The Allen Consulting Group

State tax reform: A practical approach to drive sustainable gains

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Report to Business Coalition for Tax Reform (BCTR)

The Allen Consulting Group

Allen Consulting Group Pty Ltd

ACN 007 061 930, ABN 52 007 061 930

Melbourne

Level 9, 60 Collins St

Melbourne VIC 3000

Telephone: (61-3) 8650 6000

Facsimile: (61-3) 9654 6363

Sydney

Level 1, 50 Pitt St

Sydney NSW 2000

Telephone: (61-2) 8272 5100

Facsimile: (61-2) 9247 2455

Canberra

Empire Chambers, Level 2, 1-13 University Ave

Canberra ACT 2600

GPO Box 418, Canberra ACT 2601

Telephone: (61-2) 6204 6500

Facsimile: (61-2) 6230 0149

Online

Email: info@allenconsult.com.au

Website: www.allenconsult.com.au

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Summary

The need to reform state taxes is widely recognised. Government and independent policy analysts regularly find that state taxes impose problems that are disproportionate to the revenue that they raise. However, despite the recognised need for change a concrete commitment to substantive and widespread reform has been difficult to secure.

This report seeks to bridge the gap between the recognised need for reform and actual commitment to change. It measures the expected gains of state tax reform and links them to overall policy goals and reform objectives, including improving productivity, competitiveness and long term living standards. It identifies what changes in taxes will be most beneficial and sets out a practical pathway for change.

The state of play in state taxes

Comparison of current state taxes against the principles of good taxation suggests that few are efficient, simple, transparent or equitable.

The states apply a large number of taxes that collectively raise a relatively small amount of revenue. Compliance with several separate tax systems poses a costly impediment to conducting business on a national basis.

Although discipline is required under the current fiscal environment this should not be used as an excuse against well-targeted reform. The financial prospects of the Australian Government remain strong, offering potential to fund long-term state taxation reform for the benefit of the Australian economy. The possibility of economic instability in the future does not provide an excuse to delay change – rather it highlights the importance of raising economic resilience through substantive reform and ensuring that taxes are collected at the lowest total cost.

Experience with tax reform shows that the transition to better taxes can impose particular burdens on the disadvantaged. There is a need to be careful about uneven impacts, especially the impact on small business that provides the majority of employment in Australia. Well crafted reform includes a strategy for mitigating adverse social impacts.

Lessons from the introduction of the Goods and Services Tax (GST) indicate that getting the social dimensions of reform right from the outset is crucial. Experience shows the importance of being careful about exemptions to avoid unintended losses and the imposition of significant costs on business and the community at large.

Recognition of the current complexity and high compliance costs imposed by cumbersome paper based GST administration also points to the opportunities that reform presents for reducing compliance costs. Reformed taxes could be streamlined and simplified through the use of new technology and modern administrative systems and potentially impose significantly lower opportunity costs on business.

Assessing removal of the worst state taxes

To illustrate a range of practical reform alternatives this study has undertaken an analysis changing taxation using the MMRF model of the Australian economy. This analysis shows that there are significant benefits to the Australian economy in cutting the worst state taxes.

Key findings on the effects of abolishing the worst state taxes are that, in the medium to longer term:

- the level of economic activity measured by GDP would rise substantially — an increase of 1.6 per cent;
- investment, indicative of an improvement in competitiveness Australia, is estimated to increase by around 3 per cent; and
- consumption, a measure of economic wellbeing, is estimated to rise by 4 per cent.

The positive economic impacts of removing the worst state taxes would result in a growth dividend, however this would not be large enough to offset revenue lost from cutting taxes. It is estimated that the fiscal gap would amount to around $16.8 billion in terms of today's budget in total for the state governments.

Improving state taxes

Given the continued need to raise significant revenue by the states it is likely that some of the existing taxes will continue to be used. A key possibility here is to seek to reduce the burden involved with these taxes by improving the way that they work. Tax reform should also involve tax maintenance.

Additional analysis shows that adding tax maintenance to the BCTR's proposed reforms to eliminate the worst state taxes will increase economic growth, increase investment and raise consumption. The combined changes would improve the overall fiscal position by around $500 million each year in the medium to longer term after the economy has adjusted to the changes. Despite this, a fiscal gap of around $16.4 billion per annum would remain. That is, there would still be a shortfall between the loss of revenue from eliminating taxes and the increase in revenue from increased economic activity and resulting tax collections.

Deeper, more sustainable reform

The key remaining challenge is that the fiscal dividend would still not be sufficient to close the fiscal gap and the states would enter an unsustainable fiscal path if they pursued this approach.

The second reform package involves funding a cut in the worst state taxes with the introduction of an alternative funding mechanism. A number of options have been canvassed to provide this funding, including raising a more efficient national tax, as well as reducing current tax expenditures.

An illustrative analysis using a nation tax to fund state tax reform and close the state governments' fiscal gap leaves the economy substantially better off – with growth in GDP of around 0.7 per cent per annum in the fully funded case. Other key results include:

- investment, indicative of an improvement in competitiveness, increases by 0.8 per cent;
- consumption, an indicator of household welfare, rises by 0.5 per cent; and
- the reform is costless to government when considering only first round impacts, but with the boost to economic activity a net fiscal dividend to government of around $1.7 billion per annum is expected.

Building a practical pathway to reform

Despite widespread agreement that significant reforms of state taxation are necessary, substantive and widespread reform of state taxes has stalled.

Although there is evidence of substantial gains that would flow from reform of state taxes, there are impediments. Where the states act independently, they may not have the resources to go through with reform on a substantive scale. Furthermore, experience of the past points to the of the dangers of the states competing in a race to the bottom.

The only sustainable solution is a coordinated reform agenda with a broad package. This package should be designed to:

- reform state taxes which will result in the largest economic benefits;
- be fully funded;
- where possible, enhance the efficiency of existing taxes;
- use the fiscal dividend to neutralise any potential disadvantage;
- reduce overall compliance costs of the system;
- phase in the introduction of new or broadened taxes to mitigate to ease the transition to reform;
- prioritise reforms which will result in the largest benefits; and
- provide scope for further longer term reforms to happen in the future when fiscal circumstances allow.

Keeping reform on track

An overall package of reform must be backed up by a strong governance framework to implement and maintain the reforms. Implementation of past reforms have had elements of success and failure. Implementation of state tax reform should learn from and build on the benefit of this experience.

Central to the governance framework will be co-ordinating the reforms through an intergovernmental agreement between the states and the Australian Government. Lessons from past reforms indicate that successful implementation will require this agreement to contain clear timelines and measureable outcomes, financial incentives to carry through with reforms, independent review and assessment and measures to guard against backsliding.

An independent body should be established with responsibility for ensuring that the reform agenda is observed. This body would have two functions: firstly to review, assess and enforce reform progress, and secondly, to act as a 'gatekeeper' to ensure that reforms are permanent and bad tax policies are kept at bay in the future. This would ensure that the potential benefits of reform are achieved, and that these benefits endure into the future.

Chapter 1
The case for state tax reform

Studies about state taxes have consistently demonstrated the benefits of state tax reform. These taxes adversely impact on the competitiveness of industry while imposing significant compliance costs. This chapter summarises the existing evidence for state tax reform and demonstrates the need to place the reform of state taxes at the top of the reform agenda.

1.1 This report

The Allen Consulting Group was asked by the Business Coalition for Tax Reform (BCTR) to prepare this report on state[1] tax reform. The BCTR asked that the analysis:

- quantitatively demonstrate the benefits of reforming inefficient state taxes;
- explore how the benefits of reform would contribute to meeting the long-term challenges facing Australia; and
- extend the analysis beyond merely identifying potential reforms to build a pathway to change that will, within the current fiscal constraints, work towards the Government's reform priorities.

This report is structured as follows.

Chapter 1 establishes the case for state tax reform.

Chapter 2 links the case for state tax reform with the current policy context.

Chapter 3 examines the social dimensions of state tax reform.

Chapter 4 examines the potential costs and benefits of cutting the worst state taxes.

Chapter 5 looks at the benefits of improving existing state taxes.

Chapter 6 examines how reform could be funded.

Chapter 7 sets out a pathway to reform and looks at how to keep reforms on track with effective governance arrangements.

1.2 The state tax base

State taxes and the revenues they raise

A key indicator of the problems raised by state taxes is that it is often difficult to define basic facts about them. There is a lack, for example, of a clear consensus about how many state taxes are levied in Australia. Estimates range from 25 to 36 different state taxes (AFTS, 2010c; NSW Treasury, 2010).

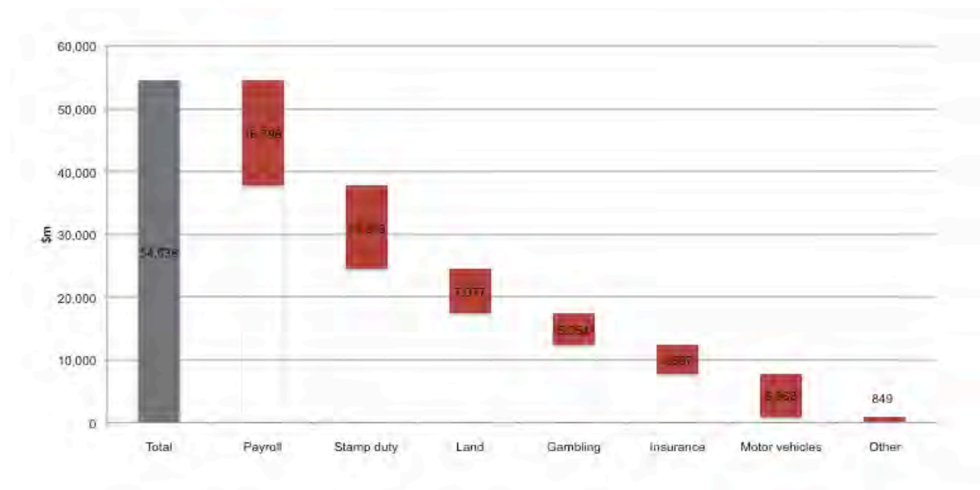
[1] The term 'state' in this report refers to both the states and territories.

The nature and details of state taxes vary from state to state. Not all states apply all of the state taxes, while some states apply unique taxes. Interstate competition also drives differences in how states apply each tax, leading to differences in rates and exemptions that create considerable complexity.

While there are a large number of state taxes, a small number generate a large proportion of the revenue raised. Figure 1.1 breaks down the various state taxes and their contribution to revenue in 2009-10. State taxes raised close to $55 billion in revenue in 2009-10. The majority of this revenue was sourced from payroll tax, land tax, stamp duties, gambling and taxes on motor vehicles and insurance. Payroll tax makes the largest single contribution, accounting for 31 per cent of total revenue, followed by stamp duty, accounting for 24 per cent of total revenue. The 'other' category includes a number of taxes on agricultural production, levies on statutory authorities and franchise taxes that in total constitute less than 2 per cent of total revenue collections. The precise tax revenue mix varies from state to state, however the dominance of a small number of taxes (especially payroll tax and conveyance stamp duty) remains consistent across states.

Figure 1.1

STATE TAX REVENUE COLLECTIONS, 2009-10 $M



Source: ABS Cat No. 5506, 2011

Volatility – how do state tax collections vary and why?

The dominance of transaction based stamp duties in the state tax mix has important implications for the stability of state tax revenues. Generally narrow based transaction taxes are subject to more volatility and are less predictable than broad based taxes (CIE, 2009). The consequences of this trend are illustrated by Figure 1.2, which shows the year to year percentage variations in selected state tax collections in New South Wales. Collections from narrow based taxes, such as stamp duties, and taxes characterised by large concessions and exemptions, such as land tax, vary widely from year to year, with fluctuations of up to 30 per cent. In contrast, the movements of the relatively broad based payroll tax are more in line with gross state product (GSP).

Figure 1.2

YEAR TO YEAR REVENUE VARIATION OF SELECTED STATE TAXES, NSW, PER CENT

Source: ABS Cat No. 5506 and 5220, 2011

The volatility of conveyance stamp duty collections is consistent across the Australian states. In 2008-9 this volatility resulted in a sharp decline of $5.3 billion in state revenue collections Australia wide. This deviation, which corresponded to the global financial crisis, placed significant strains on state government budgets. The volatility in state taxes highlights that, as currently structured, they are not a particularly good mechanism to raise revenue for the purposes of good, stable government.

Revenue volatility also creates problems for businesses that have to accommodate varying and difficult to predict taxation payments. This volatility and uncertainty works its way through individual businesses, industries and the community at large. Accommodating uncertain payment obligations is not a good basis for conducting business and can seriously undermine business confidence.

What has changed recently?

No substantial state taxation reforms have occurred since the last report on state taxes was prepared for BCTR in 2009. However some incremental changes have been made, primarily in the areas of payroll tax, land tax and conveyance stamp duty.

Payroll tax

In July 2010 the states reaffirmed their continued commitment to harmonising payroll tax administration. For business this means that although each jurisdiction continues to levy their own payroll taxes, the legislation is virtually identical across states. Each state and territory retains control over individual rates and thresholds, however, as shown by Table 1.1, there has been a general trend towards reducing payroll tax rates.

Table 1.1

PAYROLL TAX RATES AND THRESHOLDS – CHANGE SINCE 2008

State	Current rate %	Change from 2008 %	Threshold	Change from 2008
QLD	4.75	-	$1,000,000	-
NSW	5.45	-0.30	$658,000	$20,000
VIC	4.90	-0.05	$550,000	-
TAS	6.10	-	$1,010,000	-
SA	4.95	-0.05	$600,000	$48,000
NT	5.50	-0.40	$1,500,000	$250,000
WA	5.50	-	$750,000	-
ACT	6.85	-	$1,500,000	$250,000

Source: State Government Budgets, 2009-10, 2010-11, 2011-12

The landholder model

Many states have also moved towards harmonisation in taxation of transactions in unlisted companies or unit trusts through the adoption of the landholder model. Under the landholder model dealings in unlisted companies or unit trusts attract landholder duty where the value of the entity's landholdings exceeds a certain threshold, rather than looking at land as a proportion of the entities' total assets. Removing the land proportion test broadens the tax base and increases the number of entities subject to the duty. South Australia, Queensland, Victoria and New South Wales have all recently moved to the landholder model, which is now used in all states bar Tasmania.

The irony in the shift towards more consistent use of the landholder model across the states is that it exacerbates the impact of the distortions in this tax base. The AFTS review highlighted that the effect of the shift to the landholder model is to increase the impact of the tax on the narrow range of large landholders that pay the tax (AFTS 2010b). The shift towards the widespread adoption of the landholder model is an example of harmonisation that detracts from the efficiency and fairness of state taxation.

Conveyance stamp duty

New or increased concessions for first homebuyers or houses bought off the plan have been introduced in New South Wales, Victoria and the Northern Territory. In contrast, Queensland and Tasmania have either removed or reduced concessions.

Table 1.2
CONVEYANCE STAMP DUTY CHANGES

State	Changes
NSW	No stamp duty between 1 July 2010 and 30 June 2012 for new homes bought off the plan valued up to $600,000. From 1 July 2012 this concession will be restricted to first home buyers.
VIC	Concessions of 20% for first home buyers (properties up to $600,000), eligible seniors (properties up to $750,000) and farmers aged under 35 (properties up to $400,000).
TAS	First home buyer duty concession removed in 2011-12 Budget.
SA	Stamp duty on mortgages, non-real property transfers and marketable securities will be removed from 1 July 2012.
QLD	Concessions for individuals buying a house as a principal place of residence removed from 31 July 2011. First home buyers continue to receive a concession.
NT	Stamp duty concessions for first home buyers on first $540,000 value of their home and rebates of $3,500 for purchases of principle place of residence.
WA	No changes.
ACT	No changes.

Source: State Government Budgets

1.3 The general economic case for change

The major problems and adversity resulting from current state taxes have been recognised and documented in every recent review, including those undertaken by the states themselves (see eg. CIE, 2009; IPART, 2008; AFTS, 2010b).

Raising efficiency and productivity

In practice taxes distort behaviour by changing how much money people have and what incentives they face. However not all taxes are equal in this regard – different kinds of taxes impact behaviour differently and some of these impacts are less distortionary and costly than others. Taxes with a high efficiency cost are generally characterised by:

- narrow tax bases;
- high tax rates; and
- complicated and differentiated rate schedules.

These characteristics are predominant in state taxes. A high reliance on narrowly based stamp duties and the erosion of potentially efficient, broad based taxes (such as payroll tax and land tax) through the granting of exemptions means state taxes generally have a very high efficiency cost (AFTS, 2010b; CIE, 2009).

State taxes impede competitiveness

Business taxes influence the structure, costs and investment decisions of companies, and thus directly impact on competitiveness (BCA, 2006). Business in Australia operates in a world where there is intense competition in the sale of goods and services, where there is pressure to attract and retain skills and talent and where capital can move at the press of a button.

State taxes pose particular challenges to competitiveness. Business leaders often note that state taxes have the effect of increasing the cost of production in Australia and disadvantage Australian based firms in competition in overseas markets and in Australia against imports. This is essentially because many state taxes are 'origin' taxes that are levied at points along the production chain, as opposed to 'destination' taxes levied on the final product. A key aspect of the GST tax reform package was to remove many of the states' original taxes because of the impact this had on competitiveness. Still many of the remaining state taxes have this characteristic and the problem remains (CIE, 2009).

The barriers and impediments to competition raised by state taxes probably have a more subtle impact, that is also more difficult to measure. A business operating in just one state or territory in Australia would probably be required to navigate 15 businesses taxes (PwC 2007). If, through wishing to compete more fully, that business spreads its operations to cover Australia the total number of individual state taxes increases to 161. This is in addition to the 21 business taxes levied at the national level. A study conducted for the BCA and CTA (PwC, 2007) indicates that business see that the exponential increase in complexity when dealing with state taxes across Australia can be a major hindrance and cost to conducting business here.

State taxes at odds with the principles of good taxation

Taxes have traditionally been assessed against a set of principles to determine which are 'good' and which are 'bad.' The principles that are often considered to underpin a 'good' tax include criteria such as efficiency, simplicity, equity and sustainability. These criteria have been widely used in tax assessments, including those undertaken by the AFTS Review (2010a), Productivity Commission (1998) and the states themselves (for example, IPART, 2008; WA DTF, 2006). Further details on these principles are outlined in Box 1.1.

Box 1.1

TAX DESIGN PRINCIPLES

1. Efficiency

All taxes impose some efficiency cost on the economy. As such, taxes should aim to raise revenue while minimising the distortions in economic decision-making and the allocation of resources. Efficient taxes are generally characterised by low, uniform rates and broad bases with minimum exemptions.

2. Simplicity

Simple taxes are easier to understand and cheaper to comply with and administer. Having simple taxes minimises the waste of productive resources and the costs involved in collecting taxes. Differences across jurisdictions, exemptions and different rates and thresholds all detract from the simplicity of a tax.

3. Equity

Equity can be assessed from two sides: horizontal equity and vertical equity. An equitable tax should correspond to capacity to pay (vertical equity) and give similar treatment to taxpayers in similar circumstances (horizontal equity).

4. Sustainability

The central purpose of taxation is to fund Government expenditure on public services. In order to fulfil this purpose a tax must be sustainable, in that it grows in line with economic growth, and reliable, in that revenues are not subject to wide fluctuations.

