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NSW TREASURY FEDERAL FINANCIAL RELATIONS REVIEW

The Australian Industry Group (Ai Group) welcomes the opportunity to provide input to the NSW Treasury Federal Financial Relations Review.

We commend the New South Wales Government for taking a leading role in exploring the scope for improvements in the important area of federal financial relations. As the Discussion Paper acknowledges, there is a need for an ambitious national vision to better harness the considerable potential of our federal system.

More robust intergovernmental financial relations would reduce the reliance of the states and territories on the Commonwealth; would improve the accountability and transparency of government in Australia; and, by opening-up channels for, and removing barriers to innovation, would facilitate significant improvements in the quality of services provided by governments. More robust financial relations could also pave the way for more efficient approaches to raising the taxation revenue needed to fund the services provided by the public sector.

Our responses to the issued raised are in line with the high-level nature of the Review and its considerable ambition. We have not dwelt on the details of tax changes but rather on the broad contours of change. We are aware there is devil in the detail of taxation but are also aware that considerable attention to the broad architecture of taxation is fundamental to meeting the level of ambition suggested in the Discussion Paper. One consequence of this approach is that the comments we make have not had the benefit of focused consultation with our members. At this stage we see the issues as being too abstract to generate the very important feedback that would be needed in developing concrete reform proposals.

Another preliminary point is that in our responses to the issues raised in the Discussion Paper we have put to one side the issue of the equity of our systems of taxation. This is not because Ai Group does not regard equity issues as important or that we do not support the roles taxation plays in redistribution. Rather, we consider the equity dimensions are best addressed by careful consideration of the tax and transfer systems in combination and at a whole of system level.

We have a reservation about the extent to which NSW can act on its own in adjusting its tax system. While there is very considerable room for improvement, the more substantial improvements in taxation would involve trade-offs between the design features of different taxes.

For instance, a leading rationale for the current payroll tax thresholds is the very legitimate concern that smaller businesses incur disproportionately high compliance costs. However, there are much more effective and indeed comprehensive ways to address this issue than the payroll tax thresholds that in themselves add considerably to the costs of this form of taxation. At the same time, however, removing the payroll tax tax-free thresholds as an isolated measure would see small business tax burdens and compliance burdens both rise. This area of reform, as with many others, would best be addressed by bringing to bear other dimensions of how smaller businesses are taxed as part of a more effective change in taxation that generated overall benefits for smaller businesses and the people they employ.

Issue 1: Impact of taxes on people's choices and economic activity

Specific question: which state taxes impact citizen and business choices the most?

The impacts of taxes on people's choices and economic activity are complex. Taxation of an activity transfers resources that would otherwise flow to various participants involved in the activity to taxation revenue; they necessitate the deployment of resources in compliance and administration activities and they alter the direction of economic behaviour through their varying impacts on relative prices.

As a rule of thumb, for a given level of total taxation required to fund public sector activities, impacts of taxes on economic behaviour can be minimised by deploying tax arrangements that keep administration and compliance costs as low as possible and by resorting to the combination of tax bases and rates that have least impact on relative prices.

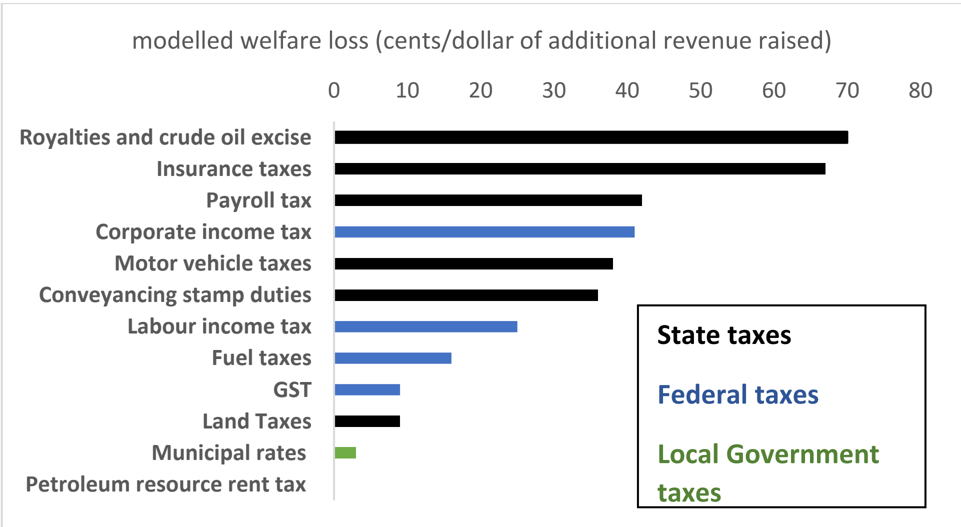
While the question posed relates specifically to the impact of taxes levied by state governments, it is worth noting that the impacts on choices and activity of taxes levied by one taxing authority can interact with those levied by other jurisdictions. For example, local government rates are often levied on the same properties as state government land taxes; and state government levies on insurance premiums coexist with federal GST liabilities on insurance. In these cases, the contribution of the state taxes to changes in behaviour is magnified and the total behavioural impact is more than the sum of the separate impacts of the taxes of the two jurisdictions. This arises because there is an exponential relationship between the combined rates of tax of the different jurisdictions and total deadweight losses.

