NSW Review of Federal Financial Relations

Supporting the road to recovery

DRAFT REPORT

July 2020

NSW GOVERNMENT

NSW Treasury
52 Martin Place
Sydney NSW 2000

www.treasury.nsw.gov.au

Contents

Glossary

ABS	Australian Bureau of Statistics
ACT	Australian Capital Territory
BITRE	Bureau of Infrastructure, Transport and Regional Economics
CFFR	Council on Federal Financial Relations
COAG	Council of Australian Governments
CGC	Commonwealth Grants Commission
COPS	Centre of Policy Studies
COVID-19	Coronavirus disease 2019
GDP	Gross Domestic Product
GSP	Gross State Product
GST	Goods and Services Tax
HFE	Horizontal Fiscal Equalisation
IGAFFR	Intergovernmental Agreement on Federal Financial Relations
IPART	Independent Pricing and Regulatory Tribunal
NSW	New South Wales
NT	Northern Territory
OECD	Organisation for Economic Co-operation and Development
QLD	Queensland
SA	South Australia
TAS	Tasmania
US	United States
VAT	Value-added tax
VIC	Victoria
WA	Western Australia

1 Executive Summary

Federation has served Australia well for 119 years. However our world is changing. Like all organisations, governments must continue to make sure that their processes and responsibilities are fit for purpose. It is timely to review our federal financial relations as it enables the effective working of our federation.

When the NSW Review of Federal Financial Relations (the Review) commenced, the State's finances were in a healthy shape, supported by a period of solid economic growth and a record pipeline of infrastructure investment.

At that time, the Review's task was to propose reforms that would enable future governments to continue funding the essential services and infrastructure that citizens expect, in the context of major demographic, economic and technological changes.

Two catastrophic and unforeseeable challenges have brought those challenges forward to today. Firstly, the devasting summer of bushfires illustrated our national vulnerability and the importance of integrated leadership from state and Commonwealth government. Secondly, the coronavirus (COVID-19) pandemic has brought the greatest economic, financial and social shock since the Second World War, leaving a major economic crisis that will burden our societies for years, if not decades, to come.

These recent events have highlighted how critical it is to maintain essential government services and resources, such as fire-fighting equipment, hospital equipment and support for the highly trained people who can use them, so that they are available to citizens when they need them.

But state and territory governments (collectively, 'the states') confront a significant decline in their tax revenues at the same time as they inject all of their fiscal firepower into the economy to avoid serious economic collapse. They now face an era of higher debt, challenging their ability to sustainably deliver essential services and infrastructure.

With economic recovery now a priority, the question facing the Review is how state governments can provide taxpayers with reliable, quality government services, while keeping the taxes they pay as low as possible. To do this, we need to identify practical ways to maximise the value we get per dollar of tax raised. We need to make taxes as simple as possible, and limit the impact they have upon citizens' lives, such as the decision about when to move house and whether to insure.

This will not be achieved by simply lifting the tax take. Rather, it will involve changing the tax mix in a way that is neutral to the overall burden on the taxpayer, while extracting the best value. Achieved, it will create better conditions for households and businesses to recover and simultaneously deliver more secure and reliable funding for the states to rebuild their balance sheets for future generations.

Reforms must simultaneously deliver secure and reliable funding to the states, allowing them to gradually rebuild their balance sheets for the benefit of future generations.

The Review received significant evidence about the sustainability of funding required for essential state services over the longer-term. Evidence points to a large backlog of infrastructure maintenance and ongoing pressures on our health system and other frontline services. Data also suggests the states' largest revenue source – the Goods and Services Tax (GST) – is a shrinking tax base.

Presented with this evidence, the Review concluded that a business as usual approach by our governments of today would create an inevitable legacy of undesirable choices for our governments of tomorrow. Future generations would be burdened with significant debts; hard choices around cutting services would need to be made, taxes raised or handouts sought from the Commonwealth.

The Review investigated the costs and benefits of federalism. Federalism can be an efficient system of government, but it needs to be properly calibrated to work well. In particular, it requires strong intergovernmental cooperation, clear lines of responsibility and proper accountability.

At present, there is too much duplication and unnecessary administrative cost involved. The imbalance in financial capacity between state and federal governments has centralised the workings of the federation. In practice, a heavy reliance on prescriptive, ad-hoc, and often small Commonwealth-state funding agreements blurs responsibilities and consumes the relationship with a disproportionate effort on negotiation and reporting. It also limits the ability of state governments to make spending decisions that produce the best outcomes for their citizens.

Importantly, delivering a major reform agenda needs political will, vision and a new era of cooperation between state and Commonwealth governments. The federation's highest forum for intergovernmental cooperation for the last 18 years, the Council of Australian Governments ('COAG'), was no longer fit to deliver this.

The effectiveness of the National Cabinet in driving the COVID-19 response shows what can be achieved when Commonwealth and state governments have clarity of purpose. It's success lies in the fact that it recognised that in some cases, a collective cooperative response is the most effective, while in others, States must have the power and responsibility to tailor responses to their own local circumstances. That respect for all as equal partners with a common aim, combined with reliance upon a single shared evidence base, to which all parties could contribute, have made the National Cabinet a valuable body with strong popular support. Its use of more flexible and less bureaucratic processes have only added to this value. The Review welcomes the agreement by the Prime Minister, Premiers and Chief Ministers to continue the National Cabinet under a new intergovernmental model to support Australia's post-pandemic economic recovery.

The Review recognised that too often, the states are seen not to be taking responsibility for their own economic problems, seeking to shift blame and relying too readily on Commonwealth funding to resolve problems. The Review decided to recommend reforms at the state level that are challenging but necessary, as the states need to show, in good faith, that they are ready to carry their part of the load. Several reforms require cooperation with other states as they share many of the same challenges and could develop a better solution together.

To build a better environment for sustained economic and fiscal recovery, priorities for the NSW Government should focus on three key pillars: phasing out many of the nation's most unfair and damaging taxes, including transfer duties and taxes on insurance; working with other states to address the hollowing out and complexity of payroll tax; and increasing the use of its best tax lever - land. These recommendations should also be complemented by targeted actions to boost business investment and employment in the near-term, including through the work of the NSW Productivity Commission.

Some of the Review's recommendations involve the Commonwealth. This is necessary to make the tax system as a whole simpler and more efficient, streamline financial relations with the states, and ensure that Commonwealth funding supports, rather than inhibits, efforts to achieve economic recovery.

Some of these recommendations will require inter-governmental cooperation. All Australian governments have seen the severe economic damage caused by the COVID-19 pandemic and the personal cost to their citizens. If these reforms can generate the revenue needed at the lowest cost to taxpayers, and provide long-term economic benefits, then all governments should be prepared to accept them. No government has the option to sit back and do nothing.

The GST is important in these considerations. It is the largest source of funding for frontline state services, but its broad exemptions are causing the revenue pool to shrink relative to the size of the economy. There is a strong case for reforming the GST and reducing our reliance on more harmful taxes, while re-directing a portion of revenue to lower income households so they do not bear the burden of reform. The Review acknowledges valid concerns about the distributional impacts of GST reform and that unanimous state agreement is needed. Equally, the Review notes that doing nothing simply avoids confronting this significant challenge. A practical step on the path to reform is for states to investigate and agree on acceptable options.

And there are many ambitious options that will need to be explored and tested further, with possible pilots in different jurisdictions. Consideration should be given to the pros and cons of a portion of personal income tax revenues being shared with the states, as is done in all other advanced federations in the Organisation for Economic Co-operation and Development (OECD). Similarly, a system of business cash flow taxation could overhaul the Commonwealth-state taxation regime in a way that is fairer, reduces the burden on business, and fosters greater incentives to invest, which this country needs for its future prosperity. Many of these ideas have significant challenges in implementation.

The Review reflected on the important economic changes that had been made in the past, which hurt at the time, but kept Australia's economy strong through the Asian financial crisis, the dot-com bubble and the global financial crisis. We recognised that we all have a responsibility to take on further reforms to ensure that our economy weathers the crises of the future. Amidst the greatest challenge of our generation, the Review hopes to offer a blueprint to lay the foundations of prosperity and security for future generations.

Draft Recommendations

Evolving the federation

1. Establish the National Cabinet as an inter-governmental body of equals with an independent national Secretariat to support governance and administrative processes.
2. To support the continued operation of the National Cabinet, create a national evidence base, including a Commonwealth-state Intergenerational Report, to support shared priority setting.
3. Strengthen monitoring and assessment of performance of Commonwealth-state commitments, enabling citizens to see the results delivered and informing government decision making.
4. Review and reform all Commonwealth-state funding agreements to:
    a. Reduce administrative burdens and shift the basis of funding towards outcomes rather than inputs and outputs
    b. Reassess roles and responsibilities in areas in which they are not completely intertwined, so that citizens know where to go and who is responsible for particular services;

c. Ensure that programs that need long-term stable funding are not subject to short-term grants with unreliable and administratively burdensome renewal processes, by replacing them with untied funding from an ongoing source (such as personal income tax sharing or GST reform).

The GST matters for our collective future

5. State Treasuries should develop projections of national GST revenues that consider the magnitude and timing of further erosion of the base to inform the appropriate policy response.

6. State governments, in consultation with the Commonwealth, should assess and agree options for lifting the GST rate and/or expanding the base over the medium to longer-term to offset base erosion and move away from more harmful taxes. Some of the revenue gained should be transferred to lower income household to maintain equity.

A broad-based land tax is more efficient and equitable than transfer duty

7. As a more equitable and efficient approach to taxation, the NSW Government should replace transfer duty with a broad-based land tax. The transition should be managed with the support of detailed distributional and financial modelling and public communication and consultation, so that the transition is fair, efficient and minimises the amount of revenue foregone.

8. In consultation with other state Governments, the NSW Government should seek assurance from the Commonwealth that it will not be disadvantaged with a lower GST share as a result of undertaking major productivity-enhancing tax reforms such as replacing transfer duty with a broad-based land tax.

Australia’s Commonwealth-state funding model has become inefficient

9. With the Commonwealth, the NSW Government should lead the development of a personal income tax-sharing model. The model should be opt-in, revenue neutral for the taxpayer and with revenue distributed to the state in which it is generated. The revenue should be quarantined from the calculation of GST relativities. A small-scale pilot could be undertaken and evaluated prior to a more expansive roll-out.

Insurance taxes – can we afford them?

10. All specific taxes on insurance products, including the Emergency Services Levy in New South Wales, should be abolished and replaced by more efficient and broad tax bases, to improve the affordability and uptake of insurance.

11. To reduce the cost of insurance and enable fairer ways to fund the fire and emergency services, the NSW Government should reconsider applying a levy on property owners and should also consider combining this with a future broad-based land tax. The reform should follow a detailed consultation and modelling process to carefully consider the impacts on different taxpayers.

Payroll taxes – a workhorse of the tax system, ultimately paid by workers

12. The NSW Government should propose that the Board of Treasurers collectively agree a strategic national approach to payroll tax reform that addresses the hollowing out of the tax base and the complexity this imposes on taxpayers.

A crossroads for road funding

13. The NSW Government should work with the Board of Treasurers and state transport departments to design a nationally compatible and fair road user charging scheme for electric vehicles.

14. Once distance-based charging for electric vehicles has been successfully implemented, the NSW Government should work with the Board of Treasurers to replace vehicle registration, licence fees, stamp duties on motor vehicles and motor vehicle insurance with a distance-based charging scheme that better reflects the social costs of road use, including wear-and-tear, pollution and congestion. Revenue should be hypothecated to expenditure on roads and other transport infrastructure.

15. The NSW Government should commence a trial for a congestion cordon around the Sydney CBD to better understand how Sydney drivers respond to time-based road pricing.

2 Evolving the federation

Federalism is an advantage, but the Australian model is not best practice.

Australia is fortunate to be a federation. Federalism is a system of government that limits, organises and regulates power 'in a way that guarantees freedom and efficiency, unity and plurality, autonomy and coordination'.[1][i] It brings government closer to the people. It protects freedom by ensuring that no one leader or government has complete control and ensures diversity and choice.

Federalism also allows governments to tailor services to the distinct needs of communities. It permits competition, to encourage constantly improving services but allows uniformity where it is needed. It gives governments the opportunity to innovate and experiment on a small scale so that others can learn from their successes, ratcheting up overall government performance. It is one of the most economically efficient forms of government.[ii]

But federalism and decentralised government also need certain settings to work well, among them a clear delineation of government responsibilities, adequate autonomy over revenue raising, and effective intergovernmental cooperation.[iii]

The federal system, as set out in the Constitution, confers specific powers on the Commonwealth but leaves the states with full powers with respect to any matters other than those taken from them by the Constitution. If valid Commonwealth and state laws conflict, the Commonwealth law prevails. The consequence of the federal distribution of powers is that the states have ended up with responsibility for the provision of critical essential services, such as hospitals, schools, transport and emergency services.

While the states deliver almost half of all government operating expenditure, the Commonwealth raises more than 80 per cent of the tax revenue and provides almost 45 per cent of state revenues.[2] The disproportion in revenue collection and spending responsibilities, means that the financial capacity of Australian governments is 'vertically imbalanced',[3] with the states relying on the Commonwealth to fund essential services critical to the wellbeing of Australians through two primary channels – the GST, which is untied, and funding agreements, earmarked for specific areas of service delivery.

---

1 Francesco and Kössler (2019), 1.

2 ABS Catalogue 5512.0 and 2018-19 Commonwealth Final Budget Outcome.

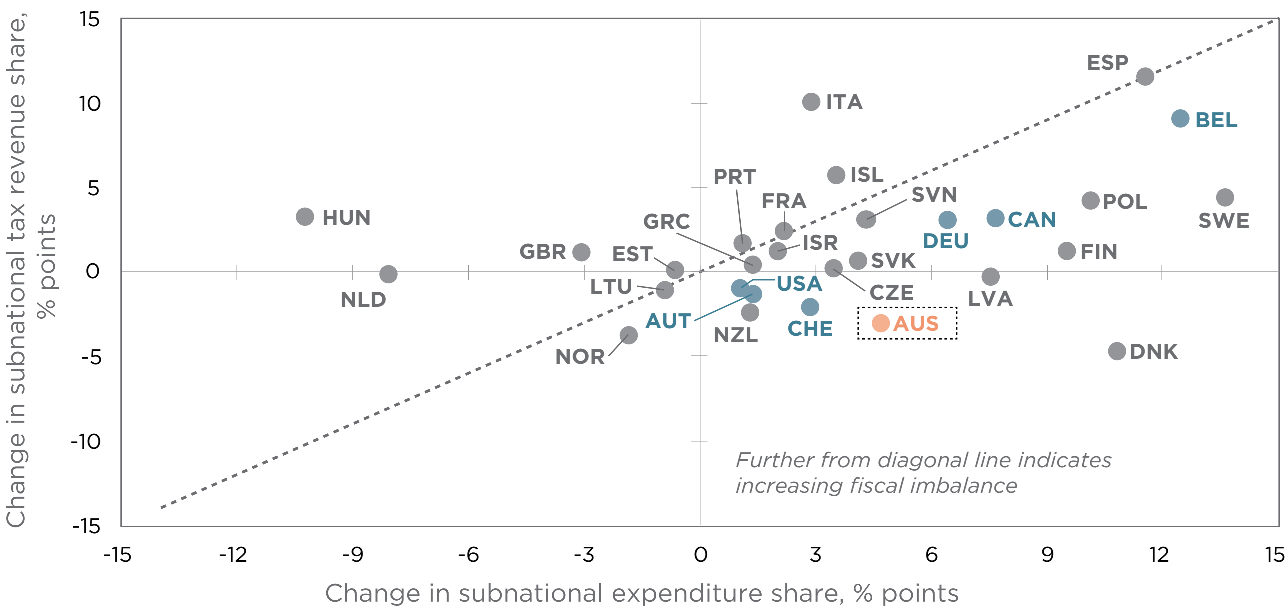
3 Known as *vertical fiscal imbalance*.

While a degree of vertical fiscal imbalance is not uncommon across federations, the sheer magnitude of Australia's imbalance has had a centralising effect on the operations of the federation. Over time, the effects of the Commonwealth having an effective monopoly on income taxing powers and imbalanced revenue raising capabilities has shifted the relationship between governments and fostered a learned financial dependency amongst the states. The result is Australia has diverged from the federation's founding principle of 'subsidiarity'- the idea that responsibility for functions should reside with the level of government closest to the people and where there are matters that affect multiple states or different rules and regulations resulting in high transaction costs, responsibility should sit with the highest level of government (the Commonwealth).

In practice, the vertical fiscal imbalance in the federation has seen the Commonwealth enter policy areas not conferred upon it by the Constitution, using funding agreements and grant funding to influence programs and policy outcomes ordinarily the domain of the states. Beholden to the need for funding, states have frequently acquiesced to funding arrangements that in many instances deprive them of the ability deliver the localised services citizens expect of them.

The imbalance is also widening, according to data. From 1995 to 2017, the state and local share of expenditure by all three levels of Australian government increased by 4.7 percentage points, but their share of national tax revenues fell by 3.1 percentage points (Figure 1). This gap has widened more than any other advanced economy federation, and more than most unitary states tracked by the OECD.

Figure 1: Change in subnational government revenue and expenditure shares, OECD countries, percentage points (1995-2017)



Note: The diagonal line indicates that changes in expenditure responsibilities have been aligned with changes in revenue raising. Federations are coloured in blue.
Source: Foreman et al (2020)[iii]

For citizens, the centralisation of power comes at a cost. An extra layer of bureaucracy can increase the administrative effort and cloud accountability, resulting in blame shifting when things don't go well. With funding agreements often containing prescriptive terms for delivery, federalism's virtue of 'government closer to the people' has been eroded, disempowering states from making decisions at a local level.

Centralisation has also manifested institutionally, having characterised the workings of the federation's chief intergovernmental decision-making body up until recently, COAG. Increasingly, the Commonwealth controlled when and whether COAG met and the agenda for all meetings, undermining its cooperative value.[4]

Even international studies have recognised that COAG had 'lost much of its importance and has become increasingly dominated by the national Prime Minister'.[5][iv] The power imbalance in COAG between the states and the Commonwealth had seen this critical leadership body wane in its ability to deliver leadership and effective outcomes. New intergovernmental arrangements, with National Cabinet at the centre, will need to forge a stronger partnership between Commonwealth and state leaders on issues of national interest.

For governments, the need to reform our federal financial landscape has been common knowledge for some time. As far back as 1990, the then Prime Minister Bob Hawke's 'new Federalism' called out the need to find a better way of integrating the policy interests of the Commonwealth and states.[6] The aim was to achieve more effective delivery of programs and services for Australians.[v] Despite Hawke's declaration of readiness over 30 years ago, very little lasting change has been made since.

While the fiscal imbalance between Commonwealth and state governments is likely to remain, as a nation we can manage it much better. Key to this is reforming the approach to funding decisions. Funding uncertainty should be eliminated, providing long-term sustainable commitments to states and frontline service providers. This approach would reduce the administrative and bureaucratic waste, which now more than ever, governments cannot afford.

Reforming our federation could have significant payoffs. Federal nations have long performed better than unitary states in delivering per capita income growth to their citizens, but this is most

[4] COAG includes all three layers of government, including representation of local government through the President of the Australian Local Government Association. As noted in the Review's *Discussion Paper*, the relationship between local government and state government is out of scope for the Review but is being considered by the NSW Productivity Commission; see NSW Productivity Commission (2019), *Kickstarting the Productivity Conversation*.

[5] Francesco and Kössler (2019), 255-6.

[6] On funding agreements, he said "We may find a need to move away from tied grants in a number of areas; and in other areas, [we] need to change our arrangements so that we get better value for money. It is timely and proper to consider this aspect of our funding arrangements" [endnote iii]

effective when subnational governments have the means to raise enough revenue to cover their expenditure and be more accountable to the people for it.[vi] If Australia were to reform its federal system to match the decentralisation in other leading OECD federal countries, per capita income could be improved by an estimated $4,571 per Australian – a payoff of $116 billion (in 2020 dollars) in Gross Domestic Product (GDP) over the long run.[7]

To achieve this payoff and meet the challenges before us, the federation must evolve. The crises of the summer's bushfires and COVID-19 have put in plain sight how the status quo is no longer fit for purpose.

The institutions of old

The operation of the Australian federation is supported by numerous Ministerial Councils, the highest of which, up until recently, was COAG - Australia's peak intergovernmental forum, consisting of the Prime Minister, Australia's First Ministers from all states and territories and the President of the Australian Local Government Association (ALGA).

Established by Prime Minister Paul Keating in 1992, COAG was designed to increase cooperation among governments; continue structural reform and review of relationships among governments; and consult when major initiatives had impacts on other governments.[vii] It was intended that the secretariat would be a joint Commonwealth-State arrangement.[vi]

Since then, COAG had been central to intergovernmental decision making and an important vehicle to achieve joint reform. It has delivered landmark reforms such as the National Competition Policy, the GST, and the National Disability Insurance Scheme. Meaningful and lasting reforms have also included uniform gun laws, native title, counterterrorism, water reform, and drug regulation.

Over the years, however, COAG was tainted by contest rather than collaboration. Its effectiveness had diminished - sometimes based on political events, and sometimes due to weaker institutional supports that have little impact without the political will to cooperate in the national interest.

This form of COAG also mirrored the financial imbalance across the federation. Despite the forum's intention to bring together all governments to discuss shared issues, the Prime Minister was both the 'bank and chair'. The Commonwealth chaired the meeting, chose times and locations, could

[7] To achieve the gain requires reconfiguration of roles and responsibilities across governments in Australia. The benefits would therefore take time as the adjustments take place, they'd not flow immediately. They are long run benefits (see Withers 2020).

command, defer or cancel meetings, ran the Secretariat, set the agenda and prioritised policy issues, entrenching a significant power imbalance between parties.[viii]

With governments failing to provide early collective leadership on many issues, public policy development has been reactive, instigated after issues have reached a crisis point. To this end, national, systemic issues have been left to Royal Commissions, such as those into natural disasters, disability care, aged care and sexual abuse, to design solutions for reform.[8] Policy developed this way is not only much more expensive but has failed the public, allowing 'worst case scenarios' to manifest before governments demonstrate a willingness to address them. We cannot keep waiting until matters have reached the level of a disaster before deciding to act.

A new way forward for responsive government

Governments' responses to this summer's catastrophic bushfires reinforced that COAG was past its use-by date and no longer met the needs of citizens. When facing the COVID-19 outbreak, Prime Minister Scott Morrison recognised the need for a new approach. He rapidly initiated the National Cabinet – a leadership group, made up of the Prime Minister and Premiers and Chief Ministers – to develop a response to the health and economic crises presented by the COVID-19 pandemic. Because of the distribution of powers amongst the Commonwealth and the states, no one level of government was able to provide an adequate response. Collective decision-making was necessary, with each jurisdiction then giving legal effect to these decisions within the scope of its own powers and with variations to accommodate its own particular circumstances.

