

# State Tax Reform: Progress and Prospects

Robert Carling

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*Perspectives on Tax Reform (16)*

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## Foreword

This paper is the sixteenth in a series of tax reform papers published by the Centre for Independent Studies (CIS). Like its predecessors, the paper identifies major structural flaws in our current taxation system, and develops a set of proposals to put them right. Unlike previous papers, however, the flaws it identifies lie in the realm of state finances, and this specific focus makes the paper distinctive.

In the past, authors of papers in the CIS Perspectives on Tax Reform series have tended to focus their attention on Commonwealth government taxes, and have placed particular emphasis on the case for reforming personal income tax. Given that the Commonwealth raises 80% of all tax revenue, and that income tax is the single biggest component of its income, this focus on federal income tax reform is certainly justifiable, and will continue in future papers.

But this is not the only area where change is required. We should not forget that, in our federal constitution, the states, too, enjoy tax-raising powers. Although they actually raise a lot less than they spend, when they do raise their own money the states rely on an array of taxes and levies that is badly in need of reform.

Most state taxes exhibit one or more of the classic characteristics of ‘bad taxation.’ They are complex, they are inefficient (for they levy higher than necessary rates on a narrower than necessary base), they distort behaviour and therefore generate high deadweight costs, and they are often driven more by social and political objectives than by the concern to raise revenue efficiently, fairly, and transparently while minimising the burden of compliance on taxpayers.

These issues were first raised in *State Taxation and Fiscal Federalism: A Blueprint for Further Reform*, which was the eleventh in this series. That paper provided an overview of the issues in the context of federalism. This latest paper analyses the state taxation issues in further detail. After reviewing various reform options, it outlines the key features of what a much improved state tax system would look like.

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## Executive summary

Interest in federal–state financial relations has been aroused by the election of the Labor federal government, which has set reform of federalism as one of its top priorities. At the same time, the government is eager to expand the economy’s productive capacity and cut red tape for business. State tax reform would further each of these objectives. Although the government has not identified it as one of its priorities, it is a high priority for some in the community, including peak business groups. While their motive is at least partly self-interest, there are also strong public interest reasons for adding state taxation to the reform agenda pursued by the Council of Australian Governments (COAG).

The GST-based reforms of the Howard government have improved the state taxation system but fall well short of the potential scope of reform. Contrary to popular impressions, the highest-profile state taxes—payroll tax, land tax, and stamp duty on housing—were not part of the GST agreement between the Commonwealth and the states. The states are doing all or most of what was intended under that agreement. The issue is not, therefore, whether the GST agreement is delivering what was intended—because, by and large, it is—but whether it was ambitious enough in the first place.

The agreement leaves two major issues unresolved:

1. vertical fiscal imbalance, whereby the states’ expenditure responsibilities far exceed their own revenue-raising powers
2. deficiencies within the shrunken range of taxes that the states still have under their control

This paper focuses on the second issue. While it does not set out to solve vertical fiscal imbalance, it recognises the imbalance as a constraint, and aims not to put forward proposals for tax reform that would worsen it. For example, any notion of replacing all state taxes with centralised Commonwealth taxation would take the imbalance to an extreme and be inconsistent with the federal system of government.

On the second issue, the state-controlled taxes we still have leave a great deal to be desired. The substitution of the GST for some state taxes has undoubtedly led to a better overall tax mix, but that progress should not blind us to what has *not* been achieved—namely, reform of payroll tax, land tax, and the stamp duties that remain. The omission of these taxes from the GST reform package owed more to constraints on that package’s scope than to the merits of the taxes in question.

The major issues with the roughly \$50 billion of state taxes that remain after the GST reforms include their narrow and highly selective bases, complex structures, taxation of transactions rather than value added, impact on business costs, and the proliferation of small ‘nuisance’ taxes that raise little revenue relative to the costs involved in complying with them.

COAG should begin by reaffirming the state tax reforms specified in the GST agreement and the commitments by the states to abolish various stamp duties according to the timetables negotiated with the previous Commonwealth treasurer. This reaffirmation is necessary because of the change of federal government and the risk of backsliding by the states.

Going beyond the GST reforms, a modest but useful first step would be for the states to agree to a set of reforms that essentially serve COAG’s business deregulation objective:

- harmonise tax bases and administrative practices across the states, particularly in relation to payroll tax, to reduce compliance costs
- simplify complicated tax rate scales, moving as much as possible to single-rate structures
- phase out the long list of nuisance taxes that raise little revenue relative to the costs of compliance

The more ambitious post-GST reforms should focus on eliminating or substantially reducing the remaining stamp duties and restructuring payroll tax and land tax. They would

- abolish stamp duties on insurance and motor vehicles, and in the states that still impose fire services levies on insurance, replace them with property-based charges as in the other states,
- at least halve the rates of stamp duty on real property transfers, and index thresholds if multiple rates of duty remain,
- lower rates of payroll tax and broaden the base by lowering the point beyond which payroll tax is payable
- and lower rates of land tax, broadening the base by lowering the tax-free thresholds for non-residential land and taxing all residential land, whether owner-occupied or not, at a very low, flat rate.

It is important that these reforms are implemented as a package so that the losers from some of the changes can see the benefits that offset them. It is also important that the overall effect of the package is a net reduction in tax, making the changes more acceptable.

Abolishing and reducing taxes in the package would involve a large revenue cost to state governments, perhaps in the order of \$15 billion per year when fully implemented. The broadening of payroll tax and land tax would partly offset this, but a large financing gap would remain—say, \$10 billion. This gap could in part be absorbed by state and Commonwealth budgets over a period of years. The Commonwealth contribution should *not* take the form of a grant, which would exacerbate vertical fiscal imbalance, but should be made by sharing power to tax personal income with the states.

The remaining financing gap would require the states to develop new sources of revenue, such as wider use of road user charges and a state-specific sales tax, even though the latter would be subject to challenge on constitutional grounds. Only after all other possibilities are exhausted should an increase in the rate of GST, or a broadening of its base, be considered.

These reforms would involve a net reduction in overall tax. They would leave the states with several major tax revenue sources under their own control, which would be relatively efficient and buoyant. The suggestion of broader coverage of payroll and land taxes will be unwelcome, but if governments and the community are unwilling to face up to the trade-offs between higher revenue from these sources and the lowering and abolition of inferior taxes, the scope for reform will be greatly diminished. In that situation, reforms would still be possible, but would be incremental and confined to the more modest measures listed above, such as interstate harmonisation of tax bases and the phasing out of nuisance taxes.

## State Tax Reform: A Review of Progress and Prospects

Interest in federal–state financial relations has been aroused by the election of the Labor federal government, which has set reform of federalism as one of its top priorities. At the same time, the government is eager to expand the economy’s productive capacity and cut red tape for business. State tax reform would further each of these objectives. Although the government has not identified it as one of its priorities, it is a high priority for some in the community, including peak business groups. While their motive is at least partly self-interest, there are also strong public interest reasons for adding state taxation to the reform agenda pursued by the Council of Australian Governments (COAG).

State taxes, although sometimes described as ‘nuisance’ taxes, are much more than that. They raised \$44 billion in 2005–06 (the latest financial year for which aggregate figures are available) and have significant effects on the economy and on the everyday lives and activities of households and businesses. Although state taxation plays a secondary role to Commonwealth taxation, the ongoing tax reform debate should include it.

The flawed condition of state taxes was one reason for the A New Tax System (ANTS) reforms that ushered in the Goods and Services Tax (GST) in July 2000. Seven years later, the GST has replaced various inefficient state taxes, which had raised over \$3 billion a year before it commenced, and the states are committed to abolishing another \$2 billion worth of taxes (in 2005–06 dollars) over the next five years.

