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Invited Article

Federalism and Tax Reform¹

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Abstract

The form and potential contributions of cooperative federalism and the additional skills and tasks required of the public service to turn well-known and developed tax reforms into actual reforms are evaluated. Cooperative federalism seems necessary for reforms involving state taxes and changes in the mix of taxes. Additional public sector skills and involvement in developing details of tax reform packages and their implementation, and then monitoring the outcomes, are important to raise community understanding of, and confidence in, taxation reform.

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1. Introduction

Chapter 6, 'More Effective Governments', of the Productivity Commission's *Shifting the Dial* (2017) report sets out proposals for governments to be more effective in raising national productivity to support higher living standards. National, state (and territory) and local government decisions to improve productivity include policies for taxation, government-supplied goods and services, and establishing and monitoring property rights and regulations to support private sector decisions on investment, employment and consumption. This article explores the application of cooperative federalism and the development of government decision-making procedures proposed in *Shifting the Dial* to facilitate adoption of productivity enhancing taxation reform across the three levels of Australian government.¹

Recent reviews of taxation for the national government, including the *Henry Review* (Henry et al., 2010) and *Re:think* (Australian Government 2015) for state governments, including the Australian Capital Territory (ACT Treasury 2012) and South Australia (SA Government 2014), along with numerous academic and other studies, have proposed and evaluated many tax reform options that would substantially increase national productivity. For example, the Henry Review (Henry et al. 2010, pp. 73–75) report estimated gains of between 2 and 3 per cent of GDP for a subset of its recommendations. Proposed productivity enhancing tax reforms include packages of removing special exemptions to broaden tax bases and fund lower tax rates, and changes of the tax mix by replacing taxes that carry high excess burdens with taxes that carry much lower excess burdens. Many of the proposed reforms involve taxes across national, state and local governments.

The rest of the article is as follows. As background, Section 2 provides a summary of current taxation by level of government and some examples of proposed reforms to raise national productivity. Examples, and potential benefits, of cooperative federalism in the design and delivery of productivity enhancing tax reform is discussed in Section 3. Concerns with the efficiency costs of vertical fiscal imbalance and the potential for taxation reform to reduce these costs are considered in Section 4. Section 5 concludes with a summary of the directions taken in *Shifting the Dial*.

2. Current Taxation

In 2015–16 the three levels of government collected \$483 billion in taxes, or about 29 per cent of GDP. The national government collected about 81 per cent of all taxation revenue, largely income tax and then, in order of importance, GST and excise taxes on petroleum, tobacco and alcohol products; the states 15 per cent, with payroll and conveyance duty the largest contributors; and local governments 3 per cent from local rates. More details are in Table 1.

[insert table 1 about here]

Taxation is the main method used by governments to gain access to limited labour, capital and natural resources to provide many goods and services that would be under-supplied by the private market. The progressive income tax, together with government-funded social security payments and the supply for free or concessionally priced health, education and other services, redistribute income and opportunities to meet society equity objectives.

Reality is that taxation involves more than a dollar for dollar transfer of resources from the private sector to government. Taxation alters relative prices and induces changes in decisions that reduce national welfare, for example, work versus leisure, current consumption versus saving, and the choice between different saving, investment and business options. Tax-distorted decisions result in the cost to the economy of a dollar of tax revenue exceeding the dollar transfer. Available estimates are that the excess burden for the large revenue raisers exceed 25 cents per dollar of tax revenue and for some over 50 cents (Henry et al. 2010, p. 13). Also, taxation involves significant losses of disposable incomes via the reallocation of scarce resources to government tax administration and to tax payer compliance.² Reform of taxes to reduce decision distortions and efficiency costs in approximate revenue neutral packages, and with status quo or better equity outcomes,³ lie behind the *Shifting the Dial* proposals for taxation reform as one component of a much larger agenda to raise national productivity.

Taxation reform involves changes in one or more of the tax bases, tax rates and the mix of taxes. Reforms to support higher national productivity and living standards reduce the excess burden by

adopting approximately revenue neutral reform packages that combine comprehensive bases and lower tax rates, and by shifting the tax mix from decisions that are sensitive to relative price changes to those with lower elasticities. Comprehensive bases with few, if any, special exemptions and deductions also add to simplicity and reduce the costs of tax administration and compliance.