With clarity of purpose, the National Cabinet has seen the Prime Minister and state first ministers working together effectively to formulate a whole-of-government response in social security, healthcare and a range of essential services.[ix] This decision-making process bears many hallmarks of cooperative federalism advocated by Hawke: governments have taken a coordinated approach to issues of mutual concern, national frameworks have been established but left to states to implement based on their local needs,[x] and oversight has been established to monitor and scrutinise the decisions of government.[xi]

The success of the National Cabinet has resulted in all first ministers agreeing to its continuation, the cessation of the COAG model, and the formation of a *National Federation Reform Council* of Commonwealth, state and local governments. The National Cabinet will in the future meet monthly in support of a job creation agenda and sit at the centre of the National Federation

[8] The Royal Commission into National Natural Disaster Arrangements; Violence Abuse Neglect and Exploitation of People with Disability; Aged Care Quality and Safety; Institutional Responses to Child Sexual Abuse.

Reform Council, which will meet annually to discuss priority national federation issues.[xii] Alongside this, Ministerial Forums and Regulatory Councils will be consolidated and the Council on Federal Financial Relations (CFFR), which includes state and Commonwealth Treasurers, will take responsibility for funding agreements.

While the prospects of collaborative leadership via the vehicle of National Cabinet may fare better, without embedding the characteristics of its success, the end of the crisis may eliminate its unifying purpose. The transition must be strategically managed to broaden and deepen the virtues of National Cabinet to longer-term structural reform of how the Commonwealth and states manage the day-to-day business of governments.[9] Key to continued success will be a commitment to the following:

→ **1. The establishment of the National Cabinet as an inter-governmental body of equals with an independent national Secretariat to support governance and administrative processes.**

Currently, the National Cabinet has been established as the 'Cabinet Office Policy Committee' of the Commonwealth Cabinet. This is a committee of which only the Prime Minister is a permanent member. According to the Commonwealth's Cabinet Handbook, this committee derives its power from the Commonwealth Cabinet, and the Commonwealth Cabinet retains ultimate power over its decisions and may alter those decisions. The Cabinet Handbook also says that the Prime Minister is responsible for the membership of the committee, regulates its arrangements, determines its agenda and when and where the meetings take place. The Commonwealth Cabinet Secretary is also given power to finalise the committee's agenda. Where a collective decision cannot be reached, the Cabinet Handbook says that the Prime Minister's view 'is authoritative'.

To reflect the founding principles of our federation, the National Cabinet should be constituted as a Cabinet of equals. Its governance and operations should reflect the coming together of equal and autonomous governments working on a co-operative basis. Its governance should be managed by a joint secretariat, with equal funding by, and representation of, the Commonwealth and states. The states should have full power to contribute to the agendas and agree upon the timing and holding of meetings. Working closely with the departments of first ministers, the secretariat should have a procedural and process role, together with an analytical capacity to provide agreed factual information to inform discussion.

[9] At the Commonwealth level, the Charter of Budget Honesty Act 1998 (Cth) requires the Treasurer to publish an Intergenerational Report every five years. New South Wales has also produced an Intergenerational report. There would be greater utility in having a report that draws upon detailed information provided by all jurisdictions in Australia. This would give a more complete picture of the nation's finances that takes into account the interconnected funding and expenditure arrangements of both levels of government.

2. The creation of a common evidence base, founded on transparency and data sharing, to inform decision making.

Under COAG arrangements, the lack of a national evidence base to inform government decision making made it difficult to determine how, in a coordinated way, to maintain living standards, cope with crisis, and undertake reform across the nation. In contrast, the National Cabinet has been underpinned by a common evidence base presented by experts, which enables effective decision-making to occur. As a start, a Commonwealth-state Intergenerational Report[3] could be prepared, based upon evidence contributed from all to provide a common data set on medium and long-term pressures to service delivery, infrastructure, and state and Commonwealth budgets.[10] The Australian Digital and Data Council, which was a Ministerial Council under COAG, or its equivalent under the new model, could be given the task of ensuring that this work was undertaken in an objective, non-political manner, by a body with a degree of independence from government, operating with support from state chief data scientists and offices.[11]

3. Strengthened monitoring and assessment of performance of Commonwealth-state commitments, enabling citizens to see the results delivered and informing government decision making.

Stronger data sharing arrangements across governments will be essential to improving transparency around government activities and spending, and delivering better-informed government programs and services.

[10] A similar arrangement was in place for the 2015 *Reform of Federation* discussions, where Commonwealth and state governments put in place cooperative working arrangements to prepare a common fact pack for the First Ministers' Retreat at Victoria Barracks.

[11] See, for example, the NSW Data Analytics Centre, the South Australian Office for Data Analytics and the Victorian Centre for Data Insights.

Draft recommendations:

i. **Establish the National Cabinet as an inter-governmental body of equals with an independent national Secretariat to support governance and administrative processes.**

ii. **To support the continued operation of the National Cabinet, create a national evidence base, including a Commonwealth-state Intergenerational Report, to support shared priority setting.**

iii. **Strengthen monitoring and assessment of performance of Commonwealth-state commitments, enabling citizens to see the results delivered and informing government decision making.**

Funding agreements: why business as usual is not an option

In theory, funding agreements[12] can be an effective way to deal with the different revenue raising capacities across governments. In reality, they create a complex web of administration and major challenges for delivery of state infrastructure and services to citizens. At their worst, they impede the ability of states to manage their budgets, plan for their future, and spend funds in a way that maximises public value.

The federal financial landscape is characterised by a complex matrix of funding flows and a large catalogue of intergovernmental agreements. For example, the 2019–20 Commonwealth Budget contained more than 100 funding agreements nationally,[xiii] and for New South Wales, 24 National Partnerships and Project Agreements (totalling around $38 million in 2018-19) provided the State with less than $5 million each in funding.[xii] Some of these small payments support a critical ongoing service need and, as per the agreed principles of the Intergovernmental Agreement on Federal Financial Relations (IGAFFR), should roll into business as usual funding after a finite period. For example, the $1.7 million Family Advocacy and Support Services agreement supports families affected by family violence with matters before the family law courts; and the $4.85 million Expansion of the Breast Screen Australia Program agreement supports an increased level of breast screening services to women aged 70-74 years.

[12] Broadly, payments are linked to National Agreements for achieving national objectives in four key areas of state-service delivery: public hospitals, schooling, housing and homelessness, and skills and workforce development, and National Partnership and Project Agreements for the delivery of specific projects or policy initiatives, which complement the National Agreements.

The impact of the complex web of agreements is felt keenly by citizens and those on the frontline of service delivery. Citizens are frustrated by the duplication of services and the corresponding lack of related services resulting from narrowly directed funding. They feel confused about where to go or who to talk to, due to the divided governmental responsibility for services. No one seems to be accountable. Citizens can also suffer because of a lack of coordination across different providers. Many are dissatisfied with a 'one size fits all' approach, that doesn't provide them with the type of service they need in their community. In addition, those on the frontline of service delivery struggle with the uncertainty around whether funding will continue. They need to be able to plan and invest in resources and staff, but they can't do so without funding certainty. They are also frustrated by restrictions on taking the initiative to deliver services in a way that is best for the community. More stable arrangements with the flexibility to meet local needs are required to improve outcomes for citizens.

The Review acknowledges that the Commonwealth has worked with the states to develop a National Partnership for Streamlined Agreements, which seeks to provide a consolidated agreement framework for simple, low value and low risk projects. By housing provisions across agreements into one referable document, this is a step in the right direction to simplify the costs of administering funding agreements.

However, more needs to be done to improve the design of funding agreements in general. At present, they limit the scope for governments to innovate and design services to deliver the best outcomes for citizens. Some funding agreements include strict conditions on how money can be spent; are renewed in a piecemeal fashion to the detriment of long-term sustainable funding; and focus on the achievement of inputs and controls rather than mutually agreed outcomes. The amount of time public servants dedicate to supporting the drafting, negotiation, and associated reporting of milestones for each of these agreements is considerable. This wastes resources at both the Commonwealth and state levels and creates tension between governments[xiv] to the detriment of finding ways to collaborate to achieve the best outcome for citizens. (Table 1).

Table 1: Key issues with the design of Commonwealth funding agreements

Key issues	Example
Funding uncertainty: agreements are often renewed year-on-year rather than delivering long-term sustainable funding to states and frontline service providers where there is an ongoing need.	Dental health (a public healthcare service) is funded by the states and the Commonwealth through the National Healthcare Agreement and the *National Partnership Agreement on Public Dental Services* for Adults. A one-year extension to the agreement was only offered at late notice before its expiry.
Over-prescription: agreements prescribe 'how' services should be delivered, including milestones and strict penalties for non-achievement. This limits opportunities for governments to be flexible, add value and innovate as circumstances change and to meet outcomes valued by citizens.	The National Partnership for Universal Access to Early Childhood Education supports quality preschool programs for children in the year before full-time schooling. Commonwealth funding is designed to increase participation and consistency.[xvi] 70 per cent of funding to states is subject to performance indicators and strict thresholds for teacher quality, enrolment, and access to programs. Yet, meeting these performance indicators year-on-year lies outside of their control, due to, for example, workforce participation and changes in population projections.
Excessive negotiation and reporting: administrative demands mean the public sector spends a lot of time revisiting agreements and reporting against their requirements.	In the Vocational Education and Training sector, the negotiating process for the National Partnership for the Skilling Australians Fund was ad-hoc, had no timetable to reach agreement, and took 13 months to negotiate and resolve the signing of a 4-year agreement.
Misaligned objectives: the states and the Commonwealth share many challenges and opportunities for government service delivery, yet, policy is often developed without a shared view of the reform vision, the outcomes to be achieved, and how to keep governments accountable.	Australia's management of its infrastructure pipeline is one of many examples where policy challenges would have been better addressed by a joint solution developed at the beginning of the process. Given the record spend on infrastructure, a lack of national coordination has created skills shortages and price bubbles, creating risks for project completion.

Impact

Citizens face lengthy wait times for treatment, sometimes for twelve months or more.[xvi] Funding uncertainty impedes longer term planning which can lead to worse outcomes for the public. For example, providers don't hire permanent staff or invest in necessary equipment because there is no certainty that they can continue to operate.

Without funding certainty for public dental care, for instance, NSW Health may choose to release skilled staff and delay investments in necessary equipment, in turn, leading to longer wait times for patients requiring dental services.

Prescriptive conditions and performance benchmarks impede the ability of states to work with the sector and commit to long-term funding models. For early childhood community providers, funding uncertainty impacts upon their ability to plan, engage staff, and deliver services to parents and carers.

The number, complexity and prescriptiveness of agreements requires public servants to focus a considerable amount of time on administrative tasks, and means governments are designing, funding, and delivering services based on their own requirements instead of those of the community.[xvii]

Current major projects could overrun their budgets. This is already occurring for several major projects, including NSW's Sydney Metro City & Southwest and Victoria's Melbourne Metro.[xviii] Better governance and oversight of coordination and implementation of the infrastructure pipeline could drive savings.

The COVID-19 pandemic has shown that governments can work together cooperatively and quickly to achieve outcomes for citizens. Negotiations on the 2020-25 National Health Reform Agreement – the largest funding agreement nationally that outlines governance arrangements, financing, and measures to deliver structural reform of Australia's health system – were prolonged, having been delayed in 2018 and 2019 without resolution of issues that states deemed critical to their hospital systems. The difficulty of these negotiations speaks to the lack of shared purpose and responsibility for the national health system as whole. Coupled with the imbalance of performance reporting expectations - the states are held accountable to the Commonwealth for their performance, but the Commonwealth does not answer to the states – it is difficult for governments to track the health outcomes that ultimately matter to people across the entire health system and agree on changes required to deliver a better system. By contrast, the National Partnership agreement on the COVID-19 Response, took a matter of days to negotiate and agree.

Compared with the day-to-day situation, when facing the COVID-19 outbreak, there was a clear call for leadership across governments to deal with the issues being faced on the ground. There was an overwhelming sense of purpose to come together quickly, partner, and take action across all levels of government. At the height of the crisis, National Cabinet met multiple times a week, issues were addressed as they emerged, and risks were mitigated by bringing together technical expertise and adequate resources.[xix] This shows what can be done when necessity requires it. But we need to sustain it after the urgency of the pandemic has died away to ensure there is a continued focus on achieving better outcomes.

A new approach is required

In 2008, amidst the Global Financial Crisis, governments took an unprecedented step towards cooperative federalism by establishing the IGAFFR.[xx] Many saw this as a new era of cooperative federalism, and the largest reform of Commonwealth-State relations since the introduction of the GST.

The IGAFFR provided a framework for collaboration and tied governments to a common cause to deliver better services to the community. It rationalised payments made to the states,[13] provided a clear specification of the roles and responsibilities for each government, and, at its heart, recognised that intergovernmental cooperation is central to improving outcomes for citizens.[xv]

[13] The framework reduced the number of agreements from 90 to six core National Agreements and around 16 National Partnership Agreements [xiii]

The agreement, however, was not enduring. The number of funding agreements ballooned quickly as governments sought to roll-out a major stimulus package, micro reforms, and deliver on the COAG reform agenda.[14] By the end of 2010 for example, the catalogue of documents relating to intergovernmental agreements had rapidly increased to over 300.[xxii] With this shift, funding agreements again included strong reporting requirements, output benchmarks, and layers of oversight to ensure the economic recovery was not, or perceived not to be, obstructed by the states. [xx]

This tells us that many of the challenges with our Commonwealth-state funding system are not easily overcome solely with the implementation of a new framework. Institutional and cultural change is also needed. To this end, the Review welcomes recent changes to intergovernmental process to allocate responsibility for funding agreements to Commonwealth and state treasurers (CFFR). In support of this, we will need to deal with the underlying problem of vertical fiscal imbalance and the lack of clarity around roles and responsibilities between governments. Most importantly, there needs to be an end to the attitude that revenue raised by Commonwealth taxes is the Commonwealth's own money which should be used for its own benefit. It is 'public money', not the money of any government,[xxiii] and it must be used for the public benefit, as intended by the framers of the Constitution

Clearer roles and responsibilities would resolve confusion and reduce waste

Federations work best with defined roles and responsibilities, enabling clear public accountability for outcomes.[xxiv] However, in Australia there is confusion over which government is 'responsible' (accountable to the public) for the delivery of services to citizens and the 'role' that each government plays (how they contribute) for the delivery of a service.

Australia is falling short of best practice. It has crept towards centralism, with the Commonwealth taking on responsibilities which fall outside those allocated to it by the Constitution. The federation's vertical fiscal imbalance has provided the opportunity for the Commonwealth to step into areas outside its responsibility through the use of conditions on grant funding. The amount of money involved is considerable, as is the number and range of programs that come under this arrangement.[xxv]

The recent scrutiny over Commonwealth sports grants and grants to build car parks has exposed prime examples of cases where a lower level of government would better align

[14] As part of the Economic Security Strategy, the Nation Building and Jobs Plan, and the National Partnership Agreement on Youth Attainment and Transitions.

investments with localised need. If funding for local sporting and community facilities were instead provided to the states to apply in conjunction with local governments in a manner that meets local community needs, there would be better coordination of facilities and services, with better outcomes for local communities. There is no sense in the Commonwealth and the states providing different grants to community organisations, with different conditions and accountability regimes. This only increases the administrative burdens on community organisations, duplicates government costs in administering the grants, and results in poor town planning and an inequitable distribution of community resources.

The impact of unclear roles and responsibilities is seen clearly in the health sector where Commonwealth, state and local governments are funders, policy developers, regulators and service deliverers.[xxvi] For issues such as the growing rate of chronic health conditions, the split of Commonwealth responsibility for primary care and state responsibility for public hospital care means that there are limited incentives for either party to invest upfront in prevention and early intervention. As a result, too many people are not treated until acute care is required. Another example is in the education sector, where states have been responsible for schooling since federation. However, despite not operating any schools, or employing any teachers, the Commonwealth influences state policy through its capacity to provide funding.[xxvii]

Despite the success of National Cabinet's response to the COVID-19 pandemic, there have been instances where the historical confusion over roles and responsibilities has had an impact upon its operation. An example is the widespread confusion over the closure of schools as part of the national COVID-19 response. With both levels of government seeking to lead on this issue, it was difficult for the public to know whose advice to follow and what action to take. It was not resolved until the Prime Minister made clear to the public that they should look to the states to make decisions about the opening and closure of schools.

There is a clear case for re-aligning government responsibilities in a way that better recognises the service delivery responsibilities of the states and the role of the Commonwealth in addressing matters in the national interest at the intergovernmental level, such as supporting equity of outcomes across the federation. A transparent framework, drawing on international best practice, could support such a re-alignment. The OECD, for example, is progressing the development of a framework for the effective assignment of roles and responsibilities in a multi-level government system (Box 1).

Box 1: Assignment of roles and responsibilities

Based on an assessment of best practice across OECD member countries Allain-Dupré (2018) considers there to be ten guiding principles for the effective assignment of roles and responsibilities with multi-level government:[xxviii]

1) **Clearly assign sector responsibilities:** to different levels of government for accountability, monitoring and effective expenditure.
2) **Clarify the functions of different government levels:** including regulation, financing, and delivery and implementation, avoiding grey areas.
3) **Ensure balance in the way different responsibilities and functions are decentralised** as this is conducive to growth.
4) **Align subnational responsibilities and revenues and enhance subnational capacity to manage their resources** by aligning the control of financial resources, particularly own-source revenues, and spending responsibility.
5) **Actively support capacity building for subnational governments with resources from the centre.** More responsibilities at the state level need to be complemented with human resources capable of managing them.
6) **Build adequate co-ordination mechanisms across levels of government.** Creating a culture of co-operation and regular communication is crucial to effective multilevel governance and long-term reform success.
7) **Support cross-jurisdictional co-operation through specific incentives.** Co-ordination supports efficiency through economies of scale and can be supported through financial incentives or governance arrangements.
8) **Allow for pilots and asymmetric arrangements.** Ensure flexibility in implementation, allowing for pilot experiences and learning-by-doing.
9) **Focus on the complementary reforms.** Effective decentralisation requires complementary reforms in the governance of land use, citizen participation, and public service delivery and governance.
10) **Strengthen monitoring systems and data collection** to monitor the effectiveness of public service delivery and investments.

Tightening the use of the existing framework which governs the financial relationship between the Commonwealth and states.

The IGAFFR provides a clear foundation for collaboration between governments. It gives states flexibility to direct resources to areas where they would produce the best results and to determine the way services were to be delivered to citizens. It also introduced stronger reporting arrangements for greater accountability.[xxiii] However, the IGAFFR's staying power has been critiqued, with calls for a more concerted approach by governments to hold themselves accountable.[xxix]

Re-invigorating the use of the IGAFFR to govern the financial relationship between governments is a worthwhile pursuit. But to make the approach more effective, processes need to be established to:

- monitor application of the framework, identifying departures and remedial action;
- retain the flexibility and efficiency required for service delivery;[xxii] and
- gather data to assess national performance.[xxii]

An alternative, aggregated model of funding

Block grants have been proposed to broad band areas of government spending as an alternative to individual tied grants across service delivery areas.

An option proposed in the Garnaut-Fitzgerald review of Commonwealth-state funding[xxx] is to roll all funding agreements into 'national programs' – the states would have clear authority over health and aged-care, and education and training,[15] while the Commonwealth would have primary control over services provided to support indigenous community development.[xxix] This option would include a realignment of roles and responsibilities across governments. Under this model, the Commonwealth and states would jointly develop and agree outcomes and performance measures, and funding would be allocated primarily according to demographic factors.

In addition to administrative savings, this approach would leave the states with the autonomy to set their own priorities based on what their citizens expect and need the most from government services. It would also allow testing and experimentation with their own programs in a way that is traditionally associated with federalism.[xxiv]

[15] Agreements that cover interjurisdictional programs such as national roads would not be affected.

The path forward

Solutions to reform funding agreements rely on political will. With blurred roles and responsibilities, ineffective accountability mechanisms, prescriptive conditions, ineffective governance frameworks, and a lack of shared vision, it is clear that our current approach to funding agreements is inadequate. To be able to deliver and sustain quality service delivery over the medium to long term requires something more than the status quo.[xxxi]

Draft recommendation:

Review and reform all Commonwealth-State grants to:

- Reduce administrative burdens and shift the basis of funding towards outcomes rather than inputs and outputs;
- Reassess roles and responsibilities in areas in which they are notcompletely intertwined, so that citizens know where to go and who is responsible for particular services;
- Ensure that programs that need long-term stable funding are not subject to short-term grants with unreliable and administratively burdensome renewal processes, by replacing them with untied funding from an ongoing source (such as personal income tax sharing, or GST reform).

Executive Summary | Evolving the Federation | The GST matters for our collective future | A broad-based land tax | Commonwealth-state funding | Insurance taxes | Payroll taxes | Crossroads for road funding

3 The GST matters for our collective future

The introduction of the GST, nearly 20 years to the day, was Australia's last major tax reform. A reform 30 years in the making[xxxii] saw governments take collective action to replace several damaging taxes with a simpler, more transparent, source of funding to equitably meet the needs of Australians. By putting in place a funding stream that was predictable, caused minimal economic damage, and grew with the economy (that is, a 'growth tax'), the GST was meant to improve the way we pay for the state services and infrastructure that Australians need.[xxxiii]

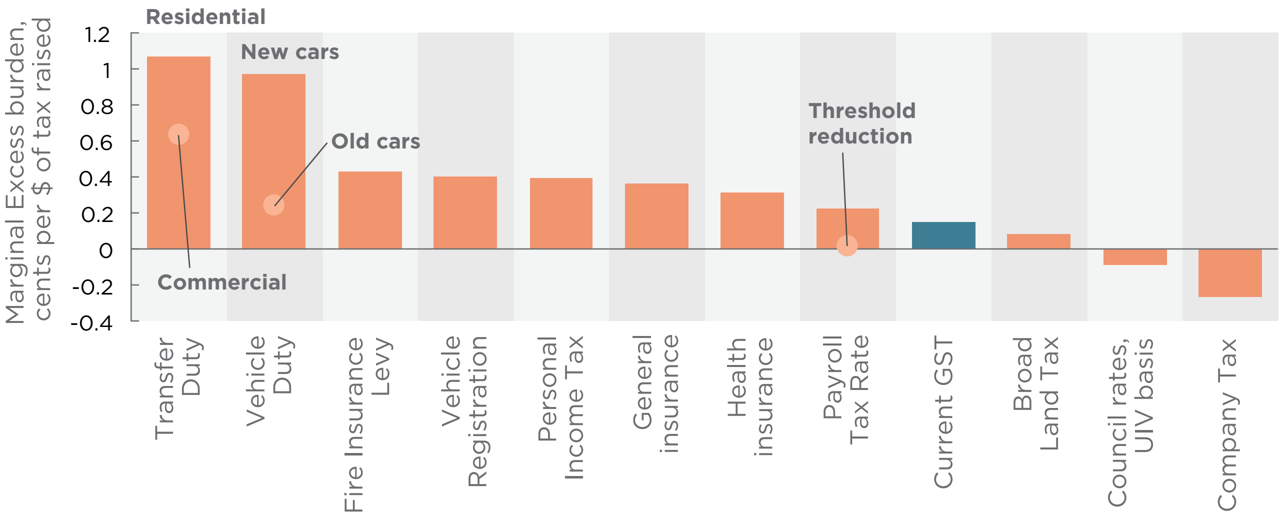
The GST is the largest revenue source for the states. Having raised $66.4 billion in 2018-19, it provided 22 per cent of revenue in New South Wales (similar to the combined value of the two most significant state taxes - transfer duty and payroll) and between 10 and 45 per cent in other states.