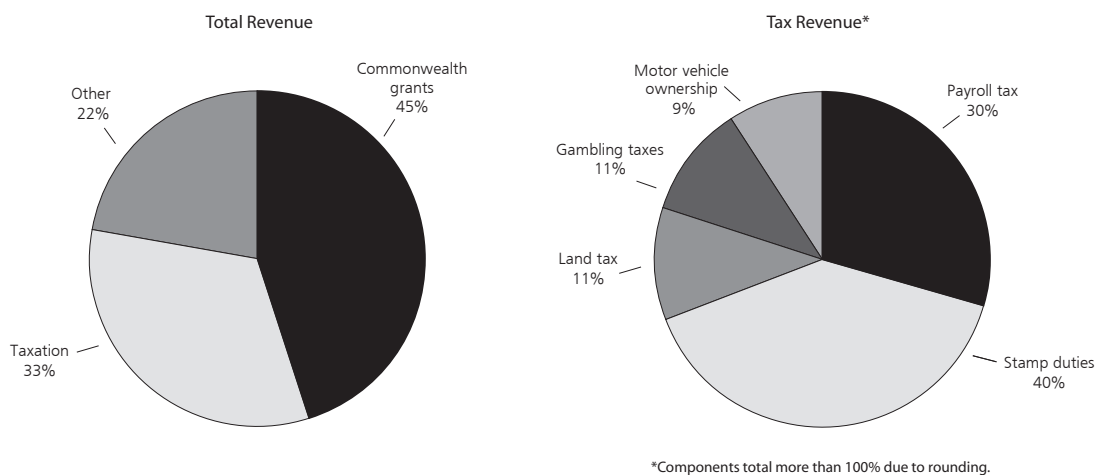
These are significant reforms, but there is much more to be done to improve the way the states are funded. If we designed a state tax system from scratch today, it is unlikely that anyone would come up with what we now have. In this paper, I review the ANTS reforms of state finances and look at ways to improve the system of state taxation further.

### State tax revenue in context

National tax revenue at all levels of government was \$300 billion in 2005–06, of which state taxes accounted for \$44 billion (15%). The states’ own tax revenue accounts for around one-third of their total revenue. As shown in figure 1, the rest comes from Commonwealth grants (45%) and an assortment of other sources (22%) such as sales of goods and services and distributions from government business enterprises. These proportions vary from state to state, but that is another story.

Consistent with the Australian Bureau of Statistics (ABS) treatment, this presentation classifies GST revenue as Commonwealth tax revenue that is transferred to the states as general purpose grants.<sup>1</sup>

**Figure 1:** Composition of state revenue 2005–06



Source: ABS<sup>2</sup>



Given the ABS treatment of GST revenue, the tax slice of the state revenue pie comprises five major components: payroll tax (30%); stamp duties on various transactions (40%), especially property; land tax (11%); gambling taxes (also 11%); and motor vehicle ownership and operation fees (9%). (These total more than 100% due to rounding.)

### State taxation before the GST

No taxes are popular, but state taxes are probably more unpopular than others. This dissatisfaction goes back many years. It has its roots in the Commonwealth's wartime takeover of income tax, which until 1941 was primarily a state tax. The effective banishment of states from the income tax field since then, together with the constitutional restriction on state indirect taxation (such as excise, sales, and consumption taxes) has resulted in the states relying on a diet of Commonwealth grants and an assortment of narrowly based taxes.<sup>3</sup> In 1971, they acquired payroll tax from the Commonwealth. In the 1980s, they ventured into financial transactions taxes such as those on deposits and withdrawals, and business franchise fees on tobacco, alcohol, and petrol. All this time, stamp duties also grew in importance, as gambling taxation did with the spread of gaming machines in clubs, hotels, and casinos.

In August 1997, the High Court ruled that business franchise fees were invalid under the Constitution, as they amounted to excises.<sup>4</sup> This blew a \$5 billion hole in state budgets overnight, and was a catalyst for the national tax review announced by Prime Minister Howard a few days later. But dissatisfaction with state taxation was much more broadly based—the High Court judgement merely provided the trigger. The core economic reason for the dissatisfaction was the belief that some state taxes—stamp duties in particular—imposed high deadweight economic costs by distorting economic activity. They had narrow bases, were levied on turnover, and became embedded in the business cost structure. While deadweight costs are by their nature difficult to measure, attempts at doing so have placed stamp duties high on the scale of economic efficiency costs.<sup>5</sup>

Other issues with state taxation before the GST included:

- the heavy dependence of the states on Commonwealth grants to finance their expenditures (the so-called vertical fiscal imbalance)
- the low buoyancy of state tax revenue (failure to generate automatic revenue growth in line with the economy)
- the volatility of some tax bases
- regressive or arbitrary effects on income distribution
- complexity, especially for companies with interstate operations having to deal with different state tax systems)

The structure of state tax revenue in 1999–2000, the last pre-GST year, is shown in table 1. Payroll tax was the largest single revenue source, but the various stamp duties in total generated more revenue. Most important among the stamp duties were those on conveyances (property transfers), financial transactions, and insurance. Gambling taxes and land tax were also important sources. Franchise taxes, although classified by the ABS as state taxes, were by then collected by the Commonwealth on behalf of the states as a result of the 1997 High Court judgment against their constitutional validity.

The popular impression was that once the GST was introduced, most or all state taxes would disappear. This is one of the enduring myths surrounding the GST and the ANTS reforms, based more on what the promoters of that myth would like to see happen than on what was intended to happen. In fact, while ANTS provided for a number of state taxes to be abolished, they accounted for only around 10% of total state tax revenue. The best known of the state taxes—such as payroll tax, land tax, and stamp duties on housing, insurance, and motor vehicles—were not among them. Furthermore, while the agreement ultimately struck between the Commonwealth and the states set specific dates for some of the taxes to be removed, the timing of others was left open, leaving threadbare the charge that the states have been slow to act on their ANTS obligations.

**Table 1:** State tax revenue before and after the GST (\$ billion)

	1999–2000	2005–06	2012–13 (IGA reforms completed)
Payroll tax	9.0	13.1	13.1
Land tax	2.4	4.6	4.6
Stamp duties:			
FID and Debits	2.2	–	–
Marketable securities	0.7	0.1	–
Loan securities	0.8	0.8	–
Leases, hiring, rental	0.3	0.3	–
Conveyances (property transfers)	5.5	10.9	10.4
Insurance	2.1	3.3	3.3
Motor vehicles	1.4	1.9	1.9
Other	0.1	–	–
Gambling taxes	4.4	4.6	4.6
Motor vehicle usage taxes	2.5	3.6	3.6
Franchise taxes	5.8	–	–
Other taxes	0.6	1.0	1.0
<b>Total</b>	<b>37.8</b>	<b>44.2</b>	<b>42.5</b>

Source: ABS<sup>6</sup>

The state tax reforms accompanying the GST were embodied in the June 1999 Intergovernmental Agreement on the Reform of Commonwealth–state Financial Relations (IGA). These reforms were less ambitious than the original ANTS proposals, as a result of amendments negotiated to achieve Senate passage of the GST legislation. Even so, as a result of the IGA, the following taxes have been abolished by all states at various times over the seven years since the GST commenced: financial institutions duty, debits tax, marketable securities duty on listed securities, and hotel bed tax where it applied (in NSW and the NT). The abolished taxes accounted for slightly over \$3 billion of revenue (around 25% of stamp duty revenue and 10% of total state tax revenue) in 1999–2000.