Table 1 provides some examples of yet to be implemented publicly assessed reforms to the current system of taxes aimed at increasing national productivity. Examples of base-broadening reforms include removing special exemptions and deductions for income, GST, payroll and land taxes and using the larger base to fund a lower rate. A comprehensive tax base reduces distortions to decision choices between the current taxed and the exempt choice options, the lower tax rate reduces the excess burden of the tax, and removal of special exemptions and deductions improves simplicity. A more neutral set of effective income tax rates on capital income received from investment in different resident household saving and investment options, including owner-occupied homes, other property, shares, financial deposits and superannuation, would reduce significant tax-caused distortions to saving and investment decisions. A more neutral system of withholding taxes on capital income earned by non-resident investors across debt, franked dividends, unfranked dividends and capital gains would bring efficiency dividends. The state transaction taxes, including conveyance duty on property transfers and stamp duty on motor vehicles and insurance, have relatively high excess burdens; less distorting revenue replacement options are available, such as land tax for conveyance duty in a tax mix change package.

There are a range of options to reduce excess taxation burdens and increase national productivity by shifting the tax mix away from tax bases with relatively high supply elasticities, especially in the context of Australia as a small player in a much larger global market, to tax bases with a relatively low elasticity. These include lower income tax in exchange for one or more higher land and natural resource tax, and higher GST tax bases. These types of tax mix change reforms often will require a broad package of reforms to several taxes and also to the social security system to maintain the status quo in terms of equity.

Replacement of the current fuel excise and state taxes on motor vehicles with explicit charges for road use, for congestion and for pollution, and a consistent tax burden across all types of alcohol to internalise external costs, provide examples of efficiency justified additional special taxes. External cost correction taxes for sugar and fat intense foods, and for pollution such as greenhouse gas emissions, may join a future tax reform agenda.

Naturally, there is both imperfect knowledge and legitimate debate about the details of reform options and about the magnitude of their potential gains in national productivity. This reality

supports the *Shifting the Dial* arguments for strengthening public sector capacity to evaluate reform options. Increasing the quantity and skills of public sector staff, drawing on non-government and international experience and analyses, and then monitoring the progress and outcomes of actual reforms, are proposed.

Accepting imperfect information, the Productivity Commission argues against yet another review of taxation. Rather, it argues for government changes to implement some of the well understood and analysed reforms, including those illustrated in Table 1.

In terms of specific tax reforms, *Shifting the Dial* contends both that a reform package across all potential reforms is too ambitious and that too narrow a reform package risks being dominated by rent-seeking groups. But, it provides neither a priority list of taxation reforms nor a specific and detailed reform package.

3. Cooperative Federalism

While some of the potential tax reforms to promote national productivity discussed in Section 2 could be implemented by a single level of government, in many cases cooperation between two or more of the national, state and local levels as proposed by *Shifting the Dial* offer better incentives and rewards. This section provides some examples.

For current income taxes affecting resident individuals, business enterprises and non-residents levied by the national government, most of the benefits from, and the means of, reform reside with the national government. Recent examples of successful income tax reforms by the national government include: base broadening to include capital gains and fringe benefits plus a lower personal income tax rate schedule package in 1987; and corporate income tax reform of 2000 with removal of most accelerated depreciation and other special exemptions to fund a reduction in the corporate rate from 34 to 30 per cent. Further reforms to the income tax base and rate schedule, reform for a standard tax rate per unit of alcohol across beverages, and potential external cost correction taxes on greenhouse gas emissions and sugar intensive products could be designed, enacted and monitored by the national government. Increases in the tobacco excise of recent years is another example.

A view that that potential reforms of taxes directly determined by state governments to raise national productivity could be left to state governments, rather than involve cooperative federal involvement, is questionable. Further, the concerns are larger if an individual state reforms alone. Potential high national productivity enhancing state tax reforms include: a more comprehensive land tax base to include land allocated to owner occupied homes and primary production, either alone or

as a component of a larger reform package to replace conveyance duty; and removing exemptions from the payroll tax base. Sensible options for the more comprehensive land and payroll tax base reforms include the local government rate base for land and the national PAYG (pay as you go) base for payroll rather than the current state administered bases.⁴

If an individual state proceeds with reforms alone, it bears most of the risks and receives only some of the benefits (Warren 2010). Risks include: the reactions and tax reforms of other states to the reform by one state, and the second-round implications of these reactions for the reforming state economy; and institutional risks of adjustments to national government payments to the states, including distribution of the GST and levels of tied grants. An important share of the benefits of a more productive state economy generated by the state tax reforms accrue to the national income tax base. And, horizontal fiscal equalisation likely would redistribute some of the first-round revenue gains of the reforming state to other states. Cooperative federalism involving all the states and national (and for land also local) governments provides a forum to internalise the risks and benefits of productivity enhancing reform of these state taxes.

