

# REVIEW OF STATE TAXATION

## Final Report

### Overview

On 4 September 2008, IPART submitted to the Treasurer the final report for its review of state taxation in NSW. The full report is available on IPART's website.

The terms of reference required IPART to:

- ▼ assess the effect of Commonwealth-State fiscal arrangements on NSW's revenue mix and its ability to fund essential public services
- ▼ compare the efficiency of the taxes available to the NSW and Commonwealth governments
- ▼ review the NSW tax system against standard taxation principles and competitiveness
- ▼ recommend options for improving the NSW tax system.

IPART made 29 recommendations to the Treasurer (see Appendix A). IPART made recommendations for improving the NSW tax system independently of the Commonwealth and other States. However, IPART's key conclusion was that a far-reaching national approach to reform would yield the greatest benefits because of the practical constraints on what each State can do on its own. Its recommendations for a national approach to reform represent broad options for such reform, and require further consultation and analysis. The National Tax Review provides an important opportunity but efforts at national reform may need to be pursued beyond this.

### Background

In Australia, the Commonwealth government raises most of its revenue from a small number of taxes, including income tax, excise and customs duty, and the Goods and Services Tax (GST). These taxes have large, broad bases, and enable the Commonwealth to raise more than 80 per cent of the total tax revenue collected in Australia - which is significantly more than it needs to meet its spending responsibilities.

The States and Territories (the States) rely upon a greater number of taxes, including payroll tax, stamp duties on the purchase of property and insurance, land tax, and gambling and betting taxes. However, many of these taxes have small and relatively

narrow bases. As a result, States raise only a small portion of the total revenue they require to meet their expenditure responsibilities – which include funding essential public services such as health, education, policing, transport, welfare and environmental protection services.

To address this mismatch between the respective taxation bases and spending responsibilities, the Commonwealth shares some of the tax revenue it collects with the States, using a complex system of horizontal fiscal equalisation (HFE).

## IPART's findings

IPART found that:

- ▼ Only 39 per cent of NSW's total State revenue comes from tax revenue with more than half of this coming from just two taxes - payroll tax and purchaser transfer duty.
- ▼ NSW's revenue from Commonwealth grants and its total revenue are both lower than in most other States - both as a proportion of Gross State Product (GSP) and per capita.
- ▼ NSW's own-source tax revenue is the highest of all States as a proportion of GSP, and third highest per capita. Its higher level of own-source tax revenue is largely due to larger tax bases rather than higher tax rates.
- ▼ Compared to the Commonwealth, NSW's tax system is less robust: it is much smaller, and relies on a wider range of taxes that are less efficient, more narrowly based, and growing at a slower rate than Commonwealth taxes.
- ▼ A range of institutional and practical constraints limit the options for tax reform in NSW, especially in the short term. For example, taxation powers in Australia are highly centralised at the Commonwealth level.
- ▼ The Commonwealth Government's current arrangements for determining the transfers from the Commonwealth to the States to correct for vertical fiscal imbalance (VFI) act as another major constraint on tax reform, and further constrain the States' fiscal autonomy. This is because the methodology creates fiscal incentives that inhibit State-level tax reform designed to improve the overall efficiency of the tax system.

In relation to individual taxes IPART found that:

- ▼ Payroll tax, which makes the largest contribution to the State's own-source tax revenue, is the best State tax in terms of performance against standard taxation principles. Its economic impact is very similar to the GST but in its current form it is significantly less efficient than GST due to the exemptions.
- ▼ Land tax, which contributes 10 per cent of NSW's own-source tax revenue, is another relatively efficient tax, with substantial scope to improve its efficiency. However, in its current form, this tax scores relatively poorly for equity, simplicity and transparency, and was ranked fourth among the State taxes overall.

- ▼ For both payroll tax and land tax, the current tax base is considerably narrower than the potential tax base. These taxes could be made more efficient and equitable by broadening their bases through the reduction or removal of exemptions and concessions. The current exemptions and concessions place a disproportionately high tax burden on those few businesses and individuals liable for payroll and land tax, and provide substantial benefits for those who are not. However, a broadening of these tax bases would be contentious and difficult to achieve.
- ▼ Purchaser transfer duty – which is the second largest contributor to the State’s own-source tax revenue – ranks among the worst of the major NSW taxes. It scores poorly for efficiency because it adds to the cost of real estate transactions and so can distort investment decisions. It also scores poorly for robustness, because the revenue collected can change dramatically from year to year, with the property cycle.
- ▼ Insurance duty and fire services funding contributions are the least efficient State taxes. These taxes penalise those who are prudent enough to take out insurance, and so encourage underinsurance and non-insurance. In addition, significant free-rider problems are associated with the fire services funding arrangements, where non-contributors benefit from the provision of fire services without contributing to the cost through insurance policies.

In relation to interstate competitiveness of the NSW tax system IPART found that:

- ▼ The competitiveness of the tax system cannot be judged from a comparison of individual rates. An efficient tax system funding efficient service delivery is more important. While some individual rates in NSW are higher (eg, payroll tax), the overall tax effort is comparable to other States, except Queensland and Tasmania, and the mix of taxes in NSW is relatively more efficient. The larger tax revenue as a proportion of GSP is due to the larger tax bases in NSW.

