

AXING THE ALCABALA: A PROGRAM FOR A 21ST CENTURY STATE TAX SYSTEM

REPORT BY
ACCESS ECONOMICS PTY LIMITED

FOR THE

BUSINESS COALITION FOR TAX REFORM

NOVEMBER 2004



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EXECUTIVE SUMMARY

This report has been commissioned by the Business Coalition for Tax Reform (BCTR) and prepared by Access Economics.

It is intended to be used as one input into deliberations by State, Territory and Commonwealth Treasurers. Those deliberations are part of the preparations for the March 2005 meeting of the Ministerial Council of Australian Treasurers, which will examine the need for the States and Territories (hereafter referred to simply as the states) to retain the state business taxes listed for abolition (or consideration of abolition) in 2005, as set out in the (revised) 1999 Intergovernmental Agreement (IGA) that formed part of the *New Tax System* (MkII).¹

The BCTR has asked Access Economics to consider the economic case for abolition of the state taxes listed in the IGA – and some other state taxes – and the economic capacity for the states responsibly to abolish them (over time if necessary).

CONCLUSIONS & POLICY RECOMMENDATIONS

Although some state taxes have been abolished, the states retain some very inefficient turnover-type taxes.

Amongst the most inefficient of these are:

- stamp duties on non-residential conveyancing,
- stamp duties on various financial instruments,
- stamp duties on insurance
- and (for NSW, Victoria and Tasmania) fire service levies.

The first two groups of taxes are listed for review by 2005 in the IGA between the Commonwealth and the states that formed part of the *New Tax System*. The last two are not mentioned in the IGA, but most states and territories have already abolished their fire services levies and moved to more efficient ways of financing fire and emergency services.

Access Economics concludes that all of these taxes (and some others) should be candidates for review (and preferably abolition) in future.

In the immediate future, Access Economics concludes that the focus should be on the first two groups of taxes, which have been specifically mentioned in the IGA. Consistent with the undertaking by all States and Territories, Access Economics assumes that Bank Account Debits (BAD) tax will be abolished, from 1 July 2005 in all jurisdictions except NSW, which has already abolished this inefficient tax.

¹ *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, June 1999.



Given Access Economics' forecasts of state budget prospects (section 4 of the report) and its estimates of the cost of abolition of the remaining IGA state taxes (section 5 of the report), and assuming no further financial assistance from the Commonwealth to the states, we conclude that a feasible program for further state tax reform is as follows:

POSSIBLE STATE TAX REFORM OPTIONS (ASSUMING NO COMMONWEALTH ASSISTANCE)

- *Either stamp duty on non-residential conveyancing (the most inefficient of all the remaining state taxes, based on our AE-CGE model results) could be abolished from 1 July 2005;*
- *or all of the 'other' stamp duties (which are at least as inefficient as BAD as a group, and, for individual taxes on financial instruments, they are probably much more inefficient, as well as being in the nature of 'nuisance' taxes) could be abolished from 1 July 2005;*
- *or, roughly speaking (and more messy from a tax administration viewpoint), the current rates for both of these taxes could be halved from 1 July 2005.*

The states are currently receiving a GST revenue 'windfall' relative to what they would have received under the pre-GST financial arrangements, and this 'windfall' has been greater than originally expected. However, given the significant economic benefits of removing these inefficient taxes, Access Economics concludes that a case can be made for additional Commonwealth Government financial assistance to the states as an incentive to complete the full IGA reforms.

Depending upon the basis for calculation, in 2005-06 magnitudes, this additional assistance might range from around \$700 million per annum (equivalent to a Commonwealth income tax 'revenue dividend' from further state tax reform, most of which would accrue within a year after the states abolished the remaining IGA taxes), up to about \$1.6 billion per annum (partly filling the GST revenue hole left mainly by the excision of GST on some food, and allowing the states to complete the IGA reform program with no further effect on their net operating balance position).

Were additional financial assistance from the Commonwealth to be forthcoming, and that assistance was about \$1.6 billion in 2005-06 magnitudes, then the states should be able comfortably to complete the IGA state tax reform program by abolishing the remaining IGA taxes from 1 July 2005.

There is one other opportunity that may be about to present itself.

Recently there have been suggestions from the Commonwealth and some states about long-overdue rationalisation of responsibilities in the areas of health and education. Difficult though this may be politically, the case for such reforms, from the perspective of efficient and effective service delivery to the community, is overwhelming and has long been advocated.

Access Economics does not suggest that the IGA reforms be delayed by consideration of these wider issues. As the states can afford to remove half of the remaining IGA taxes



immediately without assistance consideration of these wider issues should not be used as a barrier.

However, Access Economics does suggest that, if rationalisation of roles and responsibilities between the Commonwealth and the states should prove feasible, the opportunity for further reform of the remaining inefficient state taxes (including non IGA taxes) should not be lost.

Such reforms would provide efficiency dividends of considerable size, as well as a possible need for a net re-balancing of Commonwealth/state financial arrangements.

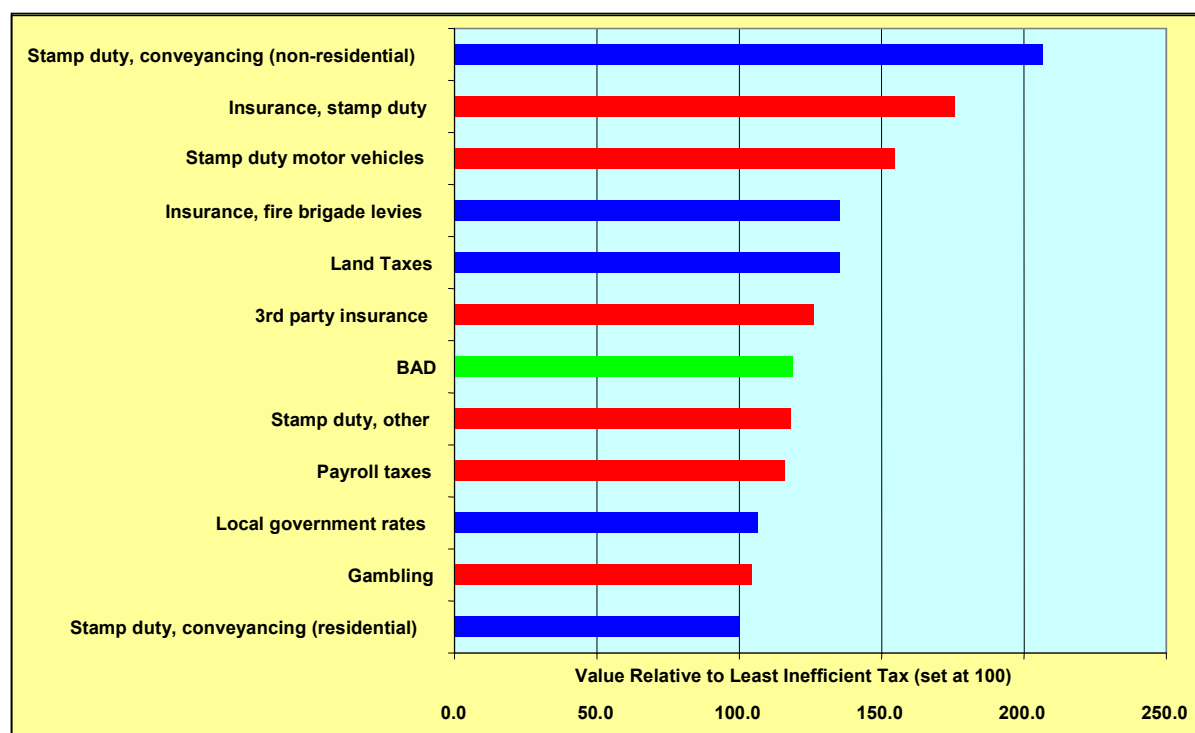
A large proportion of the efficiency dividend will and should be allocated to improving health and education services. But, as part of an overall package (with further income tax revenue dividends from further state tax reform) this rationalisation might also provide the financing wherewithal for further state tax reform beyond the IGA list of state taxes.

BASES FOR RECOMMENDATIONS

The states retain a number of very inefficient taxes, most of which are turnover-type taxes of the type originating in mediaeval Spain (the 'alcabala').

Access Economics' modelling provides an 'inefficiency ranking' of state taxes as shown in the following chart.

**ECONOMIC WELFARE GAIN FROM A \$100 MILLION REDUCTION IN STATE TAXES
(SOME LABOUR SUPPLY RESPONSIVENESS)**



These taxes include two sets:

- stamp duty on non-residential conveyancing



- 'other' stamp duties (mainly on a variety of financial instruments)

that were included for abolition from 1 July 2001 in the original IGA, and are listed for review by 2005 in the revised IGA.

They also include a number of other state taxes, each of which, in isolation, is more inefficient than BAD, which itself is to be abolished by 1 July 2005 (and which has already been abolished by NSW).

A case can be made for abolition of these taxes as well. The specific case for reform of insurance related taxes is overwhelming.

State budget prospects, based on Access Economics forecasts, are summarised in the following table.

STATE SECTOR – MEDIUM TERM PROJECTIONS BY STATE*

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
	Actual	Prelim ^a	Estimate ^a	Forecast ^b	Forecast ^b	Forecast ^b	Forecast ^b	Forecast ^b
New South Wales								
GG Net operating surplus (\$ million)	1,752	1,291	836	1,148	1,228	1,277	1,426	1,600
Net borrowing (\$ million)	747	1,751	2,291	1,765	1,436	1,321	1,229	1,140
Net debt ratio (% of GSP)	5.0%	4.6%	4.6%	4.4%	4.1%	3.5%	3.1%	2.8%
Victoria								
GG Net operating surplus (\$ million)	1,517	719	529	842	978	756	605	408
Net borrowing (\$ million)	-231	82	1,198	358	175	355	527	741
Net debt ratio (% of GSP)	1.5%	1.8%	2.0%	1.8%	1.6%	1.3%	1.2%	1.2%
Queensland								
GG Net operating surplus (\$ million)	15	2,374	646	638	513	498	539	593
Net borrowing (\$ million)	1,034	-1,265	2,020	1,085	1,064	1,071	1,045	1,038
Net debt ratio (% of GSP)	-0.3%	-1.9%	-1.3%	-1.5%	-1.6%	-1.7%	-1.9%	-2.0%
Western Australia								
GG Net operating surplus (\$ million)	254	207	243	206	72	32	191	389
Net borrowing (\$ million)	-6	327	702	440	548	614	462	281
Net debt ratio (% of GSP)	6.3%	6.7%	7.0%	6.9%	7.0%	6.8%	6.9%	6.7%
South Australia								
GG Net operating surplus (\$ million)	448	264	116	162	110	82	64	33
Net borrowing (\$ million)	-405	-142	-89	-156	-74	-37	-8	38
Net debt ratio (% of GSP)	5.5%	4.9%	4.5%	3.7%	3.1%	2.5%	2.1%	1.9%
Tasmania								
GG Net operating surplus (\$ million)	212	100	-45	36	17	11	16	19
Net borrowing (\$ million)	-156	-31	87	-85	-66	-70	-80	-84
Net debt ratio (% of GSP)	15.8%	14.2%	12.5%	11.8%	11.3%	10.5%	10.1%	9.7%
Australian Capital Territory								
GG Net operating surplus (\$ million)	188	18	-17	4	-24	-34	-45	-59
Net borrowing (\$ million)	-314	32	240	144	145	159	174	192
Net debt ratio (% of GSP)	-8.0%	-8.0%	-7.1%	-6.4%	-5.8%	-5.0%	-4.4%	-3.8%
Northern Territory								
GG Net operating surplus (\$ million)	-1	49	-12	-68	-24	-27	-14	-4
Net borrowing (\$ million)	46	-2	69	97	58	56	44	35
Net debt ratio (% of GSP)	18.2%	16.6%	17.3%	16.3%	15.8%	14.4%	13.4%	12.5%
Total (all States and Territories)								
GG Net operating surplus (\$ million)	4,385	5,022	2,297	2,968	2,870	2,596	2,781	2,979
Net borrowing (\$ million)	714	752	6,518	3,647	3,285	3,468	3,394	3,382
Net debt ratio (% of GSP)	3.5%	3.1%	3.2%	3.0%	2.8%	2.5%	2.2%	2.1%

* Minus for net borrowing indicates net lending; minus for net debt indicates a net creditor position.
* GG - General Government.
* GSP - Gross State Product.
a – Treasury estimates. b – Access Economics forecast.



The forecasts for state budget net operating surpluses are assumed to be a guide to the capacity of the states to finance further state tax reform.

The estimated cost of removing the two sets of taxes mentioned for review by 2005 in the IGA over the next five years is summarised in the following table.

ESTIMATED TOTAL REVENUE FROM REMAINING IGA STATE TAXES (\$M)

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2007-08	2009-10
	AE estimate	AE estimate	AE estimate	AE forecast	AE forecast	AE forecast	AE forecast	AE forecast
NSW	1346	1465	1453	1558	1610	1696	1778	1855
Vic	695	806	573	533	544	569	596	625
Qld	555	667	546	571	598	635	673	714
WA	235	368	295	294	304	314	320	323
SA	179	218	176	180	185	193	200	208
Tas	35	42	36	37	38	39	40	41
ACT	44	52	48	49	50	52	54	57
NT	15	18	16	18	18	19	20	21
Total	3,104	3,636	3,143	3,240	3,347	3,517	3,683	3,844

If the states were to abolish the remaining IGA state taxes, a 'revenue dividend' via increased income tax collections would accrue to the Commonwealth Government, most of it within a year or so, and there would be minor benefits to the states as well, as shown in box 1 below.

Box 1: GROSS REVENUE DIVIDENDS FROM STATE TAX REFORM

Commonwealth Income Tax Dividend	\$700 million
Payroll Tax Dividend	\$70 million
GST Dividend	\$2 million

These income tax dividends could finance a *minimum* additional financial assistance package from the Commonwealth to the states as a National Competition Policy/IGA-type incentive to complete the IGA state tax reform program.

As an upper bound to additional Commonwealth financial assistance to the states, an annual package of about \$1.6 billion in 2005-06 would allow the states to complete their IGA reform program while remaining, as a group, in net operating surplus.

A case can be made for negotiating additional financial assistance from the Commonwealth to the states within this range of \$700 million to \$1.6 billion (2005-06 magnitudes) as an incentive that (i) at least partly matches the original IGA, and (ii) allows the IGA state tax reform program to be completed with effect from 1 July 2005.

