

NSW Government Submission to the 2011 Tax Forum

Introduction

New South Wales welcomes the opportunity to contribute to the review of the Australian taxation system.

Taxation reform is essential to the efficient functioning of the Australian economy and to increasing the overall welfare of Australians.

Some tax reform can be achieved by states unilaterally. However, the nature of the Australian tax system and the linkages in Australian fiscal policy driven by vertical fiscal imbalance (VFI), means that cooperation of all levels of government is necessary to ensure the best outcomes for all Australians.

The key function of the states and territories¹ is the delivery of services and the associated infrastructure to their residents.

There is a fundamental mismatch in the service functions of the states and their revenue raising abilities. The Australian government has access to the largest and most efficient taxes which provide it with more revenue than it needs for its own functions, while the states are dependent on a range of smaller and less efficient taxes, which do not provide adequate funding for their spending responsibilities. VFI is extreme in Australia compared to other federations (such as Canada, Switzerland and Germany)².

States have lost revenue independence over time and currently have access to a very limited range of revenue sources. Many of the revenue sources that are available to the states are largely outside of the states' control (eg Commonwealth grants, GST), while state taxes are widely acknowledged to be inefficient.³

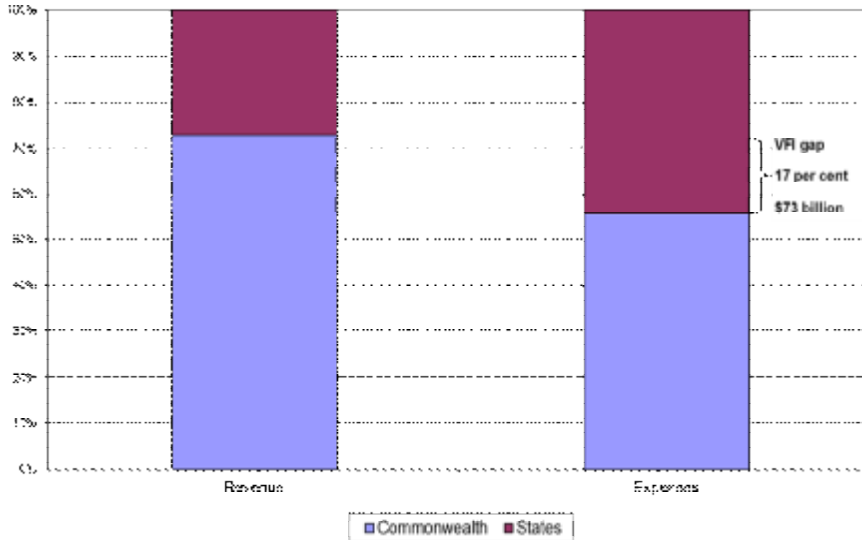
This imbalance reflects a shift over the past century between state and Commonwealth taxing powers that has meant the state governments raise much less revenue than they spend (Chart1). The states are largely dependent on Commonwealth grants to conduct their operations.

¹ Henceforth, "the states".

² Neil Warren, "Benchmarking Australia's Intergovernmental Fiscal Arrangements" (Final Report)

³ For example, Australia's Future Tax System (AFTS), December 2009, Chapter G2.

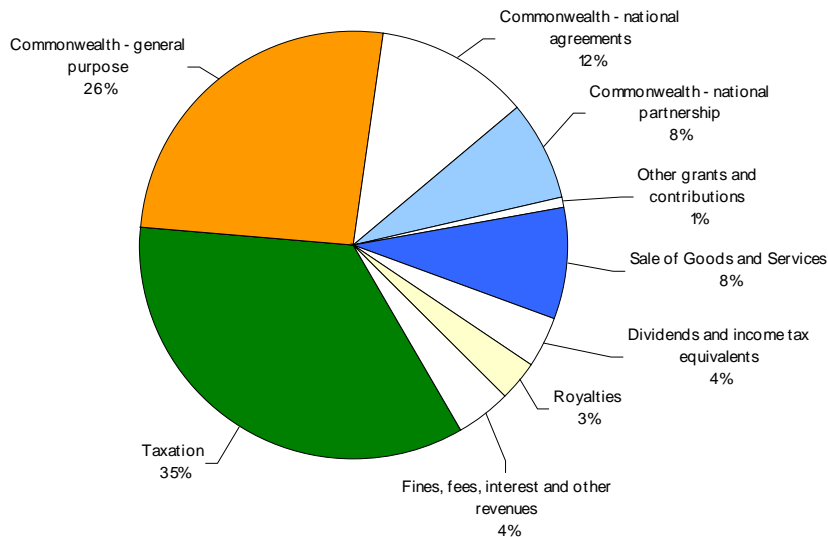
Chart 1: Vertical Fiscal Imbalance, 2009-10



