

8: The Goods and Services Tax and state taxes

Overview

This chapter provides an overview of taxes that generate revenue for state and territory governments (including local councils). This includes payroll tax, stamp duties, land tax and the Goods and Services Tax (GST).

Key points

- As with most other federations around the world, in Australia, state and territory governments (including local governments) spend more than they raise in revenue, with the difference made up by grants from the Australian Government.
- The states and territories receive all of the revenue raised by the GST. About 23 per cent of total state revenue comes from the GST, with state-levied taxes generating about 31 per cent of total state revenue. The GST is relatively efficient compared to some other taxes because it has a much broader base than many other taxes. However, exemptions reduce its efficiency and introduce significant complexity. In total, around 47 per cent of Australia's national consumption is subject to GST.
- Legislation requires that changes to the GST base or rate require unanimous agreement by all state and territory governments, as well as both Houses of the Australian Parliament. The Australian Government will not support changes to the GST without a broad political consensus for change, including agreement by all state and territory governments.
- The major sources of state tax revenue are payroll taxes and stamp duties. State governments also impose taxes on land, gambling and motor vehicles. Municipal rates are the sole source of local government tax revenue.
- Some studies have suggested there are significant economic gains associated with state tax reform, particularly reducing stamp duties and making greater use of potentially efficient payroll and land taxes.

8.1: Context

The size and distribution of taxes in Australia today is distinctly different from the early days of Australia's Federation.

Before 1901 the Australian colonies collected most of their tax revenue through customs duties and excises. The colonies also imposed income tax, stamp duties, land taxes and estate taxes. At Federation, the Constitution granted the Australian Government exclusive rights to levy customs duties and excises, reflecting the importance of free interstate trade.

Today, about 23 per cent of total state revenue comes from the GST, with state-levied taxes generating about 31 per cent of total state revenue.¹⁵⁰ Royalties also play an important role in supporting many state and territory budgets.¹⁵¹ The states and territories no longer levy estate taxes or income taxes.

The Australian Government has committed to produce a white paper on the reform of the Federation (Federation White Paper) to clarify roles and responsibilities and to ensure that, as far as possible, the states and territories are sovereign in their own sphere. In doing so, its objectives include reducing waste, duplication and second-guessing between different levels of government and achieving a more efficient and effective Federation that supports Australia's economic growth and international competitiveness.

There are significant points of overlap between the Tax and Federation White Papers, including how the structure of our Federation influences which taxes are raised by which level of government, and how those taxes are used. This chapter discusses some of the broader issues relating to the Federation that are also being discussed in the Federation White Paper. Issues relating to the distribution of tax revenue from the Australian Government to state and territory governments are being considered by the Federation White Paper.

This chapter begins with an examination of the GST and the major taxes raised by state, territory and local governments.

150 Australian Bureau of Statistics (ABS) 2014, *Government Finance Statistics, Australia, 2012-13*, cat. no. 5512.0, ABS, Canberra; and Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra.

151 Under the Australian system of *Government Finance Statistics*, royalty income is not a form of taxation and is included in the property income category, along with interest income and dividends.

8.2: The Goods and Services Tax (GST)

What is the GST?

The GST is Australia's primary tax on consumption. It applies at a rate of 10 per cent to a broad range of goods and services. In total, around 47 per cent of Australia's national consumption is subject to GST,¹⁵² however, there are also other forms of consumption taxation in Australia (as outlined in more detail in Chart 2.5 and Chapter 9).

The GST was introduced in 2000 to replace a number of narrow-based taxes. It primarily replaced the Australian Government's system of wholesale sales taxes which, by that time, had become very complex and distortive with a multitude of tax rates. It also replaced a number of narrow-based taxes at the state level, including financial institutions duties and various kinds of stamp duties.¹⁵³ At the same time as the introduction of the GST, the Australian Government also made reforms to individuals income tax and family payments, in part to compensate for the effect of an expected small net increase in indirect taxes.¹⁵⁴

The GST is levied by the Australian Government on behalf of the states and territories. All of the money raised by the GST is provided to the states and territories (except for non-general interest charge penalties), and the states and territories compensate the Australian Government for the costs incurred by the Australian Taxation Office (ATO) in administering the GST.

Any change to the GST rate or base would require the unanimous support of the state and territory governments, the endorsement of the Australian Government and the passage of relevant legislation by both Houses of the Australian Parliament. These requirements are codified in the 2008 *Intergovernmental Agreement on Federal Financial Relations* and the *A New Tax System (Managing the GST Rate and Base) Act 1999*.

As part of the Tax White Paper process, interested parties are welcome to put forward proposals to change the GST. However, the Australian Government will only consider progressing any such proposals if there is a broad political consensus for change, including agreement by all state and territory governments.

152 OECD 2014, *Consumption Tax Trends 2014*, OECD, Paris.

153 The 1999 *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (the agreement) provided for all GST revenue to be distributed to the states and territories. In return, the states and territories agreed to the abolition of several inefficient state taxes, including accommodation tax, financial institutions duty, quoted marketable securities duty and debits tax.

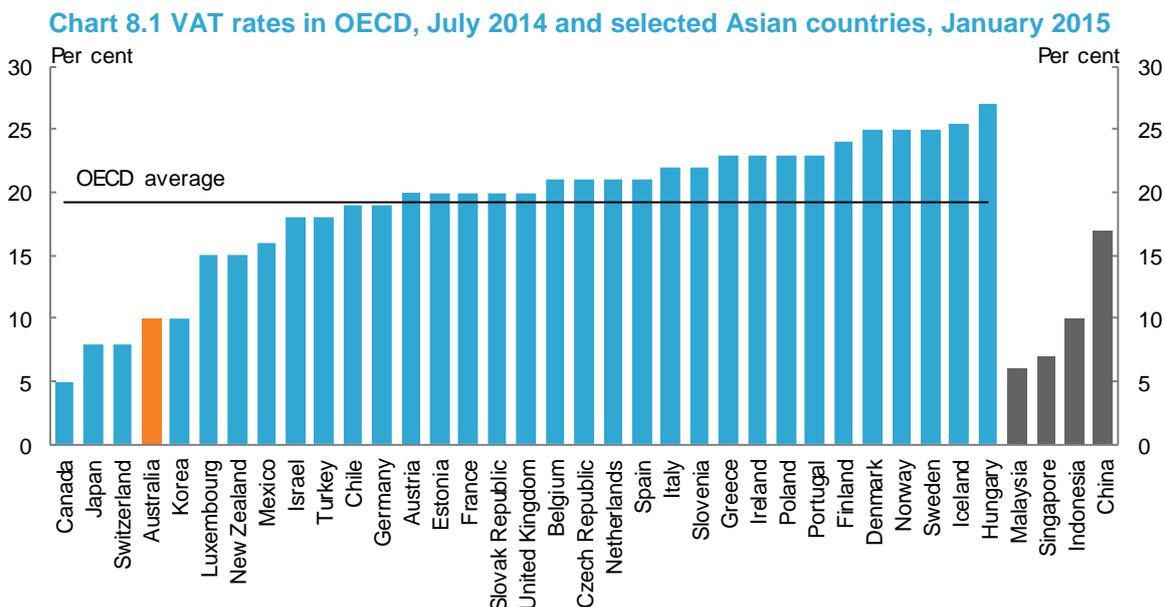
The 2008 *Intergovernmental Agreement on Federal Financial Relations* reaffirmed the commitment to abolish and not reintroduce the taxes listed in the 1999 Agreement. States and territories also agreed that any taxes not yet abolished but listed for abolition, would be abolished before 1 July 2013. Some states have deferred their obligations on certain taxes (including non-real property conveyance duty) agreed for abolition under the 2008 Intergovernmental Agreement mentioned above.

154 Australian Government 1998, *Tax Reform: Not a New Tax, A New Tax System — The Howard Government's Plan for a New Tax System*, Australian Government, Canberra.

The GST rate

Australia's GST rate is one of the lowest among developed countries and is roughly half of the average rate among OECD countries (see Chart 8.1). Of the 33 countries in the OECD that operate taxes like the GST (known more generally as value added taxes or VATs), only Canada, Japan and Switzerland have lower rates.

However, some Canadian provinces have higher tax rates than Australia when sub-central government VATs and sales taxes (another type of consumption tax) are taken into account. The United States is the only OECD country that does not impose a VAT. Nonetheless, many of its states, counties and cities impose sales taxes, the rates of which range from zero to around 10 per cent. These sales taxes are not included in Chart 8.1.