It is also one of the nation's most efficient taxes (Figure 2). The economic cost, in terms of value destroyed for raising a dollar of revenue, has been estimated at between eight and 24 cents, compared to 34[xxxiv] cents and $1.07[xxxv] for transfer duties. While the allocation of GST under Australia's system of Horizontal Fiscal Equalisation (HFE) is contentious, sharing Commonwealth taxes with the states as untied revenue benefits the nation by reducing duplication of government and strengthening the autonomy of state governments and their ability to tailor policy and delivery to local needs.[xxviii]

Yet, while the GST is one of the 'better' taxes in the tool kit, there are major risks to its resilience. It has not been the growth tax that was intended, with revenue as a share of nominal GDP and household consumption well below the levels seen in in the mid-2000s.[16] While temporary changes in household savings are a driving factor, the design of the GST means the base – household spending that is subject to GST – is eroding. According to the Commonwealth Parliamentary Budget Office, escalating costs of several GST exempt services, such as health and education, have seen the share of household spending subject to GST fall from 60.8 per cent in 2001-02, to 55.4 per cent in 2018-19.[xxvi]

16 From 2001-02 to 2009-10 GST revenues available to states made up 3.6 per cent of GDP and 6.3 per cent of household spending. From 2010-11 to 2018-19, this fell to 3.3 and 5.9 per cent respectively. Source: ABS Catalogue 5206.0 and Commonwealth Grants Commission

Figure 2: The economic cost (marginal excess burden) of different Australian taxes



Source: Nassios et al. (2019)[xxxv]
Note: Marginal excess burden refers to the economic value destroyed for every additional dollar raised, resulting from individuals and businesses making less than ideal choices. The negative marginal excess burden on company taxation and council rates reflects an increase in national income associated with taxation of foreign owned capital and land holdings respectively.

In recent years, measures have been made to shore up the base to technological change and the rise of e-commerce, through the extension of the GST to imported services and digital products in 2017, and low value imported goods in 2018. However, beyond the current crisis, there remains a real risk that the base will continue to erode as the population ages, utilisation of health services increases and more expensive health technology is adopted, and service expectations rise. Such an outcome would compromise the ability of state governments to fund the recovery and rebuild, leading to hard choices in the future around cutting services, increasing debt, or raising taxes. For the Commonwealth, weaker GST flowing to the states could increase demands for tied grant funding for health, education, and other frontline services delivered by the states.

Yet the magnitude of this risk does not appear to be well understood or documented. The Commonwealth and NSW Intergenerational Reports both assume that GST revenues will grow in line with nominal GDP out to the middle of the century. This has not been true in the past and may not hold for the future. The consequences, as flagged in the Commonwealth PBO's most recent National Fiscal Outlook, are significant for the sustainability of state budgets.[xxxvii] Stronger evidence is required to gain clarity over the scale of future GST erosion and inform the appropriate policy response. State Treasuries should develop projections that consider the magnitude and timing of further erosion of the GST base. These projections could be part of a Commonwealth-state Intergenerational report (see Chapter 2 – Evolving the Federation).

Draft recommendation:

State Treasuries should develop projections of national GST revenues that consider the magnitude and timing of further erosion of the base to inform the appropriate policy response.

The role of the GST in the future tax mix

The GST plays a key role in supporting a strong federation.[17] It is the largest source of state funding, has a relatively low economic cost and supports more accountable and flexible state government. However, its design is the source of eroding revenues, and fosters a reliance on more costly taxes and administratively costly funding agreements. As Australian governments look beyond the COVID-19 crisis, they have an opportunity to re-assess whether the design of the GST is consistent with a tax mix and federal financial relations system that will support Australia's economic and fiscal recovery.

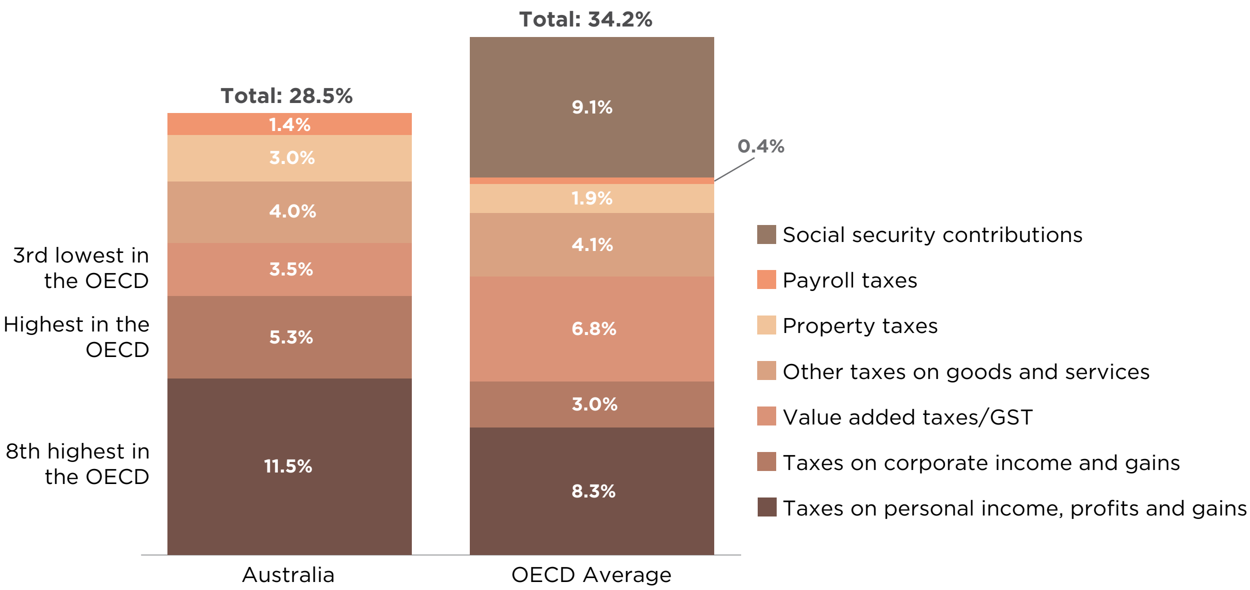
There have been numerous calls for an expansion of the GST rate or base over the last decade, both of which are well below the OECD average. The 2011 Lambert Tax Review (the Lambert Review)[xxxvii] proposed an expansion of the GST base to include health, education and fresh food; the 2012 Greiner, Brumby and Carter review of GST distributions called for the GST debate to be 'unfrozen',[xxxiii] and the 2014 National Commission of Audit saw merit in using the GST to abolish inefficient taxes.[xxii]

Amending the GST base and/or rate could address the erosion of revenues, support the medium- to long- term economic and fiscal recovery, and ensure that we have the services and resources to respond effectively to future crises. It also provides an avenue to reduce Commonwealth income taxes, abolish more harmful state taxes (such as insurance taxes) and streamline our federal financial relations system, setting course for a stronger economic and fiscal recovery.

[17] See, for example, NSW Government,2018, Submission to the Senate Standing Committee on Economics, Provisions of the Treasury Laws Amendment (Making Sure Every State and Territory Gets their Fair Share of GST) Bill 2018.

Australia's international position suggests Australia has the room – the GST makes up around 3.5 per cent of GDP, the second lowest in the OECD. Its contribution leaves more damaging taxes on income, capital and property transactions to do the heavy lifting (Figure 3). The GST's narrow coverage means that prior to the COVID-19 pandemic, the Commonwealth predicted that $27.4 billion of revenue will be foregone in 2019-20 due to exemptions on the purchases of fresh food ($7.6 billion),[18] health ($7.0 billion), education ($4.9 billion), water, sewerage and drainage ($1.1 billion) and other goods and services.[xxxviii]

Figure 3: Australian taxes as percentage of GDP compared to the OECD average



Notes: 2017 Data. While Australia's tax to GDP ratio is below the OECD average, this is partly due to the treatment of Australia's compulsory superannuation payments, which are paid directly into private accounts and therefore do not meet the definition of a tax, unlike the social security contributions levied in most countries.
Source: OECD Revenue Statistics 2019

Proposals for significant GST reform are yet to gain traction. Amendments to the rate or base need unanimous support from the states, endorsement by the Commonwealth, and passage through both houses of Commonwealth Parliament.[xxxix] Further, GST increases, particularly when combined with cuts to income tax, are widely considered to be inequitable. This is because the GST increases the cost of household goods and services, which lower-income households spend more of their income than wealthier ones.[19] Any expansion in the GST base or rate will need to involve some

18 The term 'fresh food' is used to describe food that is not subject to GST. The taxation treatment of food depends on a range of factors, including: where it is consumed; what temperature the food is at; whether the food is seen to be a close substitute for on-premise catering; and legacy issues to do with the taxation treatment that existed under the wholesale sales tax prior to the introduction of the GST.

19 The ABS household expenditure survey suggests that households in the lowest disposable income quintile (equivalised) spend on average 131 per cent of their disposable income, whereas those in the highest quintile spend 68 per cent of their income (Source: ABS Catalogue 6530.0). These statistics should, however, be treated with caution as it is unlikely that households could on average sustainably spend more than their incomes in perpetuity.

portion of the revenue being redirected towards lower-income to maintain fairness in the tax system. However, in determining whether government activities are equitable overall, it will also be important to look at the entirety of the tax and expenditure system, including universal services such as health and schooling, and targeted services such as social housing.

In addition to equity considerations, the question of whether to amend the base or rate requires consideration and investigation of several issues and trade-offs.

Broadening the base to cover fresh food, healthcare, education, childcare and water, sewage and drainage would better resolve a number of the issues with the existing GST, including:[20]

- addressing the issue of base erosion, as changes in consumer demand would have little impact on GST revenues (that is, the GST would be a growth tax);
- stabilising revenues as more non-discretionary spending, which is typically less volatile, would be subject to GST; and
- simplifying administration and compliance as businesses would have to deal with fewer exemptions, such as the complexities of defining 'fresh food', under the invoice-credit system of GST administration.

However, there are a number of challenges with base broadening:

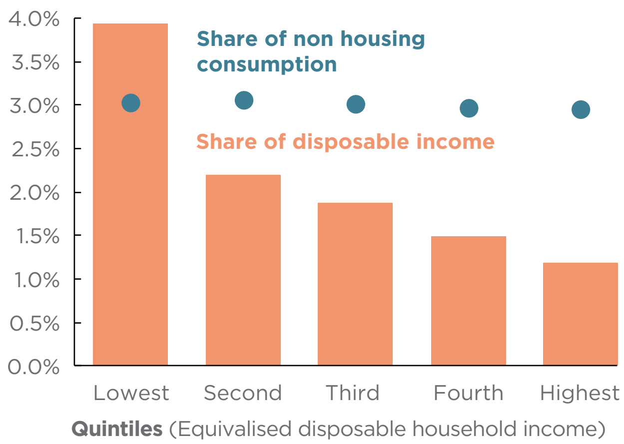
- **Education and health** spending are largely public-funded (state and Commonwealth governments contributed more than four fifths of school funding in 2018[xl] and around two-thirds of health spending in 2017-18).[xli] Applying GST to public services would result in a net neutral budget impact, plus costs of administration borne by the states. There may also be calls to subsidise private services to maintain competitive neutrality with public providers, and strong objection to higher out-of-pocket expenses.
- GST exemptions **for fresh food** are sometimes considered to provide public health benefits by reducing its relative cost, thereby encouraging consumption. However, the tax treatment of food depends on factors other than its health qualities, including, for example, the place of consumption.[21] There is also ongoing debate over whether GST exemptions are as effective as applying targeted, so called, 'sin taxes' on consumption that generates external costs to society, such as high-sugar products.[xlii]

20 The other key parts of consumption that are not subject to GST include financial services and residential housing, which are 'input-taxed'. Taxing the full value of this consumption is challenging as it is difficult to determine the implicit fee or margin within the service on which to calculate the tax.

21 For example, a salad consumed in a restaurant is subject to GST, but bacon purchased from a supermarket and consumed at home is GST-free.

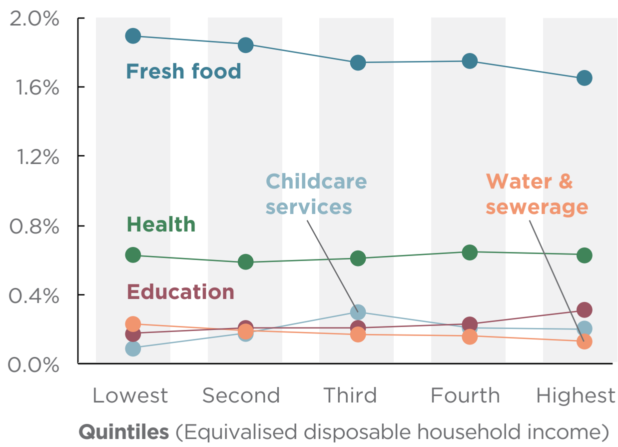
- The **distributional consequences** of a broad base or a higher rate are likely to be similar, but not for all types of spending categories. The Commonwealth's most recent tax expenditure analysis shows that the proportion of spending on GST-exempt goods and services is similar for lower-income and higher income households (Figure 4).[22] However, broadening the base to fresh food would, all else being equal, be less equitable than a higher rate, as fresh food makes up a higher share of spending for lower income households than wealthier ones. The opposite, albeit to a lesser magnitude, is true for education and childcare services (Figure 5). Notwithstanding, a more direct and effective way to sustain distributional equity is to use additional GST revenues to fund increases in social security rates or lower income tax rate.

Figure 4: Value of total GST exemptions as a share of household income and consumptions (ex. housing), 2015-16



Source: Australian Treasury, 2019 Tax Benchmarks and Variations Statement

Figure 5: Value of GST exempt categories as a share of household consumption (ex. housing), 2015-16



Source: Australian Treasury, 2019 Tax Benchmarks and Variations Statement

[22] While there would inevitably be some behavioural change with increasing the rate, spending of GST exempt goods and services (particularly fresh food, health and education) is not affected much by their price relative to other goods and services. See Daley et. al (2015)

A credible reform of the GST base and rate will require compensation for low-income households

A credible reform of the GST base or rate will require some of the additional revenue to be offset through higher social security payments or lower income tax rates so that those on low incomes do not unfairly bear the burden of reform.

When the GST was introduced, households across the income spectrum were compensated through tax cuts and transfer payments, over and above the additional tax they were to pay, by around 1 per cent of GDP. At the time, however, the economy was growing at around 5 per cent, the Commonwealth had its largest budget surplus in almost three decades, and net debt as a share of GDP was less than half of what was forecast in 2019-20 (prior to the Covid-19 pandemic).[xviii]

The challenging economic environment we find ourselves in requires a different approach. It highlights the importance of ensuring that changes to the GST are part of a broader package that improves the efficiency of the tax mix and streamlines the federal financial relations system, including through a reduction in tied grants, to improve the value for money of taxpayer dollars. Investigations into reform options will also need to take into account the Commonwealth's COVID-19 policies in determining the appropriate compensation package.[23]

The GST flows to the states, but the Commonwealth must be at the table

The Review acknowledges the practical challenges in gaining unanimous agreement by state governments on GST reform. There are valid, albeit surmountable, concerns over the distributional impacts and the fairest way to fund the future. However, doing nothing will not deliver more sustainable revenues to fund future services and infrastructure and restore state governments' capacity to respond to future crises.

The GST is part of an interconnected tax and federal funding system and reform provides an opportunity to improve both. A consultative and collaborative approach is required with both other states and the Commonwealth.

---

23 The Commonwealth's support package included higher payments and expanded eligibility for income support, and one-off payments to concession card holders.

A practical way forward would be for states to first investigate and agree an acceptable package of options to amend the GST and base and/or rate. To maintain equity in the tax system and minimise the tax burden overall, the package should re-direct some of the additional revenue to low-income household through higher social security payments and income tax cuts, and scale back the complex system of tied grants to the states.

In addition to the GST, the Review acknowledges that a number of stakeholders have raised the idea of a tax on business cash flow as part of a Commonwealth-state tax reform package. The feasibility and benefits of this option should be subject to further investigation.

Draft recommendation:

State Governments, in consultation with the Commonwealth, should assess and agree options for lifting the GST rate and/or expanding the base over the medium to longer term to offset erosion and move away from more harmful Commonwealth and state taxes. Some of the revenue gained should be transferred to lower-income household to maintain equity.

4 A broad-based land tax is more efficient and equitable than transfer duty

Since the last major cycle of tax reform two decades ago, property markets have boomed and transfer duty (stamp duty on conveyances) has assumed a new order of importance in state budgets. The NSW Government raised around $7 billion, or 24 per cent, of annual tax revenue from transfer duty in 2018-19, making it the state's second largest source of tax revenue. Only Victoria raises more as a share of state taxation.

The states have needed a growth tax – in two decades, the national population has grown by a staggering 6.5 million people, and GST revenues have not kept pace with spending needs (see Chapter 3: Why the resilience of the GST matters for our collective future).

But the volatility of revenue collections, alongside fast growth, has made it difficult for states to manage their budgets. At the height of the property market boom in 2017-18, New South Wales raised almost 28 per cent of taxation revenue from transfer duty – one third greater than a decade prior – before revenue dropped by 14 per cent the following year.[24] [xliv] [xlv] Change has been rapid and unpredictable: a $7.2 billion write-down of four-year forecast revenue in the 2018-19 NSW Budget, for instance, was followed by a $4 billion upwards revision in late 2019 as the market recovered (before the COVID-19 pandemic).

The burden of funding government services is not shared fairly

A discussion spanning close to two decades through a series of tax reviews has laid the groundwork for broad community understanding of the advantages of recurrent land value taxation over taxation of property transfers. These reviews have generally recommended abolition of transfer duty and replacement via a broad-based tax on land.[25]

24 The long-term pattern has been similar for other fast-growing states. States on average raise 22 per cent of tax revenue from transfer duty, down from a high of 26 per cent in the years from 2015 to 2018, but up from 16 per cent following the introduction of the GST and 19 per cent at the time of the Henry Review (ABS 5506.0 and 5512.0).

25 Major reviews include Harvey et al (2001), IPART (2008), the Henry Review (Commonwealth of Australia 2010), the Lambert review (NSW Treasury 2011), and the Productivity Commission's "Shifting the Dial" review (2017).

The case for this change is usually expressed in terms of the economic inefficiency of transfer duty and the efficiency of land tax, but there are important equity implications too. In the case of transfer duty, those who buy and sell property more often to pay more tax, compared to those who transact less frequently. It's effect is to shift the cost of infrastructure and essential services, like schools, hospitals and roads that everyone benefits from, onto a narrow section of the population who carry the burden simply because they decide to move house or sell a business more often.[26] Transactions are an arbitrary basis for taxation, and this way of distributing the tax burden is poorly justified on equity grounds. While a progressive scale means that wealthier property buyers generally pay higher duty, which supports vertical equity, this rationale only applies in the case of residential property.

There were 2.8 million properties in New South Wales in 2018-19, but less than 200,000 of their owners contributed to the funding of essential services via transfer duty. Only one in 20 carried the burden of paying for the schools, roads, hospitals and other services that gave all properties their value.

The Henry Review estimated that some 26 per cent of owner-occupiers have remained in the same property for at least 20 years. Most of these people have benefitted not only from the services provided by the state over that time but also from a once-in-a-generation land price windfall. In exchange for these gains, they have contributed very little towards essential services and critical infrastructure via property taxation. Others who have moved to find a job, to be closer to schools, or to match housing size to their family situation – including young buyers without the financial means or parental support to buy their 'once-and-forever' house early in life – have picked up the tab.[27] This approach just doesn't seem fair.

26 There is no consensus over who pays transfer duty in terms of economic incidence. Helm (2019) argues it is borne by the seller. Many analysts, including the Productivity Commission (2017), assume that it adds to housing prices. Freebairn (2017) argues on the basis of a simple model that a 50-50 incidence is possible.

27 Similarly, in the commercial sector, fast-growing businesses involved in frequent land transactions are likely to have borne a disproportionate share of taxation relative to established incumbents.

A tax on land would be fairer

A tax on land enacts a more equitable approach to funding government services, based on the principle of beneficiary pays. The value of land is a measure of the benefits accruing to particular locations from infrastructure, services, regulation, access to markets, amenity, culture and community. A tax on land is therefore like a generalised user charge for the benefits society at large provides the landowner, which is a principled way of funding public services.[xlvi]

Replacing transfer duties with a tax on land is unlikely to change property prices in the short run but may increase housing affordability in the long run. The increase in purchasing power of prospective buyers from abolishing transfer duty would be offset by the new annual land tax bills, which would be capitalised into property values. In the long run, a better allocation of the housing stock may lead to lower prices.[28] [xlvii] Abolishing transfer duty also removes some of the barriers to home ownership by lowering the deposit hurdle.[xlvii]

The efficiency case against transfer duty is well understood, albeit subject to counterarguments. Transfer duty drives a wedge between buying and selling prices, which discourages transactions, including some that might see property put to higher value uses. It therefore impacts citizens' freedom to move home throughout their lifetime and inhibits labour market matching and transfer of business assets, ultimately reducing the productivity with which land is used. Because it is based on improved land value rather than just land value, it also acts as a disincentive to capital investment.

For the residential sector, lower mobility may mean longer commutes and more congestion on roads and public transport, with persistent unemployment in some areas alongside labour shortages in others. It can discourage 'empty nesters' from down-sizing, which results in wasted housing space. It also encourages new housing space to be produced at higher costs via renovation rather than new construction.[xlix]

Other analysts have indicated that the real consequences for residential mobility may be somewhat over-stated: there is empirical evidence that down-sizing moves are not overly affected by tax,[29] [l] and that work relocations are not a common reason for buying a home, regardless of age.[li]

The efficiency case for a tax on land however is clearer and widely proven. Land is an immobile base and so a broad-based tax on land has no distortionary effect on how the land is used. In contrast to transfer duty, a new land tax would not penalise transfers or capital investment, and by prompting faster redevelopment of land, may also boost investment and housing supply.[lii]

---

28 Abelson (2016) estimates replacing transfer duty with a broad-based land tax could release a significant amount of under-utilised housing, increase the effective housing stock which would reduce house prices over a few years.
29 Of the residents surveyed by the authors only 10 per cent of those who were unhappy with their current housing arrangements cited tax as a reason for not moving..

