Economic Development and Infrastructure Committee

Inquiry into State Government Taxation and Debt

September 2010

Inquiry into State Government Taxation and Debt

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Committee Members

This Inquiry was conducted during the term of the 56th Parliament.

The members of the Economic Development and Infrastructure Committee are:

Hon. Christine Campbell, MP (Chair)

Mr David Davis, MLC (Deputy Chair)

Mr Bruce Atkinson, MLC

Mr Peter Crisp, MP

Mr Hong Lim, MP

Mr Brian Tee, MLC

Hon. Marsha Thomson, MP

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For this Inquiry, the Committee was supported by a secretariat comprising:

Executive Officer:	Dr Vaughn Koops
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The Economic Development and Infrastructure Committee

The Victorian Economic Development and Infrastructure Committee is constituted under the *Parliamentary Committees Act 2003*, as amended.

The Committee comprises members of Parliament drawn from both houses and all parties.

Its functions under the Act are to inquire into, consider and report to the Parliament on any proposal, matter or thing connected with economic development, industrial affairs or infrastructure, if the Committee is required or permitted to do so by or under the Act.

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Terms of Reference

The Legislative Council under section 33 of the *Parliamentary Committees Act 2003* refers Terms of Reference requiring:

That the Economic Development and Infrastructure Committee be required to inquire into, consider and report on the impact and effectiveness of increased State Government taxation (including land tax, payroll tax, stamp duties, State Government taxes and charges and development levies) and increased State Government debt on Victorian —

(a) development;

(b) competitiveness;

(c) sustainability;

(d) employment;

(e) job creation; and

(f) small businesses, including their national and international competitiveness under the State Government's current taxation arrangements;

and to table an interim report by 28 February 2010 and a final report by 30 September 2010.

Chair's Foreword

The structure of the tax system, and its role in the commonwealth and states as members of the evolving Federation, is a significant area of interest within Australia. Studies indicate that the demographic composition of Australia is going to change substantially over the coming decades, with increased proportions of older citizens, and consequently, a reduced ratio of work participation across the economy. In this context, it is important that the Australian tax system as a whole – including the Commonwealth, States and Territories – works efficiently and sustainably over the long term. This probably will mean that, over time, a number of aspects of the Australian tax system will have to be altered in order obtain the best value for government, the community, and most importantly, the taxpayer.

When this Inquiry commenced, the Committee anticipated that a large proportion of its deliberations would focus on the outcomes of the 2010 Australia's Future Tax System Review, and the subsequent response of the Commonwealth Government to the Review. At the time of tabling this report, a comprehensive response to the Review had not been released by the Government. The Committee is cognisant that the major debates about the composition of Australia's tax system are yet to take place, and consequently, the Committee has not attempted to substantially anticipate the outcomes of those discussions in this Report.

The Report contains eight recommendations for the Victorian Government regarding State taxation, with most recommending the Government examine how sustainability and efficiency in the tax system can be improved over time.

The Committee received 44 written submissions during the course of this Inquiry, and convened public hearings with 12 witnesses representing 8 organisations. On behalf of the Committee I thank these people and organisations for their important contribution.

I thank my fellow Committee Members for their contribution to the Inquiry – Mr David Davis (Deputy Chair); Mr Bruce Atkinson; Mr Peter Crisp; Mr Hong Lim, Mr Brian Tee, and the Hon. Marsha Thomson. I also thank the Committee secretariat, ably led by Dr Vaughn Koops, for their hard work and support throughout this inquiry.

