IPART
New South Wales

Independent Pricing and Regulatory Tribunal

Review of State Taxation

Other Industries — Issues Paper
October 2007

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Invitation for submissions

The Tribunal invites written comment on this document and encourages all interested parties to provide submissions addressing the matters discussed.

Submissions are due by 23 November 2007.

We would prefer to receive them by email <ipart@ipart.nsw.gov.au> with reference to 'Review of State Taxation'.

You can also send comments by fax to (02) 9290 2061, or by mail to:

Review of State Taxation
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Our normal practice is to make submissions publicly available on our website <www.ipart.nsw.gov.au>. If you wish to view copies of submissions but do not have access to the website, you can make alternative arrangements by telephoning one of the staff members listed on the previous page.

We may choose not to publish a submission — for example, if it contains confidential or commercially sensitive information. If your submission contains information that you do not wish to be publicly disclosed, please indicate this clearly at the time of making the submission. IPART will then make every effort to protect that information, but it could be subject to appeal under freedom of information legislation.

If you would like further information on making a submission, the Tribunal's submission policy is available on our website.

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1 Introduction

The Premier of New South Wales has requested that IPART undertake a review of the NSW tax system under Section 9 of the Independent Pricing and Regulatory Tribunal Act.

As part of the review, IPART will undertake public consultation, including calling for submissions and holding a public roundtable discussion.

1.1 Terms of reference for the review

The terms of reference require IPART to review the NSW tax system according to standard taxation principles and interstate competitiveness; assess the impact of Commonwealth-State fiscal arrangements; compare the efficiency of NSW and Commonwealth taxes; and recommend options for improvement.

A copy of the terms of reference is provided at Appendix A.

1.2 Review process and expected timing

IPART has been requested to provide a draft report to the NSW Treasurer by 14 March 2008 and a final report to the Treasurer by 31 May 2008.

This Issues Paper is the first stage in IPART's consultation and review process. Submissions in response to this paper are due by 23 November 2007. Details of how to make a submission can be found at the front of this paper.

Table 1.1 sets out the indicative timetable for the review. This timetable may change during the course of the review. IPART will maintain an up-to-date review timetable on its website (www.ipart.nsw.gov.au).

Table 1.1 Indicative review timetable

Task	Timeframe
Release Issues Paper	23 October 2007
Receive public submissions	23 November 2007
Public Hearing	14 December 2007
Draft report to Treasurer	14 March 2008
Final report to Treasurer	31 May 2008

1.3 Structure of this paper

This Issues Paper has been prepared to help stakeholders provide meaningful input into the review. The paper is structured as follows:

- Chapter 2 outlines some important features of the NSW tax system
- Chapter 3 discusses a number of challenges for State tax reform
- Chapter 4 discusses the criteria that the Tribunal will use in making recommendations
- Chapter 5 identifies some broad directions for tax reform.

2 NSW tax system in perspective

The NSW tax system provides one of three key sources of revenue that fund essential public services such as health, education, policing, transport, welfare and environmental protection in New South Wales. The second major revenue source consists of grants from the Commonwealth while the third category includes income from public trading enterprises and a range of other revenues.

Total NSW general government expenses are estimated to be $44.6 billion in 2007/08[1]. Of this, the State's tax system is estimated to raise $17.6 billion in 2007/08, 39 per cent of total expenses. The revenue provided by the NSW tax system is clearly inadequate to fund all public expenses, but the State's tax system is nonetheless a vital source of revenue for the Government.

Grants from the Commonwealth are another key source of revenue. These grants comprise general purpose grants sourced from the Goods and Services Tax (GST) revenue and specific purpose grants. General purpose grants are estimated to be $11.9 billion in 2007/08 and specific purpose grants are estimated to be $7.2 billion. Together these grants are estimated to total $19.1 billion in 2007/08, almost 43 per cent of NSW general government expenses.

However, the conditions attached to 'tied' specific purpose grants affect the available uses of State revenue from other sources, including untied grants and own-source revenue. For instance, these tied grants provide about 15 per cent of NSW total Budget revenues, but the conditions attached to these grants can control around 30 per cent of NSW budget outlays[2].

The third major source of NSW Government revenue comprises financial distributions from public trading enterprises and operating revenues such as the sale of goods and services and investment income. These 'other' sources of revenue are estimated to total $8.3 billion in 2007/08, approximately 18 per cent of total general government expenses.

The NSW revenue system has evolved over many years through the interplay of various constitutional, institutional and historical arrangements. New South Wales, along with all States[3], faces considerable constitutional and institutional constraints

1 NSW Budget Papers, 2007-08, Budget Paper No.2, p iii.

2 NSW Budget Papers 2006-07, Budget Paper No. 2. p 8-14.

3 "States" refers to the six Australian States, the Australian Capital Territory and the Northern Territory.

on its ability to fund its expenditure responsibilities from own-source revenue and on the design of its tax system.

To provide context for this review the following sections outline some of the important constitutional and institutional constraints on NSW government revenue raising, current State revenue sources and the structure and mix of NSW taxes.

2.1 Institutional constraints on NSW government revenue raising

2.1.1 Australian Constitution and the High Court

The range of taxes available to the States is limited by Australia's Constitution and its interpretation by the High Court. The principles of constitutional law limiting the taxing powers of the States were set out by the NSW Tax Task Force[4] in 1988 as follows and remain valid today:

1. Pursuant to s.90, the power to impose excise and customs duties is exclusive to the Commonwealth. As a result of the High Court's interpretation of s. 90, a State may not impose a sales tax, a purchase tax or a value added tax.
2. The States are not permitted to impose a tax which conflicts with the guarantee enshrined in s.92 that "trade, commerce, and intercourse among the States … shall be absolutely free."
3. The States are not permitted to impose a tax on the property of the Commonwealth (s.114). In addition, the Commonwealth enjoys a general implied immunity from State taxation.