The IGA also provided for the following taxes to be phased out (but left the timing to be determined after a review in 2005): stamp duty on mortgages; duties on leases, hiring and rentals; duty on business conveyances; and duty on unlisted marketable securities.<sup>7</sup> Although these have been characterised by some commentators as ‘nuisance’ taxes, they are significant revenue-raisers, accounting for almost \$2 billion in 2005–06. Following the 2005 review, the Commonwealth reached agreement with each state for the phasing out of most of these taxes according to state-specific schedules. The different schedules saw Victoria and the Northern Territory complete their abolition in July 2007. Tasmania will do so a year later. Western Australia, South Australia, and the ACT follow in July 2010, then Queensland in January 2011. New South Wales will complete its phase-out in July 2012.

There is a risk that with the change of federal government since these schedules were negotiated, the states will fail to implement them or will even reverse some of the reforms that have already been implemented. None of the parties involved have said anything to suggest this will happen, and the IGA stands as government policy until amended, but the new federal government will not have the same commitment to it as the previous government and may be more open to any state pressure to change the agreement. One must hope that such failure or backsliding will not happen, and that there will be an early statement by the Rudd government that it stands by all parties’ commitments to the IGA.

The states were in dispute with the previous Commonwealth treasurer over the fate of stamp duty on transfers of non-residential—essentially, commercial, industrial, and retail—real property. The Rudd government’s attitude to this is not yet clear, but the Howard government maintained that the states were obliged under the IGA to abolish this duty when their net gains from the GST were sufficient to finance it. The states, though, maintained that they were only obliged to conduct a review of the case for its retention or abolition.<sup>8</sup> On the states’ view, they were doing everything they were obliged to do, and had already done 80% of it. On the Commonwealth’s view, they were doing *only* 80% of what they were obliged to do. Whether one sees the glass as 80% full or 20% empty, one cannot make the case that the states have substantially failed to follow through on their commitments under the IGA. The bigger issue is whether the IGA went far enough in the first place.

Table 1 also shows how the structure of state taxation will look once the reforms are complete (in 2012–13). Contrary to popular belief, the GST agreement did not provide for the abolition of all stamp duties, with those on residential real property transfers, insurance, and motor vehicles remaining.

The replacement of the abolished taxes by the GST represents an unambiguous improvement in the national tax system’s economic efficiency. It will significantly reduce the tax system’s complexity and marginal deadweight cost. It will also have dynamic benefits over time, in that the additional state revenue flowing from the GST will make the states less likely to increase their remaining inefficient taxes or adopt new types of inefficient taxes.

Yet this does not mean there are no reforms left worth pursuing, only that the ANTS package tackled the highest-priority reforms within its limited scope. The remaining state taxes may have been lower reform priorities, but that does not mean that they are ones state governments would impose in an ideal world or that their existing structure is ideal.

### What should we expect of state taxation?

The community’s distaste for state taxes may account for the widely held view that even if the states are here to stay, we would be better off with the Commonwealth doing all the taxing and passing some of the proceeds on to the states to finance their responsibilities. The GST has taken Australia in the direction of this model. By agreement between the Commonwealth and the states, the GST is imposed under Commonwealth statute, but all the proceeds are handed over to the states. It is administered by the Australian Taxation Office under a service agreement with the states, which reimburse the Commonwealth for the costs of administration.

There is some support for the centralised approach in tax principles. It is administratively simpler, and avoids the economic efficiency costs that can be one result of decentralised taxation.<sup>9</sup> The problem is that centralised taxation is at odds with the federal system of government. If

**There is a trade-off between the advantages of tax centralisation and the advantages of federalism.**

federalism is to produce the benefits expected of it—better local policy responsiveness, accountability, diversity, and competition—the states need to be responsible for raising their own revenue. Therefore, the states must have some tax policy instruments under their control so they can make different fiscal choices if appropriate. There is a trade-off between the advantages of tax centralisation and the advantages of federalism. The challenge is to design state tax systems that give states the necessary autonomy and flexibility while minimising the economic efficiency costs of decentralisation.

The conventional prescription for tax design applies to states as much as to other levels of government. Taxes should be broadly based and as neutral as possible in their effects on resource allocation; they should pay regard to taxpayers’ capacity to pay, and be simple to administer and comply with. But tax assignment in a federation also needs to recognise that the different features of state (and local) government make some taxes and tax policies more suitable for the states than others. As V. W. FitzGerald wrote in 1998, ‘Principles for good tax assignment within a Federation are not a matter of mystery, but follow straightforwardly from broad economic, equity and public sector management considerations, together with the very basic principle of democratic

accountability to electorates.<sup>10</sup> FitzGerald went on to list principles for federal tax assignment, including the following:

1. Sub-national governments should tax relatively immobile bases, to avoid distorting the location of economic activity.
2. Progressive taxation for redistributive purposes should be national.
3. Benefit taxes and user charges (or taxes with that character) are best assigned to the specific jurisdiction providing the benefit or service.
4. Each level of government should be responsible for raising taxes covering a substantial proportion of what it spends, on the grounds of basic democratic accountability.

The first principle is a special case of the economic efficiency criterion of taxation: taxes should not unduly distort resource allocation. This tends to favour sales taxes, personal income taxes, and property taxes for states, and rules out taxes like company income tax and financial transactions taxes for which the base can be easily relocated.

The second principle suggests not that states should disregard the ‘capacity to pay’ criterion in tax design, but that they should avoid trying to reshape the income distribution and aim instead for a broadly neutral overall distributional impact of their tax systems (like a proportional income tax).

The final principle is a cornerstone of fiscal federalism, but in practice, no federation in the world achieves complete fiscal autonomy for its sub-national governments. The tendency for taxes to be more centralised than government spending, leaving a ‘vertical fiscal imbalance,’ follows from the superior economic and administrative efficiency of centralisation in many forms of taxation. This reality, however, does not negate the principle that each level of government should self-finance a *substantial proportion* of its expenditure, and should have the fiscal instruments at its disposal to make choices about the size and structure of its revenue and expenditure.

### Post-GST state tax reform issues

The GST reforms leave two major state tax reform issues outstanding: deficiencies in the state taxes that will remain if and when the current reform program is completed; and the states’ continuing heavy dependence on Commonwealth grants, albeit in the different guise of GST revenue grants. While these two issues cannot be kept completely separate, this paper focuses on the state taxation issues.

**Each level of government should self-finance a *substantial portion* of its expenditure.**

Some \$42 billion in state taxes (in 2005–06 terms) will remain in place once the currently scheduled reform plans are completed. Table 1 shows what they will mainly be: payroll tax; land tax; stamp duties on real property transfers, insurance, and motor vehicles; gambling taxes; and various motor vehicle usage taxes such as annual registration charges.

The case for further reform is based on the economic efficiency costs of the remaining taxes, their narrow bases, their high rates and graduated rate structures that serve no sensible purpose, and their complexity. In general, state taxes have been excessively engineered to serve policy objectives unrelated to efficient revenue-raising to fund service delivery. Current state tax policies offer several examples of this:

- Payroll tax exempts around half of its potential base by value, and land tax well in excess of half.
- Queensland has two different land tax scales, with different thresholds and rates. What you pay depends not only on the value of your land holdings, but on whether you are a resident of that state, and whether you are an individual, a company, or a trust.
- To varying degrees, all states offer firm-specific payroll tax concessions under interventionist policies calculated to attract business. New South Wales offers a payroll tax rebate for employers who go above the tax-free threshold for the first time, provided they are located in regions of the state that have unemployment rates above the state average.

- All states levy conveyance (property transfer) stamp duty under progressive rate scales whose thresholds have not been adjusted for many years, resulting in massive bracket creep. Queensland imposes different rates depending on whether or not the property is being purchased as a principal place of residence, and if it is, whether or not it is a first home.
- All states impose stamp duty on insurance premiums at multiple rates, depending on the type of risk insured. In addition New South Wales and Victoria partly finance their fire brigades through a fire services levy on insurance; the combined stamp duty and levy can be as high as 50% or more, and is in addition to the GST on insurance.

