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Special Edition: State Funding Reform in the Australian Federation

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policy reviews, it was also heavily influenced by an assessment of strategic developments in such fields as the global economy, demography, technology and social and environmental sustainability.

The broad conclusions for the future Australian tax architecture were:

- Revenue collection should be concentrated on four efficient bases – immobile rents, consumption, individual income and business income.
- Other narrow and inefficient taxes should be abolished (except those efficiently addressing market failure or other clear social purposes)
- To maximise economic growth, the relative weight of the major taxes should shift over time in accord with base mobility – more tax on immobile rents (land and natural resources) and consumption and less on personal and (particularly) business income.
- Existing major tax bases could be more neutral; the transfer system better targeted, more adequate, and less adverse for workforce participation; and some user charges and other fiscal arrangements could be reformed to improve social outcomes.

In broad terms the Review was conducted under a revenue neutrality assumption because its terms of reference specified that "...recommendations should not presume a smaller general government sector and should be consistent with the Government's tax to GDP commitments."[6] Clearly then, the Review framework requires that revenue losses from the abolition of taxes be offset by higher collections from the large efficient bases.

Several large tax base issues were addressed in very general and sometimes provisional terms, such as those relating to business income and the taxation of dividends. Because the Review was precluded by terms of reference from recommending increases in the GST rate or base, it was also guarded in the way it approached the key idea of increasing the overall weight of consumption taxes or using these to facilitate reform (often abolition) of State taxes.

The key recommendation in this regard is Recommendation 55 dealing with replacing state taxes with a destination cash flow tax, but this is worded essentially as a finding. There is no specific recommendation for the actual introduction of a new cash flow tax and the only recommendation in the chapter on State tax reform relates to general principles for inter-governmental coordination processes. Recommendation 55 states that:

> *Over time, a broad-based cash flow tax – applied on a destination basis – could be used to finance the abolition of other taxes, including payroll tax and inefficient State consumption taxes, such as insurance taxes. Such a tax would also provide a sustainable revenue base to finance future spending needs.*[7]

A destination cash flow tax would have much the same economic base as a value added tax (the GST). In the context of modern business technologies, it may be and more neutral base and for greater integration of tax administration and collection across more than one base. However, the Review essentially leaves most of these issues for further study in the future.

4. ABOLISH AND REPLACE STATE TAXES

The AFTS Review proposed that a number of state taxes be abolished and replaced by other more efficient sources of tax revenue (or user charges). A destination cash flow tax is potentially only one of these. Clearly, an increase in the rate or base of the GST itself, whether or not it is reformed in other ways, is also an alternative source of revenues if political conditions change under some future government.

The taxes proposed to be abolished were identified by the AFTS Review essentially on the basis of theoretical expectations and empirical estimates of their excess burden or 'deadweight economic loss' (the loss of social welfare arising from behavioural change arising from the tax) [8]. While this is only one criterion for the analysis of taxes, the Review had in any event decided to recommend that revenue collections be concentrated on four large and relatively more efficient tax bases. It did not support retaining in the long run any other tax whose justification was purely revenue. Some taxes may be retained where there are specific additional economic or social purposes and it can be shown these are met efficiently by taxes. The proposals for the main state taxes are summarised in Table 1.

Table 1: AFTS Proposals for State Taxes

Tax	**Revenues 2009-10 $b**	**Proposal**	**Possible Replacement**
Payroll	16.8	abolish	Consumption
Insurance	4.6	abolish	Consumption
Property transfers	12.3	abolish	Land tax
Land tax	5.8	Retain and reform	Modified base
Resource Royalties			

any changes to it requires Commonwealth legislative action that does not discriminate between states.

The abolition of state taxes would change the assessment of the fiscal capacities of the States and so would affect the distribution of Commonwealth general revenue payments to them. As with the introduction of the 10 percent GST in 2000, these issues likely would need to be the subject of a comprehensive intergovernmental agreement, possibly including guarantee provisions ensuring no state is made worse off by the changes.

In principle a greater use of the consumption tax base might also be used to replace other inefficient taxes. However, as indicated in Table 1, the analysis in the AFTS Review points to different approaches for these other taxes. Land tax, if imposed on a broad and neutral base, is particularly efficient, even more so than consumption, and the immobility of its base renders it very suitable as a state (or local) tax. Unlike consumption tax there is also no constitutional difficulty for States imposing the tax at rates of their choosing. The AFTS Review therefore envisaged that land taxes, which currently generate revenue both through an asset base and a transaction base, should be reformed without any net reduction in land revenues. The abolition (or reduction) in property transfer taxes would therefore be funded by land tax.

