

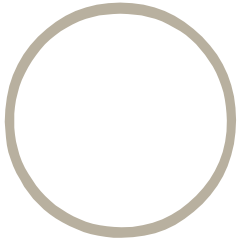


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State business tax reform

Seeding the tax reform debate



Prepared for

Business Coalition for Tax Reform (BCTR)



*Centre for International Economics
Canberra & Sydney*

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Summary

It is evident that the need for substantive and strategic tax reform is an issue of increasing importance. This need does not arise because of a lack of change in taxation policy. In fact, the opposite is the case. Tax rules are not a static edifice. They have been evolving over time reflecting incremental, piecemeal and often ad hoc responses to pressures and apparent opportunities. The result, however, is far from beneficial. Business leaders have flagged that Australia's business sector is being increasingly weighed down by a tax system which is inefficient, overly complex and levies too many taxes for little return.

State taxation, especially those taxes that impact upon the conduct of business, and the broader issue of Federal and State government finances, are key areas where there are significant problems in current arrangements. States and Territories (hereafter 'States') currently rely on a large number of taxes that include many of the worst available. Complexity in the tax mix raises costs for little or no budget revenue gain given the small scale of many of these taxes. Jurisdictional differences in how the States apply the same tax splits Australia into sub-scale markets, reducing efficiency and competitiveness.

This discussion paper reviews the major issues raised about State taxes, especially issues that matter to business. It looks at how tax reform has occurred in the past and what lessons can be learnt from this. The discussion paper also explores how taxes compare against the principles of good tax design. The study then shows what changes could be pursued within a strategic approach to tax reform. There is little point in assessing how things could be different unless it is also shown that the change is worth pursuing. Hence, the study reports on detailed economywide analysis of alternative State business tax reform scenarios. Part of this analysis specifically examines the capacity for change within the Australian and State government budgets.

The State tax base

State taxes are probably less well known than the taxes applied by the Australian Government. While the amount raised is smaller than those of the Australian Government, State taxes are still substantial. Some \$49 billion is raised in tax revenue each year by State governments. This is collected through a number of taxes applied over a wide range of goods, services and transactions. It is not straightforward to

count the number of taxes applied by State governments. Estimates range between 25 and 36 different taxes. The simple fact that there are a large number of State taxes introduces complexities for business.

Payroll taxes are the largest tax revenue source for State governments. This is followed by stamp duties on property conveyances and land taxes.

There are many asymmetries in the State tax system. There are a small number of State taxes that raise a relatively large amount of tax revenue. Meanwhile, there are a large number of taxes that raise only a small amount of revenue. While State taxes form a relatively small proportion of total general government revenue (budget revenue in all levels of government), they are a major part of the revenue raised by State governments.

Several key problems are identified with the current approach to State taxes as they are:

- *Unreliable and unpredictable* – the States are becoming increasingly reliant on volatile and unpredictable taxes for a large share of their own source revenues. Volatility in the revenue base is problematic for fiscal management and is a key risk to achieving budget targets.
- *High in compliance costs* – the reporting, assessment and compliance requirements of many taxes impose high costs on business. Australian firms have indicated that large resources are required to meet and comply with the multitude of State taxes. These costs are magnified for those firms operating in more than one jurisdiction.
- *Distortionary and inefficient* – State taxes involve high deadweight losses that weigh down the broader economy. Broad based taxes which have the potential to be efficient – such as land and payroll – have had their bases eroded over time through the granting of concessions and exemptions.
- *Non-neutral* – State taxes are applied unequally to different goods, transactions, household types and business practices which is unfair and also linked to distortions discussed above.
- *Harmful to Australia's competitiveness* – many of the States taxes are 'origin' taxes. These taxes are levied throughout the production process, and this adds to the costs of Australian produced goods and services. Exports and those goods which compete with imported products suffer a disadvantage as their foreign competitors go untaxed.
- *Less accountable* – State taxes lack transparency. By taxing intermediaries, both the extent of State taxation and its incidence is masked from the community. This reduces the States' accountability for their fiscal decisions. Complicated State-Federal fiscal arrangements further detract from government accountability by blurring expenditure and taxation responsibilities.

Lessons from tax reform in Australia

Many formal review processes have been undertaken in response to the challenges of the State tax base. As a result, taxes have continually changed. Many formal review processes undertook obligatory review, discussion and negotiation stages. In some cases, reform has taken some time to be implemented, more than two decades in the case of the Asprey Committee proposals (Fong 2005). Governments have sometimes been selective about what they have adopted from reviews. In any case, there has also been a high level of background incremental change as governments apply ad hoc solutions to apparent problems of the day.

Significant change was achieved with the introduction of the Goods and Services Tax (GST). In exchange for obtaining all of the GST revenue raised by the Australian Government, the States agreed to eliminate ten inefficient State taxes. While sound in theory, the implementation suffered from some problems. A key drawback in the initial agreement was that it did not include a specific timeline for the abolition of all the agreed State taxes. As a result, while States have obtained a guaranteed revenue source (that has often exceeded the revenue from the taxes they had agreed to abolish), more than 10 years has elapsed and the States have still not yet abolished all of the taxes included in the Intergovernmental Agreement (IGA).

The States have partly implemented their commitments by abolishing a first tranche of State taxes by 1 July 2005 (accommodation tax, financial institution duty, quoted marketable securities duty, and debits tax). Then in 2006, the Australian Government reached agreement with all States on a schedule for the abolition of the remaining State taxes in the IGA. However, this does not deliver the final tax reform agreements until 2011. Further, it does not provide a date for the removal of stamp duty on conveyances of real non-residential property (Australian Government 2007b). Clearly this is a case of reform delayed.

Analysis of previous tax reform initiatives and reviews shows us that:

- successful tax reform needs to have clear, achievable aims and should focus on outcomes, not just shuffling taxes;
- fixed timelines for the fulfilment of agreements are essential to successful tax reform;
- a 'package' approach to tax reform works better than small, incremental reforms; and
- successful tax reform requires effective implementation and cooperation of both Australian and State governments.

Important lessons can also be drawn from successful reforms in other areas of policy. An example of such a reform is the National Competition Policy (NCP) that aimed to enhance competition in Australia. Cooperation between the Australian and State governments is a central part of these reforms which often touched many different

areas of economic and social life. Some of the factors that made the NCP a successful reform program are that:

- the NCP had a clear mission- to enhance competition in Australia- and outlined definitive actions;
- as part of the NCP, the Australian Government provided payments to the States for implementing NCP reforms. These payments were conditional on the States achieving satisfactory progress with the implementation of the reforms; and
- an independent body reviewed governments' progress in implementing the NCP reforms and advised the Australian Treasurer on whether the States have achieved satisfactory progress and so met the conditions for receipt of payment.

The experience with NCP points to a number of lessons with potential relevance to any future nationally coordinated reform agenda. Some of these lessons are:

- new arrangements have to be conditional, rewarding performance and penalising poor performance. Penalties for non-achievement/delay provide the right incentives for the fulfilment of agreements;
- reform should include measures to guard against backsliding (for instance imposing financial penalties);
- independent review of performance is important for successful reform; and
- reform should include processes for monitoring the new arrangements ('gate-keeping' arrangements) to prevent bad policies from resurfacing.

The next round of business tax reform

Further tax reform in Australia is necessary, and recent events make this a good time to undertake it: the Australian and State governments are showing a willingness to engage in the Council of Australian Government (COAG) forum for dialogue and cooperation; the recent Australia 2020 Summit called for a 'root and branch' tax reform; a Senate Select Committee has recently concluded an inquiry on State Government Financial Management; and a comprehensive review of Australia's tax system has been commissioned (the Henry review of Australia's tax system). In particular, the timely arrival of the Henry review of Australia's tax system and the Senate Committee provide a platform for businesses to raise their views on State taxes and an opportunity to persuade governments to commit to a new wave of State business tax reform.

Given that there is agreement for a substantive reform process and engagement of the Australian and State governments, what specifically should be changed about State taxes? Would greater adherence to what governments already know about the principles of good tax design be of assistance? These principles are straightforward. Broadly, it is agreed that a tax should be efficient, equitable, robust, cost effective and neutral.

In practice, determining how well taxes perform against these criteria is inconclusive and remains open to debate in many key areas. Moreover, whenever assessed thoroughly by independent researchers, studies show consistently that no tax performs well against all criteria. There is no perfect tax. What application of the principles does show is that individually, State taxes can be improved considerably and most analysts provide reasonable suggestions for improving individual taxes. Generally, this involves broadening the base and lowering the rate of a tax. But such assessments will typically reveal only very little about what can be done to improve State tax systems in their entirety.

A more strategic approach points to the following reform elements:

- Little can be achieved with incremental adjustments in specific taxes on a tax-by-tax basis. A strategic approach must involve changes to a portfolio directed at shaping key outcomes.
- Reform of significant scale is needed – change of roughly \$10 billion and up to \$20 billion is required.
- Reflecting many binding constraints, State tax reform has to be revenue, expenditure and debt neutral.
- Federal-State cooperation is essential. The Australian Government has access to the better tax bases to replace poor State taxes. State cooperation is also required to improve the contribution that can be made from the State taxes that are efficient and to maintain and preserve efficient revenue sources.

Large gains from State tax reform

Three *illustrative* tax reform scenarios were constructed in a BCTR workshop. These scenarios show the effects of portfolios of investment in tax reform and were designed to assess what can be achieved through strategic tax reform.

The change scenarios alter a mixture of taxes with the intent of:

- raising growth (change scenario 1);
- raising competitiveness (change scenario 2); and
- maximising State tax reform (change scenario 3).

Changes in specific taxes in each scenario are less important than the overall point of the scenario. The design of change scenarios 1 and 2 were guided by a benchmarking exercise that highlighted how reform could generate the greatest impact on economic growth and investment respectively. Effectively ‘poor’ State taxes are replaced in the scenarios with ‘better’ Federal taxes – without any change to the overall level of government revenues.

By simply substituting State revenues for Federal revenues, the Australian Government shoulders most of the burden of tax reform. This places a natural limit

on how much reform can be pursued in scenarios 1 and 2. In change scenario 3, an effort is made to share the burden of reform between the Australian and State governments. By sharing the costs of reform, this constraint is somewhat relaxed, and greater reform can be pursued. Change scenario 3 illustrates how a cooperative approach to tax reform can produce even greater gains for the community at large.

Table 1 summarises the tax reform scenarios.

1 BCTR proposed State tax reform scenarios

<i>Change scenario</i>	<i>Objective</i>	<i>Source of funds</i>	<i>Proposed tax changes (cost of reforms)</i>
1	Raise growth	Australian Government (\$10 billion).	<ul style="list-style-type: none"> ▪ Reduce stamp duties on residential and non-residential property (\$7.5 billion). ▪ Remove insurance duties (\$2.5 billion). Total change: \$10 billion.
2	Enhance international competitiveness	Australian Government (\$10 billion).	<ul style="list-style-type: none"> ▪ Remove stamp duties on commercial property (\$4.0 billion). ▪ Remove land tax (\$4.4 billion). ▪ Reduce payroll tax (\$1.7 billion). Total change: \$10 billion.
3	Maximise elimination of the worst State taxes	Australian Government (\$8.6 billion). State contribution via a broad State tax (\$8.6 billion).	<ul style="list-style-type: none"> ▪ Remove stamp duties on residential and non-residential property (\$12.5 billion). ▪ Remove insurance duties (\$2.5 billion). ▪ Reduce land tax (\$2.2 billion). Total change: \$17.3 billion.

Note: Assumes that stamp duties on financial transactions and non-real non-residential property are removed according to the IGA timetable.

Source: BCTR workshop.

The study evaluates the difference that the proposed tax reform scenarios would make to economic outcomes using a detailed economywide model of the Australian economy. The key points are as follows.

- Shifting the composition of tax from high economic cost State taxes to lower cost Australia-wide taxes is forecast to produce improvements in many key economic outcomes.
- Adopting a portfolio of tax changes that concentrate upon removing and reducing those State taxes that introduce distortions would lift economic activity. As illustrated in scenario 1, with an initial transfer of taxes between the Australian and State governments of around \$10 billion, the analysis shows that GDP is higher by 0.6 per cent in the long term. This translates to a gain of 45 cents of economic activity for every dollar of tax change in the long term.
- Alternatively, it is feasible to adopt a portfolio of tax changes that concentrates reform on those State taxes that impact upon investment, raise Australia’s competitiveness and attract additional investment. Investment under this scenario

(scenario 2) is projected to be 1.6 per cent higher than without reform. In dollar terms, this means that investment is higher by 43 cents for every dollar of tax change in the long term.

- Notably, the impact of reform is similar with scenarios 1 and 2 where the thrust of reform is to remove State taxes that are generally among the worst whatever economic goal is being pursued. Output and competitiveness are higher under all of the scenarios examined. This reflects the fact that taxes that are poor in terms of one indicator of performance are generally equally poor in other indicators.
- Pursuit of more reform results in greater benefits. The most extensive reform scenario (scenario 3), involving the abolition of stamp duties on insurance, residential and non-residential property, and reduction in land tax, is projected to raise long run GDP by 1.7 per cent per year. This is equivalent to \$34 billion (in 2005-06 prices) across the Australian economy in 2030. For each dollar of change, this scenario provides an additional 81 cents in economic activity in the long term.
- The analysis demonstrates that the economy gains more than proportionally with bigger reform. By increasing the initial size of the reform from \$10 billion (as in the case of scenario 1) to \$17 billion (as in the case of scenario 3), the long term boost to GDP increases from 0.6 per cent to 1.7 per cent.

The analysis provides evidence that Australia would be better off with better taxes. Specifically, the biggest gain to the overall Australian economy is achieved by replacing the most inefficient taxes with the most efficient taxes.

This of course does not mean that *everyone* obtains a tax cut. That is not practical. It is also not necessary. The analysis shows that business and the community can become better off even if the overall size of the tax burden remains the same where there is *no* net change to how much tax the community actually pays. Rather, the community is made better off because the change scenarios reduce the inefficiencies of the tax system. And, as a result, business profitability improves which leads to greater economic activity, higher wages and more investment. This effect is magnified with larger scale reforms.

Importantly, the analysis has deliberately assessed the reforms in isolation of other policy changes. That is, the modelling is undertaken in a conservative manner which focuses on the impacts of switching the tax mix (by replacing inefficient State taxes with more efficient Australia-wide taxes) while keeping the overall fiscal policy unchanged (by maintaining budget neutrality).

Again, the scenarios are illustrative and it is assumed that the reforms are funded through a change in the tax mix. In practice, other options are available and the State tax reform may incorporate some finer subtleties. For example, the Australian Government may choose to fund part of the reform through:

- increasing the budget deficit (or in other circumstances, reducing budget surpluses);

- by phasing in the reform agenda over a period of time; or
- by making use of other financial arrangements that will help to mitigate the transitional costs of reform.

These variations are not included in the analysis. It is likely that the pursuit of arrangements would improve outcomes rather than detract from them.

Fiscal impacts

Economically beneficial State tax reform involves having greater reliance on the better tax base accessible to the Australian Government. A key requirement then is that the Australian Government collects taxes and provides additional grants to the States. While this involves a seemingly straightforward increase in Australian Government taxes matching tax reductions by the States, in practice allowances will have to be made for changes in tax collections as the underlying economy grows and other changes occur in the background.

At the time of writing this discussion paper (March 2009) major changes in fiscal policy settings were announced. These changes were made by the Australian Government as part of concerted efforts to stimulate domestic demand and strengthen the Australian economy in the face of the global economic crisis. The two fiscal stimulus packages announced by the Australian Government involve additional expenditure of \$52.4 billion.

There are also signs of a general deterioration in fiscal conditions and budget balances both at State and Federal levels. The underlying cash balances of four States have changed from surplus to deficits and the Australian Government's *Updated Economic and Fiscal Outlook* also indicates that the 2008-09 budget has been revised from a \$21.7 billion surplus to a \$22.5 billion deficit. This reflects part of the cost of the Government's targeted fiscal stimulus packages, as well as revenue reductions and the working of 'automatic stabilisers' in line with weakening economic conditions.

While at face value this increasing economic adversity may appear as a barrier to fiscal reform, the global economic downturn provides an opportunity to push through fundamental macroeconomic reforms, especially now that the difficulties in relying upon volatile and unreliable State government taxes are so apparent.

Given their current fiscal position, State governments cannot eliminate inefficient taxes without going into further deficit or having to reduce expenditure. Hence cooperation between the Australian Government and the States is needed to undertake State tax reform.

The Australian Government does not have to go into further deficit to offset lost revenue if States eliminate inefficient taxes. Indeed, the economic analysis in this

report shows that economic activity in Australia can be lifted by just shifting the composition of taxes from high economic cost State taxes to lower cost Australia-wide taxes, without changing the overall level of tax revenues or changing how much tax the community actually pays.

1 *This report*

The CIE was commissioned by the Business Coalition for Tax Reform (BCTR) to prepare this discussion paper.

The ultimate objective of the discussion paper is to seed the policy debate and harvest a commitment to a new round of reform of State business tax reform by governments. The study also aims to:

- identify lessons about what has worked and what does not work in tax reform;
- revive awareness about the fundamental reasons for tax reform – that we would be better off with better taxes;
- turn the message away from a topic that has been more comfortable for governments recently, which is the idea that reform should concentrate on merely improving or streamlining administrative arrangements; and
- highlight that substantive changes are feasible – that there is substantive fiscal capacity now and into the future.

The terms of reference for the discussion paper are outlined in box 1.1.

1.1 **Scope of this discussion paper**

The CIE was asked to:

- assess previous State and Federal business-related tax reform plans including an assessment of their successes and shortcomings. This should provide answers to the key question ‘what lessons can we learn from previous initiatives?’;
- analyse tax reform scenarios;
- analysis should examine fiscal dimensions as well as impacts upon the wider economy taking into account of the medium to long term economic dividends that would balance out short term losses to tax revenue;
- provide an assessment of the true fiscal capacity of jurisdictions to conduct substantial reform; and
- provide an assessment of key issues to be considered in developing a reform agenda suitable for implementation over the next two Federal parliamentary terms (the 42nd and 43rd Parliaments).

Source: The BCTR.

The focus of this analysis is upon taxes that influence business outcomes. Essentially, the study aims to concentrate on the impact that taxes have upon the size and composition of economic activity, and the size and efficiency of the economy.

There are some omissions in the scope of this study. One is that special transaction taxes, such as the excise taxes levied by the Australian Government on petroleum, alcohol and tobacco products and taxes on gambling levied by the States, are not examined. While there are good economic efficiency reasons for levying special transaction taxes on activities which generate external costs on third parties, current excise taxes and taxes on gambling are not well designed for these market failure correction roles (Freebairn 2005). Most special transaction taxes also involve a significant balancing of social objectives with the objective of raising funds for government. Analysis of how to best strike this balance is outside of the scope of this study.

The study also does not delve into the potential to adjust non-tax sources of State government own source revenue such as explicit user charges and dividends and other revenue from government business enterprises. While these areas are sometimes identified by non-government analysts (Freebairn 2005) as being available to change instead of making the harder decisions in taxation, it seems likely that the regular reviews conducted by governments and managers of these businesses would pick up whatever scope there is for additional revenue raising potential in these areas if it was in fact available in practice.

Reform objectives of the BCTR

The Business Council for Tax Reform is a forum that brings together the views of the business community on tax reform issues. BCTR members share a desire to provide a unified approach to building a better taxation system that:

...enhances both international and domestic business competitiveness and fairness and which assists in creating a business climate conducive to investment, growth, job creation and private saving (BCTR 2008a).

The BCTR members believe that Australia should continuously aim for an optimal tax system. To this end, the BCTR promotes 10 principles for Australia's tax system. These principles are outlined in box 1.2.

1.2 The BCTR's 10 tax principles for Australia's taxation system

- The tax system should be simple, transparent and should minimise uncertainty.
- The design, administration and operation of the tax system should be undertaken with full and effective consultation with relevant stakeholders including the business community.
- The tax system should fairly balance the need to protect the taxation revenue base with the principles of a good tax system, ie efficiency, fairness (horizontal and vertical equity), simplicity, clarity, certainty and low compliance costs.
- The tax system should enhance competitiveness by providing a climate conducive to improved investment in Australia and from Australia for Australian-based entities and individuals.
- Indirect taxation at the State level should be more efficient and competitive.
- The pattern of Federal/State financial relations should be transparent, efficient and sustainable.
- The tax treatment for savings should be consistent with an overall savings policy that encourages the sustainability of strong, ongoing growth.
- The tax, and social security, treatment of personal income and fringe benefits should conform to the principles of fairness, efficiency and simplicity.
- The tax system should avoid the double taxation of business income and provide relief for all business expenses.
- The tax system should not impede organisational restructuring.

Source: BCTR website, www.bctr.org, accessed 1 October 2008.

Report structure

The remainder of this report is set out as follows:

- chapter 2 provides an overview of State taxes and the State tax mix;
- chapter 3 highlights the major concerns and criticisms of State taxes;
- chapter 4 sets out the policy context for State tax reform in Australia, and highlights the key tax reforms to date;
- chapter 5 assesses the major taxes against standard principles of good tax design;
- chapter 6 discusses a more strategic approach to guide business tax reform, and measures the performance of State taxes against key benchmarks;
- chapter 7 outlines three tax reform scenarios proposed by the BCTR, and measures the performance of these scenarios using an economywide model; and

- chapter 8 shows the fiscal capacity of the Federal and State governments in undertaking the proposed tax reforms.

2 *State taxes in context*

Much of the contemporary public debate about Australian taxes tends to concentrate on the larger taxes applied by the Australian Government. It is possible that this is because there is a lower level of familiarity with State taxes across the community. This chapter provides an overview of State taxes, their magnitude and relative importance as a source of revenue to enable the business of government.

What is taxed by the States?

A recent Australian Government review counts 25 different taxes applied by State governments (Australian Government 2008d).¹ The *Interstate Comparison of Taxes* compiled each year by the New South Wales Treasury lists 36 different tax categories in the table of contents (NSW Treasury 2007). Following a nationwide survey of major businesses, a report compiled for the Business Council of Australia (BCA) identified a total of 56 business taxes – 33 of which were levied by the States (BCA and CTA 2007). Clearly, there are differences in views about State taxes and their number.

Some of the problems in obtaining consistency in estimates of the number of taxes may arise because of different views about what is a tax and other activities of government that raise revenue. Some of these issues are discussed in box 2.1.

Taking a broad view, the main categories of activities subject to State government taxation are:

- employers payroll and labour force;
- property (particularly land);
- financial and capital transactions (especially stamp duties on conveyances);
- the provision of goods and services (excise and levies, and gambling taxes);
- insurance taxes;
- use of goods and performance of activities (especially stamp duties on motor vehicle registration);

¹ A detailed description of State taxes is available in table 2.18 of the report by the Henry Review of Australia's tax system '*Architecture of Australia's tax and transfer system*', August 2008.

- franchises; and
- others.

2.1 What is a tax?

Taxes have many names. Some are simply called a 'tax', others a 'stamp duty' and others are 'levies', to name just a few titles. Sometimes people in the community argue that prices charged for government services are so high that they are really a tax. What about licence fees and the other mechanisms that governments have for collecting money, are they also really taxes?

The international economic 'bible,' the *System of National Accounts (SNA)*, defines taxes to be compulsory, unrequited payments, in cash or in kind, made by institutional units to government units. They are described as 'unrequited' because the government is not obliged to provide anything specific in return to the individual making the payment, although governments may use the funds raised in taxes to provide goods or services to other units, either individually or collectively, or to the community as a whole (United Nations 1993).²

In the *Australian System of Government Finance Statistics: Concepts, Sources and Methods* (ABS 2005), the ABS provides the following definition of tax which also builds on the SNA approach.

A tax is a compulsory levy imposed by the government, mainly to raise revenue. There is usually no clear and direct link between the payment of taxes and the provision of particular goods and services by government. Taxes are levied, inter alia, on income, wealth, production, sales and/or use of goods and services and the performance of activities.

Governments may regulate certain activities by issuing licences for which fees are payable. If the issue of such licences involves little or no work by the government then the revenue raised is deemed to be taxation revenue. However, if the government uses the issue of licences to exercise some proper regulatory function, such as checking the competency or qualifications of a would-be licensee, then the revenue raised is deemed not to be taxation revenue, but revenue from the sale of services by government unless it is clearly out of all proportion to the costs of providing the services.

(continued next page)

² The 1993 System of National Accounts is a comprehensive, consistent and flexible set of macroeconomic accounts to meet the needs of government and private-sector analysts, policy-makers, and decisions-takers. It was prepared jointly by the International Monetary Fund, the European Union, the Organization for Economic Co-operation and Development, the United Nations, and the World Bank. These five organisations constitute the Inter-Secretariat Working Group on National Accounts (ISWGNA) that has been mandated by the Statistical Commission of the United Nations to oversee international coordination in the development of national accounts.

2.1 What is a tax? (continued)

The first paragraph states that a levy is a tax is when there is no clear and direct link between the payment of the levy and the provision of goods and services for the payer. Under this definition, fire services levy imposed on insurance companies is a tax. This is because there is no link between the money paid by the tax payers (insurance companies) and the fire brigade services provided by the government, which is enjoyed by everyone.

The second paragraph states that if the levy paid for the goods or services of the government is much higher than the cost of providing the goods or services, then the levy is considered a tax. Under this definition, a stamp duty – a levy paid to obtain a stamp from the government – is a tax because the duty is higher than the cost. For instance, stamp duty is around \$20 000 for a median house in Sydney (REIA 2008), which is expected to be much higher than the cost of providing the stamping services.

Levies that are not considered as tax will appear as non-tax items, such as royalties, fines, fees and charges, under the government finance statistics. Developer charges collected by the governments on new properties for the purpose of developing facilities (such as libraries and parks) will be non-tax items, as the money collected is for specific uses (infrastructure provision) and benefits the people paying for the tax. Mining royalties are included as non-tax revenue also, as they are a form of land rent relating to the use of non-produced assets such as deposits of minerals or fossil fuel.

Source: United Nations 1993, REIA 2008, ABS 2005.

In 2006-07, the State governments collected \$49 billion tax revenue. Chart 2.2 shows the amount of revenue collected by the main tax categories.

The largest source of State taxes is taxes on financial and capital transactions, raising about \$14.6 billion (30 per cent of all State taxes). Most of the revenue in this category is collected from stamp duties on conveyances, such as transfer of real estate, business and other property. This category also includes some taxes, such as stamp duties on marketable securities and mortgages, which will be withdrawn soon. Nonetheless, these soon-to-be abolished taxes are fairly small, raising a total of about \$2 billion.

Payroll taxes represent the second largest source of State tax revenue. This tax raised \$14.4 billion (29 per cent of all State taxes) in 2006-07. While taxes on financial and capital transactions are made up a several taxes, payroll tax is a single-sourced tax.

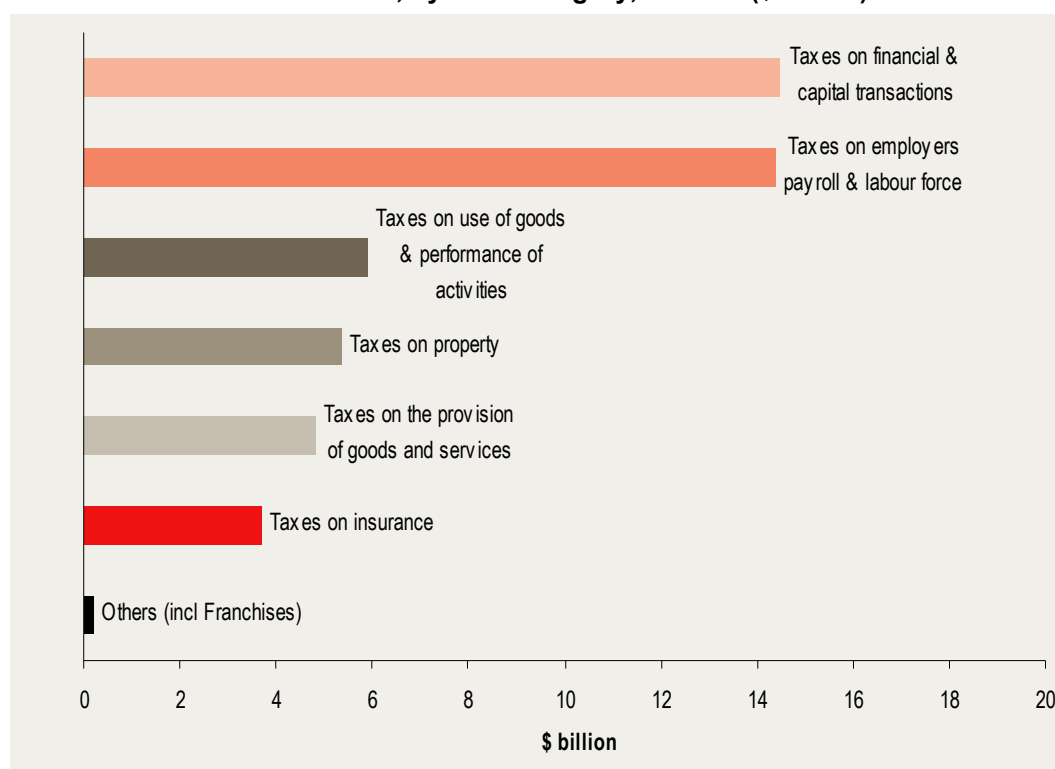
Taxes on use of goods and performance of activities raised almost \$6 billion revenue (12 per cent of all State taxes). This category consists of stamp duties on vehicle registration, motor vehicle weight tax and registration fees.

Other important revenue sources are taxes on property (which is largely land taxes) and taxes on the provision of goods and services (which is largely accounted by gambling taxes). These taxes raised \$5.4 billion (11 per cent of all State taxes) and \$4.8 billion (10 per cent of all State taxes) respectively.

Total tax revenues raised from taxes on insurance in 2006-07 was \$3.7 billion (8 per cent of all State taxes). The majority of this revenue was collected from stamp duty on insurance, with the rest of the revenue raised from insurance companies' contributions to fire brigades and third party insurance taxes.

Lastly, franchise taxes and other taxes (such as broadcasting fees) make up a relatively small proportion of State taxes.

2.2 Revenue from State taxes, by main category, 2006-07 (\$ billion)



Data source: ABS Cat No. 5506.

Generally speaking, State tax regimes are characterised by a small number of taxes that raise a relatively large amount of revenue and a large number of taxes that raise relatively small amounts. Among the individual taxes, the top two taxes were payroll tax and stamp duty on conveyances, which raised \$14.4 billion and \$13 billion respectively. These two taxes account for more than 56 per cent of all State taxes.

In contrast, the rest of the individual State taxes raised less than \$5 billion each. In fact, given that there are more than 20 State taxes (as mentioned earlier, the exact numbers of State taxes is unclear), this implies that the average size of the remaining 18 taxes is less than \$1.2 million.

Most State taxes are transaction-based taxes. Indeed, all stamp duties (including properties, motor vehicle and financial transactions) are transaction-based taxes. Under these, tax is only payable when particular transactions occur. This has broad ranging implications for the stability of State tax revenues. These implications are discussed later.

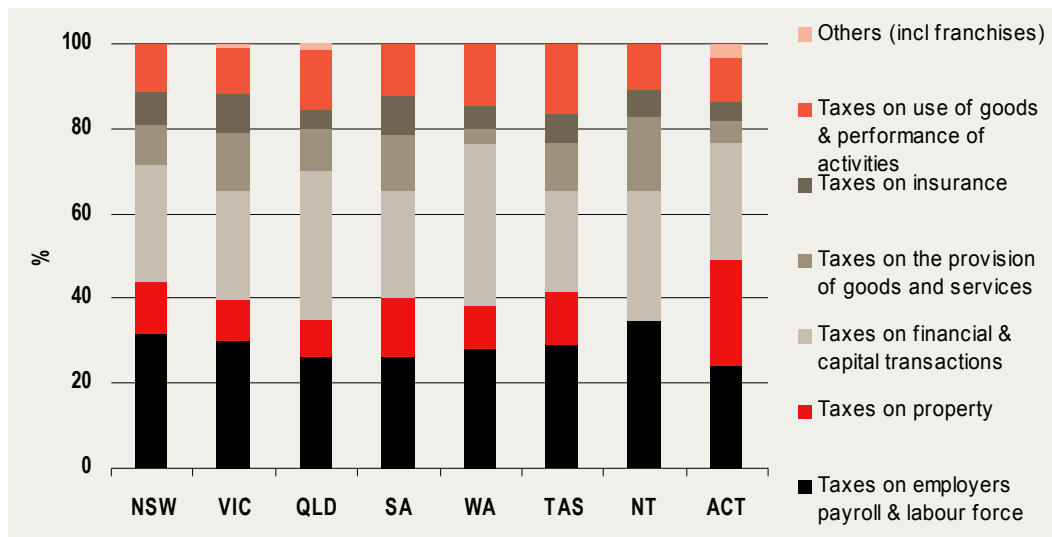
There are a few levies that are ownership-based taxes. These are mainly land taxes and municipal rates (ownership of land) and motor vehicle weight tax (ownership of motor vehicles). Some smaller taxes, such as franchise fees and broadcasting licence fees, could be considered as ownership-based taxes – taxes on the ownership of licences required to undertake certain business activities (PC 1998).

Finally, payroll tax is the only tax on income (or labour force).

Interstate tax differences

The Australian States are sovereign governments. They can and do take policy decisions about taxes to suit their needs. States face different economic circumstances and challenges. As a result there are significant differences in the tax revenue mix between the States. A breakdown of taxes in each State is provided in chart 2.3 (the amounts collected under each tax in each State is detailed in appendix A).

2.3 Mix of State taxes, by State, 2006-07 (proportion of each State tax revenue)



Data source: ABS Cat. No.5506.

A key consistency in the tax mix of the States is the importance of payroll tax and taxes on financial and capital transactions. Together these are the most significant source of revenue in all States.

The differences in the tax mix arise from the fact that not all States apply the same taxes. For instance, the Northern Territory does not levy any tax on property, and

Western Australia does not levy any duties in life insurance policies (NSW Treasury 2007).

Further, some States apply unique taxes. In South Australia, South Australia Water customers pay a 'Save the River Murray Levy,' which is used to fund projects to improve the long term health of the River Murray. In New South Wales (NSW), Victoria and Tasmania, the fire brigades are funded through taxes on insurance companies.

Another factor contributing to the differences in the tax mix is the fact that the tax mix in each State is evolving. Historically, the larger States have generally been the first to abolish older, less efficient taxes (PC 1998). For instance, NSW abolished debits tax in 2002, while the other States abolished the tax in 2005 (Australian Government 2008d).

Interstate competition has resulted in differences between how the States apply each tax. An example of this is payroll tax. Payroll tax rates differ in each State, ranging from 4.75 per cent in Queensland to 6.85 per cent in the Australian Capital Territory (ACT). Additionally, each State allows for different tax-free thresholds, exemptions and concessions for small business. Consequently, Australia does not have *a* payroll tax system, but rather it has *eight* payroll tax systems.