Hon. Christine Campbell MP
Chair

Table of Recommendations

Recommendation 1: That the Victorian Government consider, as part of its review of fire services funding arrangements, introducing a levy on motor vehicles sufficient to fund the proportion of fire services expenditure related to motor vehicle-related incident responses. 40

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Recommendation 8: That the Victorian Government request that the Council of Australian Governments consider requiring the Commonwealth Grants Commission to revise the inclusion threshold for taxes that were to be abolished under the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, to ensure taxes that were to be abolished under the Agreement contribute to the assessment of per-capita relativities. 66

Abbreviations

ACT	Australian Capital Territory
CFA	Country Fire Authority
CGC	Commonwealth Grants Commission
COAG	Council of Australian Governments
FSL	Fire Services Levy
GAIC	Growth Areas Infrastructure Contribution
GDP	Gross Domestic Product
GSP	Gross State Product
GST	Good and Services Tax
HFE	Horizontal Fiscal Equalisation
FFR	Intergovernmental Agreement on Federal Financial Relations
RCSFR	Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations
ICA	Insurance Council of Australia
IMC	Integrated Management Cycle
IPART	Independent Pricing and Regulatory Tribunal (NSW)
NHHNA	National Health and Hospitals Network Agreement
NSW	New South Wales
OECD	Organisation for Economic Cooperation and Development
OSISDC	Outer Suburban/Interface Services and Development Committee
PAEC	Public Accounts and Estimates Committee
PAYG	Pay As You Go
RACV	Royal Automobile Club of Victoria
REIV	Real Estate Institute of Victoria
SPP	Specific Purpose Payments
VFF	Victorian Farmers' Federation
VFI	Vertical Fiscal Imbalance
Vic	Victoria

Chapter

1

Chapter One: Introduction

On 29 July 2009, the Economic Development and Infrastructure Committee received a reference under the *Parliamentary Committees Act 2003* to inquire into, consider and report on the impact and effectiveness of increased state government taxation (including land tax, payroll tax, stamp duties, state government taxes and charges and development levies) and increased state government debt on Victorian —

(a) development;

(b) competitiveness;

(c) sustainability;

(d) employment;

(e) job creation; and

(f) small businesses, including their national and international competitiveness under the State Government's current taxation arrangements;

and to table an interim report by 28 February 2010 and a final report by 30 September 2010.

1.1 Introduction

The Committee received this reference at a time when there was considerable work being done nationally examining the role of taxation in Australia through the Australia's Future Tax System Review (the Henry Review). The Committee initially anticipated framing the current report in response to elements of the Henry Review considering the role of the Australian States and Territories, however, the report was not published until 2 May 2010, and is principally focused on commonwealth taxes rather than state taxes, and so provided limited material specifically directed at the states for this Committee to comment on.[1] The Committee also notes recent announcements by the Hon. Wayne Swan MP that a tax summit considering matters raised in the Henry Review will be convened in 2011. The Commonwealth Treasury, with permission of then Treasurer the Hon. Wayne Swan MP, was to appear in a public hearing to discuss matters

[1] Australia's Future Tax System Review Panel, *Australia's future tax system*, Commonwealth Treasury, Canberra, 2010.

surrounding the Henry Review, but the hearing was cancelled after the 42nd Commonwealth Parliament was prorogued on 19 July 2010.

The Committee notes that previous reviews of state taxation in Victoria have conducted, such as the 2001 *Review of State Business Taxes* by the State Business Tax Review Committee (the Harvey Review),[2] and that recommendations have already contributed, in whole or in part, to subsequent reductions in Victorian taxes, principally through changes to tax thresholds. Reviews of certain taxes are also undertaken periodically by the Victorian Department of Treasury and Finance.[3]

One of the challenges for all state and territory governments in Australia is that, while expenditure responsibilities are substantial, the range of taxes and duties available to state and territory governments to raise revenue is limited. This imbalance has occurred for a range of reasons, including:

- provisions under the Constitution Act 1901 *(Cth)* regarding the rights of the commonwealth and of the states, and in some cases, subsequent High Court interpretation of the Constitution;

- agreements for the abolition of certain state taxes in exchange for a share of commonwealth revenue (such as through the Good and Services Tax);

- competition between, and harmonisation of, states in the structure of taxes; and

- probable public distaste were the states to introduce, or reintroduce, taxes that are not currently levied (such as state income tax or death duties, for example).