Economic costs of transfer duty are significant

All taxes impose a cost on the economy in terms of a decrease in overall welfare. While a number of studies have attempted to estimate these costs, the task is inherently difficult and has produced varied estimates (Table 2). Regardless of the range of estimates, the cost to the economy from transfer duty is consistently higher than that of land tax and there remains a principled case for this reform based on the inequity of transfer duty and the equity and efficiency advantages of a land value tax replacement.

Table 2: Welfare loss from raising an additional dollar in residential transfer duty and land tax

	Residential transfer duty	Existing Land tax
Australia's Future Tax System Review (Henry Review) modelling[xxxiv]	34 cents	9 cents
Modelling commissioned by CPA[liii]	85 cents	9 cents
2015 Commonwealth Treasury tax review[liv]	72 cents	-10 cents[30]
ANU Tax and Transfer Policy Institute paper[lv]	87 cents	48 cents
Centre of Policy Studies working paper[xxxv]	107 cents	8 cents

30 The foreign ownership of land means that increasing a broad-based land tax results in a small income transfer to domestic residents, raising welfare which is reflected in the negative marginal excess burden figure.

Transfer duty is the wrong tax for rebuilding state governments' capability to deliver for citizens

In a discussion paper released in October 2019, the Review put the case to the community that New South Wales can no longer rely on traditional funding sources to meet long-term fiscal challenges. The Review asked for the public's feedback on how the tax system could work better for citizens and businesses, and improve the economy for future generations. Nearly half of all submissions raised transfer duty as an issue, and many endorsed the position put forward by prior reviews that it should be replaced by a broad-based tax on land.

The Australian Council for Social Services proposed replacing transfer duty with land tax to:

> *'...change investment behaviour (in this case to improve housing affordability) as much as to raise revenue and improve revenue stability'.*[lvi]

The Committee for Sydney considered that:

> *'...the most obvious solution lies in transitioning... towards a broad-based land tax, in order to reduce revenue volatility and reduce the disincentive for properties to trade'.*[lvii]

The St Vincent de Paul Society noted that:

> *'Land taxes also present an opportunity to capture a share of increased land values arising from government and community investment, and to return this value to community use'.*[lviii]

The Grattan Institute agreed that New South Wales should swap stamp duties for a broad-based property tax, noting that property taxes are the most efficient taxes available.[lix]

The economic shocks Australia has experienced since October 2019 have added a new dimension to the policy environment, with state governments now facing the twin challenges of economic and fiscal recovery from the COVID-19 pandemic.

Despite government support, many businesses will not survive the crisis, and some industries will be transformed irrevocably. Many individuals will lose their jobs and even their careers. The economic policy challenge is to provide immediate stimulus and support to minimise these losses, and then to establish accommodative policy settings to accelerate growth into the future.

Simply abolishing transfer duty is not the best tool for near-term stimulus. The potential revenue foregone could be spent in other ways with far greater direct impact on economic activity, such as rent relief, small business grants, fees and charges deferrals and accelerating shovel ready infrastructure projects.

However, it may play a part in a medium and longer-term recovery. Australia is likely to see significant economic restructuring, with themes of domestic resilience, diversification, reduced global integration, and new ways of working driving expansion of some sectors and contraction of others. These transformations will require reshaping of land-use, which can be facilitated by removing the additional costs of moving or transferring property.

In the future, states that free-up property transfers will support their residents to adapt by making it easier to move house in response to new job opportunities. States that make business relocation easier may also capture a larger share of new growth industries. There may also be early-mover advantages in recovery and restructuring for states prepared to reduce their reliance on transfer duty.

The funding challenge looms just beyond the crisis phase. To repay additional debt means facing up to the problem described in the discussion paper as the long run 'fiscal gap'. To avoid higher taxes, revenue sources must be as efficient as possible to remove the barriers to economic and productivity growth. The efficiency of state taxation is a critical hinge between the economic recovery and the fiscal recovery – attempting to repair fiscal capacity with economically damaging taxes will hold back progress on both goals.

A broad-based land tax is the best instrument for this task, and a transfer duty to land tax switch would establish the right settings for fiscal recovery and long-term growth. By committing to this now, states would provide lead time for design, consultation and implementation before the task of rebuilding budgets begins in earnest.

Why a tax on land is the right replacement

Some stakeholders have suggested that transfer duty should be replaced with a higher or broader GST.

The Review does not consider this strategy appropriate and agrees with the Henry Review and Australian Productivity Commission amongst others that a tax on land is the right replacement for transfer duty. States have a learned helplessness that involves seeking Commonwealth funding instead of making better use of their own efficient tax bases, such as land. The wide imbalance in revenue raising capacity between the states and the Commonwealth along with the current system of HFE has meant the states have acquired a learned helplessness and dependence on Commonwealth grants, rather than making better use of their own efficient tax bases, such as land. A switch from transfer duty to GST would exacerbate these issues. There are also distributional equity concerns with replacing a progressive transfer duty with a regressive GST, shifting too high a burden on low income households. While the Review agrees reform of the GST base and rate is merited in its own right, it should not be used as a replacement revenue source for transfer duty - states should replace one property tax with another. Crucially, this is a reform any state can enact alone.[31]

Recurrent property taxes, like council rates or a transfer duty replacement land tax, can be levied on several bases. A land value rather than capital improved value base is most efficient, since it avoids penalising capital investment. For New South Wales, it would also avoid the need to redesign the state's system of statutory valuations at great additional cost to taxpayers, which at present assess unimproved land values only (see Chapter 6: Insurance taxes – can we afford them?).

A land tax replacement also creates the possibility of a broader reform package. In Chapter 6 we discuss the possibility of replacing transfer duty, insurance duty and the state's Emergency Services Levy with a single tax on land. The NSW Government should actively investigate this broader reform package to take advantage of a once-in-a-generation opportunity to evolve the tax system.

Furthermore, a broad-based tax on land offers the opportunity to ensure equity in the tax system is retained over time. If personal income taxes, which have progressive rates, are put under pressure from population ageing, an increasing role of intangible assets and digitalisation of the economy, amongst other factors, the tax mix as a whole may become less equitable for those on

[31] Prosper Australia argued similarly in its submission to the Review: "There are numerous disadvantages to this [GST] proposal relative to states going it alone with a replacement land tax. One is distributional: it will result in windfall property price gains at the expense of any consumers not fully compensated through the income tax and transfer system. Another is that it would be significantly more difficult to implement, since it would require unanimous inter-governmental agreement, federal legislation, renegotiation of the GST-exempt boundary, and design of compensation for low-income households. Finally, it would further reduce states' autonomy over their revenue bases and accountability to their residents in relation to taxation".

lower incomes. A switch to a tax on land has the potential to improve the inefficiency of the tax system and the flexibility to make it fairer.

A transfer duty to land tax reform raises the question of what to do with existing land taxes. While the existing land tax is less efficient than it could be due to its many exemptions, the policy issues involved in reforming it are significantly different to those involved in replacing transfer duty. For one, transfer duty is levied on the property value or capital improved land value which includes the buildings on the land, whereas existing land tax is levied on the unimproved land value (land only). The existing land tax is effectively levied on commercial properties and investor-owned residential properties, while transfer duty is paid by anyone[32] who transfers property. While land tax is levied on landlords, some of it is passed on to tenants through higher rents. The progressive land tax rate schedule applies to each landowner's total land holdings, penalising large or institutional investments in residential property.

An ideal reform under the criteria of maximising efficiency and simplicity would involve the replacement of both transfer duty and existing land tax with a flat tax rate based on unimproved land value. However, flattening the progressive rate scale of existing land tax and transfer duty would involve significant redistributions of tax from large businesses and investors onto small businesses and owner-occupiers. Those with less valuable land assets would also pay more tax relative to the replaced taxes than those with larger land asset values due to the change in progressivity of the rate structure.

This reform would be the simplest and deliver the highest efficiency gains but would be politically challenging and raise significant vertical equity concerns. There are a number of alternative options that trade off the efficiency and simplicity of the above flat-rate option in exchange for smaller tax redistributions (see Table 3).

Table 3 describes design details of four types of reform options to replace existing unfair and inefficient state taxes with an approximately aggregate neutral property tax. The options differ in terms of a land or improved property base for the replacement tax; a flat or a progressive rate schedule for the replacement tax; and the same or different tax rates for owner-occupied, rental and commercial property. These options are ranked in terms of their effects on: efficiency; simplicity; and redistribution of the tax burden relative to the current taxes to be replaced. The four options have different combinations of efficiency, simplicity and redistribution properties. Hence, further exploration of details of a reform package is warranted.

32 With the exception of some first home buyers, who receive transfer duty exemptions based on the value of the property transferred.

Table 3: Options to replace existing inefficient property taxes

Options	**1. Differential rates by property category** Replace both transfer duty and existing land tax with a new land tax that has lower tax rates for owner-occupied and higher rates for rental and commercial property (reflecting higher turnover frequency and previous land tax obligations).	**2. Unimproved land base with a flat rate** Replace transfer duty and perhaps insurance duty and ESL with a new flat rate land tax. Existing narrow and progressive land tax paid by rental and commercial properties, is retained.
Benefits/costs	Some efficiency gains are lost by retaining the existing differential tax distribution between rental, commercial and owner-occupied properties.	Retains existing tax distribution across the three categories of land ownership but is somewhat more complicated with two tax regimes in place. Creates distortions where rental and commercial properties pay both new and old land taxes.
Efficiency	✓ (In between)	✓ (In between)
Simplicity	✓ (Best on offer)	✓ (Least attractive)
Minimise tax redistribution	✓ (Best on offer)	✓ (Best on offer)

Key: ✓ Best on offer ✓ In between ✓ Least attractive

3. Unimproved land base but progressive rate scale Replace transfer duty and existing land tax with a new land tax but a progressive rate scale.	**4. Improved property base** Replace transfer duty and land tax with a new land tax on capital-improved land values.
Some loss of efficiency and simplicity relative to a flat rate, but restores tax progressivity and vertical equity provided by the current progressive transfer duty and land tax rates being replaced.	Better aligns with current transfer duty tax base. However, this model creates distortions to building decisions and will impose additional operating costs for NSW and other states that do not currently value land according to capital improved value.
✓	✓
✓	✓
✓	✓

A fair and transparent approach is required for the way forward

A transfer duty replacement must be broad-based. Concessional rates and exemptions narrow the base, concentrating the burden unfairly on certain groups. This can be inequitable and create distortions, such as between land uses or between small and large firms, which reduces productivity. Exempting owner-occupiers from the existing land tax would remove around 60 per cent[lxi] of land from the tax base and penalise investors; particularly institutional investment in the types of rental property that would ordinarily benefit from economies of scale, such as low-cost rental housing.[lx]

In designing the new land tax, a balance must be struck between fairness, efficiency and revenue objectives while bearing in mind the fundamental purpose of reform – to establish as low as possible tax settings, which are sustainable and do not compromise the ability of states to fund future services and infrastructure.

Productivity-enhancing tax reform packages are often revenue-negative, but the scope for this in the present environment is limited. To reduce reliance on less efficient taxes in the context of the overall budget repair task any revenue loss must be carefully considered.

Transition design is critical. There are genuine issues of equity at stake, particularly in relation to landowners who have recently paid transfer duty and who will now face a broad-based land tax.[33] There could also be concerns from households whose properties have been held for extended periods of time and who will face a different future tax liability than previously expected under the old transfer duty regime. These property owners may have paid transfer duty many years ago (a significantly smaller amount than what is paid on average now given the rapid price growth over recent years) with the expectation of enjoying tax-free future tenure. Transitioning away from transfer duty to a broad-based land tax may be seen as a 'new tax' by these cohorts who will be asked to contribute a greater share of the cost of government services.

Governments will need to navigate the anchoring effect of the status quo. Transition design is paramount, but as discussed in Chapter 6, governments will not be able to design their way out of the fact that some properties bearing an unfairly small share of the tax burden at present, will see a change, and nor should governments try to. Where there are genuine affordability and cashflow issues, hardship and tax deferral provisions could be used to address them.

---

[33] From a technical perspective whether it is inequitable depends on the incidence of transfer duty. As noted elsewhere in the report, there is debate as to whether the incidence is on the purchaser or seller. If the incidence is not on the purchaser of the property, then the concern about double taxation is diminished.

Table 4 describes four different transition models originally proposed by the Henry Review[lxi] with various trade-offs inherent in all. Most significantly, governments will have to balance equity for existing owners against the revenue cost of providing land tax concessions and have access to thorough modelling of budget impacts and distributional effects.

Some additional features of the models described in Table 4 could have costs so significant that they undermine the fundamental aims of the reform, unless they were limited in availability and duration. This includes a voluntary opt-in option to accompany the switch on next sale model, exempting all existing property owners and allowing future buyers to choose their own tax regime. The option of deferring tax payments for landowners who are considered asset rich but income poor is preferred over blanket exemptions.[34] Governments must ensure they investigate these options and trade-offs fully before committing to specific approaches.

Draft recommendation:

As a more equitable and efficient approach to taxation, the NSW Government should replace transfer duty with a broad-based land tax. The transition should be managed with the support of detailed distributional and financial modelling and public communication and consultation, so that the transition is fair, efficient and minimises the amount of revenue foregone.

34 The Lambert Review discussed this in the case of council rates concessions, and tax deferral in the context of land tax has been examined by the Productivity Commission (2017) and by Helm (2019).

Table 4: Options to transition from transfer duty to a broad-based land tax

	SWITCH ON NEXT SALE **Transfer duty is abolished, and all properties become liable for the new land tax at their next sale. Existing properties remain exempt from new tax until sale.**	VOLUNTARY OPT-IN **At the time of property purchase, buyer has the option of paying transfer duty or the annual land tax. Property owners can also choose to opt-in to land tax.**
Pros/Cons	Maintains consistency in tax treatment for existing owners, who bought on the expectation of tax-free occupancy.	Gives property buyers and owners choice. No one is forced to pay land tax. Transition period may take decades, meaning inequities with the existing transfer duty regime will remain for some time.
Efficiency of tax	Large foregone efficiency gains from increased incentive to defer sale to avoid tax.	Large foregone efficiency gains. Benefits compared to a switch on sale model depend on rates of opt-in, particularly for existing property owners.
Impact on government revenue	Large and sustained revenue shortfall from exempting current owners and due to low rates of turnover (only around 5.5 per cent of properties are bought and sold each year).[i ii]	Large and sustained revenue shortfalls, which depend on rates of take up. Purchasers who transact regularly are more likely to opt-in, and vice versa, to minimise their tax bill.
Asset rich, income poor households & long held properties	Fully exempted and continued tax-free tenure until sale	Do not pay land tax unless they choose to.
Treatment of recent purchasers	No double tax as they are exempted until next sale	Do not pay land tax unless they choose to, based on an assessment of how a land tax would affect the future sale price of their property.
Future buyers potentially worse off (in reality or perceived)	Those about to buy a family home to occupy for a lifetime may feel worse off in that their expected future property tax liabilities exceed the duty they would have paid under the old system. May worry about unpredictability of future property tax liabilities relative to certainty of upfront transfer duty, either due to land value growth or future tax rates.	Minimal impacts as households are able to choose whether to pay land tax or transfer duty.

[i] Freebairn, *Reform options for state property taxes*, Melbourne Institute Policy Brief No. 2/17. 2017.

[ii] Daley, J and Coates, B, *Property Taxes*, Working Paper, Grattan Institute, Melbourne. 2015

CREDIT FOR PAID TRANSFER DUTY	GRADUAL PHASE IN/OUT (ACT MODEL)
Transfer duty is abolished, and all properties become liable for new property tax, but some or all current property owners are granted a credit to be used towards the new land tax liability.	**Transfer duty rates are gradually lowered while new land tax rates are increased over a period of years.**
Solves concern from recent purchasers that they may be double taxed and facilitates a more rapid transition than under the gradual phase in and switch on next sale model. Allows flexibility to support key groups (e.g. those in low value houses).	Allows early notice and a measured phase in period without any sudden jumps in new tax liabilities for existing and long-held property owners. Limited redistribution across frequent and infrequent property buyers and sellers. However, reform is progressed over many years, so the salience of the tax and the annual reminders of the changing tax rates continually ignites and prolongs any community opposition.
Since the credit applies to past decisions, the full efficiency benefits of the reform arise from day one, and this is a significant advantage over the switch on next sale and the gradual phase in options.	Turnover disincentive of transfer duty remains in place for many years, with associated efficiency cost
Revenue shortfall from cost of credit scheme which can be significant in early years.	Can be designed to be budget neutral by ensuring the revenue from transfer duty being phased out closely mirrors the profile of new land tax phased in.
Option of a tax deferral may be required for low income households.[xlvi]	Option of a tax deferral may be required for low income households
Receive credit for recently paid duty to put towards new land tax liability. Credit can be based on a sliding scale e.g. properties bought in year of reform would receive 100% of transfer duty paid in credit, those in the previous year would receive 80%, and so on.	Receive credit for recently paid duty to put towards new land tax liability. Credit can be based on a sliding scale e.g. properties bought in year of reform would receive 100% of transfer duty paid in credit, those in the previous year would receive 80% etc.
Those about to buy family home to occupy for a lifetime may feel worse off in that their expected future property tax liabilities exceed the duty they would have paid under the old system. May worry about unpredictability of future property tax liabilities relative to certainty of upfront transfer duty, either due to land value growth or future tax rates.	With slow phase in/out, buyers do not experience radically different tax treatments depending on whether their purchase precedes or follows the reform date.

Australia's federal funding system should not discourage state-led reform

While it is imperative for states to use the levers at their disposable to make their revenue sources fairer, more efficient and sustainable, it is also critical that Commonwealth funding does not inhibit their efforts.

This is particularly relevant for the allocation of GST revenue, which is based on the principle of HFE – that all states should have the financial capacity to provide a comparable standard of government services.

A criticism commonly made of the Commonwealth Grants Commission's (CGC) methodology for determining GST shares is that a state government could lose GST revenues when it undertakes productivity-enhancing reform of its tax base, even if that reform is in the national interest.

In 2018, the Australian Productivity Commission completed a review of HFE in in response to these concerns, finding that, under the CGC's formula, New South Wales could lose up to $1.3 billion of GST in a year if it unilaterally halved its transfer duty rates and replaced the revenues with a broad-based land tax. A key driver of this outcome is that higher property turnover – one of the potential benefits of the reform – would detract from a state's GST share, making New South Wales worse off financially as a result.

The Review acknowledges the illustrative nature of this modelling and the difficulty in reliably estimating the impact of transfer duty reform on a state's GST share, particularly without consideration of the design of the reform itself.

However, as the state with the largest economy and tax base, changes in NSW Government policies heavily influence the CGC's advice for allocating GST revenues. Further the Productivity Commission's Inquiry Report suggests that the issues with reform incentives will remain in the new system of HFE being implemented from 2021–22 to 2026–27.[35]

It was not the intention of this Review to revisit the findings of the Productivity Commission or the Commonwealth's response in regard to the objectives or model of our HFE system. The Review does not dispute the premise that Australians in every state should have access to a reasonable standard of government service

35 The forthcoming HFE arrangements will shift the objective from full to reasonable equalisation over the 6 years from 2021-22 to 2026-27. It seeks to achieve this through a model which provides all states with the fiscal capacity of at least the stronger of Victoria or New South Wales. This is equivalent to equalisation to the second-strongest state, a model which was found by the Productivity Commission to have little impact on reform incentives compared to the current model.

Nonetheless, it is equally important to reinvigorate the reform agenda and lift the national income in order to provide the tax revenue necessary to fund the ongoing provision of services and infrastructure.

To that end, the Review considers that assurance is required from the Commonwealth that states are not disadvantaged through the HFE system as a result of undertaking major productivity-enhancing tax reforms.

Without fundamentally reforming the model of fiscal equalisation in place, or giving rise to a system of ad-hoc carve-outs, a way forward could be to develop, in consultation with the states, an appropriate set of directions to the CGC's annual Terms of Reference for the assessment of the revenue raising capacity of each state, based on the key reforms identified. That is, the change should be within the HFE system, rather than through additional grants to be paid to the states.

To complement this, as discussed in Chapter 5, the states could be allocated a share of personal income tax revenue generated within the state in exchange for tied grants, where that revenue should be quarantined from the HFE process.

A number of stakeholders also suggested that the Commonwealth could provide incentives or transitional payments for state-based reforms, citing the competition payments made under the National Competition Policy in the 1990s and early 2000s as an example. While the Review supports the principle that federal funding should encourage rather than hinder state governments' reform efforts, it is acknowledged that this approach could be challenging given the current financial circumstances facing the Commonwealth.

Draft recommendation:

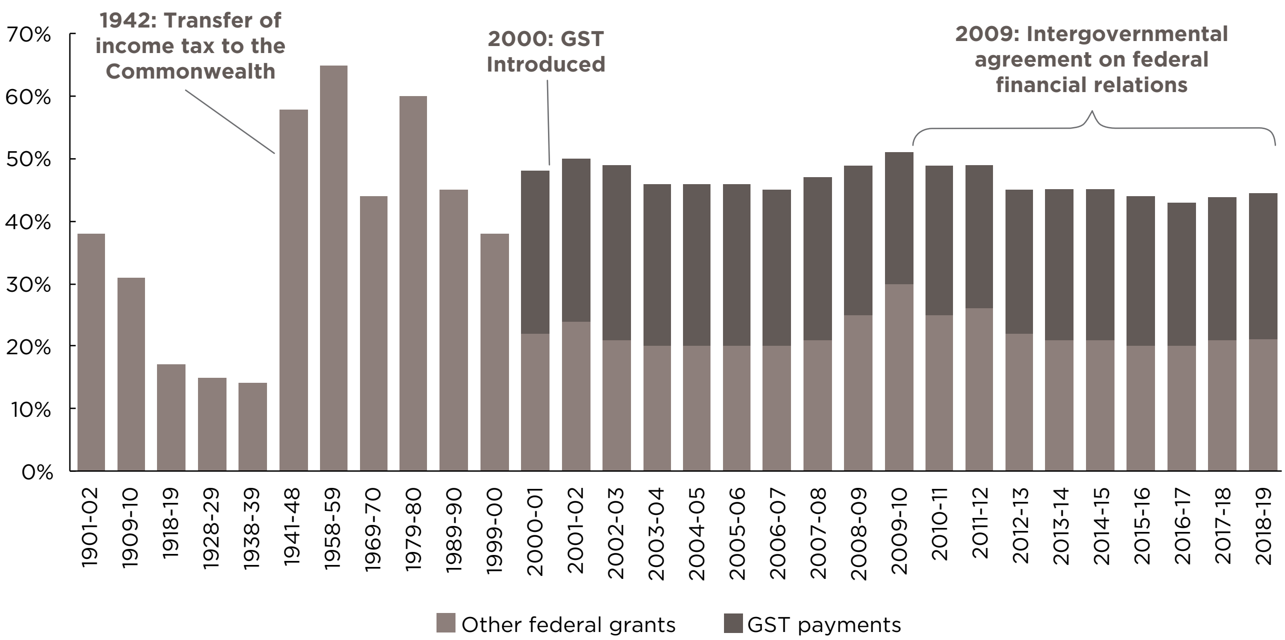
In consultation with other state governments, the NSW Government should seek assurance from the Commonwealth that it will not be disadvantaged through a lower GST share as a result of undertaking major productivity-enhancing tax reforms such as replacing transfer duty with a broad-based land tax.