### **IPART’s recommendations**

Given the various legal, institutional, policy and practical constraints on tax reform at the State level, NSW should seek to improve its tax system through cooperation with the other States and the Commonwealth. Expanding the reform agenda to the national level – which can only be done through cooperative Federalism – will create a wider range of more significant potential gains for all jurisdictions. Possible directions that this reform might take include:

- ▼ Expanding efficient Commonwealth taxes, and sharing the revenue generated with the States in return for reduction or abolition of inefficient State taxes.
- ▼ Reassigning some part of one or more efficient Commonwealth taxes to the States in return for the reduction or abolition of inefficient State taxes.

- ▼ Improving the current arrangements for revenue sharing between the Commonwealth and the States, to improve the incentives for the both State and national level tax reforms.
- ▼ Further harmonising State taxes, to remove constraints on State-level tax reform and improve the overall efficiency of the national tax system.

The State's tax system can be improved, independently of changes to Commonwealth-State fiscal arrangements, by:

- ▼ increasing reliance on broader based, simpler and more transparent taxes that facilitate modern business practices
- ▼ reducing reliance on inefficient, distorting taxes in favour of more neutral taxes
- ▼ using levies, for example environmental levies, that are carefully targeted, fair and transparent to achieve desired market interventions
- ▼ reducing the level of tax expenditures (ie, tax revenues forgone as a result of exemptions, concessions and rebates for certain taxes)
- ▼ improving the efficiency of the user pays model for charges levied by government
- ▼ strengthening the efficiency and effectiveness of tax administration in NSW.

IPART identified a range of specific reforms related to the individual State taxes, tax expenditures, user charges and tax administration, in line with these guidelines.

The recommendations emphasise the pursuit of improved economic efficiency by reducing those aspects of the current tax system that most hinder and distort productive economic activity. In particular, IPART proposes that in the longer term NSW moves away from its current heavy reliance on transactions-type taxes on property transfers, motor vehicle transfers and the purchase of insurance products, and towards broader-based annual taxes on asset holdings or economic activity.

- ▼ Payroll tax is the State's largest tax and one of its most efficient. IPART's recommended reforms would improve the efficiency and competitiveness of payroll tax over time, while increasing the revenue base.
- ▼ Stamp duties on insurance and asset transactions are among the State's most inefficient taxes. In the short-term NSW should reduce existing exemptions to help fund reductions in the standard rate of these taxes. In the longer term, it should reduce, if not eliminate these taxes by placing more weight on other more efficient taxes.
- ▼ In the short term NSW should reduce its reliance on purchaser transfer duty and make this tax more equitable by adjusting the tax rates to account for 'bracket creep'. In the medium term, NSW should consider simplifying land tax by assessing land tax liability on the individual. In the long term, it should develop a strategy for increasing its reliance on land tax to fund further reductions in its reliance on purchaser transfer duty and insurance taxes. Practical constraints may require that the strategy focus on non-residential property.

- ▼ The registration (stamp) duty should be replaced with a simpler annual tax, which would also replace weight tax for non-commercial vehicles.
- ▼ Stamp duty on the purchase of caravans and camper trailers in NSW should be abolished.
- ▼ While the potential to introduce new taxes in the short term is limited, the Government should consider possible new or increased environmental taxes to redress damage from pollution. This should include examining current policies in regard to urban road congestion.
- ▼ User fees and charges for services provided by government agencies can be a more efficient and effective means of funding specific services than general tax revenue. NSW could make better use of user fees and charges, by ensuring there are consistent guidelines and regular reviews or indexation.
- ▼ The Office of Financial Management (OFM) and OSR within NSW Treasury should be jointly responsible for implementing the reforms with progress monitored through the budget papers. OFM will need to develop a greater policy development and research capacity to support these reforms.

## A Recommendations

- 1 In the short term the tax free threshold for payroll tax should be reduced to \$500,000 pa and then indexed.
- 2 Over a two-year period, the payroll tax exemption for local councils should be removed and a corresponding increase in municipal rate-pegging limits should be phased in.
- 3 In the long term, the rate of payroll tax should be further reduced, with the long-term goal of achieving interstate parity in this rate, while not reducing the overall efficiency and equity of the tax system.
- 4 NSW Treasury should review in detail, before implementing the reforms recommended by this review, the interactions between the recommendations and the GST/CGC grant allocation to NSW.
- 5 Where the outcome is detrimental to good State tax reforms, this issue should be referred to COAG as an impediment to State reform designed to improve national competitiveness.
- 6 NSW Treasury should develop a capacity to better manage the interaction between the State's tax and expenditure policies and the CGC's HFE methodology. This will involve a regular report to the NSW Government on the impact the HFE methodology has on State (and national) tax (and expenditure) reform. All tax proposals should include an assessment of the impact on the allocation of Commonwealth grants.
- 7 The NSW Government should provide its report on the impact tax reform has on the CGC's HFE methodology for tabling at the Treasurer's Conference and referral to COAG.
- 8 In the short term, the standard rate of stamp duty for general insurance (Type A) be reduced from 9 per cent to 5 per cent.
- 9 In the short term, the stamp duty exemption for third party motor vehicle personal injury insurance should be abolished.
- 10 In the short term, the statutory contributions by insurance companies to fund fire services should be replaced by an equivalent, transparent property-based levy collected by local councils. The levy should be separately identified on rates notices, be phased in over time and be excluded from the municipal rates cap. The State Government's contribution to fire services should increase by the amount that the State Government currently contributes to the Fire Services Levy through insurance premiums.
- 11 In the short-term, the purchaser transfer duty should be reduced by replacing the existing first three rating levels with a single level for dutiable properties up to