Source: AFTS Review, 2010; IPART, 2008

Payroll tax

In theory payroll taxes rank well against the principles of good tax design. From an efficiency perspective this tax is considered to be one of the broader, more efficient taxes levied by the states (PC, 1998; Carling, 2006). However, in practice, the efficiency of payroll tax is often eroded as its incidence is characterised by a large amount of thresholds, concessions and exemptions (IPART, 2008). Payroll tax is relatively simple to administer and comply with (IPART, 2008) and is a sustainable source of revenue that moves in line with the economy (PC, 1998). However the equity of payroll tax is questionable. The economic incidence of the tax falls on employees without reference to their ability to pay (VDTF, 2001) and the concessions and thresholds mean that some firms pay the tax while others do not, although often there is little difference between the firms (IPART, 2008).

Land tax

The AFTS Review (2010b) found that well structured land taxes have the potential to be a highly efficient means of raising revenue due to the immobility of the land tax base. However land tax does not live up to this ideal in its application. A wide range of exemptions narrow the base and encourage land to be devoted to exempt activities (IPART, 2008). In practice, it is likely that a significant proportion of the economic incidence of the tax is passed forward to customers or backwards to investors in businesses that are subject to the tax which adds distortions and reduces the efficiency of the tax. The exemptions detract from the simplicity, equity and sustainability of land tax (PC, 1998; IPART, 2008).

Stamp duties on conveyances

Stamp duties are consistently rated poorly against efficiency criteria due to their distortionary effect on decisions to buy, rent, move or renovate (IPART, 2008; VDTF, 2001). The AFTS Review (2010b) concluded that stamp duty is highly inefficient and can prevent land from being put to its most valuable use. Stamp duty has also been labelled as essentially an inequitable tax as its incidence is dependent on how often people move as opposed to actual wealth (IPART, 2008). The Commonwealth Treasury Secretary recently nominated state taxes on housing as the biggest drag on Australia's productivity due to their tendency to inhibit economic adjustments (Parkinson, 2011). As stamp duties are underpinned by property values revenues are also highly volatile and subject to short term fluctuations in the property market (Carling, 2006).

Insurance taxes and fire services levies

Imposing specific taxes on insurance can deter people from insuring their property and encourage them to bear unnecessary risks (AFTS, 2010c). Although insurance is a broad tax base, its high price sensitivity makes taxing insurance very distortionary and inefficient (KPMG, 2010). The equity impacts of insurance taxes are also 'confused by the incentive to underinsure' (IPART, 2008).

New South Wales, Victoria and Tasmania impose an additional levy on insurance companies to fund their emergency services. This leads to an increase in premiums charged to customers and further distorts preferences and leads to underinsurance (Insurance Council, 2010). Funding emergency services in this manner is also inherently inequitable as it is only paid by those who have insurance. Victoria has announced that it is abolishing the fire services levy and replacing it with a levy on property, similar to that imposed in other states.

Developer contributions and infrastructure charges

The Allen Consulting Group (2003) analysed the impacts of a range of funding mechanisms for funding urban infrastructure and found that developer contributions or infrastructure charges perform relatively poorly against the benchmarks of efficiency and equity. A key impost of these charges is based on the split incentives phenomenon, with producers likely to underfund infrastructure in these arrangements, while states are likely to seek overfunding – or 'goldplating.'

Another impact on efficiency is the distortion of behaviour. In the interests of revenue raising planners are likely to seek to open up 'greenfields' developments rather than consolidate urban areas, which may not be an optimal alignment of preferences. In addition, there is a high likelihood that these charges will be passed on to consumers through higher house prices (Allen Consulting Group, 2003).

Motor vehicle taxes

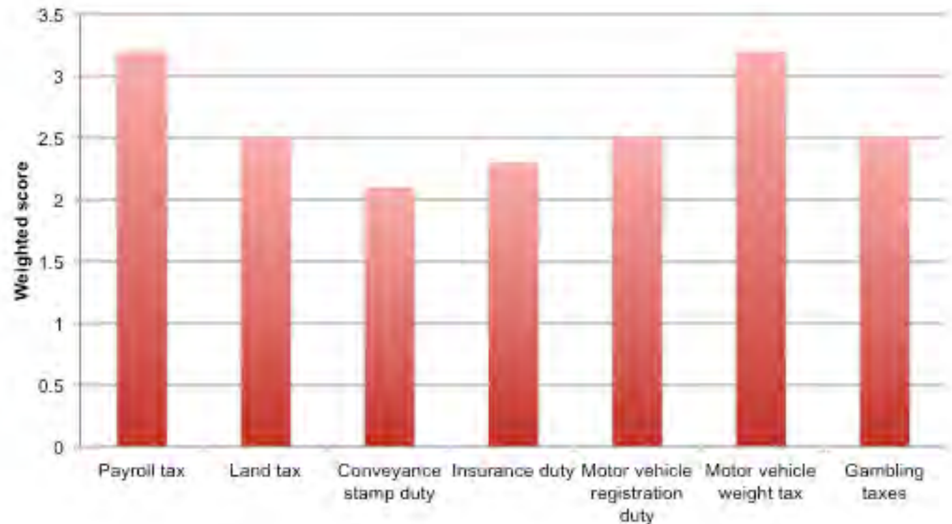
Motor vehicle taxes based on weight are generally considered to be efficient and to some extent akin to a user charge (IPART, 2008). However narrow, transaction based motor vehicle taxes such as stamp duty do not perform as well against the efficiency criteria (IPART, 2008). Motor vehicle taxes are relatively simple (VDTF, 2001), however have been labelled as regressive (PC, 2008) as they are calculated based on engine size or weight.

Comparisons of the range of state taxes

Studies about the relative performance of state taxes often produce broadly similar findings. The results of a qualitative assessment of state taxes undertaken by IPART (2008) are presented in Figure 1.3. Conveyance stamp duty was identified as the 'worst' performing tax in NSW, followed by insurance duty and land tax.

Figure 1.3

STATE TAXES VERSUS TAX PRINCIPLES: RESULTS OF IPART QUALITATIVE TAX ASSESSMENT



Source: IPART, 2008. Note: the weighted score is based on an assessment of efficiency, equity, transparency, simplicity and robustness.

A key point from assessment of individual taxes against the principles of good taxation is that no state tax obtains a perfect assessment in all of the criteria (CIE, 2009). Trade-offs are often factored in to the design of taxes, for instance the pursuit of apparent equity in the impact of a tax often leads to a reduction in simplicity. There are no perfect state taxes.

Guidance about the directions that tax reform should take based on comparison of taxes against principles is limited. The analysis may suggest which taxes are better or worse, which may assist in pointing to which taxes could be expanded and which should be reduced or abolished, but it doesn't provide insight into how much each tax should be changed, or provide an objective sense of the material gains to be expected from change.

More objective, output oriented indicators are needed to shift the debate about state tax reform from the theoretical to the practical. An assessment of the impact of such changes is provided in Chapter 2. There is a discussion of the benefits that could be achieved from making improvements in the tax base in Chapter 3.

Strategic reform to address long term issues

It is clear that there are many problems inherent in the application of state taxes. The link in the debate about tax reform that is often missing is why these problems actually imply a need to change and why priority should be given to state taxes on an already crowded reform agenda.

The Intergenerational Report (IGR) (Treasury, 2010) puts the need for reform onto a more substantive footing. The IGR stresses that reforms implemented now will determine future living standards and assist in meeting long term challenges, including an ageing population and escalating pressures on the health system. While there is little that can be done about aging *per se* the main thrust of policy should be upon improving Australia's productivity, growth and competitiveness to give us greater capacity to deal with underlying challenges (Treasury, 2010). This suggests that state (and other) tax reform options should be measured by how they provide:

- *Increased efficiency in the taxation system* – removing unnecessary costs from the taxation system and moving to less distortionary taxes has the potential to boost productivity and growth.
- *Enhanced sustainability of government finances* – moving from volatile, unpredictable taxes to sustainable revenue sources could assist in securing future Government revenue and meeting increasing budget pressures.
- *Reduced complexity and compliance costs* – removing complexity from the tax system and harmonising arrangements across states would assist in moving to a seamless national economy.
- *Improved international competitiveness* – the structure and effectiveness of any tax system is fundamental to the ability of any business to take advantage of the increasingly global and competitive economy (ITS Global, 2008).

General expectation of economic benefits from reform

In addition to other studies that have shown that state taxes are in need of reform, there is also evidence that material gains can be expected from replacing the worst state taxes with better taxes.

- A report prepared for BCTR in 2009 estimated the long run benefits of reform to range from 0.4 to 1.7 per cent of GDP each year, with the most ambitious reform scenario resulting in an expansion of annual economic activity of $34 billion across Australia in the longer term (by 2030 in 2005-6 prices). These potential gains were magnified as the size of the reform increased, with higher investment leading to an improvement in productivity and boosting output.
- A report prepared for the Finance Industry Council in May 2011 concluded that state governments remain reliant on inefficient tax bases. It estimated that revenue neutral reform was estimated to result in welfare gains in the order of 1.3 per cent to 1.7 per cent increase in consumption – approximately $2.3 billion to $3.1 billion (Deloitte Access Economics, 2011).

A consistent approach of many recent studies is to measure the gains achieved from a revenue neutral change in state taxes. That exercise is helpful in revealing the gains that arise from reducing the distorting impacts of the worst state taxes, it is less helpful in not revealing the likely impacts from reductions in state taxes.

1.4 Compliance costs and state taxes

The focus of much analysis to date in reform of state taxes has been on reducing the role of 'bad' taxes that do not match the principles of good taxation, or of reducing distortions by replacing distorting taxes with less distorting taxes. Meanwhile, a key area of business concern is centred on the disproportionate compliance cost burden associated with the taxes raised by the states.

The large number of state taxes and differences in detail from state to state make state taxes a complicated and expensive affair for businesses. This is particularly the case for businesses that operate across states and is a major source of compliance burden for Australian businesses. Possibly because many compliance costs are often hidden, or are viewed as inevitable, the policy debate tends to overlook these costs.

Compliance costs in practice

All taxes impose compliance costs. The Productivity Commission assessed the compliance costs for a range of Commonwealth taxes (Productivity Commission, 1996). The Productivity Commission regards compliance costs as one of the three pillars of tax burden, the other two being the costs to collect tax (the Australian Tax Office and various state revenue offices)[2], and the distortions imposed by tax.

The Productivity Commission looks at compliance costs as the costs borne by business in paying their tax liabilities and distinguishes them based on how they are borne.

- Direct financial costs from engaging outside professionals such as tax agents, lawyers and accountants to manage a firms tax affairs.
- Time costs from using internal staff to manage tax affairs. This is effectively the opportunity cost of having staff engaged in more productive pursuits (Productivity Commission, 1996).

The Productivity Commission notes that the core component of compliance costs are the basic costs to comply – namely:

- paperwork;
- interactions with bureaucracy; and
- record keeping.

[2] In Chapter 4, the reduction in tax complexity simulations look at measures which can reduce both compliance and administration costs, while recognising that these are separate.

Another component of compliance costs arises where there is a 'planning cost.' This is associated with those taxes, notably company income tax, where firms respond to incentives and expend resources to shape their affairs to minimise their tax burden (Pope, 1994). This may not take the form of tax evasion, which is illegal, but can include structuring their business so as to fall under particular thresholds – such as being mindful of not crossing the threshold on payroll tax between a national business operating in different jurisdictions. In practice costs incurred to bypass tax liabilities can be substantial and impose a deadweight loss on the economy at large.

Impact of compliance costs

The Banks Taskforce (2006) on Reducing the Regulatory Burden on Business found that tax complexity imposes compliance costs on business that are ultimately shared by everyone through higher prices. Previous studies have suggested that compliance costs for the main taxes levied by Government internationally range between 2 to 10 per cent of the revenue yield and in total are generally up to 2.5 per cent of GDP (Evans, 2003).

These costs are often regressive, with smaller businesses generally facing disproportionately higher compliance costs (Evans, 2003). The amount of compliance costs faced by each individual business can be significant. For instance, the 'Tax Nation' survey (PwC, 2007) reported an average tax compliance cost across the businesses surveyed of $1.5 million.

Box 1.2

TAX NATION SURVEY RESULTS

The Business Council of Australia (BCA) and the Corporate Tax Association commissioned a survey to examine business taxes at the Commonwealth, state and local levels of Government. The total number of business taxes identified was 56, including 21 Commonwealth taxes, 33 state and territory taxes and 2 local taxes. Of the 56 taxes identified, 51 were potentially borne by business. The survey found that:

- Of the 51 taxes, corporate income tax accounted for almost 66 per cent of total taxes collected, while it took 50 other taxes to raise the remaining 34 per cent.
- Of the 51 taxes, 16 Commonwealth taxes accounted for 83 per cent of revenue raised, while the remaining 35 state, Territory and local taxes accounted for just 17 per cent.
- Survey participants were paying up to $10 million in tax compliance costs, with an average cost of $1.5 million. An average of 9 tax compliance specialists were employed, with some employing as many as 40 to 50 employees.

Source: PwC, 2007

These results indicate that businesses are currently committing significant resources to compliance and the potential savings from moving to taxes with lower compliance costs are large.

Not all taxes are equal when it comes to compliance costs – taxes that are complex, those with large amounts of concessions and exemptions and those that differ across jurisdictions tend to impose higher costs. The compliance costs of state taxes, using the categories of compliance costs defined by the Productivity Commission, are likely to be substantial. Taxes that are administratively complex, or taxes that are subject to taxation planning behaviours raise the largest compliance costs. State taxes that are administratively complex include:

- payroll tax - which has multiple rates and bases across jurisdictions;
- land tax - which has a number of exemptions; and
- stamp duties on conveyances - which has a number of bases, rates and exemptions.

Box 1.3 provides an example of how the steps involved in complying with payroll tax can prove a complicated and expensive affair for business.

Box 1.3

COMPLYING WITH PAYROLL TAX

An employer will generally need to consider the following issues in relation to payroll tax obligations:

- Is my business above the relevant payroll tax thresholds?
  - Determine whether total Australian wages exceed the relevant liability threshold – these differ from state to state.
- Do any exemptions apply?
  - Some kinds of employers, such as registered charities, are exempt from payroll tax liability.
- Which state do I pay payroll tax to?
  - If services are performed in more than one state or territory, liable to pay in the worker's principle place of residence.
- How much do I pay?
  - Consider what wages attract payroll tax and what wages are exempted. Definitions can differ across states.
- When do I pay?
  - Generally payments are made monthly and then annual tax liabilities are reconciled at the end of each financial year.

Although many requirements are now harmonised across jurisdictions, employers still have to register, pay and reconcile payroll tax payments over eight jurisdictions.

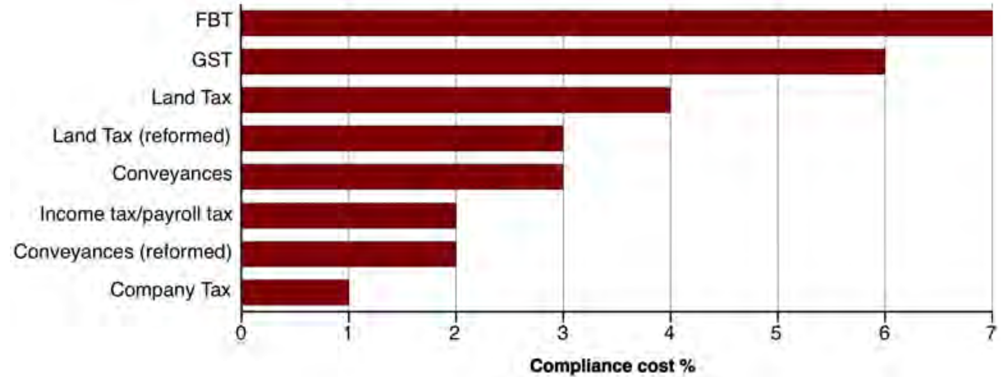
Source: Allen Consulting Group, 2011

Some state taxes are also likely to drive tax 'planning' behaviour. Taxes which firms could arrange their affairs to change their liability include:

- payroll tax — firms at significant cost could shift labour resources across states; and
- land tax — the landholder arrangements open this tax to minimisation behaviour as firms could split assets at significant cost.

Figure 1.4

RELATIVE COMPLIANCE COSTS – PER CENT OF REVENUE COLLECTIONS



Source: Allen Consulting Group, 2011, analysis of ATO data.

Estimates of the relative compliance costs of state taxes are presented in Figure 1.4. The results present the compliance cost of each tax benchmarked against the revenues raised by each tax. Land tax and conveyance stamp duty impose compliance costs of 3 and 4 per cent respectively of total revenue collections. In contrast, payroll tax has a relatively low compliance cost of 2 per cent of revenue collections.

Potential compliance cost savings

The overall state tax base is not well geared towards minimising compliance costs. Firstly, it is skewed towards taxes with relatively high compliance costs, such as stamp duties and land taxes. Secondly, it is characterised by a small number of taxes raising a large amount of revenue and a large number of taxes raising small amounts of revenue. Changing the state tax mix and reforming current taxes has the potential to achieve reductions in compliance costs and result in overall benefits for the economy.

A detailed compliance cost saving framework is developed in Chapter 6, however it is worth noting that significant reductions in the compliance cost burden will be achieved by reforms to state taxes that minimise complexity, differences across jurisdictions, and exemptions and incentives to engage in taxation planning.

Key points

State taxes have adverse impacts on business – many of these taxes are inefficient and impose high compliance costs.

These problems with state taxes are well established – however, despite the recognised need for change, a concrete commitment to reform from the Government has been very difficult to secure.

This report seeks to bridge the gap between the recognised need for reform and an actual commitment to change by quantitatively linking state tax reform to the Government's reform priorities, including improving productivity, competitiveness and long term living standards.

Chapter 2

The policy context

The policy imperative in Australia is improving productivity and competitiveness to raise long-term prosperity. Reform of state taxes is a vital component towards meeting this policy challenge. This chapter examines the policy context in light of the fiscal and macroeconomic environment.

2.1 Reform directions and opportunities

The AFTS Review – broad principles and specific state tax recommendations

Our tax and transfer system is not well placed to deal with structural change...the national reform effort has to involve the states (Ken Henry, 2010).

The final report from the AFTS Review's examination of Australia's tax and transfer system was released in May 2010. One of the key ideas that underpins the recommendations of the AFTS Review is consistent with one of the key findings of earlier analysis conducted for the BCTR: replacing or shifting the tax burden from relatively inefficient taxes to more efficient ones can result in overall gains for the Australian economy. For the AFTS Review recommendations this broadly meant concentrating revenue raising on efficient and broad based taxes such as personal and business income and maintaining narrow based taxes only if they efficiently address social or economic costs.

Box 2.1

BROAD REFORM PRINCIPLES FROM THE AFTS REVIEW

The AFTS Review's broad vision for Australia's tax system is one that meets its purposes efficiently, equitably, transparently and effectively. It would do this by encouraging workforce participation, a more efficient pattern of saving and investment in education and physical capital. This vision suggests:

- Revenue raising should be concentrated on four robust and efficient, broad-based taxes:
  - personal income
  - business income;
  - private consumption;
  - economic rents from natural resources and land.
- Narrow based taxes should only be maintained if they efficiently address social or economic costs.
- The transfer system should remain structurally separate from the tax system and remain highly targeted.
- Administration of the tax system needs to be more transparent and responsive.