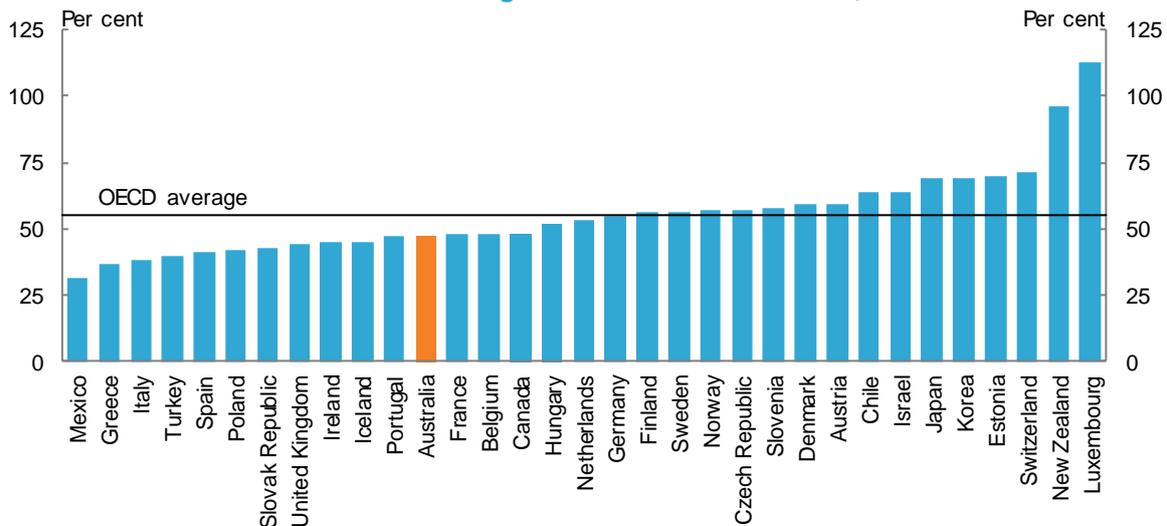
Note: The VAT rate for Japan has been adjusted to account for the increase in the rate from 1 April 2014. The rate for Malaysia reflects the GST scheduled to replace separate sales and service taxes in April 2015. The US and Hong Kong are not included in the list of countries in this chart as they do not have a VAT. India is not included in the chart due to extensive variation in consumption tax rates.

Source: OECD 2014, *Consumption Tax Trends 2014*, OECD, Paris; Deloitte 2015, *Global Indirect Tax Rates*, viewed 22 January 2015: www2.deloitte.com/global/en/pages/tax/solutions/global-indirect-tax-rates.html.

The GST base

The GST applies to most types of goods and services. However, a significant portion of consumption is excluded. Australia is not unique in this regard, as most developed countries also have a range of exemptions to their VATs. The exemptions to Australia's GST mean that it was paid on only 47 per cent (see Chart 8.2) of the consumption of all goods and services in 2012. This was slightly less than the OECD average of 55 per cent and much lower than New Zealand (96 per cent), where almost all goods and services are subject to a consumption tax. Furthermore, the coverage of Australia's GST has decreased from its peak in 2005-06 when Australia's 'VAT coverage ratio' was 56 per cent.

Chart 8.2 VAT coverage ratios in OECD countries, 2012



Note: Luxembourg's VAT coverage ratio of greater than 100 per cent is likely a consequence of its role as an international financial centre and an international centre for e-commerce which can result in Luxembourg collecting VAT revenue even though the final consumption of these services occurs in other countries.
Source: OECD 2014, *Consumption Tax Trends 2014*, OECD, Paris.

Most of the categories of consumption not subject to GST are 'GST-free'. This means that not only are these goods and services not subject to GST when sold, but their suppliers can also claim a refund on any GST levied on the inputs they used to produce them.

The main categories of consumption that are GST-free are fresh food, health, education, childcare, as well as water, sewerage and drainage services.

When the GST was introduced, health and education, for example, were made GST-free because of the significant public sector provision of these goods and services and concerns that applying the GST to them would put private providers at a competitive disadvantage.¹⁵⁵

Fresh food was made GST-free as part of negotiations with the Australian Democrats to secure passage of the GST legislation through the Senate.¹⁵⁶

Some stakeholders support the retention of many of these exemptions on the basis that these goods and services are 'basic necessities' and argue that the burden of applying GST to them would fall disproportionately on lower-income households.

Imported goods (but not imported services) are generally subject to GST, unless the value is \$1,000 or less.¹⁵⁷ On the other hand, most imported services and intangibles purchased by consumers (primarily those purchased online, such as multimedia downloads) are not subject to GST. Issues regarding the low value threshold on imported goods, and imported services and intangibles, are discussed in more detail in the section Pressures on the GST base: GST and the digital economy.

155 Australian Government 1998, *Tax Reform, not a new tax, a new tax system — The Howard Government's Plan for a New Tax System*, Australian Government, Canberra.

156 Smith, J 2004, *Taxing Popularity: the Story of Taxation in Australia*, Australian Tax Research Foundation, Sydney.

157 Tobacco and alcohol are an exception, being subject to GST even when their value is \$1000 or less.

There are other categories of consumption that are neither subject to GST nor GST-free. Instead, these goods and services are 'input-taxed'. This means that, while they are not subject to GST when sold, their suppliers cannot claim a credit or refund on the GST levied on the inputs used for producing them. In this way, input-taxed goods and services will include some GST embedded in their prices, but not the full 10 per cent. The main categories of consumption that are input-taxed are residential rent and financial supplies.

When the GST was introduced, residential rent was input-taxed so that it would not distort household decisions about whether to rent or live in owner-occupied properties. Applying GST to residential rent would also result in many more taxpayers being required to register for GST resulting in significant additional administration and compliance costs.

Financial supplies, that is, the lending and borrowing of money, were input-taxed due to the difficulty of identifying and measuring their value, which is often not explicit. While applying GST to financial supplies would introduce significant complexity, the current approach brings its own complexities and also means these services are taxed more lightly than others. The current treatment of financial supplies is estimated to be worth over \$4 billion in forgone revenue in 2014-15.¹⁵⁸

One of the key advantages of the GST is that it applies at a uniform rate to a broad range of goods and services. By taxing most goods and services in the same way and at the same rate, the GST reduces the complexity and distortions that arise when things are taxed differently.

However, exemptions to the GST detract from this. Exemptions significantly increase the complexity of the GST and introduce distortions by changing the relative prices of goods and services. This complexity is discussed in more detail later in this chapter.

How important is the GST?

The GST is Australia's third-largest tax source. In 2013-14, it raised \$56 billion, or 16 per cent of total Australian Government taxation revenue. All the money raised by the GST is distributed to the states and territories (except for non-general interest charge penalties).

Who pays GST?

Businesses are generally legally liable to collect GST on the sale of taxable goods and services and remit this GST to the ATO. While businesses have a legal requirement and incur the compliance burden of collecting and paying the GST, these costs are ultimately passed on to consumers. As such, all Australians pay the GST when they purchase taxable goods and services.

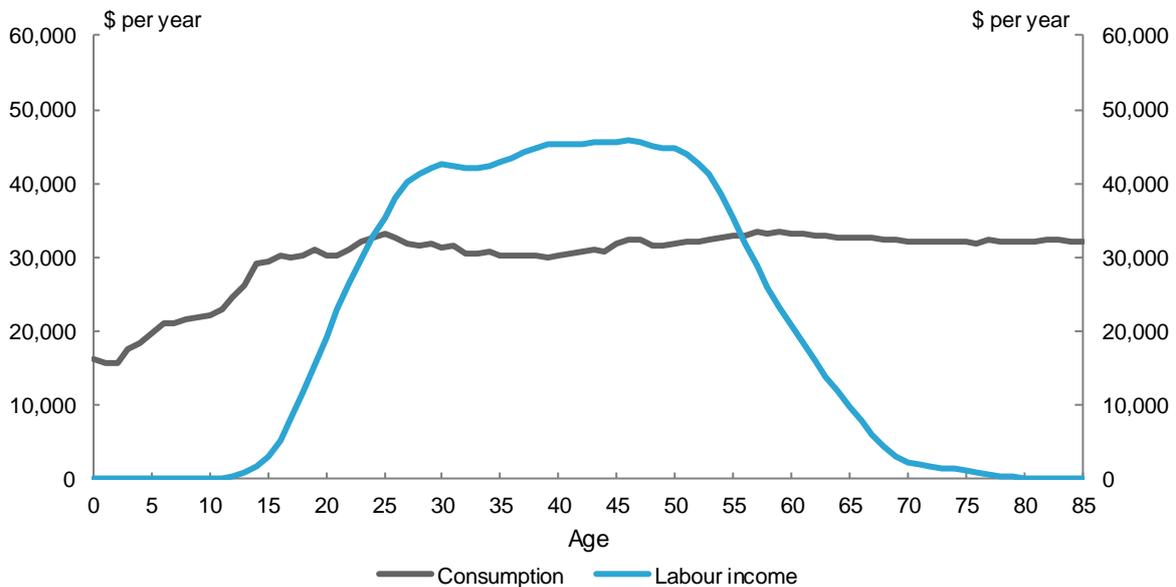
Households that save a greater proportion of their income in any given year will typically incur less GST as a proportion of their income on an annual basis. Because higher-income households tend to save more than lower-income households, this means higher-income households will typically incur less GST as a proportion of their income on an annual basis.

158 Australian Government 2014, *2014 Tax Expenditures Statement*, Australian Government, Canberra.

However, when viewed over an entire lifecycle, many individuals will ultimately incur a similar amount of tax from a broad-based consumption tax as a proportion of their lifetime income. While households that save a greater proportion of their income in any year will incur less tax as a proportion of that year's income, if and when these households eventually run down their savings they will incur more tax as a proportion of their income in those years compared to other households.¹⁵⁹

Chart 8.3 shows how this can occur. It shows that when young, individuals' labour income is lower than their spending. This then becomes higher than their spending in middle age (when they have the highest incomes and are saving) and then falls, becoming lower than their spending, when they are older and are running down their savings.

Chart 8.3 Estimated per capita consumption and labour income by age in 2003-04



Note: Consumption includes both public and private consumption, such as on housing, education, child care, aged care and health. Labour income comprises labour earnings, including fringe benefits and self-employed labour income.

Source: The National Transfer Accounts Project 2014, *National Transfer Accounts*, viewed 26 November 2014: www.ntaccounts.org.¹⁶⁰

Therefore, except for the effect of bequests and exemptions for certain categories of spending, it is likely that most individuals would ultimately pay a similar amount of tax from a broad-based consumption tax as a proportion of their lifetime income.¹⁶¹

Broad-based consumption taxes increase the price that consumers pay for goods and services, which therefore reduces the real value of the stock of existing household savings. In this way, broad-based consumption taxes have an impact on wealth, even if households do not consume all their income over their lifetimes.

