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The way forward on state tax reform: an AFTSR perspective

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Abstract

This paper reviews recommendations in the 2009 Report to the Treasurer on Australia's Future Tax System Review (AFTSR) relating to the future of state taxes in Australia. The Report proposes greater centralisation of tax collection, abolition of many state taxes, and reforms to others including land, resource and road-related taxes.

1. INTRODUCTION

The Australian Government established a review of Australia's Future Tax System ('the AFTS Review') in 2008, conducted by a five member panel chaired by the then Secretary to the Treasury, Ken Henry. The Review considered taxes at each level of government, including those levied by the States and Territories[2]. This paper provides a survey of the main findings of the AFTS Review on State taxes and a discussion of the issues and prospects for reform in coming years.

2. FISCAL IMBALANCE

The Australian States have long collected a number of relatively small and narrowly based taxes which together fund only about one half of their expenditures. The gap between own-source revenues and expenditures, or vertical fiscal imbalance, has been met by fiscal transfers from the Commonwealth so that State services rely in large part on funding from national tax revenues.

The AFTS Review sought to determine the best structure of taxes for Australia as a whole on the broad premise that the resulting revenues could be allocated between the levels of government under mutually agreed arrangements. The majority of existing state taxes were found to perform relatively very poorly in terms of allocative efficiency. The Review proposed that they be abolished. In general, the preferred replacement taxes were those imposed on large bases collected at the national level. Accordingly, adoption of the AFTS Review recommendations would lead towards greater vertical fiscal imbalance than under the existing arrangements.

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[2] References in this paper to the States refer to the States and the two self-governing Territories.

The implications for the States of the AFTS Review recommendations extend beyond the replacement of inefficient state taxes. In addition, recommendations were made that would:

- change the ways that some state functions are funded, including in ways that would alter the relative fiscal positions of the Commonwealth and the States; and
- change the design and scope of remaining state taxes and charges.

The AFTS Review did not undertake a formal assessment of fiscal federalism. In particular it did not consider issues associated with horizontal fiscal imbalances (variations in the fiscal capacities of the States to provide public services) or its amelioration. As to vertical fiscal imbalance, the preferred outcome depends on a number of factors including the allocation of spending functions between each level of government, the desired degree of policy experimentation and competition between the States, and (in contrast) the desired level and nature of coordination and harmonisation between the States and between the levels of government.

The Review found that the States with their current roles should have access to their own revenues "...to finance significant marginal expenditure decisions"[3]. The emphasis on 'marginal' is intended to imply that it is satisfactory for most revenue to be obtained through transfers from central government. Australian States have some degree of policy autonomy and hence diversity in at least some areas of continuing policy responsibility, but this is limited and declining. The Review envisaged that much of the funding would take the form of tax base sharing using centrally collected taxes – with the States themselves being likely to mainly collect revenues only from relatively immobile tax bases.

A key issue with the sharing of centrally collected taxes is whether states have any autonomy on the tax base or rate. Currently, the States receive 100 percent of the net revenues of the Goods and Services Tax, which as a Commonwealth tax is constitutionally required to have a common base and rate[4]. States could potentially exercise autonomy if instead they were to share an income tax base. However, the AFTS Review did not proceed to the point of recommendations on these issues, essentially because it considered a review of broader federal financial relations would be required first. It is possible to conceive a large range of possibilities for the ways in which public services are funded with significant implications for the ways that federal funding arrangements are conducted. These possibilities have not yet been systematically assessed across all areas of policy in Australia – recent proposals for a national disability insurance scheme however provide one illustration of the major changes that are possible. That proposal functionally separates funding arrangements and service delivery and would reduce state revenue requirements.[5]

3. THE REFORM FRAMEWORK

The AFTS Review was informed by the well-established analytical tools of the tax axioms (equity, efficiency, simplicity etc.) including recent empirical evidence on some of the key issues, and international comparisons. Perhaps more so than earlier

[3] AFTS Review Part 2 (2010), p.672

[4] The Constitution reserves excises for the Commonwealth and prohibits discrimination between the States under revenue laws (s.99).

[5] See Productivity Commission, Disability Care and Support, 2011

policy reviews, it was also heavily influenced by an assessment of strategic developments in such fields as the global economy, demography, technology and social and environmental sustainability.