The behavioural impacts of taxation are not always, or even generally, apparent from direct observation. Under most approaches to the measurement of these impacts an assessment of the behavioural impacts relies on comparison with behaviours that would prevail in the absence of the tax or of the change in taxation. Further, with behavioural impacts flowing from the economic incidence of a tax rather than from its legal incidence, the different behavioural impacts rely on an understanding of how the tax is distributed between the various parties involved in the taxed activity. A tax on profits may impact on returns to shareholders, the level of reinvestment, the prices charged to its customers and the amounts paid to its suppliers (including suppliers of labour). These in turn are affected by conditions across a range of markets and may vary over the different time periods over which adjustments are made to changes in taxation.

The obscured nature of impacts on behaviours generally requires theoretical analysis and models of interactions between the variables involved. It is not surprising therefore that between studies of Australian taxes there is some variation in the estimates of the relative behavioural impacts of various taxes.

Nevertheless, despite the range of methodologies and models used, the broad relativities are generally similar to those recorded in Chart 1 below which is adapted from the Overview of Australia's Future Tax System Final Report (page 13) and based on a set of specifications used in the KPMG Econtech MM900 model.

Chart 1: Marginal welfare loss from a small increase in selected Australian taxes



While similar in broad terms, in other studies – even by the same authors – duties on transfers of commercial and residential property are ranked considerably higher than in Chart 1; the Fire Service Levy/Emergency Services Levies still in place in some states are ranked as one of the most inefficient taxes and land tax is measured as being somewhat more efficient than the GST.

The relatively high ranking of the payroll taxes deployed by Australia's states is attributed in large measure to the tax-free thresholds and other exemptions that have been built into these taxes since they were transferred to the states and territories in the early 1970s.

As an aside, and of relevance to subsequent issues, while minimising the impacts of taxation on choices and activity should be central to the design of tax arrangements, taxes may be an efficient way to deliberately change relative prices (for example taxation may be an efficient way to change behaviour relating to tobacco use, gambling and the generation of environmental externalities).

Issue 2: Current revenue sources may not be enough to fund future levels of taxation

Specific question: how can the tax system work better for citizens and businesses and improve the economy for future generations?

There are accumulating pressures on existing taxes.

The share of consumption that is exempt from the GST has been rising and is expected to rise further as exempt services such as health and education rise in proportion to total spending.

Fuel excise revenue has been dampened by improvements in fuel efficiency and over time are expected to come under further pressure from the electrification of motor transport.

If technological developments undermine the scale and organisational advantages of large employers, greater proportions of the workforce could be covered by the tax-free thresholds that are a feature of Australia's payroll taxes.

Australia's relatively high reliance on taxes on income exposes us to:

- The relative decline of the workforce to total population (and therefore also the decline of the relative share of labour income);
- International tax competition; and
- The relatively high inefficiencies associated with these taxes (which detract from the pace of income growth).

These pressures add to the case for talking action to improve Australia's approach to taxation. Even in the absence of these pressures there are important reasons to improve the efficiency of taxation.

As the population is ageing, the relative importance of the efficient use of resources also rises because of the greater imperative to make up for the lesser contribution to future income generation from workforce expansion.

The rising demands for additional services relating to population ageing is a further reason to improve the efficiency of taxation – both as a means of reducing the costs of the higher share of taxation in GDP to the extent these services are funded by taxpayers and as a means of raising private incomes (by reducing deadweight losses) so these services can be purchased in the market without reducing other household spending.

Similar arguments apply to other social pressures relating, for instance to the greater need to invest in education and training and in greater provision for mental health and disability services.

In general, improvements in taxation can be made in two broad ways: by reducing reliance on more inefficient taxes and lifting recourse to those that are relatively more efficient; and by redesigning less efficient taxes to make them more efficient.