The Commonwealth's use of s.96 of the Constitution has also had a profound effect on States' fiscal autonomy. Under s.96 the Commonwealth has power to "grant financial assistance to any State on such terms and conditions as the Parliament thinks fit". The system of 'tied grants' under s.96 has a disproportionate impact on States' fiscal autonomy through the matching and maintenance conditions attached by the Commonwealth to tied grants to the States.

While the States retain the right under the Constitution to levy income tax, Commonwealth tax policy as presently understood has effectively removed States' ability to raise income tax.

The very broad taxes bases available to the Commonwealth allow it to raise much more revenue than it requires for its own-purpose outlays[5]. At the same time, the expenditure responsibilities of the States far exceed their taxing ability. This results in the system of revenue transfers to the States from the Commonwealth in the form of general revenue (GST) grants and specific purpose (tied) grants. The resulting

4 New South Wales Tax Task Force, (1988), *Tax Reform and NSW Economic Development: Review of the State Tax System*, (D. Collins, Chairman) NSW Government Printer, Sydney.

5 This is known as vertical fiscal imbalance.

dependence by States on Commonwealth financial transfers limits the scope for State tax reform. For instance, the Commonwealth Government collects around 82 per cent of total national taxation revenue (including GST), but is responsible for only around 54 per cent of own-purpose expenses. On the other hand, the States collect around 15 per cent of taxation revenue and account for around 40 per cent of own-purpose expenses. Commonwealth grants now account for over 40 per cent of NSW revenues, compared with around 30 per cent before the introduction of the GST[6].

2.1.2 Intergovernmental arrangements and the GST

The States have shown a willingness to abolish certain inefficient State taxes, such as some stamp duties and taxes on financial transactions, in return for revenue from a much broader and more efficient tax base, that is, from the GST. This allows tax revenue to be distributed to the States from a more efficient tax base.

Commonwealth, State and Territory Governments entered into the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (IGA) in 1999 as part of the tax and fiscal reforms associated with the introduction of the GST. The IGA was entered into with the objective of improving the financial position of all States.

Under the IGA the States receive all the proceeds of the GST in return for entering into certain commitments. These commitments include the abolition of a range of inefficient State taxes such as various stamp duties and financial transactions taxes, and a commitment not to reintroduce similar taxes. The IGA therefore further restricts the range of taxes available to the States thereby limiting options for State tax reform and reducing their fiscal autonomy.

The GST proceeds are distributed among the States based on advice to the Commonwealth Government from the Commonwealth Grants Commission (CGC). In providing this advice the CGC applies the principle of horizontal fiscal equalisation (HFE).

HFE in Australia is conducted against a background of very high vertical fiscal imbalance and a paucity of efficient State tax bases. The fixed equalisation pool (ie, GST revenue) means that equalisation is a zero-sum game whereby an increase in equalisation entitlements for one State inevitably means reductions for other States.

HFE is also highly complex. For instance, the CGC's methodologies involve examining 37 taxes and 359 expenditure responsibilities. This arrangement means that States rely on (untied) GST revenue grants from the Commonwealth for a greater proportion of their revenue than before the IGA and that a greater proportion of States' revenue is subject to HFE processes.[7] There is considerable dispute as to

6 NSW Budget Papers 2007-08, Budget Paper No.2, p 8-2.

7 Equalisation is designed to equalise States' capacity to provide services (or to fund inputs), not their results (or services actually delivered – outputs). A State's share of the revenue pool is based on its population share, adjusted by a 'relativity factor' which embodies per capita financial needs based on recommendations of the CGC. The weighted sum of the relativity factors for all States is zero.

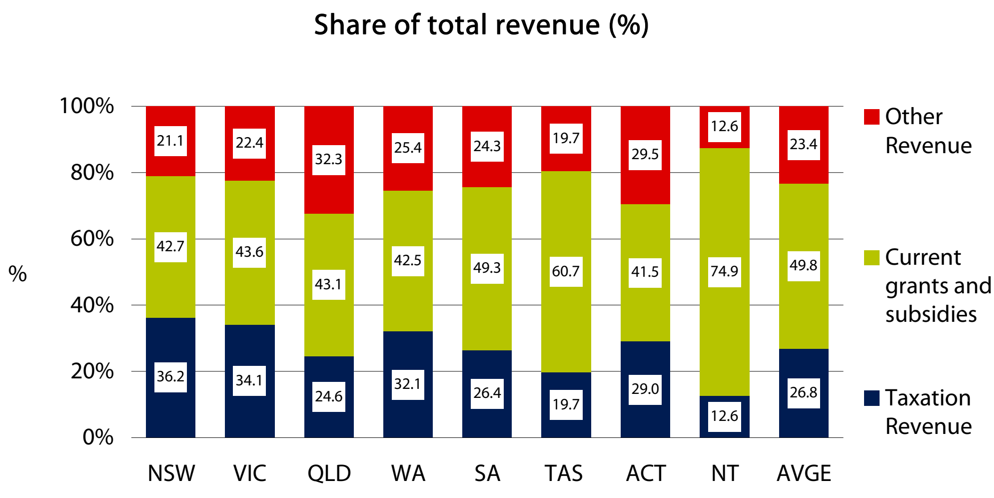
whether the process is successful in achieving equalisation or whether in fact there is overcompensation for some States.[8] For example, HFE results in around $2.5 billion per annum in NSW-sourced GST revenue being transferred to other States (excluding Victoria and Western Australia). This is one reason why New South Wales must look to other options to raise revenue to fund services and infrastructure.