The Committee has, nevertheless, conducted a broad overview of state taxation and debt in this report, and makes recommendations concerning some components of state taxes. The Committee considers some key principles that should guide the development of taxation, broadly concerning some of the following key questions governments should consider when reviewing taxation systems within the state, namely:

- does the government have room for responsible increases in fiscal spending to counter cyclical and discretional economic downturns? (sustainability);

- can the government provide forward estimates of revenue with a reasonable degree of certainty and accuracy? (certainty);

- does the taxation regime encourage growth with minimal distortion of the working of affected markets? (efficiency);

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[2] State Business Tax Review Committee, *Review of state business taxes*, Department of Treasury and Finance, Melbourne, 2001.
[3] For example, the 2006 *Review of the administration of the congestion levy*, the 2010 *Review of the effectiveness of the congestion levy*, and green and white papers on the Fire Services Levy. See www.dtf.vic.gov.au.

- is the current tax system competitive with other states and nations as to be adequately conducive to investment? (competitiveness); and

- does the taxation system assist in the distribution of wealth and services and other government policy objectives? (equity)

Key principles for taxation are considered by the Committee in Chapter Two of this Report. In Chapter Three the Committee provides an overview of current state taxes, and in Chapter Four, the Committee makes some general recommendations about future directions for key state taxes over coming decades. In Chapter Five the Committee considers the effect of the Commonwealth Grants system on state revenue and taxation. Finally, in Chapter Six the Committee considers some aspects of government debt, and its role within government policy and the Victorian economy.

1.2 Inquiry process

The Committee advertised the Terms of Reference and called for written submissions in Victorian and national newspapers in August 2009. The Committee received 44 submissions (see Appendix One).

Three public hearings were convened from August 2009 through to November 2009. Details of hearings are provided in Appendix Two. The Committee took evidence from and met 12 witnesses representing 8 organisations. While conducting overseas investigations principally for its Inquiry into Manufacturing in Victoria, a delegation from the Committee also took the opportunity to meet with key witnesses on taxation and debt matters in Paris, Belgium and Germany.

Many individuals and organisations contributed to this Inquiry by making written submissions and participating at public hearings. The Committee is grateful to these people for generously sharing their expertise and time.

Chapter

2

Chapter Two: Key principles for taxation

The right to levy taxation on residents is one of the core powers of government. It is the state's primary means to raise revenue, as other means to raise finance – such as through state borrowing of funds – are ultimately dependent on the state's capacity to repay borrowings and interest through raising revenue internally. Government revenue, such as that obtained through taxation, is required in order for government to finance its administrative and expenditure objectives, to provide security to citizens and to trade, to fund infrastructure development, and to compensate for market failures, among other things.

The state's capacity to levy taxes on individuals and businesses provides a limit to government expenditure, that can only be exceeded through acquisition of state debt. In practice, the imposition of taxation by the state is a negotiated exercise. The subjects of taxes – individuals and businesses – desire to pay as few taxes as possible, and that the state must ensure its mandate to levy taxes is maintained through reasonable exercise of its powers. In democratic societies, this mandate tends to be maintained by the state justifying the quantum of taxes raised in the context of state expenditure on activities that benefit society generally.

Consequently, the imposition of taxes has been the subject of debate since the emergence of government, and a lot of thought has been dedicated to how taxes can be fair to both the subject and the state. The development of economic theory has also contributed to thinking about taxation, particularly considering the effect of taxation on consumer and business behaviour, overall revenue, and on the activities of entities within the state.

In this Chapter, the Committee briefly considers some of the key concepts employed in contemporary analysis of taxation. A brief overview of taxation in Australia is also provided, focusing on the distribution of revenue and expenditure between the Commonwealth and the States and Territories. In Chapter Three, the role of taxation and expenditure in Victoria is examined in detail.

2.1 The objectives of taxation

While the principal purpose of taxation is to raise revenue for state expenditure, taxation can be used to fulfil other policy objectives of government. These objectives can be generally summarised as: *revenue*; *redistribution*; and *repricing*. *Revenue* is the most obvious of these, and provides government with resources to fund expenditure on services and infrastructure. *Redistribution* refers to the use of taxation to transfer wealth from one group to another. In Australia redistribution is employed

principally in the pensions system, through which taxes from wealthier tax entities (that is, persons, firms, or other tax-payers) are paid to the less wealthy (*regressive redistribution*, by contrast, is the transfer of income, wealth or property from those of less means to the wealthy). Finally, *repricing* refers to the use of taxation or levies to increase the price of a good, service or activity to the consumer or business, for the purpose, generally, or dissuading use or in order to offset increased costs to the state or public welfare as a consequence of that consumption.