A summary of the current state of play and possibilities for further state tax reform is presented in box 2 below.



BOX 2: STATE TAX REFORM STATE OF PLAY & PROSPECTS

State tax	Abolition timing under revised IGA	IGA taxes already/planned for abolition	Which remaining IGA taxes states can abolish from 1 July 2005	
			Without C'wealth assistance	With C'wealth assistance
Bed taxes	1 July 2000	already abolished		
FID	1 July 2001	already abolished		
Debits tax	1 July 2005	to be abolished 1 July 2005 in all jurisdictions (c)	to be abolished on 1 July 2005	
Stamp duty on marketable securities	1 July 2001	already abolished		
Stamp duty on non-residential property (a)	to be reviewed by 2005	existing	Yes, or abolish stamp duty on other business transactions	Yes
Stamp duties on other business transactions (b)	to be reviewed by 2005	some already abolished (d)	Yes, or abolish stamp duty on non-residential property	Yes

(a) Estimated at \$1.9 billion nationally in 2005-06.

(b) Estimated at \$1.3 billion nationally in 2005-06. This covers stamp duties on leases; mortgages, debentures, bonds and other loan securities; credit arrangements, instalment purchase arrangements and rental arrangements; and on cheques, bills of exchange; promissory notes and unquoted marketable securities.

(c) Already abolished in NSW.

(d) For example, Victoria has already abolished stamp duty on: non-residential leases from April 2001, unquoted marketable securities from 1 July 2003, and mortgages from 1 July 2004. WA has abolished stamp duty on: cheques from 1 January 2004, and leases from 1 January 2004, and unlisted securities from 1 January 2004.



1. BACKGROUND & FOCUS OF REPORT

This report has been commissioned by the Business Coalition for Tax Reform (BCTR) and prepared by Access Economics.

It is intended to be used as one input into deliberations by State, Territory and Commonwealth Treasurers. Those deliberations are part of the preparations for the March 2005 meeting of the Ministerial Council of Australian Treasurers, which will examine the need for the States and Territories (hereafter referred to simply as the states) to retain the state business taxes listed for abolition (or consideration of abolition) in 2005, as set out in the (revised) 1999 Intergovernmental Agreement (IGA) that formed part of the *New Tax System* (MkII).²

The BCTR has asked Access Economics to consider the economic case for abolition of the state taxes listed in the IGA – and some other state taxes – and the economic capacity for the states responsibly to abolish them (over time if necessary).

1.1 SOME MEDIAEVAL (AND DEPRESSINGLY RECENT) HISTORY

The Australian GST was introduced, in large part, to finance the abolition of a number of then existing, selective, narrowly-based, inefficient indirect taxes levied at the Commonwealth and state levels. A GST – especially one that is very broadly-based and applied at a uniform ad valorem rate – is generally regarded as the most efficient form of indirect taxation.

The opposite extreme – the most *inefficient* form of indirect taxation – is a turnover tax. That inefficiency may be increased if turnover taxes are haphazardly applied in a selective way, especially when they target business transactions. The history of turnover taxes has been summarised as follows:³

The oldest form (of turnover tax) originated as the alcabala in mediaeval Spain. Although in the late sixties it was still the most widely used form of sales taxation in Europe, subsequently it rapidly disappeared from the scene, largely because its distributional effects, particularly with respect to exports and imports, could not be ascertained; hence it was incompatible with the goals of the EEC. In the OECD area, the turnover tax is now found only in Spain, although the Greek sales tax system also has substantial turnover tax or cascade elements.

[Parenthesis added.]

In Australia today, we now have a relatively efficient GST.

But, contrary to the last sentence in the extract just cited, variants of the ‘alcabala’, and proposals for more, are also alive and well in Australia – even in the 21st century.

Specifically:

² Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, June 1999.

³ Sijbren Cnossen *Sales Taxation: An International Perspective* in *Taxation Issues of the 1980s* Papers presented at a conference organised by the Centre of Policy Studies, Monash University, John G. Head, Editor, page 312.



- The states still rely substantially on selective turnover-type taxes, generally known as stamp duties.
- From time to time a more broadly-based, uniform-rate, turnover tax is suggested as a replacement for many existing Commonwealth and state taxes. Pauline Hanson's support for a 2% 'Easytax' is just one example of such suggestions.
- Ironically, those criticising the 2% 'Easytax' proposal include those who are quite comfortable with the retention of already-applicable versions of an 'Easytax' – albeit applied more selectively, and with much higher and sometimes variable tax rates!

This reality is the more disappointing because the original version of the IGA between the Commonwealth and the states that was formulated as part of the *New Tax System* (MkI) specifically provided for the abolition of many of these state-level 'alcabala'-type taxes. Most of the state stamp duties on business transactions were included on the abolition list. They included (bracketed dates indicate original timing of abolition):

▪ Bed taxes (Sydney, NSW and NT)	(1 July 2000)
▪ FID	(1 January 2001)
▪ Debits Tax	(1 January 2001)
▪ Stamp Duty on Marketable Securities	(1 July 2001)
▪ Stamp Duty on Non-Residential Property	(1 July 2001)
▪ Stamp Duty on Other Business Transactions*	(1 July 2001)

* This covers stamp duties on leases; mortgages, debentures, bonds and other loan securities; credit arrangements, instalment purchase arrangements and rental arrangements; and on cheques, bills of exchange and promissory notes.

1.2 THE (AMENDED) INTER-GOVERNMENTAL AGREEMENT

The subsequent deal between the Commonwealth Government and the Democrats, which included a significant reduction in the tax base for the GST, notably via the exclusion of some food and beverage items, reduced the revenue available for abolition of all of these state taxes.

This reduced scope for reform was encapsulated in the operative version of the IGA.

The amended list was as set out in the box on the following page (brackets indicate timing for abolition):



▪ Bed taxes (Sydney, NSW and NT)	(1 July 2000)
▪ FID	(1 July 2001)
▪ Debits Tax	(1 July 2005(a))
▪ Stamp Duty on Marketable Securities	(1 July 2001)
▪ Stamp Duty on Non-Residential Property	(to be reviewed by 2005)
▪ Stamp Duty on Other Business Transactions*	(to be reviewed by 2005)

* This covers stamp duties on leases; mortgages, debentures, bonds and other loan securities; credit arrangements, instalment purchase arrangements and rental arrangements; and on cheques, bills of exchange; promissory notes and unquoted marketable securities.

(a) After review.

In relation to the last two set of taxes, the intention of the review by 2005 is to determine whether or not these taxes need to be retained, and, if not, to determine when they would be abolished as per the original IGA.

1.3 FOCUS OF REPORT

This report concentrates on this *New Tax System* 'unfinished business'.

The initial focus is on the efficiency case for abolishing all of the state business taxes included in the original version of the IGA, plus the efficiency case for extending that list to some other state business taxes.

Having established the efficiency case for abolition, the report then looks at the outlook for state budgets to establish how soon abolition could responsibly be effected.

In this context, the report also considers the efficiency gains likely to flow from abolition of these taxes, the tax revenue benefits arising therefrom, and the scope for a 'national competition policy'-type system of incentives to encourage the states to abolish the state business taxes involved.

1.4 ORGANISATION OF REPORT

The remainder of this report is organised as follows:

- Section 2 summarises some modelling results indicating which state taxes are the least efficient, and deriving a state tax abolition list on the basis of these results. The list is compared with that included in the original version of the IGA.
- Section 3 discusses the economy-wide benefits likely to flow from abolition of these inefficient state taxes, including gross taxation revenue benefits at both the Commonwealth and state levels. These benefits are quantified using Access Economics' computable general equilibrium model (*AE-CGE*).
- Section 4 reviews the most recent official (and Access Economics) outlooks for state budgets over the next several years, concluding with an assessment of the feasibility of abolition of the state business taxes covered in the preceding sections of the report.
- Section 5 presents a suggested time-frame for a state business tax reform program.



- Section 6 considers the scope for further Commonwealth Government incentives to the states to encourage them to implement the recommended state tax reform program.
- Section 7 briefly discusses the merits of extending the state business tax reform list beyond those mentioned in the original IGA.
- Section 8 summarises Access Economics' conclusions.
- More detailed supporting material is presented in attachments to the full report.



2. WHICH STATE TAXES ARE MOST INEFFICIENT?

All real-world taxes, to a greater or lesser extent, are inefficient or distorting.

In economists' jargon, they involve 'deadweight' economic losses that reduce the size of the economic cake that can be generated from any given set of scarce productive resources. A key task of tax reform is to minimise these 'deadweight' efficiency losses.

Many of the remaining state taxes on business are amongst the most inefficient taxes in Australia. Stamp duties – the states' selective 'alcabala' – feature prominently in this list, as explained in the rest of this section.

2.1 TAX DESIGN PRINCIPLES

A *brief* review of tax design principles is in order to set the scene.⁴

Public finance policymakers – if not others – make judgements about the adequacy or otherwise of taxes and tax systems using three criteria: economic efficiency; equity; and simplicity. These three criteria encapsulate the key areas through which people and businesses can be affected and are an accepted part of tax policy debates around the world.

These three criteria for evaluating particular taxes and charges are discussed briefly below.

2.1.1 ECONOMIC EFFICIENCY AND ECONOMIC GROWTH

In simple terms, a completely efficient tax system is one in which the imposition of tax does not get in the way of – that is, distort – decisions made by businesses and individuals. If the tax system were perfectly efficient, decisions would not be affected by tax considerations at all.

In the real world, as noted above, all taxes are more or less inefficient, although there is sometimes a case for imposing taxes to improve efficiency where social costs of production or consumption diverge from private costs.

Improvements in efficiency are a *means* to an end; a means to stronger economic growth. That, too, is not really an end in itself, but rather a means to generate higher living standards.

The rationale for this objective, in turn, springs from broader social goals.

Irrespective of taxation arrangements, Australia's economy and resources – including its market structures and its complementary institutional arrangements – need to be marshalled with the objective of ensuring that investment funds are allocated in such a way as to optimise economic growth.

⁴ But only a brief review: these principles are well known to Commonwealth and state Treasuries – even if often because they are still honoured more in the breach than in the observance!



2.1.2 EQUITY OR FAIRNESS

Equity or fairness is a seemingly simple concept, but there are different types of equity. Horizontal equity – treating taxpayers in similar circumstances in a similar way – in many circumstances may be almost synonymous with efficiency.

Vertical equity – requiring those who earn more to pay higher *rates* of tax – is largely a function of the Commonwealth personal tax system and (more to the point) targeted welfare systems. It can be partly in conflict with efficiency concerns.

Administrative and transitional equity – the fair application of the tax law, including in terms of transitions related to tax changes – are also important objectives. However, there is often a trade-off between this type of equity and both efficiency and simplicity.

2.1.3 SIMPLICITY

Simplicity is a straightforward concept. It includes *administrative* simplicity (minimising the taxation authority's costs of running the tax system) and ease of *compliance* with the tax system by taxpayers, minimising their time and money costs as well.

Simplicity is a laudable objective and – to the extent that it aids the understanding and administration of the tax system – can help to improve economic efficiency (and hence economic growth).

Today, Australia *still* does not have a particularly simple tax system. The plethora of (sometimes different) remaining state taxes does not help in this respect.

2.1.4 BALANCING THE KEY PRINCIPLES

To some extent but not completely, these principles are inconsistent.

For example:

- a single-minded effort to ensure an economically efficient tax system might end up being inequitable (eg, in the vertical equity sense);
- an alternative approach to efficiency, the so-called 'optimal taxation' approach (see below), might require a large number of different tax rates on individuals and products, depending upon their particular sensitivities to the imposition of tax;
- pushing too far to promote equity may generate large efficiency costs;
- in many cases, simplicity may require rough 'rules of thumb' to translate concepts that are hard to quantify into operational tax rules. These 'rough justice' approximations undermine efficiency and equity, at least a little.

A *balancing* of the three principles therefore is needed for a workable tax system.

2.1.5 OTHER TAX SYSTEM OBJECTIVES

Raising revenue efficiently, fairly and simply should be *the* determining principles for any good tax system.

Pursuit of other objectives that clearly violate these principles should be avoided. Introducing 'loopholes' in the tax system to cater for particular interest groups is inherently distorting and



unfair, and encourages 'me too' lobbying for further changes to the system to benefit other groups, further undermining the revenue base and increasing the distortions in the system.

This is not to say that, in some circumstances, taxes and charges cannot be used for other purposes, such as to change behaviour. In some cases distorting behaviour (eg, discouraging drink-driving) is the *object* of the exercise. But in general taxes and charges should be designed to do the job they are primarily designed to do – raise revenue – *without* introducing avoidable distortions, unfairness and complexity.

2.1.6 PRACTICAL TAX DESIGN FEATURES

For any given revenue target it might be possible to get fairly wide agreement on two very general tax design features that should dominate the tax/charges system:

- the first is that the *tax base* should be as *comprehensive* as possible
- the second is that the *tax rate structure* applied to the tax base should be as *uniform* as possible.

What are the advantages of these design features?

- Broad tax bases allow low average tax rates for any given revenue target.
- Low uniform tax rates themselves are more efficient, implying lower distorting effects, both absolutely and as between different products/activities/investments.
- A broad tax base means fewer revenue leakages, implying a fairer (ie, more even-handed or horizontally equitable) and more efficient revenue-raising system.
- A broad tax base/uniform rate structure is simpler to administer and with which to comply: exemptions and multiple rates are minimised.

So a broad tax base/low uniform tax rate system scores highly in terms of simplicity, effective revenue-raising, and horizontal equity. It also scores highly in terms of *neutrality*. In general, such a tax system minimises any influence on consumer choice, investment vehicle for savings, etc. This is not to say that important distortions do not remain. But the low rate feature minimises even these.

Where the focus is on *indirect* taxes, these tax design principles suggest additional desiderata:

- As far as possible, business inputs should not be taxed: efficient tax systems would place the tax burden on final demand, not intermediate demand.
- Taxes should not be levied on other taxes: that generates multiple effective tax rates and associated distortions, undermining efficiency, equity and simplicity.

Many remaining state taxes – not least the 'alcabala' – rate particularly poorly on efficiency and simplicity grounds, and in respect of the design desiderata just noted.

Indeed, this reality was largely reflected in the states' own choices of which state taxes should be abolished as part of the original IGA.

Those choices line up quite well with the inefficiency ranking of state taxes, as can be seen from a comparison of the list in sub-section 1.1 above and sub-sections 2.4 and 2.5 below.