5 The current Commonwealth-state funding model has become inefficient

For the first four decades of our federation, the states had far more financial independence than they have today. To a large extent this reflected that each state, along with the Commonwealth from 1915, administered its own income tax system, each with separate definitions and rates.[lxvi] While this made for a complex tax system, it meant the states received less than 15 per cent of their revenue from the Commonwealth Government during the 1920s and 1930s.[lxvii]

After several attempts at harmonisation, Commonwealth income tax rates were increased significantly to fund Australia's effort in the second World War, leaving little room for state income taxes. And, in 1942, the Commonwealth enacted a package of laws that effectively squeezed the states out of imposing income tax, in return for Commonwealth grants. While a necessary wartime

Figure 6: Share of state revenue from Commonwealth grants



Source: Koutsogeorgopulou and Tuske (2015)[lxviii], Commonwealth Final Budget Outcomes, 2015-16, 2016-17, 2017-18 and 2018-19. ABS Government Finance Statistics, Catalogue. No. 5512.0

measure, this permanently transformed Australia's tax and welfare system and for the states began an entrenched dependence on Commonwealth grants that remains some 78 years later (Figure 6).[36]

Having the Commonwealth solely responsible for the personal income tax system has practical benefits. A single, uniform system avoids issues of double taxation and interstate tax avoidance, is easier to administer and comply with, and supports national responsibilities for equitably distributing income and managing swings in the economic cycle.[lxix]

However, this approach has its costs. By significantly reducing the revenue raising capacity of the states, the services and infrastructure that states deliver are instead funded in-part through a system of tied grants that has become increasingly complex, based on inputs rather than outcomes, and bureaucratic (at present, New South Wales is party to around 50 Commonwealth funding agreements). Incentives for state governments to undertake productivity-enhancing reform are also limited since the revenue they receive is not linked with the revenue they generate from supporting employment and income growth.

There are better models available. An alternative often proposed is to replace the system of tied grants with direct access to a share of Commonwealth income tax revenues (personal income tax sharing). A swap of this kind was agreed to under the Fraser Government in 1976[lxx] (although a second stage, involving state-based income tax surcharges was opposed by the states),[lxxi] and alternative models were put on the table by the Hawke, Abbott and Turnbull Governments, along with South Australian Premier Jay Weatherill during the 2015 Reform of Federation discussions. The 2009 Henry Tax Review, 2011 Lambert State Tax Review, and 2014 National Commission of Audit all considered it a better way to provide money to the states.

There are multiple ways in which revenue sharing would better position our federation to support the economic and fiscal recovery (Table 5).

36 Like Australian states, Canadian provinces also ceased income taxation to fund the war effort, but then resumed again in 1957

Table 5: Key benefits of personal income tax sharing, by stakeholder

Commonwealth government	• Fewer funding agreements reduces the administrative burden associated with negotiating, administering and overseeing grants • Providing the states with stronger incentives to support wages and employment growth, and fewer incentives to ask for Commonwealth hand-outs, could boost Commonwealth income tax revenues
State governments	• Personal income taxes provide the states with a source of stable growth funding for the delivery of frontline services and infrastructure, as distinct from an eroding GST base and ad-hoc funding agreements • Fewer funding agreements allows government officials to re-focus their efforts on service delivery and away from negotiation, reporting and compliance • Reduced prescriptions on how taxpayer funding is used gives states the freedom and incentive to innovate and reap the benefits of reforms that lift the state economy
Businesses and Households	• Fewer funding prescriptions gives states full responsibility and flexibility to develop policy that achieves best value for their citizens • One level of government is responsible, giving proper lines of accountability.

Several federations and unitary states have already transitioned from a system of tied grants to revenue sharing funding models to improve local autonomy and reduce the cost of administration. In the 1990s and 2000s Canada, Finland, Iceland, Norway, Sweden, Italy and Spain replaced their system of tied grants with untied funding.[lxxii] The Sixth State Reforms of 2014 gave the regions and communities of Belgium greater tax autonomy to meet the needs of their communities.

Australia has not followed suit. Instead it retains a model of federalism where spending responsibilities are shared across governments, but revenues are not. We remain the only high-income federation in the OECD where state governments do not raise or share personal income taxes. Further it is the only one that distributes federal revenues – the GST – based on a model which fully equalises the fiscal capacity of state governments. There are different models in practice in other federal systems. For example, state and federal governments concurrently levy growth taxes in the US, Canada and Switzerland (Table 7). In Belgium, Austria and Germany, federal revenues are shared using a simpler formula that distributes revenue with regard to the economic performance and revenue generated in that state (Table 6).

Table 6: OECD federations and quasi-federations with revenue sharing models

Australia	States receive all GST revenues (but pay administration costs), subject to a comprehensive formula that equalises financial capacity across the federation.
Belgium	The three regions of Belgium receive a share of federal income tax collected in their territory and can impose an additional surcharge. Belgian Communities, a cultural equivalent of regions, also share in the VAT. Fiscal equalisation is also carried out at the regional level on the basis of personal income tax collections and unemployment.
Austria	Austrian Länder (states) receive the majority of their revenue from shared taxes (VAT, income, corporate and petrol taxes) under a fiscal equalisation grant. Taxes are distributed to the Länder based on criteria including population size and local contributions to tax revenue.
Germany	The German Constitution allocates taxes between levels of government. The Federation and the Länder are allocated a share of personal income, corporate and VAT. Personal income and corporate taxes are distributed based on the revenue generated in the Länder, while the VAT is used for fiscal equalisation purposes. Payments are also made to support the fiscal capacity of poorer Länder.
Spain	Autonomous Communities in Spain levy surcharges on federal income taxes, while the Basque Country and Navarre receive additional tax autonomy.

Source: OECD regional country profiles

Note: Spain is a highly decentralised unitary state with de-facto autonomous regions.

Table 7: OECD federations with state and federal income taxes

Canada	Provinces raise income and corporate taxes. Most provinces set their own marginal income and corporate tax rates with revenue raised by the Federal Government on their behalf. The Federal Government reduces its share of the income tax base to create room. The Canadian Provinces do not share the federal GST, as they raise revenue from their own local retail sales taxes and excises (except for Quebec, which has its own VAT).
Switzerland	Income and company taxes are directly levied by the 26 cantons (states) and their municipalities (of which there are over 2,200). Municipalities are subject to cantonal laws but set their own rates. Income tax rates vary significantly: for example, some cantons impose a flat tax rate.
United States	Most states and some local governments impose personal income taxes. There is significant variation in tax rates and some states do not levy income tax at all (e.g. Texas). State and local income taxes are deductible from federal taxes, subject to a cap. Some states also tax corporate income.

Source: Latest OECD Regional Country Profiles

Improving taxpayer value for money, not lifting taxes

Given the potential benefits at stake, the Review sees merit in swapping tied grant funding with a share of personal income tax revenues. That is, no additional funding would be sought from the taxpayer or the Commonwealth. The Review does not support raising income taxes overall, as Australia's personal and corporate income taxes as a share of GDP are amongst the highest in the OECD, and the states have more efficient tax bases, such as land, to supplement Commonwealth funds.

But, as other nations show, there are different ways in which these arrangements could be implemented with some trade-offs in terms of their impacts on state autonomy, administrative complexity, and revenues across the federation.

The Review considers that the simplest, most transparent and most sustainable model is likely to be one in which the Commonwealth continues to raise revenues and rather than distributing some of that revenue with the states in tied funding, shares an untied portion with the states based on a specified formula. There could be options to vary the formula by state to maintain an equitable distribution of revenue.

There are alternatives to the above that provide the states with greater autonomy over their revenue raising:

- States could raise their own personal income tax revenues, as was the case prior to 1942 and is the case in Switzerland, the US and Canada. The fact that states do not already do so, given there are no legal constraints, suggests that this is not a realistic or preferred approach because of its economic efficiency.

- Alternatively, the Commonwealth could continue administering the tax system but lower its rates to make room for the states to set their own, either on taxable income or as a share of tax liabilities (similar models were proposed by the Hawke Government and the 2014 National Commission of Audit).

The Review acknowledges that these models have significant challenges. Primarily, they are administratively complex and could lead to a higher overall tax burden and state-based tax avoidance. They could also undermine equity by leading to diverging service standards and outcomes across the federation, as those states with higher taxable incomes could afford lower tax rates or better services.[37]

[37] For example, Warren and Eccleston (2015) estimated that in 2011-12 Tasmania would need a surcharge more than double the ACT's to raise the same amount of per person revenue, providing a significant competitive advantage to the ACT.

A revenue sharing model requires stronger and strategic collaboration across governments. Unlike the GST, the Commonwealth could change income tax settings without the states' agreement, with direct impacts to state budgets. This interdependence means decisions on the future of our tax system should be made in consultation with the states through collaborative decision-making forums.

Creating stronger reform incentives to support the recovery while maintaining equity in the federation

As the debate over the GST distribution formula shows, the way in which Commonwealth revenues are shared amongst states affects the pay-off for undertaking reforms that lift growth and prosperity for all Australians. The challenge is to strike the right balance between maintaining equity and supporting prosperity.

The dire economic circumstances facing the nation mean that it is a priority for state governments to show leadership in pursuing productivity-enhancing reform. In support of this, it is recommended that:

- Personal income tax revenues should be shared with the states based on the state in which the income is earned to ensure states are accountable for revenue raising and expenditure.[38]

- The revenue received should be quarantined from the CGC's calculation of GST relativities.[39] [xxi] That is, a state gets to retain more revenue when it undertakes reforms that support the economic recovery and the benefits are not redistributed to other states (see Chapter 4: A broad-based land tax is more efficient and equitable than transfer duty).

This recommendation would inevitably change the distribution of funding between states compared to the status quo. This is because each state's contribution to national taxable income differs from the share of Commonwealth funding it receives, and, secondly, revenue received under Commonwealth funding agreements, which is usually not quarantined from the CGC's calculations, would be replaced by untied revenue which would be quarantined.[40]

---

38 Revenues that could be measured on state basis would likely include taxes on personal income derived from wages and salaries, personal capital income of unincorporated businesses, interest, dividends, property and capital gains. It would exclude corporate income, superannuation and fringe benefits because state assignment would be difficult

39 This model was proposed by Stone (2019).

40 Nearly 60 per cent of Commonwealth payments affect state GST shares as they are considered to affect the ability of state governments to provide a comparable level of government service.

There are a range of different design options to address these distributional challenges.

- The model could vary the share of taxable income across states to offset the value of tied grant funding in each state.[41]

- Alternatively, the model could allocate a fixed number of cents in the dollar to the states overall and reduce each states' tied grant funding by the amount of income tax revenue they receive. This approach would be revenue neutral, but would involve a reduction in funding, rather than complete abolition of certain tied grants.

- An opt-in model could allay concerns over the distributional impacts, so that states that wish to remain under the status quo can continue to do so. States that chose not to opt-in would have their GST distributions affected as a result of states that did opt-in exchanging tied grants (which are assessed by the CGC) for an untied share of personal income tax revenue (which would not be assessed by the CGC).

    - An opt-in model like the one above would, at the outset, have only small impacts on GST distributions. This is because most recurrent Commonwealth grants that are included in the CGC's formula, except for public hospital and schooling, have only minor impacts on GST payments.[42] For example, funding for early childhood education, skills, and housing and homelessness is expected to impact New South Wales' GST share by around $18.5 million in 2020-21.[lxxiv]

- Stronger support for state-based economic reforms would also lift Commonwealth revenues, which could be used to provide funding to incentivise states to opt-in.

An illustrative example in which Commonwealth funding for early childhood education is exchanged for a share of personal income tax revenue is shown below (Table 8). It is assumed that all states opt in. The net change to state funding distributions would be smaller if savings in bureaucratic effort were included. Two alternatives are shown:

- In the first model the revenue share is adjusted to completely offset the loss in tied funding for each state, although there would be a change in GST shares. This would require that each state receives a different share of the income tax revenue collected in the state. This

41 Since the Commonwealth is still raising income taxes in a uniform way, this does not breach s 51(ii) of the Constitution, which prevents the Commonwealth from raising taxes in a way that discriminates between the states or parts of states.
42 This is because each states' payment is not too different from its population share.

- approach would be equitable in the first instance but has the disadvantage of locking in the relative positions of the states at one point of time, which may not reflect future differences in each states' economic structure.

- In the second model, a fixed national share of taxable income, equal to the total value of the tied grant, is distributed to the states based on their contribution to tax collections. This would not be revenue neutral for each state – although differences could be made up in temporary Commonwealth payments – but it would ensure that it is growth in the economy and tax collections for each state that drives the revenue it receives.

Table 8: Illustrative example of swapping funding agreements for a share of personal income tax revenue ($m, 2018-19 unless specified)

State	NSW	VIC	QLD	WA	SA	TAS	NT	ACT	AUS
1) Revenue neutral for each state									
Revenue swapped*	119.2	120.9	84.9	46.3	28.2	9.3	8.1	4.8	421.7
% of income tax revenue**	0.05%	0.07%	0.07%	0.06%	0.07%	0.09%	0.05%	0.07%	
GST redistribution#	4.2	-1.0	-9.4	3.8	-0.7	0.3	0.8	2.1	
Total financial impact	4.2	-1.0	-9.4	3.8	-0.7	0.3	0.8	2.1	
2) Revenue neutral nationally									
Grant revenue foregone	119.2	120.9	84.9	46.3	28.2	9.3	8.1	4.8	421.7
Income tax revenue gained	143.3	105.0	77.5	50.3	24.8	6.7	9.9	4.3	421.7
% of income tax revenue	0.06%	0.06%	0.06%	0.06%	0.06%	0.06%	0.06%	0.06%	
GST redistribution	4.2	-1.0	-9.4	3.8	-0.7	0.3	0.8	2.1	
Total financial impact	**28.3**	**-16.9**	**-16.8**	**7.7**	**-4.2**	**-2.3**	**2.6**	**1.6**	

*Revenue is from payments delivered under the National Partnership on Universal Access to Early Childhood Education in 2018-19

** % of income tax revenue is a share of taxable income (above the tax-free threshold) of taxable residents by state, as per the 2016-17 ATO Taxation statistics. For illustration and comparability, 2016-17 amounts are inflated to 2018-19 using growth in national personal income tax receipts

#GST impacts show the redistribution of GST away from an equal per capita distribution, as per the Commonwealth Grants Commission 2018 Update

Sources: Commonwealth 2018-19 Final Budget outcome, ATO 2016-17 Tax Statistics, Commonwealth Grants Commission 2018 update

The second issue concerns the measurement of income taxes by state. The current approach by the ATO captures income tax paid by state of residence. Additional administrative and compliance arrangements may be required in cases where a worker's output differs from their state of residence, including remote workers, those who move states during the year, or workers who regularly travel interstate. The administrative adjustments involved in developing a more complete measure will need to be investigated and an agreement struck over the sharing of costs.[43]

43 Stone (2019), for example, suggests that the additional complexity is minor, citing existing payroll tax administration and the experience of countries aboard, including the US

A pilot approach that leverages the benefits of federalism

Exchanging tied Commonwealth funding for an untied share of income tax revenue ultimately means that the Commonwealth's role and associated resources will be scaled back in some areas of state service delivery. As such, a principled approach is required to investigate where the states are better placed to take full funding and service delivery responsibility (see Chapter 2 – Evolving the Federation).

The Review acknowledges that wholesale change to responsibilities and Commonwealth funding arrangements could be neither feasible nor desirable. As discussed in the Review's Consultation Findings Report, some Commonwealth-state responsibilities, such as health, appear to be beyond untangling and attempts to do so may disrupt service delivery and impact front-line outcomes.

To that end, a pilot model should be considered where a set of smaller grants, subject to agreed criteria, are substituted for a share of income tax. Some potential criteria could consider the following:

- Multilateral National Partnership Agreements that fund ongoing services but are subject to an ad-hoc and uncertain renewal process, would benefit from an ongoing funding stream. Examples of this include Commonwealth funding for early childhood education, dental services and breast cancer screening.

- Services that integrate with, or have downstream impacts on, other state-provided services, such as early childhood education and schools, could benefit from the states being solely accountable for performance and outcomes.

Subject to an evaluation of the impacts on service delivery and economic performance, the model could then be scaled up to a major service delivery area. In doing so, the federation would be working as it was designed – tailoring policy and service delivery to local needs and testing solutions that can benefit that nation at large.

Draft recommendation:

With the Commonwealth, the NSW Government should lead the development of a personal income tax-sharing model. The model should be opt-in, revenue neutral for the taxpayer and with revenue distributed to the state in which it is generated. The revenue should be quarantined from the calculation of GST relativities. A pilot approach could be undertaken and evaluated prior to a more expansive roll-out.

6 Insurance taxes — can we afford them?

The states raise revenues from a variety of levies and duties applying to most types of insurance, including home and contents, motor vehicle, disability, occupational indemnity and in some jurisdictions, life insurance and health insurance.[44]

New South Wales has three different insurance taxes, which raised a total $2.0 billion or 6 per cent of tax revenue in 2018-19:

- stamp duty on general insurance (including car, home, contents and more) and on life insurance, levied as a percentage of the premium or sum insured ($1.0 billion);
- the Emergency Services Levy (ESL), which is a charge on property insurers at differing amounts each year in order to fund 73.7 per cent of the fire and emergency services budget ($0.8 billion); and
- a private health insurance levy which applies on a per-member per-week basis to provide funding for ambulance services ($0.2 billion).

With Victoria having shifted to a property-based levy following the recommendations of the 2009 Victorian Bushfires Royal Commission, New South Wales is now the last mainland state still taxing insurers to fund fire and emergency services.[45]

44 ABS Catalogue 5506.0. Note that the ACT is an outlier, having abolished most insurance taxes from 1 July 2016.

45 Tasmania operates a hybrid property/insurance fire service funding system which raises a small share of overall funding from taxes on commercial and motor vehicle insurance.

Insurance taxes are unfair, inefficient, and shift risk on to those least able to bear it

There is no principled case for applying a special tax on insurance.[46]

Insurance taxes are inefficient: they drive up premiums and discourage consumers from adequately insuring. There can be serious human and social consequences from what has been dubbed 'a national crisis of under-insurance', especially for a country that relies heavily on insurance markets for recovery from disasters.[lxxv]

Taxes on insurance are also inequitable. There is generally no connection between the purchase (or the purchasers) of insurance and the distribution of benefits from government expenditure, and so no reason that insurance consumers in particular should be taxed. Even where there is some connection, as in the case of building insurance and demand for fire services, under-insured and uninsured parties avoid contributing a fair share (the 'free rider' problem). And when taxes make insurance less affordable, it is most likely to be low-income households that are under-insured or uninsured and hence exposed to loss in adverse circumstances.

On these grounds, the Review concurs with the numerous previous inquiries, pressing with urgency that all specific insurance taxes should be abolished, with replacement revenue sourced from more efficient and equitable taxes.[47]

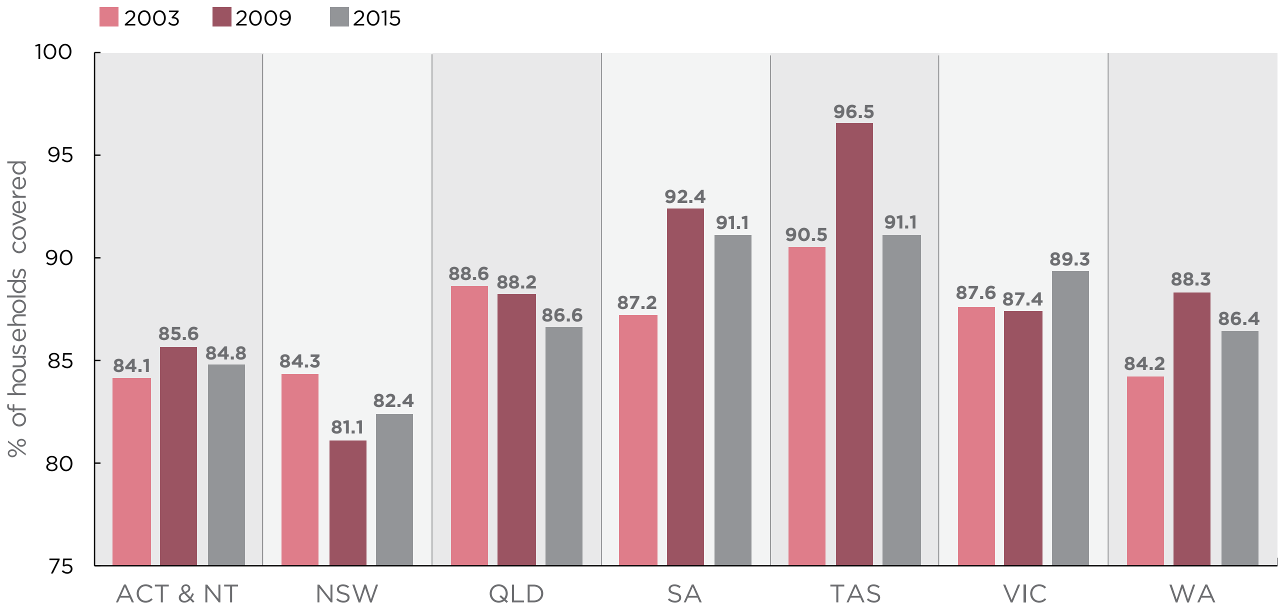
New South Wales: the over-priced, under-insured state

While the number of insurance policies have increased in recent years, New South Wales has the lowest rates of insurance in the nation – 5 per cent of home owners lack building insurance and 36 per cent of households lack contents insurance.[lxxvi] Victoria sees some 7 percentage points more households take out home and contents insurance than New South Wales, a gap that has grown over time (Figure 7).[lxxvii]

46 Insurance products should be treated like most other goods and services consumed within Australia and be subject to only one broad-based tax on consumption, such as the GST.

47 See IPART (2008), the Henry Review (Commonwealth of Australia 2010), and the Lambert Review (NSW Treasury 2011).

Figure 7: Percentage of households covered by home and contents insurance policies



Source: Insurance Council of Australia submission, data from ABS Household Expenditure survey.