If these taxes are worth having, it is valid to ask why they are so complex, narrowly defined, and curtailed by exemptions and concessions, and why the resulting rates on the non-exempt bases are so much higher than they could otherwise be.

### The current array of state taxes ... pays scant regard to the criteria for good state tax assignment and design.

Bearing in mind what we should expect of state taxation, as discussed in the previous section, the problem is that the current array of state taxes and the way they are applied pays scant regard to the criteria for good state tax assignment and design. These taxes *do* distort resource allocation, they are *not* neutral with respect to income distribution, they *do not* give states sufficient fiscal autonomy, and in many cases they *are* complex. It is true that such state tax policies are partly the result of Commonwealth tax imperialism. Since assuming all income taxing power in 1941, the Commonwealth has never welcomed the

states back to broad-based taxation. Even the Fraser government's 'new federalism' policy in 1976, while notionally allowing for a state income tax, provided no extra room for it by reducing Commonwealth income tax. But the states are not simply innocent victims. For example, they have chosen to apply payroll tax and land tax narrowly, and increasingly so over the years, by exempting large slabs of the potential base.

In what follows, we consider the major state taxes—payroll tax, land tax and the remaining stamp duties, which account for 80% of the \$42 billion of 2005–06 revenue identified above—on their merits.

### Payroll tax

Achieving the abolition of payroll tax was a key objective of the business lobby during the tax reform review of 1997–98. In the event, this did not form part of the ANTS reforms. Given the limited funds available from the GST and other reforms, there were higher priorities for state tax reform than the removal of payroll tax, which would have been very costly. This outcome has not stopped business groups from campaigning against payroll tax, and in some cases even asserting that GST was supposed to lead to its abolition.

Business despises payroll tax, but economists defend it as the best revenue source the states have under their own control. Businesses see payroll tax as another cost. Worse still, as an add-on to labour costs, it is seen as a 'tax on jobs.' Economists look through the legal incidence on employers to the underlying economic incidence, and see payroll tax being shifted to consumers (through higher selling prices) or employees (through lower wages). Thus, in the economic view, payroll tax is like the GST or personal income tax, and if states cannot gain control of either of those broad-based taxes then payroll tax is the best available substitute as an instrument for them to control their own finances.

The economists' view is closest to the mark, but payroll tax is by no means a perfect substitute for a GST or an income tax. To the extent that it works like an income tax, it is confined to labour income. Unlike the GST, it is not subject to input tax crediting and feeds into the cost of exports. Even though most of the economic incidence of payroll tax may not fall on employers, the illusion that it does may be so strong that it actually influences business behaviour. For these reasons, the opposition to payroll tax has some economic respectability.

An alternative to abolishing payroll tax and finding a replacement is to retain it and restructure it as the more efficient and less distorting tax that it could be. The most important defect of payroll

tax is that the states have emasculated its base since taking the tax over from the Commonwealth in 1971. The payroll tax we see today falls far short of its potential, suffering from a severely shrunken base and relatively high rates. When payroll tax was last a Commonwealth tax in 1971, it was imposed at a rate of 2.5%, subject to a tax-free threshold of \$20,800 per firm's annual payroll. As a state tax today, the rates range from 4.75% to 6.85%, and the tax-free thresholds from \$550,000 to \$1.25 million. Inflation accounts for part of the increase in thresholds, but even if indexed to average weekly earnings, the 1971 threshold would only have risen to around \$220,000 today.

States have exempted an increasing proportion of the employer base from payroll tax in the mistaken belief that they are assisting 'small business.' In the process, they have created a regime that combines a high rate with a narrow base—the antithesis of tax efficiency. Some state governments now boast about how few businesses pay payroll tax, while burdening those that do pay with a heavier load than would be possible under a broad-based approach. In 1998, the Productivity Commission estimated that in 1993–94 only 8% of private sector enterprises paid payroll tax, and since then some states have lifted their tax-free thresholds very substantially, further reducing the proportion of enterprises within the base.<sup>11</sup>

The Productivity Commission estimated the average effective payroll tax rate in the mid-1990s at close to 3%.<sup>12</sup> This is an indication of the rate that could raise the same amount of revenue without a tax-free threshold and without exemptions. In practice, there is a case for a small tax-free threshold, because the cost of administering the tax on very small firms would exceed the revenue collected. However, even with a low tax-free threshold, a rate of 3.5–4.0% could raise as much revenue as the current statutory rates ranging as high as 6.85%. Lower statutory rates on a broader base would impose lower economic efficiency costs than the current tax.

High tax-free thresholds cannot be justified as small business assistance. Why is small business more deserving of assistance by virtue of its size? The case for exempting small business from payroll tax is no stronger than that for an income tax exemption, yet there is no tax-free threshold for company tax and only a \$6,000 threshold where individual income tax applies to business income. Small business is not exempt from paying the 9% superannuation guarantee to employees. In any case, the 'assistance' provided by the payroll tax threshold is largely illusory, given that small business would shift the economic incidence of the tax backwards or forwards if they had to pay it.

Is payroll tax worth keeping, in its far from perfect condition? At times, the tax reform debate has contemplated replacing payroll tax with a higher GST rate. The coalition proposed this as part of its 'Fightback' package in the 1993 federal election. In contemporary terms, abolishing payroll tax would require lifting the GST rate from 10% to about 13%. Purely as an exercise in tax efficiency, this would be a welcome change, but it would also leave the states with even less fiscal autonomy than they currently have, creating more vertical fiscal imbalance. A payroll tax—albeit an imperfect one—that each state is free to vary and use as a tool of interstate competition would be replaced by a uniform GST over which no state has individual control. Payroll tax is one of the few instruments of tax flexibility currently available to the states.

**Payroll tax is worth keeping, but it should be substantially restructured as a low-rate, broad-based tax.**

On balance, payroll tax is worth keeping, but it should be substantially restructured as a low-rate, broad-based tax. Given the strength of opposition to base broadening, reform is best pursued not as a stand-alone exercise, but as part of a larger reform of state taxation or even of business taxation more broadly defined to include Commonwealth business taxation. This way, the losers from payroll tax reform can see gains from other changes.

Whether or not reform in the direction of a broad base and low rate is achievable, states should at least stop further white-anting the payroll tax base by increasing tax-free thresholds and granting firm-specific concessions.<sup>13</sup> Constructive competition should focus on tax rates. The states could also simplify payroll tax administration.

Definitions of the payroll tax base, and methods of collection, already vary between the states. These differences serve no competitive purpose, but add to complexity and compliance costs for the many firms that pay payroll tax in more than one state. State governments have recognised this

and have begun to harmonise their definitions, exemptions, and collection practices.<sup>14</sup> They should also explore whether payroll tax could be administered through the Business Activity Statement system of the Australian Taxation Office.<sup>15</sup>

## Land tax

Land tax is similar to payroll tax in the sense that both are theoretically economically efficient taxes whose reality falls far short of the ideal. The contrast between land tax's potential and reality is even greater than what we see in the case of payroll tax. Land tax is well-suited to be a revenue-collection instrument for sub-national governments because of the immobility of the base. Moreover, a broad-based property tax imposes low economic efficiency costs because of the limited economic 'wriggle room' available to the taxpayer. In Australia, while local government property rates are broad-based, the state land tax is very narrow.

Rates, which in part are a form of land tax, are the main revenue source for local government, and are subject to few exemptions and no tax-free threshold. The Australia-wide average effective rate in 1995–96 was 0.8%, comprising significant fixed charges and very low marginal rates on unimproved land values. In this form, local government property tax is relatively free of controversy and is accepted as well as any tax can be.