2.2 MEASURING INEFFICIENCY

The measurement of tax inefficiency can be undertaken, conceptually, by evaluating the size of the 'deadweight loss' areas (comprising both reductions in consumer and producer



surpluses) arising for each market from the insertion of tax ‘wedges’ between prices faced by purchasers and those faced by suppliers.

For the economy as a whole, they can be defined as economic welfare losses, measured by ‘compensating variation’ or ‘equivalent variation’⁵, or (roughly) losses of real consumption, or (in a more dynamic context) losses in real gross national income

2.3 MODELLING INEFFICIENCY

In an economy-wide context, the inefficiency associated with particular taxation instruments can be quantified using computable general equilibrium (CGE) models that are set up as ‘economic efficiency’ meters.

Access Economics’ *AE-CGE* model is normally set up in this way, and has been used on a number of occasions to rank Australian taxation instruments in terms of their efficiency (or otherwise).

The clients for this work have included public sector agencies (including at the state level), private sector industry associations, and individual businesses. They have been used for a variety of purposes, including reviews of state business taxes.

2.4 MODELLING RESULTS

This sub-section of the report very briefly summarises some of Access Economics’ earlier modelling results in terms of an efficiency ranking for a variety of state taxes⁶.

2.4.1 AUSTRALIA-WIDE EFFICIENCY RANKINGS

Access Economics has used its computable general equilibrium model (*AE-CGE*) to estimate the economic impact of reducing each of the main State taxes.

The *AE-CGE* model is an industry-level model of the Australian economy developed by Access Economics utilising advanced microeconomic theory. The standard version of *AE-CGE* models 26 broad industries, including details of production, profit, employment, trade and consumption within these industries. For the purposes of this report, the standard version of the model and associated databases have been expanded to 34 industries, to enable a more detailed analysis of State taxes.

Information on the model and the assumptions used in the modelling is provided in Appendix A. *AE-CGE* contains no time dimension, and is designed for ‘comparative statics’ analysis. The results can therefore be regarded as potential impacts in the ‘long run’.

We have altered the structure and rates of indirect tax to those applying from 1 July 2001, following the implementation of *A New Tax System* (ANTS Mk II) – that is, the tax reform

⁵ See Attachment B.

⁶ In particular, the following results are a very brief overview of work undertaken for both the Property Council of Australia and the Insurance Council of Australia and incorporated in Submissions on behalf of both Associations to the Harvey Review of State Taxes in Victoria.



package as modified by the deal between the Commonwealth Government and the Democrats.⁷

THE MODELLING APPROACH

For the modelling, we have separately identified and analysed 12 types or groups of State taxes, as are recorded in the ABS input-output tables. These are listed below:

General Insurance-Related Taxes

- Insurance, fire services levy
- Stamp duties on general insurance
- Third party insurance

Property Taxes

- Land taxes
- Stamp duty, conveyancing (non-residential)
- Stamp duty, conveyancing (residential)
- Local government rates

Other Taxes

- Bank accounts debits tax
- Gambling taxes
- Stamp duty on motor vehicles
- Payroll taxes
- Stamp duty, other

The basic approach for the modelling was to estimate the economic impacts of reducing each State tax such that the revenue raised directly by that tax was \$100 million lower (in total, for all of the States combined) than would otherwise have been the case.

This means that the total government tax revenue for Australia is reduced by \$100 million, together with any flow-on effects resulting from changes in the tax bases. Government expenditure, expressed in real terms, is fixed. As prices vary slightly from scenario to scenario, the changes in the government (nominal) budget imbalance are slightly different in each case.⁸

Other key features of the model used in this analysis include:

- the exchange rate adjusts so that there is no change in the balance of trade; and

⁷ For further details of the model, see Appendix A. The model no longer contains franchise fees, Financial Institutions Duty or stamp duties on marketable securities.

⁸ This approach was adopted so that the estimates of gains to economic welfare would not be affected by assumptions about potential increases in other sources of revenue. An assumption that an offsetting amount of revenue would be raised from, say, GST revenue, would affect the absolute size of estimates of changes in economic welfare, but would be unlikely to affect the relativities between estimates for the various State taxes. At the end of the day, the ability of States to reduce State taxes is a function of expected budget outcomes.



- the supply of capital adjusts freely in response to demand, which is influenced by changes in the price of investment goods.

We considered two labour market scenarios for the analysis. For the first one, aggregate employment is fixed and all of the adjustment in the labour market occurs through movements in real wages. This is the normal configuration in the model.

However, this implies the strong assumption that the supply of labour does not respond to changes in the real wage – in particular that there is no substitution of work for leisure. As an alternative, we therefore investigated the implications of assuming that the labour supply increases in line with real wages with a supply response ‘elasticity’ with respect to real wages of +0.2. That is, a 1% increase in real wages generates a 0.2% increase in labour supply and employment (it is assumed that additional labour demand equals the additional labour supply). The economic impacts of reducing State taxes when the labour supply and employment are flexible are similar to the results obtained under the fixed labour supply scenario.⁹

INFLUENCES ON ECONOMIC WELFARE

The results from the modelling (see below) indicate that the change in economic welfare resulting from reducing a State tax is determined primarily by whether the tax impacts mainly on capital, labour or on the overall cost of production, or a specific item of consumption.

In *AE-CGE*, economic welfare, as measured by the compensating variation (CV) (see Appendix B), is based on an explicit household utility function, in which utility moves in line with the change in total real consumption.

Some of the taxes act mainly on specific items of consumption (e.g. taxes on gambling). In these cases the change in utility will be larger, the more responsive is consumer demand for the consumption item (and vice versa) – and the more capital intensive is its supply.

Some taxes act mainly on the price of capital (e.g. stamp duties on non-residential conveyancing), while payroll tax alone acts on the price of labour. The economic benefits of reducing taxes on capital are likely to be large, given that capital supply responds elastically to changes in its price, whereas the supply of labour is comparatively unresponsive to changes in the real wage rate.

Other taxes have a component that acts more generally on the costs of inputs to production (e.g. land taxes). These in turn have a widespread impact on the prices of household consumption and will tend to produce similar impacts on economic welfare.

Reductions of taxes on inputs other than labour or capital reduce the overall cost of production and tend to increase supply, creating increased demands for labour and capital. To the extent that the supply of labour is constrained, while inputs of labour and capital are partially substitutable, benefits of removing \$100 million of such a tax exceed those of removing \$100 million of a tax on labour but are less than those of removing \$100 million of a

⁹ This labour supply elasticity assumption was used in earlier reports prepared for the Harvey Review of Business Taxation in Victoria. We modelled alternative labour supply elasticities, up to 0.8, as well. These produced larger real economic benefits, but also larger nominal wage and price reductions. As a result, effects on dollar values for Commonwealth and state revenues, which reflect both influences, were minor.



tax on capital. The increase in welfare is partially reduced by the cost of financing any increases in the use of capital.

RANKING STATE TAXES BY THEIR WELFARE EFFICIENCY

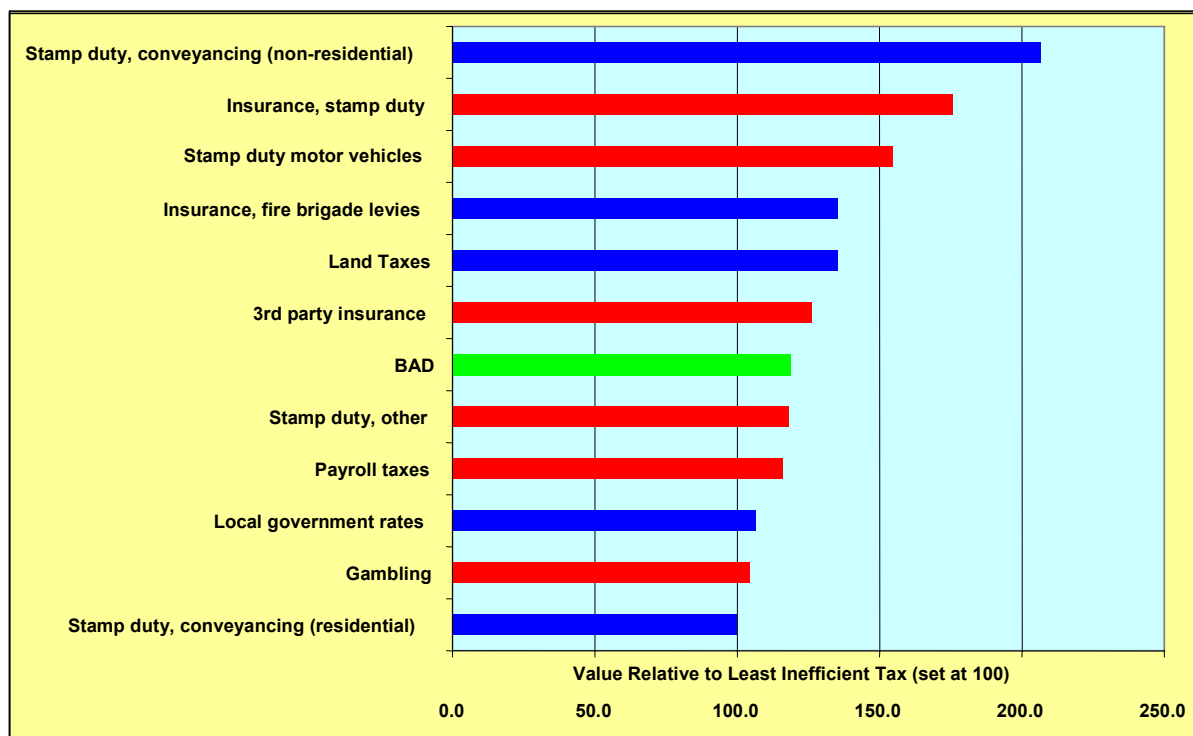
The welfare efficiency results from the modelling (under the assumption of some responsiveness of employment) are summarised in Chart 2.4.1.1 below.

The economic welfare benefits from reducing a given State tax by \$100 million are greatest for *stamp duties on non-residential conveyancing, stamp duties on insurance and stamp duties on motor vehicles*. This chart essentially provides *one* efficiency ranking for the State taxes examined.

On the basis of the modelling – which is *one* guide to determining a priority ranking for tax cuts – those taxes at the top of the chart would provide the greatest economic benefits if they were to be reduced or abolished. The higher the economic benefit, the stronger the economic efficiency case for their reduction.

The results are likely to underestimate the gains to economic welfare from reducing State taxes. This is because it is not possible, using the input-output data in the model, to model varying rates of tax at varying tax thresholds for the tax base for each tax. In the case of payroll taxes, for example, there may be substantial efficiency costs from having a tax-free threshold (which encourages businesses to stay small). These efficiency issues are not captured in the model. Market failure problems are another source of inefficiency that is not well-captured by the model. This is particularly relevant for the fire services levy.

CHART 2.4.1.1: ECONOMIC WELFARE¹⁰ GAIN FROM A \$100 MILLION REDUCTION IN STATE TAXES (SOME LABOUR SUPPLY RESPONSIVENESS)



Some brief comments on these results follow.

Reducing stamp duties on non-residential conveyances and stamp duties on insurance would result in gains to economic welfare that are much larger than the gains that would arise if, say, payroll taxes or taxes on gambling, or stamp duty on residential conveyancing were reduced by the same amount.

Reducing stamp duties on motor vehicles, land taxes, and fire services levies would also result in gains to economic welfare that are significantly larger than the gains that would arise if, say, payroll taxes or taxes on gambling, or stamp duty on residential conveyancing were reduced by the same amount.

Reducing stamp duty on residential conveyancing, taxes on gambling, local government rates, and payroll tax deliver the lowest welfare gains amongst the twelve taxes listed.

In broad terms, the results indicate that taxes that fall on investment (such as new non-residential conveyancing and stamp duties on insurance and on new motor vehicles) lead to the greatest economic costs, and would therefore provide the greatest economic benefits if they were to be reduced.

Reductions in payroll taxes provide relatively small economic gains due to the assumption that, in the very long run, labour supply and employment are relatively unresponsive to real wages.

¹⁰ CV – Compensating variation (see Appendix B).



The other State taxes considered principally fall in the category of costs on production and the results show that removal of each of these taxes has much the same benefit for economic welfare (and economic activity and investment). The exceptions to these generalisations are modest welfare efficiency results for residential conveyancing, local government rates and gambling and higher benefits from land taxes and other stamp duties. These are discussed below.

The welfare results for reducing stamp duties on conveyancing of residential property are smaller than those for reducing stamp duties on conveyancing of non-residential property. This arises because of the strong connection between residential building and the notional industry derived by the ABS called 'ownership of dwellings'. Sales of residential building are almost exclusively to private investment in ownership of dwellings, and the outputs from the ownership of dwellings sector (principally 'imputed rent', which is derived by the ABS) has only weak linkages to other industries. Removal of the tax thus has a direct effect on consumption of ownership of dwellings, but little flow-on effect to other industries. Also, because (the ABS) assumes there is no labour input into ownership of dwellings, removal of the tax has little effect on real wages or real incomes.

This does not mean that residential property is unimportant – far from it. Inputs into residential construction come from a wide range of industries and residential construction has strong multiplier effects throughout the economy. Rather, the lower results from the modelling of changes in stamp duty on residential conveyancing are likely to have more to do with the problems that the ABS has in measuring the value of the use of residential property than anything else.

Land taxes apply to most industries with wholesale & retail (26%) and education etc (17%) accounting for the largest proportions. Both of these industries are labour intensive but the increased demands arising from reduced prices are satisfied by increased use of capital inputs. Through its role in the model in increasing prices to users above the costs of production, a reduction in the price of wholesale and retail trade results in widespread reductions in prices to consumers and others. It is this widespread benefit that brings about increased output in wholesale and retail trade even though it is labour intensive.

Removal of taxes on gambling, which are incurred mainly by consumers, increases the demand for gambling. However, the high labour to capital ratio of the accommodation etc industry, which includes casinos and clubs, restricts its expansion when aggregate labour is fixed. Labour resources drawn out of gambling reduce the outputs and contributions to economic welfare from most other industries. Increased gambling does not require inputs that substantially increase the outputs of other industries. The net effect is that there is little change in utility.

Other stamp duties apply to most industries but with the financial sector accounting for the largest proportion. As for the land taxes, the widespread benefits of reduced financial costs result in increased use of labour-intensive financial services through increased use of capital.