159 Warren, N 2008, *A Review of Studies on the Distributional Impact of Consumption Taxes in OECD Countries*, OECD social, employment, and migration working paper no. 64, Paris.

160 See also Rice, J, Temple, J, and McDonald, P 2014, *National Transfer Accounts for Australia: 2003-04 and 2009-10 detailed results*, Crawford School of Public Policy, Canberra, viewed 5 December 2014: https://crawford.anu.edu.au/sites/default/files/news/files/2014-07/nta_report_2014_r.pdf.

161 Thomas, A 2014, *The Distributional Effects of the VAT in OECD Countries*, OECD, Paris.

While it is useful to understand the distributional effects of individual taxes, it is not the progressivity of any particular tax base that ultimately matters but, rather, that the tax and transfer system as a whole delivers fair outcomes.

Distributional effects of GST exemptions

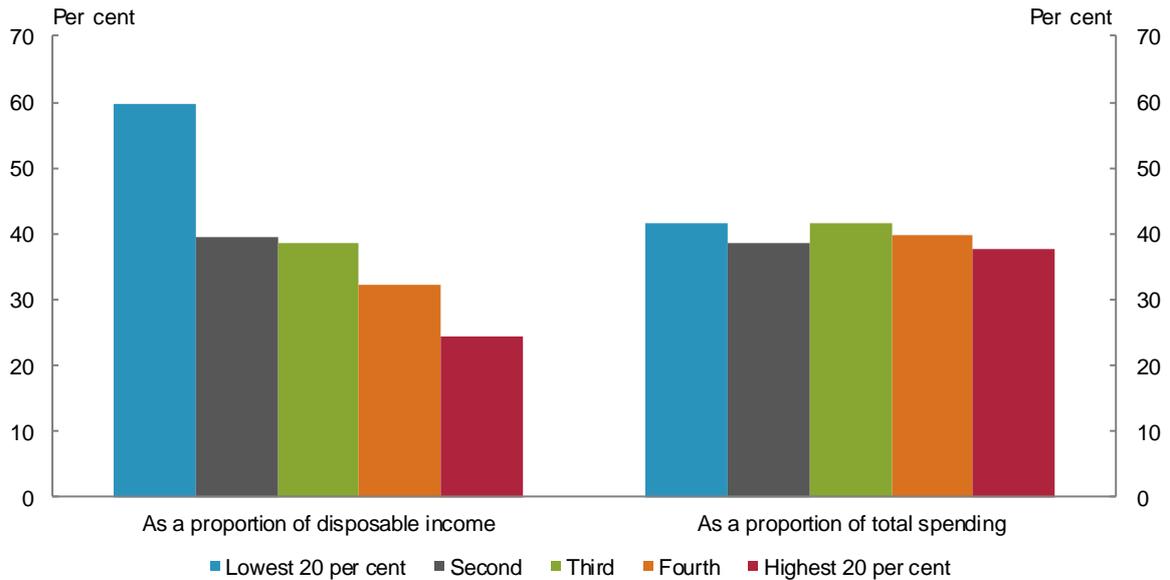
Unlike transfer payments (which are generally means-tested and highly targeted to lower-income households), GST-exemptions cannot be means-tested. The main exemptions to GST include: fresh food, health, education, child care, water sewerage and drainage, residential rent and financial services. They are available to all households, regardless of their income level. This potentially makes GST exemptions less effective and more costly than other means of targeting assistance to lower-income households.

As a proportion of their income, lower-income households spend more on GST-exempt goods and services than higher-income households. This is largely due to higher-income households saving a greater proportion of their income, meaning that their total spending represents a smaller proportion of their income.

On the other hand, as a proportion of total spending, lower-income and higher-income households spend a similar proportion on GST-exempt goods and services in aggregate. This indicates that the distributional effects resulting from having exempted these goods and services could be somewhat similar to the distributional effects of instead having taxed all goods and services, but at a lower GST rate.

While households may spend a similar proportion of their total spending on GST-exempt goods and services in aggregate, this is not necessarily true for the individual exempted categories of spending. For example, lower-income households may be more likely to spend comparatively more of their total spending on GST-exempt food, medical products and health services, or residential rent. Conversely, higher-income households may be more likely to spend comparatively more of their total spending on GST-exempt education or childcare services.

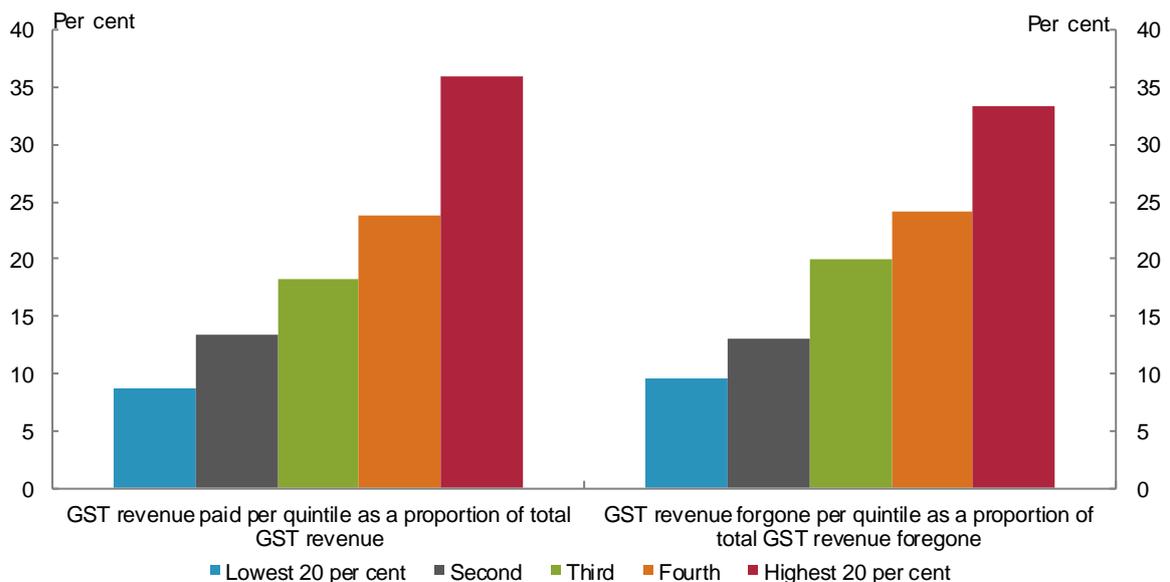
Chart 8.4 GST-exempt spending by gross household income quintile, 2009-10



Note: The main categories of GST exempt spending are fresh food, health, education, rent, and financial supplies.
 Source: Treasury estimates using ABS 2011, *Household Expenditure Survey 2009-10*, cat. no. 6530.0, ABS, Canberra.

Despite lower-income households spending a greater proportion of their income on exempt goods and services (Chart 8.4), most of the benefits from these exemptions are received by the highest-income households, because these households spend more in absolute dollar terms (similarly, the highest-income households also spend more in absolute dollar terms on goods and services which attract GST). In 2009-10, the top 20 per cent of highest-income households benefited from GST exemptions estimated to be, on average, 3.5 times more in absolute terms than those received by the lowest 20 per cent (Chart 8.5).

Chart 8.5 GST revenue paid and GST revenue forgone (as a result of exemptions to the GST) by gross household income quintile, 2009-10



Note: The main categories of GST-exempt spending are fresh food, health, education, rent, and financial supplies.
 Source: Treasury estimates using ABS 2011, *Household Expenditure Survey 2009-10*, cat. no. 6530.0, ABS, Canberra.

What impact does the GST have on economic growth and living standards?

A broad-based consumption tax like the GST is considered a relatively efficient tax. This means it has relatively lower adverse impacts on economic growth and living standards than other, less efficient taxes.

The GST can, however, reduce the reward for effort and incentives to work in a similar way to a labour income tax. Both taxes reduce the incentive to work by reducing the real purchasing power of additional pay earned from working an extra hour. The GST does this by increasing the price of goods and services an individual can buy with their pay, while a labour income tax reduces the take-home pay by the amount of the tax.

Exemptions to the GST base reduce the efficiency of the tax. Taxing some goods and services but not others changes the relative prices of taxed and non-taxed goods, which distorts consumer decisions about which goods and services they buy.

Complexity

Exemptions to the GST significantly add to its complexity and increase the compliance costs incurred by businesses (see Box 8.1). For example, businesses can incur significant costs in attempting to work through exemptions, concessions and having to classify whether goods and services are taxable, GST-free or input taxed. In Australia, these costs fall disproportionately on small businesses.

Box 8.1: GST and pizza rolls

Under the GST law, food is generally GST-free unless it is a type of food specifically listed as being subject to GST. This appears to be reasonably straightforward but is not.

Pizzas, pizza subs, pizza pockets and similar foods are subject to GST. In contrast, pizza rolls are generally GST-free but can be subject to GST when they are similar to ‘pizzas, pizza subs or pizza pockets’.

Defining whether something is a pizza or a similar food has proved complex in the context of various baked goods. The ATO has advised that determining whether a pizza roll is taxable requires consideration of the depth of any filling or topping, the recipe for the dough and whether the roll can be cut, have additional filling added or is expected to be served as is.

This analysis is complex and undertaking it places a considerable burden on businesses. The rationale for having different tax treatments apply to pizza rolls with thicker topping is not clear.

Further, the administrative costs for businesses associated with paying, collecting, claiming credits and remitting GST on sales and purchases can be significant. These costs are currently felt particularly by small businesses, despite many of these businesses paying very little GST.