Source: AFTS Review, 2010a

The idea of improving efficiency of the tax mix was particularly important for state taxes, which, consistent with BCTR's findings, the AFTS Review found to be among the most inefficient in Australia due to problems with both their quality and the way they are levied. Narrow tax bases in combination with differing arrangements across states were found to be creating an inefficient and complex system that is not well placed to meet increasing cost pressures. The review concluded that states should have access to more sustainable revenues to fund their expenditures and recommended abolishing stamp duties and insurance taxes in favour of broad based land, payroll and consumption taxes.

Table 2.1

AFTS REVIEW STATE TAX RECOMMENDATIONS

State tax	Reform direction	Recommendation
Payroll tax	Replace payroll tax with a broad based wages tax or payroll tax.	Recommendation 57
Conveyance duty	Replace with more efficient taxes levied on broad bases such as consumption and land.	Recommendation 51
Land tax	Apply an increasing marginal rate scale to the per-square-metre value of the land, calculated per land holding, with no exemptions.	Recommendation 53
Insurance taxes	Abolish all insurance taxes.	Recommendation 79
Motor vehicle taxes	Replace with efficient user charges where possible.	
Gambling taxes	Explore options for reducing conflicts in policy-making between regulation and revenue raising.	

Source: AFTS Review, 2010a

COAG and the seamless national economy

The Council of Australian Governments (COAG) is adding much momentum for cooperative and combined reform in a wide range of policy areas. COAG's key focus is on creating a seamless national economy. This is to deliver more consistent regulation across jurisdictions and address unnecessary or poorly designed regulation.

Box 2.2

COAG'S REFORM PRIORITIES – COMPETITION AND REGULATION

The Commonwealth and the states have entered into the 'National Partnership Agreement to Deliver a Seamless National Economy.' The agreement is designed:

- to create a seamless national economy, and reduce costs incurred by business in complying with unnecessary and inconsistent regulation across jurisdictions;
- to enhance Australia's longer-term growth, improving workforce participation and overall labour mobility; and
- to expand Australia's productive capacity over the medium-term through competition reform, to enable stronger economic growth.

Source: COAG Reform Council, 2011

COAG has developed a range of reforms intended to reduce excessive compliance costs on business, restrictions on competition and distortions in the allocation of resources in the economy. Some aspects of state taxes have already been addressed through COAG including payroll and land tax harmonisation. These were flagged earlier in this chapter.

A key point is that governments at both the national and state level have already acknowledged the need to work together to put in place better policy and that coordinated tax reform is a logical focus of future directions.

The Commonwealth Government's emphasis on productivity

Ultimately a lack of business investment feeds into lower living standards. Workers can feel this effect quite quickly – less investment means business demand for labour is lower, resulting in workers facing tougher bargaining conditions over wages. (Wayne Swan, AFR 9/9/11, p. 59)

State tax reform should also be seen as being consistent with the reform priorities that the Australian Government has set for itself: strong fiscal management, participation, productivity, climate change and long-term improvements in the standard of living. The Government has indicated that reforms should be directed at encouraging investment in the local economy, and has noted that when investment is discouraged lower productivity and lower business competitiveness results. Another emphasis is on the impacts of the 'patchwork' economy and measures to make the tax system work better for firms already under pressure in a changing economy. (Swan, 2011).

Box 2.3

AUSTRALIAN GOVERNMENT'S REFORM PRIORITIES

The Government's tax forum discussion paper identifies three key priorities on which to build taxation reforms:

- making the economy stronger, by boosting participation and productivity;
- making the tax system fairer, by ensuring the appropriate targeting of concessions; and
- making the tax system simpler, by removing unnecessary complexity.

The discussion paper also notes the forum discussions should consider the funding of ideas that have a budget cost, impacts on participation, saving and investment, the need for broad community consensus and the key economic, social demographic and environmental challenges facing Australia into the future.

Source: Australian Government, 2011

The AFTS Review's state tax recommendations were reinforced in a brief prepared by the Commonwealth Treasury for the returning Labour Government (Treasury, 2010a). The red book, released under freedom of information (FOI) legislation in September 2010, places state taxes as a priority area for reform, noting that state taxes are some of the least efficient and worst designed taxes in Australia. It identified the abolition of stamp duties, reform of payroll and land taxes and the introduction of road pricing as key areas for reform.

The Tax Forum

The AFTS Review has set the stage for taxation reform by identifying weaknesses in the current system and putting forward ideas for long-term reform. The Tax Forum, scheduled to take place 4-5 October, is an important opportunity to discuss the ideas put forth by the AFTS Review and identify further reforms to position Australia for the challenges and opportunities of the future.

On 28 July the Government released a discussion paper to inform and direct debate in the lead up to the forum. The discussion paper recognises that the generally narrow-based taxes imposed by states are among the most inefficient in Australia and notes that state Governments need to find ways to advance reform of these inefficient taxes. The Tax Forum discussion questions outlined in Box 2.4 suggest that state taxes are firmly on the table at the Tax Forum.

Canberra has pushed the states to the front and centre of national tax reform, asking whether state insurance levies should be abolished, stamp duties replaced, payroll taxes harmonised and public housing rents reviewed (The Australian, 29/07/2011).

Box 2.4

STATE TAXES – TAX FORUM DISCUSSION QUESTIONS

- At the state level, are there opportunities to further balance the tax system towards more efficient revenue bases?
- Does the tax system create disincentives for Australians to locate to the areas where their skills are most in demand?
- Are there opportunities for the states to replace stamp duties on property conveyances with reformed land taxes?
- Should states abolish insurance taxes? If so, how could that revenue be raised more efficiently?
- How might the reform or greater harmonisation of state payroll taxes be pursued?
- Do GST sharing arrangements create the right incentives for states to make their tax bases more efficient?
- Within our Federation, what responsibility should the states take for reforming the taxes they impose?

Source: Australian Government, 2011

How reforming state taxes fits into and contributes to these reform directions

Reforming state taxes could play a crucial role in meeting the Government's reform priorities. Removing inefficient taxes has the potential to enhance productivity and growth. Broadening tax bases and removing unnecessary concessions would improve the equity and fairness of the tax system. Harmonising arrangements across states would remove complexity and decrease compliance costs for business. Reforming property taxes has the potential to remove impediments to labour mobility and assist with economic adjustments in Australia's patchwork economy (Parkinson, 2011).

Figure 2.1

LINKING TAX AND THE GOVERNMENT'S REFORM PRIORITIES

Source: Allen Consulting Group, 2011

There is a growing consensus about the need to reform state taxes. The AFTS Review recommendations, Treasury advice, the Government's stated reform objectives and the COAG agenda are all pointing towards boosting productivity by getting rid of inefficient taxes. The IMF (2011) agrees that tax and structural reforms will play a key role in allowing Australians to take full advantage of the mining boom and removing inefficient taxes such as state stamp duty and insurance taxes should be a priority. There seems to be a general view emerging that tax and structural reforms are pivotal in helping Australia make the most of future opportunities and deal with future challenges and that inefficient state taxes are among the top contenders for reform.

2.2 The fiscal and macroeconomic context

Structural changes and taxation reforms are not easy – even where the case for change is compelling. Any pathway to reform must fit within and work with the current fiscal and macroeconomic context. This includes consideration of Government budgetary positions, net debt, net financial worth and how the economic outlook will impact these into the future.

Budget positions across all levels of government

The global financial crisis had a significant impact on state budgets. It led all states excluding Western Australia to revise their 2008-9 Budget surplus projections to deficit projections. State balance sheets have yet to fully recover and, as shown in Table 2.2, are predominantly still in deficit and facing new pressures including a high Australian dollar and slower consumer spending flowing through to GST receipts (Novak, 2011). These budgetary positions, in combination with the state's already heavy reliance on Australian Government grants suggest that the capacity for the state Governments to pay for significant taxation reforms from their own budgets is limited.

Table 2.2

STATE BUDGET POSITIONS 2011-12

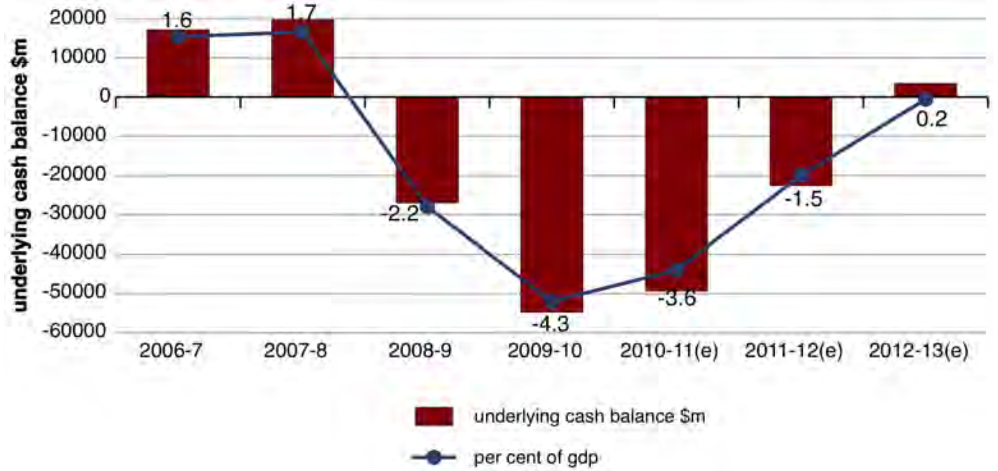
State	Budget position ($m)	Net debt ($m)
QLD	-4058	(1,294)
NSW	-718	7,900
VIC	140	16,800
TAS	-358	2,661
SA	-263	4,097
WA	442	17,291
NT	-435	2,685
ACT	-36.9	2,040
Total	**-5287**	**52,180**

Source: Estimates published in state budgets

When the Government commissioned the AFTS Review in 2008 the Australian Government had the potential to fund tax reform from a large budget surplus. This is no longer the case. The global financial crisis impacted the Australian budget both in the form of falling taxation revenues and increased Government expenditure due to the Government's fiscal response to the crisis. This is illustrated by Figure 2.2, which shows the budget position falling from a $20 billion surplus in 2007-8 to a $55 billion deficit in 2009-10.

Figure 2.2

THE COMMONWEALTH BUDGET $M



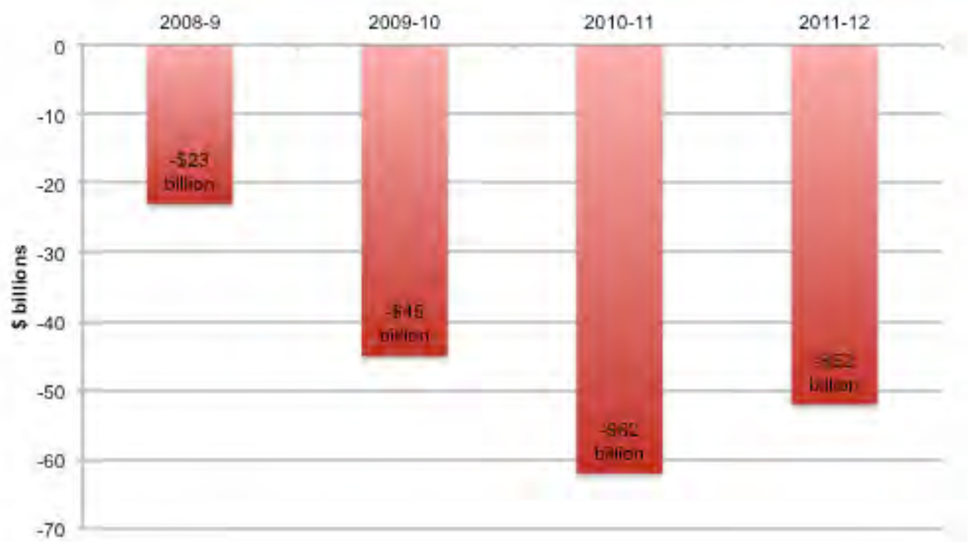
Source: Treasury, 2011-12 Budget

How the macroeconomic outlook affects revenue collection

The economic outlook is generally favourable – but by no means bulletproof. Figure 2.3 illustrates what happened to the Government's projected revenue collections as a result of the global financial crisis. Revenue projections in the 2009-10 Budget were revised down by $173 billion (14 per cent of total taxes) over the four years 2008-9 to 2011-12. Company taxation and capital gains tax accounted for around $90 billion and $30 billion, respectively, of these revisions.

Figure 2.3

VARIATION IN REVENUE ESTIMATES – 2008-9 BUDGET TO 2009-10 BUDGET



Source: Australian Government 2009. Note: Includes only effect of parameter and other variations.

Any future downtown would also impact on revenue collections and place further pressure on the Government's capacity to fund reform. The states are heavily reliant on stamp duties for revenue, which, as discussed in section 1.2, are particularly sensitive to economic downtowns. This should be kept in mind in the context of the recent turmoil in the global economic and financial markets and increasing risks for the global economy (IMF, 2011).

The fiscal rules

On August 12 2011 Prime Minister Gillard stated that it was the Government's 'expectation that the budget will return to surplus in 2012-13' and that to achieve this the Government will continue to have to look for savings in the budget.

Large-scale policy reform involving the states has often involved transitional assistance from the Australian Government. Such payments can appear as an outlay or expenditure within the Australian Government's budget.

There are significant constraints in place in the Australian Government's ability to increase expenditure. The Australian Government has committed to bringing its budget back to surplus by 2012-13. To achieve this it has put in place a set of fiscal rules that limits growth in real spending and requires new spending to be offset by genuine savings.

Box 2.5

THE FISCAL RULES

The Government's fiscal strategy provides the basis for its commitment to return the budget to surplus. In the medium-term, the strategy is to:

- achieve budget surpluses, on average, over the medium term;
- keep taxation as a share of GDP below the level for 2007-08 (23.5 per cent of GDP), on average; and
- improve the Government's net financial worth over the medium term.

In order to return the Budget to surplus the Government is also limiting real growth in spending to 2 per cent per year. To achieve this the Government is continuing to offset the cost of its new policies. In the 2011-12 Budget this required $22 billion in savings decisions.

Source: Treasury, 2011

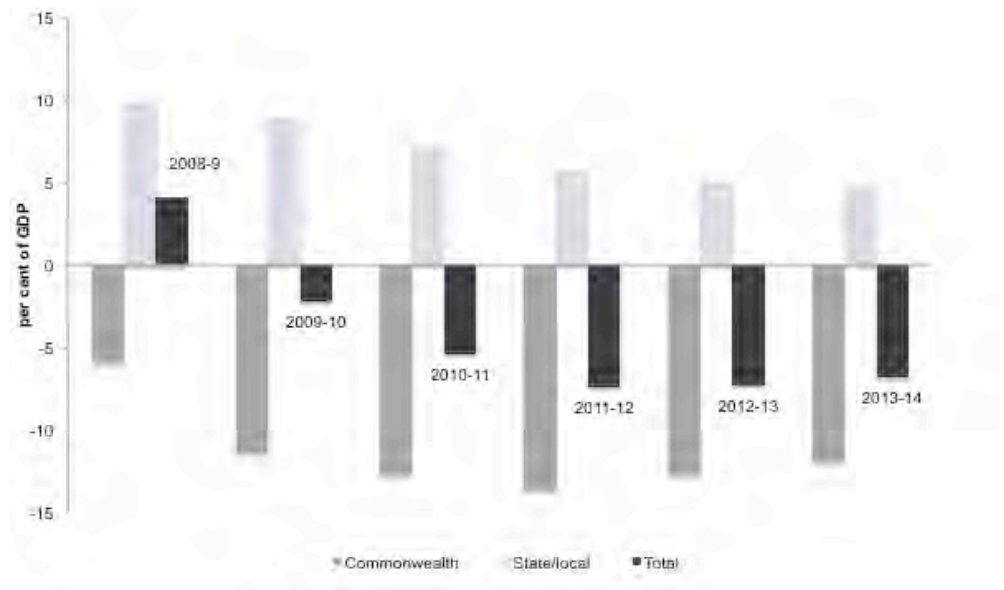
It is important to note that tax reform does not necessarily mean a cut in the overall level of taxation and a hit to the Australian Government's budget – beneficial reforms may be achieved through a range of measures and not all of these involve costs to the Australian Government's budget. It may also be feasible to fund reform by increasing volume on the less distortionary tax sources. This means that tax reform can be achieved despite the current fiscal climate. Options for funding reform will be examined in Chapter 6.

Net debt and net financial worth across all levels of Government

If outlays or expenditure are constrained in any period another means of accommodating reductions in tax revenue that may accompany reform is for governments to borrow. The net financial position is an indicator of the sustainability of government finances. It includes all financial assets, but excludes non-financial assets, which are often difficult to draw upon to meet the government's financial position. Figure 2.4 shows that although state governments maintained a positive net financial worth following the global financial crisis, Australia's net financial and total net financial worth across all levels of government has deteriorated significantly in recent years.

Figure 2.4

AUSTRALIA'S NET FINANCIAL POSITION

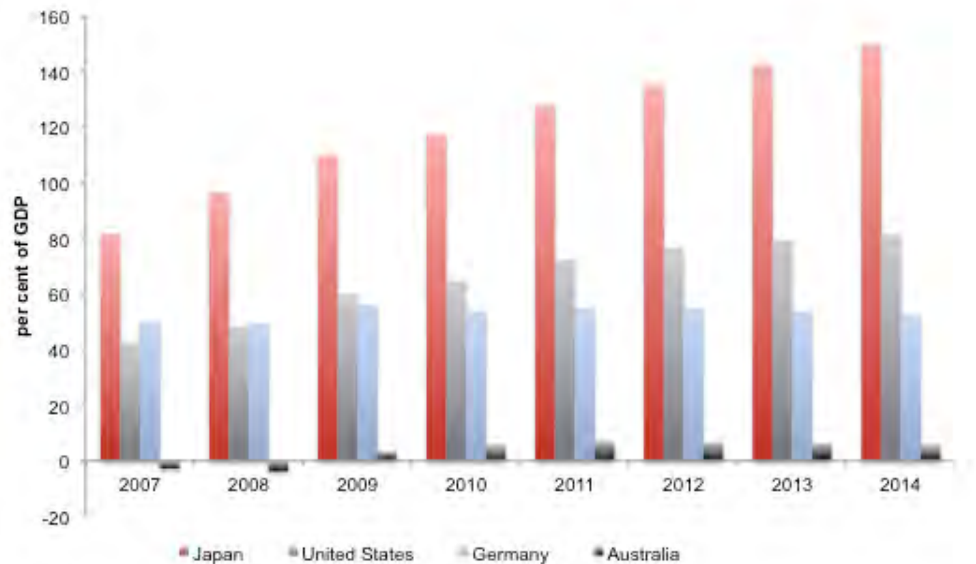


Source: Treasury, 2011

Despite this deterioration in net financial worth, comparison with other countries suggests that Australia's financial position remains relatively strong. Australia's net debt position is expected to peak at 7.2 per cent of GDP in 2011-12, which is less than one tenth of the average net debt position of the major advanced economies in 2011 (Treasury, 2011). This provides some indication that the Government's financial position is ultimately sustainable, providing scope for long-term reform.

Figure 2.5

AUSTRALIA'S NET DEBT – COMPARISON (PER CENT OF GDP)



Source: Treasury, 2011, IMF, 2011

The economic outlook – Treasury and other projections

The affordability of tax reform is linked to the underlying health of the revenue base that, in turn, is tied to the performance of the Australian economy. The Australian Treasury is projecting a generally favourable economic outlook and above trend growth for 2011-12 and 2012-13, with Australia's real GDP forecast to grow 4¼ per cent in 2011 and 4½ per cent in 2012.