2.2 Sources of State revenue

Figures 2.1 and 2.2 show the relative contributions to State general government revenue of own-source taxes, Commonwealth grants and other revenues as a percentage of total State revenue and as a percentage of gross state product (GSP). They show that New South Wales relies more heavily on own-source tax revenue relative to the other components of revenue than any other State, both as a share of GSP and of total State revenue. However, New South Wales has a relatively low ratio of total revenue to GSP.

Combining this outcome with the impact of HFE on the distribution of GST grants across the States, New South Wales receives a lower proportion of its total revenue from Commonwealth grants than most other States. Grants received by New South Wales are also lower than average as a share of GSP.

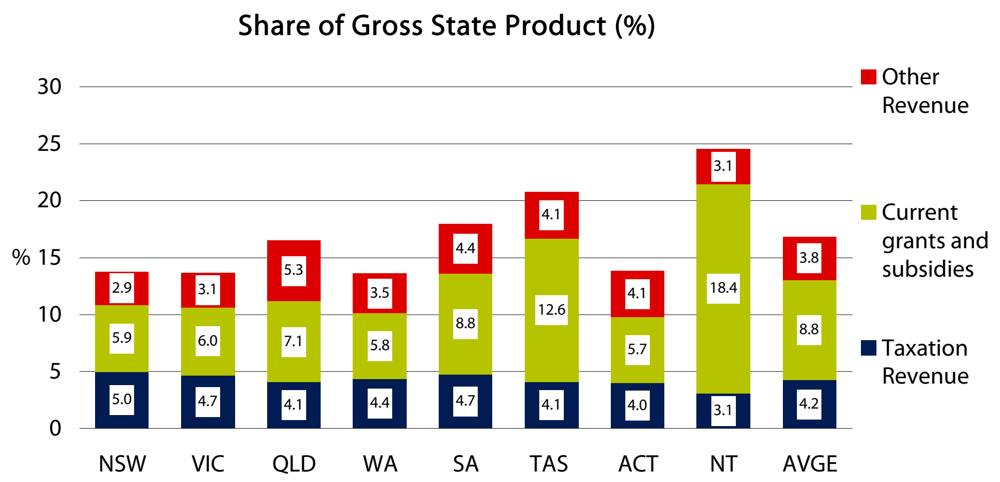
Figure 2.1 Composition of general government revenue, 2005/06, share of total revenue



Data source: ABS Cat No. 5512.0.

[8] Warren, N, (2006), *Benchmarking Australia's Intergovernmental Fiscal Arrangements, Final Report*, p 82.

Figure 2.2 Composition of general government revenue, 2005/06, share of Gross State Product



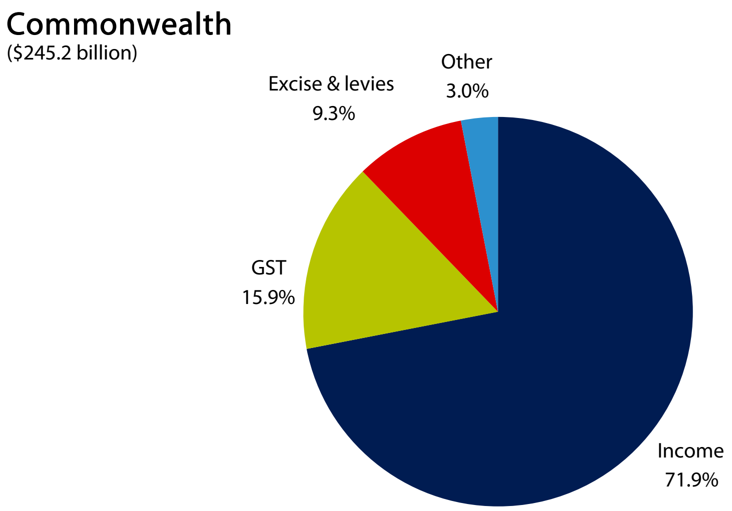
Data source: ABS Cat No. 5220.0.

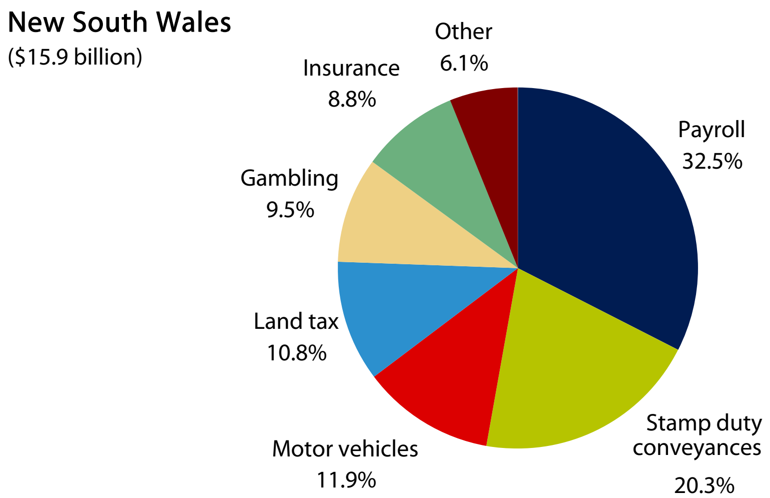
The Commonwealth Grants Commission's figures show that while New South Wales' overall tax rates are around the average of all the States, the actual rates for specific taxes vary between States. New South Wales' capacity to raise more tax revenue, for a given tax rate, is higher and this is a factor which contributes to the lower GST revenue grants for New South Wales.

