KPMG submission

Discussion Paper

NSW Review of Federal Financial Relations:

Working together for a better future

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Detailed comments

KPMG welcomes the opportunity to present its submission in relation to the Discussion Paper: *NSW Review of Federal Financial Relations: Working together for a better future.* Our submission addresses the seven consultation questions below.

Question 1 – Which state taxes impact citizen and business choices the most?

(A) Summary

1.1 KPMG has consistently supported tax reform that causes minimal disruption to citizens' lives and the economy as a means of maintaining and improving our quality of life.

1.2 Our comments relating to this consultation issue can be divided into (a) our summary of the impact of the major state taxes, and (b) broader comments on the major state taxes.

(B) Overview of the impact of state taxes based on KPMG experience

Tax	Description of impact based on KPMG's experience
Property stamp duty	- Given the degree of revenue collected and the nature of the tax, it is our conclusion that it is the most impactful state tax in terms of citizen and business behaviour.
Payroll tax	- Tends to have a lower impact despite large amount of revenue raised. - Generally will not affect commercial decision-making or hiring decisions – akin to a tax on consumption economically, although this is more so with a broader based, harmonised payroll tax.
Land tax, Motor vehicle taxes, Gambling taxes, Insurance based taxes	- Relatively low impact.

(C) Broader comments on state taxes

1.3 Considering individual state taxes as discrete items carrying their own pros and cons has value, but in reality businesses and citizens are required to consider all taxes simultaneously. It is therefore also valuable to consider how existing state taxes could benefit from broader, structural improvement in certain instances. Our response to Question 2 provides a more detailed overview of individual state taxes and our relevant comments and recommendations for consideration.

Question 2 – How can the tax system work better for citizens and businesses and improve the economy for future generations, keeping in mind:

- **the changing environment**
- **the increasing volatility to state tax revenue bases?**

(A) Summary

2.1 Assuming no change in the allocation of expenditure responsibilities between levels of government, the paper acknowledges that NSW (and the other States) will need better access to sustainable tax revenues to deal with these cost pressures.

2.2 We outline how the tax system could work better and how tax revenues could become more sustainable by considering specific state taxes below.

(B) Payroll tax

Overview

2.3 Generally, payroll tax with a wide base is a highly efficient tax. It is less so where the tax base is not comprehensive or where it is not harmonised. This is our present circumstance, although it is still a critical tax making up between one quarter and one third of State Government revenues.

2.4 Payroll tax is the most important State tax in terms of revenue collection (leaving aside the GST). It raises much more revenue in the most populous and industrialised states (NSW and Victoria) than in smaller, agricultural or resource-rich states.

2.5 There is a rhetoric associated with payroll tax which describes it as a tax on jobs. Most economists would assert that the effects of payroll tax are passed on either though higher prices and thus akin to a tax on consumption, or through lower wages and thus akin to a tax on income.

2.6 Payroll tax is levied on the total payments for employee wages of employers, over specified thresholds (including wages, fringe benefits, bonuses and commissions). Payroll tax can be weakened through tax competition, producing increases in the threshold for taxation, variable rates and special exemptions.

Comments and recommendations for consideration

2.7 The relative immobility of labour resources (compared to capital) make them a good tax base for the States. However, current Australian payroll taxes are not comprehensive. As technology improves, there is scope for further research to examine feasibility of broadening the payroll tax base, or levying it on a comprehensive national tax base, possibly through the Commonwealth PAYG wage withholding system, on behalf of the States. This would require a federal – state package.

(C) Taxes on land

Land taxes overview

2.8 Land has the major advantage of being immobile and a relatively stable and predictable revenue source. Land tax's underutilisation in the Australian environment lies in the fact that there are exemptions for one's principal place of residence, primary production, not-for-profit organisations and other selected exemptions such as low cost accommodation.

2.9 Thus it has a relatively narrow base and a relatively high rate where it does apply.

Stamp duties overview

2.10 Stamp duties are one of the most inefficient taxes from an economist's perspective. They lead to a lack of flexibility in the housing market: on the one hand it is a disincentive to sell to down-size, and on the other it is cheaper to renovate or extend than to sell and purchase a larger home. It also reduces labour mobility.

2.11 There are three main difficulties with abolishing stamp duty in some form of trade-off. The first is that at any given point the states may be experiencing very high receipts in a buoyant market. Secondly, one can pin a non-resident purchaser surcharge on to stamp duty, as many states have now done, and thus benefit from the foreign investment into the Australian property market. This investment is likely to continue and may well even increase in a more volatile international environment. Thirdly, people tend to like to pay tax when they have access to cash (i.e. borrowing from a bank). In that sense stamp may be psychologically less imposing than annual taxation.