Insurance duties add around 10 per cent to the price of most types of insurance.[48] A report commissioned by the Insurance Council of Australia estimated that abolishing these duties could lead to around one in seven currently uninsured households taking up home insurance.[49] This in turn could minimise the public costs of disaster relief and support post-disaster recovery by enabling faster rebuilding.

The most acute price impacts and policy issues with insurance taxation arise in the case of specific taxes to fund the fire and emergency services, as with the ESL in New South Wales.

The ESL adds an estimated 18 to 20 per cent to residential premiums and 30 to 35 per cent to commercial premiums.[50] For residential properties, this is approximately double the rate of insurance duty alone, and for commercial properties, triple. This means that the overall rate of tax on insurance in New South Wales can be close to three or four times the rate applying in other states.

48 Rates are between 9 per cent and 11 per cent across the states. The rate in New South Wales is 9 per cent, but certain types of insurance (excluding home and contents) are taxed at a concessional 5 per cent. Similar discounts are in place in other states.

49 Tooth (2015), Table S2. Note that this modelling examined only home and contents insurance.

50 Estimates are from the NSW Government Submission to the 2017 Legislative Council Legal Affairs Committee Fire and Emergency Services Levy inquiry. These figures include GST and insurance duty on the ESL component of the premium.

The costs of taxes on insurance, in terms of their impacts on decision making, are much higher than their effect on premiums suggests. They effectively reduce the return for any given cost of an insurance policy, meaning that people and businesses must pay far more to achieve the same level of risk reduction. This can deter people and businesses from entering the insurance market or purchasing an adequate level of insurance. It reduces the size of the insurance market and hence the scope for insurers to pool risk, leading to an increase in the cost of insurance premiums beyond the first-round impact of the tax.[lxiii] The effect on consumer and business behaviour is amplified by the emergency services levy adding to the multiple layers of taxation on insurance.[lxxviii]

While there are many drivers of under-insurance beyond affordability,[51] there is also a clear reason to expect tax rates to influence insurance coverage, and evidence supports this.

The ABS data shows an uptick in rates of insurance in Victoria between 2009 and 2015, an interval encompassing the 2013 abolition of the insurance-based fire service levy. Insurance take up rates fell in most other states during this time, suggesting this increase was related to the reform. A similar trend was noted by the Henry Review following Western Australia's reform in 2003. It is estimated that abolition of both ESL and insurance duty in New South Wales could see as many as one-third of currently uninsured households, or 70,000 households, take up home insurance.[lxxix]

A fire services property levy would be a fairer model for NSW...

Insurance-based funding for fire services was traditionally justified on the basis of the apparent nexus between fire risk, insurance premiums, and the likely need for fire services. But this is unpersuasive, since uninsured properties benefit without contributing, insurance premiums reflect numerous non-fire risks, and the value of property being protected bears little relation to the likelihood of requiring fire service attendance.

As Insurance Australia Group's submission to the Review explains:

> *'There is no correlation between the levy amount collected and the frequency of emergency services callouts. This reflects the fact that the levy is imposed on the total insurance premium, which includes the full range of perils... At an individual household level, the premium amount, and levy amount paid, is determined by the insured value of the home and/or its contents together with other price setting factors such as loyalty and no claim discounts. This method of determining premiums means that areas with very low fire risk can contribute substantially more on a per household basis to total levy collections than other areas of the State with much higher peril risks such as bushfire or flood.*[lxxx]

---

51 For example, the proportion of the population that rents affects insurance uptake.

An insurance-based model also creates perverse incentives that work against the very purposes of the services it funds. Fire services fundamentally exist to mitigate risk and improve community resilience. But the more resources are dedicated to these ends, the higher the effective penalty on insurance – and the stronger the associated incentive for individuals to opt out, leaving themselves vulnerable.

A broad-based property levy is a far more efficient approach: it makes insurance more affordable and ensures all property owners contribute to funding fire and emergency services. By including uninsured properties and reducing the contribution required from insured properties, it can in principle be fairer as well.

Funding via general revenue is a possible alternative, but this requires an efficient and equitable source of additional revenue. The first option would be a broad-based land tax, since this tax reflects the overall benefits that public services provide to each location and does not harm economic growth. But the advantage of a specific property levy hypothecated to fire services is that liabilities can be adjusted across property types and locations to better fit the benefit or cost distribution of this particular service.

… The design and implementation challenges can be overcome

States have moved one-by-one to a property-based model over recent decades, the most recent being Victoria in 2013.

In December 2015, New South Wales embarked on a similar reform process, with the Government announcing its intention to abolish the insurance-based ESL and develop a new property-based levy. Following a design and consultation process, the Fire and Emergency Services Levy (FESL) was legislated in April 2017. In May 2017, however, the planned introduction was deferred. The ESL was reinstated and has remained in force since (see Box 2).

At issue was not the principled reform direction, but the perceived inequity of the higher burdens on certain property owners under the particular FESL model designed. The proposed tax rates would have seen significant increases for properties with relatively high-value land and low-value buildings, as well as for properties currently under-insured. Once these issues became apparent, the short timeframes before commencement made redesigning the tax impractical.

Despite this experience, it is clear that New South Wales can and should revisit this reform. The implementation of equivalent reforms in almost every other state indicates that reform is achievable.

One of the issues identified as critical by a subsequent New South Wales parliamentary inquiry was NSW's land value rating base, which the inquiry considered was unsuited to an equitable distribution of the funding burden. The inquiry recommended considering an improved value base, as is used in Victoria, for any future levy.

While there are arguments for such a view, there are also arguments against. Land is worth more when protected by fire services, even if its current owners have little on the site to protect, so landowners are beneficiaries too.[52] [lxxxi] In addition, land area or land value are better proxies for the incremental costs of fire service provision incurred on behalf of each property than improved value.[53] [lxxxii]

Land value taxation has efficiency advantages too: an improved value tax would discourage capital investment by increasing the tax payable on more valuable buildings.

An improved value tax also faces one major and costly obstacle: the NSW Valuer General does not currently estimate improved land values. To implement a tax on this basis would involve a lead time of up to five years and significant financial cost to the state and ultimately taxpayers (a one-off cost of over $140 million plus annual additional costs of $30 million).[lxxiv]

While there are clearly judgements about the principles and practicality involved in selecting the appropriate tax base, it is far from clear that the costs and delays associated with redesigning the State's valuation system for the purpose of one tax are justified on either equity or efficiency grounds. In the case of a tax reform, which all parties acknowledge as worthwhile and urgent, New South Wales should not let the perfect become the enemy of the good.

Successful implementation of a future property-based levy must also confront some of the realities of tax reform. Government must be fully informed in the design phase as to the redistributive effects – an acknowledged limitation in the FESL process – and defend the reform on principled grounds despite there being vocal opponents. That defence rests most of all on the inequity of the status quo.

The apparent 'losers' from a principled change are those who have contributed an unfairly low share of taxation in the past, in this case the under-insured 'free riders'. Some households not currently paying a fair share will see their contributions increase. Where there are genuine affordability and cashflow problems, hardship and tax deferral provisions can be designed to address these, and a future levy design process should consider these options thoroughly.

52 "The value of fire protection inheres in the lot, not the building" (Vickrey 1992).

53 Nobel-prize winning economist William Vickrey argued this point (Arnott 1998). Basing funding contributions on incremental costs incurred rather than benefits received is standard in contexts such as user charging for public services and environmental taxation (Commonwealth of Australia 2010, sections E1 and E2).

Box 2: The Fire and Emergency Services Levy

In December 2015, the NSW Government announced its intention to move away from an insurance-based levy to a property-based levy, bringing it into line with all mainland states.

After a wide consultation period and joint effort from local councils, the insurance industry, the Valuer General and the NSW Government, the *Fire and Emergency Services Bill* received assent in April 2017. The new property-based levy, known as the Fire and Emergency Services Levy (FESL), was to start on 1 July 2017.

The FESL would see all property owners contribute to funding emergency services – not just those who take out insurance. As the FESL was partly based on unimproved land values, the tax burden would shift to be borne more fairly by the owners of high valued properties.

The FESL was a complex reform and it was always clear there would be challenges during the transition process. However, after concerns were raised that a number of people and small businesses would have been placed under unfair strain, on 30 May 2017, the NSW Government announced its deferral.

As a result, the Government passed legislation to re-instate the ESL on insurance premiums from 1 July 2017.

The Legislative Council conducted an inquiry into the Fire and Emergency Services Levy. Public hearings occurred during August 2018 and the Committee released its findings and recommendations in November 2018. Those recommendations included that:

- NSW Treasury conducts a full and transparent re-modelling of any new FESL;
- There should be no future government moves to implement a FESL unless it considers use of capital-improved value of land for calculation of the levy; differential levy rates, fixed charges, discounts and caps; better aligned land classifications between those used by councils and the FESL; inclusion of motor vehicles; the removal of the 11.7 per cent contribution by councils; and addressing the impact of the levy on poorer households that are unable to afford building and contents insurance; and
- The Government ensures appropriate consultation with key stakeholders.

A changing climate makes reform more critical

Two profound and dramatic shocks in the summer of 2019-20 have brought about an irreversible shift in Australians' perceptions not only of risk, but of the role of the state as a 'safety net' in people's lives. How we promote resilience and risk-sharing through our policies and institutions in response to these events will determine how well-placed we are for future shocks.

Insurance products are a key element of an integrated disaster strategy. They are a distributed, market-based solution to managing individual risks. When working well they can provide appropriate incentives for risk-taking without burdening the state or socialising losses. In a country prone to natural disasters, insurance is no ordinary consumer product – it is closer to an essential service and, in some other contexts, is mandated and publicly provided by governments on these grounds.[54]

When private insurance is inadequate, the 'insurer of last resort' – the state – often must pick up the tab. Both state and Commonwealth governments provide a range of disaster recovery grants, including some specifically targeted at households and businesses not covered by insurance.[55]

For major disasters the public costs of this support can be high. For example, after the 2003 Canberra bushfires the Australian Capital Territory (ACT) Government provided an additional $5,000 to each affected household that did not have contents insurance, in addition to the $5,000 provided to all whose homes were destroyed.[lxiii] The 2019-20 bushfires were catastrophic and although the full extent of the financial costs of the fires are not yet clear, it is expected to well surpass that of the 2003 Canberra fires.

The rest of the burden of loss falls on under-insured individuals and can be considerable. The average uninsured loss for each Australian natural disaster between 2004 and 2011 is estimated to be nearly $1 billion.[lxxxiii]

As the climate changes, and bushfires and other extreme weather events occur with greater frequency, the capacity of governments to fund disaster relief will be constrained, and the importance of affordable insurance for Australian households will grow. But so too will the funding needs of emergency service agencies, and so too under New South Wales's current policy settings the 'crisis of under-insurance' that is a result in part of heavy taxes on insurance, will worsen.

54 In New Zealand, for instance, earthquake insurance up to a capped amount with the public insurer (the Earthquake Commission, or EQC) is a compulsory add-on to private fire insurance policies for residential properties

55 New South Wales state and Commonwealth grants are described at the NSW Office of Emergency Management page: https://www.emergency.nsw.gov.au/Pages/for-the-community/disaster-assistance/financial-support.aspx

State governments need to stop penalising consumers for taking up these products, and New South Wales must heed this call most of all. Governments need to do everything possible to let insurance markets work for the social purposes they have the potential to serve. Reform to set up a fairer and more sustainable funding model that is understood and accepted by the community will be superior to dealing with future funding pressures under existing policy settings.

Funding the abolition of insurance taxes

For states other than New South Wales, a new broad-based land tax could be an efficient replacement funding source for the revenue currently derived from insurance duties (see Chapter 4: A broad-based land tax is more efficient and equitable than transfer duty). Since property owners are a significant cohort of the insured, a reform package that abolishes insurance duty at the same time as stamp duty on conveyances (as has been the case in the ACT) appears promising.

For New South Wales, a separate fire services property levy to replace the ESL may not be necessary if stamp duty is to be replaced by a broad-based land tax. The NSW Government has an opportunity to pursue tax system simplification by replacing three taxes – stamp duty, insurance duties, and the ESL – with a single instrument.

Draft recommendations:

- All specific taxes on insurance products, including the Emergency Services Levy in New South Wales, should be abolished and replaced by more efficient and broad tax bases, to improve the affordability and uptake of insurance.
- To reduce the cost of insurance and enable fairer ways to fund the fire and emergency services, the Government should reconsider applying a levy on property owners and should also consider combining this with any future broad-based land tax. The reform should follow a detailed consultation and modelling process to carefully consider the impacts on different taxpayers.

7 Payroll taxes – a workhorse of the tax system, ultimately paid by workers

Payroll tax contributes more revenue than any other state tax, having raised 30 per cent ($9.4 billion) of New South Wales tax revenue in 2018-19.[56] Readily described as the 'workhorse' of state tax systems, it provides revenues that grow steadily over time to support the budget throughout economic cycles and in the face of unexpected shocks.

Payroll tax applies at a rate of 5.45 per cent above a threshold for total national remuneration of $900,000. It is an example of a tax on wages, a model which remains common in Europe and North America to fund social security entitlements. First introduced by the Commonwealth Government in 1941 to fund the national child endowment, payroll taxes were handed over to the states in 1971, at which point the link to welfare expenditure was broken. The wage base is thus a historical artefact.[57]

Payroll taxes are seen to have a low economic cost relative to other state taxes. Over time, they have only minor overall impacts on employment, since the tax is most likely passed through to lower wages,[58] and some employers pay no tax at all. To this extent the burden, or economic incidence, of the tax falls on workers in the form of lower wages and consumers through higher prices.[lxxxiv]

Notwithstanding, many stakeholders questioned the incidence and, more broadly, the moral basis for payroll tax. Specifically, the question was asked why state governments should penalise employers through the tax system for doing the right thing – creating jobs? The NSW Business Chamber notes that:

> *'Taxes like payroll are … dispiriting for businesses wanting to create jobs in their local communities and feeling they are unsupported in this endeavour.'*[lxxxv]

---

56 2019-20 Budget forecasts prepared prior to the coronavirus crisis. Actual revenue in 2018-19 was $9.4 billion.

57 Australia is an outlier amongst OECD countries in its heavy use of payroll tax for general revenue rather than for social security contributions (i.e. payments that confer entitlement to benefits such as unemployment insurance or old-age pensions). Australia raises 5% of total national tax revenue this way, exceeded only by Sweden and Austria. See OECD (2020), Tax on payroll, at https://data.oecd.org/

58 This is because firms' hiring decisions are much more sensitive to wages than individuals' work decisions, with competition between workers ultimately forcing down wages. There are several other noteworthy outcomes. One is that competition between taxed and untaxed firms for workers sees the long-run wage reductions borne by all workers, not just those in the taxed sector. Another is that lower wages prompt some (likely small) reduction in labour supply, i.e. hours worked. See IPART (2008), Review of State Taxation, p94 and Commonwealth of Australia (2010), Australia's Future Tax System report, sD3.

This could in part reflect transitional impacts. It takes time for wages to adjust in response to higher or lower taxes. As such, payroll tax cuts may temporarily support job growth, especially when wage growth is slow.[59] Further, the salience of payroll tax means it may influence business decisions even if it doesn't add to their costs over the longer-term.

Tax competition is eroding one of the states' 'better' taxes

A by-product of competitive federalism has been attempts by state governments to attract business to their state through the payroll tax system. This has, over time, hollowed out an efficient tax and made it more complex than it needs to be. In particular, the small business exemption makes the tax less efficient and adds to compliance costs.

Several past tax reviews have recommended that the payroll tax base be broadened by lowering tax-free thresholds, including the Independent Pricing and Regulatory Tribunal (IPART) Review in 2008,[lxxvii] the Henry Review in 2010, and the Lambert Review in 2011. Typically, it has been recommended that the revenue raised is used to either reduce the payroll tax rate or cut less efficient taxes.[60] IPART (2008) described a two-part strategy for successful reform:

> *'Improve individual taxes by broadening tax bases and reducing rates and improve the mix of taxes by placing greater weight on taxes that are more broadly based, transparent, simple, and have less adverse impact on behaviour.'*[61]

Yet state governments have resoundingly moved in the opposite direction on both counts in a 'race to the bottom' that goes against their collective interest. As a result, the delivery of state services and infrastructure has increasingly been funded through economically more harmful taxes and federal funding flows.

---

59 Clear evidence of job growth effects is hard to find, however (Majeed and Sinning 2019).
60 IPART (2008), Review of State Taxation, s1.2.5; Commonwealth of Australia (2010), Australia's Future Tax System report, sD3; NSW Financial Audit (2011) recommendations 13.3 and 13.8.
61 IPART (2008), Review of State Taxation, p96

Since 2009-10, all jurisdictions have raised their tax-free threshold (see Table 9). Three jurisdictions – New South Wales, Victoria and the Northern Territory – have cut their headline tax rates, while two – South Australia and Tasmania – have introduced concessional rates for smaller firms above the tax-free threshold. The trend has been exacerbated by concessions, such as tax rebates for investment attraction, regional discounts, and apprentice or trainee discounts.[lxxxvi] Alongside these structural changes, state governments have also used payroll tax relief as a stimulus measure, including in their COVID-19 emergency responses (Box 3).

Payroll tax now comprises a lower share of state tax revenue than at the time of the Henry Review for New South Wales and Victoria and, revenue has grown roughly 0.7 percentage points slower on average than state operating expenditure.[62]

Table 9: Payroll tax rates and tax-free thresholds, 2009-10 and 2019-20

State	NSW	VIC	QLD	SA	WA	TAS	NT	ACT
Rates								
2009-10*	5.75%	4.95%	4.75%	4.95%	5.50%	6.10%	5.90%	6.85%
2019-20**	5.45%	4.85%	4.75%	4.95%	5.50%	6.10%	5.50%	6.85%
Threshold								
2009-10	$638,000	$550,000	$1m	$600,000	$750,000	$1.01m	$1.25m	$1.5m
2019-20	$900,000	$650,000	$1.3m	$1.5m	$900,000	$1.25m	$1.5m	$2m
Growth								
Wages***	31%	32%	31%	31%	30%	32%	31%	29%
Tax-free thresholds	41%	18%	30%	150%	20%	24%	20%	33%

Notes: * NSW rate was lowered to 5.65% from 1 January 2010. **VIC also has a regional rate of 2.425%. QLD has a rate of 4.75% for employers with Australian taxable wages of $6.5m or less, 4.95% for employers with Australian taxable wages above $6.5m and a discount of 1 percentage point off the applicable rate for regional businesses. SA and Tasmania apply concessional rates up to $1.7m and $2m respectively, and WA has rates of 6% and 6.5% above $100m and $1.5bn respectively. QLD, WA, and the NT use a deduction system that removes the benefit of the threshold for large employers. ***Wage growth is 2008-09 to 2018-19.
Sources: Majeed and Sinning (2009[lxxxvii]), NSW Inter-state comparison of taxes, State Revenue Offices, ABS 6345.0 Wage Price Index.

62 ABS Catalogue 5512.0 and ABS Catalogue 5506.0.

Box 3: Payroll tax relief for stimulus and recovery

Emergency response packages for both the 2019-20 summer bushfires and the COVID-19 pandemic have for several states included payroll tax measures.

During the bushfires, Victoria halved the regional payroll tax rate for six affected local government areas, while others declared wages paid to an employee while volunteering exempt.

COVID-19 economic response measures for payroll tax include:[63]

- New South Wales: a three-month waiver for employers with wages up to $10 million;
- Victoria: 2019-20 tax waived for employers with wages up to $3 million;
- Queensland: a five-month tax waiver for employers with wages up to $6.5 million, two months for all other employers;
- Western Australia: a three-month waiver for employers with wages up to $7.5 million;
- South Australia: a six-month waiver for employers with wages up to $4 million;
- Tasmania: 2019-20 tax waived for employers with wages up to $5 million, and waivers for all employers in selected industries;
- ACT: six-month waiver for employers in selected industries;
- Northern Territory: six-month waiver for employers with wages up to $7.5 million.

Most states are also offering deferral of payroll tax for many employers, some states are providing grants to employers via payroll tax administration, and New South Wales and Western Australia have also brought forward planned increases to tax-free thresholds.

There is growing recognition that payroll tax competition has ultimately been a negative-sum game, and that the rules of engagement must change. The Australian Industry Group's submission to the Review agrees, noting that:

> *'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.'*

and suggesting that:

> *'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.'*[lxxxvii]

63 Rates sourced from state Revenue Offices as at 13 April 2020.

Exemptions make a relatively efficient tax less efficient and administration and compliance more complex

While payroll tax competition has been designed to support small business and encourage investment, there have been unintended consequences on the complexity of the tax system and national productivity.

In New South Wales, payroll tax currently applies above a threshold for total national remuneration of $900,000, increasing to $1 million from 1 July 2020. This threshold creates a competitive advantage for smaller firms in product and labour markets and may discourage growing and productive businesses just below the threshold from expanding due to the additional tax and compliance costs.[64]

The compliance burden also rates highly as a concern for business. Aside from base and rate differences between states, common concerns include complex provisions for contractors and employment agents, grouping provisions, differences between the bases for payroll tax, PAYG income tax, and workers' compensation premiums, the inability of firms to leverage existing or automated information systems to submit returns, and the multiple state portals for lodgement.[65]

Some employer representatives argue that this complexity makes the tax-free threshold key to avoiding disproportionate compliance costs for small firms,[66] and that the states should pursue all available opportunities to simplify the tax and reduce compliance costs.

The states have made some progress on this front. The NSW Government, for example, has committed to enacting the recommendations of the recent Review of Payroll Tax Administration in New South Wales (Box 4). These recommendations are expected to be fully implemented before the end of 2020 and broader adoption by the other states is before the Board of Treasurers.[67] If implemented nationally, these reforms could benefit businesses through a more harmonised payroll tax system and lower compliance costs.

---

64 The evidence of this outcome is mixed, however. For example, an empirical study using administrative business income tax data found no evidence of firms 'bunching' just below the threshold. See Ralston (2018), Does Payroll Tax Affect Firm Behaviour?, Treasury Working Paper 2018-02.

65 For discussion see Commonwealth of Australia (2010), Australia's Future Tax System report, sD3-3; and the NSW Chamber of Commerce submission to the Review.

66 See, for instance, the submissions to the Review from the NSW Chamber of Commerce and Australian Industry Group.

67 The Board of Treasurers is a forum of state treasurers, established in 2017 to increase collaboration on issues of common interest, advance national reform priorities from a state perspective, and foster more constructive and effective engagement with the Commonwealth.

Box 4: Review of payroll tax administration in New South Wales (Payroll Tax Review)

The NSW Productivity Commissioner's first task was to undertake a review of payroll tax administration, which was concluded in late 2018.