2.3 Tax mix and structure

Taxes generate revenue for government and may also be used to correct market failure by influencing behaviours through, for example, environmental taxes. In NSW, taxes are overwhelmingly used for revenue raising purposes. The tax mix and structure within the State's tax system reflect this purpose, although the mix and structure also reflect certain constraints faced by the Government. As a result of the institutional and constitutional constraints on revenue raising by the States, the structure and mix of taxes in New South Wales is substantially different from that of the Commonwealth Government as illustrated in Figure 2.3.

Figure 2.3 Composition of tax revenue, 2005/06





Data source: ABS Cat No 5506.0.

2.3.1 NSW taxes

Despite abolishing a number of individual taxes over recent years, New South Wales remains reliant on a larger number of taxes with relatively smaller bases than the Commonwealth. In New South Wales, payroll tax is the largest single tax by revenue collected, followed by stamp duty on conveyances (property transfers), taxes on motor vehicles, land tax, gambling taxes, insurance taxes and a number of smaller taxes and duties.

Taxes abolished by the NSW Government since the introduction of the GST include financial institutions duty, debits tax, marketable securities duty on listed securities, vendor duty, mortgage duty on mortgages of owner-occupied residences, stamp duty on hire of goods and (from 1 January 2008) on leases. Transfer duty on non-land business assets is to be abolished from 1 July 2012.

2.3.2 Commonwealth taxes

Commonwealth Government taxation revenue is almost entirely sourced from taxes on income (individuals, enterprises and non-residents) and taxes on the provision of goods and services. Of the latter, the GST is the largest component although excises and levies (including crude oil, alcohol and tobacco) are also substantial in size.

2.3.3 Interstate comparisons

Figure 2.4 provides a comparison of the contribution that each of the major State taxes makes to total tax revenue in the respective States. Compared with the average for all States, New South Wales has a relatively greater reliance on payroll tax, land tax and insurance taxes while having a below-average reliance on transfer duty, gambling taxes and motor vehicle taxes.

2.3.4 International comparisons

A recent review[9] comparing and benchmarking Australian and international arrangements for the allocation of taxation powers and expenditure responsibilities between central and sub-national governments and mechanisms for fiscal transfers between governments found that in Australia:

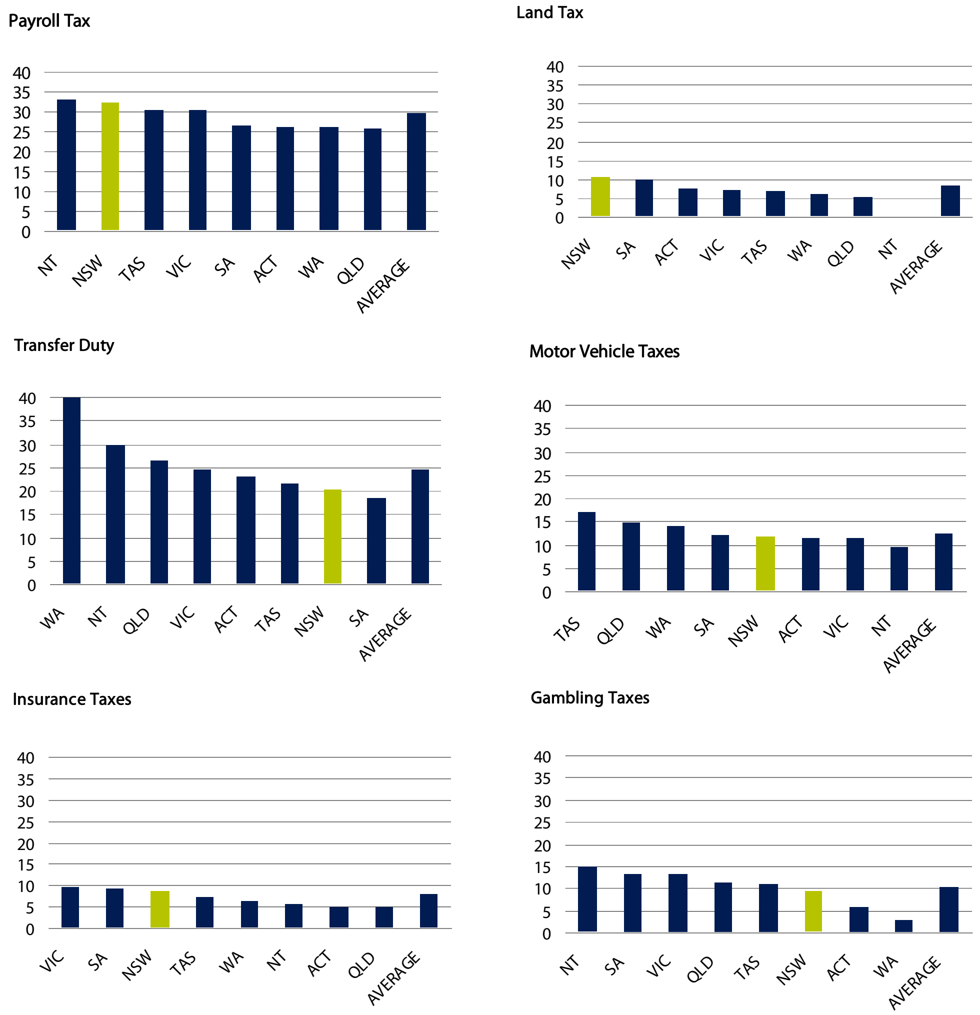
> States rely on comparatively narrow-based and inefficient taxes such as stamp duties for their own-source taxes, while the more efficient State taxes, payroll tax and land tax, are limited in their application. Sharing tax bases, including personal income, corporate income, and goods and services, is much more common in other federations.