The greater use of taxes or charges that are deliberately designed to change behaviour is a potential third way. These sources of additional revenue could help finance the reduced reliance on inefficient taxes. There may be further revenue potential from raising taxes on tobacco and gambling to better match associated marginal external costs for instance. Congestion charges for road users may be able to be used to offset the expected further decline in fuel excise and, if pricing of greenhouse gas emissions were to be pursued in Australia, this revenue source could be used to finance reductions in the more inefficient taxes.

Volatility of revenue sources

On the specific issue of the volatility of revenue, it is worth noting that of itself volatility of flows of particular sources of tax revenue to governments may not be socially harmful notwithstanding some inconveniences. For instance, volatility of tax revenues can serve an important stabilising function. Reductions in income tax collections that would arise from conditions where private sector incomes were falling may have macroeconomic benefits relative to would occur if a constant level of revenue were collected. Similarly, collecting greater revenue when the economy was overheating or at risk of overheating may avoid other, harsher corrections.

Were it not for the relative inefficiency of stamp duties on residential and commercial property transfers, the volatility of these collections across the property market cycle may not itself be harmful and may be helpful relative to alternatives. Volatility could have net benefits even after the need for greater buffers in public sector finances.

Finally, revenue flows from some conceptually efficient taxes are inherently volatile. Taxes on resource rents are a clear example because, if well-designed, they will only generate revenue arising from above-normal profits flowing from relatively high prices and revenue flows will vary considerably across often closely-correlated commodity price cycles.

The temptation for governments to spend big when the revenue is flowing is relevant to these considerations, but it must be doubtful that tax system design is the best way to address this problem.

Issue 3: Addressing potential erosion of Commonwealth tax revenues

Specific question: Are there better ways that the Commonwealth Government can ensure its revenue sources remain stable and can continue to fund grants to the states and territories?

Our approach to this question is related to the longer-term forces of erosion rather than volatility across the business cycle. There is a good deal of sense in retaining at least a large proportion of the existing responsibility the Commonwealth has for managing macroeconomic stability. Volatility of income tax collections has a key role to play in meeting this responsibility.

Further, our approach to the question is not confined to existing Commonwealth taxes: the broader issue of long-term sustainability of tax revenues is best separated from questions of the existing distribution of taxes between the different layers of the federation. In particular, it is not necessarily the case that the best way to ensure the states have sufficient revenue to fund future services is to shore up the Commonwealth's coffers so it can maintain or increase the existing levels of grants to the states and territories. The obvious alternative – for the states to raise a greater share of revenue themselves – should at least be considered. This is taken up in the next section.

Shifting reliance to more resilient taxes

The most obvious way to address erosion of tax revenues is to reduce reliance on those most prone to erosion and lift reliance on more resilient taxes. This was a key theme of the Australia's Future Tax System Review which made specific recommendations including a reduction of taxes on income from mobile capital investment; the removal of a range of inefficient smaller taxes; a greater reliance on land taxes; a resource rent tax; and the introduction of a business cash flow tax (which it argued was an effective way to expand the consumption tax base and, indirectly, could be used to substantially improve the resilience of payroll taxation).

Improving efficiency of taxation

Substituting efficient for inefficient taxes is important in building sustainability. The more economically harmful any given tax the greater the adverse impacts on the growth of tax bases in general. Conversely, switching to more efficient taxes will facilitate greater rates of expansion of available tax bases.

Broadening tax bases of potentially efficient taxes (reducing exemptions to the fundamental design of the tax base) is also important because rates can be lowered to generate exponential gains in the form of reduced deadweight losses.

Reducing the taxation of more mobile tax bases – for example of capital seeking non-location specific returns, while retaining or increasing reliance on less mobile tax bases will improve efficiency and sustainability. Relatively immobile tax bases include land, rents derived from the realisation of rents on natural resources and rents arising from domestic regulatory arrangements. While not immobile, labour is generally less mobile than capital.

Diversification of taxing arrangements

Having a range of well-designed taxes is a defence against revenue erosion in the same way that investing in a portfolio of assets can reduce the risk of sustained losses over time. If the revenue sources flowing from the various taxes in the range are not closely correlated, having a portfolio of taxes can also be a protection against shorter-term volatility and, as with diversified investment portfolios, can make efficient yet volatile sources of revenue more attractive than if the portfolio of taxes was more concentrated or the revenue flows from them more closely correlated.

Constraining tax competition

Tax competition between sub-national jurisdictions can have positive impacts – it can act as a constraint against excessive spending impulses and can spur greater efficiency in the provision of services. State and territory discretion over taxation can also play a role in presenting citizens with a range of tax/public sector service mixes between jurisdictions. At the same time, tax competition can also lead to the erosion of relatively efficient tax bases. The historical experience with Australia's death duties and payroll taxes are cases in point.