Table 2.3

AUSTRALIAN ECONOMY FORECASTS

Indicator	2010-11	2011-12	2012-13
Real GDP	2 ¼	4	3 ¾
Unemployment	5	4 ¾	4 ½
CPI	3 ¼	2 ¾	3
Business investment	4 ½	16	14 ½

Source: Treasury 2011-12 Budget forecasts

The International Monetary Fund (IMF) agrees that Australia's economic outlook is favourable, projecting GDP growth of 2 per cent in 2011 and 3 ½ per cent in 2012, with unemployment remaining below 5 per cent, however notes that risks to this favourable outlook do exist (IMF, 2011). The RBA sees these risks as two sided: strong growth in emerging economies putting pressure on commodity markets and inflation and fiscal problems in more advanced economies flowing on to global economic activity and demand for Australia's commodities (RBA, 2011).

In practice, there are always some clouds on the economic horizon. There may or may not be some adverse event in the future which will harm revenue collection and could be read as a reason to stall reform. What is more important is an assessment of the underlying benefits of reform versus the situation without reform. The following chapters examine this is more detail.

Key Points

Strategic tax reform is a long-term project that will help in addressing long-term issues and meeting the long-term challenges facing Australia.

The current fiscal position requires maintenance of discipline, however this also should not be seen as an absolute impediment to reform. The long-term financial prospects of the Government remain strong, offering potential to fund long-term reforms for long-term benefits.

State tax reform can be achieved in the current fiscal climate, however the budget position and the fiscal rules mean that it is vital to take into account funding requirements.

Chapter 3

The community context

There is a need to be cognisant of the social dimensions that accompany taxes. The welfare of disadvantaged groups can be impacted by changes in taxes. Key groups that can be impacted by tax reform include low and fixed income earners, retirees, the unemployed and small businesses. This chapter examines some of the key social issues involved in the transition to new taxes.

3.1 Potential social dimensions of tax reform

It is important to be cognisant of the social dimensions of the tax reform process. Tax reform has the potential to impact on a number of groups in society. Key groups that can be affected include:

- low and fixed income earners;
- persons reliant on government support payments, including:
  - the unemployed;
  - retirees dependent on the age pension; and
  - disability payment recipients.
- asset rich/cash poor individuals; and
- single parent families;

These groups could all be negatively affected by tax reform. For example, where individuals are on fixed or low incomes, they are particularly vulnerable to the impacts of consumption tax. Low and fixed income earners are particularly vulnerable to consumption taxes as:

- tax on consumption is not linked to an individual's ability to pay; and
- lower income individuals tend to consume a higher proportion of their income than higher income individuals (AFTS Review, 2010).

As such, discussions surrounding consumption taxation should be framed with reference to this point.

Within the business community, there is also the potential for certain segments to be adversely impacted by tax reform. Potentially vulnerable businesses include:

- businesses that do not have the scale to comply with new taxes;
- businesses that would pay new taxes; and
- specific sectors that could be impacted by tax reform.

Some small businesses are exposed to tax reform due to their scale. Without the size to have internal tax advice, or the revenue to fund external tax advice, these businesses are exposed to changes in the tax system.

Small business could also be vulnerable if changes in certain taxes made them newly eligible for taxes that they were formerly not obligated to pay. Payroll tax, for example has a large enough threshold to exempt the smallest businesses. However, any move to a new tax, or a payroll tax with no thresholds would bring small business into the payroll tax net and leave these businesses potentially worse off.

Specific sectors could suffer from tax reform. For example, any tax reform that reduces the complexity of the taxation system could incur costs sectors which thrive on taxation complexity – such as tax accounting.

The worst state taxes have adverse impacts on social outcomes

Many groups are potentially exposed to tax reform. However, many of the taxes that were described as the 'worst' state taxes have social impacts of their own. As such, reform has social benefits that shouldn't be discounted. Table 3.1 summarises the impacts of some of the worst state taxes.

Table 3.1
BAD STATE TAXES AND THEIR IMPACTS

Tax	Burden	Social impact
Developer contributions	Developers/end purchasers of dwellings	Underdevelopment/increase in dwelling prices. Housing affordability pressures for lower income earners
Stamp duties on conveyances	Purchasers of land/ buildings	Higher house prices. Felt mostly by lower income earners
Insurance taxes	Purchasers of insurance – households and business	Significant levels of underinsurance, particularly among lower income earners
Emergency services levies	Land owners	Violation of user pays principle

Source: AFTS Review, 2010

The clear message from Table 3.1 is that when the social impacts of tax reform are considered, one should not lose sight of the social good that could come from removing these worst taxes:

- the largest of these bad state taxes, stamp duties on conveyances, has a significant impact on housing affordability, and this impact is felt most strongly by those at the lowest end of the income spectrum[3];
- this impact on housing affordability is magnified when the impacts of developer contributions are considered. These contributions impact both on the supply of new dwellings and their price; and

[3] To manage this, there are stamp duty concessions applied in some circumstances in some states. See Chapter 1.

- insurance taxes lead to underinsurance – and that this is most likely to manifest itself in lower income earners being overexposed to uninsured risk (AFTS Review, 2010).

The impacts, particularly as they pertain to the ability to save are important. Equity in terms of wealth is more pronounced than inequity in terms of income. Chesters and Western (2010) show that while the lowest quintile of Australians receive around 8 per cent of income, their share of wealth is closer to 1 per cent. As such, taxes such as stamp duties, and developer contributions may have more adverse equity impacts than a consumption tax.

Another key point to note about the current tax system is that it does not promote horizontal equity. Horizontal equity implies that two businesses of the same size and type should pay the same amount of tax. Table 3.2, which summarises a study by Pitcher Partners (2011) suggests that this is not the case when the impact of having 8 state tax systems is considered.

Table 3.2

STATE TAXES AND CHARGES IMPOSED ON A HYPOTHETICAL SMALL BUSINESS ($)

	NSW	VIC	QLD	SA	WA
Workers compensation	18,260	14,740	15,620	30,250	17,017
Payroll tax	22,999	26,950	4,750	24,750	19,250
Stamp duty on conveyances	106,490	121,000	101,175	114,830	107,215
Land tax	11,508	3,775	14,200	12,471	1,100
TOTAL	159,257	166,465	135,475	182,301	144,582

Source: Pitcher Partners, 2011

Table 3.2 demonstrates that there is a significant difference in the tax revenue imposed on this business which:

- has labour costs of $1.1 million per annum; and
- purchases a piece of property (with an unimproved land value of $1.1 million) for $2.2 million.

Depending on where this business is located, multiple tax systems result in this business paying markedly different amounts of state tax.

The existing tax and transfer system has inbuilt mechanisms to protect vulnerable members of the community

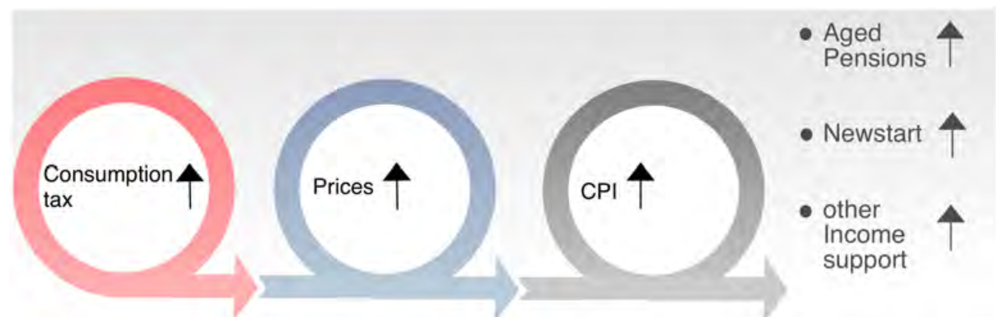
In the discussion above, the potential impacts from a social perspective of tax reform were briefly considered. Tax reform can impact on equity, and can cause some members of the community to be disadvantaged. It is important to note that while individual moves can be assessed in isolation, the AFTS review (2010) notes that the tax system at large, rather than specific taxes should be the mechanism through which 'equity' issues are pursued. Namely, the AFTS review suggests that equity should be driven by:

- the progressive personal income taxation system; and
- the transfer system.

These mechanisms could be altered in some way to adjust the equity balance as part of any tax reform process. Beyond these manual adjustments, the transfer system, as noted in AFTS has an automatic stabiliser that would 'kick in' in response to any consumption tax increase. The consumption tax would influence prices – and the Consumer Price Index (CPI) would increase in line with its component parts. As fixed income earners, such as pensioners and the unemployed, have an income stream that is linked to the CPI, pensions would adjust automatically, as shown in Figure 3.1.

Figure 3.1

AUTOMATIC STABILISERS IN ACTION: HOW FIXED INCOME EARNERS ADJUST TO INCREASES IN CONSUMPTION TAX



Source: Allen Consulting Group, 2011.

Depending on the scale of the reform, more may need to be done to ease the transition to the new tax system

It was demonstrated above that there are a range of inbuilt mechanisms to assist those vulnerable to tax reform to adjust. However, for a number of reasons – there may be the need to do more for these vulnerable groups. These considerations should be part of deep, long-term tax reform.

3.2 Lessons of previous reforms

'A New Tax System' GST reforms

The *A New Tax System* 'ANTS' reform package provides an informative case study as to why the social dimensions of reform matter. Broadly, the reform package involved the introduction of a goods and services tax (GST) to replace wholesale sales tax and a range of inefficient state taxes, in conjunction with reforms to federal financial relations and changes to personal income taxes and social security payments. Further details on the ANTS package are outlined in Box 3.1.

Box 3.1

THE A NEW TAX SYSTEM REFORM PACKAGE

The Australian Government introduced a goods and services tax (GST) in July 2000 as part of a broader package of tax reform. The revenue of the GST was to be paid to the states in exchange for the abolition of a number of inefficient state taxes. The package also included significant reductions in personal income taxes and large increases in Government payments to families, pensioners and low-income earners. Key elements of the package in its original inception:

- an increase in overall consumption taxes of around $6 billion;
- personal income tax cuts costing $13 billion and delivering an increase of $86 per week in disposable income for high-income earners; and
- compensation, family assistance packages and cuts in diesel excise, costing $8 billion.

Source: Australian Government, 1998

The release of the ANTS reform package two months prior to the 1998 election polarised debate surrounding the introduction of a consumption tax and its impact on the living standards of low-income earners. Prior to this there had been no detailed proposal or official inquiry, which seriously distorted public debate (Davidson, 2000). As a result, the package did not adequately take into account impacts on various affected interests, resulting in the package being unacceptable to various sectors of the community. In order to secure passage through parliament the original package was amended to reduce income tax cuts for high-income earners, improve compensation for low-income earners and introduce exemptions for basic food items and personal products.

The introduction of exemptions meant that the base of the GST was narrowed, eroding the overall simplicity and efficiency of the reform. The AFTS Review (2010) found that the GST food exemptions were not well targeted and added significantly to the complexity of the GST. Working out exemptions and concessions can be a confusing and time consuming task, particularly for small business (Board of Taxation, 2007), and adds significantly to compliance costs.

The removal of basic foods from the GST base was not an end in itself, rather its objective was to protect the welfare of low-income earners. If the social dimensions of the reform, that is, the need to ensure equity and protect living standards had been recognised from the outset, more efficient measures could have been introduced to achieve this very objective. The failure to adequately account for social dimensions had several implications for Australia's overall welfare, namely:

- reduced efficiency and sustainability of the taxation system;
- increased complexity and compliance costs for business were increased; and
- less GST revenue for the states, leading to deferment of the abolition of inefficient state financial taxes.

Another dimension of the GST reforms was the final design of the administrative system, which can impose high costs on business. These costs comes from registration, issuing tax invoices, distinguishing between different types of supplies, reporting and remitting GST to the ATO, computing and software requirements, and record keeping and auditing (AFTS, 2010b). The effect of these compliance costs is compounded by the archaic paper based system that businesses must use.

Box 3.2

VAT ADMINISTRATION IN THE UK

An example of international best practice in indirect tax administration can be found in recent changes that have been made to the United Kingdom's value added tax (VAT), which is transitioning from a paper based system to an electronic system. From 1 April 2010 most VAT registered businesses have been required to submit online VAT Returns and pay electronically. By 2012 this will extend to all VAT registered business. Penalties apply for the submission of VAT returns via paper rather than online. While the transition from paper based to electronic administrative systems can impose some short term transitional costs on business tat may have to invest in new systems, these are generally outweighed by long term compliance cost reductions.

Source: Allen Consulting Group, 2011

The UK experience with electronic payment of VAT suggests that potential exists to significantly improve the administration of Australia's indirect taxes. Reformed taxes could be streamlined and simplified through the use of new technology and modern administrative systems and potentially impose significantly lower opportunity costs on business.

Principles for future tax reform

The experience with the ANTS reforms suggests that failing to adequately deal with the social dimensions of reform can have significant implications. This suggests some principles that should be considered for future tax reforms:

- Social dimensions should be recognised from the outset and included as part of a rigorous reform debate.
- Potential trade offs between the overall economic gains of increased efficiency in the taxation system and equity objectives should be acknowledged.
- An assessment of any desired social outcomes should be an integral part of designing a reform package. Where possible, these outcomes should be achieved through changes to the income tax system or the transfer system as opposed to the granting of exemptions or concessions.
- Best practice administrative systems optimising the use of new technologies should be used to minimise complexity and compliance costs.

Key points

There are social dimensions that need to be accounted for in any serious discussion about tax reform.

There are groups that are vulnerable to change. Changes in taxation can result in individuals and groups facing a disproportionate burden, such as those on low or fixed incomes and small business.

The negative impacts of the current system shouldn't be discounted when assessing the social impacts of the new system.

There are inbuilt mechanisms in the tax and transfer system that can alleviate some of the pain of reform. Even so, more may need to be done to compensate the most adversely impacted individuals and groups in a reform process.

The GST reform demonstrated that getting reform right is crucial – exemptions to broad based consumption taxes reduce their efficiency and impose significant costs on business.

Chapter 4

Cutting the bad state taxes

What would reducing or cutting the worst state taxes do? Would the economic impact be material? What in turn would this mean for the budgets of state government? This chapter sets out answers to these questions using an economy-wide analytical framework.

All taxes distort behaviour by changing how much money people have and what prices they face for goods and services. However, not all taxes are equal in this regard – different kinds of taxes impact behaviour differently and some of these impacts are less distortionary and costly than others.

While studies have consistently shown (see eg CIE, 2009; IPART, 2008) that no tax performs well against every one of the principles of good tax design, it is also clear that some taxes are probably consistently worse than others. It is these taxes that can be considered to be 'bad'.

From the discussion in the previous chapter, several taxes were earmarked as the 'worst' state taxes. These include:

- stamp duty on conveyances;
- insurance taxes;
- fire services levies; and
- developer contributions and infrastructure charges.

That doesn't mean that the taxes that are not on this list should be ignored in state tax reform. Changes to payroll tax and land tax could be applied to improve them, and this will be explored later in the paper.

4.1 Measuring the economic impact of reform

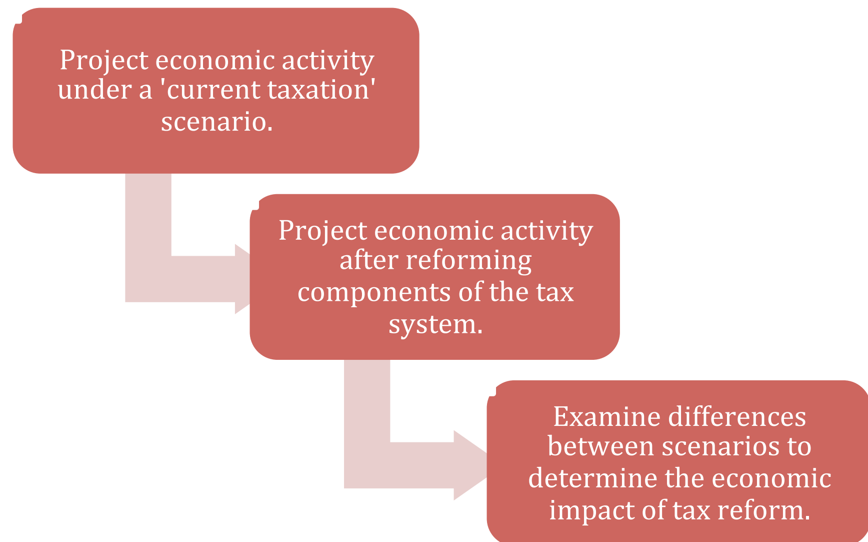
The framework used here assesses the implications of removing the state taxes that are most at odds with good design principles. The quantum to be measured includes:

- economic growth, output or GDP;
- consumption possibilities (consumption generally provides a reliable indicator of household utility or wellbeing); and
- investment, which can be viewed as the market's indicator of the change in competitiveness that has been achieved.

These factors and indicators are captured well in economic models. Analysing state taxes against these benchmarks shifts the debate about state tax reform from principles concentrating upon what goes into a tax to more practical measurement of likely outcomes. It provides a framework that can create substantive evidence about how changing taxes can lead to real improvements.

The analysis takes a comparative-static analysis. Essentially this means that a model of the economy is used to simulate the economy with and without changes in taxes after all of the changes have fully worked their way through the state and Australian economies. The difference between the two scenarios can then be compared, with the differences or deviations representing the full economic impact of the policy. This is outlined in more detail Figure 4.1 below.

Figure 4.1
MODELLING FRAMEWORK



Source: Allen Consulting Group analysis, 2011.

Because reform could take a number of forms multiple scenarios have been trialled to determine their likely impact. The focus of this chapter is upon just one, namely the abolition of a package of the worst state taxes listed above.

Computable General Equilibrium (CGE) modelling

The economy-wide impacts of the state taxation reform scenarios are estimated using a CGE model of the Australian economy, the Monash Multi Regional Forecasting (MMRF) Model. The MMRF model takes a 'bottom-up' approach to analysing the effects of a change in policy. That is, the aggregate national results are driven by the effects of reform on all of the sectors that combine to make up the Australian economy, including industries, households, and the government. Policy shocks that drive higher industry output and higher consumption by households and government will result in higher economic growth.

When state taxes are reduced or abolished, this effectively reduces the cost of doing business in the economy. This includes reductions in the cost of transactions, the cost of purchasing inputs, including labour, and the costs of complying with state taxes.

Households as a group will be better off with the reform of state taxes due to a number of factors:

- competitive pressure will compel firms to pass on at least a part of their cost savings on to consumers through lower prices;
- reduced costs, especially through payroll tax reform, will generally allow firms to expand employment; and
- reform of taxes on transactions and property such as land taxes, and stamp duties on insurance and conveyance will directly flow on to households as reduced costs.

These factors will combine to effectively increase the real wages of households and enable them to increase consumption.

Businesses will also generally do better with tax reform, from reduced costs, and the resulting increase in purchases of their output from households and other businesses. However, not all industries will benefit equally, with some even adversely affected by the reform. This is due to the fact that state taxes adversely affect different industries more than others and in fact even produce benefits for some.

The removal or reduction of the distortions from bad state taxes will free up the resources of firms and put all industries on a more even footing. Firms that no longer have to pay a state tax will have more resources to compete for labour and other inputs, which has a negative impact on other firms that were not previously subject to the tax.