A separate international comparison[10] of taxes has found Australia's property and transaction taxes are relatively high compared with other OECD countries and in particular that Australia has a high reliance on transaction taxes such as stamp duties on conveyances.

9 Warren, N, (2006), *Benchmarking Australia's Intergovernmental Fiscal Arrangements Final Report*, NSW Government.

10 Warburton, R F E, and Hendy, P W (2006), *International Comparison of Australia's Taxes*, Australian Government.

Figure 2.4 Major State taxes as a share of State tax revenue, 2005/06, %



Data source: ABS Cat No.5506.0.

3 Challenges for State tax reform

State tax reform faces a number of challenges, some arising from the legacy of past events while other fiscal pressures will emerge from expected future developments.

State tax reform must also occur against the background of complex relationships among Australian Governments. At one level, there is the relationship between the NSW Government and the Commonwealth in the context of the IGA and the fiscal equalisation process and the constraints to further State tax reform as a result of that agreement and those arrangements. At another level there is the relationship between the NSW Government and other State governments, for example, in the areas of tax harmonisation, interstate tax competition and the distribution of GST revenue grants. Finally, there is the relationship between the States as a group, where there are common interests, and the Commonwealth.

3.1 Consequences of past developments

Some of the legacy issues confronting the NSW tax system are discussed below.

3.1.1 Structural weaknesses in State taxes

The States do not have autonomy in the design of their tax systems. This results from a number of causes that are articulated earlier in this Issues Paper and include restrictions imposed by the Australian Constitution, the High Court's interpretation of the Constitution which has progressively narrowed the taxes available to the States, the Commonwealth's practice of using tied grants to the States and an agreement to abolish and not reimpose certain taxes in return for a share of GST revenue.

In addition to the constitutional and institutional limitations placed on the States in the design of their tax systems, the mobile nature of some State tax bases means that interstate tax competition also restricts the kind and level of taxes that the States may impose.

A number of studies[11] have provided evaluations of State taxes against the traditional economic criteria for taxation. While the rankings vary somewhat from study to study there is considerable support for the view that stamp duties and transactions-based taxes generate the greatest distortions while broad-based land taxes and payroll taxes are more efficient.

Major challenges in reforming existing State taxes designed to remove structural weaknesses arise from the need to find revenue alternatives to inefficient taxes and from the significant trade-offs between good tax criteria, such as efficiency versus equity.

3.1.2 Significant interdependencies between State and Commonwealth taxes

The 'national' tax system comprises taxes imposed at the federal, state and local government levels. Some of the taxes imposed by one level of government are interrelated, in one or more ways, to other taxes imposed at a different level of government. These linkages can take several forms.

Interdependencies between Federal and State taxes may arise, for instance, from the application of both Federal and State taxes to common (or closely related) bases. For example, stamp duties are imposed at the State level on insurance policies and motor vehicles. The Commonwealth imposes GST on these same items. Gambling and betting are also subject to both State taxes and the GST. From an economic point of view, payroll tax may have similarities to a broad-based consumption tax or an income tax depending on how its ultimate economic incidence falls on individuals rather than businesses.

For businesses, the direct financial cost of State taxes may be reduced because those taxes are usually deductible for Commonwealth company income tax purposes as a cost of carrying on a business. This means that the effective ('after-tax') cost of the tax is lower than the nominal State tax rate might suggest.

There is also a degree to which tax competition among States has its advantages and disadvantages. On one hand, the combination of mobile tax bases and interstate tax competition can act as a restraining influence on government in its pursuit of revenue and the impost made on the community. On the other hand, the combination of mobile state tax bases and interstate tax competition can undermine a State's ability to fund services. For instance, this can occur where there is a 'race to the bottom' in terms of reducing taxes to attract business (eg, payroll tax rates and concessions). In extreme cases it can result in the elimination of some taxes where the actions of one State precipitates corresponding action by other States (eg, in the case of death duties).

11 See for example Gabbitas, O. and Eldridge, D. (1998) 'Directions for State Tax Reform', *Productivity Commission Staff Research Paper*, AusInfo, Canberra; Department of Treasury and Finance Victoria, (2001) *Review of State Business Taxes: Full Report* (Harvey Report); and Freebairn, J., (2002) 'Opportunities to Reform State Taxes', *Australian Economic Review*, 35(4): 405-422.

From a public finance perspective, an analysis of the fiscal incentives of the HFE system has also shown that equalisation grants may influence a State's fiscal policies. This is because a State's taxes and expenditures can affect the parameters of the CGC's grant formula and that States can respond by changing their policies in such a way as to maximise their grant[12]. This encourages game playing and suggests that reforms of the CGC algorithm and revenue sharing arrangements may be necessary.

3.1.3 Effective tax administration

Effective tax administration is crucial to the successful operation of any tax system. In New South Wales, the Office of State Revenue (OSR) administers State taxation, collects revenue and implements legislation relating to State taxation. In terms of revenue performance, OSR aims to optimise revenue and tax compliance, improve legislation to enhance compliance and ensure that the NSW community understands its revenue rights and obligations[13]. To fulfil these functions OSR requires adequate resources, systems and strategies.