Pressures on the GST base

GST and the digital economy

While most imported goods are subject to GST, goods valued at or below the \$1,000 low value threshold and most imported services and intangibles provided to consumers (primarily those purchased online, such as multimedia downloads) are not subject to GST.

A low value threshold on imported goods has been in operation since the implementation of the GST. The current \$1,000 low value threshold was set in 2005. Prior to this, import thresholds for postal items were still set at \$1,000, however, import thresholds for non-postal goods (those arriving by air and sea cargo) had a threshold of \$250. The thresholds were aligned at \$1000 to ensure all modes of transport were treated in the same manner.¹⁶²

There is growing concern both internationally and domestically that the strong growth in online retail spending by consumers will continue to increase imports of low value goods, services and intangibles directly over the internet. Without reform, this would increase foregone GST revenue and affect the competitiveness of domestic businesses over time.

A 2011 Productivity Commission inquiry into the retail industry found there were strong in-principle grounds for the low value threshold to be lowered significantly. On the basis of tax neutrality, goods sourced from overseas should face the same tax regime as goods sourced domestically. The Productivity Commission estimated in its final report that in the absence of radically redesigned and highly efficient revenue collection systems, the collection costs would outweigh the revenue gains. By its estimates, removing the threshold completely would generate revenue of around \$600 million per annum but at a cost of well over \$2 billion borne by businesses, consumers and governments.¹⁶³ Accordingly, the Productivity Commission recommended the low value threshold should not be lowered until it is cost effective to do so.

Some subsequent studies undertaken by stakeholders suggest that there are alternative arrangements for collecting GST on low value goods that would not be as prohibitively expensive as current arrangements.¹⁶⁴ Other developed countries have relatively low thresholds compared to Australia,¹⁶⁵ suggesting that a cost-effective reduction in the low value threshold could be feasible.

The Australian Government agreed to a request from the states and territories to explore options around lowering the threshold, however, at the 19 September 2014 meeting of the Council on Federal Financial Relations, the states and territories indicated they had not agreed on a preferred workable approach to this issue.

162 Commonwealth Competitive Neutrality Complaints Office 2000, *Customs Treatment of Australia Post*, Investigation No. 5, AusInfo, Canberra.

163 Productivity Commission 2011, *Economic Structure and Performance of the Australian Retail Industry*, report no. 56, Productivity Commission, Canberra.

164 See, for example, National Retail Association Ltd 2012, *The threshold question: Economic impact of the low value threshold on the retail industry*, prepared by Ernst and Young.

165 Thresholds in other developed countries include €22 for most European Union countries, £15 for the United Kingdom, C\$20 for Canada and NZ\$400 for New Zealand. OECD 2014, *Consumption Tax Trends 2014*, OECD, Paris.

The exclusion from the GST base for imported services reflects how difficult it is to identify the supplier and recipient in a transaction because it has not occurred physically and, unlike imported goods, cannot be stopped at a border.

Both the OECD and the broader OECD Global Forum on VAT are investigating the taxation of imported services and intangibles.¹⁶⁶ Working Party No.9 of the OECD's Committee on Fiscal Affairs is also considering the cross-border taxation of low value goods.¹⁶⁷

The impact of changing consumption patterns

Since 2002-03, GST revenue has declined relative to the size of the economy. In 2002-03, GST revenue was 3.9 per cent of gross domestic product (GDP) but, by 2013-14, this had fallen to 3.5 per cent of GDP — in dollar terms, this is equivalent to reduced GST revenue in 2013-14 of more than \$6 billion (Chart 8.6). This decline is the result of two main factors.

Firstly, the decline in GST revenue as a share of GDP has resulted from a decline in household consumption as a share of GDP. Since 2002-03, total household consumption has fallen from 59 per cent of GDP to 56 per cent in 2013-14,¹⁶⁸ given the unprecedented growth in mining investment which was driven by record high commodity prices throughout the 2000s.

Secondly, the decline in GST revenue as a share of GDP has resulted from a decrease in the proportion of household spending spent on taxable goods and services, and a corresponding increase in the proportion spent on GST-exempt goods and services. In particular, the proportion of total household spending on health, education, rent and financial services has been increasing. Spending on these categories in 2013-14 made up 40 per cent of total household spending compared to just 33 per cent when the GST was introduced in 2000-01.¹⁶⁹ In large part, this has been the result of increases in the relative prices of these goods and services, rather than an increase in the volume of these goods and services consumed. If this trend persists, it will tend to reduce the amount of GST revenue as a proportion of GDP.

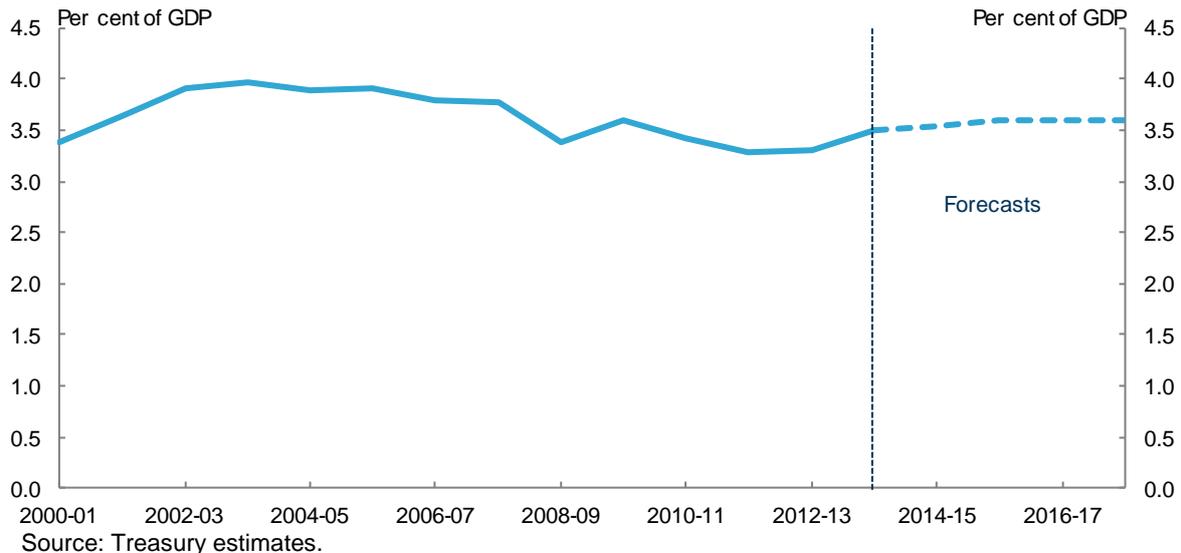
166 See, for example, OECD 2014, *Statement of Outcomes on the OECD International VAT/GST Guidelines*, OECD Global VAT Forum on VAT, Tokyo, 17-18 April 2014, viewed 11 February 2015: www.oecd.org/ctp/consumption/statement-of-outcomes-on-vat-gst-guidelines.pdf.

167 OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing.

168 Australian Bureau of Statistics 2014, *Australian National Accounts: National Income, Expenditure and Product*, cat. no. 5206.0, viewed 8 December 2014: www.abs.gov.au/AUSSTATS/abs@.nsf/ViewContent?readform&view=ProductsbyCatalogue&Action=Expand&Num=6.1

169 Australian Bureau of Statistics 2014, *Australian National Accounts: National Income, Expenditure and Product*, cat. no. 5206.0, viewed 8 December 2014: www.abs.gov.au/AUSSTATS/abs@.nsf/ViewContent?readform&view=ProductsbyCatalogue&Action=Expand&Num=6.1

Chart 8.6 GST revenue over time



The GST is distributed to the states and territories under the principle of horizontal fiscal equalisation (HFE). HFE seeks to reduce fiscal disparities between states and territories, ensuring they all have the fiscal capacity to provide an equivalent level of public services. Issues around the distribution of the GST and HFE have been considered in more detail in an issues paper on the Council of Australian Governments (COAG) and Federal Financial Relations, released as part of the Federation White Paper process. The issues paper is available at www.federation.dpmc.gov.au.

Discussion questions:

