and land tax were also important sources. Franchise taxes, although classified by the ABS as state taxes, were by then collected by the Commonwealth on behalf of the states as a result of a 1997 High Court judgment against the constitutional validity of such taxes.

Table 1: Structure of State Taxation

Tax	Pre-GST	Post-GST	Projected(a)
	1999–2000 ($, billion)	2004–05 ($, billion)	2012-13 ($, billion)
Payroll tax	9.0	12.0	12.0
Land tax	2.4	4.4	4.4
Stamp duties:			
FID and Debits	2.2	0.7	-
Marketable securities	0.7	0.1	-
Loan securities	0.8	0.8	-
Leases, hiring, rental	0.3	0.3	-
Conveyances (property transfers)	5.5	9.6	9.1
Insurance	2.1	3.5	3.5
Motor vehicles	1.4	1.9	1.9
Other	0.1	0.1	-
Gambling taxes	4.4	4.3	4.3
Motor vehicle usage taxes	2.5	3.5	3.5
Franchise taxes	5.8	-	-
Other taxes	0.6	0.3	0.3
Total	37.8	41.6	39.0

Source: ABS (Australian Bureau of Statistics), *Taxation Revenue 2004–05* ABS Cat No 5506.0 (Canberra: ABS, 2006).
Notes: (a) The structure of revenue in 2004–05 had all the reforms planned to 2012 been implemented in 2004.

3. GST related reforms

The state tax reforms accompanying the GST were embodied in the June 1999 IGA. These reforms were less ambitious than the original proposals as a result of amendments negotiated to achieve Senate passage of the GST legislation. Even so, as a result of that Agreement the following taxes have been abolished by all states at various times over the six years since the GST commenced: financial institutions duty; debits tax; marketable securities duty on listed securities; and hotel bed tax where it applied. In addition, some states have begun to remove taxes that had been scheduled for later abolition—for example, Victoria has abolished the stamp duty on mortgages. The abolished taxes accounted for slightly over $3 billion of revenue (around 25% of stamp duty revenue and 10% of total state tax revenue) in 1999-2000.

Under the IGA the following taxes are to be phased out over the period to July 2012 at different times by different states: stamp duty on mortgages; duties on leases, hiring and rentals; duty on business conveyances other than real property; and duty on unlisted marketable securities.[2] Although these have been characterised by some commentators as 'nuisance' taxes, they are significant revenue raisers, accounting for almost $2 billion in 2004–05. The different state schedules will see Victoria and the Northern Territory complete their abolition in July 2007; Tasmania a year later; Western Australia, South Australia and the Australian Capital Territory in July 2010; Queensland in January 2011; and New South Wales in July 2012.

Table 1 shows how the structure of state taxation will look once the reforms have been completed. Contrary to popular belief, the GST agreement did not provide for the abolition of all stamp duties, with those on real property transfers,[3] insurance and motor vehicles remaining.

There are grounds for scepticism that such plans will be fully implemented given the states' reluctance to commit to them in the first place and the scope for slippage and backsliding over such an extended period. Even if fully implemented, they may result in strains on state budgets that lead to increases in other taxes or adventures into new taxes that offset the benefits of the completed reforms, or increased deficit financing. Such qualifications aside, however, the replacement of the abolished taxes by the GST represents an unambiguous improvement in the economic efficiency of the national tax system. The marginal deadweight cost and complexity of the tax system will be significantly reduced.

4. Remaining reform issues

The GST reforms leave two major state tax reform issues outstanding: deficiencies in the state taxes that will remain if and when the current reform program has been completed; and the states' continuing heavy dependence on Commonwealth grants, which has actually increased as a result of the GST reforms.

Almost $40 billion in state taxes (in 2004–05 terms) will remain in place once the currently scheduled reform plans are completed. Table 1 shows what they will be: mainly payroll tax; land tax; stamp duties on real property transfers, insurance and motor vehicles; gambling taxes; and various motor vehicle usage taxes such as annual registration charges.

The case for further reform is based on the economic efficiency costs of the remaining taxes; their narrow bases; high rates and progressive rate structures that serve no sensible purpose; and complexity. In general state taxes have been excessively engineered to serve policy objectives unrelated to efficient revenue-raising to fund service delivery. The following examples are drawn from current state tax policies:

- Payroll tax exempts around half of its potential base by value, and land tax well in excess of half.
- One state has two different land tax scales with different thresholds and rates—what you pay depends not only on the value of your land holdings but on whether you are a resident of that state, an individual, a company or a trust.
- All states to varying degrees offer firm-specific payroll tax concessions under interventionist policies to attract business. One state offers a payroll tax rebate for employers who go above the tax-free threshold for the first time, provided they are located in regions of that

state which have unemployment rates above the state average.

- All states levy conveyance (property transfer) stamp duty under progressive rate scales in which the thresholds have not been adjusted for many years, resulting in massive bracket creep. One state imposes different rates depending on whether the property is being purchased as a principal place of residence or not and, if it is, then whether it is a first home or not.
- All states impose stamp duty on insurance premiums at multiple rates depending on the type of risk being insured, and some states in addition partly finance their fire brigades through a fire services levy on insurance; the combined stamp duty and levy can be as high as 50% or more, in addition to the GST on insurance.

If these taxes are worth having at all, it is valid to ask why they are so narrowly defined, why there are so many exemptions and concessions, and why the resulting rates on the non-exempt bases are so much higher than they could otherwise be.