The design of the tax system is also important to how well that system operates. Well designed taxes should be relatively straightforward for OSR to administer and for taxpayers to comply with, while poorly designed taxes are likely to be difficult to administer and make compliance more complex and expensive.

3.1.4 Implications of GST revenue sharing arrangements

Current GST revenue sharing arrangements also constrain the scope for reform of State taxes. As a result of HFE, for every $1 of GST revenue generated in NSW only about 83 cents is returned to the State. In aggregate, it is estimated that NSW will cross-subsidise the other States (excluding Victorian and Western Australia) by around $2.5 billion in 2007/08[14]. In New South Wales, the loss of GST revenue is restricting both the timing and the extent to which inefficient taxes can be abolished.

3.2 Future fiscal pressures

The 2006/07 NSW Budget provided a benchmark estimate of the long-term fiscal pressures that New South Wales may face by comparing the actual budget outcomes for 2004/05 to the projected budget outcome for 2043/44. It was estimated that demographic and other pressures could lead to a fiscal gap[15] of around 3.4 per cent of GSP over the 40 year horizon.

12 Warren, N. and Dahlby, B., (2003) 'Fiscal Incentive Effects of the Australian Equalisation System', *Economic Record*, 79(249):434-445.

13 OSR's Strategic Plan – Vision 2009.

14 NSW Budget Papers 2007-08, Budget Paper No. 2, p 8-1.

15 The fiscal gap is the difference between the base period primary balance as a share of GSP and the primary balance as a share of GSP at the end of the projection period. The primary balance is the gap between spending and revenue excluding interest transactions but including net capital expenditure. A positive gap implies that fiscal pressures will be building over the projection period.

Increased expenditure on health services associated with an ageing population and the introduction of new capital-intensive medical technologies will be a major source of demands for public funding. Expectations that the quality and quantity of State government services generally will continue to improve, with service delivery costs likely to rise faster than inflation, and increased demand for infrastructure will also add to future fiscal pressures. At the same time, GST revenue may decline as a share of GDP because the non-GST taxable components of private consumption (health services in particular) may grow faster than the taxable components[16].

Given the ongoing pressures to resource public programs, any responsible NSW revenue reform package needs to be self-funded. If a reduction in a tax rate is proposed it should be matched by a proposal to compensate for the loss of revenue. This could take the form of other changes to that tax, such as a broadening of the tax base or a curtailment of concessional arrangements, either of which could offset the revenue loss from a rate reduction. Alternatively, total revenue could be maintained by increases in other taxes or by accessing additional sources of non-tax revenue.

16 NSW Government (2004) submission to Productivity Commission Research Study into Economic Implications of an Ageing Population.

4 Guiding principles

As required by the Terms of Reference IPART will be guided by the following criteria in recommending improvements to the NSW tax system: revenue adequacy, efficiency, equity, simplicity, transparency and interstate competitiveness.

4.1 Revenue adequacy

The basic purpose of taxation is to fund public programs[17]. Along with other States, New South Wales faces a range of fiscal pressures, including the requirements of an ageing population, in conjunction with growing demand for services and the rising cost of those services, in financing essential public programs.

To provide effective funding of public programs over time, taxes that grow in line with expenditure requirements are preferred. In practice, such taxes have a positive and stable relationship to the level of economic activity and population change. Conversely, taxes that are highly cyclical or unpredictable in nature can complicate Government financial management and are therefore less desirable.

4.2 Efficiency

Taxes change economic behaviour – in the attempt to reduce tax payable – creating market distortions which result in economic inefficiency. This distortionary cost is referred to as the deadweight cost of taxation or the excess burden of taxation. It is the economic loss to society as a result of the tax in excess of the revenue collected.

Different types of taxes have varying deadweight costs. Taxes such as lump sum taxes which have little impact on incentives are generally considered to be more efficient than other taxes but may not meet the other objectives of good taxes. Taxes on goods or activities with lower price sensitivities, or with lower mobility across state borders, tend to be more efficient at the sub-national level. Broader-based taxes tend to be more efficient than narrowly based taxes.

There is also an administrative aspect to efficiency. An administratively efficient tax has lower costs of collection and compliance.

[17] As noted previously, individual taxes can also be intentionally structured to influence economic behaviour.

4.3 Equity

The equity or fairness of taxes can be assessed in two dimensions: vertical equity and horizontal equity.

Vertical equity refers to capacity to pay. Increases in income are considered to lead to a more than proportionate increase in capacity to pay. According to the principle of vertical equity, lower income taxpayers should therefore pay not only less tax but also a lower proportion of tax compared with those on higher incomes. The Commonwealth generally has greater scope to pursue vertical equity objectives through progressive[18] rate schedules for income tax. Nonetheless State taxes may also have redistributive effects.

Horizontal equity refers to equal treatment of taxpayers in similar circumstances. According to the principle of horizontal equity, tax payers in comparable situations should pay equal tax.

4.4 Simplicity

Simple taxes are preferred because they make it easier for taxpayers to meet their legal obligations and are easier to collect. As the complexity of taxes increases so also do the compliance costs borne by taxpayers and the administration costs incurred by government.

Complex taxes also create more opportunities for avoidance and evasion, encouraging the investment of resources in tax minimisation activities.

4.5 Transparency

In a transparent system, the key features of a tax – its purpose and how it operates – are easily identified and are certain. Taxpayers can clearly understand the scope and applicability of taxes and can plan with certainty their individual tax liability.