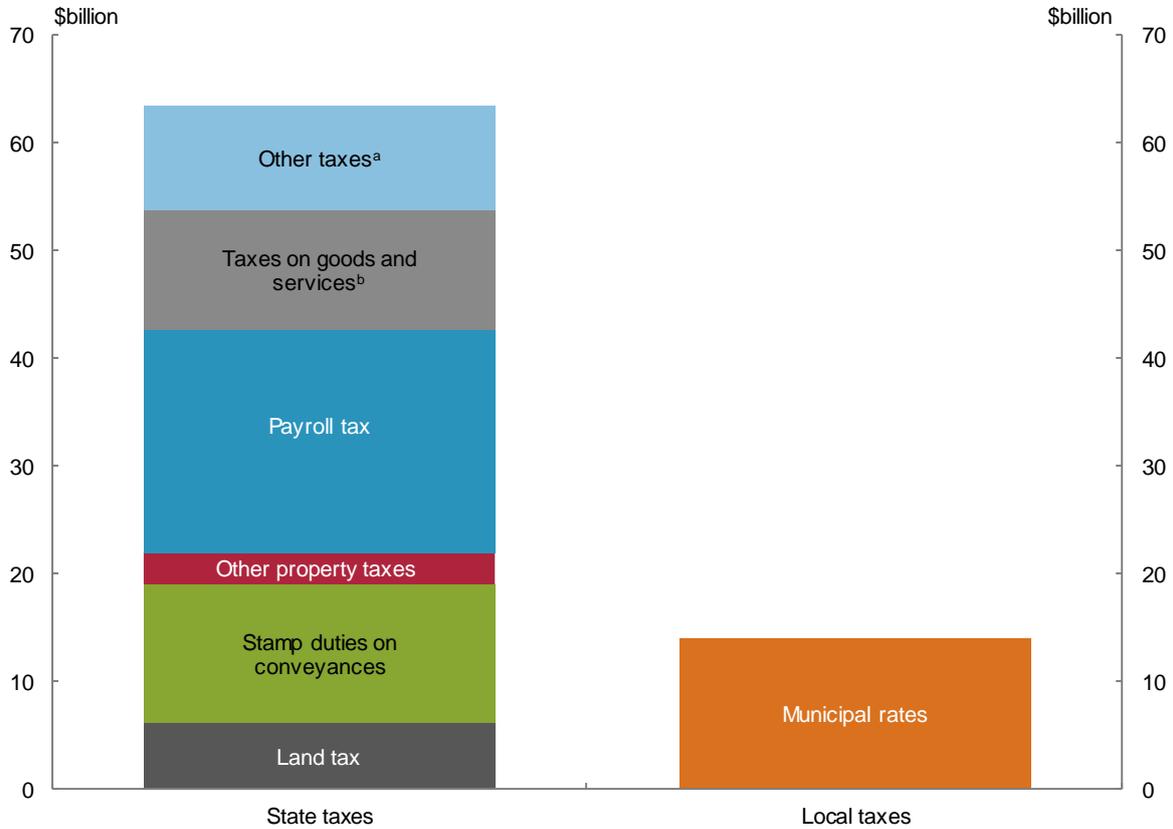
51. To what extent are the tax settings (that is, the rate, base and administration) for the GST appropriate? What changes, if any, could be made to these settings to make a better tax system to deliver taxes that are lower, simpler, fairer?

8.3: Features of state (including local government) taxes

All states and territories raise tax revenue from broadly the same range of taxes (noting the Northern Territory does not have a land tax), although each sets its own rates and thresholds. As such, each has differing reliance on particular taxes.

In aggregate, states and territories generate about 31 per cent of their revenue through state taxes.¹⁷⁰ Chart 8.7 shows the major sources of state and local government tax revenue. The chart shows the majority of state tax revenue comes from payroll taxes and stamp duties on conveyances. Municipal rates are the sole source of local government tax revenue.

Chart 8.7 Sources of state, territory and local government tax revenue, 2012-13



(a) Primarily motor vehicle taxes.

(b) Primarily gambling and insurance taxes. This does not include GST revenue.

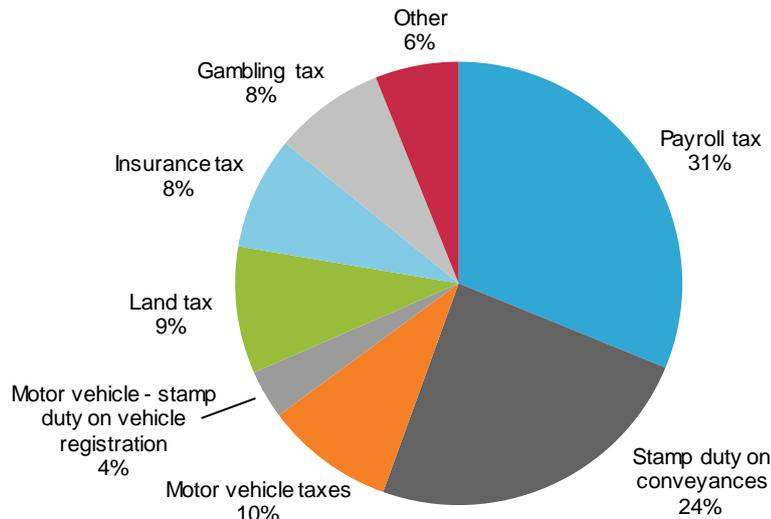
Note: Figures are for 2012-13, as this is the most recent year local government data is available.

Source: ABS 2014, *Taxation Revenue, Australia, 2012-13*, cat. no. 5506.0, ABS, Canberra.

Looking more closely at state taxes, Chart 8.8 shows about two-thirds of state tax revenue is generated from payroll tax and stamp duties on conveyances, vehicle registration, and insurance taxes, with taxes on land, gambling, motor vehicles and other taxes making up around one third of state tax revenue.

170 ABS 2014, *Government Finance Statistics, Australia, 2012-13*, cat. no. 5512.0, ABS, Canberra.

Chart 8.8 Sources of state and territory tax revenue, 2013-14



Source: Treasury calculations using state and territory 2013-14 final budget outcomes (or equivalents) and 2014-15 state and territory budgets.¹⁷¹

Note: 'Motor vehicle taxes' excludes stamp duty on vehicle registration.

Some studies have suggested there are significant economic gains associated with state tax reform. For example, Independent Economics and the 2011 NSW Financial Audit both estimated that replacing stamp duties on conveyancing with broad-based land tax could generate long-run gains to economic activity of about 1.3 per cent.¹⁷²

Payroll tax

Payroll tax is levied on employers and is based on components of employee remuneration. Payroll taxes are legally imposed on businesses. In the short run (around 12 months), business are unlikely to be able to change existing wages and prices. As such, business owners will bear any costs associated with increased payroll taxes. In the long run, the cost of the tax is likely to be passed onto employees (through lower wages) and consumers (through higher prices).

171 New South Wales Government 2014, *Report on State Finances 2013-14*, New South Wales Government, Sydney; New South Wales Government 2014, *NSW 2014-15 Budget, Budget Paper 2 — Budget Statement*, New South Wales Government, Sydney. Victorian Government 2014, *2013-14 Financial Report (incorporating Quarterly Report No.4)*, Victorian Government, Melbourne. Queensland Government 2014, *2013-14 Report on State Finances of the Queensland Government — 30 June 2014*, Queensland Government, Brisbane. Government of Western Australia 2014, *2013-14 Annual Report on State Finances*, Government of Western Australia, Perth. Government of South Australia 2014, *2014-15 Budget Paper 3: Budget Statement*, Government of South Australia, Adelaide. Government of Tasmania 2014, *Treasurer's Annual Financial Report 2013-14*, Government of Tasmania, Hobart. Australian Capital Territory Government 2014, *Consolidated Annual Financial Statements — 2013-14*, Australian Capital Territory Government, Canberra; Australian Capital Territory Government 2014, *September Quarter 2014 Consolidated Financial Report*, Australian Capital Territory Government, Canberra. Northern Territory Government 2014, *Treasurer's Annual Financial Report*, Northern Territory Government, Darwin; Northern Territory Government 2014, *Budget Paper No.2: Budget Strategy and Outlook 2014-15*, Northern Territory Government, Darwin.

172 Independent Economics 2014, *Economic impacts of negative gearing of residential property — report for the Housing Industry Association*, Independent Economics, Canberra; and NSW Treasury 2012, *NSW Financial Audit 2011 (Lambert review)*, NSW Treasury, Sydney.

Broad-based payroll taxes have similar economic consequences to a broad-based consumption tax, making them a relatively efficient way of raising revenue.¹⁷³ For governments, payroll tax revenue grows with wages. Without increases to the threshold, average payroll tax rates on businesses will increase as the payrolls of businesses grow.

In practice, payroll tax in Australia is less efficient and more complex than it could be because of tax-free thresholds and other exemptions, often introduced to reduce tax paid by groups such as small businesses. These include exemptions related to size of payroll, business type and wage type (for example, maternity pay).

As a result of current exemptions and thresholds, a significant proportion of the payroll base is not subject to tax. Estimates by the states of their tax expenditure on payroll tax give some indication of the size of the payroll tax base not subject to tax. These estimates can underestimate revenue foregone because they do not measure the impact of the threshold itself. For example, NSW reports that tax expenditure on payroll tax amounted to \$1.3 billion in 2013-14 or about 18 per cent of payroll tax revenue.¹⁷⁴ The Business Council of Australia has estimated that closer to half of the potential payroll tax base is exempt.¹⁷⁵ Current payroll tax arrangements may also impact on business decisions to expand. For these reasons, some reviews have suggested broadening existing payroll taxes by lowering the threshold, removing exemptions and cutting rates.¹⁷⁶

However, there is significant criticism of payroll tax, including of its short-run impact on business costs. While the states and territories have substantially harmonised legislation and the administration of payroll tax in recent years, some business groups, particularly those operating across state borders, remain concerned about the complexity associated with differing thresholds and rates across states.¹⁷⁷ A zero threshold would also likely impose significant administrative costs and compliance burdens on very small businesses.

Stamp duties

State governments levy stamp duties on a range of transactions, including conveyances, insurance and motor vehicles. Australia is relatively more reliant on these taxes (largely stamp duties on conveyances) than other countries, as Chart 8.9 shows.

173 While similar in many respects, consumption taxes are in principle more efficient than payroll taxes as they tax a broader range of activities. Payroll taxes are also a tax on inputs to production, as opposed to a tax on consumption.