2.2 Key principles of taxation

In 1665 French controller of General Finance Jean-Baptiste Colbert observed that “the art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing.” However, one of the first people to give serious consideration to the principles by which taxation should be organised was Adam Smith, who described four ‘maxims’ that provided a framework for determining the relative value of different taxes.[4] These maxims have been subsequently refined by economists into the following four “canons of taxation”:

- equity;
- efficiency;
- simplicity;
- certainty and sustainability;

The Australia's Future Tax System Review (the Henry Review), delivered to the Australian Government by a committee chaired by the secretary of the Australian Treasury, added another principle to this list for consideration during taxation reform:

- policy consistency.[5]

In the following discussion, each of these principles is considered.

2.2.1 Equity

Generally, ‘equity’ refers to a condition of fairness and impartiality. In the context of taxation analysis a number of considerations, some contrary, are encompassed by the concept of equity. Generally, there are two agreed measures by which equity is assessed in the imposition of taxes – ability to pay, and the beneficiary principle.

The beneficiary principle is that people (or entities) should pay in proportion to the amount of benefit they receive in return. In this regard, the

[4] The maxims were, essentially, 1) that citizens contribute to government in proportion to their ability; 2) that taxes be certain rather than arbitrary; 3) that taxes be levied at a time and in such a manner that is convenient to the taxpayer; and 4) that the cost of tax collection is minimised. Adam Smith, *The wealth of nations book IV to V.*, Penguin Books, Suffolk, 1999, pp. 415-417.
[5] Australia's Future Tax System Review Panel, *Australia's future tax system: Part one overview*, Commonwealth Treasury, Canberra, 2010, p. 17.

beneficiary principle suggests that the rate of taxation should be applied without consideration of the payer's income or resources. The beneficiary principle tends to apply across categories of taxes, where, for example, different types of tax entities, or different taxable activities or services, attract different rates of tax. In practice, however, considerations other than equity also apply to various taxes, such as willingness (or resistance) of the taxpayer to pay.

By contrast, the principle of ability to pay suggests that people (or entities) should pay tax in proportion to their income or resources. The ability to pay principle is dominant within the Australian income tax system, and is achieved through the application of progressive taxes (that is, taxes where the rate increases with income, for example). The ability to pay principle is not uniformly dominant across the Australian tax system, however, such as in cases where proportional taxes (that is, taxes applied at a constant rate to increasing income or resources) are applied to certain entities or activities.

Within considerations of ability to pay, are what are referred to as principles of *horizontal equity* and *vertical equity*. Horizontal equity suggests that individuals or businesses in similar financial and/or social circumstances should be treated the same under the taxation system. Vertical equity suggests that people or entities in different financial positions should be taxed differently. In practice, the notion of vertical equity is complicated because judgements of what comprise "different" financial positions are generally subjective, and therefore at least partially arbitrary. The key consideration in this regard is that an equitable tax system should facilitate the 'equal treatment of equals'.

In addition to these common equity principles are a range of complex considerations surrounding equity in the application of taxes. In its overview of equity assessment in taxation, for example, the Australian Treasury suggested some or all of the following could be taken into account:

- *inter-temporal equity*, which looks at how the tax-transfer system impacts on longer term decisions of individuals, such as work, saving, family structure and education. Equity therefore requires some consideration of dynamic or future lifetime resources;
- *intergenerational equity*, which looks at how the decisions of today's individuals affect future generations. In general, this includes the objective of ensuring that the wellbeing of future generations is at least no lower than the current generation;
- *spatial equity*, which focuses on the degree to which the tax-transfer system should deliver individuals in different geographic areas similar consumption opportunities, at least for certain types of goods and services;
- the *opportunity and freedom of individuals* to participate in society and to achieve the things they value. Considered here is the role of the tax-transfer system in providing individuals with capabilities and opportunities rather than specific outcomes; and
- *'rights based' frameworks*, which emphasise that the tax-transfer system should not violate fundamental rights and the procedural

