



14 September 2009, 2009–10

Economic effects of payroll tax

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Introduction

Payroll tax is a levy on the value of certain types of income paid within a particular state or territory by employers to, or on behalf of, their employees.¹ It is the largest source of state own-source revenue, accounting for about a quarter of such revenue as shown in Table 1.

Table 1: Payroll tax revenue as share of states' own-source revenue 2001-02 to 2006-07

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Average revenues (\$pc)	496.29	513.26	539.86	590.39	635.24	688.62
% of total own-source revenues	25.78	24.90	24.20	25.60	25.15	25.19

Note: pc: per capita

Source: Commonwealth Grants Commission, *2009 update report - 2008 working papers. Payroll tax*, volume 2, p. 2, March 2009, viewed 11 September 2009,

http://www.cgc.gov.au/_data/assets/file/0018/10665/03_U2008_Payroll_Tax.pdf

Key features

In general, the payroll tax base—that is, the items to which the tax applies—includes wages and salaries and other forms of employee benefit such as bonuses and fringe benefits. However, a feature is that the tax base differs from state to state. This increases compliance costs for businesses that operate in several jurisdictions. In March 2007, the states and territories agreed to harmonise their bases and administrative arrangements² and there has been progress in this undertaking.³

A second feature of all payroll tax regimes is tax-free thresholds, that is, the value of payroll below which tax is not payable. The thresholds limit the number of businesses that pay

1. O Gabbitas and D Eldridge, *Directions for state tax reform*, Productivity Commission Staff Research Paper, Commonwealth of Australia, Canberra, 1998, p. 57, viewed 11 September 2009, <http://www.pc.gov.au/research/staffresearch/statetax/statetax.pdf>

2. The states retain control over rates and thresholds. See Northern Territory Government, *State and territory treasurers agree to historic payroll tax reform*, joint media release, 29 March 2007, viewed 11 September 2009, <http://newsroom.nt.gov.au/index.cfm?fuseaction=viewRelease&id=2400&d=5>

3. Department of Finance and Deregulation, Council of Australian Governments Business Regulation and Competition Working Group, *Progress report card: July 2008-July 2009*, viewed 11 September 2009, <http://www.finance.gov.au/deregulation/coag.html>

payroll tax. In NSW, more than 90 per cent are exempt.⁴ The thresholds range from around \$500 000 to more than \$1 million as shown in Table 2.⁵

Table 2: Payroll tax thresholds 2001–02 to 2007–08

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Average
	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000
2001-02	600	515	850	675	456	1 000	1 250	600	640
2002-03	600	550	850	675	504	1 010	1 250	600	653
2003-04	600	550	850	750	504	1 010	1 250	600	662
2004-05	600	550	850	750	504	1 010	1 250	800	665
2005-06	600	550	850	750	504	1 010	1 250	1 000	669
2006-07	600	550	1 000	750	504	1 010	1 250	1 250	702
2007-08	600	550	1 000	750	504	1 010	1 250	1 250	702

Source: Commonwealth Grants Commission, *2010 Review Documents. Payroll Tax*, Commission Position Paper CGC 2008/05, p. 5, September 2008, viewed 11 September 2009, http://www.cgc.gov.au/_data/assets/file/0009/11070/2008_05_Payroll_Tax.pdf

A third feature is that tax rates vary from state to state.⁶ While most states apply payroll tax as a single marginal rate, the rates, expressed as a percentage of payrolls, differ. This also increases compliance costs for businesses operating in several states.

Legal and economic incidence

Calls to abolish or modify payroll tax are often heard. For example, the Australian Chamber of Commerce and Industry has called for the abolition of payroll tax as part of wider tax reform.⁷ While several reasons are cited for abolishing or modifying payroll tax, a common reason is that payroll tax reduces employment.