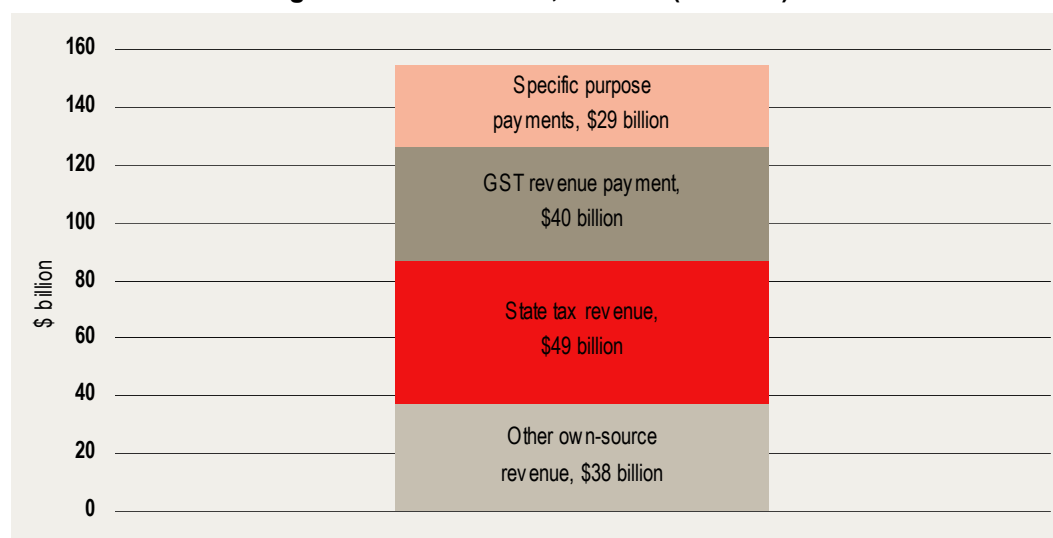
Interstate tax differences make State taxes a complicated affair. These differences are a major source of the compliance burden facing Australian businesses. This and other problems raised by complexity are discussed in chapter 3.

State taxes and other revenue

It is important to place the revenue raised from State taxes in context. The functions of government and therefore the expenditure requirements of the State governments and other governments in Australia are largely shaped by the Constitution. While developed in an earlier age this reflects, to some extent, the contemporary principle of *subsidiarity* – that is, that decisions should be taken as close as possible to the citizens by the lowest level of government possible. Under these arrangements the States have, and will continue to have, significant expenditure responsibilities (Australian Government 2008d).

The States need sustainable sources of revenue to fund their expenditure and provide the functions they are expected to meet. While a substantial amount of funds are raised from State government taxes, this is still short of the amount of funds required to operate the services provided by the States. The chart below summarises the overall sources of State government revenue.

2.4 Sources of State government revenue, 2006-07 (\$ billion)



Data source: ABS Cat. No.5506, Budget paper No.3 2007-08.

The chart above shows that the States raised around \$49 billion in taxes and \$36 billion in other own-source revenue in 2006-07. These combined sources represented around 55 per cent of the States' total revenue in that year. The remainder consists of transfers from the Australian Government.

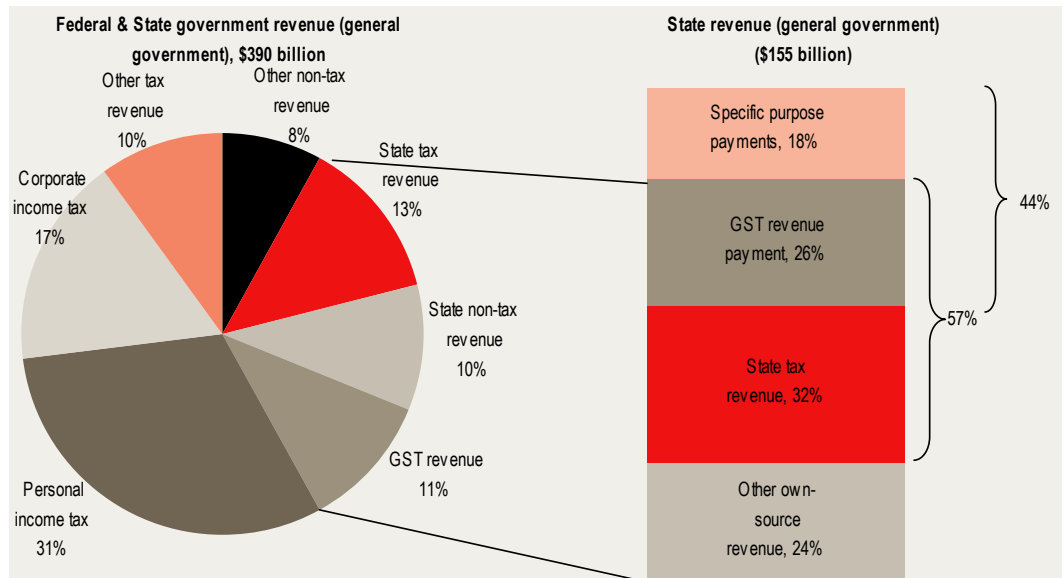
The States are reliant upon transfers they obtain from the Australian Government. In addition to their own revenue sources, the States received around \$40 billion in GST revenue from the Australian Government in 2006-07. The GST is an Australian Government tax, which was introduced through an agreement between the Australian Government and the States (the *Intergovernmental Agreement on the Reforms of Commonwealth-State Financial Relations*, IGA). Under the agreement, all the revenues raised by the GST would be provided to the States in exchange for the removal of a range of inefficient State taxes, the removal of revenue replacement payments (originally levied in place of franchise fees) and the loss of financial assistance grants. The Australian Government distributes the GST to the States as an untied grant based on the principle of *Horizontal Fiscal Equalisation* (HFE), which takes into account the relative revenue raising capacity and expenditure needs of each of the States (Australian Government 2008d).

The States also received \$29 billion in *Specific Purpose Payments* (SPPs) from the Australian Government. These are payments provided to the States to deliver specific policy outcomes in areas that are administered by the States. It should be noted that these payments are currently being reviewed by the Council of Australian Governments (COAG) (Australian Government 2008d).

There are asymmetries in the relative magnitude of State taxes. State taxes are a relatively small part of revenue raised by government at large (the general government or budget sector), accounting for 13 per cent of total general government

revenue (chart 2.5). Meanwhile, State taxes are a large proportion of the State governments' own source (accounting for 32 per cent).

2.5 Composition of Federal and State general government revenue, 2006-07 (per cent of revenue)

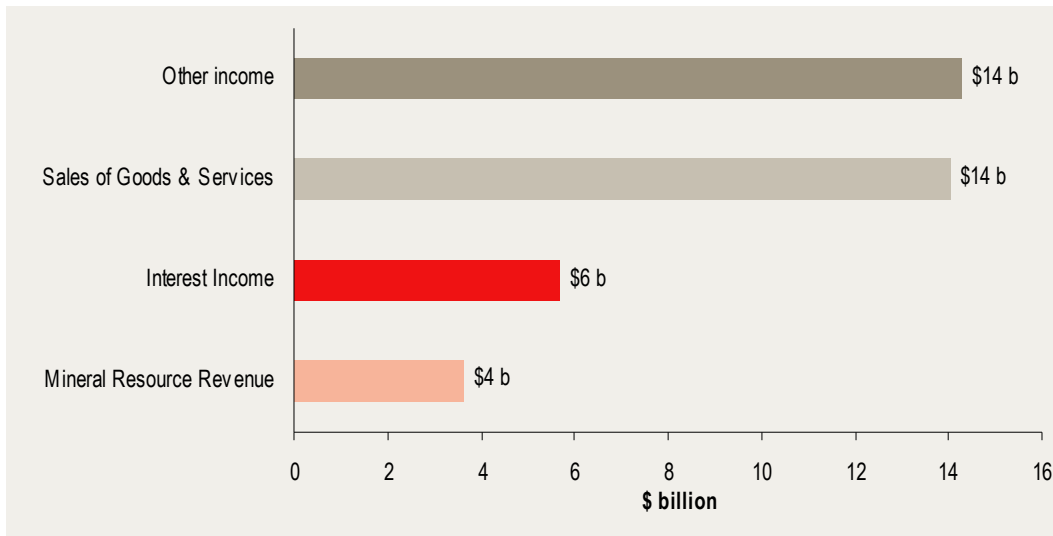


Data source: ABS Cat No. 5512, 5506 and Australian Government 2007b.

Classification of the GST revenue results in dramatic swings in the overall picture. If GST is counted as a State tax (given that all of the proceeds are given to the States) this would raise taxes to around 57 per cent of State revenue. If the GST is treated as a grant, grants would account for around 44 per cent of revenue (chart 2.5).

Finally, the remaining State revenue is sourced from other avenues such as mining royalties, developer chargers, traffic fines, sales of goods and services and investment income (chart 2.6).

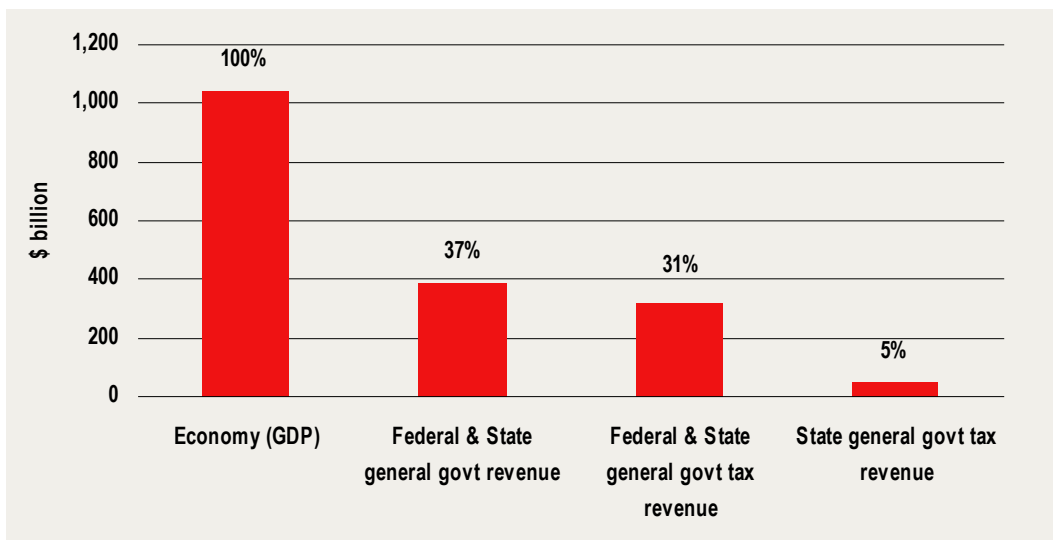
2.6 State non-tax revenue, 2006-07 (\$ billion)



Data source: ABS Cat No. 5512.

Another perspective on the relative magnitude of State taxes is to view them as a share of economic output (GDP). In 2006-07, total general government revenue collection (tax and non tax revenue) was \$390 billion, equivalent to 37 per cent of GDP (chart 2.7). Most of the revenue is collected by the Australian Government, with income taxes (both personal and corporate) comprising almost half of total revenue. At \$49 billion, State taxes are equivalent to around 5 per cent of GDP.

2.7 Size of State taxes relative to size of the economy, 2006-07(\$ billion)



Data source: ABS Cat No. 5512, 5506 and 5204.

Key points

- State governments collect some \$49 billion in tax revenue each year. This is collected through a number of taxes applied over a wide range of goods, services and transactions. It is not straightforward to count the number of taxes applied by State governments. Estimates range between 25 and 36 different taxes. The large number of taxes introduces complexities.
- Payroll taxes are the largest tax revenue source for State governments. This is followed by stamp duties on conveyances and land taxes.
- There are many asymmetries in the State tax system.
- There are a small number of State taxes that raise a relatively large amount of tax revenue. Meanwhile, there are a large number of relatively small taxes.
- While State taxes form a relatively small proportion of total general government revenue (budget revenue in all levels of government), they are a major part of the revenue that State governments obtain.

3 *Key problems with State taxes*

Evaluations of State taxes have been conducted by a number of State governments (most recently by IPART on behalf of the NSW government, and by the Victorian and Western Australian Governments), business organisations (including the Business Council of Australia and the Business Coalition for Tax Reform) and others (including the Productivity Commission and the Centre for Independent Studies). Consistently, these evaluations highlight the same set of key problems.

Generally speaking, evaluations of State taxes have labelled State taxes as:

- unreliable and unpredictable;
- high in compliance costs;
- distortionary and inefficient;
- harmful to Australia's competitiveness;
- non-neutral (that is, they are applied unequally to different goods, transactions, household types and business practices); and
- less accountable.

This chapter discusses the nature and extent of each of these concerns in turn.

Unreliable source of revenue

Taxes finance the business of government and so it is a matter of central importance for governments that their taxes raise the amount of funds that is needed. A fundamental problem with many State taxes however, is that they are unreliable sources of revenue.

The States have been voicing their concerns about revenue volatility for some years. For instance, in their 2000-01 Budget, the NSW Treasury (NSW Government 2000, p. 1-3) expressed the difficulties that a volatile tax base posed to budget management:

Some of [NSW's] major revenue sources can be subject to extreme volatility whereas the cost of service delivery is not significantly affected by such factors.

In Victoria, similar concerns have been raised with specific regard to property taxes. The Victorian Department of Treasury and Finance (VIC DTF 2008, p. 48) identified volatility in the property market as a major risk to the State's budget positions:

...some State taxes, such as duty on land transfer, are sourced from tax bases which are particularly volatile and revenue from these sources is subject to substantial annual variation.

And in South Australia, the South Australia Department of Treasury (SA Treasury 2008, p. 7.1) has noted how the adverse impacts of a volatile tax base are amplified for smaller regional economies:

Fluctuations in economic activity are typically more volatile in a small regional economy than at the national level. This heightens the risk of State taxation revenues exceeding or falling short of budget forecasts, particularly at turning points in the economic cycle.

Not all State taxes are equally volatile. Charts 3.1 and 3.2 plot changes in revenue collected in NSW from broad and narrow tax bases, as well as changes in Gross State Product (GSP).

3.1 Change in revenue of selected broad based taxes and GSP, NSW (per cent)

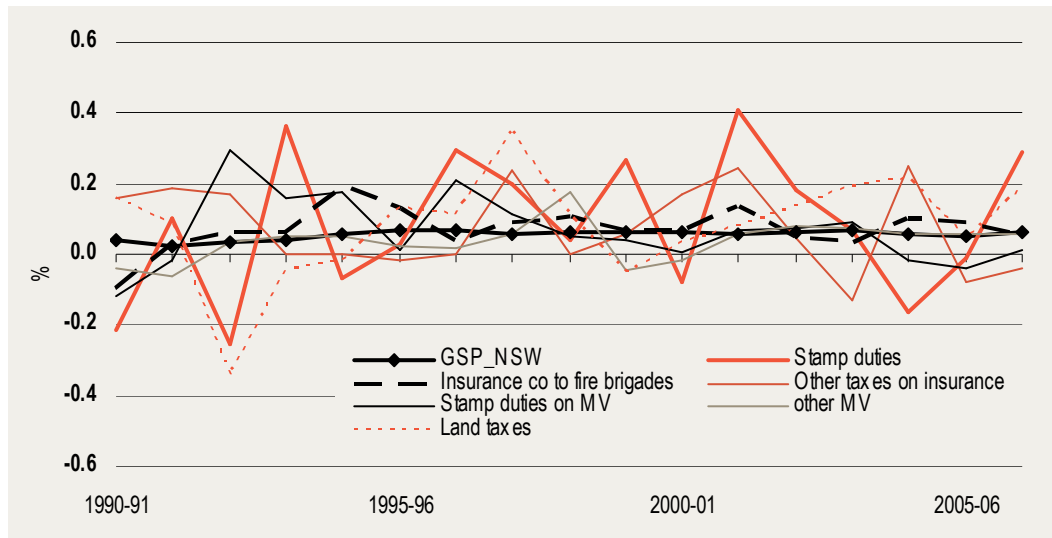


Note that the chart has not identified changes in NSW tax policies (such as changing rates of taxation or the introduction of the GST). The GST is a tax collected by the Australian Government on behalf of the States.

Data source: CIE estimates based on ABS data.

Clearly the group of taxes plotted in chart 3.1 are as broadly volatile as GSP. Meanwhile those in chart 3.2 are highly volatile and the changes are much more violent than changes in GSP.

3.2 Change in revenue of selected narrow based taxes and GSP, NSW (per cent)



Note that the chart has not identified changes in NSW tax policies (such as changing rates of taxation or the introduction of the GST).

Data source: CIE estimates based on ABS data.

The key underlying difference in these two groups of taxes is that those in chart 3.1 are broad based taxes while those in the more volatile chart 3.2 are taxes applied to a narrow base.³ Note that land taxes have not been included as a 'broad' based tax because of the exemptions which limits their breath in practice. A tax with a broad base is subject to less volatility. Taxes with a narrow base are more volatile.

When revenues grow as fast as the economy, then the government can be assured that it will have the resources to carry out its functions without having to constantly raise rates or seek new sources of revenues (NSW Tax Task Force 1988). In general, taxes on broad bases – such as payroll – provide this stability. These tax bases have the additional benefit in that they are also highly predictable (IPART 2008).

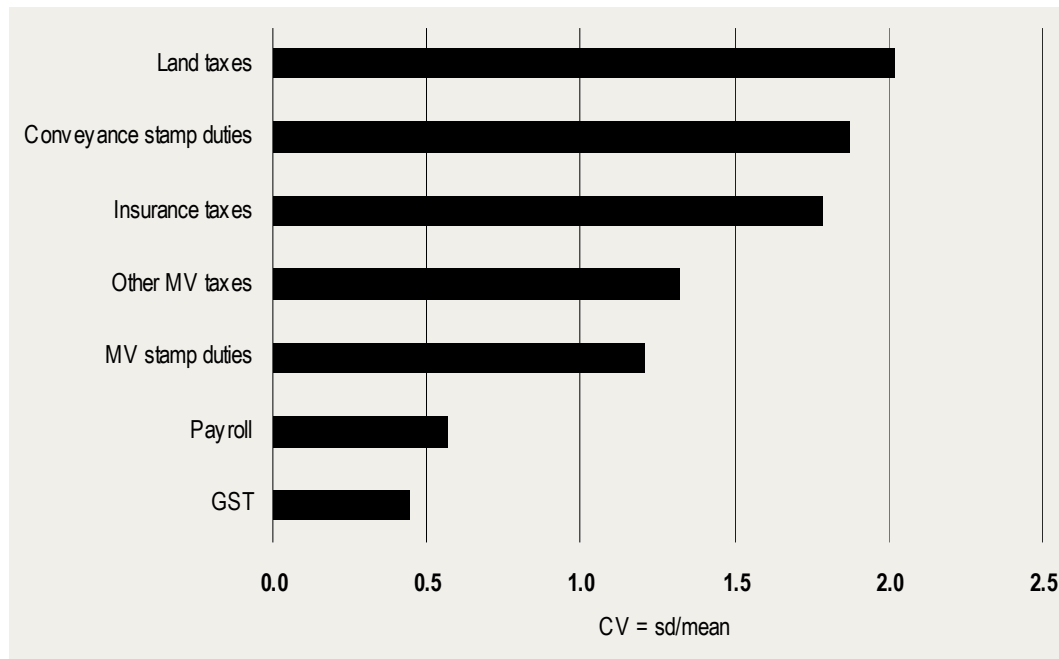
In contrast, volatile taxes are by their nature, difficult to forecast. Unlike broader based taxes, which are generally closely aligned with movements in GSP, it is not uncommon for narrow based taxes to be either pro-cyclical, counter-cyclical or unrelated to State economic conditions. For example, revenues collected from stamp duties on conveyances follow fluctuations in both the level of house prices and volume of house sales – not necessarily the broader economy. These fluctuations tend to disrupt budget management (IPART 2008).

The extent of variance in State revenue is revealed by the Coefficient of Variation (CV) for each revenue source. The CV is a relative measure of variance, taking the ratio of the standard deviation to the mean. The higher the CV, the more variable tax revenue has been. The CV can be used to compare the degree of variation from one

³ 'Broad' and 'narrow' based taxes are discussed in more detail later in this chapter.

data series with another, even if the means are drastically different from each other. Chart 3.3 shows the CV for major State taxes using NSW taxes as an example. Other States have similar patterns of variation. From the chart, the two taxes on property have the greatest degree of variance of all the tax bases. The stability of broader tax bases is evident from the low CVs of the GST and payroll tax.

3.3 Variance in growth of tax revenue collection, NSW: coefficient of variation

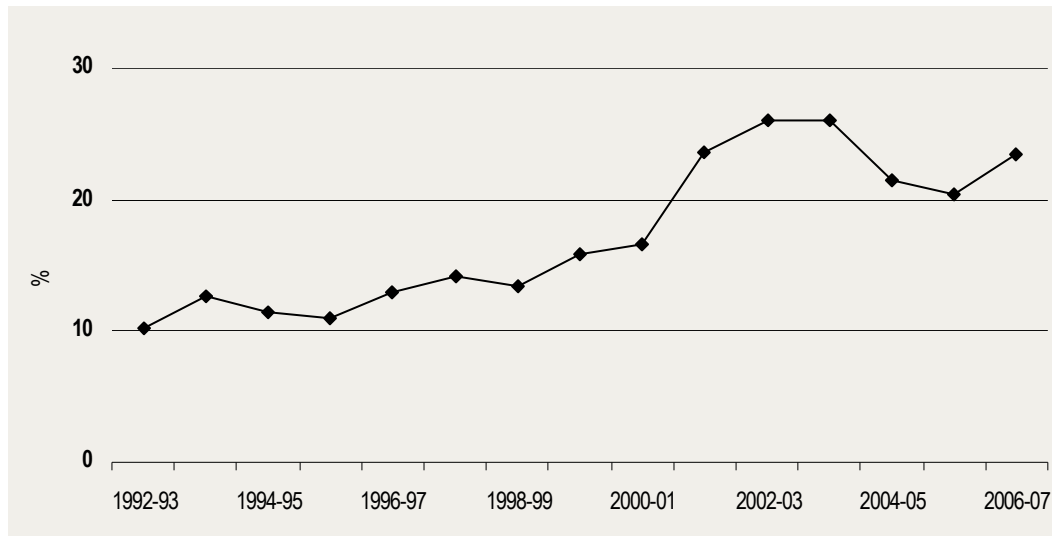


Note: CV = standard deviation / mean. Data is sourced from the period 1990-91 to 2006-07.

Data source: CIE estimates based on ABS data.

The States have become increasingly dependent on highly variable revenue sources for a substantial component of their revenue needs (WA DTF 2006). The proportion of revenues raised from relatively volatile tax bases has increased significantly over the past decade and a half. For instance, chart 3.4 plots the proportion of NSW revenues collected by one of the most variable taxes, stamp duties on conveyances, since 1992-93. In 1992-93 only 10 per cent of State revenues were collected from stamp duties on conveyances. Within just a decade this figure had more than doubled, peaking at 26 per cent in 2003-04. In their recent review of the Western Australia tax structure, the Western Australia Department of Treasury and Finance (WA DTF) also acknowledged the rapid growth in conveyance duty revenues – despite government efforts to wind back these increases (WA DTF 2007).

3.4 NSW stamp duties on conveyances (proportion of NSW tax revenue)



Data source: ABS Cat. No. 5506.

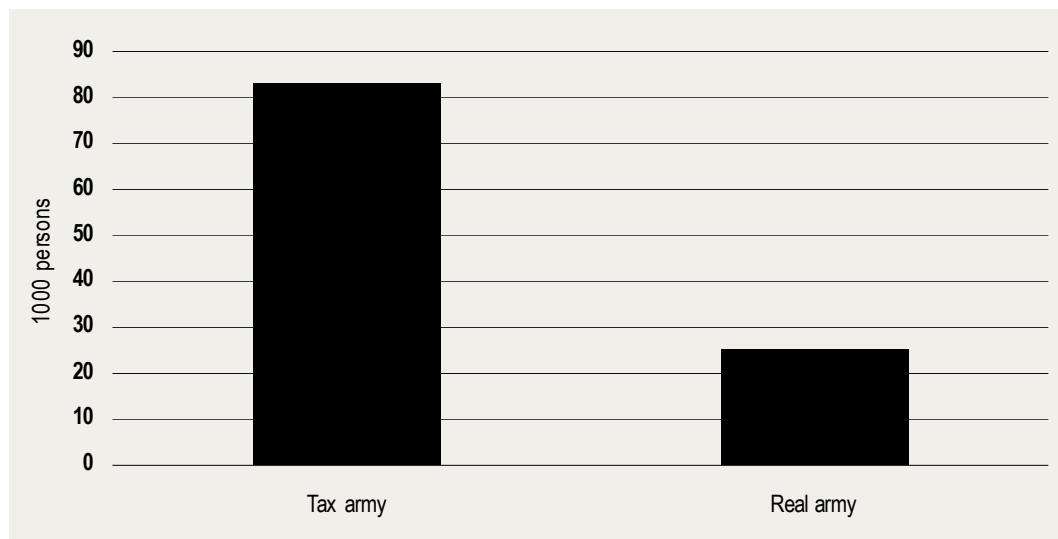
High cost tax base

Tax collection unavoidably requires time, effort and resources from both the public and private sector. These resources reflect the operating costs necessary to raise revenues. The Business Council of Australia (2007), Western Australia DTF (2007) and others (such as the Small Business Development Corporation 2005 and CPA Australia 2005) have commented that the reporting, assessment and compliance requirements of Australia's tax system add considerably to the costs of doing business. Both the Victorian and the Western Australia Treasury reviews of State taxes highlighted the high administration costs of some State taxes as well (VIC DTF 2001; WA DTF 2006).

Robson (2005) provides some perspective on the amount of resources the economy devotes to tax collection by comparing Australia's 'tax army' with the size of its 'real army' (that is, permanent Australian Army forces). The tax army is approximated using estimates of the number of accountants, tax specialists, tax lawyers and tax officials employed in the economy.⁴ Australia's real army is outnumbered by this tax army more than three times over (see chart 3.5).

⁴ Robson's methodology follows a similar study completed for the US by Vedder (2004).

3.5 Australia's 'tax' and real armies ('000 persons)



Data source: Robson (2005).

The costs of tax collection include both:

- the administration and enforcement costs borne by the public sector; and
- the compliance costs borne by the private sector in fulfilling their tax liabilities.

High administration costs detract from a tax's efficiency. For a given revenue target, the greater the administration costs, the greater the amount of taxes that will be needed to extract from the private sector. The Australian Treasury⁵ estimates that administration costs of Australia's tax system amount to 1.2 per cent of all revenues collected – this is higher than the OECD average of 1.1 per cent, and more than twice that of the US at 0.5 per cent. A discussion of administrations costs is provided in box 3.6, and the remainder of this section focuses on compliance costs.

⁵ The Australian, '2020 push to tax overhaul' posted April 19, 2008, <http://www.theaustralian.news.com.au/story/0,25197,23563505-601,00.html>

3.6 Administration costs

Administration costs are the costs borne by the public sector when collecting its taxes. These costs act as an efficiency loss in the collection of revenues, and high administration costs can substantially increase the amount of revenues that must be extracted from the private sector.

The Victorian DTF identified the following major factors that affect administrations costs (VIC DTF 2001):

- collecting revenues, including processing assessments and returns;
- the provision of education and providing advisory services; and
- enforcement.

Similar to compliance costs, those taxes with a narrow base will also generally have lower administration costs. Payroll taxes, the GST, land taxes and stamp duties are collected from a broad base of many individuals and firms. Although the liability assessment of these taxes is conducted by the private sector, State governments are unlikely to avoid the accompanying requests for information and advice.

The administration costs of land taxes are particularly high. In most States, land taxes are individually assessed by a State valuation office. Using this method to estimate an individual's liability can incur significant costs.

Source: VIC DTF (2001).

Compliance costs comprise of both the monetary and non-monetary costs. They are incurred when a business or individual (Australian Government 2007a):

- acquires the necessary knowledge of the relevant aspects of the tax system;
- compiles records;
- acquires and maintains tax accounting systems, and compiles tax return forms;
- evaluates the tax effectiveness of alternative transactions or compliance measures; and
- collects and remits taxes levied on employers and/or turnover.

Compliance costs can be significant and should not be underestimated. Few Australian studies exist that directly attempt to measure the compliance costs of specific State taxes. A recent Treasury study (Australian Government 2007a) however, estimated that the average annual compliance cost incurred by a small to medium enterprise was around \$US 8 922 (for the entire Australian tax system). This figure was below an unweighted OECD average of around \$US 12 000, but well above the figure for New Zealand of \$US 3 700. Indicatively, estimates of the compliance costs of the major Australian Government taxes (personal income tax,

company income tax and the GST) are generally found to be between 2 and 10 per cent of their respective revenue yields, and add up to as much as 2.5 per cent of GDP (Evans 2003).

Relatively speaking, the compliance burden borne by small business is likely to be even higher. Typically, small businesses are less likely than larger businesses to have ready access to expert taxation advice to deal with compliance and administration burdens of the tax system. The costs of the compliance are therefore likely to fall disproportionately onto this sector (SBDC 2005).

Compliance costs increase with a tax's complexity. Taxes which are 'simple' and 'transparent' are generally likely to impose lower compliance costs and therein minimise the waste of productive resources involved in transferring resources from the private sector to the public sector (IPART 2008). The Victorian DTF identified the following major factors that affect compliance costs (VIC DTF 2001):

- the complexity of calculating tax liabilities (for example the complexity of thresholds, deductions and exemptions);
- the lack of clarity in legislation requiring external, third party expertise and advice;
- the degree of interstate harmonisation; and
- the extent of record keeping required beyond normal management and accounting needs.

Those taxes which are directly calculated and levied by government agencies – such as taxes relating to motor vehicles – have low compliance costs. Liabilities are assessed by the government which then bills the liable entities with that assessment. A similar case exists for the collection of insurance duties, wherein registered insurers and brokers assess and collect liabilities on behalf of the government. In these cases, narrow tax bases have the advantage over broad bases when compliance and collection costs are borne by just a few actors. Even if a tax's compliance cost is small for the individual, when aggregated across the economy, compliance costs of broad based taxes can sum to substantial amounts.

In an aggregate sense, the compliance burden among the major State taxes (payroll tax, land tax, conveyance duty and the GST) however, is generally high because of their diffuse revenue bases. The sum of individual compliance effort is likely to be large. Notably, measures have already been taken by all the States to remove complexities from these taxes, and indeed this is evident in their current form. For example, in all States but Queensland, payroll taxes are levied over a single (but uncommon) rate, and a single (again uncommon) threshold. Efforts have also been made across the jurisdictions to harmonise payroll tax arrangements and reduce the compliance costs of firms that operate across borders (more information about these arrangements is presented in the next chapter).

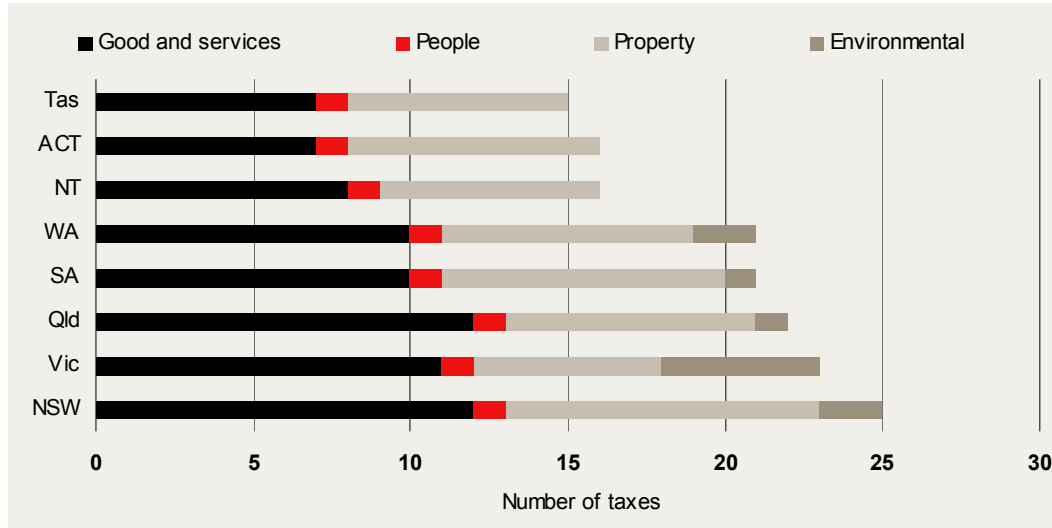
Notably, IPART’s (2008) assessment of NSW State taxes comment that while *prima facie* land taxes in NSW are a ‘simple tax’, they are complicated by their application. The extent of exemptions, the indexing of the tax free thresholds, the use of a three year average of land value, and the definition of the ‘unit’ to which the tax applies, reduce land tax simplicity.

One business, 161 State taxes

The complexities of many State taxes impose high compliance costs on the business community. These complexities and costs are magnified when businesses operate in several jurisdictions, and can be a major hindrance to business expansion.

A business operating in just one State or Territory might be required to navigate through more than 15 business taxes (BCA and CTA 2007). The potential number of taxes a company might face when operating in multiple jurisdictions increases rapidly. The Business Council of Australia calculates the total number of individual State business taxes at 161. This is in addition to the 21 business taxes levied at the Australian Government level. Chart 3.7 breaks down business taxes by their number and nature for each jurisdiction.

3.7 Australia’s business tax landscape by State (number of taxes)



Note: This chart reports only the *number* of business taxes levied in each State. It does not reflect the cumulative or relative burden of each State’s tax regime, nor the degree to which businesses are taxed in each jurisdiction.
 Data source: BCA and CTA (2007).

Of course, not all businesses are subject to all taxing points, but the BCA’s survey did reveal that, on average, their members conducted operations in six States and Territories (BCA and CTA 2007).

The complexities of State taxes demand an intimate knowledge of liabilities and compliance requirements. Across jurisdictional lines, taxes are likely to differ in regard to more than just rates and thresholds. In the tax’s specifics – such as

definitions, deductible allowances, administration requirements – is where the greatest compliance burden of multiple jurisdictions is mostly likely to accrue. For example, on payroll tax Carling (2006) writes:

Definitions of the payroll tax base and methods of collection vary among the States. These differences serve no competitive purpose but add to the complexity and compliance costs for the many firms that pay payroll tax in more than one State.

Box 3.8 provides an example of the inconsistencies in the different jurisdictions' treatment of payroll tax.

3.8 Payroll taxes and jurisdictional inconsistencies

The Australian Government transferred the then national payroll tax system to the States in 1971. Under the control of the Australian Government, payroll tax arrangements were uniform across all jurisdictions.

Since then, the States have amended their payroll tax arrangements to cater to their respective needs and demands. As a consequence, State payroll tax arrangements differ in each jurisdiction with regard to:

- tax rates;
- thresholds;
- administration (such as monthly payment date);
- definition of wages (such as treatment of employee share schemes);
- contractor provisions;
- treatment of fringe benefits;
- exemptions for charities;
- exemptions for provision of motor vehicles and accommodation; and
- grouping provisions.