In what follows, we consider the major taxes on their merits—payroll tax, land tax and the remaining stamp duties, which account for 80% of the $40 billion of 2004–05 revenue identified above.

(i) Payroll tax

Payroll tax is despised by business but defended by economists as the best revenue source the states have under their own control. The business view sees payroll tax as another business cost—and worse still, as an add-on to labour costs it is seen as a 'tax on jobs'. Economists look through the legal incidence on employers to the underlying economic incidence and see payroll tax being shifted to consumers (through higher selling prices) or employees (through lower wages). Thus, in the economic view payroll tax is like the GST or personal income tax and if states cannot gain control of either of those broad-based taxes then payroll tax is the best available substitute as an instrument for states to control their own finances.

The economists' view is closer to the mark, but payroll tax is by no means a perfect substitute for a GST or income tax. To the extent that it works like an income tax, it is confined to labour income; and unlike the GST, it is not subject to input tax crediting and feeds into the cost of exports. Perhaps more importantly, the states themselves have emasculated the payroll tax base since taking it over from the Commonwealth in 1971. The payroll tax we see today is far short of its potential, suffering from a severely shrunken base and relatively high rates.

When payroll tax was last a Commonwealth tax in 1971 it was imposed at a rate of 2.5% and subject to a tax-free threshold of $20,800 (per firm's annual payroll). As a state tax today, the rates range from 4.75% to 6.85% and the tax-free thresholds from $550,000 to $1.25 million. Inflation accounts for part of the increase in thresholds, but even if indexed to average weekly earnings the 1971 threshold would only have risen to around $220,000 today.

States have exempted an increasing proportion of the employer base in the mistaken belief that they are assisting 'small business' and in the process created the kind of high rate/narrow base tax regime that is the antithesis of tax efficiency. Some state governments now boast about how few businesses pay payroll tax, while burdening those that do pay with a heavier load than would be possible under a broad-based approach. The Productivity Commission (1998) has estimated that in 1993–94 only 8% of private sector enterprises paid payroll tax, and since then some states have lifted their tax-free thresholds very substantially, further reducing the proportion of enterprises within the base.[4]

The Productivity Commission estimated the average effective payroll tax rate[5] in the mid-1990s at close to 3%. This is an indication of the rate that could raise the same amount of revenue without a tax-free threshold and without exemptions. In practice there is a case for a small tax-free threshold because the cost of administering the tax on very small firms would exceed the revenue collected. However, even with a low tax-free threshold, a rate of 3.5–4.0% could raise as much revenue as the current statutory rates ranging as high as 6.85%. Lower statutory rates on a broader base would impose lower economic efficiency costs than the current tax.

High tax-free thresholds cannot be justified as small business assistance. Why is small business more deserving of assistance by virtue of its size? The case for exempting small business from payroll tax is no stronger than that for an income tax exemption, yet there is no tax-free threshold for company tax and only a $6,000 threshold where individual income tax applies to business income. Small business is not exempt from the 9% superannuation guarantee charge. In any case, the 'assistance' provided by the payroll tax threshold is largely illusory given that small business would shift the economic incidence of the tax backwards or forwards if they had to pay it.

Despite there being a sound *economic* case for reforming payroll tax into a broad-based, low rate tax, there is little prospect of that happening. It is one thing for such a structure to have applied in 1971, but quite another to rebuild that structure from the current starting point. It may be possible to do so, or at least to move in that direction, as part of a larger reform of state taxes that reduced other business taxes.

Given that prospect, is payroll tax worth keeping in its far from perfect condition? At times the tax reform debate has contemplated replacing payroll tax with a higher GST rate. This was proposed by the coalition as part of its 'Fightback' package in the 1993 federal election. In contemporary terms, abolishing payroll tax would require lifting the GST rate from 10% to about 13%. Purely as an exercise in tax efficiency this would be a welcome change, but it would also leave the states with even less fiscal autonomy (more vertical fiscal imbalance) than they currently have. A payroll tax—albeit an imperfect one—that each state is free to vary and use as a tool of interstate competition would be replaced by a uniform GST over which no individual state has control. Payroll tax is one of the few instruments of tax flexibility currently available to the states.

If the broad base and low rate are politically unattainable, states should at least stop further white-anting the base through increases in their tax-free thresholds and grants of firm-specific concessions.[6] Constructive competition should focus on tax rates. They could also reform payroll tax administration. Definitions of the payroll tax base and methods of collection vary among the states. These differences serve no competitive purpose but add to complexity and compliance costs for the many firms that pay payroll tax in more than one state. State governments should harmonise their definitions and collection practices and confine their competitive manoeuvres to tax rates.[7] They should also explore whether payroll tax could be administered through the Business Activity Statement system of the Australian Taxation Office.[8]

Despite there being a sound economic case for reforming payroll tax there is little prospect of that happening

(ii) Land tax

The assessment of land tax runs along similar lines to that of payroll tax; both are theoretically economically efficient taxes that in reality fall far short of the ideal. The contrast between the reality and the potential of land tax is even greater than in the case of payroll tax. Land tax is well suited to sub-national governments because of the immobility of the base. Moreover, a broad-based property tax imposes low economic efficiency costs because of the limited economic 'wriggle room' available to the taxpayer. In Australia, while the local government property tax ('rates') is broad-based, the state land tax is anything but.

Rates, which are a form of land tax, are the main revenue source for local government and are subject to few exemptions and no tax-free threshold. According to the Productivity Commission, the Australia-wide average effective rate in 1995–96 was 0.8%, comprising significant fixed charges and very low marginal rates on unimproved land values. In this form, local government property tax is relatively free of controversy and is accepted as well as any tax can be.