> fairness necessary to sustain a liberal democracy. For example, the tax-transfer system needs to treat issues of privacy carefully and certain forms of inequality — such as direct discrimination on the basis of race, gender or sexual preference — should be ruled out altogether.[6]

Consideration of *transitional equity* can also occur when changes to taxation are introduced, and largely concern the costs incurred by taxpayers as a result of changed tax rates or criteria:

> Changes in tax laws bring into question the notion of transitional equity. For example, if investors are already committed to a project, will a change in the tax system leave them worse off than they were under the old scheme?[7]

The notion of equity is clearly complex, and comprised of many elements. However, while this complexity means that it is difficult to apply generally to analysis of entire taxation systems, it does provide a useful tool with which to think about the appropriateness, and distribution, of specific taxes.

2.2.2 Efficiency

At its least complex, tax efficiency is a measure of the proportion of revenue obtained through a tax that is lost through administration or collection costs. Analysis of tax efficiency also examines the extent to which taxation distorts consumption and investment decisions, where the general objective of tax efficiency is to obtain taxes that create the least distortion on overall consumption. The concept of efficiency is based on the supposition that by applying taxes to goods, services or production, demand for and supply of those things is potentially altered, so that consumers (or producers) behave differently than they would have were no taxes applied. The difference between how people would have behaved without the tax, and how they behaved with it, provides an indication of the efficiency or inefficiency of the tax. Generally, this difference is conceived of as a cost to the economy, although ideally the services and actions that government subsequently provides using tax revenue will offset these costs.

Taxation is simply the application of a fee to a market transaction, where market transaction can be widely defined to include everything from the purchase of goods and services to the taxation of income earned or wages paid. The application of a tax may potentially affect the quantity of goods and services people are willing to provide for sale (supply) and/or the quantity of goods and services people are willing to purchase (demand). Changes to supply and demand for the good or service from the ‘natural’ market state result in reduced efficiency in the market, represented as ‘deadweight loss’ in Figure 1.

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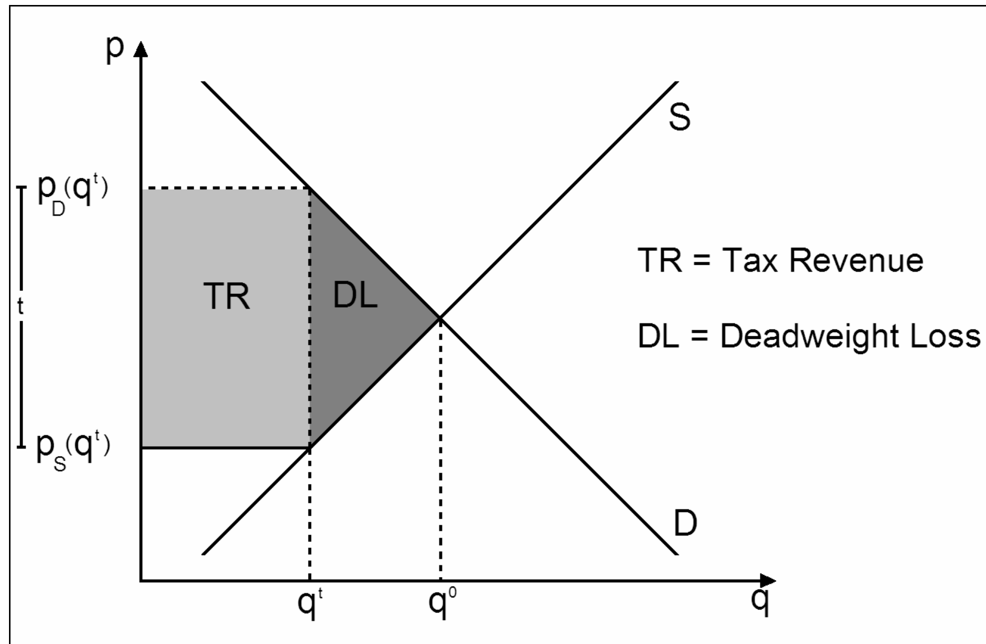
[6] Australian Treasury, *Architecture of Australia's tax and transfer system*, Australian Treasury, Canberra, 2008, p. 177.