It is worth considering whether constraints could be placed on tax competition between the states and territories to minimise tax base erosion while still preserving an adequate degree of discretion over taxation. Harmonising tax bases and removing discretion over tax base changes while leaving rates up to the states and territories is an alternative that is available to sub-national jurisdictions across a range of OECD countries. Having a range of rates over which states and territories can vary taxes is a variant that can assure taxpayers and limit both erosion and 'excessive' taxation and it may be particularly relevant in the case of shared tax bases.

A further dimension to harmonisation could be for constraints to apply over the range of taxes that the states and territories could deploy. A well-designed portfolio comprised of a limited number of taxes could have efficiency benefits while preventing incremental tax base erosion.

Issue 4: Financial dependence of the states and territories on the Commonwealth

Specific question: How can the states reduce their dependence on the Commonwealth?

The states and territories can increase own-source revenue by remodelling taxes that can be made more efficient. There would also be scope to use these taxes to finance the removal of their relatively inefficient taxes.

The sharing of the land tax base between local and state and territory governments should continue with potential for harmonising bases and broadening land tax bases a possible option.

If the compliance costs associated with payroll taxes could be substantially reduced as part of a comprehensive effort to improve the overall taxation of small businesses in a way that recognised the disproportionate compliance burdens they experience, reducing payroll tax rates and removing exemptions could be considered.

An agreement across the Commonwealth that saw the Commonwealth reduce its personal income tax rates and make room for the states and territories to raise some income tax from this base in a constrained way (for example by having scope to impose their rates within a defined range) has considerable appeal. It could increase state and territory self-reliance and help ensure they took greater responsibility for their own spending decisions. The ATO could collect the taxes on behalf of the states and territories albeit with relatively small additional complexity and enforcement costs.

Issues 5, 6 and 7: Improving Commonwealth – state and territory relations and funding arrangements

Specific issues: encouraging innovation and reform at the state and territory level; ensuring both accountability and flexibility; and better ways of working together.

Australia's federation has played, and continues to play, a valuable role in advancing economic and social outcomes for Australians. There is, nevertheless, considerable scope to build on strengths and address weaknesses to generate further advantages.

Improving how the federation works for Australia's citizens will require changes to financial and institutional arrangements and, most fundamentally, a determination on the part of all governments and supporting agencies to work cooperatively and constructively to embed and maintain a citizen-centric approach to the conduct of intergovernmental relations.

The federation at present suffers from a lack of connection between the spending undertaken by the states and territories and the taxes these governments raise. State and territory governments can deflect blame to the Commonwealth for under-provision of services while the Commonwealth can point to the responsibilities the states and territories have for service delivery.

Further, with the Commonwealth having responsibility to provide grants to the states and territories, it often imposes conditions on their allocation that reflect a desire for accountability and/or a view about how funds are best allocated. The latter goes against the subsidiarity principle and can reduce discretion, flexibility and innovation when a remote central government view is imposed on the agencies of the state and territory governments who often will be more informed about local conditions and requirements than their Commonwealth counterparts.

The longstanding commitment to reduce imbalances in the fiscal capacity of the states and territories to provide services has widespread agreement and makes an important contribution to improving equity across the federation. At the same time, there are clear difficulties in designing an approach to the reduction in imbalances that does not also create inefficiencies and disincentives within some of the states and territories.

Reducing vertical fiscal imbalance – the degree of mismatch between taxing and spending responsibilities - is an important component. Greater identification of the services provided by the states and territories with the taxes they raise would lift the accountability of states and territory governments and also give them more flexibility over how services are provided by reduce the extent of Commonwealth-imposed grant conditions.

While the quantity of intergovernmental grants could be reduced, some grants would need to continue even if only to address horizontal imbalances.

Improvements to the approach to grants could involve fewer tied grants and less prescriptive conditions where they were imposed. This would reduce administration and compliance costs and would give the states and territories more scope to bring their experience and expertise to bear in meeting agreed outcomes.

Institutional changes could also assist in improving how the federation works.

Greater state and territory input into the agenda and work program for the Council of Australian Governments (COAG) could assist in reducing the Commonwealth's domination of this forum.

The relatively short-lived COAG Reform Council added an important and independent force to Australia's intergovernmental relations and the valuable roles it served have not been preserved over the past five years. It is well worth considering the advantages of establishing a new independent force and whether arrangements can be made to give it greater longevity.

We would welcome discussing these points further with the Review Panel if necessary.

Yours sincerely,

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