In contrast, state land tax—also levied on unimproved values—is subject to major exemptions and high tax-free thresholds for those who do pay. The major exemptions are for owner-occupied housing and agricultural land. The average effective land tax rate across all states in 1995–96 was just 0.2%, compared with much higher statutory marginal rates.<sup>16</sup> Thus, land tax applies to a small fraction of its potential base.

Another feature of state land tax is the imposition of graduated rate scales in all states except New South Wales. Graduated scales represent an attempt by states to play a redistributive role that, to the extent it is warranted, is more effectively carried out by the central government. In any case, the distributional effects of a graduated land tax scale may not be what the policy aims to achieve. Most high-value commercial properties are now owned by property trusts and superannuation funds on behalf of small investors and fund members. It is not obvious that high land values are a good indicator of these ultimate owners' capacity to pay.

Ideally, the exemptions, thresholds, and multiple rate scales would be swept away and replaced by a single low rate (which may vary between the states), administered jointly with local government rates for maximum simplicity. The Productivity Commission estimates of average effective land tax rates suggest that a uniform rate of 0.2% would be required to raise the same revenue as the current arrangements. A second-best option would be to have a two-tier system, with a very low rate (say, 0.1%) for all residential land, and something like the existing rates for non-residential land. This would be administratively more complex because of the need to distinguish between residential and non-residential uses of land and to impose different rates on mixed-use land.

As with payroll tax, however, there is strong opposition to base broadening. Unlike most other taxes that households pay, which are either deducted at source or embedded in prices paid or transaction costs, land tax requires cash payments—often substantial ones—direct to the tax collection agency. It is based on valuations that, however much they are held at arm's length from political influence, taxpayers hold to be biased upward for the government's benefit.

New South Wales has served as something of a laboratory for land tax policy changes in recent years. The New South Wales government imposed land tax on some owner-occupied properties in 1997, but this was always highly controversial and was scrapped in 2004. A similar measure by Western Australia was aborted several years ago in the face of strong community opposition. Also, New South Wales removed the tax-free threshold for all land tax payers in 2004, only to reinstate it under community pressure twelve months later.

The relevance of these episodes to a comprehensive, low-rate land tax is open to debate. A selective tax such as the existing land tax, which exempts most of the potential payers, is bound to arouse more passionate resistance from the few who do have to pay, and at a much higher rate than

**Land tax is well-suited to be a revenue-collection instrument for sub-national governments.**

they otherwise would. The NSW experiment with land tax on owner-occupied land was grossly discriminatory, being confined by statute to the top 0.2% of owner-occupied properties in the state. It was the ultimate envy tax, raising little revenue but imposing large tax bills on a select few at a rate of 1.7% of value above \$2 million.<sup>17</sup>

The Australian attitude to land tax appears even more idiosyncratic when contrasted with other countries, which rely much more heavily on similar taxes. For example, local government in the United States imposes quite hefty property taxes, on improved values, as the main source of funding for schools and policing. It may be that the closer connection to distinctive local services makes property tax more acceptable in that situation, just as local government rates are reasonably well-accepted in Australia. Or it could be that the use of improved rather than unimproved values makes the tax more acceptable because improved values are more readily observed in the marketplace. Nevertheless, the NSW experiments have reinforced all governments' distaste for a broad-based land tax.

The best possibility of land tax reform would be a package that combined land tax base broadening with the removal of property transfer duty, to which we now turn.

**There is little economic logic to the use of stamp duties for revenue-raising purposes.**

## Stamp duties

Popular with taxmen, stamp duty puzzles economists. All governments must claim a share of the fruits of an economy to finance what they do for their citizens. But a stamp duty taxes exchange, not production or value added. It is like children at a birthday party, stripping a layer from the parcel every time it is passed from hand to hand.

—The Economist<sup>18</sup>

One effect of excluding the states from income tax and broad-based indirect taxation was to make them more reliant on stamp duties on 'an abnormally broad range of dutiable transactions and at high rates relative to most countries.'<sup>19</sup> Stamp duties are a significant feature of tax systems in some developing countries, but play a much more limited role in other developed countries than has been the case in Australia. Stamp duties were first applied in England in 1694, as a means of verifying the authenticity of documents, which were stamped upon payment of the duty. Governments came to find that they could raise significant amounts of revenue this way, as people had little option but to have their documents stamped if they wanted to complete transactions. The only way to avoid the duty was by not transacting in the first place.

As indicated by the quotation above from *The Economist*, there is little economic logic to the use of stamp duties for revenue-raising purposes. Transfers of the same asset can be taxed over and over again even if they add no value, and without regard to the transacting parties' capacity to pay. Because of stamp duties' effect on transaction costs, taxpayers will try to minimise transactions or restructure them to minimise duty. This creates economic costs well in excess of the revenue the duties raise—'deadweight' costs. The payment of duties by businesses becomes embedded in their costs, and cascades through the cost structure.

It was for these reasons that stamp duties were a high-priority target of the ANTS reforms, as a result of which the stamp duties on share transactions and deposits with financial institutions have been abolished, while those on mortgages, leases, and hiring are being phased out. But the largest stamp duty of all—that on property transfers—remains, as do those on motor vehicle registrations and insurance.

### *Property transfer duty*

Property transfer duty is the second-largest tax revenue earner for state governments, and the fastest-growing on average over a long period, but it is also the most volatile.<sup>20</sup> Unlike land tax, which is a relatively low annual impost on the assessed unimproved value of a small proportion of land, transfer duty is imposed at a relatively high rate on the total value of property turnover, with few exceptions.<sup>21</sup> The rapid long-term growth of revenue comes from the growth of property values,



while the short-term volatility comes from the volatility of prices and, more importantly, the volume of transactions. This volatility works against stable budget management, given the importance of transfer duty revenue to state budgets. Governments tend to lock the proceeds of property booms into their expenditure base, creating problems in the ‘bust’ phase of the property cycle.

Transfer duty is set at steeply graduated rates that have served the growth of government well over the long term by delivering a massive ‘bracket creep’ effect on revenue. Leaving the personal income tax thresholds unchanged for twenty years or longer, as prices and incomes grew, would be unthinkable. But this is just what has happened in the case of property transfer duty, resulting in large increases in effective tax rates. For example, the duty payable on a median-priced Sydney house in 1986 was 2%, but in 2007 it stood at 3.7%—an increase of 85% in the effective tax burden with no legislative effort.

The review of international tax comparisons by Dick Warburton and Peter Hendy for the Commonwealth government in 2006 found Australia’s abnormally high reliance on property *transfer* taxation was one of the outstanding contrasts with overseas experience.<sup>22</sup> The rates of such taxes in Australia were among the highest of the countries surveyed. In contrast, Australian reliance on property *value* taxation (like land tax) is relatively low.

The original policy purpose of graduated scales is lost in the mists of time, but state governments presumably had some redistributive objective in mind. This is as misguided as it is in the case of land tax. Apart from redistribution being an unsuitable role for sub-national governments, in the case of transfer duty, the tax’s distributional effects have as much to do with the frequency of property transactions by different income groups as with the rate scale. A low-income household may transact, and incur stamp duty, more frequently than a high-income household. Businesses paying duty at higher rates because of larger transaction values may pass on the costs to low-income consumers. The distributional effects are therefore unpredictable and arbitrary, notwithstanding graduated rate scales.

As a turnover tax, transfer duty imposes high deadweight economic costs. It distorts choices between buying and renting and between moving house and staying put or renovating. It tends to lock households into sub-optimal housing, and militates against resource mobility. Marginal deadweight costs have increased over the years as a rising proportion of transactions have become subject to the upper levels of the graduated scales.

It has sometimes been argued that transfer duty fills a void left by income tax concessions on property such as the absence of capital gains tax or income tax on imputed rent of owner-occupied dwellings. Whatever policy view one takes of those concessions, transfer duty is a poor substitute for higher income tax or capital gains tax on housing because it is a turnover tax that has higher economic efficiency costs and pays no regard to taxpayers’ broadly defined capacity to pay. In addition, it is not the states’ role to correct alleged deficiencies in the federal tax system.