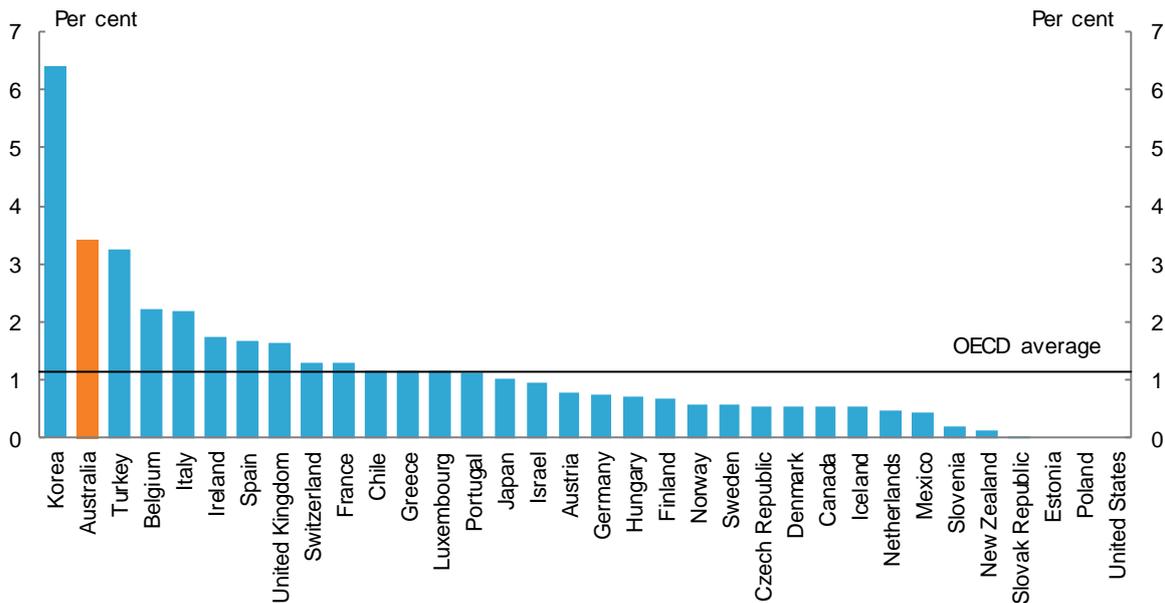
174 NSW Treasury, 2014, *Budget Statement 2014-15 — Budget Paper 2*, NSW Government, Sydney, p. 6-31.

175 Business Council of Australia 2014, *The Future of Tax Australia's current tax system*, viewed 9 December 2014: www.bca.com.au/publications/the-future-of-tax-australias-current-tax-system.

176 NSW Treasury 2012, *NSW Financial Audit 2011* (Lambert review), NSW Treasury, Sydney; and Victorian Competition and Efficiency Commission 2011, *Securing Victoria's Future Prosperity: A Reform Agenda*, Victorian Government, Melbourne.

177 For example, *ACCI Pre-Budget Submission*, provided to the Treasury, 2014, viewed 9 December 2014: www.acci.asn.au/getattachment/be749436-f50c-46b7-b876-60664cce3aa7/ACCI-Pre-Budget-Submission-2013-14.aspx.

Chart 8.9 Taxes on financial and capital transactions as a percentage of total taxation, OECD countries, 2012



Note: Taxes on financial and capital transactions include taxes on the issue, transfer, purchase and sale of securities, taxes on cheques, and taxes levied on specific legal transactions such as validation of contracts and the sale of immovable property.

Source: OECD 2014, *Revenue Statistics 2014*, OECD Publications, Paris.

Stamp duties are some of the most inefficient taxes levied in Australia. Unlike broad-based taxes on consumption or payrolls, they are levied selectively on activities or products and are taxed on the total transaction value, rather than the 'value added' component. Such transaction taxes are more likely to discourage turnover of taxed goods, as taxpayers attempt to reduce or avoid paying the tax.

Stamp duties on conveyances

Stamp duties on the transfer of residential and commercial property ('stamp duties on conveyances') are the second-largest source of state tax revenue (generating 24 per cent of state tax revenue).¹⁷⁸ All states and territories have progressive rate scales, although the rates, thresholds and exemptions (for example for first home buyers) differ in different states.

Because revenue growth is driven by property prices and numbers of transactions, stamp duties on conveyances are a highly volatile tax, with revenue collected from stamp duties on conveyances fluctuating by over 50 per cent in previous years.¹⁷⁹ Stamp duties on conveyances add to the costs of buying and selling property and can discourage businesses from undertaking productivity enhancing purchases of existing land and capital. The outcome can be retention of land for relatively unproductive purposes.

¹⁷⁸ Treasury calculations based on state and territory 2013-14 final budget outcomes (or equivalent) and state and territory 2014-15 budgets.

¹⁷⁹ ABS 2014, *Taxation Revenue, Australia, 2012-13*, cat. no. 5506.0, ABS, Canberra.

Stamp duties also impact on consumers by increasing the cost of buying and selling houses. As house prices increase over time, unadjusted progressive tax rates also increase the tax burden associated with stamp duty. For example, the burden of stamp duty on a median-priced house in Melbourne has almost doubled over the past 20 years — from 2.67 per cent of the sale price in 1988 to 5.16 per cent in 2011.¹⁸⁰

This clearly adds to transaction costs and contributes to Australia's high (by international standards) costs of moving.¹⁸¹ These costs can discourage householders from moving to housing that best suits their needs and can be an important barrier to labour mobility.¹⁸² A number of reviews have found that, by dampening the number of house sales, stamp duties can also add to commuting times.¹⁸³ Stamp duty can also be inequitable — those who move more frequently face higher costs than those who move less frequently, even if their circumstances are otherwise similar.

Stamp duties on insurance

The states and territories levy stamp duties on insurance products, including life insurance and general insurance. Some states also levy taxes on insurance products to partially fund fire and emergency services, although there has been a trend since the late 1990s to fund these services from additional taxes on property, rather than insurance.

In general, states provide a number of exemptions from tax on general insurance, including workers compensation, public liability insurance for not-for-profit organisations and insurance on the transport of goods.

As with stamp duties more broadly, insurance taxes are among the most inefficient taxes in Australia. Insurance taxes increase the cost of insurance to consumers and place a large burden on home insurance. They may lead to under-insurance or to people not insuring at all, particularly if householders are sensitive to price increases. In this regard, Tooth and Barker found that rates of non-insurance can be higher for particular demographic groups, including retirees with mortgages and single parents, leaving them more financially vulnerable in the event of loss.¹⁸⁴

180 Real Estate Institute of Victoria 2011, *Submission to the Victorian Competition and Efficiency Commission Inquiry into a State-based Reform Agenda*, viewed 9 December 2014: www.vcec.vic.gov.au/Inquiries/Completed-inquiries/State-based-reform/Submissions.

181 Andrews, D, Caldera Sánchez A and Johansson Å 2011, *Housing Markets and Structural Policies in OECD Countries*, OECD economics department working paper no. 836, OECD, Paris.

182 Van Ommeren, J and M. Van Leuvensteijn 2005, 'New evidence of the effect of transaction costs on residential mobility', *Journal of Regional Science*, vol. 45, issue 4, pages 681-702.

183 Independent Economics 2014, *Economic Impacts of Negative Gearing of Residential Property — report prepared for the Housing Industry Association*, Independent Economics, Canberra; and Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra, page 255.

184 Tooth, R and Barker, G 2007, *The Non-Insured: Who, Why and Trends — prepared for the Insurance Council of Australia*, viewed 9 December 2014: www.insurancecouncil.com.au/issues-submissions/reports/non-insurance.

Motor vehicle stamp duties

States and territories raise taxes from road users by way of annual motor vehicle registration charges, stamp duties on the sale of new and used vehicles, weight taxes, surcharges and levies on compulsory third party insurance, car parking space levies and a range of minor taxes.¹⁸⁵

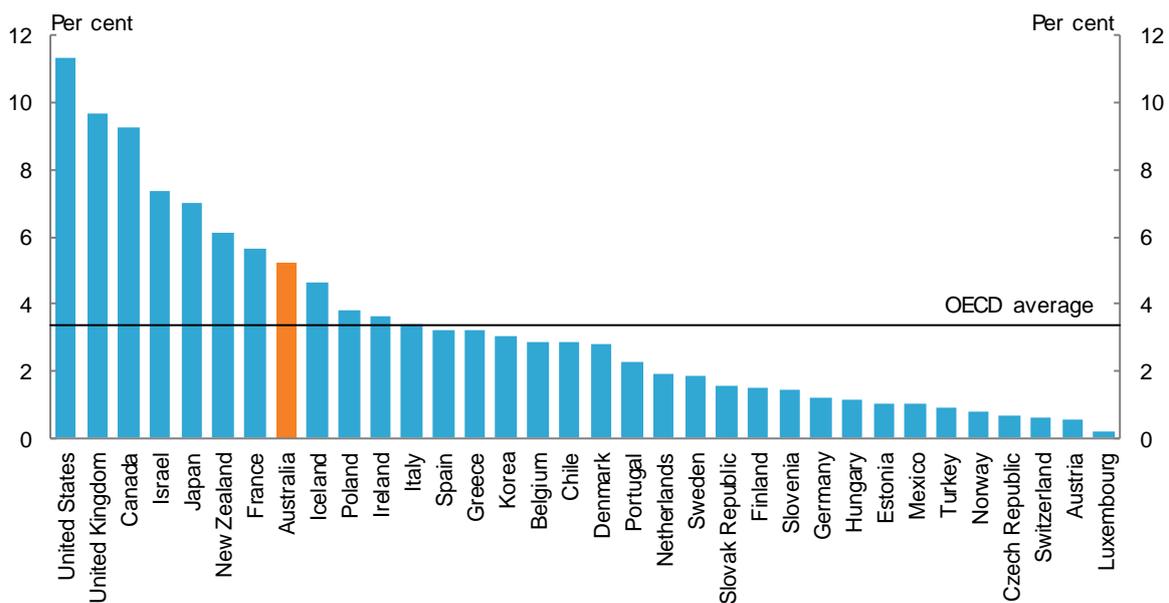
Stamp duties on the registration of new and used vehicles raised about \$2.4 billion (or 4 per cent) of state tax revenue in 2013-14.¹⁸⁶ These taxes add to the costs of transferring new and used vehicles.