4.6 Interstate competitiveness

Differences in tax rates and exemptions between States (ie, the ‘interstate competitiveness’ of taxes) can affect location decisions of business and individuals and thereby have an expansionary or restrictive impact on the State economy.

[18] A progressive tax is one where the tax rate increases as the tax base (eg, income) increases.

5 Directions for tax reform

The range of reform options for NSW taxation includes:

- improvements to the NSW tax system that can be made within the current framework of Commonwealth-State financial arrangements, that is, that can be implemented independently of other jurisdictions
- changes in the mix of tax and non-tax revenues at the State level, and
- improvements to the tax systems of all States, for example, through greater harmonisation of State tax policies or through reform of revenue-sharing arrangements with the Commonwealth.

5.1 A better tax system for New South Wales

Notwithstanding all the limitations and constraints of the current Commonwealth-State fiscal arrangements and the case for reform to these arrangements there are improvements that can be made in the short run by New South Wales independently of other jurisdictions.

Submissions that advocate proposed improvements to NSW taxes should provide an assessment of the revenue consequences of the proposed changes and should specify how such changes address the criteria presented in Chapter 4. Any proposals for tax reductions or concessions should specify how they are to be funded.

5.1.1 Individual taxes

The design features of each of the existing NSW taxes are open to review. This includes but is not restricted to all the major existing taxes - payroll tax, land tax, transfer duty, motor vehicle taxes, insurance taxes and gambling taxes.

For each individual tax, the definition of the tax base ('what is taxed'), the applicable tax rate or schedule of tax rates and any concessional arrangements have major consequences for the volume of revenue collected and also have important economic and social impacts.

For many NSW taxes, the definition of the tax base is a significant policy issue. In the case of payroll tax, for example, no tax is payable on the first $600,000 of wages. There are also substantial exclusions from the land tax base. These exemptions from tax bases designed to achieve specific policy objectives could also come at a cost to other tax payers. Broadening of tax bases could provide a revenue source that could be applied to make good the revenue loss from a reduction in a tax rate.

Options for improvement to individual taxes include:

- Broadening the tax bases to fund reductions in rates.
- Abolishing inefficient State taxes.
- Introducing new State taxes (eg, transport and environmental taxes).

IPART seeks comment on:

1 improvements in the design of existing NSW tax instruments, including proposed changes to tax rates, tax bases and any concessional arrangements

2 existing taxes that should be abolished

3 potential new State taxes and their merits relative to existing taxes.

There are important trade-offs between tax policy criteria in the design of the various individual tax instruments. Any comments should have regard to the requirement for revenue neutrality of the overall package of reform and specify how each proposal addresses the criteria in Chapter 4.

5.1.2 Tax mix

Tax system improvements may potentially be achieved by reforms that vary the tax mix – the shares of each individual tax in total tax revenue – rather than the aggregate level of NSW tax revenue.

Changes to the tax mix may be worthwhile where a reduction in a less desirable tax in favour of another tax results in a net social gain while leaving aggregate tax revenue unchanged. There are, however, likely to be 'winners and losers' from such changes and the redistributive effects need to be carefully considered.

Revenue-neutral changes to the tax mix could be considered in order to achieve one or more of the following goals of a good tax system:

- improving interstate competitiveness
- increasing efficiency
- enhancing equity
- making the tax system simpler and more transparent.

IPART seeks comment on:

4 the appropriate mix of NSW taxes to enhance the achievement of the goals of competitiveness, efficiency, equity, transparency and simplification.

5.1.3 Tax expenditures

The NSW tax system embodies an extensive range of tax concessions. Arrangements that involve granting certain taxpayers, activities or assets more favourable tax treatment than applies to taxpayers in general are referred to as 'tax expenditures' because they represent tax revenue forgone.

The larger tax expenditures in New South Wales are:

- Payroll tax – concessions arising from substantial exemptions and the $600,000 threshold.
- Purchaser transfer duty – concessions for first home buyers and property transfers under the Family Law Act.
- General and life insurance duty – concessional rates for certain categories of insurance; exemptions for 'green slip' insurance and for WorkCover premiums.
- Land tax – exemptions for land used for primary production, or by retirement villages, hospitals, co-operatives, racing and sporting clubs.
- Gambling and betting taxes – lower rates of tax on poker machines in registered clubs.

Tax expenditures can contribute to the achievement of public policy objectives and their cost to revenue needs to be weighed against the social benefits associated with the concessions, for example, the community benefits provided by registered clubs[19].

IPART seeks comment on:

5 the effectiveness of current tax expenditures in achieving the policy goals and, in this context, the appropriate range and level of tax expenditures.

5.1.4 Tax administration

Reforms of tax administration may increase the revenue yield of existing taxes by reducing the 'tax gap' – the difference between taxpayers' legal liability and actual tax collections – as well as lowering collection and compliance costs.

There may also be opportunities to reform the way taxes are administered by making tax obligations and liabilities clearer and changing the systems that are used to establish, enforce and collect tax debts. Any such improvements will benefit the tax administrator, taxpayers, and the community as a whole, the ultimate beneficiaries of the revenue collected.

19 It should be noted that IPART is currently undertaking a separate review of the role and performance of registered clubs including the community benefits that clubs provide.

Administrative reforms have the potential to contribute to achieving the following goals:

- reducing the compliance burden on taxpayers
- increasing the operational efficiency in tax collection
- improving transparency.

IPART seeks comment on:

6 improvements in NSW tax administration to reduce the costs to the State Government and to taxpayers and to reduce the 'tax gap'.