The Payroll Tax Review examined administrative arrangements for compliance with the legislation, but not payroll tax rates or thresholds, which were outside the scope.

The Payroll Tax Review offered 12 recommendations in relation to education, software, penalties, lodgement, audit, definitions, and other matters, all of which are implementable in some form by either Revenue NSW or the NSW Government without inter-state co-operation. The Government has agreed to all the recommendations and is in the process of implementation.

Despite the benefits of harmonisation efforts across states, a degree of complexity in the administration of payroll tax will remain an unavoidable consequence of current policy design, in particular the tax-free threshold.

As a general proposition, 'complexity breeds complexity'; tax exemptions inevitably give rise to loopholes, which create a need for anti-avoidance provisions. In the case of payroll tax, the contractor provisions and grouping provisions, which are key points of discontent for taxpayers,[68] are necessary to maintain the integrity of the tax by preventing firms breaking operations into smaller entities or creating artificial outsourcing arrangements to fall below the threshold.

A further unavoidable contributor to complexity and cost arise from the states' retention of revenue-raising autonomy. Payroll is a state-based tax, so firms operating across multiple states – around half of all taxpayers, according to the Henry Review – must keep separate records and lodge separate returns for each jurisdiction on top of their national reporting to the ATO.[69]

The reform dilemma is that it is difficult to broaden payroll taxes because of compliance costs for small business – but also difficult to simplify them while they are narrow-based and levied on a state basis.

68 See section 3.3 of the *Review of Payroll Tax Administration.*

69 Commonwealth of Australia (2010), Australia's Future Tax System report, p299

The Australian Industry Group's submission to the Review recognises this bind, stating:

> *'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.'* [xci]

Avoiding, rather than simply minimising, the tension between compliance costs and efficiency requires fundamental redesign. Only a move to a tax on a comprehensive payroll base without small-business exemptions can significantly reduce both complexity and economic cost.

Payroll tax reform now needs a co-operative approach amongst the states

Deferring major reform or tinkering at the edges of the existing payroll tax may no longer be an option. Transfer duty growth has slowed, and the fiscal shock of the COVID-19 pandemic has brought forward the imperative to act; long-term pressures are here today. States simply cannot afford to continue to hollow out their largest tax base.

Yet past experience suggests that states will not reverse course alone. Moreover, the timing of reform is critical, and the immediate priority is for policy settings to support economic recovery first and rebuilding budgets second. To avoid disruption to business, a broadening of payroll tax or application of a new tax should be deferred until conditions have stabilised.

To yield material progress, payroll tax reform may need to move beyond incremental improvement. Interstate co-operation will be critical to advancing the collective interest. A reform agenda playing out over a medium-to-long run timeframe to support the broader economic and fiscal recovery plan ought to be the focus.

To prevent ongoing erosion and avoid multiplying complexity – the states will ultimately need to form a mutual strategy.

The simplest approach would be for states to codify a mutual agreement to prevent further erosion of the base, whilst continuing with existing plans to simplify the administration of payroll taxes.

A more comprehensive and institutionalised approach would be transition to the model for 'ideal' payroll tax settings proposed by Freebairn, Stewart and Liu (2015).[lxxxix] This model, designed to avoid the distortions associated with current thresholds and the associated administrative complexity, would see:

- a comprehensive and harmonised payroll base with minimal exemptions (i.e. no tax-free threshold) to minimise complexity
- a flat rate of tax which each state chooses and may vary over time to support state autonomy; and
- a tax base aligning with either Commonwealth PAYG or state workers' compensation bases for ease of administration.

The reform agenda must first involve agreement on fundamental principles and objectives before reform is achievable. This could be undertaken by states alone through an appropriate forum such as the Board of Treasurers. The conflict between the ongoing erosion of state payroll taxes and the increasing need for an efficient, stable backbone to state revenue makes it critical to begin such a process now.

Draft recommendation:

The NSW Government should propose that the Board of Treasurers collectively agree a strategic national approach to payroll tax reform that addresses the hollowing out of the tax base and the complexity this imposes on taxpayers.

8 A crossroads for road funding

The uptake of new technologies is changing the way Australians travel and their demand on infrastructure. Cars are becoming more fuel efficient, electric vehicles[70] are becoming more popular and the use of ride and car sharing services is increasing. Whilst these changes have delivered the benefits of safer, cleaner, more efficient ways for citizens to move around, they have resulted in a decline in traditional government revenues.

In this context, there are opportunities to rethink how the Commonwealth and the states fund road infrastructure to make it fairer for citizens and more sustainable for governments both now and into the future. Under the Commonwealth government's fuel excise scheme, drivers of older or larger vehicles with higher fuel consumption pay more per kilometre to use the same stretch of road as drivers of newer, smaller and more fuel-efficient vehicles. Further, electric vehicle drivers use the same road at very little cost. State levied registration fees and stamp duties are also fixed charges that do not vary with the amount of time spent on the road or the wear and tear inflicted on the road network.

Population and economic growth bring many benefits, but they also bring increased traffic, congestion and air pollution. Road congestion and public transport overcrowding are costing the Australian economy billions each year. In 2016, this cost was estimated at $19.0 billion. Without action this cost is expected to more than double to $39.6 billion by 2031.[lxxxix]

Building more roads is not a sustainable answer. Governments need to look at managing demand by putting a price on the use of the roads, allowing citizens to make an informed choice about the viable transport alternatives that best meet their individual circumstances. This price needs to capture all economic and social costs associated with road use including distance, load (weight), congestion, accidents and pollution.

The COVID-19 pandemic and the resulting period in lockdown has presented governments and citizens with the chance to re-think their attitudes to work, public transport, travel and their

[70] In this report, the term electric vehicles refers to all light vehicles powered by an electric motor where the electricity is sourced from a battery (charged via plug-in to an external source) or hydrogen fuel cell. This includes the three main types of electric vehicles: Battery electric vehicles (BEVs), Plug-in hybrid electric vehicles (PHEVs) and fuel cell electric vehicles (FCEVs)

associated behaviours. There are still many unknowns. As restrictions are lifted, it is unclear if commuters' fear of crowded public transport will see a further spike in congestion as more people choose to drive. Regardless, the status quo has been challenged. Now is the time for governments to provide the visionary leadership to drive the necessary behavioural change amongst commuters and road users to create a transport network that is cleaner, more efficient, and fairly distributes the costs of road use.

Electric vehicles: the 'free' ride

Fuel excise is an unavoidable, yet almost invisible tax. Nearly four out of five Australians are unaware they pay more than 40 cents for every litre of fuel in tax.[xxii] It is also regressive, as it disproportionately affects those on lower incomes who tend to own older, less fuel-efficient vehicles and commute further. Unlike utilities such as water and energy, fuel excise treats everyone the same, with no concessional discounts.

Fuel excise is a significant source of revenue for the Commonwealth Government with an estimated net $12.7 billion[71] [xci] collected nationally in 2018-19. State governments collect road-related revenue from fees and taxes such as vehicle registration fees, drivers licence fees, motor vehicle stamp duty and road tolls, and received around $6.1 billion [lxxxviii] in 2018-19 from the Commonwealth in infrastructure and local government grants. The revenue from road-related fees and taxes collected by both levels of government is not spent directly on roads. Instead this revenue is pooled into general (consolidated) funds, from which expenditure on roads (and other public services) is allocated.[xcii] Without a link to how this revenue is spent, road-related taxes and charges do not perform the function that prices do in other markets - signalling to users the cost of provision, and to suppliers where capacity changes are needed.[xciii]

Although fuel excise revenues have increased in nominal terms in recent years, they have not kept up with the increase in vehicle kilometres travelled across Australia.[xciv] That is, fuel excise

[71] Net of tax credits under the Fuel Tax Credits Scheme, as sourced from the Australian Treasury Portfolio Additional Estimates Statements 2019-20.

revenues are in structural decline as vehicles become more fuel efficient. The uptake of electric and other low emission vehicles is expected to rise rapidly as their costs relative to petrol and diesel engine vehicles falls. Price parity is expected to occur as early as 2025, with 58 per cent of all passenger vehicle sales likely to be electric by 2040.[xciv] As more people use electric or other non-fossil fuelled vehicles, government revenue from fuel excise will disappear.

As electric cars increase their share of the total vehicle fleet, the ability of Australian governments to pay for road maintenance and construction from the proceeds of fuel excise (even though there is no strict hypothecation or earmarking of that revenue) will decline.[xcvi] Besides the immediate fiscal consequences, over time this could have severe implications for the quality of roads, and congestion levels. Road users who are unable to purchase an electric vehicle will be the only ones left to pay the main tax associated with using the road network. There are two possible consequences of this; fossil fuel vehicle drivers will effectively subsidise the kilometres driven by electric vehicles or at the very least general taxpayer revenue will be used to subsidise heavy users of the road network.

Internationally, a number of jurisdictions are already responding to these changes in technology and consumer travel patterns. The US states of Oregon, California and Washington have piloted a general distance-based charge[72] for some time.[73] [xcvii] In 2020 the state of Utah commenced a voluntary distance-based charge for electric vehicles.[74]

A road user charge for electric vehicles should not be seen as an attempt to discourage their uptake by the community. There are many social advantages that arise from the use of electric vehicles, including lowering air and noise pollution.[cxviii] But there are other levers that can be used to support the move toward electric vehicles, including providing access to the infrastructure needed to charge their batteries quickly, especially on long trips.

Ultimately, electric vehicles still use the roads and must share the costs of doing so, including the maintenance costs caused by wear and tear on the roads, the costs of congestion and accidents and the need for future infrastructure investment. All of these need to be factored in when considering how the use of roads is fairly priced. It is unfair that users of vehicles fuelled by petrol and diesel bear the full burden of funding roads, and it is also unsustainable as drivers continue to shift to electric vehicles. If properly maintained roads is desired, then drivers of all types of vehicles will have to share the burden of paying for them.

---

72 Distance-based charging is where road users pay for use of road infrastructure based on the kilometres driven.

73 Oregon Department of Transportation (2017) All subsequent discussion of the Oregon program draws on this document. California and Washington have also begun pilots: https://waroadusagecharge.org/ and https://caroadcharge.com/en-us/Resources/Ongoing-Research.

74 https://roadusagecharge.utah.gov/faq.php All subsequent discussion of the Utah program draws on this document.

In any case, it is unlikely that sharing in that cost would discourage drivers from buying electric vehicles. As research presented by the Electric Vehicle Council shows, upfront, or 'sticker' prices, are much more important considerations than operating costs when making purchasing choices in the vehicle market.[xcix]

A simple distance-based charge can be designed and easily implemented

The technology required to implement a simple distance-based road user charge for electric vehicles already exists. Odometer readings reported annually or biannually can be used to calculate the charge. These readings can be automatically submitted by vehicles, where possible, or self-reported (with photographic evidence). They can also be supplemented with auditing for compliance, or annual registration inspections.[c] In Utah, embedded telematics (a fleet management system connecting vehicles to a network) and installed devices are used to report distance travelled. Using a device or embedded telematics have the advantage of lower compliance costs. These methods simply require information related to distance travelled. There would be no need for authorities to know when and where a vehicle has travelled.[ci]

Another design consideration is the rate of the charge. In Utah, payments are capped at a fixed fee. In Australia, such an approach could ensure that those who have inadequate access to public transport and are forced to drive to work are not overly burdened. Governments may want to recognise the higher upfront cost and associated environmental benefits of electrical vehicles to ensure the charge is less or at least no higher than the fuel excise for regular petrol or diesel vehicles. Drivers could also have the choice of prepaying for batches of kilometres in advance or having the charge incorporated into the annual registration renewal processes, but clearly separate to the standard registration charge.

Due to range anxiety (the worry around how far an electric vehicle can drive before recharging) and limited regional charging infrastructure, electric vehicle use is currently concentrated to urban areas. However, as technology improves and sees ownership expand geographically, close consideration will need to be given to the distributional impacts associated with drivers of long distances in regional areas.

A third consideration is how to manage different drivers having different privacy preferences. This emerged as an issue early in the trials of the Oregon scheme, where a range of options to collect distance data were introduced. At one end of the spectrum was a device that just counted kilometres. At the other end was a GPS-enabled device that provided more features, including rewards for good driving.

The Review recognises that the proper management of privacy-related concerns is an important issue requiring expert input and broad consultation. It will be important to strike the correct balance between privacy, functionality and citizen choice. There may be some insights to be gained from electronic tags (e-tags) that record use of toll-roads and Opal cards, which if registered, record trips on public transport, which have both been in place for some time without any major privacy problems. State transport departments can offer valuable lessons here and will need to be consulted on broader design elements of the charging scheme for implications to their IT and administrative infrastructure.

Distance-based charging is a reform that can be implemented by state governments unilaterally, collaboratively or in conjunction with the Commonwealth. Freedom of movement between states however means that different charging approaches could create opportunities for arbitrage in terms of where people choose to use and register their vehicles. Therefore, there are clear benefits for state governments to collaborate to ensure consistency and compatibility across state lines, while allowing some flexibility to adapt the charging scheme to reflect local circumstances.

Unlike fuel excise, which is collected by the Commonwealth as general revenue and then partially redistributed to the states through infrastructure grants and financial assistance to local governments, a distance-based charge should be collected and retained by states. The Review recognises there may be some complexity to work through initially as the distance-based charge is operated in parallel with the fuel excise regime, however this will resolve itself in time as one becomes increasingly relevant with the uptake of electric vehicles, and the other declines in importance. This reform is a clear advantage and opportunity for states to enhance the sustainability and sovereignty of their revenue bases without relying on the Commonwealth.

Numerous reports and reviews have highlighted the need to reform the way roads are funded and road use is priced in Australia.[75 cii] In 2016, the Commonwealth Government announced an inquiry into road funding reform but the inquiry has yet to commence. There is an opportunity now to test and trial a distance-based charge on electric vehicles to at least partially correct the inequity in the road funding model with respect to fuel excise. Given their current relatively small share of the market and concentration among relatively higher-income drivers, electric vehicles provide possibly the easiest way to correct different problems.[76] They are among the newest in the market, providing governments with the technological platform to explore and implement the best mechanism to manage privacy concerns.

75 See Competition policy review (2015) by Professor Ian Harper, Infrastructure Australia's Australian Infrastructure plan (2016) Australian Infrastructure Audit (2019), Infrastructure Victoria's The Road Ahead (2016) and Good Move (2020) and the Australian Productivity Commission's Shifting the dial (2017)

76 Infrastructure Partnerships Australia (2019). The Committee for Sydney, in its submission, also strongly supported this line of argument and approach (Committee for Sydney, 2019).

Aligning road funding reform to the rise of electric vehicles makes sense now. A road user fee framework for electric vehicles as a first step, on a smaller scale, will prepare the way for a longer-term transition to a state-based road user charging scheme where all vehicles pay for road use based on the costs they impose.

There are also broader changes to transport habits and technologies beyond electric vehicles that will amplify the need for reform. Research suggests that in future with increased use of car and ride sharing services and autonomous vehicles, the car fleet size could shrink by around 80 per cent meaning less income from vehicle registration fees and stamp duties and consumption taxes, maintenance, insurance and parking fees.[ciii]

Draft recommendation:

The NSW Government should work with the Board of Treasurers and state transport departments to design a nationally compatible and fair road user charging scheme for electric vehicles.

Road network: Only paying for what you use

Two types of state-based road charges are paid by passenger and lighter commercial vehicles in New South Wales: road tolls and a set of charges associated with the ownership of a vehicle.

The latter includes registration fees which vary by vehicle size and type, stamp duties which vary by purchase price or market value, and compulsory third-party insurance which varies with customer risk levels. Registration fees and stamp duties are fixed charges and are not calculated by reference to the amount a vehicle is used.[civ]

This presents several disadvantages for vehicle owners. Firstly, all vehicle owners are liable for the same fees regardless of how often or for how long they drive. Secondly, stamp duties discourage owners from changing and upgrading vehicles. The average Australian car is 10 years old compared to an eight-year average seen in Western European countries. This means that Australians are not readily benefiting from the technological, efficiency, or safety benefits of new cars.

Thirdly and most importantly, the reliance on fixed charges, such as registration fees and stamp duties, clearly fails the primary purpose of a price – to create a transparent cost of use. Cost-reflective pricing is the key mechanism ensuring efficient use of scarce resources. Price provides information to help users choose between alternatives and helps manage demand (through peak and off-peak pricing or tariffs). Recovering costs of services from users helps reduce the tax burden on other people who do not directly benefit from the service.[xcv]

To date, road pricing reform efforts have focused primarily on heavy vehicles, reflecting the damage caused to the transport network by their size and weight. This is a supply side reform, targeted at changes to the way in which road services are provided, and is only a partial solution for a problem that covers all road users, regardless of vehicle size. There is now an opportunity to create a road network funding model that better reflects demand, use, cost of provision and prioritises user preferences.

A distance-based charge for electric vehicles could be incorporated into a future broader charging regime for all drivers that reflects their actual use of the road network. The charge could also be designed so that the average driver would be no worse off than they would be under the existing scheme, which will become particularly important for regional drivers who do not have adequate public transport alternatives and are forced to drive long distances.

An alternative approach could involve drivers contributing to the cost of building and maintaining roads, as well as any negative impacts of road use – such as congestion, carbon emissions and pollution. Drivers would have an incentive to take these costs into account when making choices about driving. As it currently stands, neither the fuel excise nor registration or stamp duty charges account for these external costs. This socially optimal pricing approach provides stronger incentives for making better use of the road networks and a more efficient and fairer framework for different types of vehicles. For example, electric vehicles would pay a lower charge due to lower carbon emissions and other types of air pollution. Heavy vehicles would pay a higher charge reflecting the greater damage done to roads.[77] [cv]

Any government considering a network wide road user charge should not overlook the significant costs to society and the economy of congestion. A more sophisticated distance-based charge that incorporates location and time has the potential to incentivise drivers to change their behaviour, and in doing so, enhance the liveability of cities and towns. More efficient use of the transport network can be achieved if people simply change their travel habits to shop locally, choose to telework, drive after peak hour, switch to public transport, or travel by bike or on foot.[c]

77 There is a well-established methodology for calculating such a charge which draws on information about operating costs, external costs and benefits. Given IPART's experience and expertise in similar calculations when setting maximum public transport fares, it would not be a great extension of their work to also consider optimal charging for roads IPART (2016).

Draft recommendation:

Once distance-based charging for electric vehicles has been successfully implemented, the NSW Government should work with the Board of Treasurers to extend the scheme by replacing vehicle registration, licencing, stamp duties on motor vehicles and motor vehicle insurance with a distance-based charging scheme that better reflects the costs to society of road use, including pollution and congestion. Revenue should be hypothecated to expenditure on roads and transport infrastructure.

Congestion: when building more roads fails

When considering how the road network is priced, it is just as important to consider how to make more efficient choices about transport methods, time of departure, or destination of travel. These choices have a direct impact on the level of congestion on the road network and in turn the liveability of cities.

Many transport users, not just drivers, suffer the consequences of highway delays, overcrowded trains or buses, wasted time looking for parking, vehicle wear and tear, and other inconveniences associated with congestion. The economic costs, such as lower productivity with more time spent commuting to places of work and higher transport costs are well known and quantified. Sydney is the 23rd most congested city in the world, with Sydneysiders losing the equivalent of nearly five days (119 hours) of their lives due to traffic in 2019.[cvi]

Building more transport infrastructure has only provided temporary relief. While additional roads improve travel times initially, more people then choose to drive to take advantage of the better speeds, rapidly eroding any benefits of the new infrastructure and congestion returns.

A continued infrastructure build without simultaneously managing demand is financially unsustainable and fiscally irresponsible, as it means all taxpayers are paying to alleviate the congestion problems affecting some. Construction through well-established suburbs is expensive, disruptive and depletes Australia's open green spaces and amenities. Supporting this significant construction and maintenance bill will require higher taxes, tolls or less expenditure on essential services.

The effects of congestion are location and time specific. Most roads are never congested at any time. But some roads are consistently congested at certain times. Because of this, travel times on all roads become more uncertain. This means that the costs of congestion include not just the time spent in traffic, but the time associated with leaving early, and the losses from the trips that are never made because of congestion. Individual drivers often consider only the time costs of congestion borne by themselves. They ignore the additional time delay and congestion costs that their trip imposes on other users of the congested road.

This problem highlights the growing inefficiency of our road funding system: road users are not appropriately charged for their use. Once registration and licence fees are paid (same amount regardless of the time of day and location of their trip), people are incentivised to drive. This means there are no financial incentives for people to change their travel habits to be more efficient; shop locally, choose to telework, drive after peak hour, switch to public transport, or travel by bike or on foot. This is another example of the failure to provide price signals.

Evidence has demonstrated the most effective way to reduce congestion is to put a price on the use of roads, which incentivises citizens to make a considered choice about transport alternatives. Where road pricing is implemented, modelling shows up to 20 per cent faster average travel speeds can be achieved.[cvii]

There are several different ways congestion charging can be implemented, drawing on successful international examples of cordon (a charge to enter a restricted area) and corridor (a charge to drive along specified section of road) style pricing (Table 10).

Table 10: International cities embracing congestion charging

Region	Type	Start date
Singapore	Cordon and corridors	1975
US	Corridors	1995
London	Cordon	2003
Stockholm	Cordon	2007
Malta	Cordon	2007
Milan	Cordon	2012
Gothenburg	Cordon	2013
Jakarta	Corridors	2020
New York	Cordon	2021

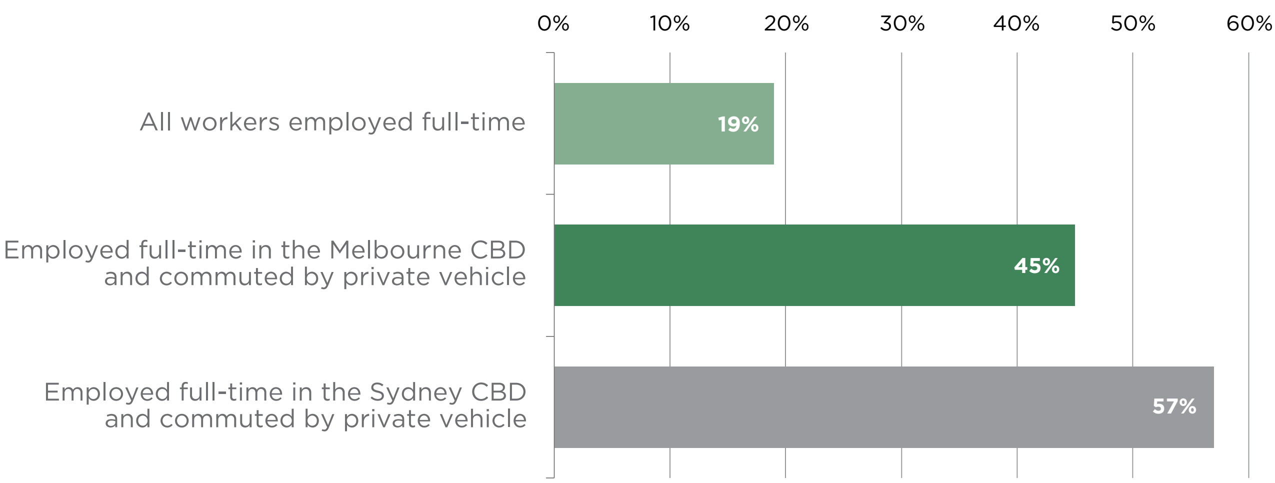
Source: Terrill, M., Moran, G., and Ha, J. (2019). Why it's time for congestion charging. Grattan Institute.