**There is a good case for abolishing transfer duty ... if a replacement revenue source can be found.**

Compliance with transfer duty is fairly simple in the case of most housing transactions, but can be complex for business and trust transactions. The states have introduced complex provisions to prevent land-rich companies and trusts from escaping transfer duty. Something of a cottage industry of specialist tax law has grown up to keep abreast—or ahead—of these complexities and to keep a lookout for loopholes and avoidance opportunities on clients’ behalf.

There is a good case for abolishing property transfer duty—or at least reducing it to a single low rate that would be less distorting—if a replacement revenue source can be found. The comprehensive land tax discussed above would provide such an opportunity to replace a tax on property *transactions* with an annual tax on assessed property *values*. This approach was discussed further in the section on post-GST state tax reform issues.

An alternative would be to lower, rather than abolish, the rates of property transfer duty. Even a bad tax can be made less bad by lowering its rate. If the cut was significant, such a reform would reduce the marginal deadweight cost of this tax. On average, across the states, halving the rates would bring top duty rates down to around 3% and rates on median-priced homes down

to around 2%. This would cost the states around \$5 billion in 2005–06 terms. In addition, the thresholds should be indexed to average property values to avoid the enormous bracket creep experienced over recent decades. A flat rate of around 1.5% would be better still, eliminating the possibility of future bracket creep.

In the current context, any consideration of lowering or removing stamp duty inevitably leads to the issue of housing affordability. One argument is that a cut in stamp duty would merely lead to an increase in pre-duty house prices, resulting in no net change. Implicitly, this argument is that the economic incidence of stamp duty currently falls on the seller, not the buyer, even though the buyer bears the legal incidence. While there may be some truth in this, the economic incidence is most likely shared between buyer and seller. But in any case, however the economic incidence is distributed, the economic distortion imposed by stamp duty remains.

#### *Stamp duties on motor vehicles and insurance*

Among the remaining stamp duties, on motor vehicles and insurance come closest to being selective consumption taxes. Unlike the GST, however, they become embedded in the business cost structure. To households, they are in a sense a double tax, as motor vehicles and insurance are also subject to the GST. There is no good reason to single out these items to carry an additional tax burden over and above the GST. These duties also suffer the defects of other stamp duties on turnover, as discussed above.

**A raft of minor state taxes ... raise[s] relatively little revenue for the effort expended in administering and complying with them.**

Motor vehicle stamp duty might be thought of as an environmental tax that helps internalise the external costs of motor vehicle usage. However, the duty falls on *turnover* in motor vehicles rather than on *usage*. If states want to mitigate the environmental impact of vehicles, they could do so more effectively through road tolls.

As well as the stamp duty on insurance, New South Wales and Victoria impose fire services levies on selected types of insurance to help fund their fire brigades. These levies are very high in some cases, and can take the combined weight of stamp duty and levies to 50% or more. Other states have moved to more appropriate property-based levies. New South Wales and Victoria should follow suit.<sup>23</sup>

### **Other taxes**

The other main taxes are those on motor vehicle ownership and operation, such as registration charges, and the various forms of gambling. These are less controversial from an economic standpoint, although state dependence on gambling tax revenue is often criticised from a social policy perspective, and in South Australia a senator has recently been elected on the single-issue platform of combating the incidence of poker machines. The omission of these areas from the reform program outlined in this paper does not mean that they raise no issues, but simply that within the inevitably limited scope for state tax reform there are higher priorities.

There is also a raft of minor state taxes that the states have imposed over the years for various opportunistic reasons. They raise relatively little revenue for the effort expended in administering and complying with them, most of the burden of which falls on business. The following list of such taxes should be taken as illustrative rather than comprehensive:

- parking space levies (NSW and Victoria)
- health insurance levy (NSW)
- insurance protection tax (NSW)
- metropolitan parks levy (Victoria)
- community ambulance cover (Qld)
- metropolitan improvement levy (WA)
- Save the River Murray levy (SA)
- environment, waste, and landfill levies (all states)

The imposition of such ‘nuisance’ taxes was more the result of budgetary stress in particular states at particular times in the past than it was of a strong tax policy justification for them. All of the above taxes combined in all states raise less than \$ 1 billion, or less than 1% of aggregate state revenue. Such taxes could be phased out over time with little impact on state budgets.

### Financing state tax reform

While some reforms could be made revenue-neutral, those that remove remaining state taxes would come at a substantial annual revenue cost. Remaining stamp duties generate revenue of \$15 billion per annum, payroll tax \$13 billion, and land tax \$5 billion. It is necessary to explain how any of this could be financed. There are five basic options.

#### 1. Revenue-reducing options

Revenue-reducing options involve all or part of the budgetary cost of tax reductions, be they state budgets or the Commonwealth’s. If matched by a reduction in government expenditure, these options combine two objectives: tax reform and smaller government, involving a sustainable reduction in the overall tax take. Although analytically these are best kept separate, in practice tax reform is more likely to be ‘saleable’ if it involves a net tax reduction, and the economic benefits are likely to be greater as a result of the elimination of some inefficient government spending.

##### (i) State-financed tax reform

**Tax reform is more likely to be ‘saleable’ if it involves a net tax reduction.**

It is open to the states individually or jointly to pursue their own tax reforms independently of any national reform exercise. In recent years, Victoria and Western Australia have undertaken major tax reviews, and New South Wales is currently doing so. Such reviews have sometimes produced far-reaching reform recommendations, but these have not been accepted by government. States regularly tinker with their tax policies: for example, in recent years states flush with revenue from the

real estate and resource booms have tended to lower payroll tax and land tax rates and lift tax-free thresholds. Yet these actions do not amount to reform, and they have left the fundamental problems in place. For genuine reform to take place, states would need to take a bolder, more strategic approach backed up by stronger expenditure discipline.

##### (ii) Future growth of GST revenue

The stamp duties already abolished or scheduled to be abolished in the future are essentially being financed out of the growth of GST revenue as the GST base grows. This growth is delivering to the states net revenue gains against the hypothetical benchmark set by the pre-2000 funding arrangements. The cost of abolishing stamp duties is absorbing part of those gains. By 2010–11 the states’ net revenue gains are estimated to be around \$9.5 billion per year, of which around \$5 billion will be absorbed by the abolition of stamp duties.

Some or all of the remaining net revenue gains could be earmarked for abolition of the other stamp duties not currently scheduled for removal. This is essentially a special case of state tax reform, as described above. The difficulty with this approach is that the states will point out that the IGA promised them a net improvement in their revenue position after the effects of tax reform were taken into account. There is scope for argument about how much of an improvement is needed to meet the IGA commitment, but even on the current projections, aggregate state revenue will struggle to keep up with nominal GDP growth. In any case, at least for the next five years or so the net gains will not be large enough in aggregate to make much contribution to abolishing remaining state taxes.

##### (iii) Personal income tax sharing

The cost of abolishing state taxes could in effect be shifted to the Commonwealth’s budget if the Commonwealth granted a portion of its existing personal income tax to the states to finance their reforms. This could take the form of revenue sharing, with the Commonwealth retaining full control of taxation of the personal income base, or base sharing, where the Commonwealth would hand the states a portion of the revenue and policy control of the corresponding portion of the

tax base. Simple revenue sharing in exchange for removing some existing state taxes would worsen vertical fiscal imbalance, but tax base sharing would not have that disadvantage. For example, the Commonwealth could allocate two percentage points of the existing personal income tax rate scale to the states in exchange for the latter agreeing to abolish some taxes permanently. The basis for this kind of trade-off would be that the Commonwealth is in a stronger fiscal position than the states to bear the burden of removing state taxes.