2.4.2 WHY ARE PROPERTY-RELATED TAXES INEFFICIENT?

The finding that taxes on property are relatively inefficient might strike some readers as odd. There is a view that efficient taxes are those levied on immobile tax bases, and that land is a particularly immobile tax base. Therefore taxes on property should be efficient.

In general, the more price sensitive are demand and supply to tax-inclusive and tax-exclusive prices, respectively, the more likely are there to be:



- Large behavioural changes – distortions – to taxpayer behaviour as a result of imposing such taxes.
- Large revenue losses as a result of contraction of the intended tax bases as a result of the imposition of taxes.

In short, price sensitive products generally are not good candidates for efficient taxation – and conversely.

As to property-related taxes, to summarise the more detailed comments that follow:

- The tax bases for property – whether land taxes or property transactions taxes – are *not* the physical property, but rather are the *values* of that property.
- Thus price (and therefore price sensitivity) as well as quantity (the physical parcels of land) form part of the relevant tax bases.
- In the short run, an unexpected change in land tax must be borne by the owner. Whether that tax can be passed on to subsequent buyers depends on market conditions.
- In the long run, property-related taxes, like other taxes, will influence relative rates of return on investment, and demand for property investments, again depending on market conditions. In these circumstances, prices for property (i) will vary to equalise risk adjusted rates of return, (ii) as a result exhibit price sensitivity to taxation, and (iii) as a result affect property tax bases.

In short, and especially in a long run context (which is the relevant context for CGE modelling), there is no reason to expect that property related taxes will necessarily be efficient.

In cases where the property involved is a business input, and especially high up the supply chain, input taxes such as land taxes and property transactions-based taxes might be quite inefficient.

So how price sensitive are the demand for and supply of commercial property?¹¹

COMMERCIAL PROPERTY DEMAND: PRICE SENSITIVE?

Is demand for commercial property likely to be price sensitive?

Obviously, this is an empirical question. But there is no reason to believe that commercial property demand is not price sensitive:

- To be sure, market price *levels* for commercial property will reflect the balance between demand and supply for the real estate in question.
- Prime commercial property will be scarce relative to the demand for it, and as a result price *levels* for such real estate will be relatively high – ‘position, position, position’.

¹¹ The remainder of this sub-section is a summary of material presented in more detail in a report prepared by Access Economics for the Property Council of Australia entitled *The Economic Case for Removing Stamp Duty on Commercial Property Transfers: A Quantitative Analysis for NSW and Australia*, February 2003.



- With advances in telecommunications, even the ‘position, position, position’ adage may be weakening, especially for increasingly competitive and therefore cost-conscious businesses (as seen, for example, in location of, say, national call centres outside Sydney and Melbourne CBDs).
- Where demand for commercial property is low relative to supply, price *levels* will be low.
- In terms of own-price elasticities of demand, for any given *marginal* response of demand to changes in price, the higher the price *level* for the commercial property in question, the higher the own-price elasticity of demand.
- Prime commercial property may well have *higher* demand sensitivity to price than other real estate, especially in relation to business demand.
- The key point is that price *levels* do not necessarily imply anything about own-price *elasticities* of demand. The former reflect the balance between demand and supply for particular parcels of commercial property. The latter involve how demand *changes* in response to price changes.
- The more sensitive commercial property demand is to changes in prices, the less efficient commercial property becomes as a tax base – because demand can shift in response to taxes, eroding that base.

COMMERCIAL PROPERTY SUPPLY: PRICE SENSITIVE?

Even if commercial property demand *is* price-sensitive, couldn’t commercial property still be an efficient tax base if supply is fixed or very price-insensitive?

The answer – *assuming* that the supply inflexibility condition is met – is ‘yes’.

It is frequently asserted that land is in fixed supply, and that taxes on land are fair and efficient because (i) the tax is borne by the business legally liable for the tax, and (ii) as land is fixed and immobile, the tax base is not subject to erosion.

Is this sensible?

A number of considerations suggest that the seeming immobility of the supply of commercial property as a tax base is more apparent than real, especially in the longer term:

- To be sure, a particular parcel of commercial property – generally speaking – is both unique and immobile.
- But is the tax base *really* just the parcel of commercial property?
- In general, the answer is ‘no’:
- Even if the tax base is defined as covering just the land, and excluding any improvements thereto (ie, its UCV), the tax base is not the physical asset, *but rather is defined as the value of that commercial property.*
 - Typically commercial property values – unimproved capital values or other – are set (more or less) with an eye to prevailing market values. (Where these values are set as a basis for collecting tax revenue or local rates, there may be debate or taxpayer cynicism about how accurate these valuations are in terms of the prevailing market. But the basic point remains: it is the value of the commercial property, not its physical features that defines the tax base.)



- And what, over time, determines the value of commercial property? The interaction between demand and supply in what is a competitive market overall sets the value.
- And *effective* demand and supply are driven by (a) what purchasers are prepared to pay for a parcel of commercial property, and (b) what existing owners are prepared to sell it for.

If the tax base for commercial property taxation is not the physical asset, but rather the value of that asset, then changes in commercial property valuations driven by fluctuations in demand and supply – for example driven by the interest rate cycle, boom/bust fluctuations in construction activity, or, more generally, the business cycle – imply a *volatile* tax base despite the apparent immobility of the physical asset. In this respect, the property market is similar to the equity market and the bond market. All the arguments about removing state taxes (eg, stamp duty on marketable securities, abolished from 1 July 2001) apply to stamp duty on commercial property transfers too.

COMMERCIAL PROPERTY: SHORT-TERM VERSUS LONG-TERM TAX-EFFICIENCY

There are many market situations where price-insensitivity also varies over time.

Typically, short-term demand and supply responses to price shocks are often smaller than longer-term responses. That is, demand- and supply-own-price elasticities tend to get larger as more time is allowed for adjustment to price shocks to occur.

In short, the nature of markets *changes* as we move from short-term to long-term perspectives.

THE NATURE OF CGE MODELLING

A comment on CGE modelling is in order here in the light of the foregoing discussion.

Computable general equilibrium (CGE) models – and indeed even ‘unchanged behaviour’ models such as Treasury’s PRISMOD model – are long-run in nature. In the latter case, much time is needed to allow cost-price effects to feed through, especially in relation to tax changes affecting the capital stock. The same is even more true of the former, because, for tax changes, both the cost effects and the subsequent behavioural responses thereto must flow through. In such models, long-term demand and supply elasticities, rather than short term elasticities, are appropriate.

In analysing the merits of structural changes such as significant tax reform, use of long run analysis is also appropriate. Such reforms are intended to be long-lasting, not undertaken annually as part of the Budget cycle.

There are several additional points that should be made:

- The immobility or otherwise of physical assets/factors of production is not really the key issue in the long term: the key issue is the mobility or otherwise of the factors of production that influence the price paid, and the *way* physical assets are improved/employed. In this respect, the financial capital that is used to purchase and improve land, in the long term, becomes critical, *and financial capital is very mobile*.
- The immobility of land *does* also apply to the financial capital invested in it *when tax reforms are effected*. The capital invested in commercial property by the current owner at the time of the tax change is ‘locked in’. But that is a very short-term perspective.



The future value of that commercial property then depends upon what subsequent investors are prepared to pay for the assets involved: that is, the tax reforms may generate realised or unrealised capital gains and losses, depending upon post-tax-reform market valuations. In the long term, the valuation of the asset depends upon what future investors are prepared to pay for the asset.

- The demand price-sensitivity of commercial property may well itself be a (rising) function of the taxes imposed on land. If tax reform were to result in the entire tax burden being shifted from other bases to land – as often recommended by land tax advocates – then after-tax returns to investors in land initially will drop substantially relative to alternative investment opportunities. Capital values will have to drop to restore the balance between rates of return on land/commercial property versus competing investment opportunities before new investment in land-related assets will resume. The flow of investment capital into land will drop.
- This sort of observation is hardly a revelation: *already* we see marked fluctuations (ie, volatility) in real estate-related investment values all the time – for office buildings, hotels – and even residential real estate.
- Allowing for the *financial* consequences of the heavy taxation of land/commercial property leads to the conclusion that, in a growing economy with mobile financial capital, land – or, more accurately, the land-related tax base *which predominantly is its value* – is not an immobile tax base after all.

Distinguishing short-term from long-term perspectives is crucial in assessing the efficiency or otherwise of potential tax bases. The latter perspective is appropriate for structural tax reform assessments, not the former. The immobility or otherwise of tax bases depends on what determines their market value over time. Where that value is determined by perceptions of investors – who control the deployment of very mobile financial capital – then the mobility of that capital, rather than the immobility of the physical asset, becomes important in determining the efficiency or otherwise of the tax base.

Treating taxes on commercial property transfers as equivalent to taxes on capital, in this long term perspective, might well be a better approximation to reality for purposes of tax reform analysis than the other extreme view that taxes on land/commercial property transfers are like pure rent taxes. They might be like the latter in the short term for incumbent owners before the tax reform is announced, but they are likely to be much more like the former down the track.

Modelling taxes on commercial property transfers more as taxes on mobile capital rather than taxes on immobile physical assets, from this financial investment perspective, is a better approximation to reality in our opinion. That is the approach adopted in the modelling results reported above.

COMMERCIAL PROPERTY: FORMAL VERSUS ACTUAL TAX INCIDENCE

If demand for commercial property is price-sensitive, and supply is as well, then the incidence of taxes on commercial property transfers is not clear:

- In the short term, taxes on commercial property transfers may well fall on commercial property owners, both legally and economically.
- But in the longer term, as the ownership of parcels of commercial property changes, the economic incidence of such taxes may diverge significantly from their legal incidence.



- The outcome will depend on the forces of demand and supply.

In the longer term, the equity implications of taxes on commercial property transfers are not clear, whatever the short term appearances might be.

2.5 A STATE TAX ABOLITION TARGET LIST

Using the efficiency ranking as summarised in chart 2.4.1.1 above, what existing state taxes should be targeted for abolition?

Access Economics notes that Bank Account Debits (BAD) tax is the only existing state tax for which there is a half-way definite timetable (1 July 2005) for abolition, (and BAD has already been abolished in NSW).

That suggests one criterion for a state tax abolition target list:

- All state taxes that are at least as inefficient as, or more inefficient than, BAD, should also be candidates for abolition.
- That suggests the following list from the 12 taxes or groups of taxes modelled by Access Economics:
 - **Stamp duties on non-residential conveyancing.**
 - Stamp duties on general insurance.
 - Stamp duties on motor vehicles.
 - Fire services levies on insurance (in the states where these still apply, including NSW and Victoria).
 - Land taxes (where these apply).
 - Third party insurance taxes.
 - **Other stamp duties** (mainly on financial transactions/instruments) – which, collectively, are about as inefficient as BAD taxes, based on the modelling results presented above.

This list includes the all existing state business taxes (with the relevant groups here highlighted in red) mentioned in the two versions of the IGA (excluding BAD, but it is assumed that this tax will be abolished, after review, from 1 July 2005). The other specific taxes up for review under the revised IGA are:

- Stamp duty on non-residential property (ie, business property conveyancing).
- Stamp duty on other business transactions. (This includes stamp duties on leases; mortgages, debentures, bonds and other loan securities; credit arrangements, instalment purchase arrangements and rental arrangements; and on cheques, bills of exchange; promissory notes and unquoted marketable securities. These are generally included in the category 'other' stamp duties as used in Access Economics' modelling.)



At the very least, this group of stamp duties should be the priority group for abolition, consistent with the clear intent of the original IGA and with the spirit of the amended IGA.

The next four sections of this report therefore concentrate on the IGA-based tax reform agenda covering these taxes.

However, our modelling also suggests a strong efficiency case can be developed to add to this list, particularly in the case of business taxes on general insurance and fire services levies on insurance, but also motor vehicle transactions, land tax, and third party insurance. The case for abolition of business insurance taxes and fire service levies thereon (and indeed insurance taxes generally) has some specific features that make the case for insurance tax reform particularly compelling.

Section 7 of this report deals with these additional tax reform cases.



3. BENEFITS FROM ABOLISHING 'BAD' STATE TAXES

Why bother with removing inefficient taxes?

The fundamental reason is that their elimination increases the size of the Australian economic 'cake', and, as a result, provides the wherewithal for increases in average living standards for the Australian community.

3.1 ECONOMY-WIDE BENEFITS

At the broadest level, any reduction in the 'deadweight' efficiency losses associated with the imposition of taxation means that the Australian economy can generate more real production from the deployment of any given amount of scarce resources.

This translates into:

- Higher real investment, employment and production.
- Higher real income (wages and profits).
- Higher real household consumption.
- Higher living standards.

3.2 STATE GOVERNMENT BUDGET BENEFITS

The states may be direct beneficiaries from the economy-wide 'efficiency dividend'. For example:

- Increased real consumption translates into increased GST collections which, (minus an administrative fee), accrues entirely to the states.
- In the case of the IGA stamp duties to be abolished, because these sit on top of GST (ie, GST forms part of the tax base for such stamp duties, and not vice versa), there is no direct erosion of GST revenue. (In the case of the fire services levy – for those states still retaining that tax – there would be some erosion of GST revenue if fire services levies are abolished because that tax is part of the tax base for GST. This raises a number of additional considerations that are considered further in section 7 below. However, these considerations are not relevant to the present IGA list of taxes.)
- Other state tax revenues – notably from payroll tax – may also benefit from increased employment as well.

3.3 COMMONWEALTH GOVERNMENT BUDGET BENEFITS

The Commonwealth is also a direct beneficiary from the economy-wide 'efficiency dividend':

- Increased efficiency generates increased real incomes which translates into increased personal, company, and capital gains tax, etc.



- These effects are reinforced because removal of inefficient state taxes (which themselves form part of the deductible expenses associated with the calculation of assessable income for tax purposes) directly increases the income tax base.
- Increased real income feeds into real consumption which, at least at the margin, will include some increases in spending on excisable products (petroleum products, alcohol and tobacco, plus some travel related levies and charges).
- Increased employment will also work to reduce demands on Commonwealth Government outlays (eg, through lower unemployment benefits), adding to Budget bottom line dividends

So both the Commonwealth and the states will benefit, directly and indirectly, from reforms increasing the efficiency of the state tax system.

3.4 WHAT'S HOLDING THE STATES BACK?

In the light of these efficiency benefits, what's holding the states back?

The benefits identified above are *gross* benefits. To these must be added the *gross* direct costs to state revenues associated with the abolition of the state taxes concerned.¹²

At least in the short term, these costs mean that:

- Combining *gross* revenue costs and benefits, given fixed tax rates, the states' *net* budget positions are likely to be weakened by abolishing inefficient state taxes.
- In contrast, the Commonwealth's *net* budget position, given fixed tax rates, is likely to be improved, even in the short term.