Source: ABS: Cat No 5512.0

Commonwealth grants are estimated to constitute 45 per cent of NSW total revenue in 2011-12 (Chart 2). These grants include both untied GST, which can be used for general purposes, and tied funding provided under National Agreements and National Partnerships that must be used for specific purposes and which, in many cases, is only provided for a limited time.

Chart 2: Sources of NSW Revenue, 2011-12



Source: NSW Budget, 2011-12.

NSW revenue is forecast to grow at an annual average rate of 3.7 per cent over the four years to 2014-15, in part reflecting the expiry of a number of National Partnership payments over that period. However, those National Partnerships fund critical areas of service delivery.

This represents a potentially large risk to the people of New South Wales and underlines one of the significant problems in the current funding arrangements. States need greater certainty in their funding and greater ability to control their

funding so citizens can rely on government services. New South Wales has recently made a submission to the Australian government (on behalf of all States) proposing a mechanism for dealing with expiring National Partnerships where they are funding service delivery that should continue.

State taxes are estimated to provide 35 per cent of NSW total revenue in 2011-12. These taxes are generally narrowly based and volatile. The states face ongoing pressure to provide services to growing and ageing populations. However, according to the Report on Australia's Future Tax System, "increasing the rates of tax on existing state taxes would not be a sustainable way of funding services in the future".⁴

States need greater revenue certainty, less revenue volatility and more certain revenue sources which will provide adequate funding for the provision of services and associated infrastructure to their populations.

The risks associated with expiring National Partnerships have already been identified.

There also needs to be greater transparency on the impact of Commonwealth funding flows on state budgets.

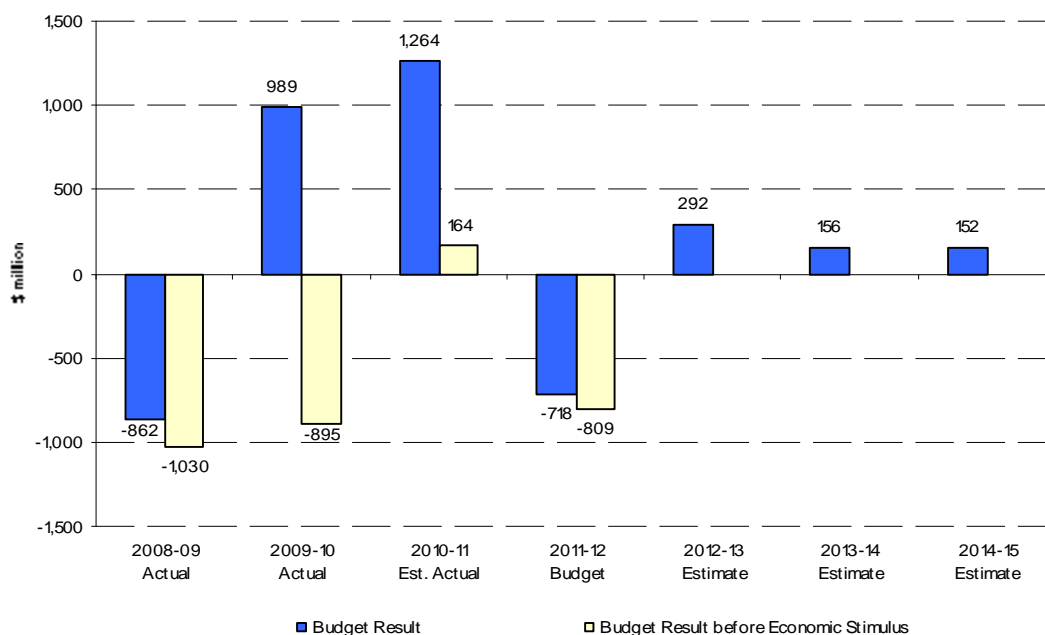
State Budget results in recent years have been significantly influenced by Economic Stimulus payments provided by the Australian Government in response to the economic downturn in 2008-09.