2.12 The *Review of Australia's Future Tax System* in 2009 recommended that stamp duties be replaced over time by more efficient annual land taxes. Commencing in its 2012-13 Budget, the ACT began a 20-year process of phasing out duties on residential property and increasing general rates and land tax. Although ACT stamp duty on residential property has since reduced, it is not yet insignificant. Therefore it is too early to ascertain the full impacts of this plan.

2.13 Annual taxation needs to deal with the difficult issue of home owners who are retired and do not have access to the same income as younger home owners. One could design a system so that a land tax or property services tax was paid for out of the equity in their home. Taxpayers who used this payment mechanism might also need to have a cap applied to their liability for the property services tax.

Taxes on land – Comments and recommendations for consideration

2.14 One solution, previously proposed by KPMG, is to broaden the base with a comprehensive progressive property services charge which would replace rates, insurance taxes and stamp duty with one annual charge.

2.15 There are clearly political and transitional difficulties with this option: the current exemptions will be hard to unseat and there are difficulties converting a stamp duty payable on exchange of property into an annual tax. Such difficulties are not insurmountable.

2.16 Additionally, KPMG has previously outlined a possible route for a land tax – stamp duty trade-off. Key features of that proposal involved the following:

- Abolish stamp duty on the transfer of residential and commercial property.
- Combine rates, land tax, insurance taxes and emergency service levies into a new Property Services Tax which would be levied at progressive rates based on unit values, with a minimum value threshold. It would be administered by the ATO, in a similar way that the ATO administers the GST revenue destined for the states and territories.
- Two thirds of the property services tax would be spent locally, at either the state/territory or local government level, at the discretion of that state or territory.
- One third of the property services tax would go into a Property Services Equalisation Fund which would be administered and distributed by an independent body equivalent to the Commonwealth Grants Commission.
- This body would distribute funds to local governments to help equalise the capacity of local government to provide local infrastructure and services. The remainder of the funds would be used for projects involving multiple local entities.
- The Property Services Equalisation Fund would produce highly transparent reports. It would show comparative income and expenditure of local government including top-up grants. This, of itself, would drive greater efficiency.
- An additional feature could be the redirection of current federal government funding of local government, which includes per capita and local road funding, to the Property Services Equalisation Fund.

- The property services tax would involve a deferral scheme ‘owned’ by the Property Services Equalisation Fund but managed by a financial institution, or consortia of financial institutions determined by tender. The deferral scheme would provide:

    a) That any individual owner over the age of 60 could defer 80 percent of the property services tax until sale of the property or death, with a government bond rate interest charge. There would be pro rata rules for joint ownership.

    b) A selected group of others (disability pensioners etc.) would be able to enter the deferral scheme.

    c) Properties not owned individually (that is, those held in discretionary trusts) would not be entitled to the scheme.

(D) Miscellaneous taxes and levies

2.17 There are a series of miscellaneous taxes, such as insurance taxes, which are regressive and highly inefficient. There needs to be a long-term plan for their removal.

Question 3 – Is there a better way that the Commonwealth Government can ensure its revenue sources remain sustainable in a changing environment?

Consolidating Australia's revenue administrations

3.1 Consolidating revenue administration under the control of the ATO would generate productivity advantages for government and also give the ATO easier access to a wider range of data that can enable it to reduce the various "tax gaps" that exist across the spectrum of federal and state taxes. In particular, this move should result in the better coordination of measures to combat the pernicious impact of the black economy, which the federal government's Black Economy Taskforce has most recently estimated to account for a revenue hole of $9 billion annually.

3.2 Therefore Australia should move to one tax administrator and the state and territory revenue offices should be absorbed into the ATO. This would also give rise to substantial benefits for business and individuals in dealing with one administrator, for simplifying returns, reducing the need for multiple computer systems and properly dealing with compliance risk. This does not require complete harmonisation of state tax systems, although that may well be desirable.

Enhanced tax certainty ("ETC") for major natural resource projects

3.3 One means of protecting the revenue base is to improve the chances of major natural resource projects taking place in Australia rather than overseas. By reducing the risk of adverse tax changes affecting a project which requires significant upfront capital investment and has a long lead-time before becoming cash-flow positive, Australia may present an improved investment case when a major resources company is weighing up where to place its bets in terms of potential projects around the world.