These differing outcomes are considered further in section 6 below.

But the net short term costs of abolishing inefficient state taxes means that, for the states, such reforms must be considered against the backdrop of the states' prospective budget positions:

- That is, can the states *afford* to embark on revenue-negative (in the short term) tax reform?
- Can this be done without being regarded as *fiscally irresponsible*? While all mainland states now have AAA credit ratings (and Tasmania is on the improve), would abolishing inefficient state taxes cost so much as to call those ratings into question and (via higher borrowing costs, etc) undermine the benefits of such reforms?

These crucial questions are considered in the next section of this report.

¹² It would be possible to abolish inefficient state taxes as part of a revenue or budget-neutral reform package that included either increases in more efficient state taxes and/or reductions in expenses. In such cases, *net* efficiency gains would still be generated, but these would be smaller than those discussed in this report. Access Economics notes these possibilities, but the focus of this report is on abolition of inefficient state taxes *without* increasing other tax rates.



4. STATE BUDGET PROSPECTS

This section of the report comments on state budget prospects over the next five years or so.

4.1 WHEN DO THE STATES GO 'GST POSITIVE'?

One perspective on the states' capacity to embark on abolishing the IGA list of inefficient state taxes is an assessment of when they each reach a position where, relative to the pre-GST Commonwealth funding arrangements, their GST revenues exceed what otherwise would have been received.

That is, in what years do each of the states reach a point where GST revenue received exceeds the level of financial assistance grants that would have been received under the previous financial arrangements?

This is the same as answering the following question:

- In what years does each state cease receiving (transitional) budget balancing assistance from the Commonwealth Government?

All States and Territories are expected to benefit from tax reform fully from this financial year (2004-05), with GST revenues for each State and Territory in excess of what each would have received from Financial Assistance Grants and their own taxes abolished under tax reform.

As a result, Budget Balancing Assistance should no longer be required from 2004-05.

The states' GST revenue has grown significantly since its introduction in 2000-01 (see Table 4.1.1 below).

The latest estimates released by the Commonwealth Treasurer following publication of the Pre-Election Economic and Fiscal Outlook (PEFO) in mid-September indicate that the estimated GST revenue provision to the states in 2004 05 represents a 45% increase over the amounts paid in 2000 01. This is close to an average annual increase of 10%.



TABLE 4.1.1: GST REVENUE TO THE STATES (CASH), 2000-01 TO 2004-05 (ESTIMATED)

	2000-01	2001-02	2002-03	2003-04	2004-05 (est)	Increase from 2000-01 to 2004-05	Increase	Average annual increase
	\$m	\$m	\$m	\$m	\$m	\$m	%	%
NSW	7,257.6	8,132.0	9,080.2	9,690.5	9,870.1	2,612.5	36.0%	8.0%
Vic	5,099.3	5,593.1	6,365.1	6,973.6	7,321.1	2,221.8	43.6%	9.5%
Qld	4,658.2	5,018.6	5,887.6	6,574.9	7,314.2	2,656.0	57.0%	11.9%
WA	2,374.6	2,518.1	2,910.2	3,159.8	3,613.1	1,238.5	52.2%	11.1%
SA	2,278.9	2,476.6	2,859.1	3,154.3	3,281.8	1,002.9	44.0%	9.5%
Tas	988.1	1,059.8	1,246.7	1,399.0	1,434.4	446.3	45.2%	9.8%
ACT	472.6	543.9	615.7	660.7	676.5	203.9	43.1%	9.4%
NT	1,225.6	1,289.8	1,514.5	1,684.2	1,711.8	486.2	39.7%	8.7%
Total	24,354.9	26,632.0	30,479.1	33,297.0	35,223.0	10,868.1	44.6%	9.7%

Source: Commonwealth Treasury

Moreover, the PEFO-time estimates indicate that, through to 2007-08, the states will benefit from a cumulative GST windfall of \$11.8 billion. (See Table 4.1.2 below).

These amounts were not factored into their budgets and so represent a straight-out financial windfall.



**TABLE 4.1.2: GST REVENUE 'WINDFALL' TO THE STATES OVER ENTITLEMENTS UNDER
PREVIOUS FINANCIAL ARRANGEMENTS, TO 2007-08 (ESTIMATED)**

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	Cumulative gain
NSW	270	244	541	908	1,963
Vic	..	127	360	291	505	794	2,077
Qld	76	504	797	590	787	1,035	3,792
WA	..	157	286	228	319	458	1,448
SA	..	99	183	160	234	319	995
Tas	..	70	107	94	124	150	545
ACT	..	39	57	52	66	89	303
NT	0	112	139	131	142	150	682
Total	76	1,108	2,199	1,790	2,718	3,903	11,794

Source: Commonwealth Treasury

With each successive update of the GST projections, the states have been receiving an ever-increasing amount of revenue. The latest aggregate (PEPO) windfall is \$2.9 billion higher than the \$8.9 billion cumulative gain projected at the time of the 2004-05 Budget in May 2004.

Moreover, the total cumulative gain to the states from the GST over the period to 2007-08 looks set to be more than triple the estimate at the inaugural meeting of the Ministerial Council for Commonwealth-State Financial Relations (MINCO) in March 2000. Back in 2000, over the entire period from 2002-03 to 2007-08, the states were originally forecast to be receiving a \$3.7 billion windfall compared with the previous system.

In short:

- All the states have now reached a position where their GST revenue receipts exceeds what they would have received under the previous financial arrangements.
- As currently forecast in the Commonwealth Budget papers, all states will go 'GST positive' starting from 2004-05.

On this basis, and depending upon the extent to which GST revenue exceeds what otherwise would have been received, every state should be in a position to consider pressing ahead with abolition of the remaining 'IGA list' of state taxes from 2005-06.

However, this is not the only perspective on the states' capacity to abolish some of their inefficient state taxes.



4.2 THE NEED FOR A WIDER STATE BUDGET PERSPECTIVE

There is a case – especially from the perspective of fiscal responsibility – for arguing that the states' capacity responsibly to abolish some of their inefficient taxes should have regard for their *overall* budget positions and prospects, and not just whether or not they have gone 'GST positive' as outlined in the previous sub-section.

Indeed, the provisions of the revised IGA could be interpreted to indicate that the states themselves agreed to *consider* abolition of some inefficient state taxes at least partly on the basis of their overall budget positions.

Part 2, Section 5, Clause (vii) reads as follows: ¹³

The Ministerial Council will by 2005 review the need for retention of stamp duty on non-residential conveyances; leases; mortgages, debentures, bonds and other loan securities; credit arrangements, instalment purchase arrangements and rental arrangements; and on cheques, bills of exchange, promissory notes; and unquoted marketable securities.

One interpretation of this provision – and one that no doubt the states themselves (and possibly the ratings agencies) would tend to support at the present time – is that the reference to 'need for retention' is a reference to their *overall* budget positions, and not just whether or not they have gone 'GST positive'.

(We recognise that others may take a different view.)

The next two sub-sections of this report therefore consider budget prospects for the states.

4.3 ACCESS ECONOMICS' STATE BUDGET MONITOR FORECASTS

The latest Access Economics state budget forecasts, covering the period out to the financial year 2009-10, are summarised in table 4.3.1 below. ¹⁴

Some of the key features evident from table 4.3.1, for the period from 2005-06 to 2009-10, are as follows:

- For the state sector as a whole, general government (GG) net operating surpluses are forecast to remain between \$2.6 billion and \$3 billion; net borrowing between \$3.3 billion and \$3.6 billion; and aggregate net debt as a percentage of GSP is forecast to decline by about a third, from 3% to about 2%.
- For individual states:
 - NSW is forecast to record GG net operating surpluses of over \$1 billion, rising to \$1.6 billion; its net borrowing is forecast to fall, both in absolute terms and, even more so, as a proportion of GSP.

¹³ *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, June 1999.

¹⁴ A much more detailed account of state budget conditions and prospects is included in Access Economics' *State and Territory Budget Monitor No 62*, October 2004. Note that the forecasts assume debits tax is abolished from 1 July 2005.



- *Victoria* is forecast to record GG net operating surpluses of over \$400 million every year (well above the \$100 million annual official target); its net borrowing is forecast to remain low, and to fall as a proportion of GSP.
- *Queensland* is in a very strong position: forecast GG net operating surpluses are \$500 million each year; its net borrowing is forecast to fall, and Queensland is forecast to remain as only one of two net *creditor* states.

TABLE 4.3.1: STATE SECTOR – MEDIUM TERM PROJECTIONS BY STATE*

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
	Actual	Prelim ^a	Estimate ^a	Forecast ^b	Forecast ^b	Forecast ^b	Forecast ^b	Forecast ^b
New South Wales								
GG Net operating surplus (\$ million)	1,752	1,291	836	1,148	1,228	1,277	1,426	1,600
Net borrowing (\$ million)	747	1,751	2,291	1,765	1,436	1,321	1,229	1,140
Net debt ratio (% of GSP)	5.0%	4.6%	4.6%	4.4%	4.1%	3.5%	3.1%	2.8%
Victoria								
GG Net operating surplus (\$ million)	1,517	719	529	842	978	756	605	408
Net borrowing (\$ million)	-231	82	1,198	358	175	355	527	741
Net debt ratio (% of GSP)	1.5%	1.8%	2.0%	1.8%	1.6%	1.3%	1.2%	1.2%
Queensland								
GG Net operating surplus (\$ million)	15	2,374	646	638	513	498	539	593
Net borrowing (\$ million)	1,034	-1,265	2,020	1,085	1,064	1,071	1,045	1,038
Net debt ratio (% of GSP)	-0.3%	-1.9%	-1.3%	-1.5%	-1.6%	-1.7%	-1.9%	-2.0%
Western Australia								
GG Net operating surplus (\$ million)	254	207	243	206	72	32	191	389
Net borrowing (\$ million)	-6	327	702	440	548	614	462	281
Net debt ratio (% of GSP)	6.3%	6.7%	7.0%	6.9%	7.0%	6.8%	6.9%	6.7%
South Australia								
GG Net operating surplus (\$ million)	448	264	116	162	110	82	64	33
Net borrowing (\$ million)	-405	-142	-89	-156	-74	-37	-8	38
Net debt ratio (% of GSP)	5.5%	4.9%	4.5%	3.7%	3.1%	2.5%	2.1%	1.9%
Tasmania								
GG Net operating surplus (\$ million)	212	100	-45	36	17	11	16	19
Net borrowing (\$ million)	-156	-31	87	-85	-66	-70	-80	-84
Net debt ratio (% of GSP)	15.8%	14.2%	12.5%	11.8%	11.3%	10.5%	10.1%	9.7%
Australian Capital Territory								
GG Net operating surplus (\$ million)	188	18	-17	4	-24	-34	-45	-59
Net borrowing (\$ million)	-314	32	240	144	145	159	174	192
Net debt ratio (% of GSP)	-8.0%	-8.0%	-7.1%	-6.4%	-5.8%	-5.0%	-4.4%	-3.8%
Northern Territory								
GG Net operating surplus (\$ million)	-1	49	-12	-68	-24	-27	-14	-4
Net borrowing (\$ million)	46	-2	69	97	58	56	44	35
Net debt ratio (% of GSP)	18.2%	16.6%	17.3%	16.3%	15.8%	14.4%	13.4%	12.5%
Total (all States and Territories)								
GG Net operating surplus (\$ million)	4,385	5,022	2,297	2,968	2,870	2,596	2,781	2,979
Net borrowing (\$ million)	714	752	6,518	3,647	3,285	3,468	3,394	3,382
Net debt ratio (% of GSP)	3.5%	3.1%	3.2%	3.0%	2.8%	2.5%	2.2%	2.1%

* GG - General Government.
* GSP - Gross State Product.

a – Treasury estimates. b – Access Economics forecast.

- *WA* is forecast to record GG net operating surpluses in every year, rising to nearly \$400 million in 2009-10; its net borrowing is forecast to fall, both in absolute terms and as a proportion of GSP.
- *SA* is forecast to record GG net operating surpluses in every year; it is forecast to be a small net *lender* in most years, and its net debt as a proportion of GSP is forecast to be *halved* between 2005-06 and 2009-10.



- *Tasmania* is forecast to record GG net operating surpluses in every year; it is forecast to be a small net *lender* in some years, and its net debt as a proportion of GSP is forecast to fall between 2005-06 and 2009-10.
- The *ACT* is forecast to record small GG net operating deficits in most years; its net borrowing is to continue over the forecast period, *but* the ACT is forecast to remain as the strongest net *creditor* states, as measured by its (negative) net debt to GSP ratio.
- The *Northern Territory* is forecast to record GG net operating deficits in every year of the forecast period; its net borrowing is forecast to decline, and also to fall as a proportion of GSP (albeit from relatively high levels compared with the other states).

Note that the 'estimates' for 2003-04 presented in Table 4.3.1 above are official Treasury estimates released when the 2004-05 state budgets were first published. Since then:

- Queensland's 2003-04 operating surplus has come in at \$3.34 billion, or about \$1 billion higher than estimated earlier this year.
- Western Australia's net operating surplus has come in at \$793 million, or about \$600 million higher than forecast.
- Victoria's net operating surplus has come in at \$990 million, or about \$300 million higher than forecast.

4.4 OFFICIAL STATE BUDGET FORECASTS

Official state budget projections at present are published out to 2007-08, and then consistently only for the GG sector.

For the states as a whole, official forecasts for GG net operating balances (for the years 2005-06 to 2007-08, inclusive) are stronger than the corresponding Access Economics forecasts except for the year 2007-08.

4.5 CAN THE STATES AFFORD TO ABOLISH INEFFICIENT TAXES?

State budget conditions and prospects suggest several key observations:

- All mainland states are now AAA rated.
- Tasmania has the second-highest net debt position (as a percentage of GSP), but it has been steadily improving its net debt position, and that improvement is expected to continue out to 2009-10.
- The Northern Territory has the weakest net debt position, but significant improvements are forecast here as well.
- Arguably, more of the past revenue windfalls associated primarily with the recent residential and commercial property boom, and those associated with increasing insurance premiums to restore industry viability, could have been 'salted away' to help finance further state tax reform. That would have increased the capacity of the states to take such action.



- Overall, and in the case of all individual states, a pattern of improving budget positions (for most) and/or very strong balance sheets (for the ACT and Queensland) are forecast to continue over the period out to 2009-10.