These inconsistencies impose additional compliance costs on businesses that are required to meet payroll tax obligations in a number of jurisdictions (WA DTF 2007).

It should be noted that in 2007 Victoria and NSW introduced harmonised payroll tax legislation and administrative arrangements. These arrangements have been designed to simplify tax complexities and reduce red tape (NSW Government 2008a). Other States have also announced their intentions to harmonise payroll tax arrangements from 1 July 2008 (NSW Government 2008a).

Source: WA DTF (2007), NSW Government (2008).

Distortions and broader economic losses

All taxes naturally distort the market, and therefore all taxes will impact on economic wellbeing in some way. It is also true that some taxes collect revenues with lower distortions than others. The problem is that the group of taxes that the States rely upon are widely viewed as adding the largest distortions.

Discussion of distortions and attributes of taxes often places the debate on a technical plane. A key point that is sometimes lost is how a tax's 'footprint' tramples on the economy and the community at large. Box 3.9 reviews relative prices, distortions and the deadweight losses of taxes.

3.9 Distortions and the deadweight loss of taxation

Relative prices influence the everyday decisions made by consumers and firms over which goods to buy, in what to invest, and how their businesses run. When taxes change relative prices, this distorts the incentives which guide decisions. Taxes drive a wedge between the prices that suppliers wish to receive for their output, and the prices consumers are willing to pay for these products. Because of these wedges, agents are induced to conduct alternative exchanges which, do not create as much wealth, and are not as mutually beneficial.

The unexploited gains from trade and exchange are the deadweight loss of a tax. The size of a tax's deadweight loss is magnified when taxes are levied on narrow and specific bases (PC 1998). Levying a tax on a specific item (such as an apple) distorts more relative prices, than would levying the tax on a class of products (such as food) or factor input (such as labour).

An estimate of the deadweight loss of payroll tax in Australia is of the magnitude of 12 per cent of revenues collected (PC 1998). This implies that for each \$1 of revenue collected, private sector's wealth is reduced by an estimated \$1.12 (including \$1 transferred to the government, and \$0.12 lost to inefficiency). A survey of studies on deadweight losses in the United States found that estimates ranged between 18 and 24 per cent of revenues collected.

Source: Robson (2005) and PC (1998).

Deadweight losses emerge where taxes have:

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

Regretfully, many State taxes have these characteristics. For instance, many State taxes are levied on narrow bases – including insurance taxes, stamp duties, motor vehicle taxes and gambling taxes. Over a third of State tax revenue (when GST

revenues are included) is collected from narrow based taxes (ABS 2008a). Table 3.10 categorises State taxes by the nature of their tax base.

The rates of tax set in State taxes can be high relative to the value of activity being taxed. This problem emerges as a corollary of a narrowly defined tax base because in order to achieve a given target amount of revenue, tax rates must necessarily be higher than when levied on goods or factors with larger bases. High rates result in an even greater distortion in relative prices, and an even greater incentive to substitute away. Box 3.11 provides additional background about the relative rates and deterrence effects in key State taxes.

3.10 Broad and narrow State tax bases

Broad	Narrow		
Payroll	Casino tax.	Environmental levies.	Landfill levy.
Land tax	Community Ambulance Cover.	Financial accommodation levy.	Metropolitan improvement levy.
GST ^a	Congestion levy.	Fire services levy.	Mortgage duty.
	Duty on acquisition of business/goodwill.	Gaming commission supervision surcharge.	Parks charge.
	Duty on hire of goods.	Insurance contributions to fire brigade.	Public lotteries tax.
	Duty on sale of livestock.	Insurance premium tax.	Racing tax.
	Duty on trust over property.	Insurance protection tax.	Unquoted marketable securities duty.
	Duty on vehicle registrations.	Land rich duty.	Vehicle registration fees.
	Electronic Gaming Machine Taxes.	Land transfer duty.	Vehicle weight tax.
	Emergency services levy.		

^a GST is a tax collected by the Australian Government and the revenue it generates is then distributed to the States.
Source: BCA and CTA (2007).

Even those State taxes with the potential to have broad bases (particularly payroll tax and land tax) have, over the years seen their bases eroded by concessions and exemptions (Carling 2006; PC 1998; IPART 2008). For instance, an ABS survey of Australian enterprises found that less than one in ten enterprises were subject to paying payroll tax. In Queensland, this figure was as low as one in twenty (ABS 1998). Currently, payroll tax thresholds exceed \$1 million in some jurisdictions, and *effective tax rates* fall far short of statutory rates in all jurisdictions. Although land tax thresholds are generally modest, land taxes are only levied on a subset of properties – for instance, all dwellings that are owner-occupied and agricultural land are exempted from the tax.

The extent of the distortions involved in State taxes has encouraged commentators to use colourful language to draw attention to the need to change. Chris Richardson⁶ from Access Economics for example, recently noted that:

We can do better on tax in Australia, mostly in and around State taxes... Many of them are not good and we can do better there... There are a bunch of State taxes which are just out and out evil. They almost destroy as much value in the economy as they raise in terms of revenue.

3.11 Relative tax rates and conveyance duty

Initial appearances about taxes can be deceptive. Transfer duty on residential property, for example, has a rate of between 1.25 per cent to 7 per cent depending upon the value of the property being transferred and the State. This may seem to be a relatively small part of the underlying value of the property.

On closer inspection, the relative base for consideration of the value of this tax is not the value of the property but the value of the transfer of property from one owner to another. One way of measuring the value of a property changing hands is the amount that vendors are prepared to pay for the services necessary to make the transaction. Essentially that is the real estate agent's fees and commissions. For residential property it is not uncommon for these to amount to around 2-3 per cent. Thus paying up to 7 per cent of the value of a property as a tax exceeds the market value of the transaction.

Rather than being modest, transfer duty taxes collect funds that are a significant share of the underlying value of the underlying transaction being taxed. At the upper end of the sliding scale, which is being used more given the price escalation in property markets in Australia, the amount being taxed enters a zone that could be considered to be punitive. When tax rates are high relative to the underlying value of the transaction they are more likely to induce significant distortions.

It is increasingly being recognised that duties add significantly to the cost of purchasing property and other assets, and can act as deterrent to potential consumers and businesses (IPART 2008). The inefficiencies induced by the stamp duty on conveyances have been linked to (VIC DTF 2001; WA DTF 2006):

- a reduction in housing turnover, leading to a less than optimal match of the housing stock with household needs;

(Continued on next page)

⁶ ABC, 'Rudd flags tax reform', Posted Mon Apr 21, 2008 7:13pm AEST, <http://www.abc.net.au/news/stories/2008/04/21/2223401.htm>

3.11 Relative tax rates and conveyance duty (continued)

- distorting investment decisions away from property (and towards other classes of assets); and
- impeding labour mobility and 'spatial economic adjustment.'

The relative price sensitivity of capital transactions is such that conveyance duty is potentially more damaging to the economy than, say, taxes on labour – where supply is relatively unresponsive to changes in real wages (WA DTF 2006).

Source: IPART 2008, VIC DTF 2001, WA DTF 2006.

Reduced international competitiveness

In a climate of increasing global integration and competition, the State and Territories' maintained reliance on business as a tax base has reduced Australia's international competitiveness.

In the Australian Government's latest review of Australian taxes, the Treasury (2008, p. 4) argues that:

Given Australia is a small, open and developed country operating in an increasingly globalised world with freer flows of ideas, investment and labour, there is increasing pressure for Australia's tax-transfer system to remain internationally competitive.

... without change, Australia's future living standards would be compromised, [and] the competitiveness of the economy reduced...

A State's tax regime has important implications for business costs, practices and competitiveness. It is important to maintain a competitive tax regime such that the overall economic burden is kept to a minimum, and to promote an economic environment that creates employment, income and wealth (WA CCI 2005).

The States generally recognise the role business taxes play in the business environment; however their focus is typically levied on competitiveness relative to *other* States. For example, a component of the Western Australia Government's ongoing fiscal strategy is to:

...maintain Western Australia's tax competitiveness by ensuring that general government tax revenue as a percentage of GSP remains below the average of other States (WA DTF 2007, p. 51).

In their recent report on Australian and State government business taxes, the Business Council of Australia (BCA 2008, p. 4) highlights the role played by the business tax system in an *international* context:

The combination of the burden and the structure of business taxation, determines the overall efficiency and competitiveness of the system. This, in turn, directly impacts on the health of the Australian business sector...

The business taxation system also influences the business structure, production costs and investment decisions of companies and thus their direct competitiveness... The need to remain cost-competitive is important in an increasingly global economy, and particularly for Australia, which will always face strategic disadvantages including relative remoteness from major global markets and relatively small and geographically dispersed domestic markets.

As well as acting as a deterrent to investment, business leaders note that some State taxes (such as payroll tax) can have the effect of increasing the costs of producing certain goods and services domestically. This is because, many State taxes are 'origin' taxes that are levied at points along the production chain (as opposed to on the final product) and are generally not incurred (or are incurred at a lesser extent) by international producers. Origin taxes are explained in box 3.12.

3.12 Destination and origin taxes

Many State taxes are *origin* based taxes. That is, they fall on items produced in Australia – for both domestic consumption and export. Competing foreign products are not required to pay a number of State taxes – the most prominent being payroll tax.

Destination taxes on the other hand, tax products where they are sold (not produced). The GST is an example of a destination tax. Destination taxes are applied to domestic and foreign products equally, giving neither a competitive advantage over the other.

Additionally, destination taxes are preferable in that they also do not tax exports. As Australian exports are not consumed in Australia, they do not attract Australian destination taxes. Exports are not treated so generously under an origin tax.

Source: Ryan (1995).

A key focus of the GST tax reform package was to remove many of the States' origin taxes because of the impact they had on international competitiveness. It was shown that these taxes cascaded throughout the production process and thereby penalised Australian exports and reduced the economy's ability to compete in world markets (Australian Government 1998). However, a number of major State taxes still have this characteristic, and as a result, the economy is less productive.

From the outset then, relative to foreign products, Australian goods and services may suffer a competitive disadvantage. This same logic extends to the competitiveness of Australian exports competing overseas.

The loss of international competitiveness in Australia may be exacerbated against a backdrop of business tax reforms recently undertaken by many of Australia's

international competitors. For example, in 2006 alone, significant efforts were made to reform business taxation systems in Singapore, New Zealand, Malaysia, Germany, the Netherlands, Denmark, Belgium, Turkey and Greece (BCA 2006). The focus of these reforms was to improve the competitiveness of domestic businesses.

Unequal treatment and inequity

The narrowness of many State taxes, combined with the extent and frequency to which exemptions and concessions are awarded has resulted in many State taxes being applied unequally across similar goods and practices (WA DTF 2007; VIC DTF 2001; PC 1998). This non-neutral treatment has the effect of:

- exacerbating the distortion in relative prices and the efficiency loss that follows;
- imposing a greater than necessary burden on the taxed part of the economy;
- unfairly disadvantaging those businesses subject to the tax, whom compete with firms (including international firms) not subject to the tax;
- providing a disincentive towards certain operating practices to avoid being taxed – such as keeping staff numbers low to avoid payroll tax liabilities;
- promoting over investment in low taxed assets, and under investment in high taxed asset classes; and
- encouraging actors in the community to seek out ways to avoid their tax liabilities.

Generally speaking, a tax regime should strive to be as neutral as is feasible. That is, the tax regime (VIC DTF 2001):

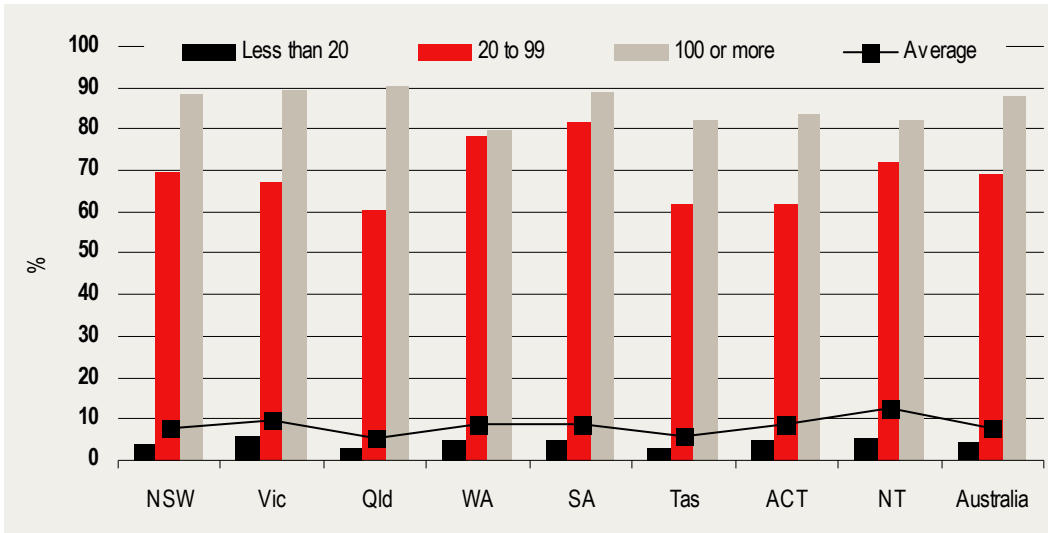
- should not discriminate between business location, form, function and transactions;
- should not create an imbalance across competitors or industries; and
- should ensure that tax payers in similar circumstances bear a similar tax burden.

Payroll tax and land tax seem to be particularly poor in terms of unequal treatment. For instance, chart 3.13 shows the proportion of enterprises paying payroll tax by State in 1993-94. From the chart we can see that most small firms (with less than 20 employees) are likely to fall beneath respective State tax thresholds. In many cases more than 95 per cent of firms in this class did not pay the tax. Even among the medium to large firms (with 20-99 employees), some jurisdictions saw over a third of firms exempt from the tax. Australia wide, less than 8 per cent of enterprises paid payroll tax in 1993-94 (PC 1998).

With so many firms exempt from the tax, those who actually pay incur a more substantial burden. For instance, in 2002-03, businesses paid out over \$300 billion in wages Australia wide. The States collected some \$10 billion in payroll taxes, implying an effective tax rate of just 3 per cent. Firms paying payroll tax however

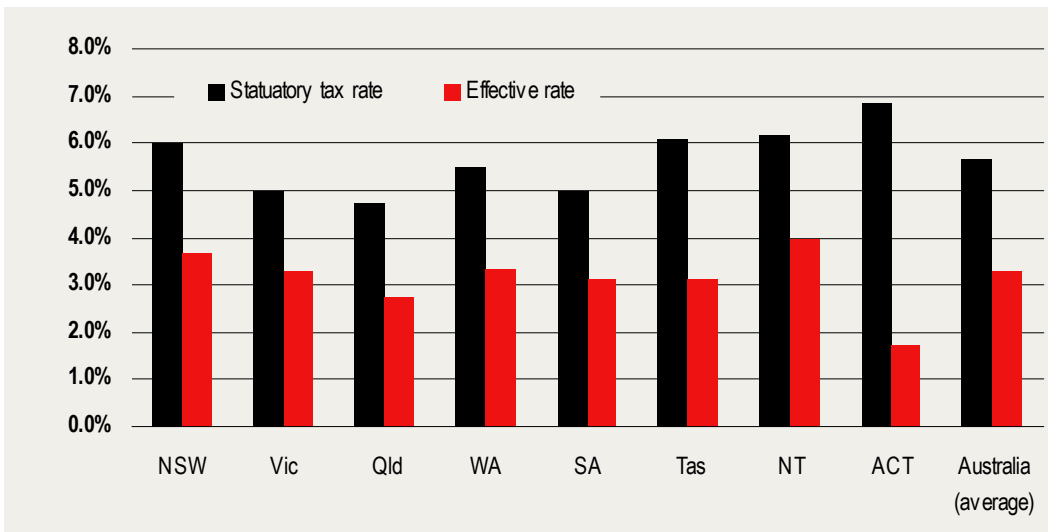
were likely to face rates of around 5-6 per cent or greater (ABS 1998). Chart 3.14 reports the effective and statutory rates of payroll tax in 2002-03 for each jurisdiction.

3.13 Proportion of enterprises paying payroll tax (per cent), 1993-94



Data source: ABS Cat. No. 6348.0.

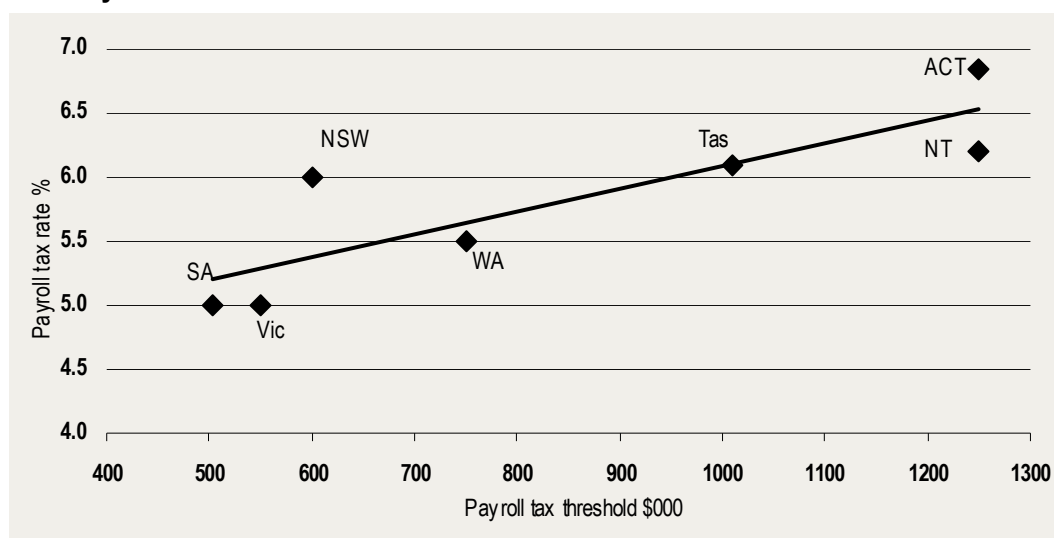
3.14 Effective and statutory payroll tax rates (per cent), 2002-03



Data source: ABS Cat. No. 6348.0.

When a concession/exemption is provided, the State’s revenue base is reduced. Achieving a given revenue target therefore requires a higher tax burden be imposed on those still subject to the tax. This can be seen by comparing tax free thresholds and tax rates for payroll taxes across the States and Territories (chart 3.15). In 2007, the ACT and the Northern Territory had the most generous tax free thresholds of all the jurisdictions. They also had the highest tax rates as well. By comparison, Victoria and South Australia had much more inclusive tax bases, and the lowest rates of payroll tax.

3.15 Payroll tax rates and thresholds



Data source: NSW Treasury (2007).

Criticism has also been levied against the State and Territories' property taxes (in particular by property groups such as the Property Council of Australia (WA PCA 2005) and REIWA (2005), but also by the Western Australia Chamber of Commerce and Industry (2005) and the Productivity Commission (1998). Taxes on land and duties on conveyances bias investment decisions against property as an asset class, and thereby favour other untaxed opportunities. The difference in the application of land tax on non-owner occupier properties only compounds this problem. Table 3.16 highlights this point by comparing the taxes applicable to investment properties relative to other asset classes. In sum, investment properties are likely to attract a total of seven taxes from the Australian, State and local governments (including developer contributions). Typically, other interest bearing asset classes will attract only two of these taxes.

3.16 Applicable taxes to savings and investment options

	Income tax	Capital gains tax	Stamp duty on property	Land tax	Stamp duty on loan/mortgage	Developer contributions	Municipal rates
Bonds	x	x			x		
Stocks	x	x			x		
Cash	x						
Investment property	x	x	x	x	x	x	x

Note: Bonds and stocks attract a shaded check mark for stamp duties for loans, as loans *could* be used to finance the purchase of the assets, however this is not regular practice.

Not included in the table above are the interactions between Federal and State taxes. It may be the case that a proportion of certain State taxes are deductible against Federal taxes.

Source: CIE.

Poor accountability

Lastly, a long standing problem with State tax regimes, is the inherently poor accountability of the State fiscal decisions (see for example: Kasper 2007; Carling 2006; Garnaut and Fitzgerald 2002; and James 2000). The States and Territories are able to avoid accountability in two ways:

- first, because of the Vertical Fiscal Imbalance (VFI), responsibility over revenue raising and expenditure decisions is blurred between the States and the Australian Government; and
- second, by levying taxes on intermediaries rather than directly on final consumers or incomes, the magnitude and nature of many taxes remain hidden from the broader community.

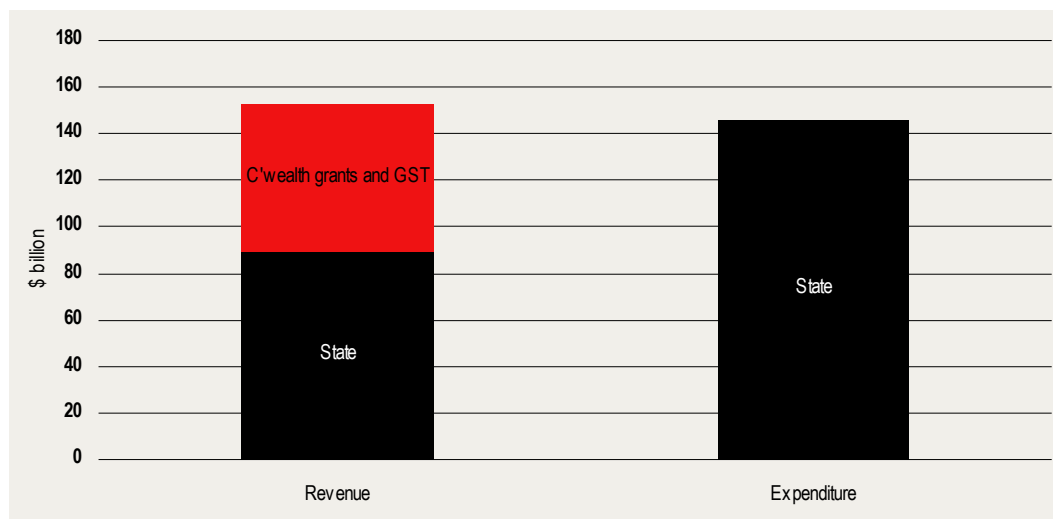
Each of these points is considered below.

The Vertical Fiscal Imbalance

In 2006-07 the States and Territories spent almost \$150 billion on government programs and operations. Tax revenues and other own-source revenues however, only summed to about \$90 billion, about 60 per cent of the required bill. This funding shortfall is made up of Australian Government grants (as either returned GST revenues or Specific Purpose Payments).

The misalignment of State expenditures and State revenues is known as the *Vertical Fiscal Imbalance* (VFI). VFI occurs when the revenues of different levels of government do not match their expenditure responsibilities. This misalignment is evident in chart 3.17.

3.17 Vertical Fiscal Imbalance, State revenues and expenditure by source, 2006-07



Data source: ABS Cat. No. 5512.0 and 5506.0.

Australia has the highest degree of VFI of any Federal country in the world (Webb 2002). This is the product of three historical factors:

- growth in Federal taxation powers (such as taking control of income taxation in 1942 and the introduction of the GST in 2000-01);
- increasing demands from the States' key program areas – such as education and health; and
- High Court decisions which have precluded the States from imposing broadly-based consumption taxes (section 90 of the Constitution).

The major concern of the VFI is its impact on government financial responsibility and accountability. Separating expenditure and revenue decisions can lead to the pursuit of competing objectives. The Australian Treasury (Australian Government 2008d, p. 303) writes that:

VFI may lead to accountability problems in regard to expenditure and taxation decisions made by governments... When a government does not have to raise the revenue it spends, this can create 'fiscal illusion' potentially leading to an over provision of services. This is because governments that receive grants might obtain a political benefit from providing services without the political cost of raising revenue.

Additionally, separation between spending and taxation powers opens the door to blame shifting and 'buck passing' between the tiers of government. Carling (2006, p. 17) adds:

A high degree of financial dependency on central government stifles Federalism. The dependency culture is the antithesis of financial responsibility and accountability. Expenditure responsibility needs to be matched by revenue responsibility if sensible public choices are to be made. Vertical Fiscal Imbalance breaks the link between expenditure and revenue raising decisions... It works against efficiency in public expenditure. And it curtails the flexibility of individual States to carry out their responsibilities differently from other States and cater to their own residents' different preferences.

To a certain extent, the NSW Treasury (NSW Government 2008a, p. 8-1) agrees with this assessment. In their most recent budget paper, the NSW Treasury writes:

The high degree of Vertical Fiscal Imbalance in Australia compared with other federations, inevitably results in conflict over fiscal matters between the levels of government and results in confused accountability among the community.

Accountability can also be blurred where the recipient government's service provision is influenced by the government that provides the transfer. The conditions on service delivery may be different to the preferred option of the recipient government. Such an outcome may result in weakened accountability, as citizens hold the recipient government responsible for the services provided, even though it is unable to provide the service in its preferred way (Australian Government 2008d).

Whether or not VFI has been addressed by the introduction of the GST remains the subject of some debate. It has been argued that even though the States do not control the GST, they have been given greater fiscal flexibility as the GST replaced revenue

from much more stagnant revenue sources (Australian Government 2008d). However, as Carling (2006, p. 17) points out, the question over VFI is one of dependency versus autonomy – and if anything, the GST is ‘more likely to [have strengthened] the States’ culture of dependency on the central government.’

Stealth taxes on intermediaries

Concerns about accountability also arise when examining how the States levy the taxes they are responsible for. Unlike the Australian Government, whom levies its major taxes at the end of the value chain, many State taxes are collected at intermediary stages along the production chain (such as payroll tax which is not applied to employees but is applied to employers). Collecting taxes in this way further masks the overall tax burden levied on the community.⁷

Economists are not generally concerned by the *legal* incidence of a tax, as the *economic* incidence matters more in welfare analysis.⁸ The legal incidence however, is important component of the tax’s transparency.

It is important that the tax system be as transparent as possible. Both the community and taxpayers must clearly understand what is being taxed, who is liable and how their liability is calculated (IPART 2008). When taxes are levied ‘upstream’ however, their ‘downstream’ economic incidence, and even their existence, is often hidden from the community. And, consequently, the community may be left unaware of their overall tax burden. A tax system should aspire to ensure that both taxpayers and those meeting the real costs of taxation are able to identify how much tax they are paying.

While IPART’s analysis found that generally taxpayers understood their liabilities, the economic incidence of the tax was not transparent.⁹ Similarly, the Victorian DTF’s review (2001, p. 47) made similar findings, adding that:

Much of the tax legislation in Victoria is not only complex, but lacks a statement of intent. Simplifying the tax system and outlining the principles of good tax design can improve legislation to the point that businesses are more aware of its objectives and requirements.

⁷ Admittedly, there may be some examples where taxing intermediaries along the production chain may reduce the overall compliance and administration costs of collecting a tax. That said, the extent to which these efficiency gains will offset the costs of ‘hidden’ taxes is unlikely to be significant.

⁸ A tax’s legal incidence refers to which party in the transaction must literally pay the tax to the administration. The economic incidence refers to the degree to which parties are burdened by the tax. For example, a tax on a good will, typically increase consumer prices and at the same time reduce the producer prices (the difference between the two is the tax collected by the government). By how much consumer prices rise, and producer prices fall, will determine the tax’s economic incidence.

⁹ This point is made explicitly in their evaluation of NSW payroll and land taxes.

Clear legislation with minimal hidden implications will reduce both tax avoidance and the administrative burden.

Key points

- The States' tax base consists of an array of taxes, many of which have been criticised as being volatile and unpredictable, inefficient, costly and/or detrimental to Australia's international competitiveness.
- The States are becoming increasingly reliant on volatile and unpredictable taxes for a large share of their own source revenues. Volatility in the revenue base can be problematic for fiscal management and is a key risk to achieving budget targets.
- The reporting, assessment and compliance requirements of many taxes impose high costs on business. Australian firms have indicated that large resources are required to meet and comply with the multitude of State taxes. These costs are magnified for those firms operating in more than one jurisdiction.
- State taxes are inefficient and distortionary. Broad based taxes which have the potential to be efficient — such as land and payroll — have had their bases eroded over time through the granting of concessions and exemptions.
- Many of the States taxes are 'origin' taxes. These taxes are levied throughout the production process, a practice that adds to the costs of Australian produced goods and services. Exports and those goods which compete with imported products suffer a disadvantage as their foreign competitors go untaxed.
- State taxes are not levied in a common way for business, goods and consumers of a similar nature. Exemptions, concessions and the narrowness of many taxes means that similar products and practices are treated differently by the State tax system. This is especially true for the States' treatment of property.
- State taxes lack transparency. By taxing intermediaries, both the extent of State taxation and its incidence is masked from the community. This reduces the States' accountability for their fiscal decisions. Complicated State-Federal fiscal arrangements further detract from government accountability by blurring expenditure and taxation responsibilities.

4 *Lessons from tax reform*

Taxes are constantly evolving. Indeed, while they seem to have an aura of permanence, history shows that arrangements are actually quite fluid.

Taxation in Australia began during the eighteenth century when colonies were reliant on customs and excise duties as their primary source of income. Then, late in the nineteenth century the colonies began to introduce direct, progressive taxes on land and income (Reinhardt and Steel 2006).

The States gave up customs and excise duties during Federation to secure interstate free trade (Groenewegen 1985) and uniform Federal tariffs and excise duties were introduced in 1901. This change left the States with a shortfall of funding because although they retained control of land and income taxes, customs and excise duties were the greatest source of taxation revenue at the time. It was not long after Federation that fiscal inequality between the States led to Federal funding in support of fiscal equalisation. Over time, horizontal fiscal equalisation was formalised with an independent body recommending distribution of Australian Government grants based on fiscal need (Reinhardt and Steel 2006).

A Federal income tax was introduced in 1915 (in addition to existing State income taxes) to finance involvement in the First World War. Following the war, the Australian Government continued to impose income tax, which meant that two tiers of government were sharing, and competing for revenue from a common taxation base (Reinhardt and Steel 2006). These arrangements continued until 1942 when the Australian Government took over the role of collecting income tax on a uniform basis across Australia. In return, State governments were given grants to compensate for their lost State income taxes.

The centralisation of income tax was followed by further changes to the State and Federal tax bases during the post-war period. For instance, in addition to the existing land taxes introduced by State administrations in the late nineteenth century, the Australian Government also introduced a flat land tax in 1910 as a form of wealth tax.¹⁰ Over time, land taxes became less effective as a form of wealth tax as the productivity base of the economy diversified from being mostly agrarian, and wealth was held in more diverse forms (Reinhardt and Steel 2006). This led to the abolition of the Federal land tax in 1952.

¹⁰ In comparison, in most States land was taxed at progressive rates.

In 1941 the Australian Government introduced a payroll tax (applied as a 2.5 per cent levy on payrolls). When the Australian Government assumed control of the income tax base in 1942, the States lobbied for access to payroll tax and in 1971 the Australian Government handed over payroll taxes to the States, acknowledging that this tax represented the sole possible growth tax available to the States (Mathews and Grewal 1997). During the following three years, the States uniformly increased the rate from 2.5 per cent to 5 per cent.

Over time, the uniformity of State payroll tax rates and the tax base to which they are applied have been eroded. Tax competition between the States and lobbying by individual employers and employer groups for exemptions have reduced the payroll tax base to less than half of the comprehensive labour income tax base (Freebairn 2005). Interestingly, a project to harmonise payroll tax across the States has recently been undertaken as part of the government's aim to cut red tape (see box 4.1 for more details). While the scope of this project has been somewhat limited (it harmonises administrative arrangements, not tax rates across the States), it is a first step in interstate cooperation to reduce compliance costs for businesses.

4.1 Harmonisation of payroll tax regimes

From 1 July 2007, NSW and Victoria introduced harmonised payroll tax legislation and administrative arrangements designed to simplify and reduce red tape. Examples of amendments made to achieve harmonisation are (NSW Treasury 2007):

- consistent contractor provisions;
- changes to fringe benefits and the gross-up rate;
- consistent charitable exemption provisions;
- consistent grouping provisions; and
- consistent exemption rates for motor vehicles and overnight accommodation allowances.

Queensland and Tasmania have also announced their intention to harmonise payroll tax arrangements with NSW and Victoria from 1 July 2008. Other States will also harmonise aspects of their payroll tax regimes with the New South Wales-Victorian agreement from 1 July 2008 (NSW Government 2008a).

The aims of this payroll tax harmonisation project is to 'support business investment, improve competitiveness and increase productivity by simplifying administration and reducing red tape and compliance costs for businesses that operate in multiple States' (NSW Government 2008a, p. 20) .

Source: NSW Treasury 2007 and NSW Government 2008a.

During the latter part of the twentieth century, the States supplemented their revenues with a range of transaction based taxes. Many of these taxes have since been replaced, or are in the process of being replaced, as part of the reforms to Federal financial relations associated with the introduction of the GST.

Today, taxes in Australia are imposed by different layers of government. Federal taxes are generally broad based and mostly consist of the personal and corporate income taxes and customs and excise duties. In comparison, the State and local government taxes are generally narrow based taxes. These taxes are mainly payroll tax, stamp duties on property transactions, land tax and specific consumption taxes, such as taxes on gambling, motor vehicles and insurance.

Interestingly, a key feature of the history of taxation in Australia is the way in which the tax base has changed over time and the impacts of these changes. Indeed, throughout the years we have seen significant changes in taxation, in the tax collection responsibilities between the Australian and the State governments and in their respective tax bases. Table 4.2 provides a summary of some of these changes.

4.2 The shifting balance between Federal and State tax powers

<i>Tax</i>	<i>Direction of change</i>	<i>Initial nature of the tax</i>	<i>Change in tax's nature</i>	<i>Effect of the change</i>
Custom & excise	States → Australian Government	Imposed as State tax with different bases & rates in each State.	Removal of interstate tariffs & harmonisation of tax rates and tax base across Australia.	Secured interstate free trade & facilitated international trade. Improved efficiency by harmonising rates & bases.
Income tax	States → Australian Government	Imposed as State tax with different bases & rates in each State.	Harmonised tax rates and tax base.	Improved efficiency by broadening the base & harmonising rates across Australia.
Land tax	Australian Government stop collecting	Started as a State tax (progressive rate, no exemptions), then a Federal component was introduced (flat rate, no exemptions).	Federal component was removed. Each State applies different rates and provides exemptions & concessions.	Removed double taxation & competition of two tiers of government for revenue from a common taxation base.
Payroll tax	Australian Government → States	Imposed as a Federal tax at a flat rate of 2.5 per cent.	Imposed as State tax with different bases & rates in each State.	Reduced efficiency by eroding the tax base & increased compliance costs by having different rates & administrative arrangements across States.

Source: Reinhardt and Steel (2006); Groenewegen (1985).

A common pattern that emerges from the changes presented in table 4.2 is that, when the Australian Government has ceded control of taxes to State governments, they have decreased the efficiency of the taxes by eroding the tax base through concessions and exemptions and by varying the tax rates across jurisdictions. In contrast, when taxes were consolidated by the Australian Government, the tax base

was broadened and uniform rates across Australia were applied, improving the overall efficiency of the taxes.