The broad conclusions for the future Australian tax architecture were:

- Revenue collection should be concentrated on four efficient bases – immobile rents, consumption, individual income and business income.
- Other narrow and inefficient taxes should be abolished (except those efficiently addressing market failure or other clear social purposes)
- To maximise economic growth, the relative weight of the major taxes should shift over time in accord with base mobility – more tax on immobile rents (land and natural resources) and consumption and less on personal and (particularly) business income.
- Existing major tax bases could be more neutral; the transfer system better targeted, more adequate, and less adverse for workforce participation; and some user charges and other fiscal arrangements could be reformed to improve social outcomes.

In broad terms the Review was conducted under a revenue neutrality assumption because its terms of reference specified that "...recommendations should not presume a smaller general government sector and should be consistent with the Government's tax to GDP commitments."[6] Clearly then, the Review framework requires that revenue losses from the abolition of taxes be offset by higher collections from the large efficient bases.

Several large tax base issues were addressed in very general and sometimes provisional terms, such as those relating to business income and the taxation of dividends. Because the Review was precluded by terms of reference from recommending increases in the GST rate or base, it was also guarded in the way it approached the key idea of increasing the overall weight of consumption taxes or using these to facilitate reform (often abolition) of State taxes.

The key recommendation in this regard is Recommendation 55 dealing with replacing state taxes with a destination cash flow tax, but this is worded essentially as a finding. There is no specific recommendation for the actual introduction of a new cash flow tax and the only recommendation in the chapter on State tax reform relates to general principles for inter-governmental coordination processes. Recommendation 55 states that:

> *Over time, a broad-based cash flow tax – applied on a destination basis – could be used to finance the abolition of other taxes, including payroll tax and inefficient State consumption taxes, such as insurance taxes. Such a tax would also provide a sustainable revenue base to finance future spending needs.*[7]

A destination cash flow tax would have much the same economic base as a value added tax (the GST). In the context of modern business technologies, it may be simpler than the GST because the invoice VAT was originally designed for mid-20th century paper based business technologies. It could offer an opportunity for a broader

[6] Terms of Reference are reproduced in AFTS Review Part 1 (2010) pp vii-ix

[7] AFTS Review, Part 1 (2010) p 91

and more neutral base and for greater integration of tax administration and collection across more than one base. However, the Review essentially leaves most of these issues for further study in the future.

4. ABOLISH AND REPLACE STATE TAXES

The AFTS Review proposed that a number of state taxes be abolished and replaced by other more efficient sources of tax revenue (or user charges). A destination cash flow tax is potentially only one of these. Clearly, an increase in the rate or base of the GST itself, whether or not it is reformed in other ways, is also an alternative source of revenues if political conditions change under some future government.

The taxes proposed to be abolished were identified by the AFTS Review essentially on the basis of theoretical expectations and empirical estimates of their excess burden or 'deadweight economic loss' (the loss of social welfare arising from behavioural change arising from the tax) [8]. While this is only one criterion for the analysis of taxes, the Review had in any event decided to recommend that revenue collections be concentrated on four large and relatively more efficient tax bases. It did not support retaining in the long run any other tax whose justification was purely revenue. Some taxes may be retained where there are specific additional economic or social purposes and it can be shown these are met efficiently by taxes. The proposals for the main state taxes are summarised in Table 1.

Table 1: AFTS Proposals for State Taxes

Tax	Revenues 2009-10 $b	Proposal	Possible Replacement
Payroll	16.8	abolish	Consumption
Insurance	4.6	abolish	Consumption
Property transfers	12.3	abolish	Land tax
Land tax	5.8	Retain and reform	Modified base
Resource Royalties	6.6	abolish	Resource rent tax
Motor Vehicle revenues	7.0	Possibly abolish tax component	Road user charges
Gambling	5.0	Retain and reform	na

Source for revenues: Taxes, ABS Taxation Revenue Australia, 2009-10, Cat. 5506.0: Royalties, Commonwealth Grants Commission website (note significant royalty revenue increases are expected in coming years)

As Table 1 shows, the AFTS proposals potentially would require additional consumption tax revenues of about $21 billion (in 2009-10 terms) to replace mainly payroll and insurance taxes. This would broadly be equivalent to a destination cash flow tax at a rate of 3-4 percent: the narrower base of the existing GST might require increasing the rate from 10 to 14 or 15 percent (base broadening aside). Of course, whether or when Australian political conditions would ever support such a reform (and under what if any broader change strategy) is difficult to judge: it is ruled out by current policy on both sides of politics.