Access Economics concludes that there is scope for further state tax reform (see section 5 below), at least to complete the IGA reform agenda, over the years ahead, without being fiscally irresponsible:

- This is especially the case for NSW, Victoria, Queensland, and the ACT
- It is probably also feasible for SA and even WA.
- It may be more difficult for Tasmania and especially the Northern Territory without some assistance or offsetting revenue or expenses measures.

It should be noted that some states have already taken the initiative to abolish or reduce inefficient state taxes listed under the original IGA, as well as some other 'non-IGA' taxes.

For example, in terms of IGA taxes:

Victoria has abolished:

- stamp duty on non-residential leases from April 2001;
- stamp duty on unquoted marketable securities from 1 July 2003; and
- stamp duty on mortgages from 1 July 2004.

WA has abolished:

- stamp duty on cheques from 1 January 2004;
- stamp duty on leases from 1 January 2004;
- stamp duty on unlisted securities from 1 January 2004.

In terms of non-IGA taxes, for example:

Victoria has:

- made changes to land tax, including increasing tax-free thresholds and reducing some higher rates.

WA has:

- abolished stamp duty on life insurance from 1 July 2004; and
- abolished stamp duty on workers compensation insurance from 30 June 2004; and
- reduced stamp duty on conveyances by 5% across the rate scale.

NSW has:

- made a number of changes to land taxation, including broadening of the tax base and lowering rates. However it has also introduced a new stamp duty on investment property sales, from 1 June 2004
- already reduced the general stamp duty rate on insurance from 10% to 5% where the period of insurance begins on or after 1 August 2002.



5. A PROGRAM FOR STATE BUSINESS TAX REFORM

This section of the report presents estimates of the cost of abolishing the remaining IGA state taxes and comments of possible time-frames for their abolition.

The following section considers the merits of the case for additional Commonwealth Government assistance as an additional incentive to encourage the states to complete the IGA state tax reform program.

5.1 WHAT WOULD COMPLETION OF THE IGA REFORMS COST?

The state taxes set for abolition that were deferred under the revised IGA can be separated into two categories:

- stamp duty on business (non-residential) conveyances; and
- 'other stamp duties', applying to a range of financial and capital transactions – leases; mortgages, debentures, bonds and other loan securities; credit arrangements, installment purchase arrangements and rental arrangements; and on cheques, bills of exchange, promissory notes; and unquoted marketable securities.

Tables 5.1.1 and 5.1.2 below show Access Economics' estimates of revenue by State and Territory, for each of these categories.

The level of detail publicly provided as to revenue raised by particular taxes differs markedly across state jurisdictions, making comparisons difficult. For this reason, where possible, the estimates in Tables 5.1.1 to 5.1.3 rely on accrual Government Finance Statistics reported by State and Territory governments as part of the Uniform Presentation Framework, also published by the ABS (ABS Cat. No. 5506.0). In particular, most jurisdictions report the total value of stamp duties on financial and capital transactions, which includes stamp duty on conveyances as well as 'other stamp duties'.

For the larger states, 'other' stamp duties is calculated as a residual ('stamp duty on financial and capital transactions' less 'stamp duty on conveyances'). Estimates (for 2003-04 and 2004-05) of stamp duty on conveyances have been obtained from the latest available state budget papers.

There is a lack of specific information available on the revenue raised by each of the remaining IGA taxes. Accordingly, while the estimates below are a reasonable guide to broad orders of magnitude, they should be used with caution.

That said, the estimates serve as a broad indication of the cost of completing the IGA state tax reform program.

Total stamp duty on conveyances is generally reported in State and Territory Budget papers. In light of consultation with the property industry, our estimate of non-residential conveyances is based on an assumption that 20 per cent of stamp duty on total conveyances relates to non-residential conveyances.¹⁵

¹⁵ This compares with a proportion of 30 per cent assumed in the Victorian context by the Harvey review of Business tax in that State. The actual percentage will vary around the country, and, presumably, also with changing conditions in the property market.



TABLE 5.1.1: ESTIMATED REVENUE – STAMP DUTY ON NON-RESIDENTIAL CONVEYANCING (\$M)

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2007-08	2009-10
	AE estimate	AE estimate	AE estimate	AE forecast	AE forecast	AE forecast	AE forecast	AE forecast
NSW	725	778	776	832	860	906	950	991
Vic	423	503	447	458	466	486	507	529
Qld	276	366	288	301	315	335	355	377
WA	186	218	169	169	174	180	183	185
SA	86	113	88	90	93	96	100	104
Tas	18	24	20	20	21	21	22	23
ACT	35	37	33	34	35	36	38	39
NT	9	10	9	10	10	10	11	11
Total	1,758	2,049	1,830	1,914	1,974	2,071	2,166	2,259

TABLE 5.1.2: ESTIMATED REVENUE – OTHER STAMP DUTIES (\$M)

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2007-08	2009-10
	ABS	AE estimate	AE estimate	AE forecast	AE forecast	AE forecast	AE forecast	AE forecast
NSW	621	687	677	726	750	790	829	864
Vic	272	303	126	75	77	83	89	95
Qld	279	301	258	270	283	300	318	338
WA	49	150	126	126	130	134	137	138
SA	93	105	88	90	93	96	100	104
Tas	17	18	16	16	17	17	18	18
ACT	9	14	15	15	15	16	17	17
NT	6	8	7	8	8	9	9	9
Total	1,345	1,587	1,313	1,326	1,373	1,446	1,516	1,584

TABLE 5.1.3: ESTIMATED TOTAL REVENUE FROM REMAINING IGA STATE TAXES (\$M)

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2007-08	2009-10
	AE estimate	AE estimate	AE estimate	AE forecast	AE forecast	AE forecast	AE forecast	AE forecast
NSW	1346	1465	1453	1558	1610	1696	1778	1855
Vic	695	806	573	533	544	569	596	625
Qld	555	667	546	571	598	635	673	714
WA	235	368	295	294	304	314	320	323
SA	179	218	176	180	185	193	200	208
Tas	35	42	36	37	38	39	40	41
ACT	44	52	48	49	50	52	54	57
NT	15	18	16	18	18	19	20	21
Total	3,104	3,636	3,143	3,240	3,347	3,517	3,683	3,844

5.2 AN APPROPRIATE REFORM TIME-FRAME

The overall cost of completing the IGA state tax reform program in 2005-06 magnitudes is, on our estimates, about \$3.2 billion for Australia as a whole, distributed across the states as indicated in table 5.1.3 above.



Based on our forecasts of state budget prospects set out in table 4.3.1 above, this cost compares with a total forecast net operating surplus for all States and Territories of about \$3 billion in 2005-06.

In ball-park terms, therefore, implementation of the remaining IGA state tax reform program *in full* from 1 July 2005 would effectively drive the total net operating surpluses of all states down slightly into deficit.

Comparing tables 4.3.1 and 5.1.3, the implications for individual states will be variations on this average, with some retaining net operating surpluses and others going further into net operating deficits:

- Victoria and Queensland would retain net operating surpluses.
- Tasmania would move to approximately a zero net operating balance.
- The other States and the Northern Territory would move to net operating deficits if no other action was taken.

Accordingly, if

- moving into (or further into) net operating deficits is considered unacceptable by the states; and
- no increase in other (more efficient) state taxes, or further restraint on state budget expenses, partially to offset the cost of abolishing these more inefficient taxes is considered acceptable by the states; then

complete abolition of the remaining IGA taxes from 1 July 2005 – desirable though that might be – might be considered to be too ambitious without additional financial assistance from the Commonwealth Government (on this see section 6 below).

That said, *if* enough additional financial assistance from the Commonwealth *could* be provided, there is a real possibility that the remaining IGA state taxes could be abolished from 1 July 2005.

If no such assistance is forthcoming, could an alternative, more gradual reform program, be implemented by the states?

If one criterion of fiscal responsibility is not to run net operating surpluses or to increase net operating deficits, then Access Economics' forecasts for state budget positions out to 2009-10 (see table 4.3.1) suggest that, over the five years from 2005-06, no further net operating surplus 'headroom', either in total or for each state, is expected to open up.

Moreover, these budget forecasts include revenue from the remaining IGA state taxes that is *growing* over that period, and the cost of abolition by 2009-10 is forecast to increase from about \$3.2 billion to about \$3.8 billion.

Accordingly, on our forecasts over the next five years:

- without further financial assistance from the Commonwealth,
- or increases in other state taxes,



- or further restraint on state budget expenses,
- and assuming that the states as a group are not prepared to run, or increase, net operating deficits,

then complete abolition of the remaining IGA taxes is not feasible.

On these grounds, what could be achieved?

POSSIBLE STATE TAX REFORM OPTIONS (ASSUMING NO COMMONWEALTH ASSISTANCE)

Access Economics considers that:

- *either* stamp duty on non-residential conveyancing (the most inefficient of all the remaining state taxes, based on our *AE-CGE* model results) could be abolished from 1 July 2005;
- *or* all of the 'other' stamp duties (which are at least as inefficient as BAD as a group, and, for individual taxes on financial instruments, they are probably much more inefficient, as well as being in the nature of 'nuisance' taxes) could be abolished from 1 July 2005;
- *or*, roughly speaking (and more messy from a tax administration viewpoint), the current rates for both of these taxes could be halved from 1 July 2005.

5.3 THE NEED TO SET REFORM OBJECTIVES UP-FRONT

Access Economics considers that, if further state tax reform in the spirit of the IGA is to be implemented, then the states should agree to a program covering both the taxes to be reformed *and* a specific timetable (whether 1 July 2005 or some other date) *in advance*.

Given the inevitable pressures on all government budgets, any tax reform 'statement of intent', that does not include specific trigger dates *determined in advance* is likely to fail.

The history of experience with government budgeting in Australia is that it is difficult to sustain sizeable surpluses against strong political pressures to spend them. Even during times when state revenues have surged ahead (as has been the case during the recent property boom), the states have had extreme difficulty resisting pressures to spend those revenue windfalls, rather than 'salting them away'.

If more of those surging revenues during the recent property boom had been saved, the IGA tax reform program could have been completed by 1 July 2005 without additional financial support from the Commonwealth and without major pressure on state budget bottom lines.

However, that opportunity has now been lost, and most of the revenue windfall has been allocated to increased state budget spending.

At the end of the day, maintaining net operating surpluses *and* removing the remaining IGA taxes requires the states to commit to reforms in advance, *and to sustain net operating surpluses through the trigger date for reform.*

The shorter the period between agreement to the reforms and the trigger date for their implementation, the more likely it is that the states will be successful.



Whatever further reforms are decided, on our forecasts, 1 July 2005 is a feasible trigger date to incorporate in the agreement.



6. SHOULD THE COMMONWEALTH ASSIST THE STATES?

The state tax reform program suggested in section 5 will:

- directly cost the states substantial annual revenues both in gross and in net terms (after allowing for any efficiency gains benefiting their budgets); and
- over time, provide net efficiency benefits, both via increased income tax revenues and reduced Budget expenses, for the Commonwealth Government

as outlined in section 3 above.

Should the Commonwealth provide additional assistance – that is, over and above the GST revenue ‘windfalls’ now flowing to the states – as an incentive to complete the IGA state tax reform program?

This section considers arguments relevant to this question and presents some illustrative figuring.

6.1 A COMMONWEALTH PERSPECTIVE

A possible Commonwealth Government answer to this question might contain the following elements:

- The allocation of all GST revenue to the states (less an administration fee) has provided the states with a source of financial assistance that grows more rapidly than the previous financial assistance grants.
- As noted in section 4 above, growth in GST revenues to date and in prospect is even faster than was expected in March 2000.
- In short, the GST windfall expected when the IGA came into operation has emerged, and has done so even more quickly than was then expected.
- Because GST *growth* is expected to be *permanently* faster than growth in the previous financial assistance grants, the financial capacity of the states to abolish the remaining state taxes listed for review by 2005 is not in question.
- The only question is when that can occur.
- If the states exerted even moderate fiscal discipline on the expenses side, they should be able to commence, if not complete, the abolition of the remaining IGA taxes from 1 July 2005.
- In this context, there is no case for additional Commonwealth financial assistance beyond access to the ‘growth tax’ revenue in the form of the GST.

6.2 A STATE PERSPECTIVE

A possible state response to this Commonwealth position might contain the following elements:



- The *original* IGA contemplated specific times for the abolition of *all* of the state taxes in the IGA list – at the latest by 1 July 2001 – on the basis of expected GST revenue calculated on a larger tax base (eg, that included all food) than was finally implemented after the deal in May 2000 between the Commonwealth Government and the Democrats.
- The states signed up to the original IGA, and made the commitment to abolish all of the IGA list of state taxes by no later than 1 July 2001, *on the basis that they would receive all GST revenue, including GST on food.*
- That is, any GST ‘windfall’ to the states over time – where that ‘windfall’ included GST on food – was factored into the states’ thinking when they signed on to the original IGA.
- The deal between the Commonwealth Government and the Democrats eroded the GST base substantially – by of the order of \$4 billion in 2002-03 on the Commonwealth’s own estimates, growing, on our estimates, to as much as \$4.7 billion in 2005-06 (mainly reflecting the excision of some food from the GST base).¹⁶
- *That revenue loss is itself a vary large proportion of any GST windfall to the states, however that windfall is measured.*
- Other changes since the IGA was implemented have disadvantaged the states as well, and these were not expected when the IGA was signed.
- Even accepting that food as a proportion of total private consumption *might* decline over a long period of time, the loss of GST revenue to the states, relative to that expected when the original IGA was signed, will remain very substantial for decades to come.
- Without additional – and growing – financial assistance to fill the gap left by the changes to the GST tax base as a result of the deal between the Commonwealth Government and the Democrats, the states have no financial capacity, especially given other competing demands on their budgets, to complete the IGA reforms.

6.3 AN INTERMEDIATE POSITION

If the positions adopted by the Commonwealth and the states, respectively, reflect these sorts of considerations, then no further reform of state taxes under the IGA may be implemented.

The only obligation under the IGA is for the states to review their ‘need’ for stamp duty on non-residential conveyancing and the other stamp duties. They could undertake this review, and conclude, given other budget pressures and priorities, that they needed to retain the revenue from these taxes.

Is there a credible intermediate position between the Commonwealth and state positions as characterised in sections 6.1 and 6.2?

¹⁶ Attachment to letter from the Prime Minister to Senator Meg Lees, May 1999.