In particular, while funding received for school building projects was accounted for as revenue, the associated spending is recorded as capital expenditure which affects net lending but not the Budget result. This significantly improved the Budget result in 2009-10 and 2010-11 but has no impact on underlying state finances, as reflected in net lending, net debt and net financial liabilities.

A comparison of the headline Budget result and the result adjusted for stimulus payments is shown in Chart 3.

⁴ AFTS, op cit, page 680.

Chart 3: Budget Results 2008-09 to 2014-15



Source: NSW Budget Papers 2011-12, Budget Paper No 2, page 3-6.

Several recent events have highlighted a further problem of fiscal security for state governments. The Australian Government has demonstrated a willingness to make decisions with major implications for state budgets with minimal or no consultation. Examples include:

- The Commonwealth's carbon pricing proposal is estimated to have a cumulative impact on the NSW Budget of \$948 million during 2012-13 to 2014-15, principally through the loss of dividends from state-owned electricity businesses.
- In March 2010 the Commonwealth Government proposed changes to health funding that would have seen the Commonwealth retain a third of GST revenue (ie around 10 per cent of NSW total revenue). This was despite the *Intergovernmental Agreement on Federal Financial Relations*, signed in December 2008, which reaffirmed that all GST revenue should be passed to the states.
- The Commonwealth's proposed Minerals Resource Rent Tax (MRRT) will see the Commonwealth expand its taxing powers into a traditional domain of the states. This expansion complicates the state task of raising revenue through royalties, and reduces states' fiscal flexibility.
- The Commonwealth's proposed introduction of a range of gambling reforms is another example of the Commonwealth extending its powers into a traditional state domain. If implemented, these proposals are expected to reduce state revenue significantly.

Each of these decisions erodes the State's tax base further, without lessening the state's service responsibilities.

Constitutional intention

The drafters of the Constitution did not envisage the imbalance between revenues and expenditures that has emerged for state and federal governments over the past 110 years.

The Constitution granted the Commonwealth Government exclusive power over customs and excise taxes in order to provide it with a revenue base to support its functions. But it was accepted that, in its initial years, the Commonwealth would spend less than the revenue raised from these taxes.

The Constitution required the excess revenue to be passed back to the States:

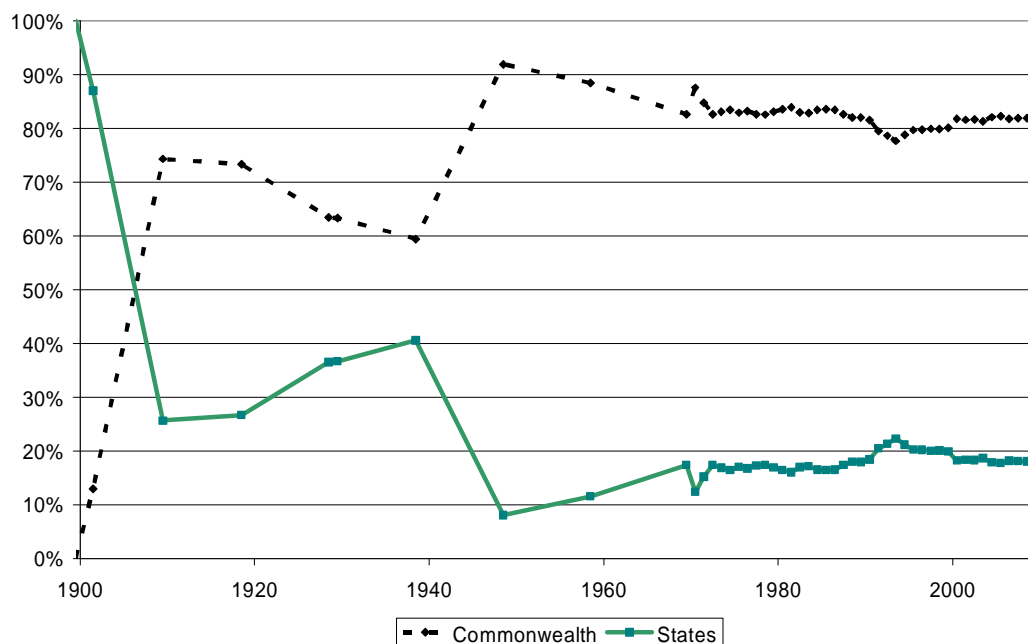
- Section 87 of the Constitution (the 'Braddon clause') states that a minimum of 75 per cent of revenue from customs and excess duties should be passed to the states, for at least the first ten years of the federation.
- Sections 93 and 94 of the Constitution require the Commonwealth to pass any surplus revenue to the states on a monthly basis.