5.2 Non-tax revenue measures

State taxes contribute less than half of total general government revenue in New South Wales. Compared with the other States, non-tax revenue in New South Wales is low relative to gross state product (Figure 2.2). In assessing the adequacy of a given level of State taxes to fund essential public programs, consideration needs to be also given to the level of own-source non-tax revenues that may be available to the State. These include income from public trading enterprise and licences, fees, fines, levies and royalties.

Within New South Wales, the balancing of tax and non-tax revenue measures is an important policy issue. The revenue adequacy of a given set of State taxes is therefore linked to such factors as the level of user charges for goods and services provided by government (eg, public transport fares), concessional arrangements and the efficiency of State government business enterprises. However, the question of the net fiscal benefits of privatisation is outside the scope of this review.

IPART seeks comment on:

7 the respective roles of NSW own-source tax and non-tax revenue measures in funding essential public services.

5.3 A better tax system for all States

Improvements to taxation may also arise from co-operation between the States. For example, New South Wales and Victoria have recently agreed to harmonise the definition of the payroll tax base. There may be opportunities to harmonise other State tax bases and their administrations. This could reduce tax compliance costs for businesses operating across State borders and also simplify State tax administration, resulting in efficiency gains for the economy.

Harmonised tax bases mean that interstate tax competition, to the extent that it occurs, can be restricted to different tax rates and thresholds for individual taxes rather than the composition of the bases of those taxes.

IPART seeks comment on:

8 opportunities for further tax reform initiatives by agreement among the States.

5.4 A better system of Commonwealth and State taxation

Over time there are potentially large gains from fundamental reform of Commonwealth-State fiscal arrangements.

One area of potential reform is to the allocation of taxing and spending powers and responsibilities between the Commonwealth and the States. The current imbalance in the expenditure responsibilities and taxing powers of the States is restricting the scope for State tax reform. However, the introduction of the GST provides a relatively recent example of a shift away from various inefficient State taxes in favour of a broader national tax.

Another area of possible reform is the current arrangements for the sharing among the States of the tax revenue effectively collected on their behalf by the Commonwealth and the heavy reliance by the Grants Commission on the principle of HFE.

Commonwealth-State reforms in these areas have the capacity to make major contributions to the reform or abolition of the less efficient State taxes.

IPART seeks comment on:

9 improvements in the mix of State and Commonwealth taxes

10 improvements to Commonwealth-State tax sharing arrangements.

Appendices

A Terms of reference

TERMS OF REFERENCE FOR IPART TO INQUIRE INTO STATE TAXATION

I, Morris Iemma, Premier of New South Wales, under Section 9 of the *Independent Pricing and Regulatory Tribunal Act 1992*, refer the following matters to the Independent Pricing and Regulatory Tribunal:

- Given the existing GST agreement, assess the impact of the current system of Commonwealth-State fiscal relations on NSW revenue mix and the ability of NSW to fund essential public services.
- Compare the efficiency of the taxes available to NSW and the Commonwealth.
- Review the existing NSW tax system according to standard taxation principles (that is, efficiency, equity, simplicity and transparency) as well as the interstate competitiveness of NSW taxes.
- Recommend options to improve the efficiency, equity, interstate competitiveness, simplicity and transparency of NSW tax system, given the taxes available to it.

The Tribunal is to provide a draft report to the Treasurer by 14 March 2008. The Tribunal is to provide a final report to the Treasurer by 31 May 2008.

Background

The Australian system of Commonwealth-State fiscal relations is characterised by high vertical fiscal imbalance and a complex system of horizontal fiscal equalisation.

The Commonwealth Government collects around 82 per cent of national taxation revenue (including the GST), but is responsible for only around 54 per cent of own-purpose expenses.

The States and Territories collect around 15 per cent of national taxation revenue and account for around 40 per cent of own-purposes expenses. In 2007-08, Commonwealth grants are estimated to account for 42.5 per cent of NSW's total budget revenue while State taxation revenue is estimated account for 39.0 per cent of total budget revenue.[1]

In addition to being more dependent on fiscal transfers from the central government than in most other federations, the range of taxes available to the States is generally inefficient and narrowly based. The base became narrower after the introduction of the GST following the required abolition of certain State taxes. This will be more so after further State taxes are abolished given the Commonwealth's interpretation of the GST agreement.

GST revenue grants are distributed among the States and Territories according to the principle of horizontal fiscal equalisation (HFE). This is currently defined by the Commonwealth Grants Commission as providing each State with the capacity to provide the same standard of service, if each operated at the same level of efficiency and made the same effort to raise revenue.

[1] Based on the latest available data from ABS, Government Finance Statistics, Cat No 5512.0, 2005-06.

This system is highly complex and data intensive. The Commonwealth Treasurer makes the final determination of the GST relativities.

Under the current HFE system, NSW is estimated to cross subsidise the other States (except for Victoria and Western Australia) by around $2.4 billion in 2007-08.

The Warren report found that "State governments in Australia are forced to rely on relatively inefficient, narrow-based and sometimes highly cyclical transactions based taxes rather than on more efficient broadly-based consumption and income taxes which in Australia are central government taxes. They are forced into such tax systems through very tight constitutional constraints on their tax powers, Commonwealth policies and interjurisdictional tax competition."[2]

[2] Warren, N. Benchmarking Australia's Intergovernmental Fiscal Arrangements, Final Report. NSW Government, 2006.

B Comments sought

IPART seeks comments on:

The comments should have regard to the requirement for revenue neutrality of the overall package of reform and specify how each proposal addresses the criteria in Chapter 4.