Taxes on land

In Australia, taxes on land are levied by state governments in the form of land tax and by local governments in the form of municipal rates. Currently, the ACT levies both land tax and municipal rates (see Box 8.2 for more detail on ACT land tax reforms).

Chart 8.10 compares tax revenue raised from land in Australia to other developed countries. It shows Australia's reliance on taxes on land, as a percentage of total taxation is higher than the OECD average, but around half the proportion raised in the US, UK and Canada.

Chart 8.10 Recurrent taxes on immovable property as a percentage of total taxation, OECD countries, 2012



Note: Recurrent taxes on immovable property cover taxes levied regularly in respect of the use or ownership of immovable property.

Source: OECD 2014, *Revenue Statistics 2014*, OECD Publications, Paris.

185 Some of these taxes, for example, annual motor vehicle registration and operation fees, have some features of user charges, which are discussed in Chapter 9 *Indirect taxes*.

186 State 2013-14 final budget outcomes and 2014-15 budgets.

Land tax

All states and territories, apart from the Northern Territory, levy annual land taxes on property, with some states using unimproved land value and other states using market value to determine land value. State land tax regimes commonly feature a tax-free threshold and progressive rate scales.

The land tax base in Australia is narrow due to tax-free thresholds and many exemptions, some of which are motivated by equity concerns. Exemptions apply primarily to owner-occupied housing and primary production land. In fact, more than half of the potential land tax base, by value, is exempted from state land taxes.¹⁸⁷

This results in forgone revenue and distorts land-use. For example, levying land tax at progressive rates on total landholdings leads to higher taxes on large landholdings, compared to smaller landholdings. The OECD argues this introduces a bias against large investments in residential property and discourages institutional investors from investing in private rental housing.¹⁸⁸

Unlike capital and labour, land is an immobile and fixed factor in productive activity. An ideally designed land tax would result in a once-off reduction in the value of the land. Even with this reduction in land value, land supply remains fixed and cannot fall. Without a decline in the supply of land, renters would be unwilling to pay higher rents. As such, in an ideal land tax, land owners would bear the full cost of the tax and would not pass any onto renters.

In practice, no land tax fits the theoretical ideal. Land tax as currently implemented in Australia is far from such a model because of exclusions and because different types of land attract different rates of tax (for example, commercial versus residential). Because of this, the burden of land tax is likely to be shared by landowners and downstream users.

Box 8.2: Australian Capital Territory tax reforms

In its 2012-13 Budget, the ACT Government committed to a 20 year tax reform process to replace insurance duties and stamp duties on conveyances with a broad-based land tax regime that includes owner-occupied housing.

The reform involved significant transitional costs, including to governments (with short-term falls in revenue as stamp duties decline), new home buyers (with equity concerns about people who have recently purchased a house facing double taxation) and low-income home owners (who might have financial difficulty making regular land tax payments).

The ACT government's response to these concerns included a range of concessional schemes and a long and phased implementation programme (with insurance duties abolished over five years and conveyance duties over 20 years).

187 Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra p. 260; and Business Council of Australia 2014, *The Future of Tax Australia's current tax system*, viewed 9 December 2014: www.bca.com.au/publications/the-future-of-tax-australias-current-tax-system.

188 OECD 2010, *OECD Economic Surveys: Australia 2010*, OECD, Paris; and OECD 2012, *Activating Jobseekers: How Australia Does It*, OECD, Paris.

Municipal rates

Local councils levy municipal (or council) rates under powers provided by state governments. They are applied broadly across all residential land based on land valuations with few exemptions and are used to fund a broad range of local activities.

As with broad-based land taxes, municipal rates are an efficient way to raise revenue. In the theoretical scenario, land is a fixed factor of production and therefore the tax burden of broadly-applied municipal rates is paid by landowners, rather than passed onto final land users. Low rates and few concessions or exemptions also reduce the incentives and ability to avoid the tax.

While municipal rates are widely agreed to be one of the most efficient taxes in Australia, there are some concerns about how land values are determined and rates are set. For example, some councils determine land value on the basis of improved value, rather than unimproved value, which can discourage capital improvement.¹⁸⁹

Differences between councils may also generate some complexity for people with landholdings in different regions. Councils collect substantially different amounts of revenue through rates. In 2010-11, the proportion of revenue raised from rates varied between a high of 57 per cent for South Australia and a low of 20 per cent for the Northern Territory.¹⁹⁰

Part of the explanation for this variation is due to institutional differences. While most local councils have the authority to set municipal rates in their area, in New South Wales the Independent Pricing and Regulatory Tribunal determines the maximum percentage rate rise each year. In addition, there is substantial variation across Australia in population density, average incomes and land values, which has an impact on the ability of some councils to raise additional revenue through rates.

Both the ACT and South Australia have rate deferral schemes, which allow eligible homeowners to defer rates using a mechanism akin to a reverse mortgage.¹⁹¹ These schemes help taxpayers, particularly with low incomes, meet the costs of municipal rates.

Gambling taxes

Gambling taxes are a tax on gambling activity and take many forms, including a turnover tax, a tax on net profits and a tax on player loss and licencing fees. Rates differ on the basis of both the form of gambling and the type of venue. In general, lotteries are taxed more heavily than other forms of gambling.

The gambling sector is highly regulated, with restrictions on the numbers of machines and venues. State tax reviews in the ACT and NSW have argued that government restrictions on competition to deal with problem gambling generate 'excess profits' for the owners of

189 Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra, page 692.

190 Department of Infrastructure and Regional Development 2013, *2010-11 Local Government National Report*, Australian Government, Canberra.

191 Brownfield, C 2014, *The Fourth Pillar — the role of home equity release in retirement funding*, presented to the Actuaries Institute Financial Services Forum, 5-6 May 2014, Sydney.

gambling venues and that taxing these profits is an efficient way to raise revenue.¹⁹² Both of these reviews recommended increasing gambling taxes.

In a similar vein, the Productivity Commission recommended that governments eliminate tax concessions for particular types of gambling providers. The Productivity Commission argued that support for these businesses would be better provided by way of transparent and direct government funding.¹⁹³

While gambling taxes have historically been a stable source of revenue for governments, competition between states and growing trends in online gambling, particularly with providers outside Australia, may threaten gambling revenues.

Royalties

A mineral royalty is the price charged by government for the transfer of the right to extract a mineral resource. The prices (royalty rates) for different minerals are prescribed in mining legislation and associated regulations. Royalties are generally based on a percentage of the value of production (ad valorem) or a fee per unit produced (volumetric).

Royalties are not classified as taxes, but do make up a significant proportion of revenue in resource-rich states. For example, royalties generated 22 per cent of Western Australia's revenue in 2013-14, up from 6 per cent of revenue in 2004-05.¹⁹⁴

The efficiency of volumetric royalties depends on the prevailing price for mineral products. When prices are high, the impact of volumetric royalties on economic activity is relatively low but revenue does not reflect the full value of the resources. When prices are low, they have a larger impact on a project's viability and can affect the viability of some mines. Ad valorem royalties, being price-based, will reflect rising prices, but as they are levied on the price of a unit of production rather than profit, ad valorem royalties may still compromise marginal projects. For example, the unit sale price and hence royalty payments may be increasing but if costs of production are increasing at a rate faster than unit price growth, profitability will be decreasing as royalty payments are increasing. Some states have adopted a progressive scale of royalties to give themselves more flexibility.

Royalty revenue depends on commodity prices, the exchange rate and production volumes. The inherent volatility of the resources sector and the size of royalties in some state budgets can make budget planning more challenging. There is a trade-off between price-based and volumetric royalties. Profit-based royalties respond better to changes in profitability and are less likely to compromise a project's viability, but are more volatile. Volumetric royalties are simple, have low compliance costs for industry, are easily enforced, and are more stable in terms of revenue generated, but by not responding to changes in profitability, may negatively

192 NSW Treasury 2012, *NSW Financial Audit 2011* ('Lambert review'), NSW Treasury, Sydney; ACT Government 2012, *ACT Taxation Review*, ACT Government, Canberra.

193 Productivity Commission 2010, *Gambling*, no. 50, Productivity Commission, Canberra.

194 Government of Western Australia 2014, *2013-14 Annual Report on State Finances*, Government of Western Australia, Perth; and Government of Western Australia 2005, *2004-05 Government Financial Results Report*, Government of Western Australia, Perth.

impact a marginal project's viability. Of the two forms of royalties, royalties based on the volume of resources extracted are more stable than royalties based on prices but may be less economically efficient.

Discussion questions:

52. What are the relative priorities for state and local tax reform and why? In considering reform opportunities for particular state taxes, what are the broader considerations that need to be taken into account to balance equity, efficiency and transitional costs?

8.4: Principles for assigning taxes in a Federation

A full consideration of taxation in Australia needs to take into account state government revenue raising as people bear the cost of poorly performing and inefficient taxes, no matter which level of government levies them. However, there are broader issues relating to how the Federation works that help explain why and how governments levy the taxes they do.

On this topic, much academic literature has focussed on the principles of effective federations.¹⁹⁵ Discussion has centred on principles, including that:

1. each level of government should have access to tax revenue it can use to finance new spending decisions;
2. the central government should levy taxes for macroeconomic stabilisation, redistribution purposes and taxes on mobile bases; and
3. the assignment of tax responsibility should take account of how different arrangements affect the complexity of the tax system.¹⁹⁶

Another principle that falls more squarely within the scope of the Federation White Paper, but is clearly relevant to this discussion, is that intergovernmental grants should be transparent. This is to ensure all levels of government are accountable for their taxing and spending decisions.