Key reforms in Australia's taxation

Developments in taxation can be broadly classified into two periods. Up until the 1970s, the focus of significant changes to the tax system was on expanding the revenue base to fund expenditure. Since the 1980s, increased attention has been paid to reforming the tax system to improve equity and efficiency and, more recently, to reduce tax system complexity (Reinhardt and Steel 2006).

The catalyst for this reform was a growing concern about the equity of the taxation system, which led to the establishment of the Taxation Review Committee (the Asprey Committee) in the early 1970s (Asprey et al. 1975). The *Asprey Taxation Review Committee* became the forerunner of serious tax reform in Australia. Since then, several major tax reforms and reviews have been undertaken. Box 4.3 provides a summary of Australia's major tax reforms/reviews.

As mentioned in box 4.3, the last comprehensive tax reform in Australia took place in the late 1990s with the ANTS. Nonetheless, while ANTS introduced key ideas for major tax reform, it has taken years to bring about changes. Indeed, while the GST legislation was passed in 1999 and the IGA was signed between the Federal and State governments in the same year, the agreed reforms are still not completed, almost a decade later (see chart 4.4).

The IGA established that the State governments would receive the GST revenue in the form of Federal grants. In return, State governments would abolish ten inefficient State taxes and commit not to reintroduce similar taxes in the future. Nonetheless, the IGA did not indicate a specific timeline for the abolishment of inefficient State taxes. Indeed, ten years after the ANTS reforms began, several State taxes included in the IGA have still not yet been abolished.

As shown in chart 4.4, the States partly implemented their commitments by abolishing a first tranche of State taxes by 1 July 2005 (accommodation tax, financial institution duty, quoted marketable securities duty, and debits tax). Then, in 2006, the States agreed on a schedule for a second tranche of State taxation reform. The schedule provided for the abolition of a further five taxes (non-quoted marketable securities duty, lease duty, mortgage duty, credit arrangement and rental duties, and cheque duty). This schedule also provided for the partial abolition of the stamp duty

on non-residential property conveyances. However, the States only agreed to the abolition of this tax in respect of non-real non-residential property.¹¹

4.3 Major tax reforms in Australia

Tax reforms in the 1970s

In 1972 a Taxation Review Committee chaired by Justice K W Asprey was established. The Taxation Review Committee subsequently released a full report (the Asprey Report) in 1975. The Asprey Report identified the key criteria for a 'good' tax system – namely efficiency, equity and simplicity.

The Asprey Taxation Review Committee examined and reported on a broad range of taxation issues. Among the many recommendations in the Asprey Report were income tax reforms (taking into account capital gains tax and fringe benefits tax) and the introduction of a broad based consumption tax. Unfortunately, many recommendations of the Asprey Report (including the introduction of a broad based consumption tax) were shelved due to the political turmoil during that period.

At around the same time, the (Matthews) Committee on Taxation and Inflation was set up to investigate the effects of inflation on taxation. The Matthews report recommended personal income tax indexation and proposed the adoption of a modified concept of taxable income for all businesses (Groenewegen 1980, p.p.162-165). These recommendations were largely accepted by the government due to the desire to reduce the burden of personal taxation and to stimulate business activity.

However, in 1979, the government reversed its decision to implement the recommendations of the Matthews Report. The Treasury stated that 'whether or not tax indexation can be restored in 1980-81 will depend upon general economic conditions' (Groenewegen 1980, p.121).

(Continued on next page)

¹¹ There are two types of non-residential property – real and non-real. Real non-residential property refers to realty property such as buildings and land. Non-real non-residential property refers to non-realty property such as copyright and intellectual property.

4.3 Major tax reforms in Australia (continued)

Tax reforms in the 1980s

The 1980s saw the introduction of various income tax reforms, including some of the recommendations of the Asprey Report. In 1985, the Australian Government released a White Paper on the Reform of the Australian Tax System, which recommended broadening the tax base via a broad-based consumption tax, a capital gains tax, a comprehensive fringe benefits tax and a broader foreign income tax base (Australian Government 1985). This reform eventually led to some changes in the tax system, notably the capital gains tax, fringe benefits tax and controlled foreign corporations legislation in the late 1980s.

Interestingly, reforms over this period made the income tax system more complicated. If the number of pages of a tax act is an indication of the complexity of the tax, the Income Tax Assessment Act went from one volume in 1980 to four volumes in 1989 (Fong 2005). Therefore, while it is possible that income tax had become more efficient following the tax changes, it definitely did not become simpler.

Tax reforms in the 1990s

In 1993, the government embarked on another tax reform project, known as the Tax Law Improvement Project (TLIP) to revamp the tax system. The TLIP's objective was to simplify the tax laws so that they could be more easily understood (Harrison 1996).

However, a new government was elected and the TLIP was abandoned. Then, a comprehensive and elaborate tax reform took place in the late 1990s, with which a White Paper on A New Tax System (ANTS) was released in 1998. ANTS recommended personal income tax and family benefits reforms, the introduction of the Goods and Services Tax (GST) to replace the wholesale sales tax, the removal of inefficient State taxes, and changes in the Federal-State financial relationships (Australian Government 1998).

Research commissioned by the Senate Select Committee on ANTS showed that the impacts of ANTS on overall welfare were minimal. Specifically, results showed that the gain in overall welfare would range from \$30 million to \$600 million per year (Australian Government 1999).

(Continued on next page)

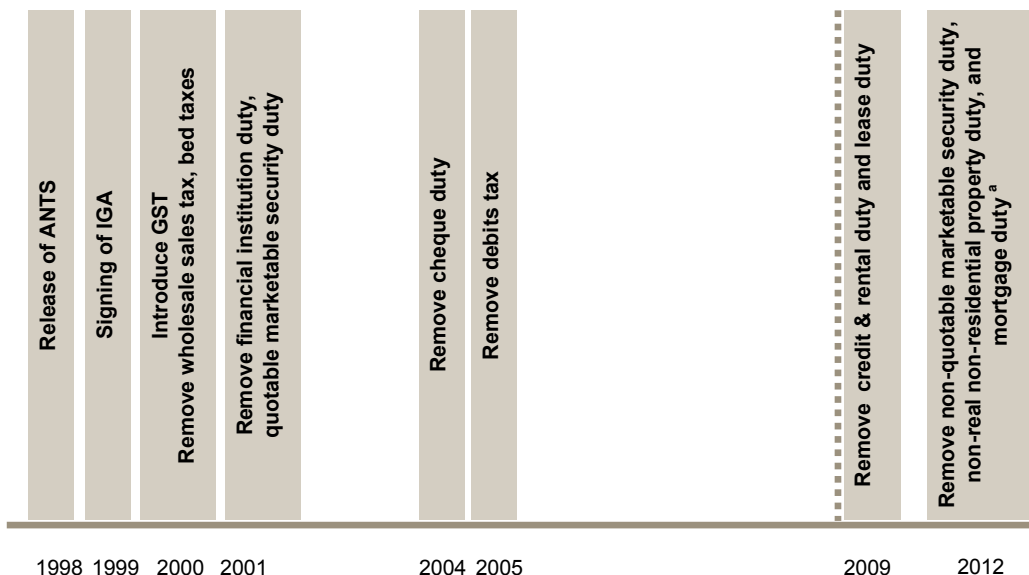
4.3 Major tax reforms in Australia (continued)

Separately, the government commissioned a Review of Business Taxation (the Ralph Review) to examine the strategies specified in ANTS and to consult on the framework of reform for taxing business entities and on the extent of reform for taxing business investments. The Ralph Review recommended lowering corporate income tax in return for axing the accelerated depreciation concession, lowering the capital gains tax and simplifying the tax system for company groups (Ralph et al. 1999). Although the Ralph Review was a comprehensive business tax review, not all the recommendations were implemented.

In 1999, the GST legislation was passed and the Intergovernmental Agreement on the Reforms of Commonwealth-State Financial Relations (IGA) was signed between the Federal and State governments. The IGA stated that State governments were to abolish ten inefficient State taxes in return for GST revenue. The IGA marked the last major State tax reform in Australia.

Sources: Asprey et al. 1975; Australian Government 1985; Ralph et al. 1999; Australian Government 1998; Groenewegen 1980; Australian Government 1999; Harrison 1996; Fong 2005

4.4 Timeline under the IGA



^a The abolition of some of these taxes has been recently deferred by States. NSW deferred until 1 July 2012 the abolition of non-quotable marketable security duty (previously scheduled to be abolished on 1 January 2009), mortgage duty (previously scheduled to be abolished on 1 July 2009) and non-real non-residential property duty (previously scheduled to be abolished on 1 January 2011) (NSW Government 2008b). Queensland deferred until 1 July 2012 the abolition of non-real non-residential property duty (previously scheduled to be halved from 1 January 2010 and fully abolished by 1 January 2011) (QLD Government 2008). South Australia deferred until 1 July 2012 the abolition of non-quotable marketable security duty (previously scheduled to be phased out between 1 July 2009 and 1 July 2010) and non-real non-residential property duty (previously scheduled to be phased out between 1 July 2009 and 1 July 2010) (SA Government 2009).

Data Source: Australian Government 2007b; NSW Government 2008b.

Another important feature of the IGA was that the Australian Government guaranteed that the budgetary position of each State would be no worse than it

would have been had its reforms not been implemented. A guaranteed minimum amount (GMA) is an estimate of the revenue that each State would have received under the previous system of financial assistance grants if their own inefficient State taxes had not been abolished as part of the reforms. The Australian Government agreed to pay budget balancing assistance (BBA) to the States during a transitional period (which will expire on 30 June 2009) if a State's share of GST revenue in a financial year was less than its GMA for that year.

GST revenues have proved to be a robust source of State revenue that has been growing over time. Furthermore, every State now receives more revenue under the current Federal financial arrangements than it would have if the previous arrangements had continued. Table 4.5 shows that in 2006-07, the States had an estimated revenue gain of \$2.1 billion from the IGA tax reform. Further, from 2007-08 and the forward years, all States will receive more GST revenue than their GMA. Indeed, these revenue gains are estimated to increase to \$4.6 billion by 2010-11, as shown in table 4.5 (Australian Government 2007).

Notably, even though the States have received the gains from the GST for more than a decade and GST revenues are now sufficient so that the States would not be worse off (relative to if the previous financial arrangements had continued) they have so far declined to completely fulfil their commitments by nominating a timetable for abolishing the stamp duty on conveyances of real non-residential property (Australian Government 2007).¹²

4.5 State revenue gains from tax reform

	2006-07	2007-08	2008-09	2009-10	2010-11
	\$m	\$m	\$m	\$m	\$m
(1) GMA	37 440	38 642	40 019	41 931	44 296
(2) GST revenue	39 552	41 850	44 200	46 450	48 850
(3) BBA (1)-(2)	0	0	0	n.a.	n.a.
(4) State revenue gain (2)-(1)	2 112	3 208	4 181	4 519	4 554

Note: GMA = Guaranteed minimum amount (revenue that each State would have received before abolishment of inefficient taxes). BBA= Budget balancing assistance (to be paid if GST revenue < GMA). Assistance expires in 2009.

Source: Australian Government 2007b.

¹² This is a contentious point because the original 1999 IGA only stated that the Ministerial Council would review the need for the retention of a second tranche of taxes, which included the stamp duty on non-residential conveyances and a few other stamp duties (IGA 1999). In 2006, the Australian Government reached agreement with all States on a schedule for the abolition of the second tranche of taxes, except for the stamp duty on non-residential conveyances (Australian Government 2007). However, some States (like NSW) argue that they have fulfilled their IGA obligations (NSW Treasury 2007). The Australian Government stated that it would continue to pursue on this issue and work towards the abolishment of the stamp duty on non-residential conveyances (Australian Government 2007).

Reform in practice - lessons learned

The numerous reform programs and reviews of Federal and State government taxation in Australia discussed above provide us with valuable lessons about successful, and less successful, approaches to tax reform. These insights are useful to ensure that proposed reform packages are practical, cognisant of what can realistically be achieved and do not repeat mistakes made in past.

Some key messages from previous State and Federal tax reform initiatives are discussed below.

A clear objective is a key element of successful reforms

Generally, tax reforms have all been well intentioned, designed to meet rising challenges facing the Australian economy. However, they have not always had a clear aim in mind. For instance, there was no clear aim for the *Asprey Taxation Review Committee* (Groenewegen 1980 p.115). On the flip side, the Ralph Committee was attempting to target three distinct aims: optimise growth, ensure equity and simplify taxes. Although the Ralph Review was a comprehensive tax review, not all its recommendations were implemented.

In contrast, ANTS had more specific aims, most of which were achieved (to remove inefficient taxes, lower personal income tax, and introduce GST). Further, ANTS used a 'package' approach to tax reform that worked better than previous small, incremental reforms.

A key lesson to be taken from this is that a successful tax reform needs to have clear, achievable aims and should focus on outcomes, not just shuffling taxes. Further, ANTS showed us that a 'package' approach to tax reform works better than small, incremental reforms.

Fixed timelines are essential to successful reform

ANTS reforms started in the late 1990s. Today, ten years after the beginning of the reforms, States are still in the process of fulfilling their agreements. Further, State governments have refused to fulfil their commitments to abolish transaction taxes on real non-residential property. This is the result of two factors:

- the lack of an agreed fixed timeline for the fulfilment of the agreements under the IGA; and
- the lack of penalties for non-achievement.

In late 2008 and despite an Intergovernmental Agreement targeting specific reforms, the NSW, Queensland and South Australia Governments decided to defer the abolition of a number of inefficient taxes in order to repair their budget positions.

This highlights the vulnerability of reform programs which have no clear milestones/performance penalties or timelines.

As such, a key lesson from ANTS is that a successful reform requires fixed timelines with strict performance milestones for the fulfilment of agreements.

Effective implementation and cooperation of all levels of government are necessary

Reform outcomes are constrained by the implementation process. Traditionally, nothing has bound governments to follow through on recommendations. Past experience shows that even if a recommendation is adopted, the government can reverse that decision. For instance, in 1979, the government reversed its decision to implement the recommendations of the Matthews Report. The Treasury stated that 'whether or not tax indexation can be restored in 1980-81 will depend upon general economic conditions' (Groenewegen 1980, p. 121).

Another example is the IGA, which failed to bind State governments in the abolishment of all the inefficient State taxes. Hence, a key lesson from these processes is that successful tax reform requires effective implementation and the cooperation of both Australian and State governments.

Political and economic climate play a part

Successful implementation of tax reforms also depends on the political and economic climate. For instance, the recommendations put forward by the Asprey report were shelved due to the political turmoil during that period, and were not implemented until the late 1980s.

Additionally, as an independent report, the recommendations in the Asprey report were not fully supported by either the Labour or Liberal Party. Consequently, it took 25 years for the key recommendations in the Asprey report to be implemented – the introduction of the capital gains tax that was implemented by the Labour Party in 1985, and the introduction of a value-added tax was implemented by the Liberal Party in 2000 (Fong 2005).

Recommendations play an important role

Each wave of tax reform has followed a fairly standard procedure. First, a tax committee is formed. Second, a review of current taxes is undertaken according to a set of terms of reference. A white paper with reform recommendations is then released by the committee, requesting submissions and discussion. Finally, a new tax bill (incorporating the recommendations) is passed and reforms are implemented.

The tax review preceding the tax reform provides, at a minimum, a set of academic findings on the pros and cons of the current tax system. It also provides a list of

recommendations. However, the success of these recommendations depends on their effectiveness and the general acceptance of the review.

The Asprey Report is a good example in highlighting the importance of making effective recommendations. While the *Asprey Taxation Review Committee* was a forerunner in tax reform in the 1970s, its report did not receive much attention. One reason was that the report lacked agenda and was indecisive in putting forward the precise manner in which its recommendation were to be implemented (Groenewegen 1980, p. 115).

The effectiveness of the Ralph report recommendations was compromised by the fact that public perceived the report to be a pro-business political agenda by the Howard Government (Phillips 2005). As a result, some of the recommendations did not receive much public support and were shelved.

Separately, many of the recommendations put forward by the State governments in their tax reviews are small scale attempts to fix problems with taxes, rather than the tax system. In fact, these recommendations are often reactions to complaints raised by the public and usually involve small incremental changes or just shuffling taxes (see box 4.6).

4.6 The 2008 IPART Review of State Taxes

The latest State tax review was conducted by IPART for the NSW Treasury. IPART assessed NSW taxes and ranked them in terms of performance against standard taxation principles. IPART also made recommendations for reforming the NSW tax system.

IPART's assessment showed that even after abolishing a number of inefficient taxes in accordance with the IGA, NSW still relies on a large number of taxes that are relatively inefficient. Despite this assessment, IPART's recommendations appear to be small scale attempts to fix problems with taxes, rather than the tax system. For instance, the review concluded that effectiveness of payroll tax is eroded by the tax-free threshold. In response, IPART's recommendations are to lower the threshold from \$600 000 per annum to \$500 000 per annum and decrease the tax rate from 6 per cent to 5.75 per cent. Additionally, IPART concluded that stamp duties on property 'rank among the worst of the major NSW taxes' (IPART 2008, p. 5), especially in terms of efficiency as it is levied on a narrow base. Yet, IPART's recommendation is to index the tax rates annually, reduce the number of brackets and reduce the tax rate of the first bracket. While IPART's review gives a good assessment of State taxes, it is not clear if their recommendations are effective in making the State taxes better as measured against the standard taxation principles.

Source: IPART (2008).

Lessons from other successful policy reforms

Important lessons can also be drawn from other successful policy reforms. An example of such a reform is the National Competition Policy (NCP). The NCP was a package of reforms aimed to enhance competition in Australia. Some of the factors that made the NCP a successful reform are:

- The NCP had a clear mission- to enhance competition in Australia- and outlined definitive actions.
- As part of the NCP, the Australian Government provided payments to the States for implementing NCP and related reforms. Each State's payments were conditional on that State achieving satisfactory progress with the implementation of the reforms, including a commitment to review legislation that restricts competition, applying competitive neutrality principles to government business activities and introducing specific reforms in the electricity, gas, water and road transport sectors (Australian Government 2007).¹³
- An independent body (the National Competition Council) reviewed governments' progress in implementing the NCP reforms and advised the Australian Treasurer on whether the States have achieved satisfactory progress and so met the conditions for receipt of payment.

The lessons that we can draw from the NCP reform are the following:

- New arrangements have to be conditional, rewarding performance and penalising poor performance. Penalties for non-achievement/delay provide the right incentives for the fulfilment of agreements.
- Independent review of performance is important for successful reform.

Additional details about the NCP are provided in box 4.7.

¹³ For instance, in 2005-06 the Australian Government suspended \$43.2 million in NCP payments, following recommendations provided by the National Water Commission. This included water reform suspensions for outstanding obligations relating to interstate trading in the southern Murray-Darling Basin, and for lack of progress and outstanding reforms with respect to water planning.

4.7 The success story of the National Competition Policy (NCP): Policy lessons

In April 1995, all Australian governments agreed on a package of reforms – known as the National Competition Policy (NCP) – to promote enhanced competition in Australia.

NCP was a landmark achievement in nationally coordinated economic reform. Several factors underpinned its success:

- recognition by all governments of the need for reform;
- broad agreement on the priority problem areas;
- a solid conceptual framework and information base to guide policy prescriptions; and
- some highly effective procedural and institutional mechanisms to implement reform.

Almost a decade of experience with NCP points to a number of lessons with potential relevance to any future nationally coordinated reform agenda. Some of these lessons are:

- A broadly-based reform program improves the prospect that those who might lose from a specific reform still gain overall. This can make it easier to progress reforms that might be difficult to implement on a stand-alone basis.
- Reform is likely to progress more effectively where commitments are specified in advance and there is prioritisation of the reform task.
- An effective public interest test is essential to secure beneficial reform as well as community acceptance of the reform process.
- Independent and transparent review and assessment processes are critical to secure good outcomes, especially on contentious issues; they help prevent backsliding and promote public understanding of the justification for reform.
- Providing financial incentives for jurisdictions to follow through with agreed reforms can be very useful in promoting effective outcomes. Competition payments played an important role in keeping NCP reforms on track.

While there are many successful lessons from NCP, a review by the Productivity Commission pointed out some aspects that could be improved, amongst other:

- Measures to guard against backsliding should be improved (for instance imposing financial penalties).
- Processes for monitoring new and amended regulation ('gate-keeping' arrangements) should be strengthened to prevent unwarranted restrictions on competition from resurfacing.

Source: Productivity Commission 2005.

Future reform

Further tax reform in Australia is necessary, and recent events make this a good time to undertake it. For instance, the Australian and State governments are showing a willingness to engage in the COAG forum for dialogue and cooperation and the recent Australia 2020 Summit was headlined by calls for 'root and branch' tax reform. Specifically, a major theme of the 2020 Summit was (Australia 2020 Summit 2008, p. 10):

the need for a holistic tax system that is fair, simple and efficient. Australia needs a tax system that supports the global competitiveness of our economy, provides incentives, minimises distortions and supports fiscal responsibility.

Notably, a key aspect of the 2020 Summit was that a gathering of Australian people acknowledged the need for tax reform. Indeed, the 2020 Summit showed that there is a consensus for reform that has not existed for some time.

Following the 2020 Summit, the Australian Government commissioned a comprehensive review of Australia's tax system led by Secretary to the Treasury, Dr Ken Henry (the Henry review of Australia's tax system). The review will look at the current tax system and 'make recommendations to position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century' (Australian Government 2008a, p. 28).

The Henry review of Australia's tax system will encompass Australian Government and State taxes, and interactions with the transfer system. It will reflect the government's policies not to increase the rate or broaden the base of the GST and to preserve the tax-free status of superannuation payments for those aged over 60. Further details about the Henry review of Australia's tax system are provided in box 4.8.

Separate to the Henry review of Australia's tax system, a Senate Select Committee (the *Senate Select Committee on State Government Financial Management* (the Senate Committee)) was established to inquire into 'Commonwealth and State and Territory fiscal relations and State and Territory government financial management' (Senate Select Committee on State Government Financial Management 2008a). The Senate Committee was formed to look into a range of issues related to taxes, including:

- the cash and fiscal budgetary positions of State governments;
- Australian Government funding to the States and Territories; and
- the level and efficiency of revenue and spending.

In its final report, the Senate Committee recommends that 'the Commonwealth Government should require all States to abolish inefficient State taxes covered by the Intergovernmental Agreement' and that 'States should agree to, and abide by, a timetable to abolish stamp duty on conveyances of real non-residential property' (Senate Select Committee on State Government Financial Management 2008b, p. xii).

The Senate Committee was also a platform for public suggestions. Indeed, various business groups and State governments submitted their views on State taxes and the current Federal-State financial management to the Committee.

The recent conclusion of the Senate Committee's inquiry and the timely arrival of the Henry review of Australia's tax system provide a platform for businesses to raise their views on State taxes and an opportunity to persuade governments to commit to a new wave of State business tax reform. Business groups have been advocating for comprehensive tax reform for some time (see for example Access Economics (2004 and 2008), BCA (2006) and BCA and CTA (2007)). For instance, the BCTR has been working to persuade governments to commit to a new wave of State business tax reform and has commissioned this discussion paper as a further step to energise a debate amongst its members that will shape a robust advocacy platform.

4.8 The Henry review of Australia's tax system

The Henry review of Australia's tax system will examine and make recommendations to create a tax structure that will position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century and enhance Australia's economic and social outcomes. Among other things, the review will consider :

- the appropriate balance between taxation of the returns from work, investment and savings, consumption (excluding the GST) and the role of environmental taxes;
- the tax and transfer payment system for individuals and working families, the role and structure of company taxation; and
- reducing tax system complexity and compliance costs, including consideration of appropriate administrative arrangements across the Australian Federation.

Importantly, the review will:

- reflect the government's policy not to increase the rate or broaden the base of the goods and services tax (GST), preserve tax-free superannuation payments for the over 60s and the announced aspirational personal income tax goals;
- not presume a smaller general government sector; and
- provide recommendations that are consistent with the government's tax to GDP commitments.

In August 2008, the review panel released a discussion paper on 'Architecture of Australia's tax and transfer system' which highlights current tax and transfer system and the emerging challenges and opportunities in reforming the system.

(continued on next page)

4.8 The Henry review of Australia's tax system (continued)

Subsequently in December 2008, the review panel released a consultation paper that outlines the emerging issues from the public submissions process and provides the basis for further submissions, public meetings and direct consultations. The consultation paper highlights the issues that are considered to be central to the design of the tax-transfer system by the panel. These issues include:

- the mix of taxes through which revenue is raised;
- the fundamental structure of the tax, transfer and retirement income systems;
- the way individuals interact with the tax-transfer system; and
- the structure of taxation in our federation.

The review will conduct public meetings in capital cities and major regional centres as part of its public consultation process in March 2009. The public meetings are expected to focus on the issues highlighted in the consultation paper, including likely changes to the corporate income tax arrangements which have been raised in the media releases from the review panel and the Treasury (Henry 2009, Swan 2009).

Following the public consultation process, the review panel will provide a final report to the Treasurer by the end of 2009. Consequently, the Government will respond in a timely way to the tax review's recommendations as they are released.

Source: Henry review of Australia's tax system *Terms of Reference*, Australia's future tax system website (<http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/reference.htm>), Accessed 14 October 2008, *Timeline for the review*, <http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/timeline.htm>, Accessed 6 March 2009, Australian Government 2008d, 2008e

Key points

- **Successful tax reform needs to have clear, achievable aims and should focus on outcomes, not just shuffling taxes.**
- **Fixed timelines within an Intergovernmental Agreement linked to strict performance milestones is essential to successful Federal/State tax reform.**
- **A 'package' approach to tax reform works better than small, incremental reforms.**
- **Successful tax reform requires effective implementation and cooperation of both Australian and State governments.**

- **New arrangements have to be conditional, rewarding performance and penalising poor performance. Penalties for non-achievement/delay provide the right incentives for the fulfilment of agreements.**
- **Reform should include measures to guard against backsliding (for instance imposing financial penalties).**
- **Independent review of performance is important for successful reform.**
- **Reform should include processes for monitoring the new arrangements ('gate-keeping' arrangements) to prevent bad policies from resurfacing.**
- **Further tax reform in Australia is necessary, and recent events make this a good time to undertake it: through COAG the Australian and State governments have a forum for dialogue and cooperation; the recent Australia 2020 Summit called for a 'root a branch' tax reform; a Senate Select Committee on State Government Financial Management has been formed; and a comprehensive review of Australia's tax system has been commissioned (the Henry review of Australia's tax system).**

5 *Principled tax design*

Previous chapters of this report have identified the major problems with State taxes and the potential for further reform of State tax regimes. To help identify how and where further reforms might be pursued, this chapter provides an assessment of State taxes against a set of ‘good’ tax design principles. The assessment criteria employed here are the same as those used by the States themselves when conducting their own assessments.

When designing a tax, there are many desirable attributes that policy makers and legislators might aspire to. A general consensus exists that a well designed tax is one that is characterised by efficiency, equity, simplicity and transparency and is sufficiently robust and predictable to satisfy the government’s fiscal strategy (IPART 2008).

Evaluations of State tax regimes – including those recently conducted by NSW’s Independent Pricing and Regulatory Tribunal (IPART 2008), the Western Australia Department of Treasury and Finance (WA DTF 2006), the Victorian Department of Treasury and Finance (VIC DTF 2001) and the Productivity Commission (PC 1998) – have each been conducted using, more or less, the same principle based approach. These principles are well accepted across the community and business world (see box 5.1).

Tax design principles used to assess State taxes can be distilled down to the following:

- efficiency – that the tax does not stifle economic activity, nor alter the consumption, production and investment decisions made by households and businesses;
- equity – that is, the tax is applied ‘fairly;’
- neutrality –that the tax treats those in similar circumstances similarly;
- buoyancy and robustness – the tax is sizable and reliable to fund government programs; and
- cost effectiveness – the tax is simple and transparent enough such that it imposes low compliance and administration costs.

Often the State governments will employ an additional criterion of ‘interstate competitiveness’ in their assessments (IPART 2008; WA DTF 2006; VIC DTF 2001).

However, given the economywide orientation of this assessment, this criterion is not relevant here.

An assessment of each of the State's major taxes is provided below.

5.1 Tax criteria — community views

The Western Australian Government's review of Western Australia State taxes invited submissions from the community. Below is a summary of what these submissions highlighted as necessary criteria for how to evaluate State taxes.

- The Western Australia **Chamber of Commerce and Industry (CCI)** identified five key principles for taxation policy - equity, efficiency, competitiveness, adequacy and transparency.
- **CPA Australia** set out five key positions on tax reform: State taxes should be broad-based, simple and few; State taxes should meet the criteria of simplicity and efficiency; equity should be achieved via the social security system; there is a need for tax harmonisation with other States where possible; and there is a need to minimise compliance costs for all taxpayers (particularly for individuals and small businesses).
- The **Property Council of Australia** considered that the tax system should be competitive, efficient, transparent, simple and equitable.
- The **Council on the Ageing Western Australia** highlighted the importance of equity (including intergenerational equity); simplicity and transparency; consistency between the Federal, State and local levels of taxation; and compliance costs, value for money and cost effectiveness.
- The **Council on the Ageing National Seniors Partnership** argued that the progressive elements of Australia's tax system should be maintained; tax reform should be of social and economic benefit to all Western Australians; and no seniors in the low to middle income groups should be worse off under any tax reform proposals.
- **Western Australian Council of Social Services** outlined the principles that it considered should be applied for a 'good' tax system, including: low administration and compliance costs; utilising tax bases that minimise the scope for tax evasion; achieving horizontal and vertical equity; applying progressive taxes; transparency; concessions and benefits for those on low incomes; using the tax system to support broader policy objectives; not entering into mutually destructive bidding wars with other States to reduce taxation or provide incentives to businesses; consider the overall impact of Federal, State and Local government taxation; and be stable and predictable enough for businesses and government to make long term plans.

Source: WA DTF 2007.

Tax evaluation

A qualitative assessment can be a useful, and even necessary, tool for conducting a holistic appraisal of State taxes. Much of the assessment criteria is immeasurable and cannot be made the subject of a quantitative assessment.

The assessment of State taxes below has drawn heavily on evaluations conducted by the State governments themselves, as well as the comprehensive report conducted by the Productivity Commission (1998).

Payroll tax

On efficiency grounds, economists are generally quite fond of payroll tax as a source of State revenues (Ryan 1995). The Productivity Commission (1998) for instance, labels a payroll tax as ‘...one of the broadest and more efficient State taxes...’ available. Carling (2006, p. 12) goes so far as to say that payroll taxes are ‘the best revenue source the States have under their own control.’ Similar praise for the potential of payroll tax to deliver on efficiency is repeated in Victorian (VIC DTF 2001), West Australian (WA DTF 2006) and NSW (IPART 2008) reviews of taxation.

The appeal of payroll taxes stems from their potential to be levied on a broad base, at a low and uniform rate. However, the efficiency of the payroll tax has eroded over time due to increasing tax free thresholds, concessions and exemptions (IPART 2008; Freebairn 2005). Carling (2006) argues that a small threshold may be warranted to reduce administration and compliance costs, but mostly concessions have been made in the pursuit of inter-jurisdictional competition (VIC DTF 2001) and equity reasons (WA DTF 2006).

As a consequence of the sizeable thresholds and concessions granted by the State governments, few businesses (in absolute terms) actually pay payroll tax.¹⁴ In NSW, many firms are operating either just above, or just below the payroll tax threshold (IPART 2008) and this means that firms which are similar in most other respects, are subject to different tax treatments (IPART 2008 and PC 1998). The existence of the threshold may inhibit job growth at the margin where medium sized businesses expand to levels which push them above the threshold (VIC DTF 2001).

Despite efforts to provide thresholds and concessions, it is unclear if payroll taxes perform well against an equity criteria (IPART 2008). Although the legal liability for payroll tax falls on employers, in the longer term it falls on employees and consumers without reference to their ability to pay or their individual circumstances. This finding contradicts earlier conclusions reached by the NSW Tax Taskforce (1988). The NSW Tax Taskforce argued that payroll tax was likely to be progressive

¹⁴ Chapter 3 considers this issue in more detail.

because it fell entirely on either labour income or the owners of capital. Under these conditions, the tax's burden would fall more heavily on higher income earners. A similar conclusion was made in the Western Australian Government evaluation as well (WA DTF 2006).

Notably, within each jurisdiction, payroll taxes are generally well understood by those who pay the tax (PC 1998). Payroll tax is a relatively simple tax, from both a compliance and administrative perspective (IPART 2008). Also, as so few firms are liable to pay the tax, compliance costs are not borne by the majority of the business community. A study by Pope et al (1993) found that the private compliance cost of payroll tax was considerably lower than that of the major Federal taxes. That said, differences in tax liabilities and administration requirements across jurisdictional lines generally add to compliance costs from payroll tax (WA DTF 2006).

The incidence of payroll tax is likely to fall more heavily on those industries that are labour intensive. However, as the Western Australia DTF (2006) notes this argument may be difficult to sustain as labour intensive firms are most likely to be competing most directly with other labour intensive firms – who are also subject to the tax.

Payroll taxes are a broad based tax that moves in line with the economy, and have been one of the most stable and predictable sources of revenues for the State governments. The Productivity Commission's (1998) study on State taxes highlighted research that indicated that a 1 per cent increase in the GSP led to a 1.06 per cent change in payroll tax as evidence of the stability of the payroll tax base.

Land tax

Many highly acclaimed economists (including Henry George, Richard Musgrave and Nobel prize winners Milton Friedman, Robert Solow and William Vickery) have labelled land tax as *the* most efficient tax available to governments. Notionally, land is fixed and immovable, and therefore its supply cannot be altered through price changes as are other goods and factors of production. Therefore, it is said that a land tax does not induce the distortions discussed in chapter 3.

However, there is some distance between the efficient land tax theorised by economists, and its actual application by politicians and policy makers. The Productivity Commission (1998, p. 157) writes:

...its supply is still unresponsive relative to goods and services or to other productive factors, especially in the short run. This property makes a broad-based *property tax* desirable tax on efficiency grounds.

However, *land tax*, in its current form, falls well short of this ideal. It has a fairly narrow base – most States only tax land used for commercial and industrial purposes and for non owner-occupied housing.

Firstly, the supply of *taxed* land is not fixed. Most States apply land tax only to land used for commercial and industrial purposes and for non-owner occupied housing.

Therefore, when land use changes from an untaxed use to a taxed one, the stock of *taxable land* increases. Most importantly, a change in land use is likely to be induced by cyclical factors in the property market – which in turn are driven by rates of return, value for money and the presence alternatives. Because land tax decreases the return earned on industrial and commercial land use, this may encourage investors to devote land to exempt uses, therein creating a distortion in the market (PC 1998).

IPART (2008) points out that because land taxes are levied at relatively low rates, the tax is likely to have a minimal impact on investment and consumption choices. The Western Australia DTF (2006, p. 203) evaluation makes a similar claim stating that land tax has a ‘relatively non-damaging impact on land owners’ behaviour’. However, even at the ‘low’ rates of land tax, the tax might be considered punitive. Over the last 13 years, median land prices have risen in real terms by an average of 4.6 per cent (Demographia 2007). A tax on the value of land of say 1.6 per cent (as in NSW), accounts for 35 per cent of the landowner’s capital gain. This is higher than the average rate of personal income tax – and land is still subject to other Australian Government taxes.