For practical and constitutional reasons (noting a destination tax is imposed on imports) a cash flow tax would need to be a uniform national tax, just as the GST and

[8] AFTS Review, Part 1 (2010) p 13

any changes to it requires Commonwealth legislative action that does not discriminate between states.

The abolition of state taxes would change the assessment of the fiscal capacities of the States and so would affect the distribution of Commonwealth general revenue payments to them. As with the introduction of the 10 percent GST in 2000, these issues likely would need to be the subject of a comprehensive intergovernmental agreement, possibly including guarantee provisions ensuring no state is made worse off by the changes.

In principle a greater use of the consumption tax base might also be used to replace other inefficient taxes. However, as indicated in Table 1, the analysis in the AFTS Review points to different approaches for these other taxes. Land tax, if imposed on a broad and neutral base, is particularly efficient, even more so than consumption, and the immobility of its base renders it very suitable as a state (or local) tax. Unlike consumption tax there is also no constitutional difficulty for States imposing the tax at rates of their choosing. The AFTS Review therefore envisaged that land taxes, which currently generate revenue both through an asset base and a transaction base, should be reformed without any net reduction in land revenues. The abolition (or reduction) in property transfer taxes would therefore be funded by land tax.

Similar considerations apply to resource royalties – the most efficient replacement for these is resource rent taxes. The AFTS Review recommended that royalties be replaced in this way and that the Australian and State governments negotiate an appropriate allocation of the revenue and risks. Subsequent announced policy, applying to a more limited range of resources, was developed without this consultation on revenue sharing. It provides for the retention of both forms of tax, with the States retaining royalty revenue and the Commonwealth taking rent tax (with a credit for royalties). Some States have already announced higher royalties in order to secure higher shares of revenue, but the retention of royalties has compromised for now the potential efficiency benefits of these reforms.

In the case of the motor taxes (which at the state level mainly comprise registration charges and stamp duties on purchases of motor vehicles), the initial recommendation is to make these explicit and link them to recovery of costs related to road provision. In the long term these could be replaced if efficient road pricing is introduced, but this is a highly contingent proposal.

While taxes on bequests are generally considered politically unattainable in Australia, the AFTS Review did survey the issues because such taxes are clearly relatively efficient. In practice they could contribute to state revenues, to tax system progressivity and to encouraging philanthropy (assuming such bequests are exempted). The recommended course, however, was no more than to encourage further study and community discussion of the options.

5. REFORMING CONTINUING STATE TAXES

The AFTS Review provided few substantive recommendations for the reform of specific state taxes except for land tax. Land and gambling taxes would be the only substantial state taxes continuing to exist if the Review recommendations were fully adopted.

5.1 Land Tax

The potential efficiency of land as a tax base has long been recognised. The AFTS Review included land among its four preferred tax bases (including it with natural resources as the main immobile economic rent bases). In Australia, however, taxes based on land take three main forms with only one, the local government rate, coming close (in most cases) to an efficient design. Much less efficient are state land taxes (because they apply on an aggregate landholding basis and only to certain land uses) and property transfer taxes which share the efficiency costs of many other transaction taxes.

The Review proposed a single, comprehensive land tax base (essentially shared between local and state government). It proposed that the rate of tax be set by reference to the unit value of land (that is, the value per square metre rather than the aggregate value of total landholdings of each taxpayer). Low unit value land such as most rural land would fall below a threshold value for tax, but in general there would be no exemptions based on the use of land. As the unit value of land rises, generally in or near population centres, the rate of tax would also rise. The highest rate would apply to the most valuable land per square metre, although implicit in the recommendations is that the rate of tax would never be so high as to confiscate a very high share of rents. Of course, it is to be expected that such a tax structure would through capitalisation of the tax result in some reduction in land prices and amelioration of the land price gradient.