Access Economics suggests that such an intermediate position is worth developing. The remainder of section 6 presents an attempt to sketch out one such position.

Is there any case for additional Commonwealth assistance to the states, and how could it be financed?

6.3.1 COMMONWEALTH REFORM BENEFITS

As explained in section 3 above, the efficiency gains from abolition of the remaining taxes listed in the IGA – which include the most inefficient of state taxes – will translate into increased income tax revenues for the Commonwealth Government (as well as some reduction in expenses).

That income tax dividend from state tax reform is one possible source of additional financial assistance to the states as an incentive to complete the reform program (see sub-section 6.4 below for quantitative estimates).

6.3.2 FEDERAL FINANCIAL RELATIONS: VFI & VFE

Under current and foreseeable arrangements, vertical fiscal imbalance (VFI) is a fact of life in the Australian federal system of government.

It follows that, for each level of government to be able to finance the activities for which it is responsible, the revenue-surplus level of government must provide financial assistance, whether general (untied) or for specific purposes, to the revenue deficit levels.

In Australia – and in part the more so because of the introduction of the GST and the IGA state tax reform program – VFI, if anything, has increased. The allocation of GST revenue to the states is a recognition of this. It would be a complete coincidence if the transfers to the states under a particular specification of the GST were to prove precisely adequate to meet the states' needs for financial assistance.

In short, if all levels of government are to be equally capable of financing their activities – what might be termed vertical fiscal equalisation (VFE) – then transfers from the Commonwealth, which dominates tax revenue collections – to the other levels of government will need to be:

- sizeable; and
- subject to regular review.

In short, allocating GST to the states does not end the need for the adequacy of these transfers to be regularly monitored.

6.3.3 THE EROSION OF THE ORIGINAL GST TAX BASE

It seems clear to Access Economics that the erosion of the GST tax base, mainly through the excision of some food, has cut a very substantial and permanent hole (around \$4 billion estimated in 2002-03 and estimated at about \$4.7 billion in 2005-06) out of the revenue stream expected by the states when they signed the original IGA.

Moreover, that hole is a permanent shortfall – and is large relative to any 'windfall' revenue gain relative to the previous financial arrangements.



It is also probably true that the states could exercise more rigorous restraint on expenditure to reduce the bottom line impact of that hole, and thereby themselves provide the capacity to finance abolition of the remaining IGA state taxes.

But why should they *have* to do so?

After all:

- The excision of some food, and the other modifications to the GST tax base, were not decisions made by the states.
- These decisions were made at the Commonwealth Government level as part of the deal with the Democrats.
- They were then put before the states, and modifications were made to the IGA to accommodate them.
- Those modifications include the arrangements in relation to stamp duty on non-residential conveyancing and the other stamp duties.

From that perspective, it could be argued that the Commonwealth should consider additional financial assistance, at least *partly* to plug the GST hole left by the deal it negotiated with the Democrats, as a further incentive for the states to complete the IGA reforms.

6.3.4 THE NATIONAL COMPETITION POLICY/IGA PRECEDENT

The IGA (both versions) have a National Competition Policy (NCP) flavour in some important respects:

- They encourage the states to contribute to a more efficient, and more uniform Australia-wide market, specifically by abolishing a number of inefficient (and to some extent varying by state) indirect taxes.
- In exchange for these reforms, the Commonwealth provides incentive payments in the form of GST revenue, where the incentive is the expected excess of GST revenue over financial assistance grants calculated as per the pre-GST arrangements.

But the move from IGA Mk I to IGA Mk II reduced the NCP-type incentive payments *dramatically*:

- because a \$4.7 billion GST shortfall (in 2005-06), relative to the excess of forecast GST payments over financial assistance grants calculated on the pre-GST basis, is a very large percentage reduction;
- and the Commonwealth did not wish to modify its income tax cuts (beyond the modifications achieved by the Democrats);
- and, as a result, the states' indirect tax reform program had to be drastically modified as well.

It might be concluded that, if the Commonwealth Government really wants the states to complete the IGA reforms, consistent with the NCP and original IGA precedents, it should go



a fair way towards re-establishing the financial incentives to the states that were contained in the original IGA.

6.4 A POSSIBLE COMPROMISE: SOME ILLUSTRATIVE FIGURING

For the purposes of this report, Access Economics assumes that:

- The States will reject the proposition that they should abolish the remaining IGA taxes if the Commonwealth refuses absolutely to provide additional financial assistance.
- The Commonwealth will reject outright the notion that additional assistance of \$4.7 billion in 2005-06 (ie, completely restoring the original GST tax base) is in any way justified.

On the basis of these assumptions, is there a reasonable range for additional Commonwealth financial assistance that would be a basis for negotiation between the Commonwealth and the states?

Ultimately, that is for the governments themselves to determine.

In the remainder of this section of the report, Access Economics presents some comments that might be helpful in determining such a negotiating range.

6.4.1 A POSSIBLE UPPER BOUND TO ADDITIONAL FINANCIAL ASSISTANCE

The revenue 'hole' in the states incentive package to abolish all of the IGA list of indirect taxes has been officially estimated at around \$4 billion in 2002-03. That is estimated to grow to about \$4.7 billion in 2005-06.

Access Economics does not suggest that this estimate provides an upper bound to the quantum of additional financial assistance that the states could credibly demand in exchange for full implementation of the IGA state tax reform program.

There are several reasons for this. For example, the GST 'windfall', relative to the pre-GST financial arrangements, exceeds that expected when the GST was introduced:

- As noted in section 4.1 above, the total cumulative gain to the states from the GST over the period to 2007-08 looks set to be more than *triple* the estimate at the inaugural meeting of the Ministerial Council for Commonwealth-State Financial Relations (MINCO) in March 2000. Back in 2000, over the entire period from 2002-03 to 2007-08, the states were originally forecast to be receiving a \$3.7 billion windfall compared with the previous system.
- On this basis, some would argue that there is no case for a compromise amount of additional financial assistance that includes this 'unexpected' windfall. The un-forecast 'excess windfall' has, in significant part, eliminated the GST tax base hole.

Access Economics also notes that:

- Without additional Commonwealth Government financial assistance, the states as a group could go about half-way to abolishing the remaining IGA taxes from 1 July 2005 (see section 5.2 above).



- On that basis, with additional financial assistance from the Commonwealth totalling about \$1.6 billion in 2005-06, the states would be able to complete the IGA state tax reform task with no further effect on their net operating surplus position.
- This assistance represents only about one-third of the 'hole' in the GST tax base resulting from the deal between the Commonwealth and the Democrats.

6.4.2 A POSSIBLE LOWER BOUND TO ADDITIONAL FINANCIAL ASSISTANCE

What would be a sensible lower bound on the quantum of additional financial assistance to the states if the answer 'zero' is unacceptable?

Access Economics recognises that this is a question to which there will be many answers.

One possible response is to suggest that all, or at least most, of the income tax 'revenue dividend' from further state tax reform accruing to the Commonwealth Government should provide a 'floor' to the possible range of additional financial support.

There is a precedent – if only in reverse – for this argument under the IGA itself.

Under the Guaranteed Minimum Amount (GMA) provisions of the IGA (Appendix C, Clause C2) the Commonwealth *reduces* the level of the GMA to the states by the estimated state revenue gains flowing from the 'growth dividend' associated with the gains that in turn flow from the *Commonwealth's* reforms to its own tax system. By the same logic, the states should be entitled to some *additional* Commonwealth financial assistance should the Commonwealth Budget benefit from revenue dividends caused by state tax reforms that improve the efficiency of the economy as a whole.

To that end, the rest of this section of the report presents some modelling results – necessarily very rough – using Access Economics' *AE-CGE* model to quantify the income tax revenue dividend that might be expected from completion of the IGA state tax reform program.

Naturally, the estimates will need to be refined using more precise state estimates of the revenue forgone from abolition of the remaining IGA stamp duties, but the following presents broad orders of magnitude.

6.4.3 MODELLING THE COMMONWEALTH'S INCOME TAX 'WINDFALL'

The objective is to estimate the tax revenue effects for the Commonwealth and the states if the states remove the remaining state taxes mentioned in the IGA.

These are: stamp duties on conveyancing in relation to business properties, and stamp duties on financial arrangements (leases; mortgages, debentures, bonds and other loan securities; credit arrangements, instalment purchase arrangements and rental agreements; cheques, bills of exchange; promissory notes and unquoted marketable securities).

We have used State and Local Government taxation revenue data for 2002-03 (ABS 5506.0, *Taxation Revenue*).

Under the heading 'Taxes on financial and capital transactions' we assume 20% of 'Stamp duties on conveyances' is related to non-residential conveyancing, and 100% of 'Other stamp duties' (items 335 and 336) covers stamp duties on financial arrangements.



The modelling 'shock' was a reduction in state taxes in 2005-06 by \$3.2 billion.

The *AE-CGE* simulations assumed:

- a flexible exchange rate (and fixed balance of trade); and
- flexible wages, and with a labour supply elasticity of +0.2, so that a real wage increase of 1% increases the supply of labour by 0.2%¹⁷;
- apart from the state taxes being removed, all tax rates were held fixed. The Commonwealth budget and the aggregate State and Local Government budget were allowed to deviate from the pre-shock levels as a result of the state tax reforms.

The pertinent results for the purposes of this report are as follows (these are rounded, long run results, expressed in 2005-06 magnitudes).

GROSS REVENUE DIVIDENDS FROM STATE TAX REFORM	
Commonwealth Income Tax Dividend	\$700 million
Payroll Tax Dividend	\$70 million
GST Dividend	\$2 million

Some comments on these results follow:

- The income tax dividend to the Commonwealth reflects:
 - Reductions in deductible expenses (state tax payments) as a result of abolishing the remaining IGA taxes in calculating taxable income.
 - Increased economic efficiency, boosting real GDP by about \$3.3 billion.
- The small increase in payroll tax reflects both increased employment and increased wages as a result of abolition of the remaining IGA taxes.
- GST revenue is barely affected, and so the dividend to the states from this source is negligible. This is the net effect of:
 - Increased real consumption (up about \$1.9 billion).
 - Reduced unit cost bases and therefore prices as a result of abolition of the remaining IGA state taxes. Although these taxes sit on top of the GST for any individual business or household, indirectly the cost reductions associated with abolition of these state taxes lowers the value of the GST tax base.

¹⁷ This labour supply elasticity assumption was used in earlier reports prepared for the Harvey Review of Business Taxation in Victoria. We modelled alternative labour supply elasticities, up to 0.8, as well. These produced larger real economic benefits, but also larger nominal wage and price reductions. As a result, effects on dollar values for Commonwealth and state revenues, which reflect both influences, were minor.



In short, completion of the IGA state tax reform program would directly cost the state about \$3.2 billion (net of the small payroll tax gain), and through income tax alone, provide a revenue dividend to the Commonwealth Government of around \$700 million. (The Commonwealth *may* also benefit via lower expenses on unemployment benefits due to higher employment under the assumptions set out above.)

This 'revenue dividend' from removal of existing inefficient state taxes is the result of:

- The removal of these state taxes from the 'deductible expenses' or 'cost base' calculations for purposes of quantifying assessable income for income tax (including capital gains tax) purposes (by far the most important component).
- As these changes work through the economy, the removal of these taxes reduces the 'deadweight' efficiency losses associated with taxation, allowing greater production from a given supply of scarce resources (a relatively small component).

It should be noted that the *AE-CGE* model generates model solutions that are properly interpreted as long-run, steady state, economy-wide, results. That said:

- The cost of abolition of the remaining IGA state taxes is expressed as annual flows.
- These reflect the volume and value of taxable transactions *in one year* attracting the remaining IGA stamp duties in any year (given applicable tax rates).
- In the year following their abolition, the deductible expenses/cost base deductions for income tax purposes will fall by about \$3.1-\$3.2 billion, assuming only that the value of the transactions that would have been taxable under these IGA taxes continues at the same annual rate.
- On that basis, and especially on an accruals basis, in the year following the abolition of these IGA taxes, accrued Commonwealth income tax should increase by almost the full \$700 million.
- Moreover, the cost of abolition of the remaining IGA taxes is forecast to increase over the period from 2005-06 to 2009-10 (see table 5.1.3 above).
- As a result, the annual \$700 million will increase as well.

In all the circumstances, Access Economics concludes that almost all of the income tax benefit to the Commonwealth would accrue within twelve to eighteen months of the abolition of the remaining IGA taxes. Note also that the state taxes *must* be abolished in full *before* this income tax benefit can accrue.

It should also be noted that the abolition of state taxes since 1 July 2000 as part of the *New Tax System* – and, in the case of some states such as NSW, Victoria and WA, state tax reductions already undertaken unilaterally – have already delivered income tax 'dividends' to the Commonwealth.

These conclusions are broadly consistent with the conclusions reached by the Commonwealth Government in relation to cost savings from the indirect tax reforms as part of the *New Tax System*:



*The experience of other countries is that most of the price impacts of major indirect tax reform flow through within the first twelve months.*¹⁸

Access Economics therefore suggests that a lower bound to possible additional assistance to the states might therefore be of the order of \$700 million in 2005-06 magnitudes, increasing by (say) the growth in GST revenue transfers to the states each year thereafter.

6.4.4 A NEGOTIATING RANGE FOR ADDITIONAL FINANCIAL ASSISTANCE?

If others agreed with the thrust of the discussion in this section of the report, it would suggest that the range within which negotiations on additional Commonwealth financial support as a *quid pro quo* for completion of the IGA reforms, expressed in 2005-06 magnitudes, might be from about \$700 million per annum up to about \$1.6 billion per annum.

¹⁸ *Tax Reform: Not A New Tax, A New Tax System* The Howard Government's Plan for a New Tax System, circulated by the Honourable Peter Costello, MP, Treasurer of the Commonwealth of Australia, August 1988, page 161.



7. REFORMING OTHER STATE TAXES

Completion of the IGA state tax reform program is highly desirable from an efficiency perspective.

But even when that program is implemented, a number of very inefficient state taxes remain. These include:

- Stamp duty on general insurance.
- Stamp duty on motor vehicles.
- Fire services levies (FSL) for those states (especially NSW and Victoria) where these remain.
- Land taxes.
- Third party insurance.

All of these taxes, taken in isolation, are more inefficient than BAD. Stamp duty on general insurance is almost as inefficient as stamp duty on non-residential conveyancing.