Second, land taxes are levied on land *values* (as opposed to say, a constant rate per square metre), not the *quantity* of land (Access Economics 2004). Land values are determined by a number of competing and substitutable factors in the market place. For example, as preferences shift towards and away from high density housing, or as businesses choose to provide more or less office space for their workers, or and as infrastructure improves a city’s connectivity, land prices will fluctuate in response. As buyers and sellers of land are sensitive to changes in price, the imposition of a land tax (like any other tax) will impact on these decisions. In fact, volatile fluctuations in the property market are the reason for the unpredictability of revenues (VIC DTF 2001).

Because land is taxed differently to other assets, land taxes are (like other property taxes) a fundamentally discriminatory tax (IPART 2008). Other financial assets, such as shares and bonds, are only subject to the Australian Government’s income and capital gains taxes (which also apply to land). This problem is further worsened by the array of exemptions to land tax. Again, as only certain types of land holders are liable to pay land tax (that is, owners of commercial, industrial purposes and investment housing), leaving properties which are owner-occupied or used in agricultural production untaxed.

Since land taxes are levied regardless of revenue and income stream, those whom are ‘asset rich’ but ‘income poor,’ might be excessively burdened by this tax (VIC DTF 2001). That said, it has also been argued that to some extent land taxes promote vertical equity, in that tax payers who own higher valued properties pay more in tax. But this assumes, that property owners bear the economic incidence of the tax, and that it is not passed on ‘downstream’ to tenants through higher rents (IPART 2008).

IPART (2008) considers land taxes as complex and costly to administer. This is due in part to the number of exemptions to the tax, indexation of the threshold, calculation of land values, and the definition of 'unit' to which land taxes apply. Compliance costs of land tax are however, relatively low as most of the assessment is conducted by the public sector (PC 1998).

Stamp duty on conveyance

Stamp duties add significantly to the costs of real estate transactions, and this can distort choices between buying and renting, and between moving house or renovating (Carling 2006). Taxing on the basis of the frequency of transfer may discourage turnover of housing to minimise or avoid tax. Consistently, stamp duties on conveyances score poorly against the efficiency criteria. In fact, the high *inefficiency* of purchaser transfer duty led IPART (2008, p. 58) to recommend that NSW 'should seek to reduce its dependency' on this duty over the long term.

Some evaluations have concluded that stamp duties are a progressive tax. The Victorian Treasury (VIC DTF 2001) argues that they could in fact be considered a 'wealth turnover tax.' And the NSW Tax Taskforce (1988) also noted that there was an apparently favourable distributional impact from this tax. However, IPART (2008, p. 60) makes the point that:

While the rate structure of purchaser transfer duty appears to make it progressive, other aspects of its structure reduce its equity... The tax has a narrow base as it only applies to property transfers. As a result, less affluent tax payers who move will pay more tax than affluent landowners who do not move... Others who may have to buy/sell property more frequently as they move jobs, change family status or simply cannot afford the home to meet their longer term needs are not protected.

On this basis, IPART concludes that stamp duties are essentially inequitable taxes. This concurs with the findings of an earlier study by Wood (1994).

As with land tax, the revenues collected from conveyance stamp duties are underpinned by property values. This has meant that in recent years the States have enjoyed long term growth in revenues, but have also been susceptible to short term fluctuations in the property market (Carling 2006). Short term fluctuations are not only caused by variance in housing prices, but also as the number of transactions fluctuates annually as well. Given the importance of conveyance stamp duties to State budgets (the second greatest revenue source behind payroll tax), this volatility works against State budget management.

Evaluations generally concluded that stamp duties impose a low compliance cost as they are a 'relatively simple tax' (VIC DTF 2001, p. 51). IPART (2008) add that stamp duties are a long standing part of the process for purchasing property, and are therefore well understood by the community. Additionally, the Productivity Commission (1998) concluded that, like land tax, conveyance duties also incur in

high administration cost. But, as the value of the property is revealed during the transaction, assessing stamp duty liabilities requires less resources.

Insurance taxes

The market for insurance is already subject to a number of substantial market failures that has resulted in a state of underinsurance and non-insurance. Taxes on insurance exaggerate this problem and provide a further disincentive to insure (IPART 2008; VIC DTF 2001). The Western Australia DTF (2006) acknowledges that although insurance taxes are effectively a broad based tax, insurance is highly price sensitive and therefore the tax should be considered distortionary.

An assessment of the equity aspect of this tax is difficult to make. While true, insurance taxes are generally proportional to the value of the asset insured (WA DTF 2006), it is difficult to argue that the insurance taxes are progressive because risk plays a substantial role in the setting of insurance premiums (IPART 2008).

Taxes which are directly calculated and levied by government agencies – such as taxes relating to insurance – generally have low compliance costs (IPART 2008). Liabilities are assessed by the government whom then bills the liable entities with that assessment. Insurance taxes are levied on only a small number of registered insurers (as well as some brokers) and therefore compliance and administration costs are kept to a minimum (IPART 2008; WA DTF 2006). As mentioned in chapter 3, in these cases, narrow tax bases have the advantage over broad bases when compliance and collection costs are born by just a few actors. Even if a tax's compliance cost is small for the individual, when aggregated across the economy, compliance costs of broad based taxes can sum to substantial amounts.

Motor vehicle taxes

Taxes on motor vehicles which are based on weight are generally regarded as efficient – and are akin to a user charge (VIC DTF 2001). Motor vehicle taxes based on transfer or registration are regarded as less efficient because they are a narrow, transaction based tax (IPART 2008). Although only a small part of the overall capital outlay, transfer duties may dampen the demand for new motor vehicles at the margin.

Some have argued in favour of motor vehicle taxes as an environmental tax – a means of 'correcting' the environmental damage caused by vehicle emissions. However, both motor vehicle stamp duties and weight taxes are poorly correlated with motor vehicle usage, which is what would need to be taxed to appropriately correct this externality (Carling 2006).

Vehicle weight is a poor indicator of income, and in fact has been labelled regressive by some commentators (IPART 2008). A case could be made that in those States and Territories that have incorporated a higher duty for luxury cars, vehicle transfer and registration taxes are progressive. But as IPART (2008) notes where thresholds have not been indexed (as is the case in NSW) bracket creep means that an increasing number of purchases are becoming subject to the higher rate.

Motor vehicle taxes are collected in a similar way to insurance taxes. That is, they are assessed by government agencies and levied on liable parties. This again reduces the compliance costs on the community.

Tax comparisons

Looking forward, it is useful to compare each tax against one another to identify where the major reform efforts should be directed. Some assessments have provided this comparison qualitatively. For instance, the assessments conducted by the Victorian and Western Australian Treasuries compare taxes in an overall evaluation that summates each tax's pros and cons. Others, such as the Productivity Commission (1998) and IPART (2008) have attempted to quantify their assessments using a weighted scoring of each criterion.

IPART's assessment is reported in table 5.2. Here, a score of 5 means the tax meets the criteria very well, and 0 means it barely meets it at all. The criteria are then weighted and an overall score is awarded.

5.2 Qualitative tax assessment by IPART

<i>Tax</i>	<i>Efficiency</i>	<i>Equity</i>	<i>Trans- parency^a</i>	<i>Simplicity^b</i>	<i>Robustness</i>	<i>Weighted score</i>	<i>Ranking^c</i>
Payroll tax	3	2	4	4	4	3.2	1
Land tax	3	2	2	1	3	2.5	3
Purchaser transfer duty	2	2	4	3	1	2.1	8
Insurance duty	1	3	4	5	2	2.3	6
Motor vehicle registration duty	2	3	3	4	2	2.5	3
Motor vehicle weight tax	3	2	4	4	4	3.2	1
Fire services funding contributions ^d	1	2	3	3	4	2.2	7
Gambling taxes	3	1	1	4	3	2.5	3

^a Transparency has been assessed in terms of transparency to the person who ultimately bears the burden of the tax.

^b Simplicity includes administration costs and compliance costs.

^c In order from highest to lowest (ie 1 is the highest ranked tax).

^d Fire Services Contributions in this assessment refers to the Statutory Contribution made by insurance companies.

Source: IPART 2008, Review of State Taxation.

On the back of this analysis, IPART identified purchaser transfer duty as the worst performing tax in NSW. NSW's payroll and motor vehicle weight taxes were considered the best performing taxes in the State. However, even among the top performing taxes, deficiencies were identified across each criteria. Moreover, from the table it can be seen that no tax emerges performs well against *all* the principles of a good tax system; and in fact only one tax (insurance duty) scored maximum points in any single category. The Productivity Commission's (PC 1998, p. 52) assessment came to the same conclusion. The PC explicitly remarking that 'No one tax performs well against all the criteria.'

One concern about qualitative assessments is the lack of transparency in how the evaluator awards different scores. Even when using a palatable guide, as IPART does, the difference between scoring a tax a 2 or a 3 on a criterion such as equity can be unclear. Fundamentally then, a qualitative assessment can only carry the evaluation so far before requiring value based judgements to advance recommendations and conclusions.

Further, scores do not reflect the absolute differences between the taxes. For instance, payroll tax, purchaser transfer duty and insurance duty are given a score of 3, 2 and 1 respectively against the efficiency principle. This does not mean that the difference in efficiency between payroll tax and insurance duty is twice that between payroll tax and purchaser transfer duty. And weights given to calculate the final weighted score may not be reflective of the actual trade-offs.

Aside from these issues though, there is a greater underlying problem to how these assessments have been conducted. The assessment criteria are essentially input orientated, highlighting where individual taxes can be improved against design principles. This leads the assessor to provide recommendations on how to better engineer the tax base – one tax at a time – rather than providing a strategic approach to holistic and output orientated tax reform.

This is evident in the nature of IPART's recommendations. Following their assessment, IPART clearly outlines how individual taxes should each be adjusted such that they might perform better against each design principle. These recommendations are summarised in table 5.3.

5.3 Summary of IPART recommendations

Tax	Recommendation
Payroll tax	<p>Improve the efficiency and competitiveness of this tax over time, while maintaining the revenue base. This might be best achieved by:</p> <ul style="list-style-type: none"> ▪ lowering the tax free threshold; ▪ removing some exemptions (such as those which apply to local councils); and ▪ over the longer term provide further reductions in the rate.
Insurance taxes	Fund reductions in the standard tax rate by removing existing exemptions from the tax base. In the longer term, NSW should seek to reduce its dependency on this tax or remove it in favour of more efficient revenue sources.
Land tax	Land tax should be simplified, and over the longer term expanded.
Stamp duty on conveyance	NSW should reduce its dependency on stamp duties, and this tax should be made more equitable by adjusting rates to account for 'bracket creep.'
Taxes on motor vehicles	Motor vehicle stamp duties should be replaced with a more efficient, but revenue neutral tax on all cars. Over the medium term, motor vehicle taxes should be better aligned with road use and congestion.

Source: IPART (2008).

Addressing the problems with State taxes requires more than just incremental adjustment at the margin. Rather, the reform process needs to take on a strategic and holistic approach that addresses the tax system and mix of taxes in its entirety. Additionally, such an assessment should be objective and output orientated.

The next chapter outlines how a more strategic approach to tax reform might be undertaken.

Key points

- **Governments and the community generally agree on the desirable characteristics of a tax. Broadly, it is agreed that a tax should be efficient, equitable, robust, cost effective and neutral in its application.**
- **Exactly how well taxes perform against these criteria is largely inconclusive and remains open to debate. Moreover, whenever assessed thoroughly by independent researchers, studies show consistently that no tax performs well against all criteria.**
- **Many of the deficiencies State taxes exhibit extend from them having a narrow base. Narrow based taxes are likely to be volatile, inefficient and unfair.**
- **This assessment has revealed that individually, State taxes can be improved considerably. But the assessment reveals little about what can be done to improve State tax systems in their entirety.**

6 *A more strategic approach*

The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing. -- Jean-Baptiste Colbert (French Finance Minister to King Louis XIV), 1619-83.

Nearly four centuries later State government taxes in Australia still reflect the application of Colbert's 'art of taxation.' State governments spread their tax collection efforts widely over the body politic to collect handfuls of returns. Their tax base reflects many measures intended to keep the 'hissing' of taxpayers to minimum. Ad hoc arrangements over time have resulted in many of the problems identified in earlier chapters of this report.

The approach to tax reform frequently proposed by tax professionals in State Treasuries, advisors such as IPART in NSW, and in commentary from the Productivity Commission, is focussed upon smoothing out the wrinkles in taxes by broadening the base and lowering the rate. Applying this tactic can improve some existing taxes one at a time.

The tactical approach is generally constrained where the overall mix of taxes is taken as a given. A further constraint arises when working within the existing demarcation between the Australian and State governments regarding sharing revenue and the tax base. Reform proposals in this vein typically have little to offer, being limited to changes that technical experts can best appreciate with little gains likely to noticed or felt by the community at large.

The poor state of State taxes, together with the problems identified earlier in this study, demand a more substantive response. To make the significant changes needed it is necessary to shift from a *tactical* approach, to a *strategic* approach. Strategic considerations shift attention to what outcomes can be achieved from changes in taxation. A strategic approach also involves making informed choices about the mix of taxes and the roles played by different levels of government.

This chapter reviews the broader objectives that the BCTR considers can be achieved through substantive reform. Results of tax performance benchmarking analysis are reported to assist in making choices about the tax mix. Some overall reform scenarios drawing new roles between the State and Australian governments are also proposed.

Benchmarking tax outcomes

Making strategic choices about the tax mix to be used by State governments should reflect what taxes do. That is, consideration should dwell upon tax outcomes. This is in contrast to mainly tactical approaches that concentrate upon the features of different taxes which are more input oriented.

A four dimensional approach

To date, where analysts have examined tax outcomes, they have generally focused upon economic efficiency (for example, see Access Economics 2004 and 2008). That is, the impact that taxes have upon resource use and therefore upon economic wellbeing (measured either in terms of changes in GDP or consumption).

In this study, the output performance tax changes are measured against four broad dimensions. Taxes are benchmarked in terms of their impacts on the following indicators:

- economic efficiency – output of the economy (GDP) is used to measure the efficiency of individual taxes. This will also capture the related effects of productivity, simplicity and buoyancy, as:
 - efficient taxes raise productivity;
 - simpler taxes raise efficiency; and
 - efficient taxes raise the consistency in revenue collected, thus increasing buoyancy.
- competitiveness – exports and investment are used to measure the effect of individual taxes on competitiveness:
 - investment: the ability to attract more investment (either via increasing foreign investment or retaining Australian capital from flowing out to other countries) to enhance the productive capacity of the Australian economy; and
 - exports volume: the ability to exports more goods and services thus improving Australia's trade balance.
- the price level – Consumer Price Index (CPI) is used to measure the effect on prices of individual taxes; and
- the Vertical Fiscal Imbalance – Federal and State revenues and expenditures are used to measure the effect of changing individual taxes on the balance of State own source revenues as a share of their total revenue.

Economywide modelling

The impact of tax change is quantified using an amended version of the dynamic MMRF (Monash Multi Region Forecasting) model of the Australian economy.¹⁵ This is used because it provides a broad representation of the key features of the Australian and State economies and allows assessment of outcomes with and without tax changes and therefore the difference that tax change makes.

Key aspects of the model that are helpful for the analysis are that it:

- is a multi-regional applied general equilibrium model developed by the Centre of Policy Studies (CoPS) at Monash University who are recognised world leaders in this field;
- accounts for the six States and two Territories as distinct regions including specific details about the budgetary revenues and expenditures of each of the eight State governments and the Australian Government;
- specifically accounts for major taxes including land taxes, payroll taxes, stamp duties and others at the State level, as well as income taxes, tariffs, excise, the GST and other taxes at the Federal level;
- traces out the impact of transfers between governments; and
- provides a detailed account of industry activity, investment, imports, exports, changes in prices, employment, household spending and savings and many other factors.

The CIE has added additional details to the MMRF in order to analyse the full range of taxes studied. Appendix B provides a description of the MMRF model used for this study, including the assumptions for the model simulations.

When used for this benchmarking exercise, the MMRF is operated in a long run closure. That is, the modelling results reflect the impacts of the tax cuts that are likely to occur after there has been full adjustment of capital and labour between jurisdictions and industries (say between 5 and 10 years). The MMRF results in this case provide a snapshot of the economy at a point in time after full adjustment to the policy change.¹⁶

¹⁵ The CIE amended the MMRF model to enhance its specification of State taxes, reflect their incidence and improve the specification of State government finances. In particular, the CIE has adjusted the model data to accurately reflect taxation revenues from each separate tax in each State for 2005-06. Additionally, the CIE imposed changes in the State taxes expected under the IGA. This required the removal of five taxes in 2010 (non-real non-residential property duty, mortgage duty, credit and rental duty, lease duty and non-quotable marketable security duty).

¹⁶ In economic terms, the analysis is conducted on a comparative static basis.

Notably, some benefits from tax cuts are not reflected in this analysis. Examples of these benefits include administrative cost savings, reduced compliance costs for businesses, reduced tax collection costs for governments and improved certainty and quality of the price signal (that is, the improvement in the price discovery process). These additional benefits make the results of the benchmarking exercise undertaken for this analysis conservative.

The taxes that are evaluated in this study are presented in table 6.1. This selection of taxes was based on the reforms that have been proposed by the BCTR and various stakeholders. These represent taxes that have a significant impact on business or the underlying economy. Other taxes, such as those designed for market failure correction roles, are excluded from this analysis.

6.1 Taxes selected for evaluation

Property-related taxes and charges

Land tax

Municipal rates

Developer charges

Insurance taxes

Stamp duties on insurance

Fire services levy

Stamp duties

Stamp duties on residential property transactions

Stamp duties on motor vehicle transactions

Stamp duties on financial transactions (such as mortgage and lease duty)

Stamp duties on non-residential property transactions (real and non-real)

Other taxes

Payroll tax

GST

Source: CIE.

The key to benchmarking performance is to establish a common metric or basis of change. Two devices are used to establish this metric.

Firstly the level of tax changes is normalised – the approach used here is to measure the impact of reducing the revenue raised from each tax studied by \$10 million. That is, revenue is cut from all of the State governments to the point where \$10 million is reduced Australia wide. The model traces the economic incidence of individual taxes starting from their legal incidence.

Secondly, a common comparator is used – in this case the GST is chosen as a ‘benchmark’ tax. The results are reported in terms of the amount of change that arises

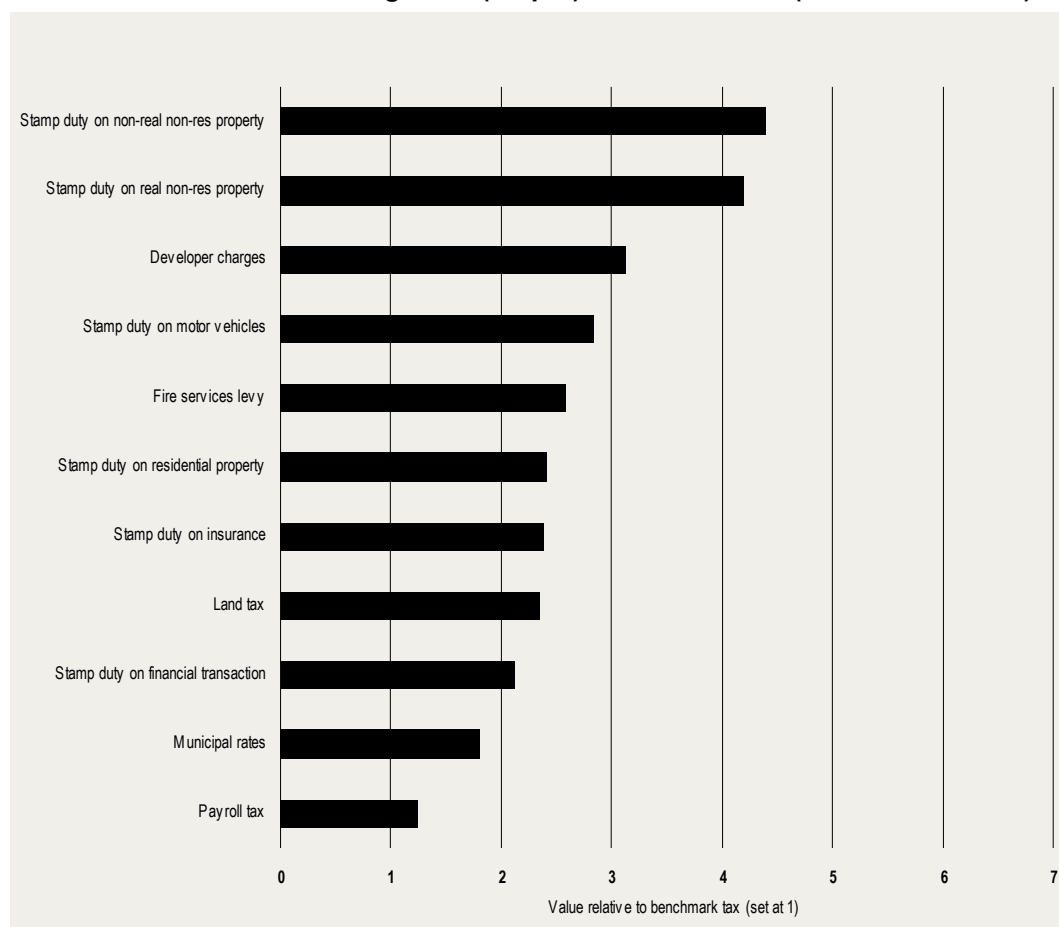
from a change in taxation compared with the change that would be achieved from a similarly sized change in the benchmark tax revenue. Thus, when a particular tax scores a one for example, this means that changes in that tax would have the same expected impact as a similarly sized change in the benchmark tax. A score of two means that a change in that tax would produce twice the impact that a similarly sized change in the benchmark tax would. For simplicity, the GST has been used as the benchmark to make it easier to assess differences. This choice does not reflect any particular policy position about the future of the GST. The technical advantage in using this as a comparator is that it is applied in every jurisdiction in Australia and is applied on the same terms in every jurisdiction.

Benchmarking results

Economic efficiency (output)

Results of the benchmarking analysis looking at economic output are reported in chart 6.2.

6.2 Benchmark 1: taxes and growth (output) — index scores (Benchmark tax=1)



Data source: MMRF simulation results.

The results in chart 6.2 are sorted according to benchmark index score from the largest to the lowest score. Those at the top of the chart are worse taxes than those at the bottom in terms of their impact upon economic output. That is, those with higher scores impose the largest reduction on economic output and reducing them would produce the greatest gain.

Key points that emerge from this analysis are as follows:

- Stamp duties on non-residential properties are the ‘worst’ taxes within the selection – that is, reducing them would produce the greatest gains in economic output for every dollar reduced.
- The State developer charges (currently applied only in NSW and therefore only analysed in that State) impose a significant burden, having an impact on economic output that is three times larger than a similarly sized change in the benchmark tax.
- Transaction taxes in general perform poorly on this measure – all of the stamp duties examined, have index scores that are more than two times worse than the benchmark tax.
- Some readers may be surprised to see the result for land tax. Land tax has a higher index score than payroll tax and land tax is viewed as being twice as bad as the score for the benchmark tax. The result reflects the narrow incidence of the tax (in legal and economic terms) which induces a distortion (a competitive disadvantage) between those activities that are reliant upon land and those that are less reliant upon it.
- Municipal rates are viewed as being slightly less distorting in terms of economic output than land tax. This reflects that practice where fewer businesses obtain exemptions to their liability to pay rates than land tax where thresholds narrow the legal incidence and raise distortions.
- Payroll tax appears to be a relatively efficient tax in terms of economic output. Indeed, despite the various concessions and problems noted in chapter 3, its relative performance is not as bad as other taxes. This is because its legal and economic incidence is quite broad and is broader than all of the taxes studied apart from the benchmark tax.

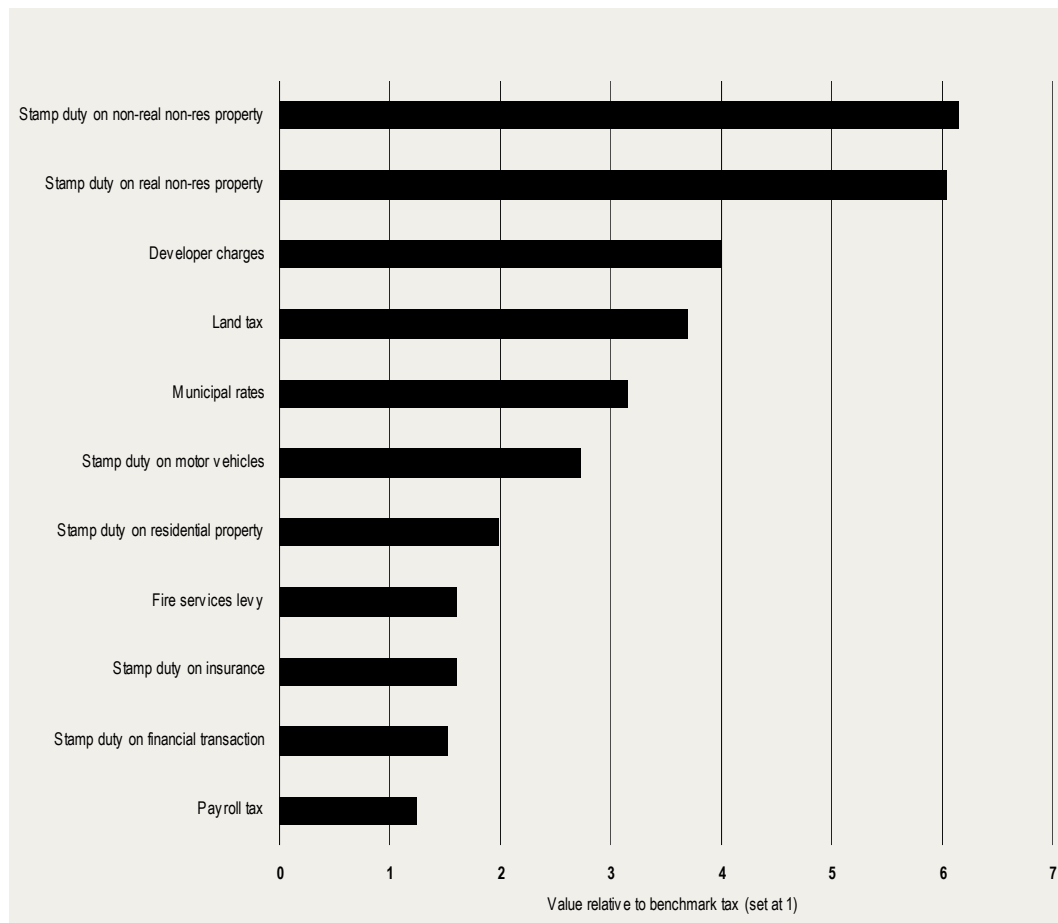
The results provide further insight about why the commitment to eliminate stamp duty upon non-real non-residential property and upon real non-residential property is essential. The planned elimination of these taxes should be pursued as a matter of priority because they are so distorting.

Competitiveness

Benchmarking results looking at the impact of tax upon investment competitiveness are reported in chart 6.3. In the chart, changes in the level of investment as a result of changes in the benchmark tax are given a score of one. Here, the index score awarded

to changes in stamp duty on non-real non-residential property of six implies that this tax would be expected to generate an impact that is six times greater than the benchmark tax. The results for the tax changes have been ranked when plotted in the chart.

6.3 Benchmark 2: taxes and competitiveness (investment) — index scores (Benchmark tax=1)



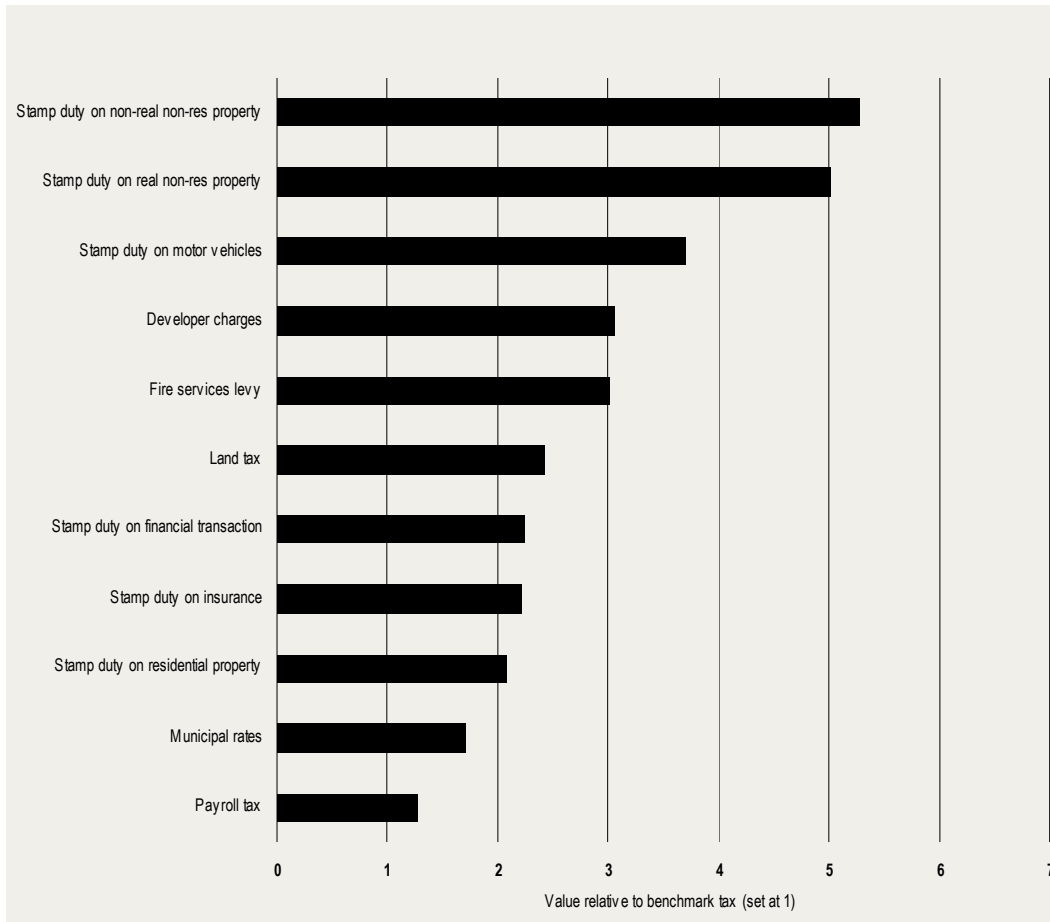
Data source: MMRF simulation results.

Key observations from the benchmarking results reported in chart 6.3 follow below.

- Stamp duties on non-residential properties and the State developer charge (NSW only) are the 'worst' taxes within the selection — that is, reducing these taxes would produce the greatest gains in investment for every dollar reduced.
- Stamp duties have a generally deleterious impact upon investment and reducing them would have a beneficial impact on investment.
- Land taxes and municipal rates are also viewed as having an adverse impact upon investment (over three times higher than the impact of the benchmark tax).
- Payroll tax was viewed as having a relatively modest impact upon investment with an index score that was little different than the benchmark.

The impact on export competitiveness is reported in chart 6.4.

6.4 Benchmark 3: taxes and competitiveness (exports) — index scores (Benchmark tax=1)



Data source: MMRF simulation results.

Key points from the analysis follow.

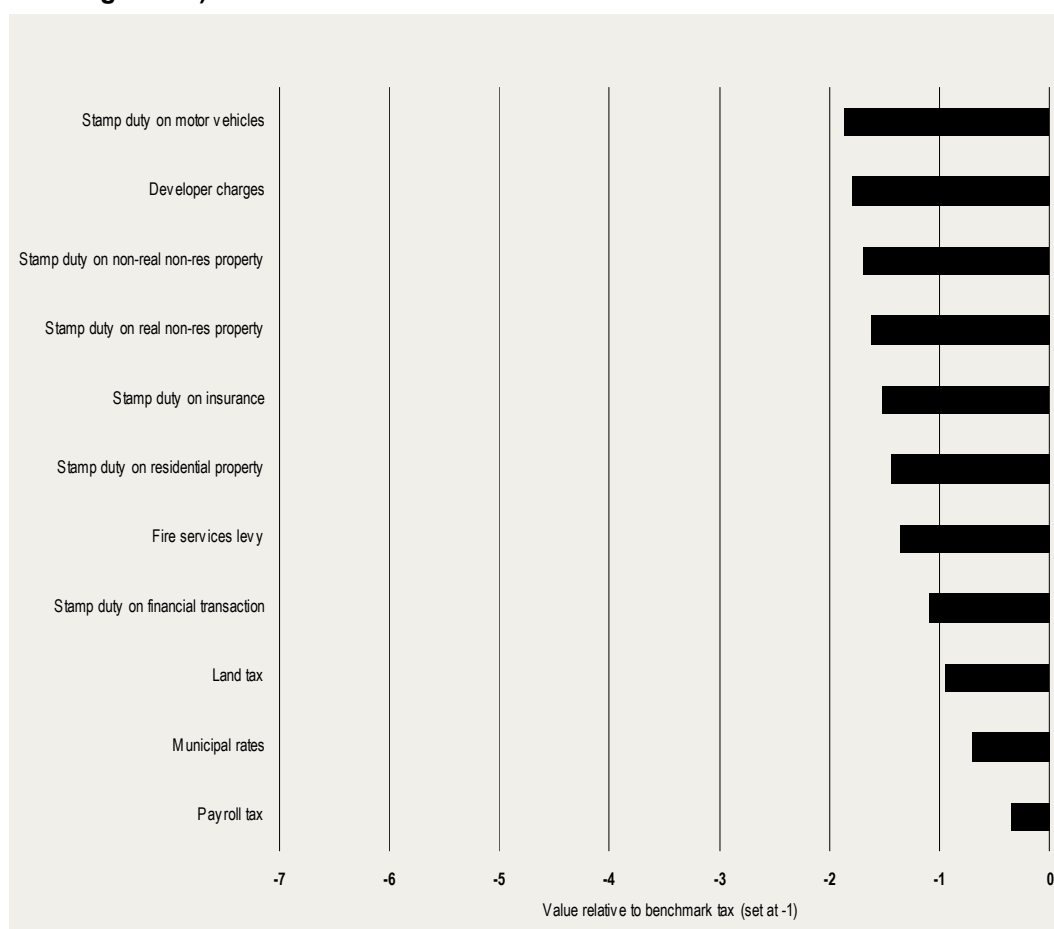
- Stamp duties on non-residential properties are again the 'worst' taxes within the selection – that is, reducing them would produce the greatest gains in exports for every dollar of taxation reduced. This does not reflect any direct connection between property and exports. Instead, the analysis indicates that these taxes induce distortions that reduce efficiency in general which also reduces export competitiveness.
- Stamp duties on motor vehicles and developer charges are next in their deleterious impact upon exports. Again, this does not reflect a direct connection between the goods being taxed and exports, rather than reflecting another attribute about the pervasive nature of distortions and their broad impact on many attributes of economic performance.
- There is a cluster of taxes with an index score or around two on this indicator including land tax and some stamp duties which seem to involve distortions.