The modelling results prepared for this report are based on an analysis of the long run impacts of state tax reform. These results can be interpreted as a snap shot of the post-reform Australian economy in a typical year, after all the changes flowing on from the reforms have worked its way through the economy. The changes in industry output, prices and investment, as well as in household and government consumption as described previously will take place over a number of years and the reported results reflect the state of the economy after all the changes have occurred.

Accounting for state taxes

The MMRF model is a high-level representation of the Australian and state economies, facilitating measurement of the wider effects of changes in economic activity in key industries and regions. To the extent that economic activity is interlinked, the MMRF model captures any indirect effects that arise from reforming the state taxation system. The key modelling challenges and the way they are addressed in the model are set out in Table 4.1.

Table 4.1

CHALLENGES AND APPROACHES IN ECONOMIC MODELLING

Challenge	Model approach
A reduction in government revenue, which may be a benefit to producers and consumers, may also mean that government spends less, which reduces benefits given to industry and households.	The model assesses the full impacts after these factors have fully flowed through.
State taxes can be different in each state and so the changes when moving to nation wide approaches may also be different.	State budgets are modelled directly including all of the major revenue items in each state. State (and federal) budgets have been updated to the 2009-10 fiscal year.
There is a need to take into account taxes on transactions such as a stamp duty on residential conveyances essentially discourage those transactions rather than alter the number and value of the underlying asset.	Changes in transaction costs are factored in to the value of assets or the return on those assets. Changes in the number of transactions are not directly taken into account.
Some taxes relate to use of assets or services where there may be external impacts not captured in market prices.	The likely average effects of changes in charges or taxes upon costs are taken into account. Changes in externalities are counted in the same way that they are in the present national accounts meaning that improvements that may arise from say a reduction in congestion due to different road pricing arrangements is not fully factored in, but the cost of the charge is.

Source: Allen Consulting Group, 2011

CGE models can provide a more accurate portrayal of broad changes and reform in a modern economy than alternative techniques such as multiplier analysis. Whilst both techniques are based on the ABS input-output tables, CGE analysis will produce a more robust result because:

- CGE modelling recognises supply side constraints – labour and capital are finite; and
- CGE models take into account price responses – both input prices and output prices can vary.

Box 4.1 provides a more detailed description of the MMRF model.

Box 4.1

THE MMRF MODEL

The Monash Multi-Regional Forecasting (MMRF) model is a multi-sector dynamic Computable General Equilibrium (CGE) model of Australia's regional economies developed by the Centre of Policy Studies (CoPS) at Monash University (CoPS, 2008). It is a model of the Australian economy and captures the interactions between different regions and sectors.

The MMRF model treats each of the six states and two territories (regions) as an economy in its own right, with region-specific prices, region-specific consumers, region-specific industries, and other region-specific detail. Results from each region then flow on to contribute to a picture of the entire Australian economy in aggregate. For a detailed description of the theoretical structure of the model see Peter et. al., (1996).

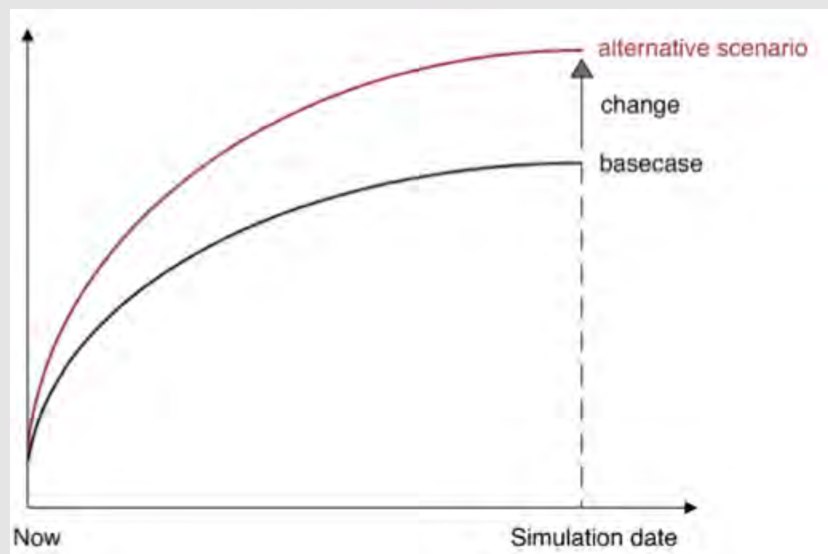
The MMRF model has been used for a wide range of policy studies, including the analysis of state tax reforms and the potential benefits of the National Reform Agenda. More recently, the Department of the Treasury and the Garnaut Climate Change Review applied the MMRF model to the national climate change modelling to assess the impacts of the proposed CPRS on the Australian economy.

The standard long-run comparative static closure of the model assumes that labour-supply is fixed and wages move to adjust. Capital stocks are also allowed to adjust to after-tax rates of return. These standard long-run assumptions are used by CGE modellers to model the long-run effects of major reform policies, such as trade liberalisation.

The results of the MMRF modelling simulations are estimated as deviations from the baseline. The baseline case represents a scenario that depicts the best estimate representation of the state of the world out to 2035. This includes expected demographic, economic and policy changes over time.

Reporting impacts in this way allows the discussion to focus on the 'change' that the investment can be expected to deliver (rather than on how the economy will develop over time). This is depicted in the following figure.

APPROACH TO MODELLING



Source: The Allen Consulting Group, 2011

The impacts of cutting the worst state taxes

In the first scenario that is analysed in this paper, the impacts of cutting the worst state taxes is assessed. In the model, when taxes are cut, there are a number of flow-on effects. Most of these taxes are imposed on business, accordingly reducing these taxes in a competitive market means that businesses cut prices.

Price reductions have a number of important effects. First, businesses are able to export more at this lower price. Other businesses that rely on domestic inputs into their production find their costs reduce – and they can pass on these reduced costs to their domestic and export consumers.

With these reduced prices, households effectively see their real wages increase and are able to:

- consume more locally made goods and services;
- consume more imported goods; and
- save more.

The key findings from this CGE analysis of the reduction of the worst state taxes are reported in Table 4.2.

Table 4.2

THE BENEFITS OF ABOLISHING THE 'WORST' STATE TAXES

Tax	Change in State Revenue ($m)	Change in GDP ($m)	Change in GDP (%)	Benefit index (gain in revenue per $1 tax cut)
Developer Contributions	-1,250	1140	0.1	0.9
Stamp Duty on Conveyances	-14,600	13200	1.2	0.9
Insurance Taxes	-3,900	2560	0.2	0.7
Emergency Services Levies	-1,170	770	0.1	0.7
TOTAL	**-20,920**	**17,760**	**1.6**	**0.84**

Source: Allen Consulting Group Analysis, 2011

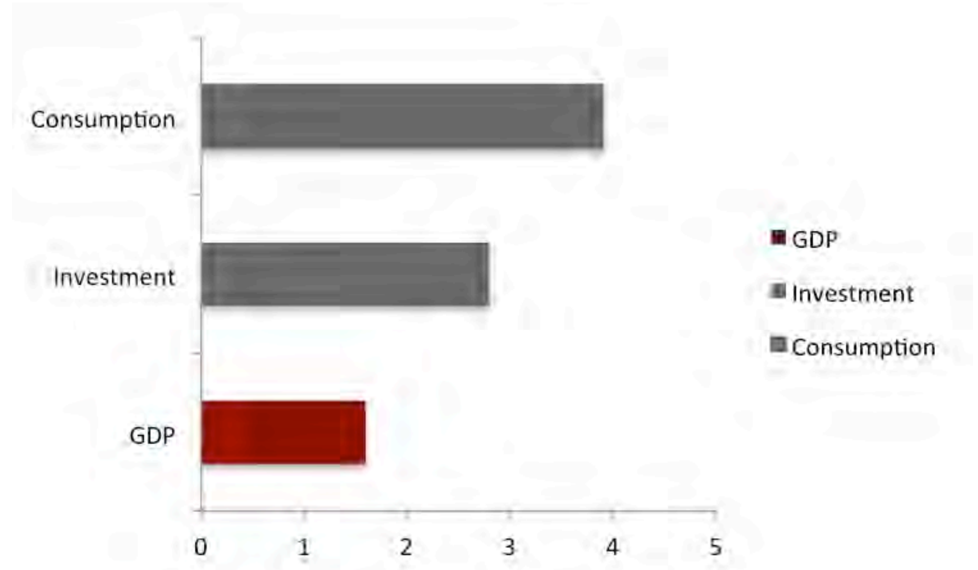
The key results from Table 4.2 are summarised below. These include:

- In aggregate, GDP increases by over $17 billion, or around 1.6 from the abolition of the worst state taxes.
- The decline in state revenue is significant – almost $21 billion.
- GDP growth is not as significant as the decline in the state budget position – this reflects the leakages to imports and saving discussed above.

- From the results it is also clear that approximately 90 per cent of the total increase in GDP has been derived from the abolition of stamp duty and insurance taxes alone.

The macroeconomic results of the change in state taxes are presented in Figure 4.2.

Figure 4.2
MACROECONOMIC INDICATORS FROM CUTTING THE FIVE WORST STATE TAXES



Source: Allen Consulting Group, 2011

The model results demonstrate that GDP would increase by around 1.6 per cent if the worst state taxes were removed.

Investment represents expansion by the private sector, and grows strongly by around 3 per cent. Consumption, which is a good proxy for welfare, increases by 4 per cent.

GDP increases by significantly less than consumption and investment. To understand this result, consider that GDP is made up of four main components – spending by households, business, government and net purchases by foreigners. Given that the government is cutting taxes by a significant margin, GDP will be dragged down by a corresponding contraction in government sector spending, while the other sectors of the economy expand.

4.2 The fiscal consequences of cutting taxes

Although the $1 billion addition to GDP clearly suggests the tax cuts provide an overall economic benefit, it coincides with a significant reduction in revenue which would threaten the long-term viability of programs managed by state governments. For instance, the reduction in revenue is equivalent to approximately 80 per cent of total expenditure on schools by the state governments (Harrington 2011).

Second-round impacts

The economic growth reflected in expanded business activity or output and increased incomes and consumption derived from the elimination of the worse state taxes would also drive a fiscal dividend. Reflecting the application of taxes (that equate to an average tax rate of around 23 per over the economy) we could expect a second round increase in state and Commonwealth tax revenues of approximately $4 billion.

It should be noted that the majority of Australia's taxes are levied by the Commonwealth government. In practice it is probable that much of the fiscal growth dividend would not flow directly to the states in its entirety (Treasury, 2010).

Filling the gap

If state governments are able to capture all of the second round increase in taxation revenue due to the reduction in the worst state taxes it is still likely that there would be a revenue shortfall. Subtracting the second round dividend from the direct reduction in revenue leaves a residual unfilled revenue gap of $16-17 billion each year.

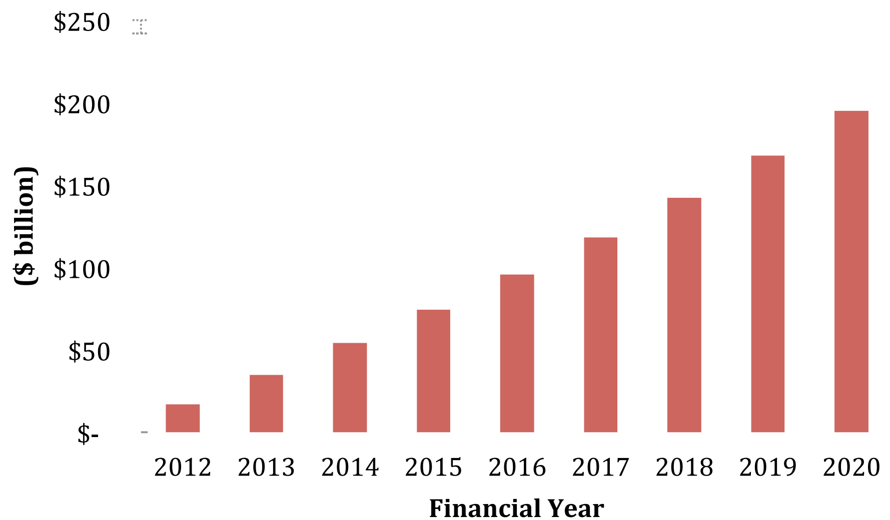
Given the significant fiscal gap arising for the states because of the proposed reforms it is clear that alternative sources of revenue will be needed.

One option is for state governments to both increase their efficiency and/or decrease their provision of goods or services. Given the significance of the revenue gap relative to total state revenues this is clearly unlikely to be a viable option, particularly in the short-term without major reductions in service provision by states in areas such as schools, hospitals and police.

Alternatively, state governments could fund the revenue gap through borrowings. However, given that this would need to be repaid at some point in the future, it would be necessary that states have some means to repay this over the long-term. Given that this alternative would also simply transfer current liabilities into future time periods there would need to be some confidence that states would be better positioned to fund the gap inclusive of the interest costs of the debt.

Figure 4.3

CUMULATIVE VALUE OF STATE BUDGET DEFICIT GIVEN DEBT FINANCING OF REVENUE GAP[4]



Source: Allen Consulting Group Analysis, 2011

The potential accumulation of debt arising from sustained carry over of revenue shortfalls due to the policy change is illustrated in Figure 4.3. As the figure illustrates, the level of state debt would rise steeply as a consequence of financing the policy through borrowing. Given that the policy erodes a significant proportion of the state's revenue base already, it appears highly unlikely state governments as whole would be able to extinguish the liability that would arise from funding the policy through borrowings.

Given the large proportion of state government revenue already provided by the Australian Government and the large emphasis currently being placed on tax reform, this superficially appears to offer an additional alternative source of funds. However, given that a significant proportion of the Australian Government's transfers to the state governments is sourced from GST revenue, it is not likely that this could be increased without an increase in the GST rate. Given the Australian Government's current policy position of excluding consideration of changes in the GST this is not a viable source of funding. Other funding sources from the Commonwealth are impeded by the Government's commitment to returning the budget to surplus. This requires that any increases in funding provided by the Government would require savings from elsewhere in order to avoid adding to the Australian Government deficit.

4 Assuming recurrent revenue gap of $16 billion borrowed at an interest rate of six per cent.

What does the gap mean for long term budget positions and net debt?

The tax reduction scenario analysed here would result in significant benefits to the Australian economy as a whole, however, given the limited options available to fund this shortfall any such policy would be likely to come at a significant cost to state governments. In fact in the face of being unable to raise alternative forms of revenue it is highly likely that the debt burden will rise, threatening the long-term financial viability of state governments.

Key points

There are significant benefits to the Australian economy in cutting the worst state taxes.

GDP rises by 1.6 per cent through the abolition of the worst state taxes in this analysis.

The impact on state Government budgets is significant. State governments can fund this through either;

- *significant reductions in service delivery;*
- *federal funding; or*
- *accruing debt.*

Accruing a large increment of debt is unsustainable in the current fiscal climate.

As such, reform needs to be funded.

Chapter 5

Tax maintenance

The AFTS Review concluded that the efficiency of some state tax bases is being eroded by exemptions, concessions and inconsistencies. This chapter looks at how existing taxes could be improved and examines the potential economic gains and fiscal consequences of improving the current tax base.

5.1 Maintenance of state taxes

Targeting taxes that are levied on bases that are relatively efficient is a way to achieve substantial reform that is effectively costless. Maintenance in this context is designed to meet two criteria:

- reducing the compliance costs of existing taxes; and
- aiming to meet these first two criteria in a way that is revenue neutral.

The two major taxes which are being targeted for 'maintenance' are:

- payroll tax; and
- land tax.

How to exactly go about the process of state tax base maintenance is not discussed in depth in this analysis. How to broadly reduce compliance costs are described below. These are not prescriptive discussions about tax design, but highlight the opportunities for benefits from straightforward tax maintenance.

Payroll tax

The AFTS review suggests that payroll tax should be:

> 'replaced by a tax that better captures the value-add of labour. This could be a broad-based wages tax, or preferably a cash-flow tax.' (AFTS Review, 2010b).

While this option has some significant advantages, namely that a broad based consumption tax would tax all factors of production (AFTS Review, 2010b), there is some appeal in retaining the payroll tax base, and using this desirable tax to fund the more egregious state taxes.

Closer to this idea of 'tax maintenance' would be the alternate option raised in the AFTS review – using the PAYG system to collect a payroll tax equivalent.

Compliance costs under such a system would reduce significantly. For example:

- It would fall under the current nationally administered regime, and accordingly reduce significantly the administration costs for 8 separate state payroll tax administrators. The administration costs for state governments include:
  - a large army of bureaucrats required to process payroll tax returns; and
  - the cost of audit. Audit costs are likely to be a significant issue with payroll tax given the myriad of exemptions for payment and the consequent high

incentives for business to attempt to avoid or minimise their payroll tax liability.

- It would reduce the burden on business from having to comply with up to 8 payroll tax systems. These compliance costs for business include:
  - costs in record keeping and paperwork. For national enterprises, there are 8 separate forms and 8 separate payroll tax calculations;
  - the cost in tracking thresholds and exemptions; and
  - the cost in complying with audit (theoretically, a national firm is 8 times more likely to have to comply with a payroll tax audit than it would be under a uniform national system).

A harmonised system could involve a single, lower rate, applied to a base with no exemptions. Much of the payroll tax debate centres around the impacts on efficiency of exemptions. However, there is also a compliance cost from exemptions as firms have to engage the services of the 'tax army' to attempt to meet these criteria for exemptions and may restructure their business at some cost to do so.

A system with no exemptions could reduce the rate of payroll tax significantly. In 2011-12 the New South Wales tax expenditure on payroll tax – basically the cost of the exemptions – is estimated to be around 18 per cent of the total tax base (NSW Treasury, 2011). While not all states are equal in this respect, this implies that removing the exemptions from the payroll tax regime could allow the reduction of the national rate by a substantial amount.

In practice the specifics of payroll tax maintenance require substantially more analysis than is able to be covered within the scope of this report. In addition those specifics will inevitably involve addressing details in payroll taxes that the states will want to be involved in shaping. Recent tax reform exercises have highlighted that intervention in areas of state responsibility without their involvement can raise significant challenges. Really what is required here is to highlight the opportunities of this general direction and suggest the framework for achieving the change.

Box 5.1

WHAT WOULD A REFORMED PAYROLL TAX LOOK LIKE?

Based on principles from the AFTS Review (2010b) a reformed payroll tax would have the following characteristics:

- consistency across states;
- no thresholds;
- minimal exemptions;
- one national administrative body.

Source: AFTS Review, 2010b

Land tax

The AFTS Review wrote in favour of continuing to use land as a base for taxation, citing the relative efficiency of this tax relative to other bases. However, it recommends that a uniform low rate and broad based land tax would serve the purpose of increasing the efficiency of this tax (AFTS Review, 2010).

Similar reforms, that is the use of a low-rate, broad-based land tax, that is uniformly applied across states and territories would have another impact – the reduction in the compliance costs associated with the tax.