The Commonwealth Government rapidly found ways to circumvent these provisions. The *Surplus Revenue Act 1908* permitted the Commonwealth to retain surplus revenues by paying them into a trust fund. The *Surplus Revenue Act 1910* permitted the Commonwealth to retain the full amount of customs and excise duties.

With exclusive power over the major pre-federation taxes of customs and excise, and having established a practical discretion over whether to provide a proportion of that revenue to the states, the Commonwealth had the means to exert greater control over state revenues.

In 1942, the Commonwealth used its power to withhold state grants to ensure the repeal of state income taxes. The practical consequence of these developments is that since federation state tax revenue has dramatically declined as a proportion of total tax revenue (Chart 4).

Chart 4: Share of total tax revenues by government level



Sources: For 1900 to 1969-70: Mathews and Jay (1997); for 1970-71 to 1994-95: Mathews and Grewal (1997). Subsequent years: ABS 5506.0.

New South Wales considers that the principles underlying the initial constitutional provisions remain sound:

- the revenues raised by each tier of government should reflect spending responsibilities, and
- if the Commonwealth raises more money than it needs, these funds should be transferred to the states.

Four Key Recommendations

Consequently, the New South Wales Government is making four key recommendations to the Tax Forum:

1. Return surplus revenue to the states

To enforce Budget discipline and to provide a revenue source for infrastructure, New South Wales has decided that any 'windfall revenue' in surplus years should be paid into the 'Restart NSW' fund, which will be used to build state infrastructure. Windfall revenue is any revenue that exceeds Budget forecasts.

The NSW Government considers that the Commonwealth should embrace a similar approach to budget discipline. To restore the spirit of the Constitution, any Commonwealth windfall revenue should be transferred to the state governments.

2. Tax base sharing

To improve the balance between revenue and spending responsibilities, the states should share some tax bases with the Australian Government.

The AFTS Report suggested that states could raise revenue from sharing the personal income tax base⁵.

In order to better share the income tax base, the Commonwealth should quarantine a proportion of income tax which would then be discretionary funding for states to use to meet service requirements. Administration would continue to be by the Australian Tax Office, with the revenue attributable to state and territory residents passed directly to the relevant jurisdictions.

An additional tax base that might be considered is excise tax. The Commonwealth should share this tax base again on a jurisdictional basis to better enable states to meet their service requirements.

For example, the Australian Government is estimated to raise around \$13.2 billion from excise duty on petrol and diesel in 2011-12. This is revenue which is primarily related to road usage⁶. However, the Australian Government is only providing \$4.3 billion to the states in road infrastructure funding.

New South Wales expects to receive around \$1.3 billion in road infrastructure funding from the Australian Government in 2011-12. However, NSW share of the excise raised would be around \$4.3 billion on an equal per capita basis.

This represents a significant difference between the excise tax raised in New South Wales on road usage and the funds returned to New South Wales.

Chart 4 shows the current level of road spending in NSW. Combining capital and maintenance spending on roads over the four years to 2014-15, the average annual expenditure on roads is forecast to be around \$4.6 billion.

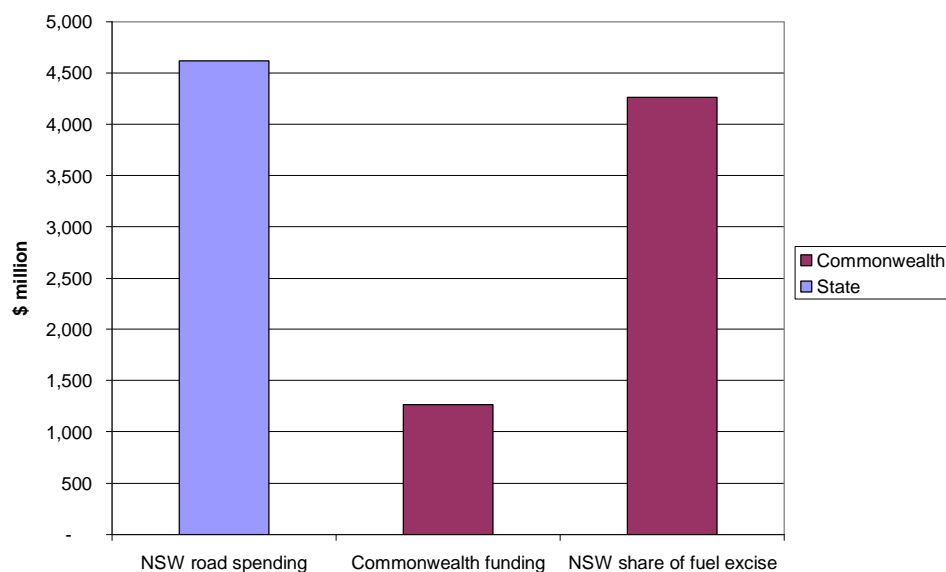
The Commonwealth only provides around \$1.3 billion in road grants, which is much less than the amount of fuel excise raised in New South Wales and also much less than the amount of road spending in New South Wales.