3.4 ETC for selected major projects would apply (for up to 20 years from project commencement) to federal and state industry-specific taxes, and to general taxes that impact the return on sunk costs. So for example, ETC would apply to thin capitalisation, capital allowances and royalties, but not to payroll taxes on operational labour costs.

3.5 Potential tax uncertainty is one input to whether an Australian project is preferred over others that a company is considering in other countries. Therefore ETC would increase the chances of the Australian project being selected for investment.

3.6 ETC would require federal and state government cooperation. It could apply on a total tax cost model, rather than be itemised by individual taxes, with the mechanism only being triggered if the total tax costs exceeded a certain bar.

Opportunities for broadening the tax base – wealth taxes

3.7 Asset, wealth and inheritance taxes need to be fully considered. Currently the tax and transfer system produces significantly different outcomes for those who own a very valuable principal residence when compared to those with other assets, who may be renting. This may appear anomalous to the latter category of taxpayers.

Dynamic models for road user charging

3.8 Future fuel excise tax revenue is at risk as electric vehicles become more prevalent. The federal government should consider whether some combination of distance-based and geographic road user charges would be a cost-effective replacement. There are a variety of models for road-user charging in operation around the world, from central London's congestion charge to distance-based motorway tolling. The federal government should study these in determining what would be the most effective model for Australia.

3.9 Road user charging can be an efficient or low-distortionary tax, particularly where it accommodates dynamic pricing to manage access and to pay for variable 'externalities' such as road, health and air pollution costs. Arguably it has the potential for low levels of regressive impact, where those on lower incomes have some flexibility, including to use public transport.

3.10 Where the tax uses GPS infrastructure, there may be secondary benefits including parking and insurance. Another advantage is that user charging may reduce the demand for future infrastructure.

3.11 Geographically-based charging has raised privacy concerns, although these may be dealt with using encryption technology. More comprehensive road user charging may be implemented with other reforms in such a way that the package becomes politically tenable.

Opportunities for broadening the tax base – further consumption taxes

3.12 We quote from KPMG Australia Chief Economist, Dr Brendan Rynne's KPMG Newsroom article of 5 November 2019:

"KPMG remains of the view that Australia needs a comprehensive agenda of fiscal policy measures targeted at the short-medium term, allied to productivity reforms and tax reforms rebalancing tax receipts away from Corporate and Personal Income taxes and towards a higher consumption tax mix."

Tax on consumption could include putting a price on carbon, either directly through a tax, through an emissions trading scheme or a hybrid scheme. We recognise that there is a wide variety of divergent views on this subject.

3.13 There is scope to review the use of selective taxes as a way for government to intervene in markets to achieve more equitable and efficient outcomes. A selective (narrow-based) taxation may be appropriate to correct the negative social or economic costs that are not adequately factored into private transactions.

3.14 Environment and health-related taxes can be imposed to increase the price of activities or goods that generate negative externalities that affect society as a whole. For example, a tax on food wastage similar to rules on food wastage in the European Union, or on consumption of plastic. In conjunction, there is the opportunity to consider tax incentives for behaviour that may reduce risks to the environment and public health (and consequential costs to government).

3.15 There is also the potential to significantly expand the level of user charging on federal government services. Singapore applies user charges such that they comprise nearly half of the Singapore Government's revenue base.

Question 4 – How can the states reduce their dependence on the Commonwealth?

Vertical fiscal imbalance

4.1 Ideally, there would be no vertical fiscal imbalance (VFI). Each body would be responsible for raising its own revenue. This would assist in accountability, transparency, sound management and greater flexibility for communities to act in accordance with their own choices.

4.2 Australia is very far from this ideal. The Commonwealth passes on almost a quarter of its own revenue to the states. About 40 percent of the revenue of the states is from the Commonwealth. This is very high by international standards.

Centralised tax administration

4.3 Centralised administration of state taxes (as suggested in the first of our comments on Question 3) would not only be more efficient, but would be additive to revenue. The increased revenue would be driven by enhanced information sharing across the administration, and greater opportunity for the use of data analytics to target compliance and enforcement activity. Taxpayers would also recognise that there was less likelihood of being able to "slip through the cracks" in the administrative architecture.

State taxes

4.4 Our recommendations on improving state taxes have been inserted in our response to Question 2 for consideration.

Question 5 – How can Commonwealth – state relations encourage states to innovate and reform?