Compliance costs would reduce to a significant extent under such a system. The benefits to business and government would include:

- The potential for the number of government agencies responsible for administering land tax could reduce from seven[5] to one. Administration of land tax is costly and is primarily based on:
  - assessing land values and land uses is currently the function of seven valuers-generals, which creates a large cost;
  - there is a large division of the 'tax army' comprised of bureaucrats involved in processing land tax returns and managing land tax policy; and
  - there are substantial exemptions to the land tax net. An example of this is the exemption for owner-occupied housing (AFTS, 2010b). Exemptions such as this increase the incentives for businesses and individuals to 'game' the system and thus require a substantial expenditure on audit to enforce compliance.
- There are considerable compliance costs for business from the existing model. These are a function of the current seven separate regimes and are driven by:
  - interaction with seven separate bureaucracies, the associated need to maintain seven separate inventories for land tax purposes and the associated forms;
  - the complexity from a calculation standpoint of the landholder model. This means that firms are not paying flat rates of land tax on a per property basis but against a detailed inventory – some of which, depending on its use – will be exempt; and
  - the landholder model creates perverse incentives – firms may seek to unbundle their land holdings to avoid or minimise their tax. This type of complex tax avoidance could require expensive advice and transaction costs.

As such, moving to a broad-based, low-rate land tax that is nationally administered and does not involve the bundling from the landholder model would be a significant step to reduce a large volume of compliance costs.

[5] The Northern Territory does not have a Land Tax (AFTS Review, 2011).

Box 5.2

WHAT WOULD A REFORMED LAND TAX LOOK LIKE?

Based on the princples in the AFTS Review (2010b), a reformed land tax would have the following characteristics:

- consistency across states;
- a broad base with minimal exemptions;
- land values would not include building values or be triggered by transactions – only the true unimproved land value (UIV) would be reflected;
- rates would not be varied to include vertical equity objectives; and
- should be applied on individual, rather than aggregate land holdings.

Source: Allen Consulting Group, 2011

Analysis of changes in compliance costs

Compliance costs were modelled in the simulation that follows as demonstrated in Figure 5.1. Compliance costs have been modelled with two components:

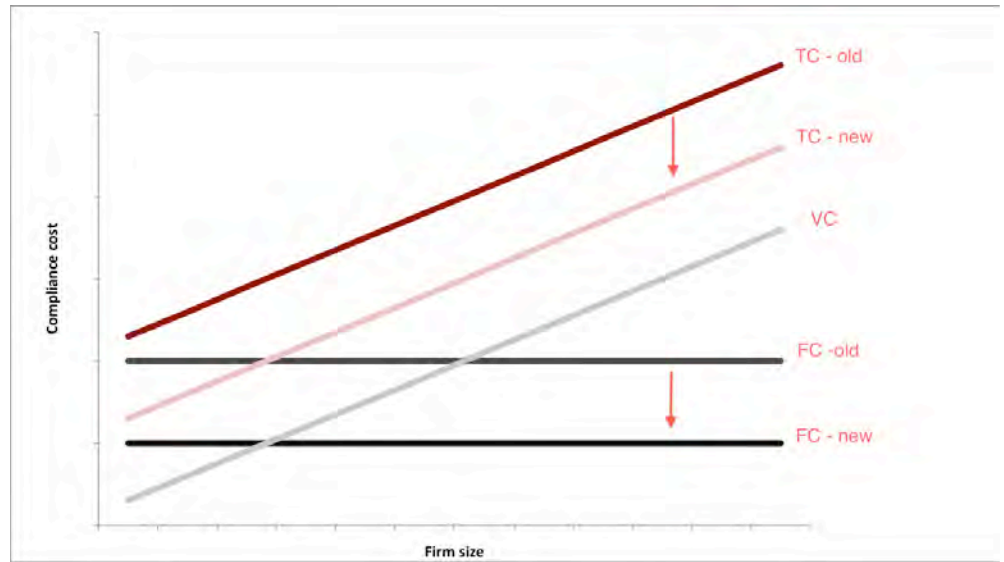
- a fixed cost, which is not related to the amount of tax revenue collected; and
- a variable cost, which is related to the amount of revenue collected.

The fixed cost of compliance relates to the compliance activities undertaken by all firms and administration costs faced by government in relation to taxes. Fixed compliance costs relate, not to the amount of the tax paid, but factors that influence the simplicity of the tax system to firms. Factors that drive fixed costs include:

- the number of taxes faced by the entity and enforced by government;
- the number of agencies responsible for administering taxes;
- the number of bureaucracies which firms need to work with to meet their tax obligations; and
- the complexity of individual taxes, and the scope to avoid taxes.

The variable cost component reflects the fact that firms with more activity generally face more complicated tax affairs that smaller firms, all else equal.

Figure 5.1
THE IMPACT OF TAX REFORM ON COMPLIANCE COSTS



Source: Allen Consulting Group, 2011

Reducing fixed compliance costs

The simulation assumes there is a reduction in compliance costs faced by firms and a reduction in fixed administration costs faced by government through the maintenance of the payroll tax and land tax regimes. This is achieved through:

- reducing the number of agencies responsible for each tax to one;
- reducing the number of rates for each tax to one;
- abolishing the exemptions from each tax; and
- abolishing the landholder model.

5.2 The benefits of tax maintenance

This section builds on the results from 4.1. In this case, in addition to the impacts of reducing the worst state taxes, there is an impact from the reduction of compliance costs. In response to less complexity in the tax system, firms are able to move resources – whether within or outside the firm - which would otherwise be used in complying with the tax system into more productive activities. This expands the productive capacity of industry, with output expanding, or prices reducing.

Table 5.1

THE BENEFITS OF TAX CUTS AND TAX MAINTENANCE

Tax	Change in State Revenue ($m)	Change in GDP ($m)	Change in GDP (%)	Benefit index (gain in revenue per $1 tax cut)
Developer Contributions	-1,250	1140	0.1	0.9
Stamp Duty on Conveyances	-14,600	13200	1.2	0.9
Insurance Taxes	-3,900	2560	.2	0.7
Emergency Services Levies	-1,170	770	0.1	0.7
Tax Maintenance	*0*	*1945*	*0.2*	*N/A*
TOTAL	**-20,920**	**19,660**	**1.7**	**0.94**

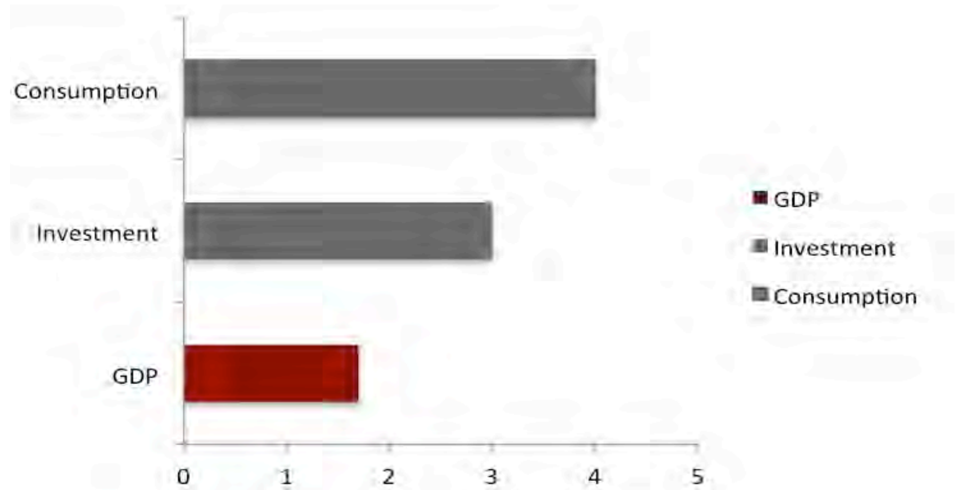
Source: Allen Consulting Group analysis, 2011

The benefits from cutting the worst state taxes are combined with the benefits of tax maintenance and are presented in Table 5.1. The key results are:

- the first round cost to the state budgets is the same as in Table 4.2;
- GDP has risen from the first to the second simulation – by another $1.9 billion, or just under 0.2 per cent;
- this rise has been effectively costless, reflected in the performance ratio – which presents the gains to GDP per dollar of revenue lost. This ratio has risen from 0.84 dollars of GDP per dollar of tax cut, to 0.94 dollars of GDP per dollar of tax cut; and
- there still remains a significant gap in the funding arrangements – even though this has improved significantly (see Table 5.2).

Figure 5.2

MACROECONOMIC INDICATORS – CUTTING THE WORST FIVE STATE TAXES AND MAINTAINING PAYROLL TAX AND LAND TAX



Source: Allen Consulting Group, 2011

The macroeconomic results for this package presented in Figure 5.2 are similar to those presented in Figure 4.2. Some key results from this simulation are:

- Consumption, a proxy for welfare, increases significantly by over 4 per cent. This reflects that many of the most egregious state taxes are levied on households directly and that abolition of these taxes acts as an effective increase in disposable income.
- Investment increases by around 3 per cent. This is also a strong result reflecting the increased competitiveness of this sector.
- GDP increases by less than consumption and investment. This again reflects the contraction of the government sector dragging down GDP.

Table 5.2

OVERALL FISCAL COST OF THE REFORM PACKAGE

Package	Cut worst state taxes ($b)	Cut worst state taxes and improve PRT and Land ($b)
First round impact	-20,920	-20,920
Increase in GDP	17,670	19,660
2nd round tax increase	4,060	4,520
Overall fiscal impact	-16,860	-16,400

Source: Allen Consulting Group, 2011

The impacts on the overall fiscal position – borne across the Commonwealth has improved by around $500 million per annum, but is still very large, around $16.4 billion per annum. This means that the analysis from 4.2 holds, and that there remains the need to consider deeper funding arrangements.

Key points

- *Deeper tax reform, where taxes that are applied to relatively efficient bases such as payroll and land tax are reformed to reduce their compliance costs can have a positive impact on economic performance.*
- *This type of deep reform, where existing taxes are maintained has positive impacts on GDP, business competitiveness and consumption by households.*
- *Although combining cutting the worst state taxes with deep tax maintenance produces a significant fiscal dividend, this fiscal dividend would still not be sufficient to close the fiscal gap and the states would enter a long term path of fiscal unsustainability.*

Chapter 6

Deeper state tax reform

Is there a deeper more sustainable approach to state tax reform? Crucially sustainability in this case relates to funding reforms largely from within the economic gains of reform. This chapter measures the impact of alternative approaches that would meet these criteria.

6.1 Broader options to fund tax reform

In order to be credible and practical, reform must be funded. The growth dividend is insufficient to fund reform, and simply cutting state taxes without a funding package in place leads to two rather unpalatable alternatives:

- a reduction in the capacity for states to pay for essential services; and/or
- escalating levels of state debt, which rapidly becomes unsustainable.

As such, this chapter considers alternative means of funding deeper, more sustainable reform. It will explore potential tax bases, both existing and new, that could be used to fill the fiscal gap and use an illustrative example to explore the overall benefits of funded reform.

6.2 Funding the gap — assessment of old and new bases

The strength of properly targeted tax reform comes not only from its ability to significantly simplify the current tax system but also from its ability to realign government revenue with the needs of the community, both now and into the future. However, achieving the economic dividends associated with reform in the long-term requires that the simplification of the tax system is sustainable, such that the revenue needs of government are satisfied in the long-term, thereby avoiding the reintroduction of poorly designed taxes by future governments.

The AFTS Review recommended that revenue for the provision of public goods is best raised through the taxation of income, consumption and land (AFTS, 2010b). If levied consistently upon a broad base, such taxes can be efficient, and if properly structured allow the burden of taxation to be distributed as widely as possible. Table 6.1 summarises some taxes with these characteristics, along with the approximate rates of taxation that would be required to fund the abolition of the worst state taxes.

Table 6.1

SOME POTENTIAL FUNDING SOURCES

Tax base	Rate %	Additional Revenue $m
BBCT – broad base	3-3.5, or around 12 to replace GST.	17,000
BBCT – medium base	3-4, or around 13 to replace GST.	17,000
Increased GST	14	17,000
Business CFT	3-4	17,000
Income tax base sharing (state additional rate)	3	17,000

Source: Allen Consulting Group, 2011. Note: rate is the approximate rate needed to fund the abolition of developer contributions, stamp duties on conveyances, insurance taxes and emergency services levies.

Consumption taxes

Consumption taxes are a potentially efficient and sustainable tax base that could be used to fund the abolition of inefficient state taxes (AFTS, 2010a). It is recognised that consumption taxes can be regressive in incidence due to the tendency of lower income earners to spend a higher proportion of their income on consumption. However, in order to preserve the efficiency and sustainability of consumption taxes equity objectives can be achieved through the transfer system (AFTS, 2010).

There are a number of potential taxes that utilise consumption as a tax base, including the existing Goods and Services Tax (GST), a broad based consumption tax (BBCT) and a business cash flow tax (BCFT). Of course, any new consumption tax should either supersede or fit seamlessly into the current GST reporting systems – otherwise the complexity reduction from replacing bad state taxes would be nullified.

GST

While the GST is an efficient tax relative to many of the other taxes levied in Australia, its complex design detracts from its efficiency potential. Exemptions from the GST tax base also mean that it is not as sustainable as other consumption taxes. The Productivity Commission (2005) found that by 2044-45 GST revenues may decline slightly as a share of GDP due to the growth of tax exempt consumption. The Commonwealth Treasury (AFR, 2011) has recently advised the Government that the GST is becoming increasingly inefficient and less robust.

While funding state tax reform through an increase in the GST is an option, it is clear that its design is not optimal and more benefit could be achieved through the use of a consumption tax applied to a broader base.

Broad based consumption tax

A broad based consumption tax levied consistently across goods and services would be simple to calculate and, by being incorporated through the same remittance regime as the GST, would involve minimal compliance costs. It would also not involve the same exemptions as the GST, which would enable it to apply to a broader base at a lower rate, thereby minimising inefficiency. Such a tax could apply to a very broad base, which would move it towards the New Zealand model, or alternatively be levied on a medium base, with simple inclusions such as fresh food.

A BBCT could be delivered through 'base sharing' arrangements and collected by the Commonwealth. An important distinction between the GST and a broad based consumption tax (BBCT) is that:

- a BBCT is not the GST and is thus not explicitly, 'off-the-table';
- a BBCT is not subject to the same intergovernmental agreement as the GST.

Cash flow tax

A cash flow tax that would apply at a single rate to the net cash flow position of an entity is another options that could potentially replace inefficient state taxes. The AFTS review (2010) found that such a tax would be the simplest use of the consumption tax base and could significantly reduce tax compliance costs while at the same time providing a sustainable revenue source.

A cash flow tax targets consumption, like the current GST. Rather than taxing consumption through the invoice credit method (like the GST), a cash flow tax works on a direct subtraction method (AFTS Review, 2010). This makes a cash flow tax, a potentially lower compliance cost manner of taxing consumption.

Payroll tax

Payroll tax, as one of the more efficient state taxes, has the ability to provide funding for the reform of less efficient state taxes. A nationally harmonised payroll tax, applied across a broad base at a uniform rate has the potential to provide a reliable, efficient and sustainable source of revenue for the states. Such a tax would need to be levied at a higher rate in order to fund abolition of the worst state taxes (above and beyond current payroll tax collections).

If a broad based payroll tax were to be considered, the impacts on small and medium enterprises being brought within the payroll tax base would need to be carefully considered and managed. Agreement of the states to stick to a national uniform rate and broad base would also be necessary to avoid future incremental adjustments on a state by state basis.

Income tax base sharing

Sharing the personal income tax base is also a potential means of giving the states capacity to raise revenue sustainably and with some autonomy and accountability. This would involve the states levying a flat rate surcharge on income tax payable to the Australian Government, with Australian personal income tax rates and grants to state governments adjusted accordingly.

A flat surcharge on income tax of around 3 per cent could potentially fund the abolition of the worst state taxes identified in chapter 2. Careful design would be required to ensure consistency with national objectives for redistribution and workforce participation (AFTS, 2010b). Such a tax could be administered centrally, however the administrative arrangements would need to allow for the revenue derived in each state to be returned to that state.

Reduced tax expenditures

Tax expenditures, in the form of exemptions, rebates and concessions, are equivalent to direct Government spending in that they must be financed by resources drawn from other programs or increased taxation. However, they are generally not required to go through the same review processes as direct spending, which tends to make them less accountable and transparent than direct spending (Spies-Butcher and Stebbing, 2009). The number and value of these expenditures have increased steadily over recent years (Spies-Butcher and Stebbing, 2009).

Reducing the amount of these tax expenditures is an often forgotten potential source of funding for reform.

Areas of taxation that are currently characterised by large tax expenditures include superannuation, capital gains taxation, fuel excise and alcohol taxation. Alcohol taxation has been raised as a tax expenditure with scope to be reformed. For example, the AFTS Review (2010b) recommended applying a less distortionary volumetric tax which treats standard drinks equally.

The problem with using tax expenditures is that in most cases there is not enough revenue in individual tax expenditures to fund genuine reform. Even where a number of tax expenditures are cut, there is not likely to be enough revenue to fund genuine reform.

Choosing and applying a tax base

The tendency for the tax system to be influenced by a range of interest groups is an important consideration in ensuring that reform is sustainable. Consequently, the taxation alternative to be selected needs to be applied such that there are minimal incentives to squander the benefits of reform.

The analysis and example are not intended to be prescriptive of how tax reform should be funded. The intention is to merely identify potential options for deeper reform going forward and stimulate debate as to the merits of these options.

6.3 The benefits of deep funded reform

This section examines the impacts on the national economy of an illustrative scenario under which the fiscal gap is funded with a broad based consumption tax of the type examined in section 6.2. A broad based consumption tax was chosen for the illustrative scenario. However, as all the funding alternatives identified in section 5.2 are broad based, efficient taxes it is expected that similar results would apply across each funding option. The illustrative scenario involves:

- cutting the worst state taxes, including developer contributions, stamp duties on conveyances, insurance taxes and emergency services levies;

- maintaining land tax and payroll tax; and
- funding the fiscal gap with a broad based consumption tax.

In this simulation, there is a similar starting point to the unfunded simulations, however, raising consumption taxes effectively reduces the spending power of the household sector, and leads to lower demand for goods and services. This results in industrial contraction.

The negative impacts from the reduced purchasing power of households is less significant than the positive impacts from abolishing the worse state taxes. For one, there are lower compliance costs, freeing up more productive labour and capital. Further, a broad based tax on consumption leads to a more efficient resource allocation.

The results from this simulation are presented in Table 6.2.