New South Wales will face significant demands for additional road spending in coming years. New South Wales has a significant infrastructure backlog, and has established Infrastructure NSW to review infrastructure investment plans. It is likely that this review will identify large additional infrastructure road investment needs, as well as increases in maintenance that would flow from an increased road stock.

⁵ AFTS, op cit, page 683.

⁶ Some of this revenue may relate to non road usage of fuel.

Chart 4: Funding NSW roads



Note: NSW road spending is the average of the forecasts over the four years to 2014-15. NSW share of fuel excise reflects the NSW population's share of Commonwealth fuel excise forecast for 2011-12.

The return of fuel excise duty raised in New South Wales would be consistent with the general principle of user pays, as it reflects road usage. Based on population share, the fuel excise could provide up to \$4.3 billion in revenue per year for New South Wales. This would enable New South Wales to utilise the excise that New South Wales has paid to deliver the road infrastructure required.

Furthermore, fuel excise returned to New South Wales in this manner would release state sourced revenue which could be used to begin to remove some of NSW existing inefficient taxes (along with Recommendation 4 below).

3. Remove tax impediments to infrastructure investment

The NSW Government has inherited many challenges, not least a backlog of infrastructure investment and an inefficient tax system that makes it difficult to raise additional revenue in a sustainable manner. New South Wales seeks to work with the Commonwealth to tackle these challenges.

Increased investment in NSW infrastructure could deliver a significant boost to Australia's GDP. New South Wales has established Infrastructure NSW to examine and prioritise the state's infrastructure investments. The New South Wales Government envisages that the private sector could play a significant role in financing these projects, and seeks to remove tax impediments to such investment.

The AFTS Report's recommendations concerning the taxation of income from savings could, if implemented, play a major role in lifting Australia's economic growth. The Report highlighted the wide variation in tax treatment of different types of investment. In particular, interest earnings have the least favourable tax treatment. People who save in this form will pay a higher lifetime tax bill than people with similar earnings who either choose not to save, or who save through tax-favoured investments, for example, superannuation.

The NSW Government seeks a neutral treatment for private investment in infrastructure, relative to the tax treatment of other investments. In the absence of broader implementation of the AFTS Report's recommendations on savings income, the NSW Government considers there is a strong case for income tax concessions for coupon payments on bond investments designated for infrastructure investments. As an example, interest earnings on municipal bonds in the US are generally not subject to income tax. Similar tax treatment on interest earnings on bonds used for eligible infrastructure investments should be considered in Australia. At the very least, the lower tax rates available to superannuation should be available for eligible infrastructure projects.

The NSW Government is encouraged by the Commonwealth's proposal in July 2011 for a new tax incentive for designated infrastructure projects. Under the proposal project losses will be uplifted at the government bond rate, and the losses will be exempted from usual income tax tests concerning continuity of business and the same business. This proposal will ensure a more economically neutral tax treatment of long-life infrastructure investments. The Commonwealth has indicated that it will prepare a discussion paper on the design of the new tax incentive.

To ensure that the tax incentive is not misused, as has previously occurred in respect of infrastructure tax incentives, eligible projects must be on Infrastructure Australia's National priority List as 'Ready to Proceed' or 'Threshold' and have at least \$100 million of capital expenditure, with an exception for Regional Infrastructure Fund projects and projects that are flagship or demonstrate unique national interest qualities.

The New South Wales Government proposes that priority projects designated by Infrastructure NSW should receive the same tax treatment.