5.1 Currently there is little public understanding of how relatively efficient the federal, state and territory governments are at either raising revenue or spending it. The benefit of achieving increased transparency of this information would be the incentive it would provide for governments to be seen to be efficient and applying best practice in their management of public finances. Any government that lagged the field in these attributes would find itself very publicly held to account by its taxpayers.

5.2 This transparency should include an Efficiency Index for the key federal and state taxes. Components of this index should include the average and marginal excess burden of each tax. There should be an explanation of each tax's economic incidence over both the short- and long-term, and the changes in collections over the last ten years, together with predictions for the next ten.

5.3 Once the above transparency measures are embedded and have currency in public debate, there would be the opportunity for Horizontal Fiscal Equalisation to have regard to state and territory performance against these measures, such that there would be a penalty for sustained relative underperformance in efficiency of revenue-raising or spending. The continued independence of the Commonwealth Grants Commission from the political process would be critical if this idea is to succeed.

5.4 In principle, the focus of state and territory taxation should be on those factors of production that are relatively immobile, such that there is a reduced risk of a "race to the bottom" in using tax rates and concessions to compete with one another.

5.5 A further principle supporting this objective would be that states and territories should place more reliance on taxes that have a relatively low drag on the economy. To date, those governments have tended to generate a major component of their revenue from taxes that are generally perceived as "high drag" – including stamp duty and insurance taxes.

Question 6 – How can agreements between the Commonwealth and states ensure accountability for how the money is spent but allow flexibility to deliver the best outcomes for citizens?

6.1 Good government (of which accountability and delivering the best outcomes are features) requires a level of predictability in revenues. Without this, planning for long-term projects is very difficult. It is important for this principle to be borne in mind in the allocation of GST revenues, the renewal of other Commonwealth grants and other agreements between federal, state and territory governments which may be subject to major modification or abandonment by subsequent governments.

6.2 Accountability and autonomy tend to go hand-in-hand. This principle should underpin Australia's approach to addressing Vertical Fiscal Imbalance. It should also underpin the approach to other federal funding, including consideration of whether grants requiring a "matching" contribution from the state or territory government are supportive of accountability.

6.3 Greater transparency and public knowledge in respect of transfers from federal to sub-national governments would also promote accountability and optimum allocation of funds. This is particularly the case for those public services where there is a funding overlap, such as health and certain education and environmental services.

Question 7 – How can governments work better together and learn from each other, putting citizens at the centre of decision making?

The contribution of the Council of Australian Governments

7.1 There is the opportunity to consider a restructuring of the Council of Australian Governments (COAG). Currently, the Prime Minister is responsible for setting COAG's agenda, and this influences its areas of focus.

7.2 COAG would benefit from an independent secretariat setting the agenda with a view to long term reform and improvement in the Federation. It would need the resources to produce substantive reports on the workings of the Federation. As a secretariat, it needs to be trusted and politically independent. It should be able to initiate any reform agenda of its choosing.

7.3 An independent secretariat would support the emergence of a more cooperative agenda between the federal, state and territory governments.

Governmental peer review of cost impacts of regulatory change

7.4 Federal, state and territory governments should commit to reporting annually on the cost of changes in regulation, both any claimed reduction, and any increases, as part of the annual budget reporting. This should include all forms of regulation.

7.5 As part of this initiative, any change in regulation which imposes or reduces annual costs over a specified threshold could be subject to an independent review of the costing, to validate these estimates. Each jurisdiction's Auditor General could periodically investigate the rigour of the process.

7.6 The benefit would be the increase in transparency and accountability for all governments for the net costs they impose on the community through their regulatory activities. Improved reporting would create a disincentive to increase regulation that does not have a strong public policy justification.

7.7 A government would have access to better quality data about other governments' legislation for the purpose of informing its own policy decisions. This benefit would surely outweigh the cost of carrying out the peer review process.

Harnessing business- and citizen-centricity to streamline interaction with government

7.8 The recent announcement of the introduction of Services Australia by the Prime Minister pointed to a future world of better customer- and citizen-centred service delivery. There is much that can be shared and leveraged between the three layers of government.

7.9 The involvement of business in identifying opportunities for streamlining of regulation should be a priority for all three layers of government. A regulation taskforce, which would supplement the government lens with a business lens, should be established with a goal of devising better regulation that supports business in exploiting the economic benefits of digital communication, data and other new advances in technology.

7.10 Government should focus on reviewing how other nations are transforming service to customers and reducing costs of service delivery. In this day of digital design, access to and delivery of government services should be frictionless for the great majority of customers.