[7] Access Economics, *Analysis of State Tax Reform*, Financial Industry Council of Australia, Sydney, 2008.

Figure 1: The effect of taxation on market equilibrium.



Deadweight loss is also known as excess burden, and is highly dependent on the elasticity of the market in which the taxation is levied. If the elasticity of supply is zero, the consumer will pay the entirety of the cost. That is, the cost of the good or service will be equal to exactly the price plus the taxation levied on its purchase.

2.2.2.1 Tax incidence

The incidence of a tax describes who the burden of the tax falls on, or in simpler terms, which party pays the cost of the tax. Understanding the market for which a tax is considered being levied on is key to ensuring that the tax efficiently targets its policy objectives.

There are two types of tax incidence: *legal incidence* and *economic incidence*. Legal incidence refers to the party that is legally responsible for paying a tax. Economic incidence, by contrast, describes who actually bears the cost of the tax, and is the an important factor to consider when analysing the efficiency and effectiveness of a tax. In the following pages, the Committee refers to *economic incidence* when discussing *tax incidence*.

2.2.2.2 Tax incidence elasticity

The tax incidence largely depends on the elasticity of both demand and supply functions, where elasticity is defined as the change in quantity in response to a change in price. There are three main scenarios in the short-run: equal elasticity for supply and demand; elastic demand and inelastic supply; or inelastic demand and elastic supply.

Equal elasticity for supply and demand is the most common scenario in a majority of market functions, where both the supply and demand sides respond to a change in price. In this scenario, both the producer and the consumer will incur the burden of the tax, with the proportion of tax

incidence on each side depending on the difference in elasticities – the higher the elasticity, the less tax burden will be incurred.

Where demand is elastic and supply is inelastic, consumers will respond to increased price changes caused by taxes by reducing the amount of a good or service they purchase, but suppliers are not able to alter the quantity of goods they provide to the market. Consequently, suppliers must sell their goods and services at reduced prices, and bear the entire incidence of the tax.

Where supply is elastic and demand in inelastic, consumers will not change the amount of a good or service they purchase, regardless of price. The supplier of a good or service, by contrast, is very price sensitive and will adjust supply in response to the tax. As a consequence, in this case it is likely that most or all of the tax incidence will be entirely shifted on to the consumer.

2.2.2.3 The application of efficiency to taxation

Drawing upon the concept of efficiency, some bodies, such as the Organisation for Economic Cooperation and Development (OECD), suggest that governments can improve economic growth and taxation efficiency by focusing on property and consumption taxes, broadening the tax base while reducing tax rates.[8] In practice, however, it is very difficult for governments to assess the elasticity of demand for certain goods and services. Furthermore, some solutions to efficiency problems in the administration of taxation – such as broad-base, flat taxes on relatively immobile assets or income – are antithetical to the objective of equity in the application of taxation.

While the general application of efficiency principles to taxation is problematic, the Committee heard of specific instances where taxation is inefficient – for example, the Fire Services Levy, as applied in Victoria, certainly has a highly distortionary effect on the insurance market. Specific Victorian taxes are discussed in detail in Chapter Three of this report.

2.2.3 Simplicity

Simplicity in taxation essentially refers to the ease with which the taxation system can be understood by tax payers. Ideally, a tax system that is easy to understand will result in improved compliance by tax payers, and in less inefficiencies to the economy through tax compliance, as people will spend less time and resources complying with tax requirements.

In 2005 the OECD noted that around 73 per cent of people liable for paying federal taxes in Australia use a tax agent to do so.[9] This suggests that there may be opportunities to improve efficiency in the taxation system by simplifying tax administration. A tax system that can be easily understood may also reduce market distortion by allowing consumers to make rational

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[8] Hansjörg Bloechliger, Senior Economist, Structural Policy Analysis Division, Economics Directorate, OECD, *Meeting*, Paris, 12 February 2010; Dr Asa Johansson, Senior Economist, Structural Policy Analysis Division, Economics Directorate, OECD, *Meeting*, Paris, 12 February 2010.