Insurance taxes are worth special mention for several reasons¹⁹:

- In the case of general insurance, and where fire services levies also apply (especially in NSW and Victoria), basic premiums are subject to ‘tax-on-tax-on-tax’ effects:
 - FSL applies to basic premiums;
 - GST applies to basic premiums plus FSL;
 - Stamp duty applies to basic premiums, plus FSL, plus GST.
- FSL and stamp duty on general insurance are inefficient enough in isolation. In combination – and even if the tax base for insurance was properly specified – the taxation of general insurance products subject to all three taxes is the most inefficient taxation treatment existing at the state level.
- On efficiency grounds alone – and even if the tax base for insurance was properly specified – both FSL and stamp duty on general insurance should be priority candidates for abolition. In fact, NSW has halved its stamp duty on general insurance, and now only three states (NSW, Victoria, and Tasmania) retain fire services levies. (This last point might complicate a reform program where Commonwealth revenue gains via income tax would flow in exchange for revenue losses from these three states. Other states have moved to alternative financing mechanisms to cover the cost of fire and emergency services. If NSW, Victoria and Tasmania did likewise, the net revenue gains from such reforms by these three states would be much smaller, and

¹⁹ For a more detailed account of the problems with taxation of general insurance see the Submission on behalf of the Insurance Council of Australia to the Harvey Review of State Taxes in Victoria.



demands by them for 'compensation' from the Commonwealth could be echoed by the other states who abolished their own FSLs earlier without seeking compensation.)

But there's more.

The tax base for insurance is mis-specified, not only for FSL and stamp duty purposes, but also in relation to the GST.

This report is not the platform for a detailed account of why this is so²⁰, but some key comments summarise the issue:

- Insurance and gambling have common features:
 - In both cases, industry value added, and consumption as recorded in the national accounts, are defined in terms of the gross margin, which is premium income (or wagers) received, *less* claims (or winning bets) paid.
 - All tax 'experts' agree that the appropriate tax base for these activities is the gross margin, not the total premium income or total wagers received.
- In practice, at the state level:
 - Both the FSL and stamp duties on insurance are turnover taxes, defined with respect to the total premium, not the insurers' margin.
 - Ironically, most state taxes on gambling are imposed on the industry's margin, consistent with 'good' tax design.
 - So the prudent act of self-provisioning for future contingencies (insurance), at the state level, is treated more harshly under the tax system than gambling (even though the latter is widely regarded as a 'sin' or 'vice' activity).

But it gets worse:

- At the Commonwealth level, the GST is also often a tax on the full insurance premium:
 - At the level of the insurer, in general, the GST arrangements end up constituting a tax on the insurer's margin.
 - But in relation to claims settled via provision of products that are taxable supplies for GST purposes, GST is also payable when such products are supplied in settlement of an insurance claim.
 - As a result, in such cases, directly and indirectly, GST applies both to the insurer's margin and to claims – in short, to the full insurance premium.

There is an overwhelming case for a thorough review, at both Commonwealth and state levels, of the basic nature of insurance as a taxable product, and both the income tax and indirect tax treatment of insurance that is currently applicable.

²⁰ Submission on behalf of the Insurance Council of Australia to the Harvey Review of State Taxes in Victoria. Other reports are available on request from Access Economics.



Both for insurance and for the other state taxes listed in this section of the report, there is a strong efficiency case for further state tax reform. However, beyond flagging that basic point, this report concentrates on completion of the current IGA state tax reform program.



8. ACCESS ECONOMICS' CONCLUSIONS

Although some state taxes have been abolished, the states retain some very inefficient turnover-type taxes akin to the old Spanish 'alcabala'.

Amongst the most inefficient of these are:

- stamp duties on non-residential conveyancing,
- stamp duties on various financial instruments,
- stamp duties on insurance
- and (for NSW, Victoria and Tasmania) fire service levies.

The first two groups of taxes are listed for review by 2005 in the IGA between the Commonwealth and the states that formed part of the *New Tax System*. The last two are not mentioned in the IGA, but most states and territories have already abolished their fire services levies and moved to more efficient ways of financing fire and emergency services.

Access Economics concludes that all of these taxes (and some others) should be candidates for review (and preferably abolition) in future.

In the immediate future, Access Economics concludes that the focus should be on the first two groups of taxes, because these are specifically mentioned in the IGA. (Access Economics assumes that Bank Account Debits tax will be abolished, after review, from 1 July 2005 in all the states except NSW, which has already abolished this inefficient tax.)

Given Access Economics' forecasts of state budget prospects (section 4 of the report) and its estimates of the cost of abolition of the remaining IGA state taxes (section 5 of the report), and assuming no further financial assistance from the Commonwealth to the states, we conclude that a feasible program for further state tax reform is as follows:

POSSIBLE STATE TAX REFORM OPTIONS (ASSUMING NO COMMONWEALTH ASSISTANCE)

- *Either* stamp duty on non-residential conveyancing (the most inefficient of all the remaining state taxes, based on our *AE-CGE* model results) could be abolished from 1 July 2005;
- *or* all of the 'other' stamp duties (which are at least as inefficient as BAD as a group, and, for individual taxes on financial instruments, they are probably much more inefficient, as well as being in the nature of 'nuisance' taxes) could be abolished from 1 July 2005;
- *or*, roughly speaking (and more messy from a tax administration viewpoint), the current rates for both of these taxes could be halved from 1 July 2005.



The states are currently receiving a GST revenue 'windfall' relative to what they would have received under the pre-GST financial arrangements, and this 'windfall' has been greater than originally expected. However, given the significant economic benefits of removing these inefficient taxes, Access Economics concludes that a case can be made for additional Commonwealth Government financial assistance to the states as an incentive to complete the full IGA reforms.

Depending upon the basis for calculation, in 2005-06 magnitudes, this additional assistance might range from around \$700 million per annum (equivalent to a Commonwealth income tax 'revenue dividend' from further state tax reform, most of which would accrue within a year after the states abolished the remaining IGA taxes), up to about \$1.6 billion per annum (partly filling the GST revenue hole left mainly by the excision of GST on some food, and allowing the states to complete the IGA reform program with no further effect on their net operating balance position).

Were additional financial assistance from the Commonwealth to be forthcoming, and that assistance was about \$1.6 billion per annum in 2005-06 magnitudes, then the states should be able comfortably to complete the IGA state tax reform program by abolishing the remaining IGA taxes from 1 July 2005.

There is one other opportunity that may be about to present itself.

Recently there have been suggestions from the Commonwealth and some states about long-overdue rationalisation of responsibilities in the areas of health and education. Difficult though this may be politically, the case for such reforms, from the perspective of efficient and effective service delivery to the community, is overwhelming and has long been advocated.

Access Economics does not suggest that the IGA reforms be delayed by consideration of these wider issues. As the states can afford to remove half of the remaining IGA taxes immediately without assistance consideration of these wider issues should not be used as a barrier.

However, Access Economics does suggest that, if rationalisation of roles and responsibilities between the Commonwealth and the states should prove feasible, the opportunity for further reform of the remaining inefficient state taxes (including non IGA taxes) should not be lost.

Such reforms would provide efficiency dividends of considerable size, as well as a possible need for a net re-balancing of Commonwealth/state financial arrangements.

A large proportion of the efficiency dividend will and should be allocated to improving health and education services. But, as part of an overall package (with further income tax revenue dividends from further state tax reform) this rationalisation might also provide the financing wherewithal for further state tax reform beyond the IGA list of state taxes.



ATTACHMENT A – THE AE-CGE MODEL

Broad Description of the AE-CGE Model

The *AE-CGE* model is a small, long-run, non-linear, computable general equilibrium (CGE) model of the Australian economy. *AE-CGE* was initially developed by Access Economics for the Economic Planning and Advisory Council, Bureau of Industry Economics, Industry Commission and Business Council of Australia in 1992.

The standard version of *AE-CGE* models employment, profit, production, consumption, investment, imports and exports for 25 separate industries. Interactions between industries are modelled using input-output data, a measure of the various inputs required by each industry to produce its output. Changes in each industry are then aggregated to provide estimates of macroeconomic variables. The strategy underlying the design of *AE-CGE* was to construct a CGE model of manageable size where interactions within and between industries could be modelled in reasonable detail. At the same time, the number of industries in *AE-CGE* can be increased readily to provide necessary detail in particular applications.

AE-CGE, unlike many other CGE models (such as ORANI), solves in levels rather than percentage deviations. This non-linear approach maintains the complex detail of the equations describing supply and demand. This full impact, particularly for consumption and production technologies, can be blurred by the linearisation commonly employed in solving larger models.

Within the business sector of *AE-CGE*, profit maximising firms are assumed to demand labour, capital and the output of other firms, to produce output. This output is disposed of through domestic or export markets (which are imperfect substitutes). Production supplied to domestic markets is combined with imports (which are imperfect substitutes for domestic supply) to satisfy total demand. Australia is assumed to be a price taker in import markets. Total demand consists of private consumption, intermediate input demand, investment and government consumption.

The model distinguishes Commonwealth and overall state/local government sectors. For each, the government sector imposes a series of direct and indirect taxes. In the standard version of the model, the rates of indirect taxes are determined from input-output data while direct tax rates are assumed to adjust to maintain budget balance. Governments maintain real government current expenditure in each industry (again determined from input-output data) irrespective of price changes.

For the current analysis, rates of both direct and indirect taxes are held at initial values, except for the particular State tax that is being examined.

The long-run snap-shot nature of the *AE-CGE* model is reflected in the assumptions about market behaviour. In the standard long-run closure of the model, nominal gross national expenditure (GNE) is taken as “numeraire” relative to which other nominal variables adjust. The exchange rate is assumed to adjust to keep the overall trade balance unchanged. Capital and labour are assumed to be fully mobile between sectors. The total supply of labour is assumed to be fixed in the standard version of the model, with the wage adjusting to equate supply and demand. The alternative approach – reported here – allows some labour supply responsiveness to real wage changes. The capital stock is assumed to be



flexible, with expansion/contraction in each industry sufficient to maintain a fixed, economy-wide, rate of return to capital.

The current implementation of *AE-CGE* models the Australian economy as reflected in ABS Supply Use tables for 2000-01 scaled up to 2003-04 and ABS input-output data for 1996-97 but scaled up inter alia to 2003-04 to reflect the implementation of the *New Tax System* as at 1 July 2001.

Consumption expenditure is wages and profits less the sum of taxes (which equal government spending) and the resources – saving – needed for gross investment. This expenditure is allocated between the outputs of the various industries using a Klein-Rubin (or Stone-Geary) utility system. This system allows consumption of each industry's output to reflect sensitivity to changes in the industry's output price, as described by their own-price elasticities. For each commodity there is a fixed or 'autonomous' level of consumption and a 'discretionary' level. The discretionary levels of consumption adjust, subject to the constraints imposed by the model, so as to maximise utility.

A more detailed description of the model is available in *Access Economics Computable General Equilibrium (AE-CGE) Model Documentation*.

Modelling Changes in State Taxes

The *AE-CGE* model allows for taxes on labour, output, final consumption, investment, exports, imports and inputs to intermediate usage. The input-output data include taxes by input-output industry for 11 CTLS categories (commodity taxes less subsidies) and 11 ITLS categories (other indirect taxes less subsidies), as well as total commodity taxes on each of the input-output table cells. From ABS 5506.0, *Taxation Revenue*, we obtain control totals for the different types of State taxes, some of which are at a finer level than the input-output data.

For this report, the 106 industries in the ABS input-output tables have been aggregated to 26 industries, keeping separate those industries which are most strongly associated with individual taxes of interest.

The taxes addressed in this analysis may be summarised as follows.

Stamp duties on a range of financial and capital transactions

- We have assumed that this corresponds to the other stamp duties part of taxes on financial and capital transactions within ABS *Taxation Revenue*. Reductions in financial stamp duties are modelled as reductions in industry costs of production.

Stamp duties on business (non-residential) conveyances

- We have assumed that business accounts for 20% of the total stamp duty on conveyances. These stamp duties apply to both sales of new buildings (and land) and to transfers of ownership for existing buildings (and land). We assume that stamp duties on conveyancing are split between new construction (20%) and transfers of existing buildings (80%). Reduction of stamp duties on sales of new buildings are modelled as reductions in the price of investment in industries. Reductions of stamp duties on transfers of existing buildings are modelled as reductions in the costs of production of industries.



ATTACHMENT B – MEASUREMENT OF ECONOMIC WELFARE

Standard Measures of Economic Welfare: A Short-Cut Summary

Measures of economic welfare are commonly used concepts in economic analysis. Their precise definition is somewhat complicated for non-economists. As a practical, observable approximation, total household spending on consumption of goods and services is a reasonable approximation to economy-wide economic welfare.

For modelling purposes in this Report, the change in Australian consumer spending is a good summary measure of the change in welfare caused by tax reform.

Standard Measures of Economic Welfare: A Little More Detail

The AE-CGE model generates estimates of a wide range of aggregate and sectoral variables – covering production, incomes, expenditure, trade and prices. An important issue is how to measure the improvement in economic welfare that results from a change, such as a reduction in a state indirect tax.

Standard microeconomic texts²¹ identify the welfare impact of an indirect tax in terms of a “dead-weight loss” – that is the sum of the reduction in consumers’ and producers’ surplus on the introduction of the tax. However, this is a partial measure, focussing only on the particular market in which the tax is imposed. It does not take account of changes induced elsewhere in the economy. Nor does it allow for the possibility that the marginal utility of income may vary as a result of the imposition of the tax.

A general equilibrium model, such as AE-CGE, has markets for all the goods and services in the economy. It also contains an explicit household utility function, allowing us to estimate the utility associated with particular consumption bundles. We are therefore in a position to provide more sophisticated estimates of the overall impact of a tax change on economic welfare – based on the “compensation principle”²².

In practice in the AE-CGE model, welfare measures based on the compensation principle are usually close, numerically, to the change in aggregate real consumption caused by a shock to the model. It is this latter measure that is emphasised in this Report.

²¹ See for example H.R. Varian *Microeconomic analysis*, New York, Norton, 1978 or R.S. Pindyck and D.L. Rubinfeld *Microeconomics*, New York, MacMillan, 1989

²² See for example Johansson, P-O, *An introduction to modern welfare economics*, Cambridge University Press, 1991. Two closely related welfare measures based on the compensation principle are the Compensating Variation and the Equivalent Variation. The former is the amount of money that consumers would have to be given (or pay) after the change, to keep them at the same level of utility in the event that the change were subsequently reversed. The latter is the amount of money that consumers would have to be given before the change that would make them as well off as they would be if the change were in fact to proceed.