195 Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra, pages 669-675.

196 This list is not exhaustive. Other principles include adequacy (taxes meet local need and expand over time to meet growing expenditure) and revenue stability at the sub-national level. See Bird, R 2010, 'Taxation and Decentralization', *The Economic Premise*, no. 38, Poverty Reduction and Economic Management (PREM) Network Vice-Presidency of the World Bank.

8.5: Issues in the Federation

How individual federations measure against the principles listed above is a matter of judgement, but it is clear that no federation meets all these principles. In fact, principles may well need to be balanced against each other, rather than achieved entirely.

The remainder of this chapter discusses how the Australian Federation meets these principles and highlights points where particular principles might be at odds.

Does each level of government have access to tax revenue bases sufficient to finance new spending decisions?

Accountability in federations is achieved with the principle that each level of government should have access to tax revenue bases in order to finance marginal expenditure decisions. It ensures that all governments face the full (electoral and financial) costs associated with new spending decisions.

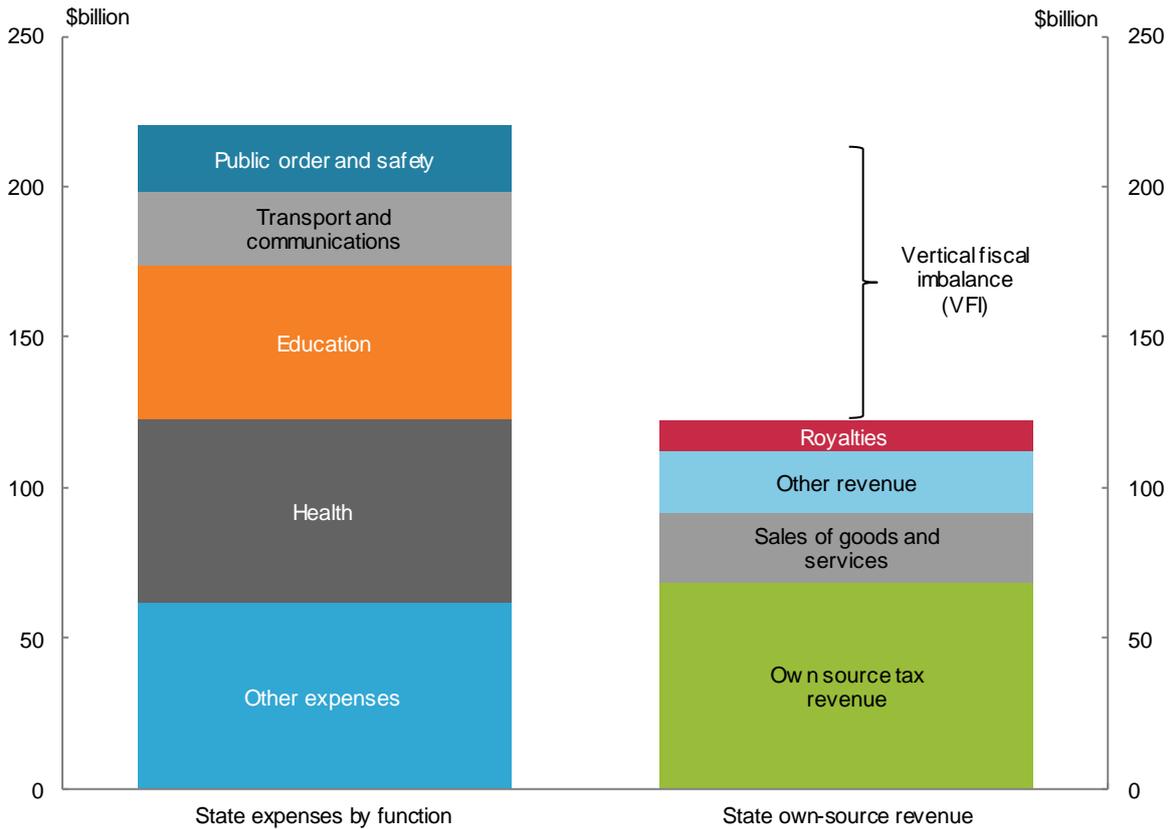
As with most other federations around the world, in Australia, the Australian Government raises more tax revenue than it spends on its own programmes. The states (including local governments) spend more than they raise in revenue, with the difference made up by Australian Government grants. In fact, about 45 per cent of state government revenue comes from the Australian Government.¹⁹⁷

Chart 8.11 shows the difference between state and territory expenses and own-source revenue, with the difference made up from grants from the Australian Government (around \$100 billion in 2013-14 including the transfer of GST receipts).¹⁹⁸

197 State and territory 2013-14 final budget outcomes (or equivalent) and 2014-15 budgets.

198 Federal, state and territory 2013-14 final budget outcomes (or equivalent) and 2014-15 budgets.

Chart 8.11 State and territory government expenses and own source revenue, 2013-14



Note: 'Sales of goods and services' includes user charging on state provided services. For the purpose of this chart the distribution of GST revenue is not considered state own-source revenue. 'Own source tax revenue' includes stamp duties on conveyances, land tax, other property taxes, and payroll tax, among other state taxes.

Source: Treasury calculations based on state and territory 2013-14 final budget outcomes (or equivalent) and state and territory 2014-15 budgets.¹⁹⁹

While fiscal imbalance exists in all federations, vertical fiscal imbalance (with central governments collecting more tax revenue than they spend, and sub-central governments spending more than they directly finance) is higher in Australia than in other federations.

How vertical fiscal imbalance impacts on the principle that each level of government has access to sufficient tax revenue to finance marginal expenditure decisions has been the source of much debate.

199 New South Wales Government 2014, *Report on State Finances 2013-14*, New South Wales Government, Sydney; Victorian Government 2014, *2013-14 Financial Report (incorporating Quarterly Report No.4)*, Victorian Government, Melbourne. Queensland Government 2014, *2013-14 Report on State Finances of the Queensland Government — 30 June 2014*, Queensland Government, Brisbane. Government of Western Australia 2014, *2013-14 Annual Report on State Finances*, Government of Western Australia, Perth. Government of South Australia 2014, *2014-15 Budget Paper 3: Budget Statement*, Government of South Australia, Adelaide. Government of Tasmania 2014, *Treasurer's Annual Financial Report 2013-14*, Government of Tasmania, Hobart. Australian Capital Territory Government 2014, *Consolidated Annual Financial Statements — 2013-14*, Australian Capital Territory Government, Canberra. Northern Territory Government 2014, *Treasurer's Annual Financial Report*, Northern Territory Government, Darwin.

On the one hand, some have argued that the growth of grants tied to particular activities has added to complexity in service delivery and reduced state government autonomy. State governments have also argued that Australian Government decisions to change the size, growth rate and form of payments to the states reduce their ability to effectively manage their own budgets.

At the same time, there is an opportunity for states to make better use of their existing efficient tax bases. Importantly, the principle that each level of government should have access to tax revenue bases does not require that governments raise all the revenue they spend. Instead, this principle is about imposing a 'hard budget constraint' to ensure that governments that want to increase spending should finance new spending themselves. Governments need not fund all of their own activities to meet this principle — just those on the margin. A more detailed discussion of the advantages and disadvantages of vertical fiscal imbalance is included in an issues paper on COAG and Federal Financial Relations, released as part of the Federation White Paper. The issues paper is available at www.federation.dpmc.gov.au.

Should the states and territories only levy taxes on immobile bases?

Much of the discussion on whether the states and territories should only levy taxes on immobile bases is centred on the argument that states in a federation will compete against each other to attract business and particular groups of people, including by reducing tax rates and introducing greater exemptions and concessions. The result is lower taxes overall, particularly on mobile tax bases.

In Australia, examples of competitive forces include decisions by states to increase their statutory payroll tax thresholds. A second example is the abolition of estate duties, starting with Queensland in 1977 and quickly followed by the Australian Government (1979), South Australia and Western Australia (1980), Victoria and New South Wales (1981) and Tasmania (1982). Narrowing the land tax base by introducing exemptions for primary production land and principal place of residence from the 1970s onwards might be a further example.²⁰⁰

There has been a mixed assessment of these competitive forces, with some academics arguing that devolved and competitive federal structures give citizens more control over government decisions.²⁰¹ The outcome is argued to be an optimal mix of taxes and services that meets the needs of the population. Alternatively, competition between states may result in a 'race to the bottom', with states competing against each other to lower their taxes and, as a consequence, deliver fewer services.

200 Smith, J 2004, *Taxing Popularity The story of taxation in Australia*, Australian Tax Research Foundation Research Study no. 43.

201 Kasper, W 1996, *Federations: competing jurisdictions*, presented at Australian Treasury seminar series.

How important is complexity across the Federation?

Because states and territories set the rates, base and exemptions of the taxes they levy, it is likely that there will always be some difference between them, which adds to complexity.

Further efforts to support the principles outlined above may come at the cost of greater complexity. For example, proposals that the states levy personal income tax alongside the Australian Government, and be permitted to vary the rate, could help ensure that they have access to revenue to fund their activities. At the same time, this option could add complexity for governments and taxpayers alike, particularly in determining the location of income where rates differ across states. In assessing this and other reform options, it will be important to weigh potential costs from complexity alongside other benefits.

Discussion questions:

53. Does each level of government have access to tax revenue bases to finance new spending decisions? If not, should arrangements change to achieve this? How should they change? How important is it that the national government levies taxes on mobile bases? Could some taxes be shared?