The reality is that the Commonwealth is always likely to want to retain surplus revenues for its own use, to fund either tax cuts or increased expenditure. A transfer of personal income tax to the states could, however, stand a better chance of being considered in the context of Commonwealth–state negotiations surrounding the national economic reform agenda. The National Competition Policy (NCP) adopted in the mid-1990s involved a stream of payments from the Commonwealth to the states, to share the fiscal dividend from the NCP reforms. The new federal government is considering a similar approach, which could take the form of a transfer of part of personal income tax revenue or the personal income tax base to the states. In return, the states would agree to use this dividend to abolish or reduce some existing state taxes.

## 2. Revenue-neutral options

### (i) Increase the GST rate

The current GST rate of 10% would need to increase to 13.5% to cover the full cost of abolishing remaining stamp duties, to 13% to finance abolition of payroll tax, or 11.5% to cover land tax. To abolish all three of these taxes, the GST rate would need to rise to 18%, which would give Australia a European-sized value added tax (VAT).

A European-sized VAT/GST is too high a price to pay for state tax reform in Australia. Although the GST is a relatively efficient tax, taken too far it would become a problem in itself. For any tax, the higher the rate is, the higher are the marginal deadweight economic costs. Moreover increasing the GST rate would cause a further increase in vertical fiscal imbalance, as a set of taxes that the states do control (stamp duties and so on) would be replaced with additional revenue from one that they don't.

There is also a 'thin end of the wedge' argument: that the GST is *too* efficient as a revenue-raising tool, and that any increase, no matter what the trade-offs, should be resisted because it would set in train a ratcheting up of the GST and of the overall tax burden. On this view, the existing 10% rate is a line in the sand that should never be crossed. International experience supports this pessimistic view, as most other countries that have adopted a GST or VAT have increased it several times from its initial level.

Nevertheless, a modest increase in the GST could represent an improvement in the tax system's economic efficiency (reduction in deadweight costs). Also, administration and compliance costs would be reduced, as increasing the GST rate on the existing base would be simple and costless, and would lower the costs associated with state tax administration and compliance. Maintaining the 'line in the sand' for the GST rate means continuing to bear the higher economic efficiency costs of the taxes that the GST could replace.

Moreover, the inefficiency of existing state taxes is likely in the long run to place the marginal burden of revenue-raising increasingly on more efficient Commonwealth tax instruments. State budgets would be supported by increased Commonwealth grants back to the states, such as specific purpose payments for health and education. In that event, the increased resort to more efficient tax instruments would still take place, but in a form other than an increase in the GST.

The previous Commonwealth government was firmly opposed to any increase in the GST, and the new government has already set itself firmly against any increase.<sup>24</sup> While it is understandable that they would oppose it as a net tax increase, it is not clear why it should be ruled out as a revenue-neutral substitute for other, less efficient state taxes. Yet any such substitution should be made conditional on its never being reversed—if any state were to reintroduce an abolished tax, its share of GST revenue should be reduced.

**A European-sized VAT/GST is too high a price to pay for state tax reform in Australia.**

*(ii) Reform and increase efficient state taxes*

The review of payroll and land taxes in the above section on what we should expect of state taxation canvassed the possibility of broadening these tax bases to finance the removal of less efficient taxes. For purposes of illustration, working with national data, a tax of 0.25% on *all* unimproved land values, additional to the existing land tax, would raise about \$6 billion, which would be enough to replace more than half the stamp duty on property transfers. Replacing a property turnover tax with a tax on land values has a strong economic logic, as discussed above.

Each additional 1% tax on payrolls, with no tax-free threshold, would raise around \$4 billion, enough to finance abolition of insurance and motor vehicle stamp duties. Again, there is a strong economic case for such a switch.

These options could be finessed in all manner of ways, and are offered only as illustrations. The more important point is whether any such trade-offs would be politically feasible, given the reality of fierce resistance to payroll and land tax base broadening. The key would be to package base broadening with other state (and Commonwealth) tax reforms that would at least partly offset the costs to the losers from base broadening. For example, broader land tax and payroll tax could be offset by removal of stamp duties.

*(iii) New state taxes*

The option of creating new state taxes is raised in this context not with the objective of increasing the overall tax burden, but of replacing deficient taxes with better ones in a revenue-neutral package. The possibilities that conform to likely constitutional restrictions include income tax, wealth taxes, estate and gift duties, environmental taxes of various kinds, and user-pays-type taxes such as road user charges. The standout example among these is personal (not company) income tax.

The problem with a state income tax is that the Australian tax system already relies relatively heavily on personal income tax. Most reform proposals rightly envisage reducing rates of personal income tax, not adding to them, which would be the effect of a state personal income tax without an offsetting reduction in Commonwealth rates. Trading off state stamp duties for a higher personal income tax burden would replace one set of problems with another. A better role for a state personal income tax, as discussed above, would be in reducing vertical fiscal imbalance by substituting for a slice of the existing Commonwealth personal income tax.

The reference above to likely constitutional restrictions is an acknowledgement of the history of High Court rulings against the imposition of sales, consumption, and like taxes by the states, under section 90 of the Constitution.<sup>25</sup> However, such rulings have been made in contexts where there was no Commonwealth support for the the state taxes in question. While plans to amend the constitution to allow the states to impose such taxes would be unrealistic, it is intriguing to consider what the outcome might be if the Commonwealth were to support a state sales-type tax in any proceedings before the High Court.<sup>26</sup> If such a tax were to prove sustainable under those circumstances, it would open up the possibility of the GST being converted to what it is not now—a bona fide state tax.

*(iv) A combination of the above*

Obviously none of these options are mutually exclusive. A combination of some increase in the GST rate (say, to 12.5%), some further commitment by the states of their net GST gains to substituting revenue from existing state taxes, and some payroll and land tax base broadening would also serve the purpose. Such a package could raise the \$15 billion needed to replace all stamp duties.

**Limited reform options**

Sweeping reform of state taxation would require one or more of a higher GST, broader bases for payroll tax and land tax, and devolution of some income taxing power from the Commonwealth to the states. Given that there are high obstacles to all of these options, it is worth considering what kinds of state tax reforms could be pursued without them.

One approach would be for states to continue acting unilaterally to gradually lower key tax rates such as payroll tax and land tax. However, this does not constitute 'reform,' some states do not

currently take part, and state governments' willingness to continue along this path is only likely to last as long as the strength of their revenue flows.

Other approaches include:

- interstate harmonisation of state tax legislation and administrative provisions other than tax rates and thresholds, on which states should continue to compete (this approach has already begun with payroll tax)
- rationalisation of antiquated tax rate scales, and adoption of automatic threshold indexation to prevent further bracket creep (this is especially relevant to stamp duty on property transfers)
- phasing out nuisance taxes—as discussed in the above section on other taxes—which raise little revenue relative to the compliance burden they impose

### **Bringing together the elements of a better state tax system**

Bringing together the elements of reform developed above—in the sections on payroll tax, land tax, stamp duties, other taxes, and financing state tax reform—provides a blueprint for a better state tax system. This should be implemented as a package so that the losers from some of the changes can see their offsetting benefits. The reforms should be pursued through COAG because of its link to federalism and other COAG-initiated reforms, and because all governments will need to be involved even though the precise details of the changes may vary from state to state.

COAG should begin by reaffirming the state tax reforms specified in the 1999 IGA and the commitments by the states to abolish various stamp duties according to the timetables negotiated with the previous Commonwealth treasurer. This reaffirmation is needed because of the change of federal government and the risk of backsliding by the states. In the process, COAG must clarify the fate of stamp duty on business real property transfers, which was the remaining area of dispute between the Commonwealth and the states. If this duty is not to be phased out, then the equivalent revenue should be used to reduce stamp duty on property transfers across the board (residential and non-residential) to honour the original intent of the IGA.