4. State tax reform

There needs to be better alignment between revenues and service responsibilities of the various levels of government, and tax reform will be a key measure to achieve such alignment.

The NSW Government considers that a central focus of national discussions of tax reform should be the fiscal imbalance between revenue and spending responsibilities of the state and federal governments. To better match state spending and revenue responsibilities, measures are needed which would:

- Ensure that there is less imbalance between the funding and spending responsibilities of the different levels of government;
- Enhance medium to long term planning; and
- Reduce the vulnerability of state and territory finances to shifts in Commonwealth policy.

New South Wales believes discussions between the national, state and territory governments concerning detailed proposals for revenue-neutral tax reforms that improve the efficiency of the national tax system would be very worthwhile.

New South Wales considers there is a strong case for improving the efficiency of state taxes, by reducing reliance on inefficient taxes and increasing reliance on efficient taxes. Modelling results indicate a cooperative scheme of tax reforms,

involving both state and federal taxes, could increase GDP by more than 1.8 per cent over the long term⁷. State taxes are significantly more inefficient than Commonwealth taxes. Transfer duty and the emergency services levy are particularly inefficient⁸. However, moving to a more efficient tax system will require Commonwealth involvement as the Commonwealth has access to the larger and more efficient taxes.

The NSW Government proposes that discussions be held involving the national, state and territory governments to review options that could help to lessen reliance on less efficient taxes and improve the balance between state spending and revenue.

⁷ KPMG Econtech, 2011, CGE modelling of NSW Implications of Henry tax Review Implications.

⁸ Tables showing the excess burdens associated with NSW and Australian Government taxes is at Appendix A.

Appendix A

NSW analysis agrees broadly with the Henry Review's analysis of the efficiency of state taxes. Table 1 sets out estimates of the excess burden of NSW taxes. Excess burden is a measure of the economic cost of a tax, over and above the revenue it raises. On average, the economic cost of NSW taxes is equivalent to 26 per cent of the revenue raised.

For comparison, the economic cost of Australian government taxes is equivalent to 14 per cent of the revenue raised (Table 2).

Table 1: Excess Burden of NSW Taxes

Revenue source	Revenue 2011-12 ^(a) (\$m)	Total excess burden (\$m)	Marginal excess burden (cents per dollar of revenue)	Average excess burden (cents per dollar of revenue)
Transfer duty	4,126	2,558	80	62
Emergency services levy	633	373	68	59
Vehicle stamp duty	608	188	33	31
Insurance duty and health insurance levy	893	259	31	29
Vehicle registration	1,895	474	31	25
Payroll tax rate	6,855	1,371	35	20
Payroll tax threshold			-8	
Land tax rate	2,483	149	9	6
Land tax threshold			-8	
Royalties	1,809	72	13	4
Gambling taxes	1,878	0	0	0
Total	21,180	5,445		26

a. State revenue estimates are from the 2010-11 Half-Yearly Review of the Budget. Source: Econtech (2011).

- NSW modelling suggests that mineral royalties are among the most efficient state taxes. The AFTS Report suggested that mineral royalties were highly inefficient. The different results occur because the efficiency of royalties varies with minerals prices. When royalties are a low proportion of profits, they are relatively efficient. The AFTS Report assumed the 2004-05 terms of trade as a long-term average, while the NSW modelling used the 2005-06 terms of trade, when mineral prices were higher.

Table 2: Excess Burden of Australian Government Taxes

Revenue source	Revenue 2011 12 (\$m)	Total excess burden (\$m)	Marginal excess burden (cents per dollar of revenue)	Average excess burden (cents per dollar of revenue)
Tobacco excise	5,830	-1,341	-8	-23
Import duties	7,520	-526	-3	-7
Petroleum resource rent tax	2,050	0	0	0
GST	50,630	3,038	8	6
Alcohol excise and wine equalisation tax	3,790	265	9	7
Luxury car tax	510	50	20	9
Fuel taxes	13,480	1,348	15	10
Personal income tax	150,890	24,142	24	16
Corporate income tax	74,600	17,158	40	23
Total	309,300	44,134		14

Sources: Econtech (2010), Commonwealth Budget 2011-12, NSW Treasury calculations.

Note: Commonwealth taxes not covered in the table are: fringe benefits tax, superannuation funds, certain excise revenues, agricultural levies and other taxes.