In contrast, state land tax—also levied on unimproved values—is subject to major exemptions and high tax-free thresholds for those who do pay. The major exemptions are for owner-occupied housing and agricultural land. The average effective land tax rate across all states in 1995–96 was just 0.2% compared with much higher statutory marginal rates.[9] Thus, land tax applies to a small fraction of its potential base.

Another feature of state land tax is the imposition of progressive rate scales in all states except New South Wales. Progressive scales represent an attempt by states to play a redistributive role

that, to the extent it is warranted, is more effectively carried out by the central government. In any case, the distributional effects of a progressive land tax scale may not be what the policy aims to achieve. Most high value commercial properties are nowadays owned by property trusts and superannuation funds on behalf of small investors and fund members. It is not obvious that high land values are a good indicator of capacity to pay for these actual owners of the land.

Ideally the exemptions, thresholds and multiple rate scales would be swept away and replaced by a single low rate (which may vary across the states) administered jointly with local government rates for maximum simplicity. The Productivity Commission estimates of average effective land tax rates suggest that a uniform rate of 0.2% would be required to raise the same revenue as the current arrangements.

As with payroll tax, however, there is little prospect of such a change being made. Land tax is the economist's dream but the politician's nightmare. It generates more political heat per dollar of revenue raised than any other tax. Unlike most other taxes that are paid by households, which are either deducted at source or imbedded in prices paid or in transaction costs, land tax requires large cash payments direct to the tax collection agency. It is based on valuations that, however much at arm's length from political influence, are considered by taxpayers to be biased upwards for the government's benefit.

New South Wales has served as something of a laboratory for land tax base broadening in recent years. The New South Wales government imposed land tax on some owner-occupied properties in 1997 but this was always highly controversial and was scrapped in 2004. A similar measure by Western Australia was aborted several years ago in the face of strong community opposition. And New South Wales removed the tax-free threshold for all land tax payers in 2004 only to reinstate it under community pressure 12 months later.

The relevance of these episodes to a comprehensive, low-rate land tax is open to debate. The Australian attitude to land tax is even more idiosyncratic when contrasted with other countries which rely much more heavily on similar taxes. For example, local government in the United States imposes quite hefty property taxes (on improved values) as the main source of funding for schools and policing. It may be that the closer connection to distinctive local services makes property tax more acceptable in that situation, just as local government rates are reasonably well accepted in Australia. Or it could be that the use of improved rather than unimproved values makes the tax more acceptable because improved values are more readily observed in the market place. Be that as it may, the New South Wales experiments have doubtless reinforced all governments' distaste for a broad-based land tax. The only possibility of reform would be a package that combined land tax base broadening with the removal of property transfer duty, to which we now turn.

(iii) Stamp duty on property transfers

> Popular with taxmen, stamp duty puzzles economists. All governments must claim a share of the fruits of an economy to finance what they do for their citizens. But a stamp duty taxes exchange, not production or value added. It is like children at a birthday party, stripping a layer from the parcel every time it is passed from hand to hand.

The Economist, 2–8 September 2006

Property transfer duty is the second largest tax revenue earner for state governments, the fastest growing on average over a long period, but the most volatile.[11] Unlike land tax which is a relatively low annual impost on the assessed unimproved value of a small proportion of land, transfer duty is imposed at a relatively high rate[12] on the total value of property turnover with few exceptions.[13] The rapid long-term growth of revenue comes from the growth of property values, while the short-term volatility comes from the volatility of both prices and, more importantly, the volume of transactions. Given the importance of transfer duty revenue to state budgets, this volatility works against stable budget management. Governments tend to lock the proceeds of property booms into their expenditure base, creating problems in the 'bust' phase of the property cycle.

Transfer duty is set at steeply progressive rates which have served the growth of government well

over the long term by delivering a massive 'bracket creep' effect on revenue. Leaving the personal income tax thresholds unchanged for 20 years as prices and incomes grew would be unthinkable, but this is just what has happened in the case of property transfer duty, resulting in large increases in effective tax rates. For example, the duty payable on a median price Sydney house in 1986 was 2%, but in 2006 stands at 3.6%—an increase of 80% in the effective tax burden with no legislative effort.

The recent review of international tax comparisons by Warburton and Hendy for the Commonwealth Government found Australia's abnormally high reliance on property *transfer* taxation to be one of the outstanding contrasts with overseas experience.[14] The rates of such taxes in Australia were among the highest of the countries surveyed. In contrast, reliance on property *value* taxation is relatively low.

The original policy purpose of progressive scales is lost in the mists of time, but state governments presumably had in mind some redistributive objective. This is as misguided as in the case of land tax. Apart from redistribution being an unsuitable role for sub-national governments, in the case of transfer duty the distributional effects of the tax are unpredictable because they have as much to do with the frequency of property transactions as with the rate scale and the incomes of buyers and sellers of property.

As a turnover tax, transfer duty imposes high deadweight economic costs. It distorts choices between buying and renting, and between moving house and staying put or renovating. It tends to lock households into sub-optimal housing and militates against resource mobility. Marginal deadweight costs have increased over the years as a rising proportion of transactions have become subject to the upper levels of the progressive scales.