- Payroll tax and to a lesser extent municipal rates seem to be broadly in line with the benchmark tax in terms of their impact upon changes in exports.

State taxes and prices

Benchmarking results that examined the impact of reducing taxes on the level of prices are reported in chart 6.5. It is important to note that this analysis relates to the level of prices rather than the rate of change (inflation). The level of prices relates to whether goods are affordable or not. An index score here reflects how much the general level of prices would be reduced given a reduction in taxes relative to a similar sized change in the benchmark tax. The analysis reflects the fact that the final price of goods reflects how much tax is paid as well as the cost of economic resources used to produce that good. The level of prices reported relates to prices throughout the economy, not just the goods where the taxes are applied.

6.5 Benchmark 4: taxes and the level of prices — index scores (Benchmark tax= negative 1)



Data source: MMRF simulation results.

Key points observed from this analysis are that:

- Reductions in stamp duties in general would result in greater reductions in general prices than reduction in the benchmark tax.
- Developer charges (applied at the State level in NSW only) also have an adverse impact on the general level of prices (essentially the point is that making housing expensive flows through to many other goods).
- Reductions in land taxes and municipal rates would result in price reductions that are about the same magnitude, or a little less than changes in the benchmark tax.
- Reductions in payroll tax would have significantly less impact upon changes in prices than the changes in the benchmark tax. The model results suggest that very little of payroll taxes are passed forward to customers in terms of higher prices. It is notable that while the simulation results also suggest that relatively little of land taxes or municipal rates are passed forward to customers (these taxes also have lower price index scores than the score for the benchmark tax), payroll tax has a much lower impact on price levels than these taxes.
- Overall, it is notable that the range of variance in the index score in regard to price levels is significantly smaller than the range for other economic outcomes studied. That is, the impact on the general price level is smaller than the impact upon indicators such as economic output, investment or exports.

Australian and State Government fiscal balances

The analysis also looked at the impact of tax changes upon the balance of finances between the Australian Government and the States. In this analysis the initial focus is upon changes in the Vertical Fiscal Imbalance (VFI).

Changes in the VFI are measured using the following conventional summary indicator (IMF 2007):

$$\text{VFI} = \frac{\text{Aus Gov Rev.} - \text{All State Gov Rev.}}{\text{Aus Gov. Exp.} + \text{All State Gov. Exp.}}$$

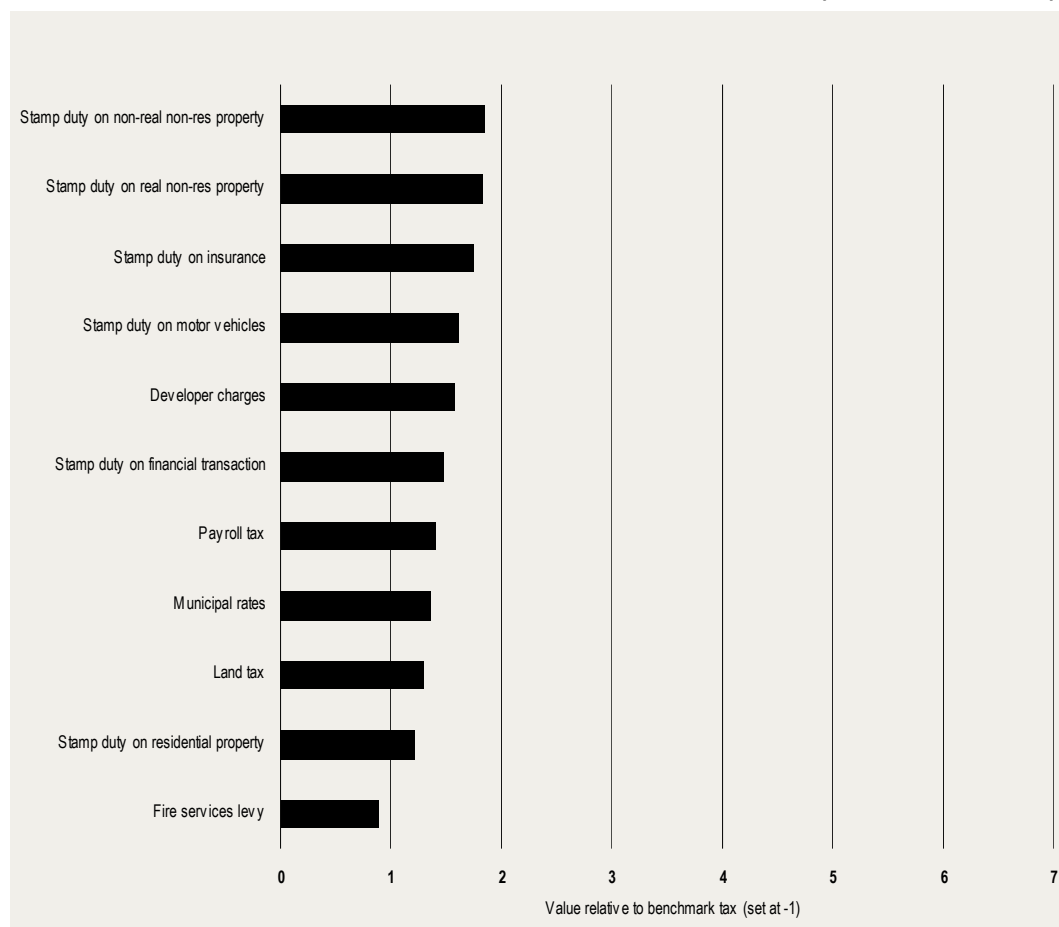
The greater the deviation between the Australian Government revenue to expenditure ratio and the combined State government revenue to expenditure ratio the more reliant the States are on the tax base of the Australian Government.¹⁷ The benchmark is a cut in the GST. This is treated as Australian Government revenue so that change has a negative sign. Other changes examined are similar sized cuts in State taxes. These reduce State own source revenue which results in a 'worse' (larger) VFI which therefore results in an index score that has a positive sign. In addition to the direct effect, cutting inefficient (that is, distorting) State taxes raises economic

¹⁷ This is a better measure than using State government finances in isolation as it is invariant to the level of total government budget deficit or surplus.

activity which typically raises Federal tax collections by more than it raises State tax revenue collected. As a result, cutting the 'poor' State taxes tends to make the VFI deteriorate.

Index scores that result from this analysis are reported in chart 6.6. A higher positive score indicates a worsening of the VFI. That is, reducing taxes with a high index score reduces fiscal autonomy for the States.

6.6 Benchmark 5: taxes and the fiscal balance — index scores (Benchmark tax=1)



Data source: MMRF simulation results.

From the analysis it is apparent that:

- Reductions in most State taxes raise the VFI by an amount that is larger than the absolute amount of change in revenue due to the change in the benchmark tax (which would have an index value of +1). The index 'premium' (above +1) indicates that the reduction in the tax and subsequent flow on increase in activity and flow-on tax increases has a stronger effect in raising Federal taxes than State taxes. Reductions in the stamp duties tend to dominate this effect.
- Notably, the range between the highest and lowest index scores for cuts in the State taxes is relatively small (between 0.9 and 1.9, with many taxes at around 1.5).

This suggests that there is not a substantive effect upon the VFI between changes in State taxes. Essentially cutting State taxes will increase the VFI, while raising State taxes will reduce it.

There are 'better' and 'worse' taxes

The benchmarking results display a high degree of consistency. Taxes tend to be consistently positioned at either the top or bottom of the charts. That is, there are taxes that are regularly 'worse' (at the top of charts), and those that are consistently 'better' (at the bottom).¹⁸

Stamp duties on real and non-real non-residential properties are regularly among the poorest performing taxes. This finding reinforces the decision by the Australian Government and State governments to abolish these taxes under the IGA.

Transaction taxes – essentially the stamp duties, levies and the developer charges (in NSW) – distort activity. These may not be the worst taxes but they do perform poorer than most taxes against the majority of indicators. Raising these taxes has damaging impacts upon economic performance measured over the range of indicators considered and reducing them would improve economic performance.

By comparison, taxes with a broader revenue base consistently perform well. Payroll tax outperformed all other State taxes on every benchmark except for the VFI.

Land taxes are generally somewhere between the worst and best taxes in the evaluation. Contrary to what some might have expected, land taxes perform consistently 'worse' than payroll tax in every indicator (except the VFI). This counters traditional argument that the immovability of a taxed good or service is a proxy for its efficiency (and being clearly immovable, land taxation should be highly rated).

The fact that there are consistently some taxes that are 'better' and 'worse' taxes than the others suggests that adjusting the tax mix could alter economic outcomes for the better or worse as well.

This benchmarking exercise also highlights the key trade-offs inherent to the design of the tax system. For example, expansion of those taxes that enhance economic growth may worsen the problems caused by the fiscal imbalance. Therefore, a tax reform portfolio that tries to achieve the maximum growth outcome and minimise fiscal imbalance may not be feasible. This strengthens the notion that the reform agenda must include a clear, consistent and non-contradictory objective.

¹⁸ The characteristics of the benchmark tax – being a broad based, uniform tax with a low rate – consistently positioned it as the 'best' performing tax of all those included in the exercise.

Constraints to change

Having identified the problems with State taxes and given the knowledge that it is feasible to discern taxes that engender consistently poor outcomes, the key next step should be the removal of these taxes. The discussion now turns to the strategic constraints to be addressed in making such changes.

The need for large scale reforms

The objectives of State tax reform are unlikely to be achieved through small scale incremental adjustments. Inevitably, as discussed when reviewing the application of tax principles, taxes involve significant trade-offs. It is unlikely that reform can leave *everyone* paying less tax. Constructive changes involve a mix of tax and non-tax benefits (such as increased employment and increases in background levels of activity) that can take some time for the community to see as being tangible. Governments will be reluctant to impose the costs that come with most tax reform exercises unless these are offset by gains that are clearly worth the effort. Making the changes more noticeable generally involves making them larger.

A genuinely strategic approach to State tax reform would involve reasonably large scale change. The approach proposed here is to examine changes of between \$10 billion and \$20 billion in State governments' annual revenue collection.

This raises an overarching constraint: what to do about the loss of revenue that the elimination of bad taxes brings? Key possibilities include:

- induced revenue;
- new State taxes;
- reduce State government expenditure;
- increase State government debt; and
- revenue base sharing.

These possibilities are reviewed in the sections that follow.

Insufficient revenue growth dividend

One possibility is that the removal of inefficient or distorting State taxes would boost economic growth and increase a government's overall revenue collection from the remaining efficient taxes. That is: it is possible that a reduction in taxes might *increase* tax revenue. The expectation of a 'growth dividend' from tax reform is sometimes raised in the tax reform debate. Sometimes this conjecture arises from the Laffer curve. Some observations about the Laffer curve are provided in the box 6.7.

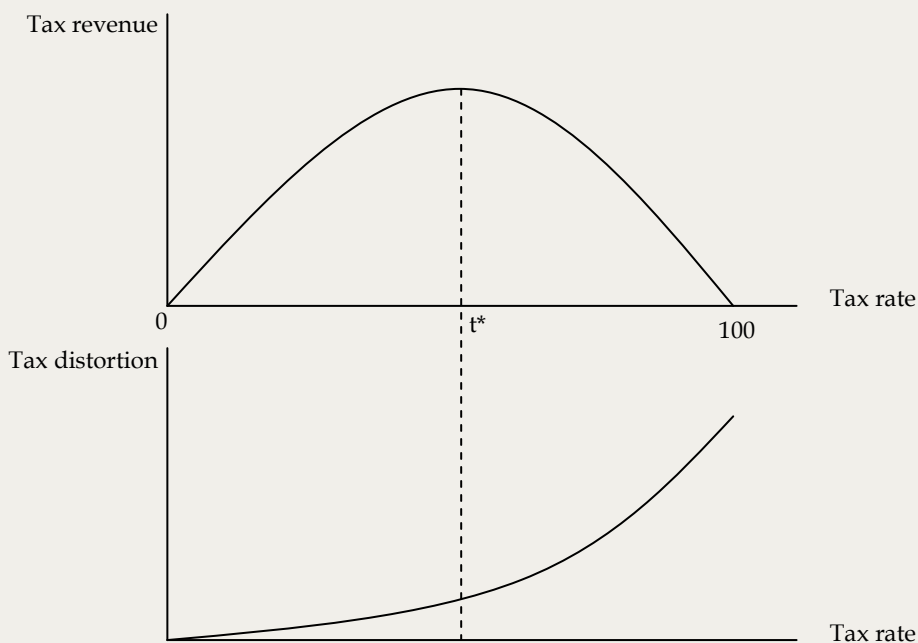
6.7 The Laffer curve

When taxes are small, progressively increasing the tax rate will generally result in a government collecting greater tax revenues. However, when taxes are raised too high, economic activity will be sufficiently stifled such that further increases will actually begin to reduce tax revenues. The relationship between tax rates, tax revenues and economic activity is described by the Laffer curve, and is depicted in the figure below.

Initially, at a tax rate of 0 per cent, \$0 tax revenue is collected. A tax rate of 100 per cent however, also collects \$0. Revenues are maximised at a point in between these two extremes. In the chart below, this occurs at rate of t^* .

The Laffer curve is often used to show how tax cuts can *increase* revenue collected. This can be achieved when the economy is located to the right of t^* . However, empirical evidence on the shape of the Laffer curve, and the economy's location on it, is mixed. Generally, changes in tax rates are accompanied by other fiscal policy measures and occur in periods where there have been pressures for policy change such as the onset of a recession, or the opposite problem, emerging inflation, which makes empirical analysis difficult.

An often overlooked accompaniment of the Laffer curve is the relationship between tax rates and inefficiency. Although the effect on revenues is dependent on where the economy lies on the Laffer curve, the economic distortion created by increasing a tax will always increase at an increasing rate. So, while lower taxes may or many not increase tax revenues, they will always increase the economy's efficiency.



Source: Stiglitz (2000).

Practical experience with tax reform in Australia suggests that it is not realistic to expect that cuts in State taxes will result in more than offsetting increases in revenue collections. A key point is that, because of weaknesses in the State tax base, growth in economic activity generally results in increases in Australian Government revenue receipts rather than State tax gains. The benchmarking analysis regarding the impact upon the VFI adds further weight to this characterisation. In addition, even when looking at national or general government sector tax collections, the experience has been that growth is not sufficient to fully offset the original cut in taxes. To put this into Laffer curve terms, it is likely that Australia's tax systems are at that point where cuts in taxes still result in reductions in revenue.

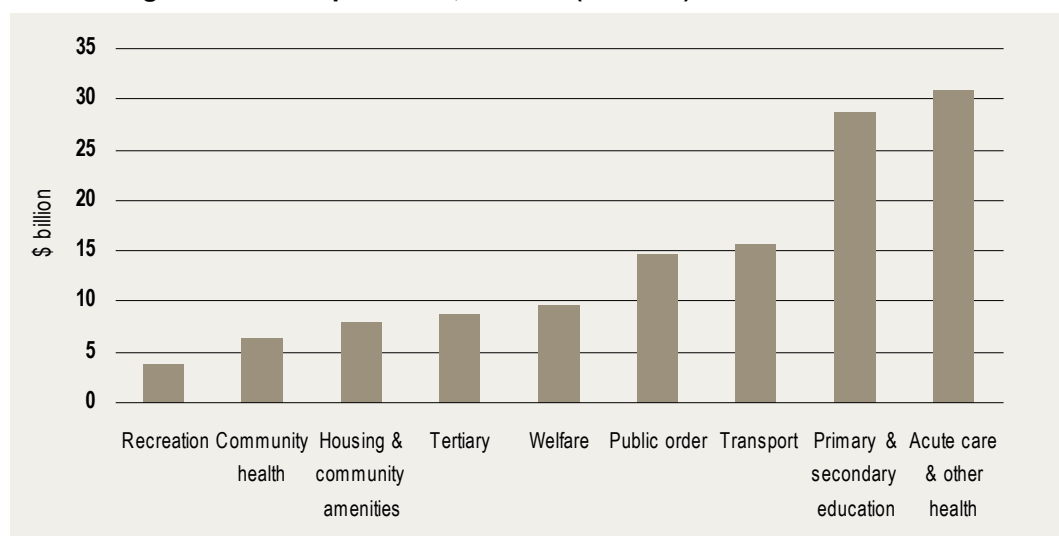
This does not suggest that there is no increase in tax revenue from tax cuts. Many studies (for instance, Australian Government 1998 and Ralph 1999) have shown that increases can and should be counted when undertaking useful tax reform. The case made here is that the gains will probably not fully offset the taxes foregone, certainly not in the initial years.

Cannot rely upon large scale State expenditure cuts

Tax reductions could be paid for through reductions in State government spending. The magnitude of tax reductions sought in this strategic approach pose a significant constraint where the required expenditure reductions would cut deeply into State government service provision.

To put this into perspective, chart 6.8 shows State government expenditure by purpose.

6.8 State government expenditure, 2006-07 (\$ billion)



Data source: ABS Cat. No.5512.

As shown in the chart, State governments provide essential public services, including education, health and public order. A tax reform involving, say, abolishment of stamp duties on all properties, costing the State governments around \$12 billion, will imply either cutting all expenditure on housing and community health or cutting 40 per cent of primary and secondary schools funding. A \$20 billion reduction in State taxes would probably require changes in health care and hospitals. It is unrealistic to expect that deep cuts in these services could be accommodated by the community in the name of eliminating even the most grossly distorting taxes which the community has been paying for many decades.

The current Australian Government does not seem to have an explicit appetite for the pursuit of smaller government. For example, the terms of reference of the ongoing Henry Review of Australian Taxes (Australian Government 2008d) specifically require that the review should not presume a smaller general government sector.

Another possibility is that the State governments transfer responsibility for some key and expensive service provision activities to the Australian Government. This has been proposed from time to time, most recently by the previous Coalition Government. This raises many fundamental issues about efficient service provision and the responsibilities of different levels of government. Consideration of these issues in the name of State tax reform is to 'wag the dog by the tail'. It is unlikely that raising these possibilities as the only means of funding tax reform would raise a great deal of interest in those reforms and more likely, that the greater issues would be seen as a major barrier.

Limited scope for new major State taxes

There are very few potential tax bases that could raise the amounts of money being considered that are not already subject to taxation. The area sometimes raised as offering possibilities is in the introduction of 'green' or more sustainable taxes.

The most likely candidate for green tax revenue is the revenue from measures to combat greenhouse gas emissions. It is likely that this would provide an excellent revenue base. Greenhouse emissions are pervasive throughout the economy and applying a charge for these could raise substantial revenue and, rather than induce distortions, could correct the situation where excessive use was being made of the atmosphere and reduce the threat of global warming.

The Australian Government recently released a green paper discussing the introduction of a Carbon Pollution Reduction Scheme (Australian Government 2008b). While the sale of pollution permits under the proposed scheme would raise substantial revenue, the intent is to redirect these funds to facilitate and accelerate the process of decarbonisation and to ease the transition and encourage a

fair distribution of the burden of adjustment. There is no prospect of using this tax base as a source of funds for State government tax reform.

Gambling taxes, user charges and increased State owned business dividends are also regularly proposed as potential sources of additional revenue. State governments have been active in these areas and they have made alterations to raise revenue. Government should continue to pursue these areas, but it should be viewed that it is not likely that there is scope for additional funds of the magnitude considered here that have not already been found.

A further long standing possibility is the re-introduction of State income taxes. Previous Australian Governments have legislated to enable this, but the possibility has not been taken up by the States. Realistically, it is likely that political pressures and popular sentiment weigh heavily against the introduction of separate State government income taxes or State-by-State top ups to Australian Government collections.

It should be noted that there are some perverse incentives in Australia's fiscal federalism arrangements that pose further barriers to innovation in revenue collection by the State governments. These arise from the methodologies used by the Grants Commission in determining relativities used in calculating the distribution of Federal grants between the States under the process of horizontal fiscal equalisation (IPART 2008). If a State government introduces a new tax and that State remained the only State that applied that tax under the current approaches the State would retain the full revenue collected. If sufficient States followed suit so that the tax became part of the average revenue collection of States, grant distribution arrangements would neutralise the overall revenue collected. States with that new tax get the average revenue and the political pain of having an additional tax, while States without the tax also obtain the average revenue without the tax. This and other attributes of the HFE (Horizontal Fiscal Equalisation) system are subject to strategic behaviour. The net result is difficult to measure, however it clearly weighs heavily against innovation in the tax base.

A structural increase in debt is not realistic

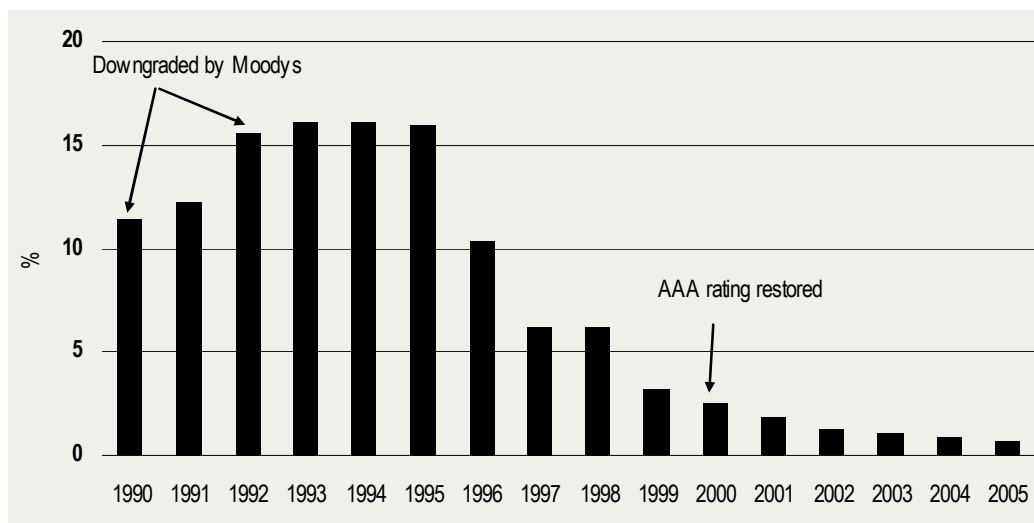
Conceptually, governments could fill the loss of tax revenue through increased borrowing. Recent announcements by State governments indicate that special factors, especially the downturn in property prices and stamp duty revenue collections, will involve an increase in borrowing. State governments will put the case that these developments are essentially cyclical. While there will be a period of increased debt, this does not change the underlying or long term structural budget situation and their ability to service debt without default.

The situation would be different for an essentially permanent \$10-20 billion increase in borrowings. State governments would find that the financial markets and credit

rating agencies will view that this involves a structural deterioration. The capacity of the States to repay debt and the risk of default would be viewed as increasing.

Experience shows that credit ratings are lowered following deterioration in the fiscal situation of States. In addition, it takes a long time to convince the markets that an improvement in budget balances is in fact a structural improvement. As shown in chart 6.9, in the case of Victoria, it took a long time (around 10 years) and good financial management (increased taxes and lower expenditure) to recover its AAA credit rating after being downgraded by Moody's.

6.9 Relationship between Victoria's net debt level and its credit rating



Data source: Owen (2007).

A reduction in State government credit ratings and higher interest rates, accompanied by an increase in the amount of debt, would raise debt servicing costs. This would reduce funds available for service provision or force an increase in borrowing, or a mix of both responses. State governments are unlikely to relinquish their fiscal discipline or their reputation for economic management in this way in exchange for the gains from tax reductions. It is not realistic to expect that a significant shortfall in revenue due to tax reform can be financed through an increase in general government debt.

Limits to expansion of existing taxes

State governments could choose to self-fund tax reform. That is, pay for revenue losses when cutting inefficient taxes by raising the rates of remaining taxes.

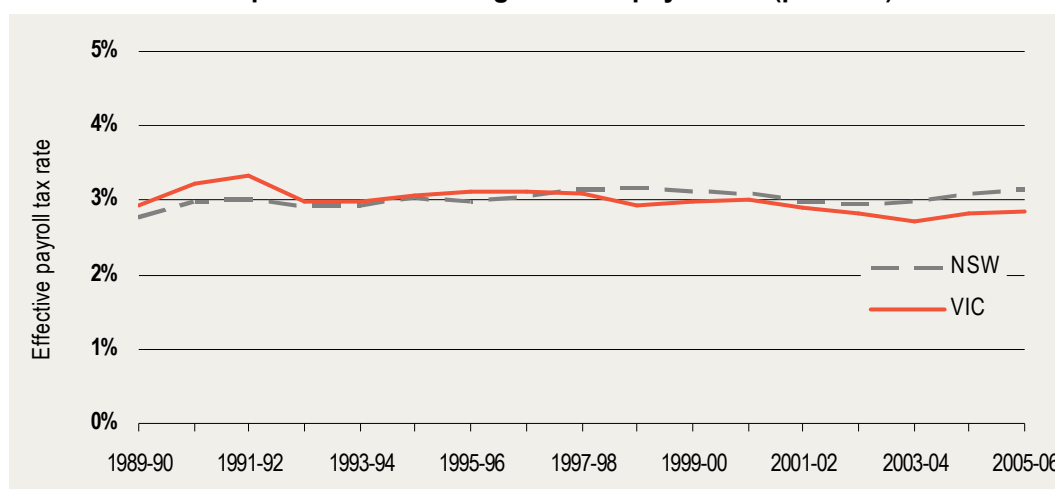
A substantial tax reform agenda that would see the elimination of \$10 billion to \$20 billion in taxes would eliminate many transfer duties and eat into land taxation. Given the earlier benchmarking results the next best remaining State tax is payroll tax. Changes of the magnitude envisaged would imply doubling the current payroll

tax rate (or doubling the current tax base). While it may be feasible to lift payroll tax collections, it is not clear that doubling the tax would be saleable.

There are a number of additional problems with an increase in payroll taxes. Notably, payroll taxes still involve generally poorer performance than the benchmark tax. Reliance on payroll tax increases therefore still involves a tax base with some of the problems of the current mix.

Additionally, possibly more than many other taxes, there is considerable tax competition between the States through payroll tax. The States adjust payroll taxes when seeking to attract investment and employment (as well as when responding strategically to incentives under the system of HFE and grants commission processes). One effect of this competition is for smaller States to undercut the larger States whenever the larger States cut their tax rate. The chart below which plots the 'effective' payroll tax rate applied by NSW and Victoria (which measures the average rate given various concessions and progressive scales) shows Victoria cutting its rate by more than NSW in recent years (see chart 6.10).

6.10 Interstate competition via lowering effective payroll tax (per cent)



Data source: CIE estimates based on ABS Cat. No. 5506 and 5220.

Over time, the main effect of interstate competition has been to reduce the overall amount of revenue raised from payroll taxes. It is likely that interstate competition in payroll tax would become more intense if this source of tax revenue was increased in absolute terms and in terms of relative importance. It is likely that increased reliance on this tax base will be unstable and unsustainable.

A State tax reform that is totally self-funded by the State governments will be difficult to implement. Some problems of this approach can be reduced if the States are able to act in a coordinated way, especially in terms of agreeing to eliminate tax competition in areas such as the payroll tax. This could add to the existing agreement between NSW and Victoria regarding harmonisation of payroll tax regimes.

Sharing the good tax bases

While some taxes are better than others, the benchmarking results suggest that most of the State taxes are poor taxes. All of the State taxes performed less well than the benchmark tax. The benchmark tax basically performs better than all of the existing State taxes because it has a very broad base. It is notable that other Australian Government taxes share the characteristic of having a broad base as well. Reflecting this, other studies have found that income taxes are also better than most if not all of the State taxes.

To obtain the best outcomes from tax reform, the focus of change should be upon elimination of the inefficient 'worse' taxes and finding a way to close the gap created by the loss of State tax revenue. Logically, this would involve substitution of the worst taxes with revenue from the best tax bases, which are those of the Australian Government.

Strategic tax reform approaches

Cooperative Federalism

Review of the strategic constraints to substantive State tax reform points to the salient role that cooperation in Federal arrangements needs to play. Essentially there are three broad themes in co-operative arrangements:

- cooperation within the States – agreement between the States eliminating inefficient taxes and expanding more efficient State taxes;
- cooperation between the Australian Government and the States – where Australian Government taxes (such as GST or personal income tax) are used to replace State tax revenue, or introduction of a State personal income tax or State income tax premium (as proposed by Carling 2007); and
- combined cooperation – a mixture of the preceding two themes.

BCTR reform approaches

To make the benefits of tax reform more tangible it is helpful to think about specific reform scenarios. Of course there are many State taxes and many possible combinations and permutations involving which taxes to change, which to increase and by how much. To illustrate and communicate effectively some of the key attributes of tax reform it is necessary to be selective. Three basic tax mix scenarios have been prepared to illustrate the potential gains from tax reform. Each scenario shows the effects of a portfolio of investment in tax reform.

The reform scenarios have been prepared in consultation with the BCTR project steering group for this study. Additional details on how these reform scenarios were selected are provided in box 6.11.

Given the focus of the study upon State business tax reform the scenarios deal with the removal or reduction in State business taxes. The State tax reform scenarios selected by the BCTR are intended to illustrate key discussions. They are designed to show that economic performance in terms of improved economic growth or enhanced international competitiveness can be delivered through reform. A further dimension that is important to illustrate is the effect of the scale of reform and how much tax reform we can afford to 'purchase,' given the revenue, debt, and expenditure neutrality constraints. Thus, the more funding we have, the more tax reform can be achieved.

All three scenarios reflect funding involvement from the Australian Government. Reflecting general fiscal policy constraints, it is assumed that the Australian Government will only fund up to \$10 billion. These funds are then transferred to the States through Federal grants. More details about each of these scenarios are provided below.

6.11 How were the change scenarios selected?

The change scenarios modelled in this study were selected by the BCTR through a workshop. During this workshop, the following evidence was presented to assist the BCTR in making choices about the reform scenarios:

- Evidence about the effects of changes in taxation. The analysis showed that the biggest gains from reform come from replacing inefficient State taxes with more efficient State or Federal taxes. This information assisted the BCTR in selecting the tax mix of the reform scenarios.
- Analysis of previous tax reform exercises and taxation reviews and of constraints to change was presented to assist the BCTR in identifying a strategic approach to reform. A more strategic approach pointed to the following elements of reform:
 - little can be achieved with incremental adjustments in specific taxes on a tax-by-tax basis;
 - reform of significant scale is needed;
 - reflecting many binding constraints, State tax reform has to be revenue, expenditure and debt neutral; and
 - Federal-State cooperation is essential. The Australian Government has access to the better tax bases to replace poor State taxes. State cooperation is also required to improve the contribution that can be made from the State taxes that are efficient and to maintain and preserve efficient revenue sources.

(continued next page)

6.11 How were the change scenarios selected (continued)

Based on the above, the BCTR selected three change scenarios that:

- turned the microscope of analysis upon issues that the BCTR viewed as important;
- were directed at shaping key outcomes (raising growth, raising competitiveness and maximising State tax reform);
- were revenue, expenditure and debt neutral;
- incorporated cooperation between the Australian and State governments;
- involved a reasonably large scale reform (change of roughly \$10 to \$20 billion); and
- recognised the fiscal constraints of the current economic conditions.

Change scenario 1: raising growth

The main thrust of this scenario is to obtain a boost to economic activity by removing or reducing State taxes that are suppressing it.

This is achieved by reducing State taxes that were found to have the higher index scores against benchmark 1 (taxes and growth) until the funds available for reform are exhausted. In this scenario the source of funds is funding from the Australian Government with the constraint discussed above. With only \$10 billion funding from the Australian Government, this scenario can afford to reform a few State taxes.

Specifically, the scenario of change includes:

- removal of stamp duty on insurance; and
- reduction in stamp duty on both residential and non-residential properties. This can be achieved by reducing the rate of those duties.

Payroll tax, land tax and stamp duties on motor vehicles remain unaltered.

Change scenario 2: enhancing international competitiveness

The target of this scenario is to enhance competitiveness, attracting more investment by removing State taxes that were found to have the higher index scores against benchmark 2 (taxes and competitiveness). These taxes are reduced or removed until the funds available for reform are exhausted. In this scenario the source of funds is funding from the Australian Government with the constraints discussed above.

Specifically, change scenario 2 involves:

- removal of stamp duty on non-residential properties;
- removal of land taxes; and

- reduction in payroll tax – achieved by either lowering the tax rate, or increasing the tax-free threshold, or broadening and reducing the tax rate. In the modelling, the reduction in payroll tax is simulated by broadening the tax base and reducing the tax rate.

Stamp duties on residential property, insurance and motor vehicles remained unaltered.

Change scenario 3: maximising State tax reform

This scenario illustrates the case where Australian and State governments use their combined resources to make the most substantial reductions in the worst taxes. By combining State and Australian Government resources, more reform is feasible than under the other two change scenarios. Consequently, change scenario 3 involves the largest change in State taxes. In this change scenario the Australian Government's contribution is broadly matched by the States' contribution to reform.¹⁹

Specifically, change scenario 3 includes:

- removal of stamp duty on insurance;
- removal of stamp duty on both residential and non-residential properties (compared with reduction in tax rates in Scenario 1);
- reduced land taxes – achieved by either lowering the tax rate, or increasing the tax-free threshold, or broadening and reducing the tax rate. In the modelling, the reduction in land tax is simulated by reducing the tax rate; and
- an increase in revenues raised from a broad based, uniform State tax.

Other State taxes remain unaltered.

Realistically, the scope for the States to raise additional revenue necessary from a broad based tax is constrained. Ideally, the States and Territories would replace their inefficient legacy taxes with an efficient broad based tax. Although not within the scope of the review, broadening the base and/or increasing the rate of the GST is one example of an efficient and non-distortionary mechanism for funding this high-growth scenario.

Table 6.12 summarises the three proposed tax reform scenarios and chart 6.13 shows the relative change in the State tax bases. As mentioned before, these scenarios are based on input from the BCTR and are selected to illustrate the impacts of different targets, different tax mix and different amounts of reform.

¹⁹ Similar to the treatment of Federal funding, this analysis does not advocate financing State tax reform with an increase in a particular State tax. For modeling and analytical convenience, the analysis assumes that the States have access to a low, uniform, broad based tax – and this tax is used to finance the State's contribution to this change portfolio.