An important set of potential tax reform packages to raise national productivity involves changes to the tax mix. In several examples the package includes changes to taxes levied by at least two levels of government. One example is the proposal canvassed by many, including *Shifting the Dial*, to replace the current, essentially general revenue-raising, fuel excise levied by the national government and state motor vehicle taxes, which include vehicle registration, stamp duty on motor vehicle transfers, licence fees and CBD parking fees. A productivity enhancing reform package would replace the general revenue-raising taxes with explicit charges to motorists for the social costs they incur for road use by different vehicles, to internalise the external cost of congestion where relevant, and to correct the external costs of pollution, including greenhouse gas emissions. With these current taxes collecting about the same revenue as the combined national, state and local government expenditures on road investment and maintenance, the reform package in aggregate should be revenue positive. Fundamental questions on the reform package include: design details of the three new user charges; which level(s) of government should be responsible for setting the three user charges and collecting the revenue; and distribution of the revenues received. Cooperative discussion across the different levels of government clearly is a prerequisite for reform.

Other examples of potential tax reform packages to raise national productivity which include changes to the mix of taxes levied by different levels of government are: a larger GST to replace stamp duties on insurance, other stamp duties, and perhaps payroll tax, and then changes in the income tax rate schedule and social security rates to meet current equity outcomes; a larger or

smaller payroll tax with matching changes to the income tax; a larger land tax and smaller income tax package; and a tax mix change involving a larger GST driven by a more comprehensive base and/or higher rate to fund a lower income tax take. The *A New Tax System* reform package of 2000 provides an illustration. Clearly, cooperative discussion across the different levels of government is required in the design, implementation, operation and monitoring stages of future tax mix change reforms.

The foregoing illustrative reforms of state taxes and of tax mix change packages provide supporting evidence for greater levels of genuine federation cooperation as proposed in chapter 6 of *Shifting the Dial*.

4. Vertical Fiscal Imbalance

About 45 per cent of state government revenue come from transfers from the national government, of which about half are untied grants as a share of the GST,⁵ and the other half are tied grants, mostly under the headings of Special Purpose Payments and National Partnership Payments. On average, local governments receive about 15 per cent of their funds as transfers from the national and state governments. All federal government systems across the globe have vertical fiscal imbalances (VFI) and some level of VFI seems inevitable. The magnitude of VFI between the national and states is more extreme in Australia. While the causes of VFI lie on both the expenditure and revenue sides of the budget, this section considers only potential taxation reform as a policy option to reduce VFI.

There is an extensive and controversial literature about the reasons for, and the effects of, VFI. On the taxation side, arguments for efficiency and simplicity point to the national government collecting taxes on bases where there is high mobility across the lower levels of government, including income tax, to impose market failure correction taxes with common external costs across the country and to collect taxes where the cost savings associated with scale economies and simplicity are large. In general, these arguments leave tax bases on geographically immobile inputs for the states and local governments, including land and other natural resources.

Whether VFI is detrimental to national productivity, both of government expenditure and taxation, is debatable. One set of pro and con arguments consider budget accountability. Those critical of VFI take a 'soft budget constraint' view with concerns that the overlaps of levels of government and VFI result in a lack of transparency and accountability, blame-shifting and duplication. Those less concerned with VFI take a 'hard budget constraint' view that at the margin the lower levels of government explicitly and publicly evaluate the relative benefits of additional state level outlays

against the additional costs of increases of state taxes. An interesting and unresolved issue is whether the plausibility of a 'hard budget constraint' is negatively related to the magnitude of VFI? Given this and other contradictory arguments in the literature, it is no surprise that *Shifting the Dial* does not promote a reduction in VFI as a rationale for tax reform.