Many public and non-government institutions in Australia have advocated for the adoption of congestion pricing – particularly for large cities, like Sydney. The Grattan Institute, in their submission to the Review, outlined a sequence of reforms that would lead to general congestion pricing across a city like Sydney, with the first being a cordon charge on the CBD.

A cordon charge would need to be high enough to encourage those who can switch to public transport or change their time of travel, to do so, but not too high to discourage high-value trips, like on the day of a job interview. Grattan suggests this charge could be around the same level as the public transport fare most commuters in Sydney and Melbourne pay to travel to the CBD. Transport modelling can also assist with price setting. In Singapore, targets are set for speeds on roads and charges are reviewed regularly to see if these targets are being met and, if not, charges are raised or lowered as appropriate.

One of the concerns about road charging is its impact on low income households. However, it has been documented that people who drive to the Sydney CBD tend to earn around $1,000 a week more than the typical income for full-time workers in Sydney (see Figure 8). These drivers to the CBD are more likely to come from wealthier, richer parts of the city that are also generally well-served by public transport. More generally those that tend to travel further for work purposes tend to do so to earn higher incomes. Conversely since regional areas don't suffer from congestion, a good road charging system that over time rebalances towards more congestion charging will see rural areas benefitting overall.

Figure 8: Proportion of full-time workers who reported a total weekly income equivalent of at least $104,000 per year in the 2016 census



Source: Grattan Institute analysis of ABS Catalogue 2073.0
Notes: The Sydney CBD is taken to be the 'Sydney – Haymarket – The Rocks' SA2 as defined by the ABS. The Melbourne CBD consists of the 'Melbourne', 'Docklands', and 'Southbank' SA2s. Commuters who travelled by 'car, as driver', 'car, as passenger', 'taxi', 'truck', or 'motorbike/scooter' are considered to have commuted by private vehicle.

As the introduction of a congestion cordon would be a novel reform, a trial would offer opportunities to test and refine while learning more about how a range of Sydney drivers, including those on low incomes, respond to road pricing. Box 5 on the Melbourne and Stockholm's trials provides some valuable lessons from successful trials in swaying public opposition to change. The NSW Government may also wish to offset any additional revenue from a cordon charge to lower the parking space levy, as this may achieve the time of day behaviour change without increasing the overall tax burden on CBD car drivers.

Box 5: Road-charging trials in Stockholm and Melbourne

The running of a full-scale trial was particularly effective in Stockholm. Before the trial the cordon charge was both unpopular and attracted negative press coverage. During the trial, public opinion gradually shifted from a large majority opposed to the charges to a small majority in favour of them, and a referendum resulted in the charges being reintroduced in 2007.[cviii]

In 2016, Transurban performed a user-pays charging trial with 1,635 motorists across the whole Victorian road network, not just on their toll roads. Before the trial, 85 per cent of drivers were comfortable with the current road funding system in Australia. After the trial was over, 60 per cent said they preferred shifting to a user-pays system, and 84 per cent were comfortable with the GPS technology used.[cix]

Draft recommendation:

The New South Wales Government should commence a trial for a congestion cordon around the Sydney CBD to better understand how Sydney drivers respond to time-based road pricing.

In Australia and around the world, the COVID-19 pandemic has proven that we can indeed change our behaviour. Congestion and emissions have reduced substantially and life in our cities is better for it. Entire workforces have almost instantaneously embraced telecommuting. People are exploring local communities by foot or bike while spending more time with families. These seismic shifts in people's daily lives offer an opportunity to re-evaluate and re-prioritise. There is great potential to lock in at least some of these benefits.[cx]

The shared experience of flattening the curve has shown the power of collective action towards a common goal. It has demonstrated our collective capacity to prioritise societal benefits over individual interests. The same collective approach could be taken to deal with congestion and road funding, by pricing road usage in a way that mitigates peak demand, encourages the use of public transport, cycling and walking, and provides incentives for staggering or delaying school and work commutes.[cxi]

The benefits of acting now will be enduring, improving the efficiency of the movement of people and goods between and around cities. Importantly, it will improve the quality of our lives. Less infrastructure and operational expenditure will be required to achieve the same or possibly better outcome, freeing up important funds and resources that are more urgently needed for the recovery of other parts of the economy.

There may never again be a chance like this to make cities and economies stronger and healthier.

Endnotes

i Francesco Palermo and Karl Kössler, *Comparative Federalism – Constitutional Arrangements and Case Law* (Hart, 2019) 1.

ii Anne Twomey and Glenn Withers, *Australia's Federal Future*, Council for the Australian Federation, Federalist Paper 1, April 2007.

iii Foreman, K. Dougherty. S and Blöchiliger, H, *Synthesising Good Practices in Fiscal Federalism, OECD Economic Policy Paper*. April 2020, No. 28, OECD Publishing, Paris, 2000.

iv Francesco Palermo and Karl Kössler, *Comparative Federalism – Constitutional Arrangements and Case Law* (Hart, 2019) 255-6.

v Department of Prime Minister and Cabinet, *Towards a Closer Partnership Speech by the Prime Minister*, Canberra 19 July 1990. Available from: https://pmtranscripts.pmc.gov.au/sites/default/files/original/00008059.pdf. [Accessed 24 April 2020].

vi Withers, G. (2020), Economic Benefit from Commonwealth-State Reform, A Report for the NSW Review of Federal Financial Relations

vii Parliament of Australia, Press releases. Heads of Government Meeting Canberra 11 May 1992. Available from: https://parlinfo.aph.gov.au/parlInfo/download/media/pressrel/HPR02012046/upload_binary/HPR02012046.pdf;fileType=application%2Fpdf#search=%22media/pressrel/HPR02012046%22. [Accessed 24 April 2020].

viii Davis G, Silver H, Intergovernmental Relations and the Role of Senior Officials: *Two Case Studies and Some Lessons Learned*. Australian Journal of Public Administration. 2015;74(4):467-483.

ix Burton, T, *National Cabinet Creates a New Federal Model*. The Australian Financial Review. 2020 March 18. Available from: https://www.afr.com/politics/federal/national-cabinet-creates-a-new-federal-model-20200318-p54bar [Accessed 20 March 2020].

x The Australian Editor, *National Cabinet a Basis for Rebooting Federation*. The Australian. 2020 April 15. Available from: https://www.theaustralian.com.au/commentary/editorials/national-cabinet-a-basis-for-rebooting-federation/news-story/f2934f19e7ca07610e60b220a662af71

[Accessed 20 April 2020].

xi Prime Minister of Australia. Update following National Cabinet Meeting. Media Release (29 May 2020). Available from: https://www.pm.gov.au/media/update-following-national-cabinet-meeting

xii Chambers, G., Taylor P, COVID 19 *Crisis Cabinet to Outlive Pandemic and Replace COAG*. The Australian. 2020 April 13. Available from: https://www.theaustralian.com.au/nation/politics/covid19-crisis-cabinet-to-outlive-pandemic-and-replace-coag/news-story/99c3a892fc7175ea62cc7a5d8aadfa33 [Accessed 16 April 2020].

xiii NSW Treasury, *NSW Review of Federal Financial Relations: discussion Paper*, Sydney, 2019.

xiv The Allen Consulting Group, *Governments Working Together: Assessing Specific Purpose Payments – Report to the Government of Victoria*, Melbourne, 2006.

xix Menzies, J, *Explainer: What is the National Cabinet and is it democratic?* The Guardian. 2020 March 31. Available from: https://www.theguardian.com/world/2020/mar/31/explainer-what-is-the-national-cabinet-and-is-it-democratic [Accessed 20 May 2020].

xx Anderson, G., Fenna A, *Australian Federalism and the Global Economic Crisis of 2008-09*'. L'Europe en Formation, 2010;4(358) pp. n/a.

xxi Council for the Australian Federation, *Common cause: Strengthening Australia's Cooperative Federalism. Final report to the Council of the Australian Federation*, May 2009. Adelaide, 2009.

xxii Shepherd, A.F., Boxall, P., Cole, A., Fisher, R., and Vanstone, A., *The Report of .the National Commission of Audit, Commonwealth of Australia*. Canberra, 2014.

xxiii *Williams v Commonwealth (No 1)* (2012) 248 CLR 156, [173] and [216].

xxiv The Commonwealth Government of Australia, Budget: Australia's Federal Relations – Budget Paper No. 3 2009-10. 12 May 2009. Canberra, 2009. Available from: https://archive.budget.gov.au/2009-10/bp3/bp3.pdf

xxv Fenna, A, *Commonwealth Fiscal Power and Australian Federalism*. UNSW Law Journal. 2008;31(2):509

xxvi Australian Institute of Health and Welfare, How does Australia's Health System Work? Canberra, 2016. Available from: https://www.aihw.gov.au/getmedia/f2ae1191-bbf2-47b6-a9d4-1b2ca65553a1/ah16-2-1-how-does-australias-health-system-work.pdf.aspx

xxvii Australian Department of Education, Skills and Employment, *Commonwealth and state responsibilities for schools*. Available from: funding'https://docs.education.gov.au/system/files/doc/other/commonwealth_and_state_responsibilities_for_school_funding.pdf

xxix Department of the Prime Minister and Cabinet (Australia), *Reform of the Federation: discussion Paper 2015.* June 23. Canberra, 2015.

xxx Garnaut, R., Fitzgerald, V, *Review of Commonwealth-State Funding: Final Report*, Melbourne, 2002.

xxxi De Brouwer, G, Gordon de Brouwer: Getting on with public sector reform, The Mandarin. 2020 March 18. Available from: https://www.themandarin.com.au/127771-gordon-de-brouwer-getting-on-with-public-sector-reform/?utm_source=TheJuice&utm_medium=email&utm_source=newsletter&utm_type=mandarin [Accessed 20 March 2020].

xv Australian Dental Association, Submissions: *Australian Dental Association 2020–21 Pre-Budget Submission*. 2020. Available from: https://www.ada.org.au/News-Media/News-and-Release/Submissions/Australian-Dental-Association-2020%e2%80%9321-Pre-Budget-S/ADA202021_Prebudget_Submission_Australian_Dental_H.aspx

xvi Department of Education, Skills, and Employment, Universal Access to *Early Childhood Education*. 2020. Available from: https://www.education.gov.au/universal-access-early-childhood-education

xvii McKinsey and Company, *Implementing a Citizen Centric Approach to Government Service Delivery*. 2015. Available from: https://www.mckinsey.com/industries/public-sector/our-insights/implementing-a-citizen-centric-approach-to-delivering-government-services#

xxviii Allain-dupré, D, *Assigning responsibilities across levels of government, OECD Working Papers on Fiscal Federalism*, September 2018, No. 24, OECD Publishing, Paris, 2018.

xviii Parliament of NSW, *Legislative Council - Budget Estimates 2019-2020*. Sydney, 2020. Available from: https://www.parliament.nsw.gov.au/lcdocs/transcripts/2350/Transcript%20-%2011%20March%202020%20-%20UNCORRECTED%20-%20PC%206%20-%20Transport%20and%20Roads%20-%20Further%20hearing.pdf

xxxii Eccleston, R and Australian Tax Research Foundation, *The Thirty-Year Problem: the Politics of Australian Tax Reform.* Sydney, 2004.

xxxiii The Australian Government, *GST Distribution Review: final report.* Canberra, 2012

xxxiv KPMG Econtech, *CGE Analysis of the Current Australian Tax System, modelling for Henry tax review*. 2010

xxxv Nassios, Madden, Giesecke, Dixon, Tran, Dixon, Rimmer, Adams and Freebairn, *The economic impact and efficiency of state and federal taxes in Australia*, CoPS/IMPACT Working Paper G-289. 2019. Available at http://www.copsmodels.com/ftp/workpapr/g-289.pdf

xxxvi Commonwealth Parliamentary Budget Office, National Fiscal Outlook 2019-20. Canberra, 2019.

xxxvii NSW Government, 2011, NSW Financial Audit 2011

xxxviii Commonwealth of Australia, Tax Benchmarks and Variations Statement 2019. Canberra, 2020

xxxix *2008 Intergovernmental Agreement on Federal Financial Relations and the A New Tax System (Managing the GST Rate and Base) Act 1999* (Cwlth)

xl Australian Productivity Commission, *Report on Government Services 2020*, Chapter 4. School Education. Canberra, 2020

xli Australian Institute of Health and Welfare, *Health Expenditure Australia 2017–18. Health and Welfare Expenditure Series* no.65. Cat. no. HWE 77. Canberra, 2019

xlii Daley, J., Wood, D., Parsonage, H., and Coates, B., *A GST Reform Package*, Grattan Institute. 2015

xliii Australian Government, 2019-20 Budget. Budget Paper no.1 Budget Statement 10.

xliv ABS 5506.0, *Taxation Revenue, Australia, 2018-19*, 2020 April 28.

xlv ABS 5512.0, *Government Finance Statistics, Australia, 2018-19*, 2020 April 28.

xlvi Helm T, *Stamp duty to land tax: designing the transition, Report for Prosper Australia*. 2019 July 31.

xlvii Abelson, P. (2016). Housing costs and policies: with special reference to Sydney. 1322-1833. Sydney: Applied Economics (Section 5)

xlvii Grattan Institute submission to NSW Productivity Commission (2019), pg. 10.

xlix Daley, Coates and Chen, *Abolish stamp duty. The ACT shows the rest of us how to tax property*, The Conversation. 2018 November 1.

l Kelly, Weidmann and Walsh, *The housing we'd choose*, Grattan Institute. 2011.

li RBA, *Housing Market Turnover*, RBA Bulletin, March 2017.

lii Murray, *Developers pay developer charges*, Cities 2018; 74: pp1-6.

liii KPMG *Econtech, Economic Analysis of the Impacts of Using GST to Reform Taxes,* Report for CPA Australia, September 2010.

liv Cao, Hosking, Kouparitsas, Mullaly, Rimmer, Shi, Stark, and Wende, *Understanding the economy-wide efficiency and incidence of major Australian taxes*, Treasury Working Paper 2015-0. 2015.

lv Murphy, *Efficiency of the tax system: a marginal excess burden analysis,* TTPI Working Paper 4/2016. 2016.

lvi ACOSS, Submission to the NSW Review of Federal Financial Relations. 2019

lvii Committee for Sydney, Submission to the NSW Review of Federal Financial Relations. 2019

lviii St Vincent de Paul Society, Submission to the NSW Review of Federal Financial Relations. 2019

lix Grattan Institute, Submission to the NSW Review of Federal Financial Relations. 2019

lx Freebairn, Submission to NSW Productivity Commission. 2019.

lxi *Australia's Future Tax System (Henry Review), 2009*, Final Report to the Treasurer, Canberra. 2009.

lxii Freebairn, *Reform options for state property taxes*, Melbourne Institute Policy Brief No. 2/17. 2017.

lxiii Daley, J and Coates, B, *Property Taxes, Working Paper*, Grattan Institute, Melbourne. 2015

lxvi Reinhardt S and Steel L, *A brief history of Australia's tax system*, The Treasury, Economic Roundup Winter 2006

lxvii Commonwealth Grants Commission, *Commonwealth-state financial relations*. Canberra, 2018.

lxviii Koutsogeorgopulou, V and Tuske, A. (2015), Federal-State Relations in Australia, OECD Economics Department Working Papers no. 1198, OECD Publishing, Paris

lxix Eccleston R and Warren N, *The Devil is in the Detail: The Distributional Consequences of Personal Income Tax Sharing in the Australian Federation*, Australian Tax Forum, 30, 2015.

lxx *States (Personal Income Tax Sharing) Act 1976 (Cwlth)*.

lxxi *Denis James, Federal-State Financial Relations - The Deakin Prophecy in G Lindell and R Bennett (eds) Parliament - The Vision in Hindsight. Federation Press; c2001. p.210.*

lxxii *Twomey, A, Reforming Australia's Federal System. Federal Law Review 3; Federal Law Review. 2008; 36(1)57-81.*

lxxiii Stone A, *Restoring Hope: practical policies to revitalizes the Australian Economy*, Quadrant Books. 2019.

lxxiv Commonwealth Grants Commission (2020), *Report on GST Revenue Sharing Relativities – 2020 Review*

lxxv Lucas, Erikson and Bowman, *A crisis of underinsurance threatens to scar rural Australia permanently*, The Conversation, 2020 January 7.

lxxvi NSW Government, *Submission to Legislative Council Legal Affairs Committee Fire and Emergency Services Levy inquiry*, 2017 December 20.

lxxvii Insurance Council of Australia, Submission to the NSW Review of Federal Financial Relations. 2019

lxxviii Independent Pricing and Regulatory Tribunal (IPART), *Review of state taxation: report to the Treasurer*, October, 2008.

lxxix Tooth, *Analysis of demand for home and contents insurance*, Sapere Research Group for the Insurance Council of Australia. 2015.

lxxx Insurance Australia Group, Submission to the NSW Review of Federal Financial Relations. 2019

lxxxi Vickrey, W, *Henry George, Economies of Scale, and Land Taxation in Wenzer, K.C (ed.) Land-Value Taxation: The Equitable and Efficient Source of Public Finance*, 1999

lxxii Arnott, *William Vickrey: Contributions to Public Policy*, International Tax and Public Finance, 1998; 5(1)93-113.

lxxxiii Booth, Tranter and Eriksen, *Properties under fire: why so many Australians are inadequately insured against disaster*, The Conversation, 2015 November 20

lxxxiv Commonwealth of Australia, *Re:Think Tax Discussion Paper*. 2015.

lxxxv NSW Business Chamber, Submission to the NSW Review of Federal Financial Relations. 2019

lxxxvi Freebairn, Stewart and Liu (2015), Reform of State Taxes in Australia: Rationale and Options, Melbourne School of Government; KPMG submission to the Review; NSW Treasury Interstate Comparison of Taxes 201718

lxxxvii Majeed, O and Sinning, M (2019), *Do payroll tax cuts for Australian firms affect their use of capital and labour?*, TTPI – Working Paper 8/2019, September 2019

lxxxviii Australian Industry Group submission to the NSW Review of Federal Financial Relations.

lxxxix Infrastructure Australia, *Urban Transport Crowding and Congestion*, Sydney, 2019. Available from: www.infrastructureaustralia.gov.au.

xc Australian Automobile Association, *What happens when electric card run over fuel excise?* 2018. Available from: https://www.aaa.asn.au/2018/04/16/what-happens-when-electric-cars-run-over-fuel-excise/

xci Commonwealth Government, *Final Budget Outcome 2018-19*, Canberra ACT: Australian Government; 2019, Table 3, Australian Government general government sector (cash) receipts. Available from: https://archive.budget.gov.au/2018-19/fbo/FBO_2018-19_web.pdf

xcii Australian Productivity Commission, *Shifting the Dial: 5 year productivity review*, Canberra, 2017.

xciii Australian Productivity Commission, *Public Infrastructure, Inquiry Report No. 71*, Canberra, 2014

xciv Bureau of Infrastructure, *Transport and Regional Economics (BITRE)*, Yearbook 2019: Australian Infrastructure Statistics, Statistical Report, BITRE, Canberra 2019.

xcv Bloomberg New Energy Finance, *Electric Vehicle Outlook 2020.* Available from: https://about.bnef.com/electric-vehicle-outlook/

xcvi Eslake, *National Economic Panel, Electric Vehicles and Road-Use Pricing*, 2020. Available from: https://esacentral.org.au/polls-item/33648/electric-vehicles-and-road-use-pricing-june-2018/?type_fr=902 [Accessed 20 May 2020].

xcvii Oregon Department of Transportation, *Oregon's Road Usage Charge*. 2017

xcviii Infrastructure Australia, *An Assessment of Australia's Future Infrastructure Needs*, Canberra. 2019

xcix Electric Vehicle Council, *State of Electric Vehicles*, 2019, page 26. Available from: https://electricvehiclecouncil.com.au/wp-content/uploads/2019/09/State-of-EVs-in-Australia-2019.pdf [Accessed 20 May 2020].

c Infrastructure Partnerships Australia, Submission to the NSW Review of Federal Financial Relations. 2019

ci Infrastructure Victoria, *The Road Ahead*. 2016. Available from: https://www.infrastructurevictoria.com.au/wp-content/uploads/2019/04/The-road-ahead-final-web.pdf

cii Infrastructure Victoria, *Good Move: Fixing Transport Congestion*. 2020. Available from: https://www.infrastructurevictoria.com.au/wp-content/uploads/2020/03/Good-Move-fixing-transport-congestion-Infrastructure-Victoria.pdf

ciii Swinburne University, Submission to the Victorian Parliamentary Inquiry into electric vehicles, no. 46, pp. 5-6.

civ Transport for NSW, Registration costs and concessions. Available from: https://www.rms.nsw.gov.au/roads/registration/fees/index.html

cv Independent Pricing and Regulatory Tribunal (IPART), *More efficient, more integrate Opal Fares*. May 2016

cvi INRIX Research, 2019 Global Traffic Scorecard, page 10. 2020.

cvii Terrill, Marion, Greg Moran and James Ha, *Why it's time for congestion charging*. Grattan Institute. 2019

cviii Jonas Eliasson, Lessons from the Stockholm congestion charging trial, Transport Policy 2008;15(6): 395-404. Available from: https://www.sciencedirect.com/science/article/abs/pii/S0967070X0800053X

cix Transurban, Changed Conditions Ahead: The transport revolution ahead and what it means for Australians. Melbourne Road Usage Study, 2016. Available from: https://www.transurban.com/content/dam/transurban-pdfs/01/melbourne-road-usage-study-report.pdf

cx WSP Australia, Public Transport and COVID-19: How to transition from response to recovery, 2020. Available from: https://www.wsp.com/en-AU/insights/covid-19-and-public-transport-from-response-to-recovery [Accessed 1 May 2020].

cxi Gavin Nicholls, 2020, Planning a legacy for our cities, Veitch Lister Consulting, 2020. Available from: https://veitchlister.com.au/planning-a-legacy-for-our-cities/ [Accessed 1 May 2020].

You can find more information on the Review at:
www.treasury.nsw.gov.au/federal-financial-relations-review

You can make a submission to the Review at:
FFRReview@treasury.nsw.gov.au

You can get in touch with the Review at:
FFRReviewSecretariat@treasury.nsw.gov.au