Given its implications for land values and hence for existing wealth-holding, this reform, if it is to have any prospects, likely would be phased in over a potentially long time frame along with the reduction and perhaps even ultimate abolition of property transfer tax. Clearly, however, this is still politically challenging, both in relation to its different transitional effects on taxpayers and as it involves a tax base shared by two levels of government. Recognising this, the Review suggested consideration of some more incremental steps, including:

- Applying land tax to each holding rather than aggregate holdings (potentially removing disincentives for the expansion of holdings of residential investment properties by institutional investors); and
- Applying the reform only to commercial and industrial property.

The main problem with comprehensive reform in this area is the difficulty in seeing who would champion it. The performance of land markets in Australia is mainly of concern because prices are often high relative to incomes. The reasons for this are controversial. The implications are also unclear and contested, although there is growing concern about housing affordability particularly for the new generations of potential first homebuyers. It is in this concern that land tax reform has its most obvious potential prospects, along with other tax reforms (such as the taxation of investment properties) and for regulatory reform beyond the tax agenda.

However, set against this are strong interests benefiting from existing outcomes, not least existing landowners. It is unlikely that there will be much change unless and until a much clearer consensus emerges about market performance, its causes, and opportunities for improvement. Even then, there may need to be other gains packaged with this reform. The future role of local government may also play an important part, given the fundamental place that property and land use plays in that role and its funding.

5.2 Gambling Taxes

Gambling taxes are controversial in Australia as elsewhere given differing perspectives on how the social costs of problem gambling should be addressed. As for alcohol, the AFTS Review tended to the presumption that responsible gambling consumption was welfare improving in keeping with the standard consumer sovereignty framework of mainstream economics. The role of taxation was therefore seen mainly as collecting monopoly rents arising from government regulation of gambling. Attention focused also on ensuring that outcomes were neutral, in particular not serving one supplier interest (such as clubs) over others.

5.3 Reforming other taxes

The AFTS Review put its faith in abolishing the most inefficient state taxes rather than reforming them. While these taxes continue, there may be scope for their reform to improve efficiency and other outcomes. The Review observes that thresholds and exemptions create distortions and increase the welfare cost of the payroll tax, but this analysis is not taken further to detailed recommendations about payroll tax design.

The Review also proposes that minor state taxes and charges be reviewed against the principles enunciated in its Report – it would follow logically that this apply to other major taxes as well, but the Review itself did not attempt to do so.

The Review also recommended (Rec. 138) that uniform state reporting of state tax expenditures should be introduced through agreement reached under the umbrella of the Council of Australian Governments (COAG)[9]. It envisaged that the standards for the reporting of tax expenditures by both the Commonwealth and the States would be set by an independent body. While these are not the type of recommendations that usually attract much attention, the publication of tax expenditures can facilitate longer term reform efforts as the opportunity costs of inefficient taxes are made more transparent.

6. OTHER FISCAL REFORMS

The recommendations of the AFTS Review extend beyond specific state taxes themselves to measures that would affect the fiscal position of the States in other ways. Overall, the effect of many of these may be to reduce the tax revenue needs of the States. Some would affect tax administration or revenues and others state spending needs, or the ways that Commonwealth programs directly or indirectly fund those programs. These are briefly illustrated here.

[9] COAG is a formal structure for meetings of heads of Commonwealth and State governments and is the principal body for the negotiation of intergovernmental agreements within the Australian federation.

6.1 Road congestion

The Review proposes that governments investigate the possible introduction of variable congestion pricing and potentially wider road pricing reforms if new technologies prove cost effective. Ultimately, such a reform has the potential to remove the requirement for a large part of Commonwealth and State funding of roads from tax sources. These approaches to road pricing carry with them requirements for major institutional and market reform in the roads sector. The reform task here is complex and challenging with major implications for all levels of government, with tax arrangements playing only one of many parts. Roads are the last major economic infrastructure to resist substantive microeconomic reform. For the foreseeable future progress on this issue will depend on broader road reform (and technology related) developments.

6.2 Local Government

The Review proposes greater revenue autonomy for local government but also eventual integration of land based state and local government taxes. The roads and housing reforms also have implications for local government. Each of these would rely on high quality coordination between state and local authorities, although the potential also exists for pursuing greater fiscal autonomy for local government if that is considered desirable, with reduced reliance on intergovernmental transfers.