Notably, the tax changes presented in table 6.12 reflect the *direct* costs of the reforms. That is, the table reports the gross impact of reform and does not account for changes in tax collections that might result from *indirect* or second round effects (adjustments that occur as the direct impacts - the tax changes-, filter through the economy).²⁰

6.12 BCTR proposed State tax reform scenarios

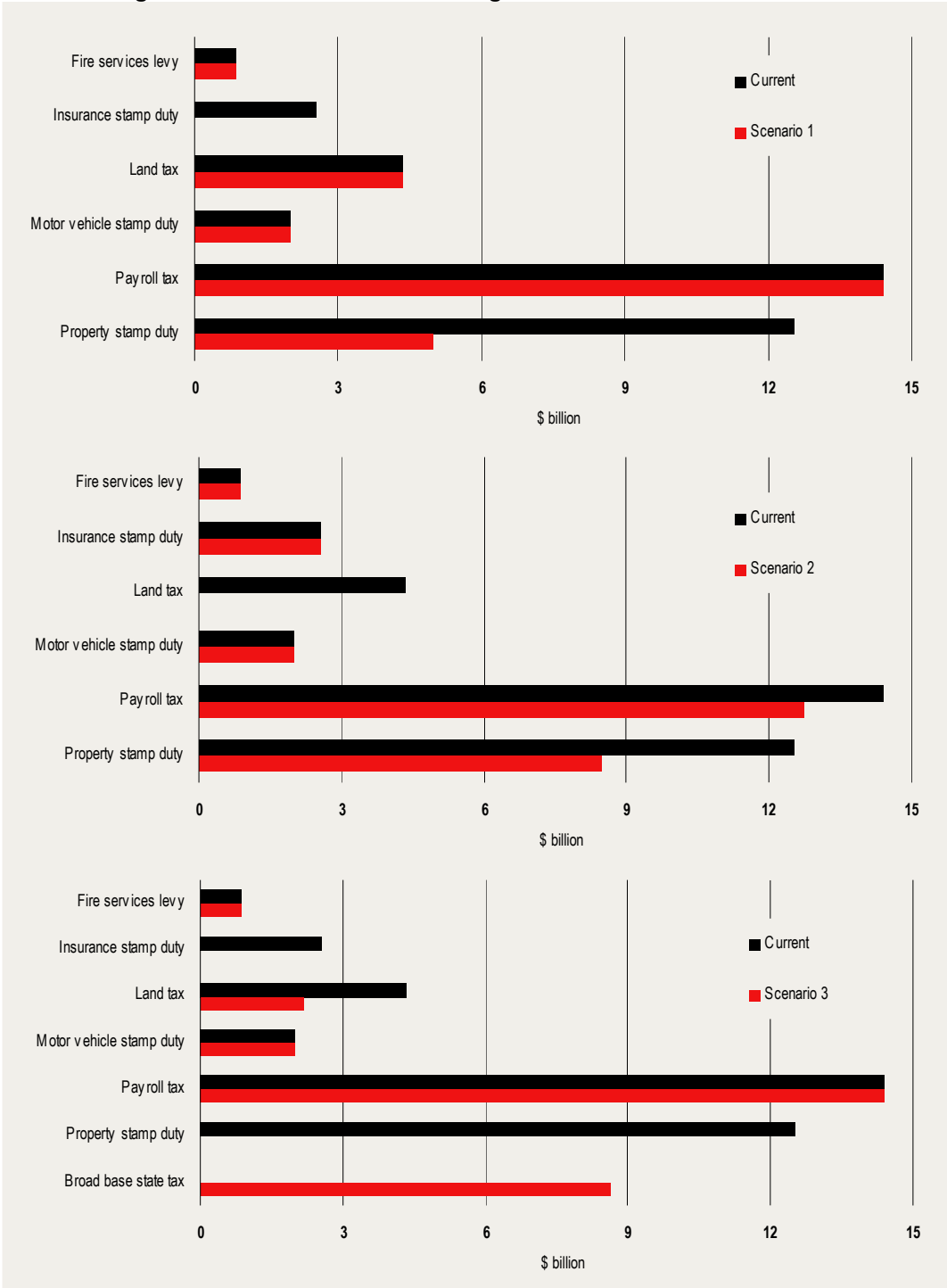
<i>Change scenario</i>	<i>Objective</i>	<i>Source of funds</i>	<i>Proposed tax changes (cost of reforms)</i>
1	Raise growth	Australian Government (\$10 billion).	<ul style="list-style-type: none"> ▪ Reduce stamp duties on residential and non-residential property (\$7.5 billion). ▪ Remove insurance duties (\$2.5 billion). <p>Total change: \$10 billion.</p>
2	Enhance international competitiveness	Australian Government (\$10 billion).	<ul style="list-style-type: none"> ▪ Remove stamp duties on commercial property (\$4.0 billion). ▪ Remove land tax (\$4.4 billion). ▪ Reduce payroll tax (\$1.7 billion). <p>Total change: \$10 billion.</p>
3	Maximise elimination of the worst State taxes	Australian Government (\$8.6 billion). State contribution via a broad State tax (\$8.6 billion).	<ul style="list-style-type: none"> ▪ Remove stamp duties on residential and non-residential property (\$12.5 billion). ▪ Remove insurance duties (\$2.5 billion). ▪ Reduce land tax (\$2.2 billion). <p>Total change: \$17.2 billion.</p>

Note: Assumes that stamp duties on financial transactions and non-real non-residential property are removed according to the IGA timetable.

Source: BCTR workshop.

²⁰ Second round effects on revenue collections are an important part of the MMRF analysis, and their impacts are accounted for in the next chapter.

6.13 Change scenarios and current State government revenues



Data Source: CIE & BCTR.

Key points

- Reform of significant scale is needed — change of roughly \$10 billion to \$20 billion is required.
- Reflecting many binding constraints, State tax reform has to be revenue, expenditure and debt neutral.
- Little can be achieved with incremental adjustments in specific taxes on a tax-by-tax basis. A strategic approach must involve change over a portfolio directed at shaping key outcomes.
- Three illustrative scenarios have been identified based on guidance from the BCTR. These focus upon raising growth, raising competitiveness and maximising State tax reform.

7 *Gains from strategic reform*

Strategic reform requires the evaluation of portfolios of taxes rather than an assessment of each tax in isolation. This section reports on the expected economic impact of the adoption of strategic tax reform. The potential gains of different portfolios of investment in tax reform are illustrated using three basic tax mix scenarios.

Analysis framework

For each scenario of tax changes the analysis measures how a range of economic variables are expected to vary through time. The assessment is made relative to a base case (baseline). The baseline is a projection of outcomes without the strategic changes being studied. The baseline is not static. It includes some changes, such as the completion of tax reform commitments made by the States under the IGA. This base case projection assumes that stamp duties on financial transactions and non-real non-residential property will be removed according to the IGA timetable; otherwise it assumes that there will be no future change to State taxes.

The analysis then introduces the mix of tax changes undertaken in each reform scenario. The tax changes for each scenario start from 2010. All three change scenarios are modelled as budget neutral for the government sector as a whole. If a change scenario involves fewer revenues being collected by the States, it is assumed that the shortfall will be met with an increase in grants from the Australian Government. These grants are in turn funded with an increase in Federal taxes.²¹ Essentially, the analysis seeks to identify the effects induced by changing the composition of tax revenues, not their overall level.

The analysis captures both short term and long term impacts of tax changes. The main difference between the two is that capital and wage adjustments cannot occur

²¹ Importantly, this analysis is not advocating to finance State tax reform with an increase in a particular Federal tax. However, for analytical and modelling convenience, the analysis is framed around funding reform with additional GST revenues. The GST is a broad based, uniform tax that is applied equally in all jurisdictions. Other Federal taxes, such as personal income tax, involve complicated tax thresholds that can confuse the analysis. That said, income taxes and the GST are broadly equivalent in an economic sense. Consequently, it can be expected that the difference between funding reform with greater GST revenues versus income tax revenues will be relatively non-material.

instantly in the short term. Policy changes with long term economic gains may have short term economic costs as the economy adjusts to the new incentives captured in prices and rates of return and wages adjust to equilibrium.

While the model is able to separate and identify the specific implications of reform to each jurisdiction (and to the fiscal balance of those jurisdictions), for simplicity the States are treated as a group. Attempting to account for the different tax arrangements of each jurisdiction would weaken the analysis because:

- the results would be influenced by inter-jurisdictional competition; and
- arbitrary decisions would be required about how each change scenario would be applied to each regime.

By treating the States as a group the analysis is able to avoid both of these issues. Tax rates and thresholds are thus averaged such that they are applied in a common way across the States and the economy. Additionally, this assumption captures the spirit of cooperation among the States in the pursuit of improved taxation arrangements.

Details about the analysis framework and the Computable General Equilibrium (CGE) model employed (the MMRF) are provided in appendix B of this report.

Impacts of scenarios against objectives

The tax reform scenarios proposed by the BCTR aim to increase economic activity and/or enhance competitiveness (in terms of higher investment). This section evaluates the performance of the three scenarios against these objectives.

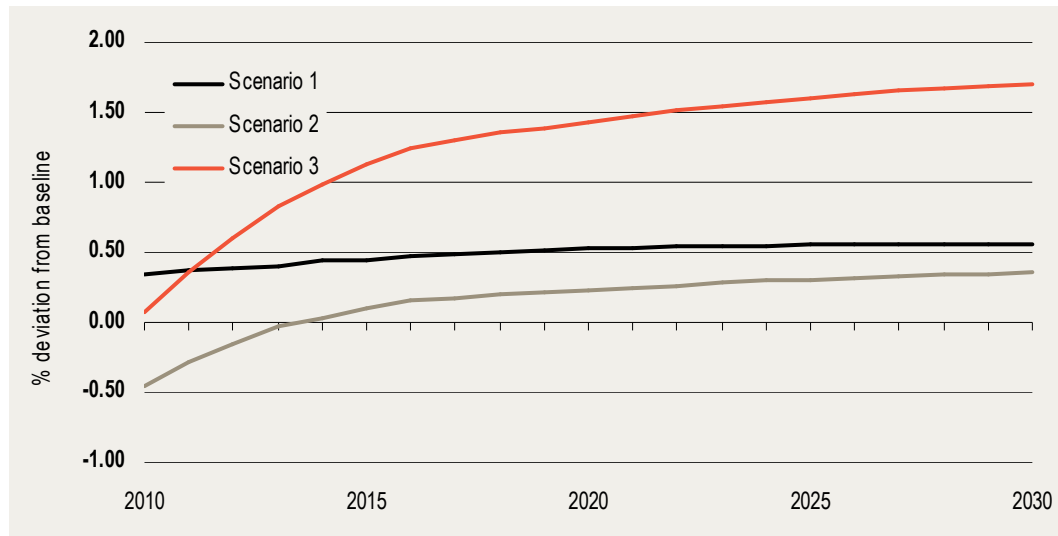
Economic activity (GDP)

The three change scenarios would generate higher GDP in the long run than would have been the case without tax reform (chart 7.1):

- Scenario 1, which aims to remove impediments to growth, would increase long run GDP by 0.6 per cent.
- Scenario 2, which aims to remove impediments to investment, increases long run GDP by 0.4 per cent.
- Scenario 3, which aims to maximise tax reform, has the largest impact on GDP in the long run. Under these tax changes, GDP is 1.7 per cent higher than baseline.

In each scenario, the impact on GDP increases over time. In the short run, tax reforms reduce tax and stimulate investment. As Australia imports most of its investment goods, the higher investment leads to higher imports demand. In the first few years, this higher demand for imports would put a drag on GDP. Over time however, higher investment leads to an improvement in the productive capacity of Australia, boosting the economy's output.

7.1 Impacts on GDP (per cent deviation from baseline)

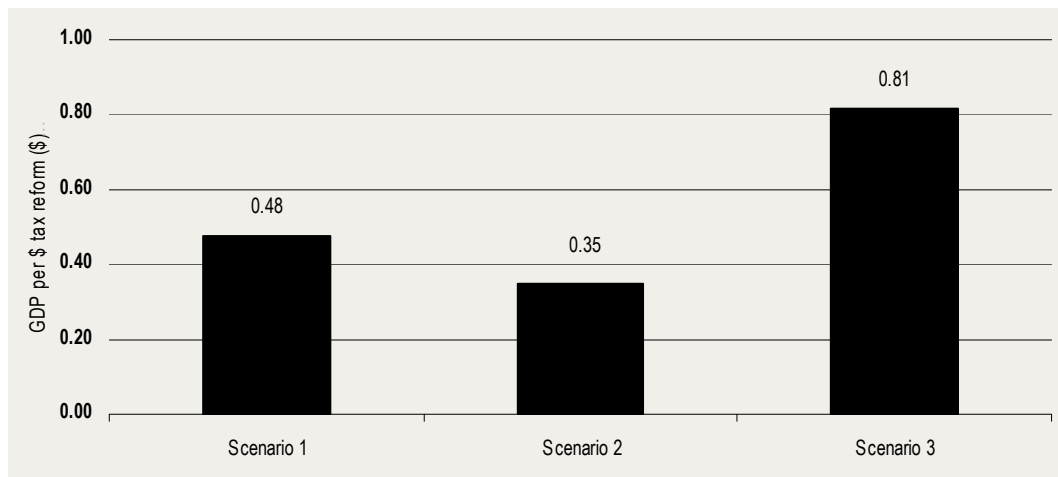


Data source: MMRF simulation results.

The GDP gains available through these tax reform scenarios are substantial. For example, a one per cent increase in GDP in 2015 is equivalent to a \$566 increase in GDP per person. The long run increase in GDP estimated under change scenario 3 is equivalent to an additional \$34 billion across Australia's economy in 2030 (in 2005-06 prices).

Growth in GDP can also be measured against the 'size' of change. Change in scenario 3 reflects the deepest reforms of the three scenarios and has a commensurately larger impact on economic activity. This set of tax reforms also has the highest impact on GDP for each dollar of change (chart 7.2), with each dollar of change providing an additional 81 cents of economic activity. Change scenario 1 provides 48 cents additional economic activity for a dollar of change, while scenario 2 generates 35 cents per dollar of change.

7.2 Increase in GDP per dollar of 'change', long run (\$, p.a.)



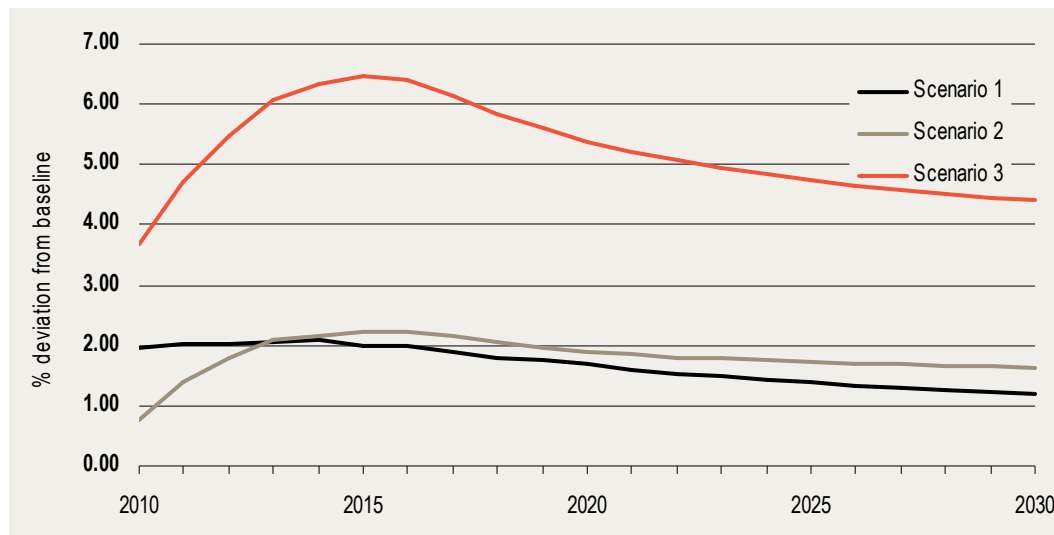
Data source: MMRF simulation results.

Competitiveness (Investment)

All three tax reform scenarios increase investment. Of the two scenarios of similar size, the scenario that aims to reduce impediments to investment, scenario 2, achieves a greater increase in long run investment. Changes in investment under each scenario peak in about 2015, as the capital stock adjusts to the higher rates of return available (chart 7.3).

Forecasts of long term outcomes provide a better indication of changes in economic sustainability. In the long run, scenario 2 generates a 1.6 per cent increase in investment per year compared with the base case scenario. Scenario 1 generates an increase in investment that is nearly as high of 1.2 per cent. The similar investment performance reflects one of the observations from the benchmarking analysis that the worst taxes in one indicator are also generally poor in other indicators. Reforms which remove the worst taxes will therefore have a similar favourable outcome.

7.3 Impacts on investment (per cent deviation from baseline)

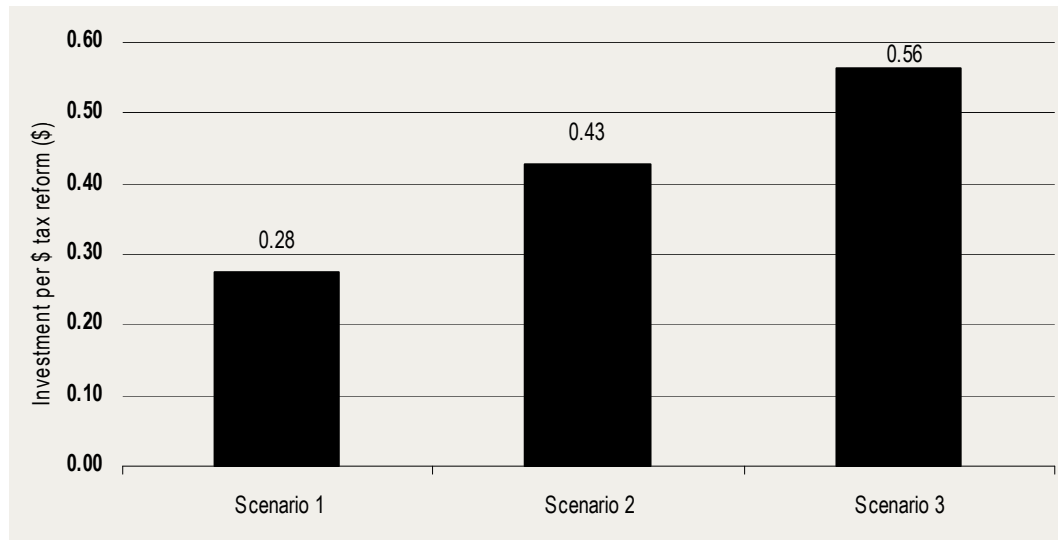


Data source: MMRF simulation results.

The largest change in investment is achieved with more extensive reform. In scenario 3, investment exceeds the baseline by 4.4 per cent in the long run. In dollar terms this is equivalent to an additional \$23 billion across Australia's economy in 2030 (in 2005-06 prices).

The increase in investment can also be measured against the 'size' of change. Again, when comparing the two scenarios of similar size, the change in investment generated by scenario 2 has the biggest 'bang for its buck.' Each dollar of change in this scenario provides an additional 43 cents of investment (chart 7.4). Scenario 1 however, only generates an additional 28 cents of investment per dollar of change. This is largely due to the fact that scenario 2 is designed to remove impediments to investment. Reflecting the deepest reforms, change in scenario 3 has a larger impact on investment generating 56 cents of additional investment per dollar of change.

7.4 Increase in investment per dollar of 'change', long run (\$, p.a.)



Data source: MMRF simulation results.

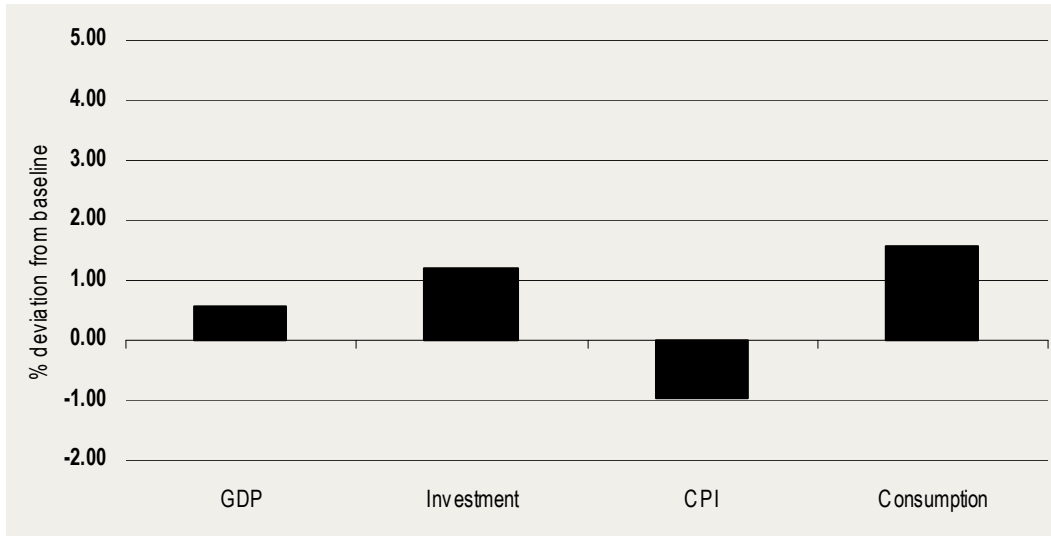
Impacts of scenarios on other economic variables

The analysis of the tax reform scenarios can trace through a range of additional economic impacts. Charts 7.5 to 7.7 show the long-term impacts of change scenarios 1, 2 and 3 on consumption and the Consumer Price Index (CPI), with GDP and investment impacts reported alongside for comparison.

Consumption, which is a good measure of consumer welfare, is higher than the baseline under all three scenarios. This is because the three scenarios boost investment and increase Australia's overall output. This additional output is directed towards the domestic market and leads to higher consumption. Scenario 3 has the biggest long run consumption benefits, as it undertakes the deepest reform of inefficient taxes.

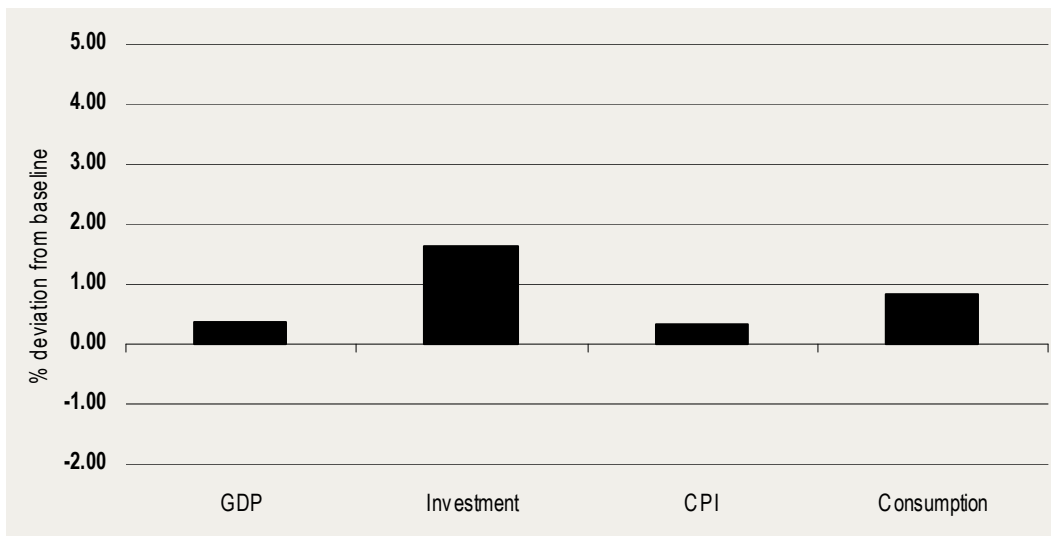
The CPI (used as a measure of the general price level) is lower than baseline under scenario 1 and scenario 3, but it is higher under scenario 2. Change scenario 2 focuses on removing impediments to investment (through reductions in land tax and payroll tax) rather than increasing general economic activity (through reductions in stamp duties on property and insurance). As shown in chapter 6, reducing land tax or payroll tax is not as effective in lowering prices as reducing stamp duties for property or insurance. Consequently, in scenario 2, any fall in prices that result from reducing land and payroll taxes are more than offset by the increase in the Australian Government taxes required to fund the reform. In contrast, in scenarios 1 and 3, the fall in prices resulting from the reduction in stamp duties on property and insurance is only partially offset by the increase in the Australian Government taxes to fund the reform.

7.5 Long run impacts of scenario 1 (per cent deviation from baseline)



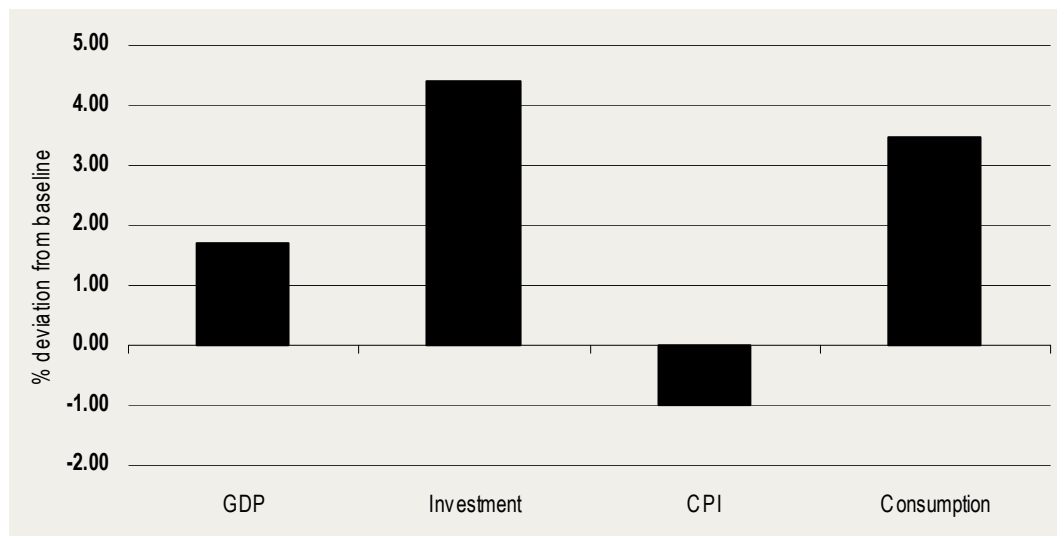
Note: The impacts in 2030 are used to illustrate the long term impacts.
 Data source: MMRF simulation results.

7.6 Long run impacts of scenario 2 (per cent deviation from baseline)



Note: The impacts in 2030 are used to illustrate the long term impacts.
 Data source: MMRF simulation results.

7.7 Impacts of scenario 3 (per cent deviation from baseline)



Note: The impacts in 2030 are used to illustrate the long term impacts.
Data source: MMRF simulation results

Other issues

Economywide modelling of the three change scenarios has highlighted the different attributes of change that can be accomplished by a new wave of State tax reform. The change scenarios illustrate the different outcomes that can be achieved through different strategies.

To this end then, the analysis has deliberately assessed the reforms in isolation of other policy changes. That is, the modelling is undertaken in a conservative manner which keeps overall fiscal policy unchanged by maintaining budget neutrality in the government sector in total (including both the Australian and State governments). Specifically, current government policies regarding expenditure and the fiscal balance are held constant, as is *total* government revenue collection. This modelling approach allows the analysis to focus on the impacts of changing just the *composition* of Australian taxes (that is, the effect of replacing 'bad' State taxes, with 'better' Federal taxes).

In practice, State tax reform may incorporate some finer subtleties that are not included in this analysis. It is likely that further State tax reform might seek to:

- reduce transitional costs by phasing in a reform agenda over a given period of time;
- account for the differences in State resources and conditions such that the gains from reform are distributed more evenly across the jurisdictions;
- underpin the reform process with an arrangement similar to the *Guaranteed Minimum Assistance* policy of the GST reforms; or
- be partially funded through an increase in the budget deficit .

It is clear from the analysis that mitigating the transitional costs of reform, as well as accounting for some horizontal equity issues, can be achieved by 'borrowing' against the future gains of reform. Certainly, drawing down on future reform gains may be necessary to make some aspects of the reform agenda more affordable to all in the community.

Additionally, while the model attempts to replicate the behaviour of the Australian economy as accurately as possible, there are some effects of tax reform which cannot be accounted for. For example, State tax reform as illustrated in the three change scenarios may involve:

- a decrease in the compliance burden and administration cost of the tax system;
- an increase in innovation;
- improved government sector performance;
- improved resource allocation from better 'price discovery;' and
- an increase in productivity from freer factor inputs.

Together, these factors imply that the efficiency gains of State reform are likely to exceed what the model predicts. The fact that the model does not account for these issues implicitly means that this analysis is conservative.

Key points

- **This chapter provides evidence that Australia would be better off with better taxes. Shifting the composition of taxes from high economic cost State taxes to lower cost Australia-wide taxes is forecast to produce improvements in many key economic outcomes.**
- **Adopting a portfolio of tax changes that concentrate upon removing and reducing those State taxes that introduce distortions would lift economic activity.**
- **Alternatively, it is feasible to adopt a portfolio of tax changes that concentrate reform upon those State taxes that impact upon investment, raise Australia's competitiveness and attract additional investment.**
- **Notably, the impact of reform is similar if the thrust of reform is to remove the worst State taxes. Output and competitiveness increase under all of the scenarios examined. This reflects the fact that taxes that are poor in terms of one indicator of performance are generally equally poor in other indicators.**
- **Pursuit of more reform results in greater benefits. The most extensive reform scenario, involving the abolition of stamp duties on residential and non-residential property, removal of insurance duties and reform of land taxes and payroll taxes is projected to increase long run GDP by 1.7 per cent per year,**

equivalent to an extra \$34 billion across Australia's economy (2005-06 prices), and investment by 4.4 per cent per year. Compared with the next best change scenario, change scenario 3 generates economic growth by more than a full percentage point.

8 *Fiscal capacity for reform*

The three scenarios of tax reform increase Australia's economic activity and investment. This is not because taxes are lower but because taxes are collected with fewer negative impacts on behaviour. While these tax reforms are a positive for the Australian economy, implementation of the reforms requires coordination between the Australian and State governments.

This chapter first discusses the fiscal impacts on the Australian and State governments' revenue collection under each tax reform scenario. It then assesses the capacity of governments to undertake tax reform following the recent deterioration of economic conditions due to the global financial crisis.

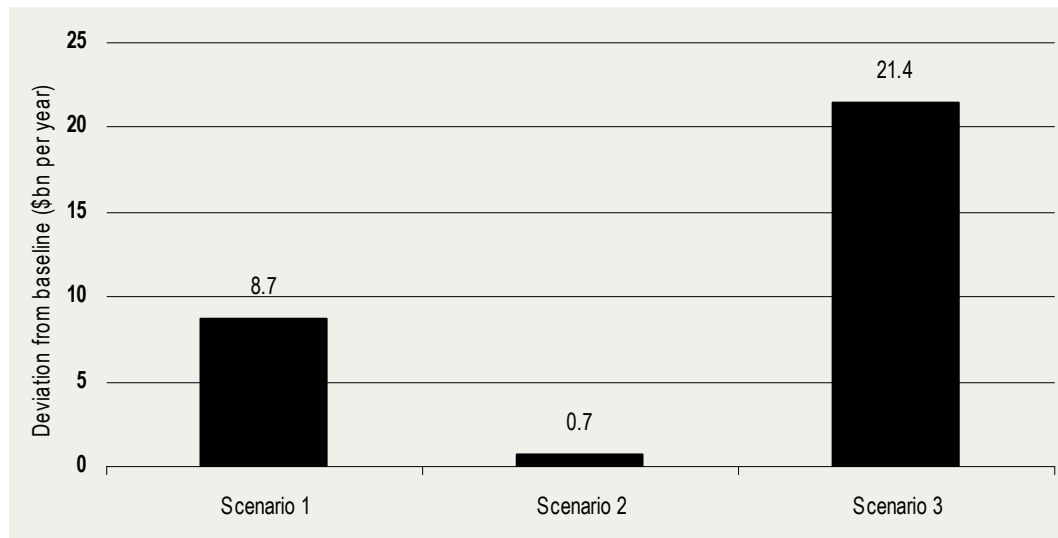
Increased revenue collection

The change scenarios examined maintain fiscal discipline. In particular, they involve maintenance of budget neutrality. That is, the overall general government sector maintains the same amount of taxes less expenditures. Only the shares of taxes collected by State versus Australian governments have been changed.

The analysis also imposes a further level of fiscal neutrality. When economic activity increases, government expenditures can increase (or fall) reflecting the obligations of governments. In the analysis, revenues also adjust to match any additional expenditure. This leaves the share of government as a proportion of activity at large unchanged. In other words, the analysis does not slip in assumptions about change in the role of government. It also reflects real world characteristics of built-in stabilisers in Australian budgets.

In the long term, the three scenarios would boost real government revenues for the combined Australian and State governments, compared with the baseline scenario where there is no tax reform (see chart 8.1). The higher revenue collection is to match the higher government expenditure in line with the bigger economy, which in turn is brought about by a more efficient tax system under each scenario. The differences between the revenue requirements of each scenario reflect their impacts on the growth of the economy (for instance, reforms under scenario 3 have a larger impact on economic activity and hence the revenue requirements are higher).

8.1 Long run revenue requirements (deviation from baseline, \$ billion, 2005-06 prices)



Data source: CIE estimates.

Composition of tax collection

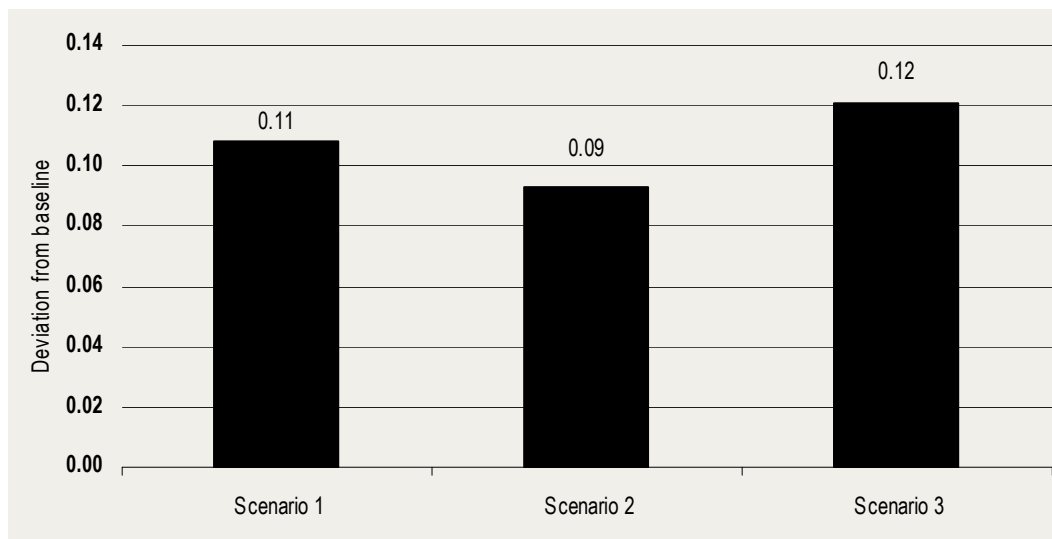
For the most part, the change scenarios have replaced inefficient State taxes with more efficient Australian Government taxes. This exercise has been conducted with an eye to reducing the 'costs' of the State tax system. However, altering the source of tax revenues has implications for the Vertical Fiscal Imbalance (VFI).

Each change scenario increases the VFI. As mentioned in chapter 6, the greater the difference between State revenues and expenditures, the more reliant the States are on the tax base of the Australian Government (and hence the larger the VFI).²² Under the baseline scenario, the VFI is projected to be 0.64 in 2010, falling to 0.55 by 2030.