[9] Australia's Future Tax System Review Panel, *Australia's future tax system: Part one overview*, Commonwealth Treasury, Canberra, 2010.

decisions based on the best available information – provided of course that the tax system has been designed according to the principle of efficiency, as described above.

Administrative simplicity may also facilitate horizontal equity, by making it easier to comply with taxation laws uniformly applied across all tax payers in similar circumstances[10].

2.2.4 Sustainability and certainty

The principle of sustainability incorporates a number of related considerations, but essentially requires that the tax system be designed in such a way as to minimise the need for ad-hoc taxes or new revenue over time. In the context of Australian tax policy, for example, sustainability means that the taxation system should be able to accommodate demographic changes associated with an ageing population; contribute to Australian notions of what comprises a fair and equitable society; and that it should facilitate the attainment of sustainable environmental outcomes. According to the Henry Review, sustainability "also means that the structural features of the system should be durable in a changing policy context, yet flexible enough to allow governments to respond as required."[11]

Another aspect of tax system sustainability, which incorporates the principle of certainty, is that it must retain credibility. This requires that the "legislative and administrative institutions and frameworks should also be robust enough to maintain the effectiveness of the system and underpin the legitimacy of the system."[12] Finally, the principle of certainty suggests that taxpayers should be able to anticipate how much taxation will cost them over time.

2.2.5 Tax competitiveness

With increasing mobility of some forms of capital and industry in global markets, one of the objectives of governments is to ensure that their tax systems remain internationally competitive. In Australia, there is also interest in ensuring that state taxation regimes are broadly comparable, to reduce administrative and other costs for businesses operating across jurisdictions.

While evidence suggests that reductions in marginal tax rates can promote economic growth,[13] the best outcome will not always be obtained by reducing taxes – government spending on infrastructure and services also contributes to competitiveness by providing other incentives for business and labour to locate in a given jurisdiction. There is merit, however, in

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[10] Independent Pricing and Regulatory Tribunal, *Review of state taxation*, Independent Pricing and Regulatory Tribunal, Sydney, 2008.

[11] Australia's Future Tax System Review Panel, *Australia's future tax system: Part one overview*, Commonwealth Treasury, Canberra, 2010, p. 17.

[12] Australia's Future Tax System Review Panel, *Australia's future tax system: Part one overview*, Commonwealth Treasury, Canberra, 2010, p. 17.

[13] Willi Leibfritz, John Thornton, and Alexandra Bibbee, *Taxation and Economic Performance,* Organisation for Economic Co-operation and Development, Economics Department, Working Paper No. 176, 1997; Dr Asa Johansson, Senior Economist, Structural Policy Analysis Division, Economics Directorate, OECD, *Meeting*, Paris, 12 February 2010.

governments examining how economic growth can be promoted through the use of more efficient taxes without affecting government revenue (and consequently, spending on infrastructure and services). While developing efficient taxes, it is important that governments continue to consider key principles of equity, simplicity, sustainability, and consistency.

In general, taxation regimes in Australia appear to be broadly comparable to other developed nations. In comparison to other OECD countries, Australia is a low-tax country, with the eighth lowest tax-to-GDP ratio in the OECD.[14] However, in comparison to OECD countries within the ASEAN region (Cambodia, Laos, Philippines, Indonesia, Thailand, Malaysia, Singapore, Vietnam and Brunei), only Brunei has a higher ratio of tax-to-GDP. Australia's corporate tax rate is the eighth highest in the OECD, with the fourth highest ratio of corporate tax revenue-to-GDP in the OECD.[15]

The Committee notes that a 2010 report by KPMG comparing tax competitiveness for businesses in 95 cities from ten countries ranked Melbourne ninth overall, with the next Australian city, Sydney, ranked eleventh.[16] While the study only considered three major components of taxation – corporate income taxes, statutory labour costs, and other corporate taxes – it does suggest that Victoria's taxation regime is globally competitive.