It is not the states' role to 'correct' alleged deficiencies in the federal tax system

It has sometimes been argued that transfer duty fills a void left by income tax concessions on property, such as the absence of capital gains tax or income tax on imputed rent of owner-occupied dwellings. However, transfer duty is a poor substitute for higher income/capital gains tax on housing because it is a turnover tax that has higher economic efficiency costs and pays no regard to taxpayers' broadly defined capacity to pay. In addition, it is not the states' role to 'correct' alleged deficiencies in the federal tax system.

Compliance with transfer duty is fairly simple in the case of most housing transactions but can be complex for business and trust transactions. The states have introduced complex provisions to prevent 'land rich' companies and trusts from escaping transfer duty. Something of a cottage industry of specialist tax lawyers has grown up to keep abreast—or ahead—of these complexities and to keep a lookout for loopholes and avoidance opportunities on their clients' behalf.

There is a good case for abolishing transfer duty—or at least reducing it to a single low rate that would be less distortionary—if a replacement revenue source could be found. The comprehensive land tax discussed above would provide such an opportunity to replace a tax on property *transactions* with an annual tax on assessed property *values*. This approach is discussed further in section 5.

(iv) Stamp duties on motor vehicles and insurance

Stamp duties on motor vehicles and insurance are selective turnover taxes that are not to be abolished as part of the agreed GST reforms even though they cover areas of consumption that are now subject to the GST. They also fall on business inputs. There is no good reason to single out these items to carry an additional tax burden over and above the GST. They also suffer the defects of other stamp duties on turnover as discussed above.

Some people might defend motor vehicle stamp duty as an environmental tax that helps internalise the external costs of motor vehicle usage. However, the duty falls on *turnover* in motor vehicles rather than their *usage*.

As well as the stamp duty on insurance, New South Wales and Victoria impose fire services levies on selected types of insurance to help fund their fire brigades. These levies are very high in some

cases and can take the combined weight of stamp duty and levies to 50% or more. Other states have moved to more appropriate property-based levies. New South Wales and Victoria should follow suit.[15]

These stamp duties and associated levies are good candidates for abolition.

5. Financing further state tax reform

Further state tax reform involving the removal of remaining stamp duties will come at a substantial revenue cost of up to $14 billion. It is necessary to explain how this could be financed. There are three basic options.

(i) Future growth of GST revenue

The stamp duties already abolished or scheduled to be abolished in the future are essentially being financed out of the growth of GST revenue as the GST base grows. More precisely, this growth is delivering to the states net revenue gains against the hypothetical benchmark set by the pre-2000 funding arrangements, and the cost of abolishing stamp duties is absorbing part of those gains. For example, by 2009–10 the states' net revenue gains are estimated to be around $9 billion per year, of which around $5 billion will be absorbed by the abolition of stamp duties.

Some or all of the remaining net revenue gains could be earmarked for abolition of the other stamp duties not currently scheduled for removal. This approach is not likely to get far. For a start, the states can validly point out that the IGA also promised them a net improvement in their revenue position after the effects of tax reform. While there is scope for argument about how much of an improvement is needed to meet the IGA commitment, even with the current projections aggregate state revenue will struggle to keep up with nominal GDP growth. Second, at least for the next five years or so the net gains are not large enough in aggregate to be able to make much contribution to abolishing remaining stamp duties of more than $14 billion. Third, the net gains are unevenly distributed across the states; for example New South Wales, whose participation in stamp duty reform is critical, gains only around half as much per capita as Queensland.

(ii) Increase the GST rate

The current GST rate of 10% would need to be increased to 13–14% to cover the full cost of abolishing remaining stamp duties. This would represent an improvement in economic efficiency of the tax system (reduction in deadweight costs). Administration and compliance costs would be reduced as increasing the GST rate on the existing base would be simple, while the costs associated with stamp duty administration and compliance would disappear.

The disadvantage is that there would be a further increase in vertical fiscal imbalance, as a set of taxes that the states do control would be replaced with additional revenue from one that they don't. However, this concern is overridden by the deficiencies of the state taxes that would be abolished. The benefits of the tax switch would be worth the cost of the further loss of state financial autonomy.

(iii) Increase efficient state taxes

The review of payroll and land taxes in section 4 alludes to the scope for broadening these tax bases to finance the removal of less efficient taxes. For purposes of illustration and working with national data, a levy of 0.4–0.5% on *all* unimproved land values, over and above the existing land tax, would be needed to finance abolition of property transfer duty. Replacing a property turnover tax with a tax on land values has a strong economic logic. And a 1% *additional* impost on payrolls, with no tax-free threshold, would raise around $5 billion, enough to finance abolition of insurance and motor vehicle stamp duties. Again, the economic case for such a switch is strong.

These options could be finessed in all manner of ways and are offered only as illustrations. The more important point is whether any such trade-offs would be politically feasible given the reality of fierce resistance to payroll and land tax base broadening. All experience suggests that economic

logic would count for little in such a debate. However, advocates of greater economic efficiency in state taxation should not abandon hope of some modest base broadening as a quid pro quo for the removal of all stamp duties.

(iv) Some combination of the above

Obviously none of the above options is mutually exclusive. A combination of some increase in the GST rate (say to 12.5%), some further commitment by the states of their net GST gains and some modest payroll and land tax base broadening would also serve the purpose.