Similar considerations apply to resource royalties – the most efficient replacement for these is resource rent taxes. The AFTS Review recommended that royalties be replaced in this way and that the Australian and State governments negotiate an appropriate allocation of the revenue and risks. Subsequent announced policy, applying to a more limited range of resources, was developed without this consultation on revenue sharing. It provides for the retention of both forms of tax, with the States retaining royalty revenue and the Commonwealth taking rent tax (with a credit for royalties). Some States have already announced higher royalties in order to secure higher shares of revenue, but the retention of royalties has compromised for now the potential efficiency benefits of these reforms.

In the case of the motor taxes (which at the state level mainly comprise registration charges and stamp duties on purchases of motor vehicles), the initial recommendation is to make these explicit and link them to recovery of costs related to road provision. In the long term these could be replaced if efficient road pricing is introduced, but this is a highly contingent proposal.

5. REFORMING CONTINUING STATE TAXES

The AFTS Review provided few substantive recommendations for the reform of specific state taxes except for land tax. Land and gambling taxes would be the only substantial state taxes continuing to exist if the Review recommendations were fully adopted.

5.1 Land Tax

The potential efficiency of land as a tax base has long been recognised. The AFTS Review included land among its four preferred tax bases (including it with natural resources as the main immobile economic rent bases). In Australia, however, taxes based on land take three main forms with only one, the local government rate, coming close (in most cases) to an efficient design. Much less efficient are state land taxes (because they apply on an aggregate landholding basis and only to certain land uses) and property transfer taxes which share the efficiency costs of many other transaction taxes.

The Review proposed a single, comprehensive land tax base (essentially shared between local and state government). It proposed that the rate of tax be set by reference to the unit value of land (that is, the value per square metre rather than the aggregate value of total landholdings of each taxpayer). Low unit value land such as most rural land would fall below a threshold value for tax, but in general there would be no exemptions based on the use of land. As the unit value of land rises, generally in or near population centres, the rate of tax would also rise. The highest rate would apply to the most valuable land per square metre, although implicit in the recommendations is that the rate of tax would never be so high as to confiscate a very high share of rents. Of course, it is to be

However, set against this are strong interests benefiting from existing outcomes, not least existing landowners. It is unlikely that there will be much change unless and until a much clearer consensus emerges about market performance, its causes, and opportunities for improvement. Even then, there may need to be other gains packaged with this reform. The future role of local government may also play an important part, given the fundamental place that property and land use plays in that role and its funding.

5.2 Gambling Taxes

Gambling taxes are controversial in Australia as elsewhere given differing perspectives on how the social costs of problem gambling should be addressed. As for alcohol, the AFTS Review tended to the presumption that responsible gambling consumption was welfare improving in k

disability care and support, each affecting both major levels of government and the subject of Productivity Commission Inquiries. A major challenge now arises in integrating responses to these issues with the quite high fiscal cost decisions already taken on retirement income policy.

Second, the fiscal situation facing Australia is one of very limited policy room. Projected national budget surpluses in each of the three years to 2014-15 are very small (reaching only $3.1 billion in the final year). In the context of strong bi-partisan commitment to budget surpluses, this largely rules out for some time the tactic used in most past tax reforms of providing net tax cuts with reform packages. These were previously possible in large part because significant bracket creep revenues (that is, higher revenues as average rates of tax increase under an unindexed progressive tax scale) were returned to give the impression of net gains.

Third, the policy settings in coming years will likely act as a brake on the growth rate of disposable household income which limits the political appetite for reforms that have any real or apparent household cost. The elements of this include bracket creep for a number of years, the introduction of an additional 3 percent superannuation guarantee obligation, and the possible costs of the aged care and disability care 077 s elderly may often be based in part on misunderstanding of the actual economic incidence of this tax, a switch from that tax base to consumption would be expected to support growth.

Overall it is not clear what will develop, but there is certainly early evidence of considerable concern among the States at their fiscal circumstances and the ways that these developments and existing policy affects them. This could generate interest in a broader solution to their revenue and spending pressures.

In the current setting, it seems that those interested in further reform may need to focus on furthering the analysis and understanding of the key issues for some time. The AFTS Review made a number of recommendations that would further this type of work (see Recommendations 113, 131 and 134 which each propose arrangements for

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