Table 6.2

OVERALL REFORM PACKAGE RESULTS

Tax	Change in Revenue ($m)	Change in GDP ($m)	Change in GDP (%)	Benefit index (gain in revenue per $1 tax cut)
Developer Contributions	-1,250	1140	0.1	0.9
Stamp Duty on Conveyances	-14,600	13200	1.2	0.9
Insurance Taxes	-3,900	2560	.2	0.7
Emergency Services Levies	-1,170	770	0.1	0.7
Tax Maintenance	*0*	*1945*	*0.2*	*N/A*
Broad Based Consumption Tax	21,120	-12,200	-1.1	0.6
TOTAL	**0**	**7415**	**0.7**	**N/A**

Source: Allen Consulting Group Analysis, 2011

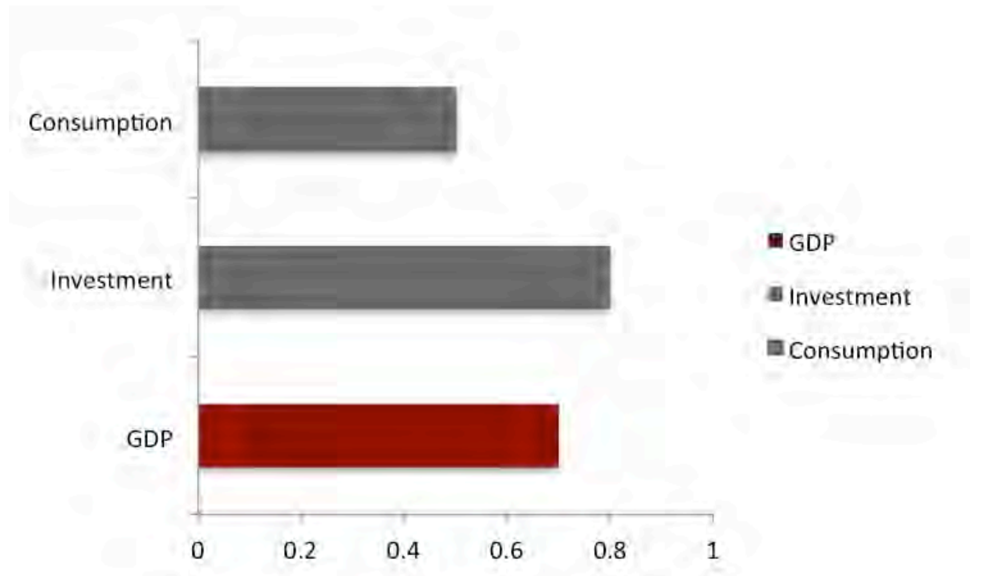
The key results from the simulation demonstrate that:

- This is a fully funded tax reform package – one that leaves the fiscal position no worse off raises GDP by a substantial amount – around 0.7 per cent or $7.4 billion.
- This does not even take second round impacts into account. Given an increase of $7.4 billion in GDP, and a tax to GDP ratio of around 23 per cent, there is an additional fiscal dividend of around $1.7 billion. This could be used to fund policies to mitigate effects on any adversely impacted groups

- There are two drivers that generate this significant economic impact even though the aggregate tax take increases. These are:
  - replacing inefficient taxes with more efficient taxes; and
  - reducing compliance costs through tax maintenance.

The macroeconomic results from the analysis are presented in Figure 6.1.

Figure 6.1
MACROECONOMIC INDICATORS – AGGREGATE TAX REFORM PACKAGE



Source: Allen Consulting Group analysis, 2011

Some key results from Figure 6.1 are that:

- GDP grows by around 0.7 per cent. In this deep reform scenario, GDP growth is comparable to consumption and investment – this is reflective of the government sector not contracting in this 'balanced budget case.'
- Investment outstrips GDP and consumption. In this case, as the new tax base targets households, consumption (a proxy for welfare) drags down the GDP results.

Key points

- *A deeper reform package involves abolition of the worst state taxes, tax maintenance and the introduction of an alternative funding mechanism. This is an approach mentioned in the AFTS Review and involves the use of a Broad Based Consumption tax, which has many of the desirable features of the GST, but is applied over a wider base, making it more efficient.*
- *This overall package of reform leaves the economy substantially better off – with growth in GDP of around 0.7 per cent per annum in the fully funded case. Other key results in this case include:*

- *Investment increases by 0.8 per cent, which reflects increased competitiveness of the business sector.*

- *Consumption rises by 0.5 per cent, reflecting increases in the economic welfare of households.*

- *The deep reform proposed would be fully funded, and thus fiscally sustainable. In addition, a key result is that budgets would benefit from a fiscal dividend from the additional growth in the underlying economy. Some part of these proceeds could be used to fund policy measures directed towards easing the transition and minimising disadvantage arising from reform.*

Chapter 7

Pathway to reform

This chapter looks at how to turn the potential reform benefits presented in Chapters 4 to 6 into concrete improvements in the lives of Australians. It builds a realistic pathway to reform by identifying certain reform realities and designing a package of reforms to work with these realities. It also draws on previous reform experiences to build a framework to successfully implement state tax reform and ensure that the benefits of the reforms endure into the future by guarding against backsliding.

7.1 Reform realities

The economic modelling results presented in Chapters 4 to 6 show that the potential benefits of reform are large. However, despite the clear benefits, in the past a number of barriers to reform have hindered progress on state tax reform. As such, in order to push reform forward it is necessary to be pragmatic about what realities will act as a barrier to reform and how these barriers can be overcome.

Reality 1 – The states cannot undertake reform on their own

State tax reform is unlikely to happen without co-operation, both among the states and between the states and the Australian Government. Several factors contribute to this:

- The interaction of tax reform with the methodology applied in calculating intergovernmental fiscal transfers means that the majority of benefits are redistributed, leaving states little incentive to undertake reform on their own (Warren, 2010).
- The Australian Government budget will benefit more from state tax reform than the states themselves (Warren, 2010). It is unrealistic to expect individual states to support reforms that have severe short-term impacts on their budgets without funding from the Australian Government.

Over time the states have not been able to undertake significant reforms to their taxes and they periodically engage in destructive competition. The fiscal equalisation process does not promote reform (Treasury Red Book, p.23).

These factors interact to make it irrational for states to embark on reform unilaterally, with first movers potentially facing a reduction in interstate competitiveness and a redistribution of benefits to other states. This issue was recognised by the Commonwealth Treasury in their September 2010 briefing for the incoming Labour Government (Treasury, 2010a).

Solution – Reform must be co-ordinated across the Australian and state governments and be given top priority on the COAG reform agenda. The upcoming tax forum should be used as an opportunity to discuss and facilitate co-ordinated action.

Reality 2 – Reform has social dimensions

Despite the long term overall benefits, revenue neutral reform inevitably involves initial winners and losers, and this issue is complicated by the asymmetrical visibility of the costs and benefits. As discussed in chapter 3, reforms that involve the removal of concessions, or the lowering of thresholds, tend to create a small group of clear losers, along with a large group of winners who each enjoy small benefits. These reforms are often difficult because the voices of the small number of losers will invariably drown out the overall benefits. These effects can make it very difficult to implement reform that has overall benefits.

Solution – Reform should take place as part of a package of measures designed and ordered to neutralise potential disadvantage and provide offsetting advantages.

Reality 3 – We can't do everything at once

Reform is a long-term process. As noted by the AFTS Review (2010a) it is neither possible nor desirable to make large-scale changes to the tax system too quickly. Constraints on the number of reforms that can be implemented are due to both and the desirability of giving the community time to adapt to changes and the current fiscal limitations on funding reforms. Prioritisation of reform is necessary, and should draw on evidence, such as that presented in this report, about which taxes are the worst and need reforming first.

Solution – As part of an overall reform package, reforms which will result in the greatest potential benefits should be prioritised.

Reality 4 – States will be tempted to 'backslide'

In the past states have shown a tendency towards what has been termed 'reform recidivism' (Warren, 2010). There is a real risk that following the implementation of reforms states will backslide and reinstate bad taxes or narrow bases by reintroducing concessions. The unwinding of reforms through the incremental re-introduction of inefficient state taxes would undermine the growth and productivity improvements achieved through reform.

Solution – A strong governance framework is needed to lock in reforms, prevent backsliding and stop bad tax policy from resurfacing.

Reality 5 – Genuine reform is essential

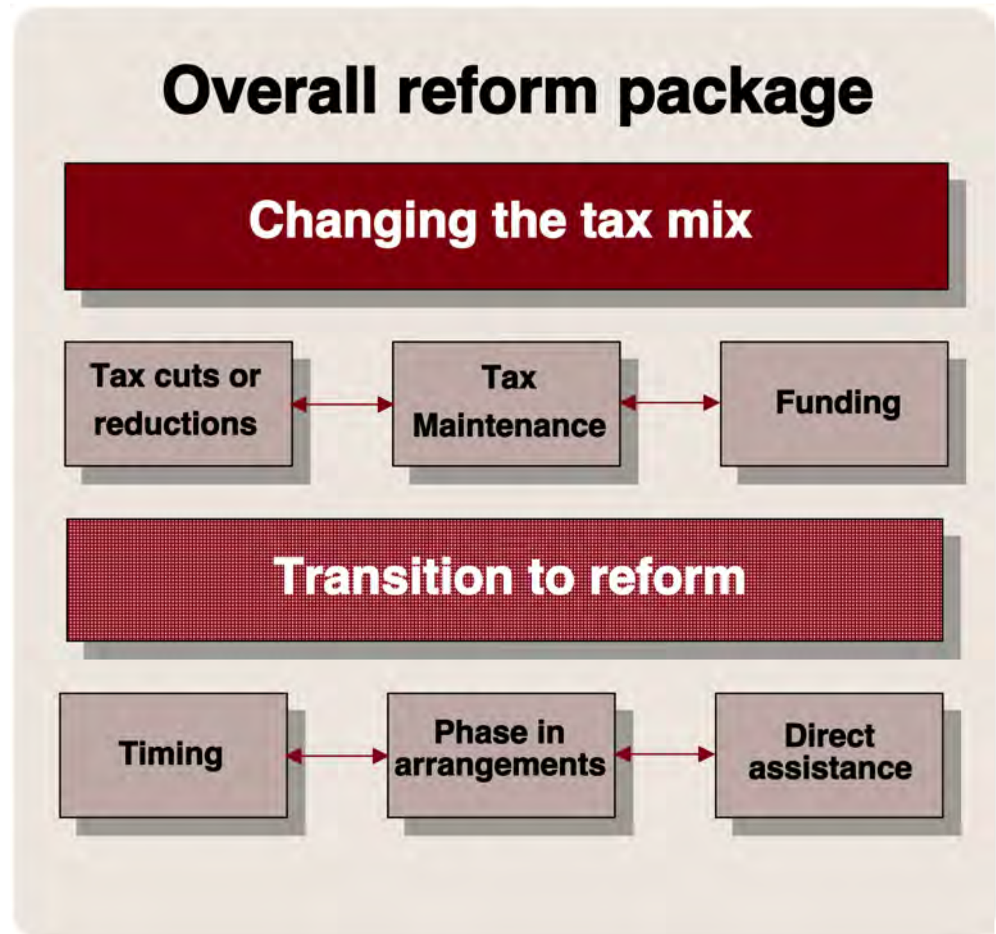
Australia's continued prosperity is not guaranteed. It requires recognising and meeting a number of challenges, including demographic change and deepening international integration and competition (AFTS, 2010a). As discussed in Chapter 2, state tax reform has the potential to play an important role in meeting these challenges. The costs of not undertaking reform are subtle and hidden, but nonetheless substantial. They include the costs of foregone growth and productivity improvements, erosion of Australia's international competitiveness and the compliance costs which business will continue to face.

Solution – Build awareness about the hidden costs of failing to reform and gather support for a genuine reform package through platforms such as the upcoming tax forum.

7.2 Packaged reform

The reform realities identified above make the pathway to reform a difficult one. To traverse this path a well designed package of reforms, facilitated by an agreement between the state and Federal Governments, is needed. This report will not attempt to set out the details of a precise reform package – this is for discussion and agreement between the state and Australian Governments. Instead this section will highlight the essential elements of such a package and draw out key issues that should be considered in designing a successful overall reform package.

Figure 7.1
THE PATHWAY TO REFORM



Source: Allen Consulting Group, 2011

Specifying taxes to be removed or reduced

Targeting which state taxes are to be removed or reduced is complicated and confused by a profusion of self-interested analysis from many quarters. It would materially advance the public interest to construct a reliable and agreed data base containing evidence about the impact of different state taxes. Decisions about which taxes to concentrate on should be based on this evidence.

The economic modelling results presented in Chapter 4 suggest that the greatest potential benefits would result from the removal of:

- conveyance stamp duty;
- insurance taxes and related fire services levies; and
- developer contributions.

Taxes that require maintenance

Reform is about more than removing or reducing taxes - it is also about how current taxes can be improved. The results presented in chapter 5 suggest that gains can be achieved through:

- harmonisation of payroll tax;
- harmonisation of land tax; and
- other measures.

Specifying funding for change

As discussed in chapters 4 and 5, the growth dividend will be insufficient to fund reform, which means that funding must come from new or increased taxes, either at the Commonwealth or state level. A funding mechanism must be both efficient and acceptable. It is also desirable, where possible, that groups that face new taxes also receive some offsetting benefit from reform through tax cuts in other areas. As such, specifying funding may be dependent on what particular changes are being funded. As discussed in Chapter 6, funding mechanisms that could be considered include:

- a new broad based consumption tax or a cash flow tax;
- an increased, broad based, harmonised payroll tax;
- sharing the personal income tax base and applying a flat rate state surcharge; and
- reduced tax expenditures in other areas.

Setting a timeframe

Setting a timeframe involves two aspects: the order that reforms are implemented and the timing of implementation. Ordering of reforms should be pragmatic and recognise that it is not possible to implement all reforms at once, and that larger benefits can be achieved by reforming the worst taxes first. Setting a timeframe should take into account the time needed by businesses, individuals and regulators to adjust to reforms.

Transition to reform

The discussion in chapter 3 identified some of the important social dimensions of state tax reform and established the importance of addressing these issues at the outset as part of a reform package. These issues can be addressed through two avenues: the use of direct assistance and phasing in new or increased taxes.

Using the growth dividend to offset social implications

The results presented in chapter 6 indicate that funded state tax reform would result in an additional fiscal dividend of approximately $1.7 billion. There is potential to use these funds for income tax cuts and/or direct payments for potentially disadvantaged groups, including low income earners and small business. The design of any compensation package would need to be carefully designed according to the overall impacts of the remainder of the package.

Phase in arrangements

Consideration also needs to be given to how arrangements could be phased in to mitigate any perceived unfairness from changing taxes. For instance, immediately imposing land tax on individuals who have recently purchased property and paid stamp duty can effectively result in these individuals bearing the burden of two taxes.

An overall reform package should consider these dimensions and be designed such that initial impacts on disadvantaged parties are minimised where possible. The transition to reform could be eased using a number of methods, including phasing in new taxes at a specified rate each year or grandfathering arrangements such that new taxes only apply to assets acquired after a given date.

Box 7.1

AN ILLUSTRATIVE PACKAGE

The scenario examined in in section 6.3 provides an illustrative example of which taxes to reform as part of an overall package. The elements of this package include:

1. Remove the worst state taxes, including stamp duty on conveyances, insurance taxes, developer contributions emergency service levies and ACT municipal rates.
2. Improve existing taxes, including payroll tax and land tax by broadening bases and harmonising arrangements across states.
3. Fund the remaining fiscal gap through an efficient, broad based consumption tax (BBCT).

A successful overall package of reform would involve more than the identification of which taxes to reform. For an illustrative package such as this a reform package could also include:

- Using the growth dividend to fund income tax cuts for low-income earners and increased Government assistance payments to offset the potentially regressive impact of a new BBCT.
- Phasing in broadening of the payroll tax and land tax base. For payroll tax the rate applying to small and medium enterprises could be phased in at a rate of 1 per cent each year. Similarly, the rate of land tax could be gradually increased for previously exempt properties.

Source: Allen Consulting Group, 2011

7.3 Staying on track

Any reform process can only be as successful as its implementation and the governance arrangements that underpin the process. Effective governance is particularly important in the state tax reform arena for a number of reasons, including:

- The economic modelling results presented in Chapters 3 to 5 indicate that the potential benefits of reform are very large. Effective governance is needed to ensure that reforms are carried through with and result in real improvements in outcomes.
- As discussed in section 7.1, successful reform requires the co-operation and agreement of both the state and Australian governments. The AFTS Review recommended that the best means of achieving co-ordinated reform is through an intergovernmental agreement (IGA).

Effective governance is not as simple as a mere agreement. Experience with previous reform suggests that more is needed to ensure that forward reform momentum is maintained through the use of appropriate incentives and safeguards. How the reforms are implemented will be a crucial determinant in whether the potential benefits of reform become a reality.

Key lessons from previous intergovernmental reforms

The last major state tax reform in Australian took place in 1999 with the introduction of the GST. The IGA on the Reform of Commonwealth-State Financial Relations required the states to abolish inefficient taxes in return for GST revenue. Further details on the GST IGA can be found in Box 7.1.

Box 7.1

INTRODUCTION OF THE GST

The IGA on the Reforms of Commonwealth-State Financial Relations provided for the revenue from the GST to be paid to the states and territories in return for the abolition of inefficient state taxes. The implementation and operation of the agreement was overseen by a Ministerial Council comprising the Commonwealth, states and territories. As a transitional measure the agreement provided that the budgetary positions of the states would be no worse off than they would have been in the absence of reforms.

The agreement set down a timeline for the abolition of a first tranche of state taxes and provided for a review of the need for the retention of a range of other duties by the Ministerial Council. The states partially fulfilled their commitments by abolishing a first tranche of state taxes by 1 July 2005. In 2006 a schedule was agreed for the abolition of the second tranche of taxes, except for the stamp duty on transfers of non-real business property. However, the states did not meet this schedule and deferred abolition of a number of taxes. A new IGA was reached in 2008, which provided a final timeline for the abolition of all taxes specified in the original agreement by 1 July 2013.

Source: Intergovernmental Agreement on Federal Financial Relations, 1999

The GST reforms are still not complete more than 10 years after the original agreement was reached, with some states yet to abolish stamp duty on non-real business property transfers. This demonstrates the importance of specific, enforceable timetables. An absence of these meant that, although a number of states deferred the abolition of taxes in order to repair their Budget positions, they were able to continue receiving GST revenue.

The experience with the GST also demonstrates the dichotomy that each individual state faces when considering major tax reform. As illustrated by the example in Box 7.2, the benefits of state tax reform accrue primarily to the Australian Government, and intergovernmental grants essentially redistribute any fiscal incentive to reform. In the absence of incentives or penalties under an IGA reform momentum can be lost — states have little reason to embark on reform and even less reason to stick with the reforms.

Box 7.2

TAX REFORM AND INTERGOVERNMENT FISCAL ARRANGEMENTS

If New South Wales implemented independent reforms to grow its economy by 1 per cent, while growth in the other states remains unchanged:

- GST revenue would increase $144 million;
- personal Income Tax revenue by $660 million; and
- payroll tax by $64 million.

The benefits would flow three ways: to NSW, to other states and to the Australian Government. Assuming the GST grant increases in line with the increase in GST, NSW only benefits by $107m from the increase in these three taxes while other states received $101m in increased GST grant and the Australian Government, $660m in personal income tax receipts. Across these three taxes, NSW would therefore receive 12 per cent of the boost to their receipts.

Source: Warren, 2010

The example in Box 7.2 shows why incentives are such an important aspect of an IGA dealing with state tax reform. They are needed firstly to provide an incentive for reform and secondly to prevent the states backsliding and re-introducing taxes similar to those that were abolished.[6] A precedent for the use of incentives can be found in the National Competition Policy (NCP) reforms of the 1990's and early 2000's, which contain some important lessons for successful reform processes.

[6] For example, while NSW has moved to abolish stamp duties on commercial property purchases, it recently introduced a Land Registration Charge imposed at progressive rates on the purchaser of residential and commercial property worth more than $500,000.