6. Reforming fiscal federalism

The vertical fiscal imbalance in Australia—the extent to which the states depend upon transfers from the central government to finance their own expenditure responsibilities—is extreme among the world's federations. This is a well-established fact,[16] although it has been muddied in recent years by the dispute over whether the GST is rightly classified as state or Commonwealth tax revenue. Under the ABS treatment adopted in this paper—that it is Commonwealth tax revenue transferred to the states as grants—the Commonwealth accounts for around 80% of national tax revenue but only 54% of own-purpose spending. The corresponding figures for the states are 16% and 40%. These percentages have not changed much in the post-Second World War period. On the alternative view of the GST as a state tax, the Commonwealth's share of tax revenue has come down to 68%. Under either approach, the extent of vertical imbalance is high, but on one view the GST reforms reduced the imbalance while on the other view they increased it by replacing some state taxes with a Commonwealth tax as described in section 3.

The issue is not the amount of funds flowing to the states; rather it is dependency as opposed to autonomy

It has been argued that even though the states do not individually or jointly control the GST, it has given them greater fiscal flexibility by endowing them with a faster growing revenue source than those the GST replaced.[17] It has therefore given the states more room to manoeuvre with respect to other tax and expenditure policy choices. However, taken to its logical end this argument would favour replacing all state taxes by more buoyant, centrally imposed and administered taxes. The issue is not the amount of funds *per se* flowing to the states; rather it is one of dependency as opposed to autonomy. It is a mistake to think that increasing the buoyancy of state revenues by granting them the GST revenue without individual control over GST policy will enhance their financial responsibility and strengthen federalism. It is more likely to strengthen the states' culture of dependency on the central government.

If it is accepted that the Australian federation exhibits a high degree of vertical fiscal imbalance and that the GST reforms have done nothing to redress that imbalance, then these facts go to the heart of the federalism debate. The case for an effective federal system of government—one in which sub-national governments have substantive responsibilities and the autonomy to carry them out as they see fit—has been made elsewhere and need not be repeated here.[18]

The point that requires emphasis here is that fiscal autonomy of sub-national governments is a *sine qua non* of an effective federal structure.[19] A high degree of financial dependency on central government stifles federalism. The dependency culture is the antithesis of financial responsibility and accountability. Expenditure responsibility needs to be matched by revenue responsibility if sensible public choices are to be made. Vertical fiscal imbalance breaks the link between expenditure and revenue raising decisions. It raises a confusion of accountability in the minds of voters and a tendency for the central government's influence on sub-national expenditure choices to grow, resulting in overlapping responsibilities. It works against efficiency in public expenditure. And it curtails the flexibility of individual states to carry out their responsibilities differently from other states and to cater to their own residents' different preferences.

These problems obviously can be corrected from either the expenditure side—by substantially narrowing the states' expenditure responsibilities to fit their limited revenue bases—or from the revenue side—by substantially broadening the states' revenue autonomy and reducing their

dependence on Commonwealth grants. Indeed, the logical starting point is a redefinition of Commonwealth and State expenditure responsibilities respecting the principles of subsidiarity and exclusivity,[20] leading to a redefinition of revenue powers. However, a redefinition of expenditure responsibilities is beyond the scope of this paper. Rather, I take as a starting point the premise that any such exercise that properly respects the principle of subsidiarity would not lead to any narrowing of state responsibilities and would lead to a reduction in central government interference in state service delivery through the conditionality of tied grants.

An effective federal system does not require that sub-national governments have complete financial autonomy. In practice no federal system in the world is structured in such a way. Some level of untied grants on a much smaller scale than we currently have in Australia may be consistent with an effective federal system, particularly having regard to the reality of constitutional restrictions on states' taxing powers in Australia. There is also a very limited legitimate role for tied grants[21] where the recipient (lower) levels of government left to their own devices would deliver a sub-optimal national level of service provision[22] or there is an agreed national policy objective that can only be achieved through coordinated sub-national service delivery. However, tied grants in Australia have gone well beyond this narrow scope. Tied grants to the states now amount to more than $20 billion, or half as much as the states receive from the GST. They reach into most areas of state service delivery. The conditions imposed by the Commonwealth have become increasingly intrusive.

The direction that fiscal federalism has taken in Australia over many decades has meant that the states were well on the way to being mere 'branch offices' of the central government before the advent of the GST; and the GST has done nothing, and by its very constitutional nature could not have done anything, to alter that course.[23] Given these beginnings, there is clearly a major task on the revenue side of the vertical fiscal imbalance to restructure state revenue away from dependence on Commonwealth grants and towards revenue sources that the states can control.

7. Restructuring state revenue

Table 2 shows the current structure of state revenue. How in practice could this be changed in the way described above? In all the options for change discussed below, revenue neutrality is assumed for the public sector as a whole—that is, if more revenue is raised at the state level, then Commonwealth revenue and grants to the states are reduced by an equivalent amount. In this way, the question of the distribution of revenue raising power can be kept separate from the question of the size of the overall public sector.

Table 2: Structure of state revenue

Revenue source	2004-05 ($ billion)	2006-07 ($ billion)	2006-07 with reform (a) ($ billion)
Commonwealth grants:			
GST revenue	35	40	30
Other general purpose	1	-	-
Specific purpose	18	21	2
Total	54	61	32
Own-source			
Tax	42	45	71
Other	30	32	32
Total	72	77	103
Grand total	126	138	135

Source: ABS (Australian Bureau of Statistics), *Government Finance Statistics 2004–05*, ABS Cat No 5512.0 (Canberra: ABS) and *Government Financial Estimates 2006–07* , ABS Cat No 5501.0.55.001 (Canberra: ABS).

Notes: (a) Estimates of the structure of state revenue in 2006–07 if all the reforms proposed in this paper were implemented.