6.3 Housing policy

At present rental housing assistance is provided both by the Commonwealth in the private rental market and the States in the public housing sector. The Review proposes that the Commonwealth provide a common (and higher) level of assistance across both sectors, with potential implications for the future funding models (and respective roles of government) in public sector housing. Potentially, the Commonwealth could replace the States as the source of all housing assistance funding, while the States may continue to manage public (or other community) housing supply. Attempting to contribute to ameliorating the broader problem of housing affordability, the Review's housing-related recommendations included economic reform of the basis for setting developer charges.

6.4 Social policy programs

The Review made a range of recommendations that would potentially alter state financial responsibilities in relation to some social support programs. These included a recommendation that the provision of concessions tied to goods and services be reviewed, particularly as some deliver benefits on a regressive basis and value for money is uncertain. More fundamentally it recommended a review of the models for funding social programs – anticipating the Productivity Commission work on client-centred funding for disability care and aged care. These potentially involve models where the States remain as regulators and service providers but not as ultimate funders of programs. Such models could extend to many areas and have profound implications for federal financial relations.

7. REVIEW TIMETABLE

The AFTS Review was commissioned by the Government in May 2008. It followed a business-inspired call for a tax review at the so-called 2020 summit, a gathering of diverse individuals aimed at discussing Australia's future course. At that time Australia appeared to be facing benign economic and fiscal conditions, so the main focus was on how to make best use of our luck. This included expectations of continuing future budget surpluses, and no doubt many saw an opportunity to benefit from them. However, within a few months, the Global Financial Crisis was triggered and fiscal surpluses soon disappeared. The AFTS Review reported in a very different environment from the one in which it commenced.

This fundamental change in conditions reinforced the long term focus of the Review. In its Report, the Review discussed at length why it did not propose timetables or packages of reforms[10]. These included:

- The need to assess critical links to other areas of public policy, including taking into account overall developments affecting income distribution.
- The need to assess the right balance over time between competing policy objectives and to link appropriately to fiscal and macroeconomic circumstances (these were influenced by the prevailing GFC problem and its uncertain course).
- The need to obtain intergovernmental agreement.

In making these and other observations, the Review sought a robust *approach* to reform rather than immediate *results*. Its goal was to produce a reference document for future reform efforts. This positioning, of course, is not easily understood or managed in contemporary political settings. The Government did not release the Report for nearly six months, and then only after making many policy decisions for announcement at the same time. Some further decisions have followed in a small number of areas.

Only in October 2011 was a formal community discussion of tax reform organised. It resulted in very limited intergovernmental agreement on tax reform[11]. Some States have indicated an interest in reviewing their own taxes, and some processes along these lines have been commenced, but at this stage it appears unlikely that these will lead to any major push for major structural reform. Australia in 2011-12 is undergoing a period of considerable political change and uncertainty which may not be conducive to early major action.

8. PROSPECTS FOR REFORM

The prospects for further tax reform are constrained by several key issues.

Firstly, the tax reform policy agenda is already quite heavy, at least in political terms. The immediate agenda is dominated by two main measures – introduction of a carbon pollution price and a minerals resource rent tax. Although the gross tax receipts of each of these is less than 2 percent of total tax revenues, they have proven highly controversial, arguably consuming the political space for tax reform for some time. Beyond this, governments face difficult reform agendas relating to aged care and

[10] AFTS Review Part 1 (2010) Pathway to reform, pp xxiv-xxvi

[11] See the Hon Wayne Swan MP, Deputy Prime Minister and Treasurer, "Closing Remarks for the Tax Forum" 5 October 2011 (at www.treasurer.gov.au/speeches)

disability care and support, each affecting both major levels of government and the subject of Productivity Commission Inquiries. A major challenge now arises in integrating responses to these issues with the quite high fiscal cost decisions already taken on retirement income policy.

Second, the fiscal situation facing Australia is one of very limited policy room. Projected national budget surpluses in each of the three years to 2014-15 are very small (reaching only $3.1 billion in the final year). In the context of strong bi-partisan commitment to budget surpluses, this largely rules out for some time the tactic used in most past tax reforms of providing net tax cuts with reform packages. These were previously possible in large part because significant bracket creep revenues (that is, higher revenues as average rates of tax increase under an unindexed progressive tax scale) were returned to give the impression of net gains.