Box 7.3

NATIONAL COMPETITION POLICY REFORMS

The National Competition Policy Reforms undertaken throughout the 1990's and early 2000's involved a series of reforms aimed at improving competition in Australian markets. Co-ordinated action across all levels of the Australian Government was facilitated by three IGAs, which comprehensively set out a nationally co-ordinated microeconomic reform policy. The key features of the arrangements included:

- Governments undertook to review all legislation that restricts competition and remove any restrictions which were not shown to provide a net public benefit.
- The Australian Government provided payments to the states for implementing the NCP and related reforms. These payments were conditional on the states making satisfactory progress with the implementation of the reforms.
- The National Competition Council (NCC) reviewed progress and made recommendations to the Commonwealth Treasurer as to whether the states and Territories had met their commitments and should receive payments in full.
- The Commonwealth Treasurer was ultimately responsible for the final decision on the imposition of any penalty.
- States that proceeded with reform and applied principles received full payments. Those that failed to do so received penalties and deductions in payments.

Source: Agreement to Implement the National Competition Policy and Related Reforms, 1995, Productivity Commission, 2005

The NCP reforms are widely regarded as successfully contributing to Australia's growth and productivity (PC, 2005). The NCC itself (2004) attributes several factors to this success, including:

- an agenda agreed by all governments that outlines the reform commitments with a practical degree of specificity;
- an independent body responsible for negotiating, monitoring and reporting on reforms and
- the provision of appropriate incentives, including financial payments.

In a review of the NCP reforms the Productivity Commission (2005) found that the procedural and institutional mechanisms that were used to implement the reforms, in particular the use of payments to leverage the reform process, were highly effective.

Future reforms need to draw on and repeat the successful aspects and improve on the less successful aspects of previous reform implementations. As such, it is useful to isolate the factors that contributed to these successes and failings to inform future reforms. Table 7.1 provides a summary of these factors for both the NCP and GST reforms.

Table 7.1

PAST REFORMS – WHAT WORKED AND WHAT COULD BE IMPROVED?

NCP reforms	GST reforms
What worked?	
• Independent and transparent review processes, with a clear governance framework • Clear timelines • Financial incentives to follow through with reforms • Agreed principles, while still allowing for some flexibility in implementation • Reform task was prioritised, with most important reforms taking place first	• Clear roles and responsibilities for the states and the Commonwealth • Guarantee that states would not be worse off than if reforms were not implemented • Included an obligation that taxes be permanently abolished • Timeline for abolition of the first tranche of taxes
What could be done better?	
• Stronger gatekeeping arrangements to monitor new and amended regulation • Financial incentives to guard against backsliding • Reviews of Commonwealth performance and extension of rewards/penalties to the Commonwealth • Built in flexibility to accelerate change where circumstances permit	• Incentives to reward good performance and penalise bad performance • Specific timeline for removal of the second tranche of taxes • Mechanisms to assess and review performance • Dispute resolution mechanisms • Tax cuts if revenue exceeds expectations

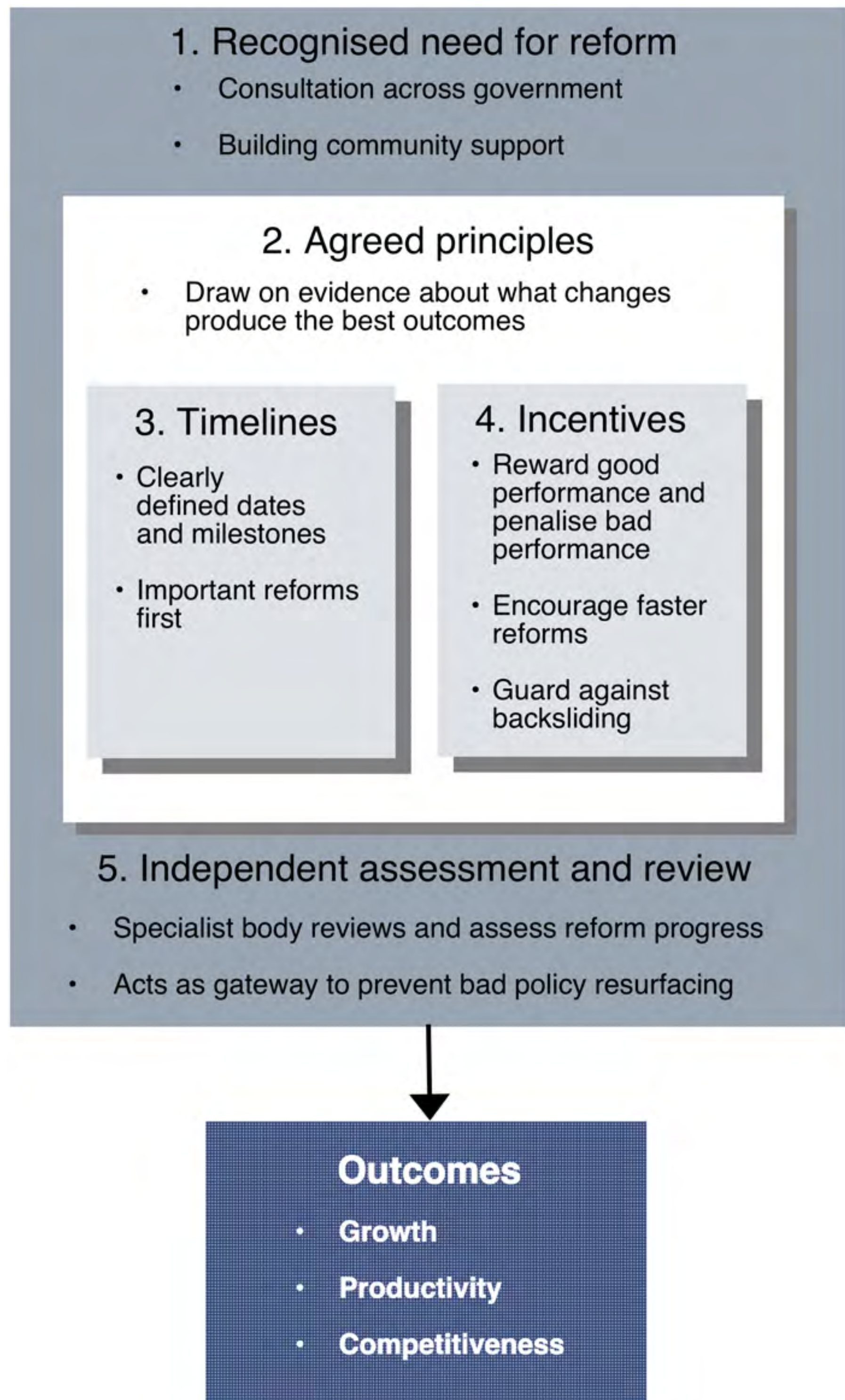
Source: Allen Consulting Group

7.4 An agreement for better state taxes

A map that translates the lessons from previous reforms, as summarised in Table 7.1, into a framework for successful tax reform IGA is set out in Figure 7.2. The key elements of this framework are discussed below.

Figure 7.2

KEY ELEMENTS FOR A SUCCESSFUL REFORM



Source: Allen Consulting Group, 2011

Vision

All parties must recognise and agree on the need for reform and agree on a solid framework on which to build reforms. As discussed in Chapter 1, state tax reform has been on the reform agenda for some time, and numerous reports and reviews across all levels of Government (for example, AFTS 2010a-c and IPART 2008) agree on the need for reform. However, more work is needed in articulating and agreeing on a clear reform vision. This should involve:

- agreement on what the desired outcomes of reforms are;
- raising awareness about the need for co-ordinated reforms across all levels of Government; and
- educating the public about the benefits of reforms and building forward reform momentum.

Setting principles

Once agreement is reached on the need for reform it must be translated into agreed principles and outcomes that will guide the reform process. The process for reaching agreed principles should be based on consultation and inclusive decision-making across all levels of Government, and should draw on evidence, such as that presented in Chapters 2 and 3, as to how change can improve outcomes. While the precise taxes for removal and how these will be funded is a matter for the parties, there are several principles which should underpin the approach. These include:

- Recognition from the parties that better taxes can create better outcomes and a commitment to national reforms.
- An evidence based framework on which to build reforms that will accord with the principles of good tax design: efficiency, simplicity, equity and sustainability.
- A commitment to implementing permanent reforms and implementing review processes to block bad taxes from coming back.
- Reform is a priority and should be implemented as quickly as circumstances allow.
- Reforms will not disadvantage individual states, and should involve appropriate protections to avoid disadvantaging vulnerable groups in the community.

Setting timelines and performance measures

Timelines should be linked to achievable, clearly agreed outputs and outcomes. In setting a timeline, an appropriate balance must be struck between recognising that circumstances may change and different approaches may be taken, while still being clear and precise enough to ensure progress. One means of imposing a specific timeline while still allowing for some flexibility would be to link the timeline to the Australian Government's budget surplus, with reforms required each time the surplus reaches a certain level. This would overcome some of the fiscal restraints discussed in Chapter 1 and speed up the reform process during favourable economic and fiscal circumstances.

An effective timeline should display the following characteristics:

- Clearly defined dates, with flexibility built in to provide for faster progress if circumstances permit.
- Pragmatic ordering of reforms, in accordance with importance, difficulty and potential benefits from each reform.
- Mechanisms to monitor and review progress.

Setting incentives

The interactions of tax reform with intergovernmental fiscal relationships discussed in the previous section suggest that well designed incentives are essential to state tax reform implementation. The Commonwealth should make payments to the states conditional on the satisfactory performance of their obligations. Making these payments conditional on reform progress would give teeth to the reform timeline and ensure that strong forward reform momentum is maintained. The incentives should be designed to:

- Reward good performance and penalise poor performance.
- Encourage reform to happen faster than the agreed timeline by providing additional payments for reforms implemented ahead of time.
- Continue to guard against backsliding once reforms have been completed through the imposition of penalties if bad policies resurface.
- In addition to penalising the states, the Commonwealth should be penalised for poor performance. The Commonwealth could be required to increase its grants to states if it does not meet its obligations.

Assessment and review

Effective accountability is about improving performance, assessing progress and providing guidance. This requires a clear definition of the roles and responsibilities of each level of Government and a framework though which governments are made accountable for implementing reforms through independent assessment and review by an external body. This is essential to ensure that the review process, which may take a number of years, stays true to the agreed principles. There are a number of important features that should be included in the assessment and review process:

- Assessment and review processes should apply to the Commonwealth, as well as to the states.
- An independent body should carry out the assessment and review function. Further detail on possible governance arrangements for this body is set out in section 7.3.

Gatekeeping and future tax policy changes

The assessment and review process should not stop once the reforms have been implemented. A key finding of the Productivity Commission (2005) review of the NCP reforms was that mechanisms to help lock-in the gains of reform should be a central component of any future reform agenda. As such, the assessment and review process should extend beyond the completion of the reforms to ensure that reforms are not unwound through backsliding. This requires effective gatekeeping arrangements. Key feature of these arrangements should include:

- Financial incentives that, in addition to ensuring that reforms are implemented, are oriented towards future reforms by imposing penalties for backsliding.
- Processes to review and enforce the efficacy of new and amended taxation regulations and guard against backsliding.
- An ongoing role for the independent assessment and review body in monitoring and reviewing new and amended legislation or regulation. This is discussed further in section 7.3.

What would the IGA look like?

The principles and elements discussed above would need to be reflected in an IGA between the states and the Commonwealth. Key elements that would need to be included in the IGA to achieve are listed below in Table 7.2.

Table 7.2
AN IGA ON STATE TAX REFORM

Key elements
Preliminaries
Objectives
Agreed principles
Roles and responsibilities of each party
Taxes to be abolished or reformed
Implementation timeline with specific dates for completion and timelines
Funding arrangements
Transitional arrangements (to ensure states are not worse off)
Administrative arrangements
Incentives and penalties
Establishment of independent review body
Review and assessment processes
Processes for ongoing legislation and regulation review

Source: Allen Consulting Group

7.5 A governance framework

Section 7.2 established the key elements needed for a strong state tax reform IGA. This section will examine the next layer of implementation – the body that will sit above the IGA and be charged with responsibility to guide, assess, and report on state tax reform progress. The role and structure of this body will be a central determinant of how the obligations set out in the IGA are actually carried out and thus how successful the reforms are overall.

Independent intergovernmental supervision and accountability

The assessment and review function could potentially be carried out by either the COAG reform council or by an independent authority, similar to the NCC. The nature and functions of the COAG reform council are summarised in Box 7.4.

Box 7.4

THE COAG REFORM COUNCIL

The COAG reform agenda has an overarching objective of improving the wellbeing of Australians now and into the future. This agenda is implemented through National Agreements, National Partnerships and other intergovernmental agreements. The COAG reform council is the key accountability body for the national reform agenda and was established to report directly to COAG on progress in undertaking reforms of national significance. Its objectives are to:

- strengthen accountability through objective and credible monitoring, assessment and reporting of the performance of governments in areas referred by COAG;
- improve the public's ability to evaluate and drive performance in the COAG reform agenda;
- proactively improve COAG's capacity to deliver and develop its reform agenda; and
- be a centre of excellence and creativity on cross-jurisdictional performance monitoring, assessment and reporting.

Source: COAG, 2011

The COAG reform council plays a valuable role in monitoring many important reform processes. However, it is already monitoring a broad, crowded and complex reform agenda. Charging the state tax reform monitoring and assessment role to COAG risks the task being lost amongst a plethora of other reforms and assessments. It would be more appropriate to set up a dedicated, specialised state Tax Reform Council (STRC) to ensure that focus and priority is maintained. The functions of the new body could include:

- conducting independent assessment of implementation progress by the states and the Commonwealth;
- making independent recommendations regarding the provision of payments to the states for satisfactory reform progress;
- making independent reports to COAG regarding the status of implementation and directions for future reforms;
- engaging with the community to provide education about the benefits of reform and build support for the ongoing reform process; and
- assessing the impact of reform on vulnerable sectors of the community and identifying mitigating measures to assist in the transition to reform.

The body would be responsible to all levels of Government through COAG. It would be governed by a board of Commissioners, supported by a secretariat, and would include representation from the Australian and state and territory governments party to the agreement.

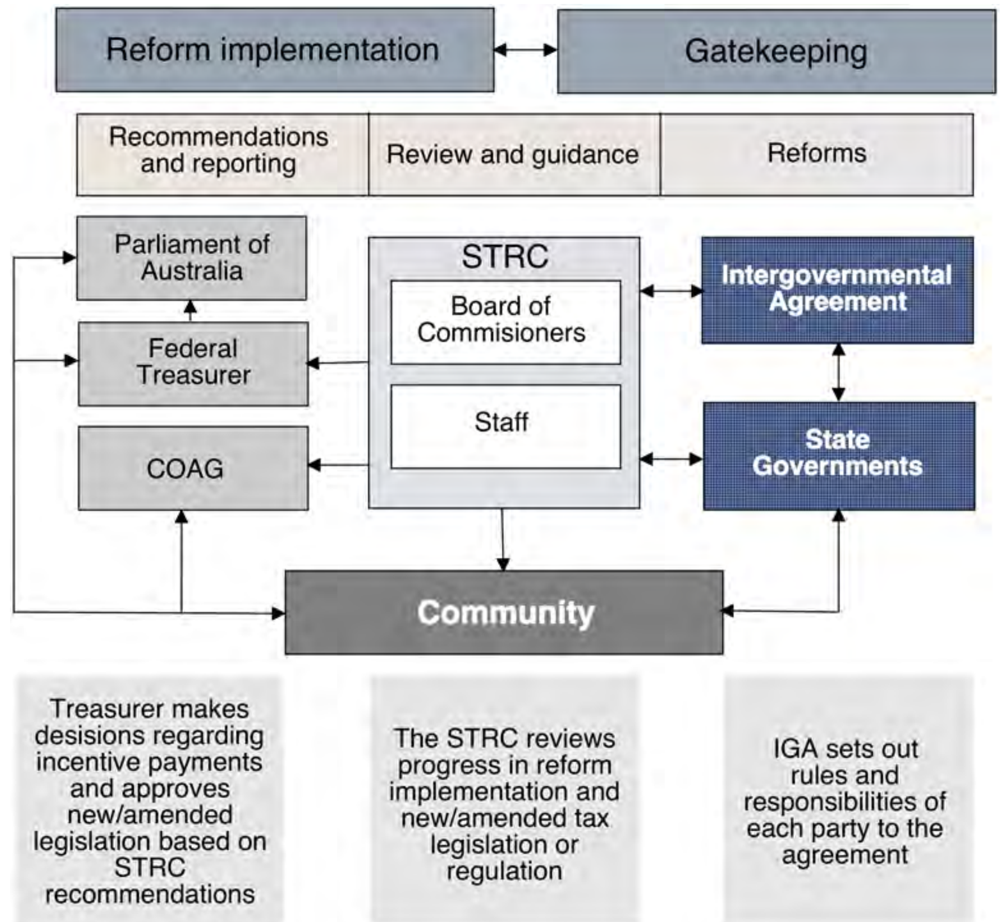
The role of gatekeeper in review of future tax changes

In addition to overseeing the implementation of reforms, the STRC should have an ongoing role as a 'gatekeeper' in reviewing future tax changes to ensure that bad taxes do not re-emerge. A key finding of the Productivity Commission's review of the NCP reforms was that arrangements whereby the states essentially acted as their own gatekeepers and reviewed their own legislation were not strong enough. As such, to ensure that reforms are locked in, the STRC could review all new and amended regulations and make recommendations regarding the imposition of penalties.

Figure 7.3 illustrates the possible structure of the STRC and how it would carry out its functions in both reform implementation and gatekeeping.

Figure 7.3

A GOVERNANCE FRAMEWORK



Source: Allen Consulting Group, 2011

Costs of good governance

While necessary for effective implementation, a governance framework is not without its own costs. It is expected that the size and structure of the STRC would be similar to that of the NCC. As such the costs of funding the body would likely be comparable to those incurred funding the NCC, which were in the order of $3 to $4 million annually throughout the NCP reform period. As a national reform body, the costs of funding the STRC should be borne by the Commonwealth. The states may also incur some additional administrative costs in reporting reform progress and submitting new or amended legislation to the STRC for review.

Key points

Despite the general view that state tax reform is needed, substantive state tax reform has stalled.

Although there are gains to be made, reform is challenging.

States face impediments to making substantive changes. Where they act independently, they may not have the resources to go through with substantial reform.

Experience has shown the dangers of states competing in a race to the bottom.

The only real, sustainable solution is a coordinated reform agenda with a broad package. This package should be designed to:

- *reform state taxes which will result in the largest economic benefits;*
- *be fully funded;*
- *where possible, enhance the efficiency of existing taxes;*
- *use the fiscal dividend to neutralise any potential disadvantage;*
- *reduce overall compliance costs of the system;*
- *phase in the introduction of new or broadened taxes to ease the transition to reform;*
- *prioritise reforms which will result in the largest benefits; and*
- *provide scope for further longer term reforms to happen in the future when fiscal circumstances allow.*

An overall package of reform must be backed up by a strong framework to implement and maintain the reforms. The states do not have sufficient fiscal incentive to implement tax reforms unilaterally – co-operation and agreement of both the Australian and state governments is needed.

An intergovernmental agreement to reform inefficient state taxes should include certain key elements, including:

- *clear timelines and measureable outcomes;*

- *financial incentives to carry through with reforms;*
- *measures to guard against backsliding; and*
- *independent review and assessment.*

An independent body should be set up to ensure that the reform agenda is stuck to. This body would have two functions: firstly, it would review, assess and enforce reform progress and secondly, it would act as a 'gatekeeper' to ensure that reforms are permanent and that bad tax policies are kept at bay in the future.

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