4. Independent Pricing and Regulatory Tribunal, *Review of state taxation. Report to the treasurer*, October 2008, Sydney, p. 101, viewed 11 September 2009, <http://www.ipart.nsw.gov.au/files/Final%20Report%20-%20Review%20of%20State%20Taxation%20-%20Michael%20Seery%20-%2017%20October%202008%20-%20PDF%20Website%20Document%20Version.PDF>
5. NSW Treasury, *Interstate comparison of taxes 2008–09*, Research and Information Paper 09–2, Sydney, May 2009, viewed 11 September 2009, http://www.treasury.nsw.gov.au/_data/assets/pdf_file/0006/13947/TRP09-2_dnd.pdf
6. Rates can be found in NSW Treasury, *Interstate comparison of taxes 2008–09*, op. cit.
7. Australian Chamber of Commerce and Industry, *Payroll tax – the case for abolition*, Issues Paper, July 1998, Canberra, viewed 11 September 2009, http://www.acci.asn.au/text_files/issues_papers/Taxation/TX01.pdf

It is important to distinguish between the legal incidence of a tax and its economic incidence. Legal incidence refers to the party legally responsible for paying the tax. In the case of payroll tax, legal incidence falls on the employer. The cost to the employer is, however, reduced by the fact that payroll tax is a deduction for company tax assessment purposes. Economic incidence refers to who finally bears the tax. As with other taxes—such as excise on alcohol—the economic incidence of payroll tax can shift along the production and distribution chain. Tax shifting occurs if the price of what is taxed increases when the tax is imposed.

When tax shifting occurs, lower employment is only one of several possible effects of payroll tax. The review of state taxation in NSW observed:

Some stakeholders criticise payroll tax on the grounds that it is a tax on employment and as such acts as a drag on economic activity. However, in practice, the cost of paying the tax can be passed on either to employees (through lower wages) or to consumers (through higher prices).⁸

The effects of payroll tax are thus similar to those of income tax or a consumption tax:

The equivalence of income to consumption and saving, means that in the long run taxes on consumption (such as the GST and excise) can be broadly thought of as taxes on labour ... For example, a payroll tax that reduces the after-tax income of a worker means the worker has less money to buy goods and services. The payroll tax can therefore be viewed as a tax on labour *income* or, equivalently, as a tax on the *consumption* of goods and services.⁹

Overall, payroll tax is a relatively efficient tax:

... being akin to that of either a flat rate income tax or broad-based consumption tax.¹⁰

Reform proposals

This is not to say that the application of payroll tax cannot be improved. A principle guiding tax policy is efficiency, that is:

... the tax system should be as neutral as possible, i.e. minimise discrimination in favour of or against any particular economic choices ... improvements in efficiency can be achieved

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8. Independent Pricing and Regulatory Tribunal, *Review of state Taxation. Report to the treasurer*, op. cit., p. 57.
 9. Treasury, *Architecture of Australia's tax and transfer system*, Commonwealth of Australia, Canberra, August 2008, p. 169, viewed 11 September 2009, http://taxreview.treasury.gov.au/content/downloads/report/Architecture_of_Australias_Tax_and_Transfer_System_Revised.pdf
 10. Independent Pricing and Regulatory Tribunal, *Review of state taxation. Report to the treasurer*, op. cit., p. 57.

by: (i) broadening tax bases by eliminating exemptions and special regimes; (ii) flattening rates structures ...¹¹

Scope exists to improve the efficiency of payroll tax by broadening the base and lowering the rate:

Payroll tax ... is one of the broadest and more efficient State taxes, with a relatively stable base and low administration costs. Yet, there is scope to improve efficiency by broadening the base, lowering the tax rate and streamlining the compliance procedures. Compliance costs of payroll tax are high, but considerable scope exists to lower them through greater harmonisation between States. Current exemptions cost the State governments ... forcing them to rely on higher tax rates and other less efficient taxes. Over time, the base has narrowed as exemptions have become more widespread. The level of thresholds cannot be justified solely on the grounds of minimising administration and compliance costs. The States are increasingly using payroll tax exemptions to attract industries to their State. While the States may (often incorrectly) perceive a gain through this competition, Australia as a whole is likely to lose.¹²

There is, therefore, considerable scope to improve the application of payroll tax.

Summary

The effects of payroll tax are similar to those of an income tax or a broadly-based consumption tax. Lower employment is only one of several possible effects of payroll tax. Payroll tax may also lower wages and increase consumer prices. While payroll tax is one of the more efficient state taxes, scope exists to improve its efficiency by broadening the base and lowering the rate.

11. P van den Noord and C Heady, *Surveillance of tax policies: a synthesis of findings in economic surveys*, OECD Economics Department Working Papers, No. 303, July 2001, p. 16, viewed 11 September 2009, <http://www.oecd.org/dataoecd/30/18/2399416.pdf>

12. O Gabbitas and D Eldridge, *Directions for State Tax Reform*, p. 67.

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