Several of the potential tax reforms to state taxes discussed above would have effects on VFI. Reforms to broaden the land and payroll taxes potentially mean more own-source state revenue, although the initial higher revenue effect of a larger tax base could be partially or fully offset if the reform package included a lower rate. More comprehensive and larger base state taxes likely provide a greater capacity and willingness for states to adjust the tax rates in a 'hard budget constraint' sense. If some—and even if all—of the revenue gain of a tax mix change involving a larger GST, either a broader base or higher rate, is allocated to the states, VFI would be reduced. Options found in other federal systems to reduce VFI include the states receiving a pre-agreed share of income tax revenue or being given the right to levy an additional state-level income tax using the national income tax base. Clearly, the introduction, and the management, of these and other reform options to reduce VFI require extensive federal discussion and cooperation.

5. Conclusions

Taxation reform across national, state and local levels of government is an important component of the Productivity Commission's initial five-year productivity review report, *Shifting the Dial*, to raise national productivity and living standards.

Rather than another review of taxation and reform options, *Shifting the Dial* focuses on government changes to implement already extensively evaluated reform options undertaken by the national and state governments, and by academics and interest groups.

Potential taxation reforms to improve national productivity and to reduce operating costs include removing special exemptions and deductions for more comprehensive and larger income, expenditure and asset tax bases, changes in tax mixes towards those bases with relatively low supply elasticities, and more directly designed special taxes as user fees and external cost correctors. Arguments to reform taxation to reduce VFI alone are not convincing. No priority ranking of the many reform options, nor details of specific recommended reform packages, are offered in *Shifting the Dial*.

Instead, *Shifting the Dial* focuses on changes in government procedures to facilitate turning available reform ideas into actual taxation reforms. Given that taxation is a quasi-constitutional policy with longer-term effects on incentives and rewards for the private sector, there is an emphasis on

articulating longer-term reform strategies with general agreement across levels of government and political parties. The need for greater and more effective cooperative federalism is promoted. Many of the available tax reform options involve taxes now levied across the different levels of government. Cooperative federalism offers a way to internalise the risks and the benefits for reform of state taxes that deter individual states from undertaking reform.

Also recommended is a more proactive and higher quality public sector engagement in the analysis and evaluation of tax reform options for use by politicians and for better informing the public debate, and then monitoring the progress and outcomes of reforms. This involves raising the quality, training and time commitment of public servants, and drawing upon the work and experiences of the wider community, and internationally.

The importance of political leadership and involvement is noted by the Productivity Commission, but no magic wands are offered.

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Table 1 Taxation by Base and Level of Government and Potential Reforms for Efficiency

<i>Tax</i>	<i>Govt. level*</i>	<i>2015–16 Revenue (\$b)^</i>	<i>Potential reforms[#]</i>
1. Income base:			
Australian income	N	263.3	Broaden base, capital income neutral, rate simplify
Non-resident income	N	1.8	Neutral treatment
Payroll	S	22.7	
	N		
2. Consumption:			
GST		60.3	Broaden base
	S		
3. Asset base:	L		
Land tax	N and S	7.2	Broaden base, increase tax mix
Local rates		16.9	
Mining taxes		17.6	Broaden base, increase tax mix
	S		
4. Transaction:	S		
Conveyance duty		20.6	Replace with land tax
Taxes on insurance		5.7	Remove
	N		
5. Special taxes:	S		
Fuel excise	N	15.9	Replace with user charges
State motor vehicle	N	7.1	Replace with user charges
Alcohol excise & WET	S	5.4	Standardise rate per unit alcohol
Tobacco excise		9.8	
Gambling		6.1	
Total		483	

Notes: *N for national, S for state and L for local.

^Data from ABS (2017), details of excise from Morrison and Cormann (2017) and state mining taxes from Commonwealth Grants Commission (2017).

Author drawn from Henry et al. (2010) and Australian Treasury (2015).

¹ For reasons of brevity, approximate aggregate revenue neutral and status quo vertical equity reform packages are considered. Given the current national fiscal deficit and Intergenerational Report (IGR) estimates of a rising share of government expenditure to GDP, a higher revenue take may be appropriate. With vertical equity primarily a political judgement, the status quo is accepted, but of course open for discussion.

² Australian Government (2015) report estimates for compliance costs of 'the order of \$40 billion per year', and ATO annual costs of \$3.7 billion.

³ The taxation reforms also may improve horizontal equity.

⁴ The ACT as both a state and local government in 2016 introduced a 20-year phased replacement of conveyance duty with a higher local rate tax.

⁵ Further complications and challenges to reform arise with the distribution of the GST across the different states to achieve horizontal fiscal equalisation.

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