- First, the GST could be converted to a bona fide state tax or the states could be empowered to impose a surcharge on the national GST or to operate their own sales tax. This approach is attractive in principle. A broad-based expenditure tax is very suitable for sub-national governments because the base is immobile and its distributional effects are relatively neutral. However, there are two major practical problems. One is that Australian experience strongly suggests that a state GST or sales tax would be ruled constitutionally invalid by the High Court. The chances of a constitutional amendment to give the states the necessary powers would be remote. The second problem is that cross-border transactions within a federation render a value-added tax (like the GST) difficult to administer, particularly if the states were to have different rates of tax. A single-stage retail sales tax would be simpler to administer, but also less economically efficient.
- Second, existing state taxes could be increased and Commonwealth taxes and grants reduced by an equivalent amount. As discussed in section 4, there is scope to increase some existing state taxes by broadening their bases. However, such changes would be better made in the context of improving the overall economic efficiency of state tax systems, which would require the additional revenue from base broadening to be used to finance the abolition of the least desirable existing state taxes. Increasing state payroll and land taxes and reducing Commonwealth taxes and grants by an equivalent amount would not do much to redress vertical fiscal imbalance because the additional state revenue that could be raised in that way could not have a major impact on the imbalance. Such a tax swap would also increase the economic efficiency costs of the overall tax system.
- Third, new broad-based taxes could be imposed within the scope of the states' existing constitutional powers. The possibilities include income tax, estate or inheritance taxes, wealth taxes and various environmental taxes. Estate and inheritance taxes have been imposed by states in the past but their history makes them unlikely candidates for reintroduction. In any case, they are unlikely to be major revenue raisers in practice. Wealth taxes would be an unwelcome and ultimately ineffective intrusion of the states into the realm of redistributive policies. Environmental taxes are used more to influence behaviour than to raise significant amounts of revenue. Income tax offers the best possibility. What follows is an outline of how a state income tax might work, combined with an equivalent reduction in Commonwealth income tax and grants to the states.

New broad-based taxes could be imposed within the scope of the states' existing constitutional powers

8. A state income tax?

The experience of other federations is instructive in designing an income tax for the Australian states.

In the United States not all states have an income tax but those that do operate essentially separate systems from the federal income tax. Each state defines its own income tax base, designs its own rate structure and its own tax credits, and has its own income tax administration. The income tax applies to both personal and corporate income.

By contrast, in Canada the provincial income tax is applied and administered as an integral component of the federal income tax with a single administration, although the taxpayer's federal and provincial liabilities are separately identified. This is known as a 'piggybacking' approach. However, the Canadian provincial system has evolved over time from a 'tax on tax' to a 'tax on income' approach. Under the 'tax on tax' approach prior to 2000, provinces applied their own surcharges to the taxpayer's federal liability. For example, a province might add 50% to its resident taxpayers' federal liabilities. (In practice, towards the end of the 'tax on tax' system, the average provincial surcharge was 56%). This system meant that the provinces were able to choose their own *level* of income tax without interfering with the *structure* (thresholds, degree of progressivity in the rate scale, definition of base) of the federal income tax on which they were 'piggybacking'.

Over time the provinces pressed for greater control over the structure of their income taxes while retaining some features of the 'piggybacking' approach. This led to a federal-provincial agreement in 2000 that provinces could opt for a 'tax on income' approach under which they use the federal definition of the tax base but are free to apply their own structure of thresholds, tax rates and credits to that base. This could for example be a flat percentage tax across all income levels or a progressive one of a province's own design. In practice one province has adopted a flat tax while the others have not departed much from the federal structure.

Which approach would be best for Australia? The basic Canadian 'piggybacking' approach has much to commend it on the grounds of administrative simplicity and lower compliance costs while still giving the provinces control over the level of their income tax and allowing transparency. The pre-2000 'tax on tax' approach has the disadvantage that any changes in federal income tax revenue—whether due to discretionary policy changes, growth in the base or bracket creep—automatically flow through to the provincial level unless neutralised by policy change at that level. It also restricted provinces' flexibility in designing their own income tax structure. However, if one accepts that sub-national governments should stay out of the business of income redistribution and leave it to the national government, it is entirely appropriate that they be restricted to setting the *level* of their income tax.

On balance what seems best for Australia would be a 'tax on income' piggybacking system but with the states using the federal tax base and thresholds and applying either a flat percentage tax (for example, 10% on income above the federal tax-free threshold) or a rate scale that mimics the federal structure (for example, if the federal structure is 10/20/30% a state's structure would be 5/10/15%). The advantages of a flat state income tax are its simplicity and its good fit with the optimal role of state taxation—that is, efficient revenue raising while leaving redistribution to the central government. For these reasons I favour this approach.

The advantages of a flat state income tax are its simplicity and its good fit with the optimal role of state taxation

Fringe benefits tax should also be included in the state base; although it is paid by employers, its economic incidence is more like the personal income tax. Unlike the US and Canada, however, company (as well as superannuation fund) income tax should be left as exclusively federal taxes because of the additional layer of complexity involved in attempting to tax these as residents of states. Technical issues would need to be addressed, such as how to deal with dividend imputation credits and foreign tax credits. Such issues are beyond the scope of this paper and their resolution one way or the other does not undermine the principles involved.

If a state income tax is to gain acceptance and not be an instrument of further enlargement of the public sector it would be essential at the outset that the state income tax be fully offset by a reduction in Commonwealth income tax, leaving the total unchanged and avoiding charges of 'double taxation'. Over time, as individual states exercise discretion over the level of tax rates, they may go up or down.