Chart 8.2 shows the long run deviations in the VFI (from baseline) that result from the three tax reform scenarios. For all three scenarios, the VFI is higher relative to baseline. This is because all the scenarios involve a reduction in State taxes funded through higher Australian Government grants (which are in turn funded with an increase in more efficient Australia Government taxes). For scenario 1 the VFI is higher than baseline by 0.11. Scenario 2 has the smallest impact, with the VFI rising by 0.09. The tax reforms in scenario 3 raise the VFI by 0.12. The different effects on the VFI reflect the fact that the impacts on the economy vary under each scenario. Consequently, the flow-on effects on the tax collection are different.

²² For more details about the way VFI is measured refer to chapter 6.

8.2 Vertical Fiscal Imbalance (long run deviation from baseline, units)



Data source: MMRF simulation results.

Table 8.3 shows the additional Australian Government grants (in real terms) required by the State governments under each scenario to ensure that State governments' budget position is unchanged relative to baseline in the 3rd year, 10th year and 20th year following the implementation of the tax reform scenarios. Three years from the start of the reform measures, the additional grants required by the States to keep their budget positions unchanged range between \$10 billion and \$12 billion per year (in constant 2005-06 prices). In the long term, the additional grants required are projected to range between \$18 billion and \$27 billion (in constant 2005-06 prices) per year.

8.3 Additional grants from the Australian to State governments (\$ billion per year, 2005-06 prices)

	Scenario 1	Scenario 2	Scenario 3
3rd year	11.36	10.05	10.58
10th year	15.36	13.00	16.48
Long term	22.16	18.10	26.72

Note: The impacts in 2030 are used to illustrate the long term impacts.

Data source: MMRF simulation results.

To put these numbers into perspective, under the baseline scenario (where taxes remain unchanged), total grants received by the State governments are expected to increase from \$68 billion in 2010 to \$71 billion in 2013 to \$98 billion in 2030 (in constant 2005-06 price). In comparison, under scenario 1, grants would increase from \$77 billion in 2010 to \$82 billion in 2013 to \$120 billion in 2030. Under scenario 2, the grants would increase from \$77 billion in 2010 to \$81 billion in 2013 to \$116 billion in 2030. Finally, under scenario 3, the grants would increase from \$77 billion in 2010 to \$81 billion in 2013 to \$125 billion in 2030.

The increase in the required grants over time is mainly due to two factors. First, the foregone revenue from the State tax reform increases over time in line with the growth in the economy. Second, as mentioned earlier, as a result of the additional growth of the economy, government expenditure is higher for each scenario and this is funded mainly through Australian Government taxes.

The higher VFI is the trade off for shifting to more efficient taxes available through the Australian Government. Policies would be required to mitigate potential negative consequences relating to accountability and control and to effectively manage the flow of funds from the Australian to State governments.

Impacts on continuing State taxes

Tax reforms impact on the State (and Australian) taxes that remain in operation. These impacts can lead to higher or lower revenue collection from these taxes depending on how tax reforms shift economic activity. Table 8.4 outlines the impacts of each tax reform scenario on the taxation revenue from both reformed and non-reformed taxes. Results are reported for the Australian and State governments for the 1st year, 3rd year and long run following the introduction of the reforms. The focus is on short term changes in the revenue gathered from other taxes as this is an important input into the management of State government budgets.

As shown in table 8.4, total revenue collection from the non-reformed Australian and States taxes is higher than baseline for the three scenarios. This reflects the indirect impacts of the growing tax base arising from the boost to economic activity. There are some differences in the revenue impacts across the scenarios, again reflecting the fact that the size of the impacts of each scenario on economic activity is different.

For scenario 1, revenue from non-reformed State taxes and Australian Government taxes in the first year following the reforms is expected to be higher than baseline by \$1.9 billion and \$4 billion respectively. The higher revenue collection reflects the increase in economic activities in areas that continue to be taxed such as motor vehicle use, gambling and payroll.

8.4 Impact of reform on tax revenue (\$ billion, nominal)

		1st year	3rd year	Long term
Scenario 1	States			
	Reformed taxes	-11.3	-12.2	-23.0
	Non-reformed taxes	1.9	1.8	2.5
	Australian Government			
	Reformed taxes	8.3	9.4	19.2
	Non-reformed taxes	4.3	3.6	1.4
Scenario 2	States			
	Reformed taxes	-11.0	-11.4	-20.3
	Non-reformed taxes	1.4	1.5	2.7
	Australian Government			
	Reformed taxes	11.6	10.3	16.1
	Non-reformed taxes	2.1	2.6	3.7
Scenario 3	States			
	Reformed taxes	-9.3	-9.9	-26.1
	Non-reformed taxes	3.0	3.2	5.3
	Australian Government			
	Reformed taxes	11.2	9.7	20.9
	Non-reformed taxes	8.0	8.4	7.5

Note: The impacts in 2030 are used to illustrate the long term impacts.

Data source: MMRF simulation results.

Scenario 2 would also experience higher revenue collection from non-reformed taxes, although in the initial years following the implementation of reforms, its impacts are slightly smaller than in the other two scenarios. In the first year, revenue from non-reformed State taxes is higher by \$1.4 billion and revenue from non-reformed Australian Government taxes is higher by \$2.1 billion. This reflects the increased investment and an increase in tax collections from gambling, insurance and motor vehicles. Although residential stamp duties collection is expected to be higher under this scenario, the total revenue collection from property taxes is lower than baseline due to the removal of non-residential stamp duties and the reduction in land tax.

Scenario 3 reforms more State taxes than do the other change scenarios, and consequently produces the biggest gains in economic activity. The larger economic impacts from this scenario are also reflected in government finances. Indeed, both during the first years after the implementation of the reforms and over the longer term, revenue from non-reformed State and Australian Government taxes is higher than under the other two change scenarios.

It is notable that under all three change scenarios the unreformed tax increases are larger for the Australian Government than the State governments as a group. This confirms the point that the Australian Government's tax base is essentially more efficient than that of the States, which is a key part of the reason to reform the mix of taxes.

Adjustment to tax levels through time

The policy implication of having higher revenue collection from non-reformed taxes is that the Australian Government would need a smaller than expected rate increase for the chosen funding tax – be it GST or income tax, or another broad based and efficient tax. Changes in any Australian Government broad based tax (or a mixture of two or more) would allow poor State taxes to be replaced by better taxes.

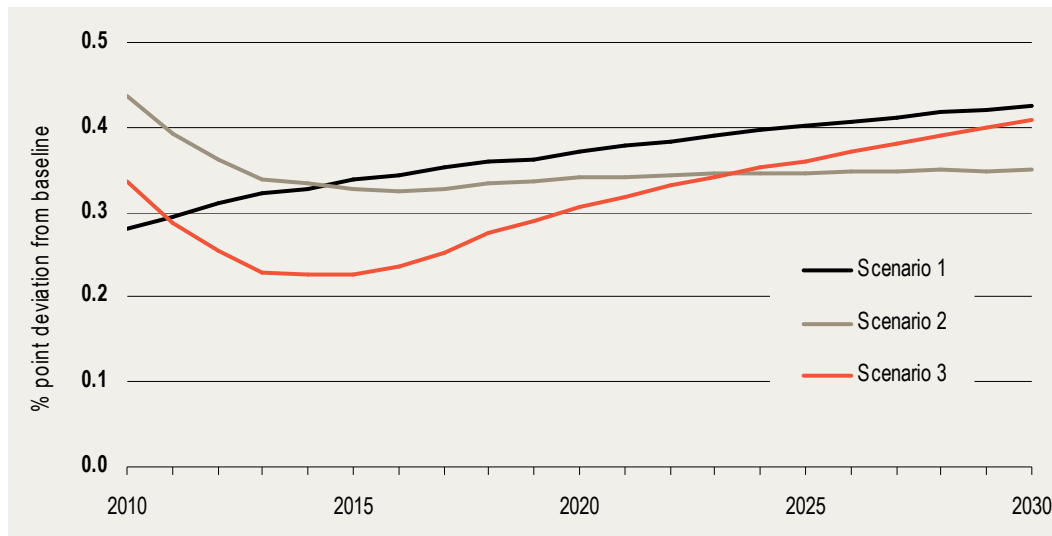
A simple way to illustrate the adjustments to tax levels through time is to look at how changes might be made to the GST to fund reform. The current GST rate is 10 per cent, and it collects around \$40 billion revenue. Using a back of the envelope calculation and assuming there are no indirect effects from changing the tax mix, increasing GST collection by \$10 billion would require raising the GST rate from 10 per cent to 12.5 per cent.

However, analysis shows that the required increase in the GST rate under the reform scenarios is between 0.35 and 0.45 percentage points (chart 8.5). In other words, the Australian Government could fund State tax reform by raising the GST rate from 10 per cent to around 10.45 per cent. The GST rate would not have to be increased by 2.5 percentage points (as in the back of the envelope calculation) because the State tax reforms would have positive flow-on impacts on the economy that would result in higher revenue collection from other revenue sources. A higher revenue collection from other sources means that the GST collection would not need to be increased by the full amount of the reform. Additionally, the reform would lead to more consumption, thus widening the tax base for the GST. This implies that a smaller GST rate increase would be sufficient to raise the additional revenue needed to fund the reform.²³

Importantly, the GST is used for illustrative purposes here because of the complexities involved in discussing results that relate to changes in the other taxes and mixtures of taxes. These are less concrete and may be subject to misinterpretation.

²³ This analysis and the results point to an advantage from the use of a CGE model that traces out the direct and indirect effects of a policy change. Without this it is possible that excessive taxes could be raised and States governments could be 'overpaid' for tax changes.

8.5 Australian Government tax rate changes through time (deviations from baseline, per cent)



^a The Australian Government taxes are presented as the equivalent change in the GST.
Data source: MMRF simulation results.

Implications of emerging economic adversity

The outlook for the global economy has deteriorated sharply in the last few months. The IMF has cut its forecast for global growth three times and is now forecasting a deep global recession (Australian Government 2009a).

The global financial crisis has driven almost all major advanced economies into recession – including the United States, United Kingdom, Euro area, Japan, Hong Kong, Singapore and New Zealand. Australia has not escaped the effects of this severe global economic contraction. The latest figures from the ABS show that the Australian economy contracted by 0.5 per cent in the last quarter of 2008 (ABS 2009).

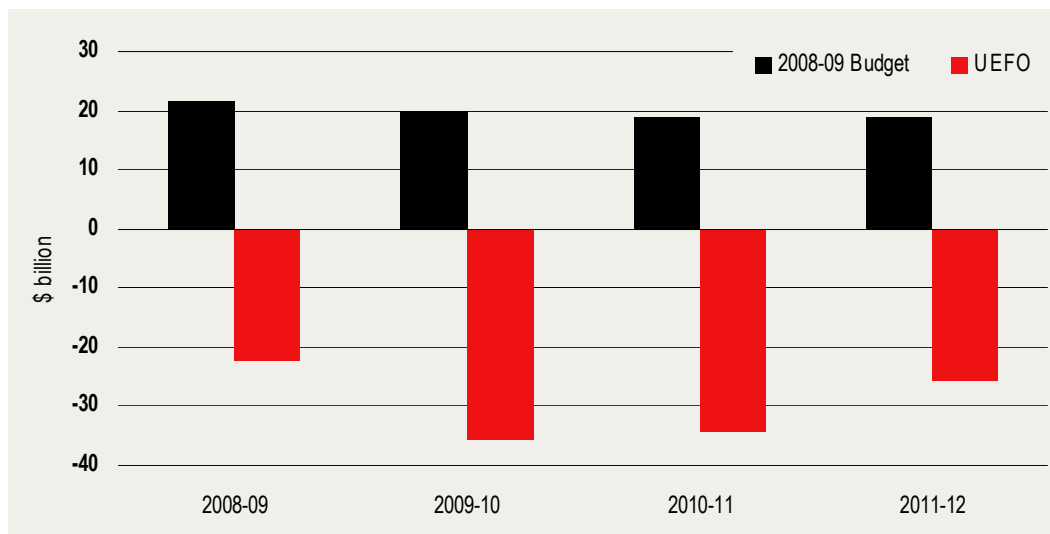
It is clear that this emerging economic adversity – especially its impact on the property market – has had significant implications for State finances and the States' credit ratings:

- In the *2008-09 Half Yearly Budget Review*, the NSW 2008-09 budget was revised from a \$268 million surplus, to a \$712 million deficit – a \$980 million deterioration in the fiscal position of the State (NSW Treasurer 2008b). Despite this deterioration of the budget, in January 2009 Moody's affirmed the NSW AAA rating (NSW Treasury 2009).
- The Victorian Government has recently revised down its surplus projections by \$446 million, from \$828 million in the original 2008-09 budget to \$382 million in its *2008-09 Budget Update* (VIC DTF 2009). According to an article by ABC news released on February 2009, Victoria's AAA credit rating will remain unchanged despite the global economic slowdown (ABC 2009a).

- The Queensland Government's *Economic and Fiscal Update* released in February 2009 reports that Queensland's budget has been revised from a \$809 million surplus to a \$1.6 billion deficit – a \$2.4 billion change (Queensland Government 2009). Reflecting the deterioration of the State's budgetary performance, on February 2009 Standard and Poor's (S&P) revised down Queensland's credit rating from AAA to AA+ (S&P 2009).
- The South Australian Government's *Mid Year Budget Review* indicates a deterioration of \$272 million in the government's net operating balance, taking the 2008-09 budget from a \$160 million surplus to a \$112 million deficit (SA Government 2009). Although South Australia continues to hold an AA rating, the 'State's rating... is now under increased scrutiny in the wake of the global financial crisis' (Adelaide Now 2009).
- The outlook for the Western Australian Government operating balance has deteriorated significantly. The 2008-09 operating surplus has been revised down by \$744 million, from \$1.9 billion in the Pre-election Financial Projections Statement (PFPS) to \$1.2 billion in the government's mid-year review (WA Government 2009). While the State continues to hold an AAA rating, the Treasurer has recently indicated that 'any failure to address the continued excessive growth in expenditure will see the State's AAA rating downgraded' (WA Treasurer 2009, quoted in WAtoday 2009).
- The Tasmanian Government's *Mid-Year Financial Report* reports that Tasmania's budget has been revised from a \$227 million surplus to a \$428 million deficit – a \$655 million change (TAS DTF 2009). On January 2009, Moody's confirmed Tasmania's AAA credit rating (Tasmania Treasurer 2009).

The recent deterioration in the global economic conditions has also had an impact on the Australian Government's fiscal position. The Australian Government's *Updated Economic and Fiscal Outlook* (Australian Government 2009a) indicates that the 2008-09 budget has been revised from a \$21.7 billion surplus to a \$22.5 billion deficit (see Chart 8.6).

8.6 Australian Government underlying cash balances, budget estimates and UEFO revisions



Note: UEFO is Updated Economic and Fiscal Outlook.

Data source: Australian Government (2009a).

The budget deficit reflects falling tax revenues resulting from the deterioration of the global economy and the Australian Government's fiscal response to the crisis which include (Australian Government 2008c, 2009a):

- Allowing the 'automatic stabilisers' to support economic stability.
- The *Economic Security Strategy* – a \$10.4 billion discretionary fiscal stimulus package announced by the Prime Minister in October 2008. This package was designed to 'strengthen the Australian economy in the face of the worst global financial crisis since the Great Depression' (Rudd 2008). The Strategy aimed to provide a targeted fiscal stimulus to the economy by providing a one-off payment to around four million pensioners and two million families. In addition, the government will double, and in some cases triple, the First Homeowners' Grant until June 2009.
- The *Nation Building and Jobs Plan* – an additional \$42 billion fiscal stimulus package announced by the Prime Minister in February 2009. This second package is designed to 'support jobs and invest in future long term economic growth' (Rudd 2009). Key measures funded by this Plan include:
 - free ceiling insulation for around 2.7 million Australian homes;
 - build or upgrade a building in every one of Australia's 9 540 schools;
 - build more than 20 000 new social and defence homes;
 - \$950 one-off cash payments to eligible families, single workers, students, drought effected farmers and others;
 - a temporary business investment tax break for small and general businesses buying eligible assets; and

- significantly increase funding for local community infrastructure and local road projects.

While at face value the increasing economic adversity may appear as a barrier to fiscal reform, the global economic downturn provides an opportunity to push through fundamental macroeconomic reforms. This has been recognised both by government and industry:

...the need to respond swiftly and decisively to the global recession shouldn't mean we lose sight of the need for longer term and more fundamental reforms. (Swan 2009)

...times of economic weakness are often also the best time to implement change. (Henry 2009, quoted in ABC 2009b)

ACCI also considers in the context of current world economic slowdown more urgency needs to be assigned to the taxation reform agenda (ACCI 2008).

Indeed, the current circumstances suggest that it is a particularly appropriate moment to readjust the mix of taxes within Australian governments, especially now that the difficulties in relying upon volatile and unreliable State government taxes are so apparent.

Given their current fiscal position, it would be very difficult for State governments to eliminate inefficient taxes without reducing their expenditure and going into further deficit. A more realistic approach to reform would be to change the composition of taxes (that is, replace the 'bad' State taxes, with 'better' Federal taxes.

Tax reform of significant scale is needed and States have limited capacity to undertake it by themselves. As such, substantive State tax reform would require cooperation between the Australian Government (which has access to better taxes) and the States. This cooperation does not necessarily mean that the Australian Government would have to go into further deficit to offset the lost revenue from the elimination of inefficient State taxes. Indeed, the economic analysis in this report shows that economic activity in Australia can be lifted by just shifting the composition of taxes from high economic cost State taxes to lower cost Australia-wide taxes, *without changing the overall level of tax revenues.*

Reforming State taxes is still more important than other changes. Indeed, the analysis in this report shows that replacing inefficient State taxes would produce larger economic benefits to the community than replacing more broad Australian Government taxes. This view is also shared by the Australian Chamber of Commerce and Industry (ACCI), which has indicated its preference for reforming State taxes over reducing the corporate income tax rate (ACCI 2008).

Key points

- Economically beneficial tax reform scenarios shift funding from the State governments to the Australian Government. Grants from the Australian Government are required to maintain the budget positions of the States. Australian Government taxes may be required to change through time to fund these grants. The management of these transfers will be an important element in successful tax reform.
- State taxes that are not reformed are expected to generate increased revenue following tax reform, particularly in the short term. This reflects increased investment and economic activity, parts of which are subject to tax.
- At the time of writing this discussion paper (March 2009) major changes in fiscal policy settings were announced. These changes were made by the Australian Government as part of concerted efforts to stimulate domestic demand and strengthen the Australian economy in the face of the global economic crisis. The two fiscal stimulus packages announced by the Australian Government involve additional expenditure of \$52.4 billion.
- Reflecting pressures imposed by the global financial crisis and weakening economic conditions, State government budgets have deteriorated significantly. Revenue collections from transaction taxes, especially from property conveyances have fallen significantly. These developments highlight the difficulties inherent in reliance upon current State government taxes that are volatile and unreliable.
- The Australian Government fiscal condition and budget balance have also deteriorated considerably. The *Updated Economic and Fiscal Outlook* released in February 2009 indicates that the 2008-09 budget has been revised from a \$21.7 billion surplus to a \$22.5 billion deficit.
- While at face value the increasing economic adversity may appear as a barrier to fiscal reform, the global economic downturn provides an opportunity to push through fundamental macroeconomic reforms, especially now that the difficulties in relying upon some State government taxes are so apparent.
- Given their current fiscal position, State governments cannot eliminate inefficient taxes without going into further deficit or having to reduce expenditure. Hence cooperation between the Australian Government and the States is needed to undertake State tax reform.
- The Australian Government does not have to go into further deficit to offset lost revenue if States eliminate inefficient taxes. Economic analysis shows that economic activity in Australia can be lifted by just shifting the composition of taxes from high economic cost State taxes to lower cost Australia-wide taxes,

without changing the overall level of tax revenues or changing how much tax the community actually pays.

A State Taxes, 2006-07

In 2006-07 the States collected nearly \$49 billion in tax revenues. The table below provides a detailed account of the amounts raised by State taxes for each jurisdiction. This table has been reproduced from the Australian Bureau of Statistics' most recent release of *Taxation Revenue, Australia* (ABS 2008a).

A.1 State taxes 2006-07

	<i>NSW</i>	<i>VIC</i>	<i>QLD</i>	<i>SA</i>	<i>WA</i>	<i>TAS</i>	<i>NT</i>	<i>ACT</i>	<i>Total</i>
	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>
Taxes on employers payroll and labour force									
Employers payroll tax	5 664	3 479	2 232	845	1 607	218	128	225	14 398
Taxes on property									
Taxes on immovable property									
Land taxes	2 036	989	485	332	386	62	0	67	4 358
Municipal rates	0	0	0	0	0	0	0	159	159
Other	72	173	252	125	202	30	0	6	860
<i>Total</i>	<i>2 108</i>	<i>1 162</i>	<i>737</i>	<i>457</i>	<i>588</i>	<i>92</i>	<i>0</i>	<i>232</i>	<i>5 376</i>
Taxes on financial and capital transactions									
Financial institutions transactions taxes	0	0	0	0	0	0	0	3	3
Government borrowing guarantee levies	97	16	67	17	14	10	0	0	221
Stamp duties on conveyances	4 166	2 961	2 542	721	2 158	157	107	242	13 054
Other stamp duties	632	44	368	92	26	11	5	10	1 187
<i>Total</i>	<i>4 895</i>	<i>3 021</i>	<i>2 977</i>	<i>830</i>	<i>2 198</i>	<i>177</i>	<i>112</i>	<i>255</i>	<i>14 465</i>
<i>Total</i>	<i>7 003</i>	<i>4 183</i>	<i>3 714</i>	<i>1 287</i>	<i>2 786</i>	<i>269</i>	<i>112</i>	<i>487</i>	<i>19 841</i>
Taxes on the provision of goods and services									
Excises and levies	0	60	0	0	0	0	0	0	60
Taxes on gambling									
Taxes on government lotteries	284	0	201	76	88	0	0	7	656
Taxes on private lotteries	8	330	13	0	0	30	13	7	400
Taxes on gambling machines	1 109	932	518	312	0	54	2	31	2 958
Casino taxes	99	118	57	22	36	3	33	2	370
Race betting taxes	147	122	36	13	39	0	0	1	359
Taxes on gambling nec	7	6	0	0	0	0	16	0	29
<i>Total</i>	<i>1 653</i>	<i>1 508</i>	<i>825</i>	<i>422</i>	<i>164</i>	<i>86</i>	<i>65</i>	<i>48</i>	<i>4 772</i>

(Continued on next page)

A.1 State taxes 2006-07 (continued)

	<i>NSW</i>	<i>VIC</i>	<i>QLD</i>	<i>SA</i>	<i>WA</i>	<i>TAS</i>	<i>NT</i>	<i>ACT</i>	<i>Total</i>
	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>
Taxes on insurance									
Insurance companies									
contributions to fire brigades	479	368	0	0	0	13	0	0	860
Third party insurance taxes	90	119	55	42	0	3	0	0	309
Taxes on insurance nec	875	608	366	259	335	35	23	43	2 545
<i>Total</i>	<i>1 443</i>	<i>1 095</i>	<i>421</i>	<i>301</i>	<i>335</i>	<i>51</i>	<i>23</i>	<i>43</i>	<i>3 714</i>
<i>Total</i>	<i>3 096</i>	<i>2 664</i>	<i>1 246</i>	<i>724</i>	<i>500</i>	<i>137</i>	<i>88</i>	<i>92</i>	<i>8 546</i>
Taxes on use of goods and performance of activities									
Motor vehicles taxes									
Stamp duty on vehicle registration	554	552	289	133	393	39	20	25	2 004
Other	1 427	728	887	262	432	84	20	70	3 911
<i>Total</i>	<i>1 980</i>	<i>1 280</i>	<i>1 176</i>	<i>395</i>	<i>825</i>	<i>123</i>	<i>40</i>	<i>96</i>	<i>5 915</i>
Franchise taxes	8	0	0	0	0	0	0	0	8
Other	-39	97	115	0	0	0	0	30	203
<i>Total</i>	<i>1 950</i>	<i>1 376</i>	<i>1 291</i>	<i>395</i>	<i>825</i>	<i>123</i>	<i>40</i>	<i>125</i>	<i>6 126</i>
<i>Total</i>	<i>17 713</i>	<i>11 702</i>	<i>8 484</i>	<i>3 250</i>	<i>5 718</i>	<i>748</i>	<i>368</i>	<i>929</i>	<i>48 911</i>

Source: ABS Cat. No. 5506.

B The MMRF Model

This study has used an amended version of the Monash Multi-Regional Forecasting (MMRF) model to establish the benchmarking of State taxes and quantify the economywide and the regional effects of the BCTR's proposed scenarios (box B.1). The MMRF Model has been used widely by the CIE, Productivity Commission and others to analyse the effects of public policy in Australia.

A number of versions of the MMRF Model are available for use. The version used in this study is from the Centre of Policy Studies (CoPS) at Monash University. The model builds on the basic structure and operation of the original MMRF model, and includes facilities to account for modelling of government finances that aligns as closely as practicable to the ABS government finance data.²⁴ It allows for the modelling of the direct and indirect effects of tax changes on the economy and on the budgets of each of the States, Territories and the Australian Government.

The core of the MMRF model is its database. The database is based on 2001-02 input-output tables.²⁵ This captures the economic inter-relationships in Australia post GST. The model has been updated to 2005-06 by CoPS to better reflect the current size of the Australian economy.

B.1 Monash Multi Region Forecasting model

The MMRF model is a multi-regional dynamic Computable General Equilibrium (CGE) model. MMRF models the behaviour of economic agents in each Australian State. It models the six States and two Territories as separate regions, recognising:

- domestic producers classified by industry and domestic region;
- eight region-specific household sectors;

(Continued on next page)

²⁴ These developments are based in part on the MMRF-Green model, described in Adams, Horridge and Wittwer (2002).

²⁵ See ABS (*Australian National Accounts: Input-Output Tables - Electronic Publication, 2001-02*, Cat. no. 5209.0.55.001, Canberra).

B.1 Monash Multi Region Forecasting model (continued)

- an aggregate foreign purchaser of Australia's exports;
- eight State governments; and
- the Australian Government.

The database can be thought of as being composed of:

- a production core comprised of eight input-output tables that are linked through interstate trade; and
- fiscal accounts comprised of a set of nine government accounts.

The production core of the MMRF model database shows how each industry in each State economy is linked to other industries within the State and in other States. The database used has 53 industries in each region, each producing a single commodity. The database has one representative private consumer, State government consumer and Australian Government consumer in each State.

The database provides a detailed description of the structure of production and demand in each State. The database shows for each State economy:

- the flow of industry outputs to other industries (termed 'intermediate inputs'), final demands by households (consumption), government, investment (for capital formation purposes) and exports; and
- the cost structures of industries in terms of intermediate inputs of commodities (goods and services supplied by domestic industries and by imports), primary factors of production (labour, capital and agricultural land), other costs to production and commodity taxes and subsidies.

Additionally, unlike some other CGE models which provide only comparative statics (a single solution period), MMRF can also be used in recursive dynamic mode. It thus produces a sequence of annual deviations from a reference case in response to a policy change. Within the modelling framework, MMRF accounts for both capital accumulation over time and structural lags in the adjustment process.

Key outputs from the model include:

- the major national and regional variables including GDP (GSP), total employment, household consumption and investment;
- output and employment by industry sector, both nationally and for each region;

(Continued on next page)

B.1 Monash Multi Region Forecasting model (continued)

- international and interregional exports, imports and trade balances; and
- Federal, State/Territories revenues and expenditures.

The MMRF model is based on a post-GST database for the reference year 2001-02 and contains a detailed treatment of government finances. More detailed information about the MMRF can be found in Productivity Commission (2006) and Adams, Horridge and Wittwer (2002).

Treatment of fiscal details

The model provided by CoPs links government revenues and expenditures to data from the Australian Bureau of Statistics (*Government Finance Statistics*: Cat. no. 5512.0; *Taxation Revenue Australia*: Cat. no. 5506.0). Government revenue data is divided into the various sources of tax (such as income tax and GST), as well as non-tax income. The CIE has adjusted the model data to accurately reflect taxation revenues from each separate tax for 2005-06.

For the baseline scenario, the CIE imposed changes in State taxes expected under the *Intergovernmental Agreement on the Reforms of Commonwealth-State Financial Relations* (IGA). This required the removal of the following State taxes in 2010:

- non-real non-residential property duty;
- mortgage duty;
- credit and rental duty;
- lease duty; and
- non-quotable marketable security duty.

To model the tax reform scenarios the CIE made a number of assumptions regarding the treatment of taxes. Table B.2 highlights the treatment of each tax in the MMRF.

B.2 Treatment of taxes in MMRF

Tax	Treatment in MMRF
Personal Income tax	Tax levied on individuals' income accounting for different income brackets.
Corporate income tax	Tax on income of enterprises across all industries.
GST	Tax on the consumption of goods and services, paid by households. Relevant exemptions are included.
Stamp duties	Tax applied on transactions (in property, motor vehicles, insurance and financial transactions).

(Continued on next page)

B.2 Treatment of taxes in MMRF (continued)

Tax	Treatment in MMRF
Payroll tax	Tax applied on payroll. Adjusted proportionally for small business concessions by industry sector.
Land tax	Tax applied on the proportion of capital (assets) that is land by value. This has been adjusted to account for exemptions and varying rates.
Developer charges	Applied theoretically only in NSW to new residential dwellings.
Municipal rates	Levied on estimated land holdings by value. Has been adjusted to account for varying rates across different property types (residential, commercial and rural).
Fire service levy	Levy on insurance sector. Applied as a fixed cost to the insurance industry.

Source: The CIE.

The economic environment

The MMRF model reflects a view about the way that the economy will adjust to economic changes.²⁶ In the short run, the economy is less able to respond to policy changes by adjusting the composition of industrial activity and wages. In this case there can be unemployment. In the longer-term, the economy will fully adjust. All labour will be used and capital is allocated to the sectors according to required rates of return. In the modelling of reform scenarios we report both short run and long run implications of tax reform, while in the benchmarking we report only the long run implications. The technical model parameters that reflect these economic environments are provided in detail below.

For the purpose of modelling scenarios of tax reforms, the CIE adjusted Australian Government taxes and grants to the States so that the tax reforms were budget neutral for all governments.

Long run economic environment

The key elements of the longer-run economic environment adopted in the model are as follows:

- The model nominal exchange rate is the numeraire. The model's index of consumer prices is flexible.

²⁶ In technical terms this is referred to as the model closure. Model closure is used to refer to the assignment of the model's variables between those determined outside the model (that is, exogenous variables) and those determined by the model (that is, endogenous variables).

- The real wage adjusts to ensure that national employment is fixed. Wage relativities between occupational groups and industries are also fixed. Employment by occupation, industry and State adjusts.
- Each industry adjusts its capital stocks in order to equilibrate its expected and actual rates of return on capital. The base line expected rates of return are determined by values in the MMRF database. Industries' demands for investment goods are linked by an exogenous investment/capital ratio to changes in their capital stock.
- Nominal household consumption in each region is a constant share of post-tax household disposable income, while the balance of trade as a ratio of GDP in local currency prices is allowed to vary.

Some additional key elements adopted in the MMRF for the benchmarking exercise are as follows:

- The government revenue and budget deficit are allowed to vary.
- Aggregate real government expenditure moves in line with changes in real household consumption. Nominal government expenditure will be affected by price changes.
- In assessing the taxes against the price objective, all macroeconomic variables were held fixed except prices to capture the full impact on price.
- In assessing the tax impact on exports, the model's level of consumer prices was used as the numeraire to capture the full impact on exchange rates and exports.

Some additional elements adopted in the MMRF for the scenario modelling exercise are as follows:

- The Australian Government taxes and grants to the States are adjusted to ensure budget neutrality for all governments.
- Most government expenditure is treated as discretionary and fixed in real terms. Exceptions, which are driven by changes in economic activity, are:
 - unemployment benefits move in proportion to national unemployment;
 - other benefits, such as age and disability benefits, move in line with national population; and
 - 'all other expenditure' (including grants to local governments, universities and private industries, property expenses, subsidy expenses and capital transfers) move in proportion to State GSP or national GDP.

Short run economic environment

The short run/dynamic economic environment, for which the impacts of tax reform scenarios are shown, differs from the long run in that:

- wages are fixed and unemployment is possible; and

- capital stocks are fixed and can adjust only slowly to the new optimum as new investment occurs.

Recent Changes in Fiscal Policy

There have been recent changes to State and Australian fiscal policy that are not incorporated into the economic modelling. On the 12th of October the Australian Government announced significant future fiscal changes to pensions, first-home buyer grants and family payments, which are expected to cost around \$10.4 billion. The States have announced relatively small changes in their taxes in their 2008-09 budgets as set out in table B.3. These generally reflect adjustments to threshold rates, additional exemptions to some taxpayers and small reductions in tax rates.

The incorporation of State tax changes would have only small impacts on the modelling through adjusting the baseline against which tax reform impacts are measured. The more significant announcements, in terms of their size, are those by the Australian Government in response to financial turmoil. These fiscal changes will have very little or no impact on the analysis in this report as the economic impacts of the announcements would be very similar under the baseline scenario and the tax reform scenarios.

B.3 State fiscal policy changes not incorporated into the modelling

<i>Government</i>	<i>Fiscal policy change</i>
ACT	<p>Increase in payroll tax threshold from \$1.25 m to \$1.5 m.</p> <p>Stamp duty concession for people on disability or aged pensions.</p> <p>Increase in income threshold for home buyer concession from \$100 000 to \$120 000.</p> <p>Abolition of duty on establishment of trusts.</p>
NSW	<p>Reductions in payroll tax rate from 6 to 5.5 per cent by 1st January 2011 (in increments).</p> <p>Indexation of payroll tax threshold.</p> <p>Abolition of transfer duty on non-land business assets.</p>
NT	<p>Reduction in stamp duty on property (maximum rate from 5.4 per cent to 4.95 per cent; minimum rate from 2.1 per cent to 1.6 per cent).</p> <p>Reductions in payroll tax rate from 6.2 per cent to 5.9 per cent.</p>
QLD	<p>Abolition of mortgage duty.</p> <p>Increases in threshold for exemption from transfer duty (for first home buyers from \$320 000 to \$350 000 on 1st July 2008 and to \$500 000 on 1st July 2009; for principal place of residence from \$320 000 to \$350 000 on 1st July 2008).</p> <p>Revision and simplification of transfer duty schedule.</p> <p>Revision and simplification of land tax schedule.</p> <p>Extension of payroll tax deduction for eligible businesses.</p>
SA	<p>Increase in payroll tax threshold from \$504 000 to \$552 000 on 1st July 2008 and to \$600 000 from 1st July 2009.</p>
VIC	<p>Land tax reduction (land tax threshold increase by 10 per cent and top land tax rate falls from 2.5 per cent to 2.25 per cent).</p> <p>Reduction in stamp duty on land transfer (approximately 10 per cent).</p> <p>Reduction in payroll tax from 5 per cent to 4.95 per cent.</p>
WA	<p>Concession for transfer duty.</p> <p>Increases in land tax thresholds and reductions in land tax rates.</p>

Source: State Budgets 2008-09.

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