\$80,000 and reducing the duty payable up to this level to 1 per cent, and reducing the marginal rates for larger transfers by 0.25 percentage points with the details as shown in Tables 5.3 and 5.4.

- 12 In the short-term, the purchaser transfer duty rate scale should be indexed annually, based on an index of movements in all NSW property values.
- 13 In the medium term, consideration should be given to changing the tax unit for land tax from joint ownership to the individual, funded by a decrease in the tax-free threshold.
- 14 In the long term, the Government should develop a strategy for increasing property holding taxes (for example, broadening the land tax base, increasing the land tax rate and/or increasing municipal rates on land values) to fund substantial reductions in purchaser transfer duty and insurance taxes on a revenue-neutral basis. The strategy will need to consider carefully the impacts on the various taxpayers as well as the overall benefits to the community. In recognition of the complexity of the implementation and transitional issues involved, these reforms should be focused on commercial and industrial properties.
- 15 In the medium term, motor vehicle registration duty for all vehicles and the weight tax for non-commercial vehicles should be replaced with a revenue-neutral annual motor vehicle charge.
- 16 In the short term, stamp duty on purchases of caravans and camper trailers should be abolished.
- 17 In the medium term, consideration should be given to increased use of environmental levies in the NSW tax system. In this context, a review of policies for addressing congestion, such as public transport options, parking charges and road pricing, should be undertaken.
- 18 In the short term, to improve transparency and accountability:
  - all tax expenditures should be reported as line items within the budget so that portfolio ministers are required to explicitly consider the funding for tax expenditures during the budgetary allocation for the relevant policy agency
  - each tax expenditure should cease at the end of a specified period unless Parliament specifically agrees to its continuation.
- 19 In the short-term:
  - NSW user fees and charges practices should be benchmarked with those in other States
  - guidelines and principles for these fees and charges should be developed
  - all NSW user fees and charges not currently subject to a periodic review or indexation arrangement should be indexed annually to movements in the CPI.

- 20 In the short term, priority should be given to the following strategies to further strengthen the efficiency and effectiveness of tax administration in NSW:
- ongoing investment in the renewal and development of IT systems
  - further improvements in data management and in data sharing with other NSW government agencies
  - greater functional specialisation in some areas to address issues of high value or critical importance to revenue collection
  - increased use of formal performance evaluation techniques such as performance benchmarking and tax gap studies.
- 21 NSW should encourage the Commonwealth Government to develop options for further expanding efficient Commonwealth taxes to fund the reduction or abolition of inefficient State taxes, including by making submissions to the National Tax Review.
- 22 NSW should encourage the Commonwealth Government to develop options for tax reassignment to the States, and/or revenue sharing to encourage and promote State tax reform.
- 23 NSW should encourage the Commonwealth Government to amend HFE procedures to quarantine fiscal transfers that are compensating adjustments for State tax reform.
- 24 NSW should encourage the Commonwealth Government to amend the HFE methodology for national tax reforms or changes in grant sharing arrangements to ensure individual States have incentives to introduce tax reforms that are in the State and national interest, including through the participation in the National Tax Review. This could include quarantining some taxes in part or in full from the HFE process or allocating the revenue generated by some taxes on a per capita basis.
- 25 NSW should encourage the Commonwealth Government, including through participation in the National Tax Review, to amend the CGC procedures, by:
- equalising less than 100 per cent of the difference in standardised per capita tax
  - removing some (current and future) taxes from HFE consideration
  - removing some part of each tax from HFE consideration
  - distributing less than 100 per cent of the general revenue grants through the equalisation pool
  - distributing the grant 'pool' part by per capita and part on HFE principles.
- 26 OFM and OSR should be jointly responsible for implementing the short to medium recommendations for change to the NSW taxation system that are endorsed by the Government. OFM should provide the implementation strategy, and report annually on progress against the strategy in the budget papers.

- 27 NSW Treasury should allocate funds to enable it to undertake or commission specific research to support future strategic directions for improving the tax system.
- 28 NSW should pursue further opportunities for the interstate harmonisation of State taxes through an appropriate national forum.
- 29 NSW should propose that COAG should foster initiatives between States in the area of intergovernmental fiscal arrangements.