It is also essential that the federal and state components of each taxpayer's liability be separately and clearly identified in PAYE deductions, PAYG payments and annual tax assessments, even though both the federal and state income tax would be administered by the Australian Taxation Office.

Given the states' tax policy track record, there would inevitably be concerns about whether they could be trusted with such a powerful fiscal tool as personal income tax. Would they do as they have with payroll tax and emasculate the base while hiking tax rates? Under the scheme suggested here, the states would not control the personal income tax base, only their rate of tax. While there would be nothing constitutionally preventing the states from defining their own base, this risk could be reduced through a renegotiated intergovernmental agreement.

There are grounds for concern that giving two tiers of government access to the personal income tax base could over time lead to a higher overall level of personal income tax and a larger public sector than Australia already has. Here there are conflicting forces between a horizontal externality that tends to drive state taxes down and a vertical externality (states' disregard for the effects

of their taxes on a tax base shared with the central government) that tends to drive them up. It is difficult to draw empirical conclusions, but in principle whether the horizontal or vertical externality dominates depends, unsurprisingly, on the degree of mobility of the shared tax base. With the personal income tax base being reasonably mobile, upward pressure on states' rates of tax should be constrained by interstate competition. This seems to have been the US and Canadian experience overall, although variations in state and provincial income tax rates in those federations are substantial.

The role of horizontal fiscal equalisation is beyond the scope of this paper, but it must at least be noted that a redesign of states' revenue raising powers as outlined above would strengthen the case for a fundamental reform of the equalisation system. Bringing the personal income tax base into the scope of equalisation is likely to increase the degree of equalisation. This would not only rule out donor states' agreement to the reforms described above, but would run counter to its basic objective of giving individual states greater self-reliance and the freedom to be different from one another. Equalisation works in favour of uniformity.

9. Tax and grant switching options

The key figures to keep in mind are that in 2006–07 Commonwealth personal income tax and fringe benefits tax revenue is expected to be $120 billion, GST revenue $40 billion and specific purpose payments (tied grants) to the states $21 billion.[24]

One option would be for the Commonwealth to retain half of the GST revenue (that is, 5 percentage points of the GST), transfer the other half to the states and reduce its personal income tax take by an equivalent amount (that is, $20 billion or around one-sixth). Retention of some GST revenue by the Commonwealth—quite apart from being needed to finance the partial transfer of personal income tax to the states—makes sense given that the Commonwealth has legislative power over the GST. The states' income tax would be designed to raise $20 billion in aggregate. This would be revenue-neutral for both levels of government and would give the states access to personal income tax and a degree of control over that tax. It would therefore go some way to reducing vertical fiscal imbalance and restoring states' fiscal autonomy. However it would leave no room for a revenue-neutral reduction in specific purpose payments.

Another option would be for the Commonwealth to reduce its personal income tax by a larger amount, making room for a larger state income tax, and reducing specific purpose payments accordingly. This would be a superior option given the damage that the growth of specific purpose payments has done to state autonomy and to clarity in the roles and responsibilities of Commonwealth and state governments. Redesigning specific purpose payments is a large topic in itself and is bound up with the fundamental issue of the roles and responsibilities of the Commonwealth and the states. However, few of the existing specific purpose payments can readily be justified and the potential reduction is very large. For example, a $20 billion reduction would almost eliminate them, and would enable an equivalent amount of personal income tax—and the taxing power—to be transferred from the Commonwealth to the states. This would bring the total shift in personal income tax to $40 billion or around one-third.

Equalisation works in favour of uniformity

A one-third reduction in Commonwealth income tax rates would equate to around 10 percentage points on the income tax base.[25] This would see the current 15/30/40/45% rate structure replaced by 5/20/30/35%.[26] The initial revenue-neutral state rate would then be 10% of individuals' taxable income.

If this scheme were combined with an increase in the GST rate to finance abolition of stamp duties as discussed in section 5, the states would receive a larger share of the higher GST. For example, of a 12.5% GST they would receive 7.5 percentage points and the Commonwealth would retain five percentage points. The states would be left to finance the balance of the cost of stamp duty abolition from their own existing sources such as the automatic growth of GST revenue and/or broadening of their payroll and land tax bases as they see fit.

10. Bringing it together—A blueprint for more state tax efficiency and fiscal autonomy

Bringing together the elements of reform developed in sections 4–9 provides a blueprint for a more economically efficient state tax system and greater fiscal autonomy for the states consistent with a renewal of fiscal federalism in Australia. The precise details will be different in each state but the picture sketched here will be broadly representative.

A. Reform existing state taxes

(i) Abolish the remaining stamp duties not currently scheduled to be abolished—namely, property transfer duty and the duties on motor vehicles and insurance, along with fire services levies on insurance in those states that still have them.

(ii) Finance (i) mainly through an increase in the GST rate to 12.5%, with the balance of the cost to be covered from states' existing sources such as automatic GST revenue growth and broadening of payroll tax and land tax bases.

(iii) Ideally, as part of this reform, payroll tax and land tax would be restructured as broad-based, low rate taxes.

B. Reform fiscal federalism

(i) The Commonwealth to retain five percentage points of the new 12.5% GST rather than pass 100% of it to the states. The states to receive 7.5 percentage points.

(ii) Most Commonwealth Specific Purpose Payments to the States to be eliminated as part of a fundamental review of the roles and responsibilities of the Commonwealth and the states.