Going beyond the IGA reforms, a modest but useful first step would be for the states to agree to a set of reforms that essentially serve COAG's business deregulation objective:

- harmonise tax bases and administrative practices across the states, particularly in relation to payroll tax, to reduce compliance costs
- simplify complicated tax rate scales, moving as much as possible to single rate structures
- phase out the long list of nuisance taxes that raise little revenue relative to the costs of compliance

The more ambitious post-IGA reforms should focus on eliminating or substantially reducing the remaining stamp duties, and restructuring payroll tax and land tax:

- abolish stamp duties on insurance and motor vehicles, and, in the states that still impose fire services levies on insurance, replace them with property-based charges as in the other states
- at least halve the rates of stamp duty on real property transfers, and index thresholds if multiple rates of duty remain
- lower rates of payroll tax, and broaden the base by lowering the tax-free threshold
- lower rates of land tax, and broaden the base by lowering the tax-free thresholds for non-residential land and taxing all residential (owner-occupied and other) land at a very low, flat rate

The abolition and reduction of taxes in this package is likely to cost state governments in the order of \$15 billion per year when fully implemented. The broadening of payroll tax and land tax would partly offset this, but a large financing gap would remain—say, \$10 billion. State and Commonwealth budgets could partly absorb this gap over a period of years. The Commonwealth contribution should not take the form of a grant, which would exacerbate vertical fiscal imbalance.

The Commonwealth should instead share personal income taxing power with the states. The remaining gap would require the states to develop new sources of revenue, such as by making wider use of road user charges and a state-specific sales tax that would be subject to challenge on constitutional grounds. Only after all other possibilities are exhausted should an increase in the GST, or a broadening of its base, be considered.

These reforms would involve a net reduction in overall tax. They would leave the states with several major tax revenue sources under their own control, which would be relatively efficient and buoyant. The suggestion that payroll and land taxes should have broader coverage will be unwelcome, but if governments and the community are unwilling to face up to the trade-offs between higher revenue from these sources and the lowering and abolition of inferior taxes, the scope for reform will be greatly diminished. In that situation, reforms would still be possible, but would be incremental and confined to the more modest measures listed above, such as interstate harmonisation of tax bases and the phasing out of nuisance taxes.

## Endnotes

- <sup>1</sup> Hitherto, the Commonwealth budget has classified the GST as a state tax—on the grounds that all the revenue is received by the states—and excluded it from the Commonwealth accounts. The new government, however, has stated that it will align the Commonwealth budget with the ABS treatment that sees GST revenue as Commonwealth tax revenue.
- <sup>2</sup> ABS, *Government Finance Statistics, Australia, 2005–06*, Cat. No. 5512.0 (Canberra: ABS, 2007).
- <sup>3</sup> Section 90 bars the states from imposing ‘duties of customs and of excise.’
- <sup>4</sup> *Ha v New South Wales* [1997] HCA 34; (1997) 189 CLR 465; (1997) 146 ALR 355; (1997) 71 ALJR 1080 (5 August 1997).
- <sup>5</sup> For examples, see Owen Gabbitas and Damien Eldridge, *Directions for State Tax Reform*, Productivity Commission staff research paper (Canberra: Ausinfo, 1998); V. W. FitzGerald, ‘A Review of State Tax Reform Options,’ in *State Taxation: Repeal, Reform or Resignation*, ed. Neil Warren, Australian Tax Research Foundation Conference Series 21 (Sydney: Australian Tax Research Foundation, 1999); and John Freebairn, ‘Opportunities to Reform State Taxes,’ *The Australian Economic Review* 35:4 (December 2002).
- <sup>6</sup> Australian Bureau of Statistics (ABS), *Taxation Revenue, 2005–06*, ABS Cat. No. 5506.0 (Canberra: ABS, 2007).
- <sup>7</sup> States disputed the Commonwealth view that the agreement obliged them to abolish—as distinct from merely ‘reviewing’—these taxes, but that dispute does not require comment here.
- <sup>8</sup> This is a description of the situation as it existed under the previous government. At the time of writing, it is not clear what the position of the new Commonwealth government will be on this issue.
- <sup>9</sup> For example, see Boadway’s discussion of the efficiency costs of destructive tax competition and tax exporting, distortion of cross-border transactions, and differential impact on the fiscal capacities of sub-national governments. Robin Boadway, ‘Grants in a Federal Economy: A Conceptual Perspective,’ in *Intergovernmental Fiscal Transfers—Principles and Practice*, ed. Robin Boadway and Anwar Shah (Washington, DC: World Bank, 2007).
- <sup>10</sup> V. W. FitzGerald, ‘A Review of State Tax Reform Options,’ 38.
- <sup>11</sup> Owen Gabbitas and Damien Eldridge, *Directions for State Tax Reform*, 84.
- <sup>12</sup> This is defined as revenue as a percentage of the potential tax base with no tax-free threshold.
- <sup>13</sup> For an excellent statement of the case against firm-specific concessions, see Wolfgang Kasper, *Competitive Federalism Revisited: Bidding Wars, or Getting the Fundamentals Right?*, IPA Issues Paper 5 (Melbourne: IPA, 1996).
- <sup>14</sup> At its July 2006 meeting, COAG agreed to pursue harmonisation of the payroll tax base and administrative arrangements as a deregulatory measure. As a first step, New South Wales and Victoria harmonised their legislation, exemptions, and administrative arrangements from 1 July 2007, but each state continued to set its own tax rates and tax-free thresholds independently. Queensland and Tasmania are to join this arrangement from 1 July 2008.
- <sup>15</sup> Issues here would be the legality of the ATO collecting a tax imposed under state statute, and the feasibility of using the BAS to identify within-state tax liabilities.
- <sup>16</sup> Currently, marginal rates range from a single 1.6 % in New South Wales to a top rate of 3.7% in South Australia.
- <sup>17</sup> The threshold began at \$1 million in 1997, but through indexation it had risen to \$2 million by 2004.
- <sup>18</sup> The Economist, ‘Licking the Stamp Duty; Taxing Share Trades,’ *The Economist* (2–8 September 2006).
- <sup>19</sup> Phil Anderson, ‘Stamp Duties: The Case for Reform,’ in *State Taxation*, ed. Neil Warren.
- <sup>20</sup> Over the ten years to 2005–06, revenue from stamp duty on property transfers grew at an annual average rate of 13%. Although this period included an exceptional residential real estate boom, the long-term average growth rate of this category of state revenue has typically been in double digits.
- <sup>21</sup> Marginal rates range as high as 7% in New South Wales. The main exception is purchases by first home buyers, which are exempt up to value levels that vary by state.
- <sup>22</sup> Dick Warburton and Peter Hendy, *International Comparison of Australia’s Taxes* (Canberra: Commonwealth of Australia, 2006).
- <sup>23</sup> Both states have reviewed the case for replacing insurance-based fire services levies with property-based levies in recent years, and decided to continue with the insurance-based levies.
- <sup>24</sup> The then leader of the opposition, Kevin Rudd, went so far as to say on 27 August 2007 that the GST would be increased ‘over his dead body.’
- <sup>25</sup> A discussion of this history is provided in Cheryl Saunders, ‘The High Court, Section 90 and the Australian Federation,’ in *Reshaping Fiscal Federalism in Australia*, ed. Neil Warren, Australian Tax Research Foundation Conference Series 20 (Sydney: Australian Tax Research Foundation, 1997).
- <sup>26</sup> For this suggestion, I am indebted to John Stone, former secretary to the Commonwealth Treasury, currently a board member of the Samuel Griffith Society and editor and publisher of its proceedings.



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