Third, the policy settings in coming years will likely act as a brake on the growth rate of disposable household income which limits the political appetite for reforms that have any real or apparent household cost. The elements of this include bracket creep for a number of years, the introduction of an additional 3 percent superannuation guarantee obligation, and the possible costs of the aged care and disability care reforms. In combination, these will limit the rate of growth of real household disposable income – arguably at a time when widespread expectations for continuing rapid income growth remain unrealistically high.

This is not to say that the prospects for reform will necessarily be dominated by negative factors. For the States in particular, other economic developments may raise interest in reform issues. The mining boom in Australia is having profound effects on the relative fiscal positions of the States, and these effects could continue to grow. These effects include:

- A large increase in revenue disparities between the main mining States (mainly WA and Queensland) and the other States
- In consequence, an offsetting redistribution of GST payments under Australia's horizontal fiscal equalisation system: already underlying controversies in this regard have led to the establishment of a Review of the GST distribution arrangements[12];
- Weak growth in the GST pool: this partly reflects the two-speed economy problem but in future may also be influenced by the effects of other policies on the rate of growth in household disposable income (and hence consumer spending).

It is also possible that the very high terms of trade enjoyed by Australia will undergo a correction. If this occurs, some of the effects noted above may ameliorate but only at the expense of other developments associated with weakening national income. Renewed concerns about trade competitiveness and employment growth could emerge and with that revitalised interest in the adverse economic effects associated with inefficient taxes.

If Australia in a future period undergoes a protracted period of relatively high unemployment (as it did throughout most of the years of tax reform in the past) there may be greater interest in particular in abolishing the payroll tax. While this interest

[12] The GST Distribution Review, commissioned in March 2011 and due to make a final report by August/September 2012: refer www.gstdistributionreview.gov.au

may often be based in part on misunderstanding of the actual economic incidence of this tax, a switch from that tax base to consumption would be expected to support growth.

Overall it is not clear what will develop, but there is certainly early evidence of considerable concern among the States at their fiscal circumstances and the ways that these developments and existing policy affects them. This could generate interest in a broader solution to their revenue and spending pressures.

In the current setting, it seems that those interested in further reform may need to focus on furthering the analysis and understanding of the key issues for some time. The AFTS Review made a number of recommendations that would further this type of work (see Recommendations 113, 131 and 134 which each propose arrangements for ongoing review, coordination and independent policy research).

Developing a renewed understanding and vision for the federation may need to be added to that agenda. Disputes over the role of state royalties and national resource rent taxation illustrate the ongoing difficulties in the federal relationship. The likely coexistence of these taxes now raises a clear reform opportunity if a revenue sharing (or even full tax reassignment) agreement could be reached so that interests can be aligned favouring a more efficient structure.

9. CONCLUDING COMMENTS

The AFTS Review provided a broad vision for the future Australian Tax System rather than a detailed design or roadmap for change. For the States the vision is ultimately one of greater revenue base sharing and hence continued financial dependency on the Commonwealth. There is some risk that this fact alone will be an impediment to tax reform because for the States it comes at the price of losing even more of the little remaining revenue autonomy they enjoy.

This observation supports a conclusion that tax reform at this level will depend on reform of the federal fiscal relationship. This relationship raises a complex set of questions that requires considerably more research work and stakeholder discussion before it will progress far. That work and discussion is not properly or sustainably one for the Commonwealth and the States alone, represented by their ephemeral executive governments. The stakeholders extend to all in the Australian community.

Efforts to date to achieve better relations between the Commonwealth and the States have brought some results but as quickly as gains are made new setbacks emerge. With widespread areas of policy responsibility now entangled by shared responsibility, the political costs and drain on leadership time and attention of these problems suggest that there should be incentive for more concerted action.

On the tax front, the immediate prospects for major structural reform along the AFTS lines are not strong. As the next few years unfold, much will depend on the way economic conditions unfold. Core questions ultimately will include whether there is enough force to the argument that a higher general consumption tax should replace the payroll tax (and some smaller inefficient state taxes) and whether, once the dust settles, the benefits of one rent-based tax on resources can better serve the States as well as the Commonwealth.

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