(iii) The Commonwealth to use the budgetary savings from (i) and (ii) to reduce its personal income tax by one-third in the form of a flat percentage points reduction in all existing personal income tax rates.

(iv) The states to legislate flat state-specific personal income tax rates for their residents, initially equivalent to the one-third withdrawal by the Commonwealth. The states would use the same definition of the income tax base as the Commonwealth and the same tax free threshold. The Australian Taxation Office would administer both the Commonwealth and state income taxes, but taxpayers' liabilities to the different governments would be separately identified.

(v) Over time the states would have the freedom to vary their income tax rates, but only through increases or reductions in their flat rates.

These reforms would leave the states with several major tax revenue sources under their own control that are relatively efficient and buoyant: personal income tax; payroll tax; land tax; gambling taxes; and motor vehicle usage taxes. In addition, they would share in GST revenue. Table 2 shows the resulting composition of state revenues using 2006–07 estimates. The states' self-funding ratio would rise to 75%, which would be more in line with other federations such as Canada, Germany and the United States. The proposals are pragmatic in that they recognise the real world constraints on the theoretically superior option of handing states control of a broad-based consumption tax and give less prominence to payroll and land tax reform than the full force of economic logic would suggest should be the case.

These reforms would leave the states with several major tax revenue sources under their own control

This is intended as a revenue-neutral package and as such is not aimed at raising or lowering the size of government. That is a separate issue. But by making government at all levels more accountable for their spending, the package would give greater grounds for confidence that the size as well as the composition of government expenditure is an accurate reflection of the public's choices.

Endnotes

[1] For example, *Directions for State Tax Reform*, Staff Research Paper (Canberra: Productivity Commission, May 1998) and V W FitzGerald, 'A Review of State Tax Reform Options' in *State Taxation—Repeal, Reform or Resignation*, ed. Neil Warren (Sydney: Australian Tax Research Foundation Conference Series No 21, 1999).

[2] States disputed the Commonwealth view that the Agreement obliged them to abolish, as distinct from merely 'review' these taxes, but that dispute does not require comment here.

[3] The agreement did provide for a reconsideration of the case for abolishing stamp duty on *non-residential* real property transfers. The schedule to 2012 does not include such abolition.

[4] *Directions for State Tax Reform*, Staff Research Paper (Canberra: Productivity Commission, May 1998), p 84.

[5] Defined as revenue as a percentage of the potential tax base with no tax-free threshold.

[6] For an excellent statement of the case against firm-specific concessions see Wolfgang Kasper, *Competitive Federalism Revisited: Bidding Wars, or Getting the Fundamentals Right?*, IPA Issues Paper No 5 (Melbourne: IPA, February 1996).

[7] The Council of Australian Governments at its July 2006 meeting agreed to pursue harmonisation of the payroll tax base and administrative arrangements as a deregulatory measure.

[8] Issues here would be the legality of the ATO collecting a tax imposed under state statute and the feasibility of using the BAS to identify within-state tax liabilities.

[9] Currently marginal rates range from a single 1.7% in New South Wales to a top rate of 3.7% in South Australia.

[10] The threshold began at $1 million in 1997 but through indexation it had risen to $2 million by 2004.

[11] Over the 10 years to 2004–05, revenue from stamp duty on property transfers grew at an astonishing annual average rate of almost 17%. Although this period included an exceptional residential real estate boom, the long-term average growth rate of this category of state revenue has typically been in double digits.

[12] Marginal rates range as high as 7% in New South Wales.

[13] The main exception is purchases by first home buyers, which are exempt up to value levels that vary by state.

[14] 'International Comparison of Australia's Taxes', Australian Government, April 2006.

[15] Both states have reviewed the case for replacing insurance-based fire services levies with property-based levies in recent years and decided to continue with the insurance-based levies.

[16] For example Neil Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements*, Final Report (Sydney: New South Wales Government, May 2006), Ch 5.

[17] Commonwealth ministers make this argument and the Commonwealth budget papers show that the states will have $2 billion more revenue available to them in 2006–07 than they would have had under the pre-GST funding arrangements.

[18] For example, Geoffrey de Q Walker, *Ten Advantages of a Federal Constitution*, CIS Policy Monograph 49 (Sydney: The Centre for Independent Studies, 2001) and Wolfgang Kasper, *Competitive Federalism: Promoting Freedom and Prosperity*, IPA Issues Paper No 3, (Melbourne: IPA, January 1995).

[19] This is what Kasper (1995) calls the 'fiscal equivalence' principle—that 'governments must finance their assigned and chosen tasks with the funds that they raise themselves through taxes, fees and borrowings for which they are responsible.'

[20] See Kasper (1995) for a discussion of these principles.

[21] What are called in Australia 'specific purpose payments'.

[22] For example, interstate highways.

[23] The Commonwealth Treasurer recently used the term 'branch offices' to describe the current direction of federalism in Australia, but unlike this paper he attributed this to the states' failure to seize the opportunities presented by the GST reforms rather than to the failure of the GST reforms to change the fundamental dependency of states on Commonwealth grants.

[24] Such payments 'to' the states exclude payments 'through' the states such as Commonwealth grants to local government.

[25] This is an approximation based on Taxation Statistics 2003–04, Australian Taxation Office.

[26] The Commonwealth could take one further step at relatively low revenue cost by eliminating the 35% rate and achieving parity between the company income tax rate and the top rate of Commonwealth personal income tax. This is a separate issue from the topic of this paper, but the economic and compliance benefits are obvious.

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