2.2.6 Policy consistency

"Policy consistency" was proposed by the Henry Review as part of the suite of principles around which a taxation system should be directed. The Henry Review described policy consistency as:

> Tax and transfer policy should be internally consistent. Rules in one part of the system should not contradict those in another part of the system. To the extent possible, tax and transfer policy should also be consistent with the broader policy objectives of government. However, the primary objectives of the tax and transfer system, to raise revenue and provide assistance to those in need, should not be compromised by other policy objectives.[17]

To some extent, policy consistency in the sense used by the Henry Review draws together some of the principles espoused more generally by taxation theorists: an internally consistent taxation system would, for example, be simpler for tax payers to understand; and a taxation system consistent with government policy would contribute to certainty among tax payers, at least to the extent that government policy remains consistent.

2.2.7 Tax incentives and user-pays principles

As noted above, an important function of taxation for government is its use as a mechanism to encourage or discourage activities or purchases by

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[14] Australian Treasury, *Architecture of Australia's tax and transfer system*, Australian Treasury, Canberra, 2008, p.201-202.
[15] Australian Treasury, *Architecture of Australia's tax and transfer system*, Australian Treasury, Canberra, 2008, p.201-202.
[16] KPMG, *Competitive alternatives 2010: Special report focus on tax*, KPMG Canada, 2010, p. 5.
[17] Australia's Future Tax System Review Panel, *Australia's future tax system: Part one overview*, Commonwealth Treasury, Canberra, 2010, p. 17.

effectively repricing them. Taxation can also be employed as a means to ensure that the costs of an activity or good are appropriately met by the person or entity that benefits the activity or good. The critical factor contributing to the effectiveness of a tax in achieving either of these objectives is the tax incidence. One example of this use of taxation is congestion levies, which are further discussed in Chapter Three.

In general, congestion levies are regarded as Pigouvian type taxes, which are levied on transactions on use that generate negative externalities. In principle, these taxes provide a means through which the true cost to society of a given activity can be paid by the person or entity that benefits from that activity. The main challenge for the implementation of these types of taxes is in determining the price at which a given levy offsets the costs of the negative externalities. These types of taxes may also provide a means through which behaviours that produce costs to third parties are modified. The IPART review in NSW suggested that in future, and in contrast to the potential for the introduction of other new taxes, "there is considerable scope for other environmental levies (eg, levies to address market failures in private road transport and household energy usage) to play an increased role in the state tax system."[18]

2.2.8 The application of taxation principles

While tax principles provide an elegant set of criteria by which to assess specific taxes within a taxation system, application of the principles can often prove problematic. For example, the Committee heard evidence provided by the OECD that Gross Domestic Product (GDP) growth could be maximised by moving away from income-based taxes into consumption and land-based taxes.[19] The Committee was also told of research by the OECD indicating that progressive income taxes (that is, where tax rates increase along with income) reduced overall GDP, as they provided a disincentive for people to earn higher incomes.[20] However, while the adoption of such taxes would almost certainly improve tax system efficiency and simplicity, the removal of progressive taxes would also likely compromise equity in the tax system.

A 2008 report by Access Economics for the Financial Industry Council of Australia drew attention to a number of cases where the application of one or more taxation principles could lead to conflict with another:

> - Replacing the personal income tax scales with a lump-sum tax levied equally on all individuals will make the tax system less distorting. However, by disregarding the large differences in income of individual taxpayers, the potential increase in economic efficiency would come at the cost of a (substantial) reduction in equity.
> - Another approach to minimising distortions in the system is to set tax rates inversely proportional to the magnitude of the distortion

[18] Independent Pricing and Regulatory Tribunal, *Review of state taxation*, Independent Pricing and Regulatory Tribunal, Sydney, 2008, p. 11.
[19] Dr Asa Johansson, Senior Economist, Structural Policy Analysis Division, Economics Directorate, OECD, *Meeting*, Paris, 12 February 2010.
[20] Dr Asa Johansson, Senior Economist, Structural Policy Analysis Division, Economics Directorate, OECD, *Meeting*, Paris, 12 February 2010.

they cause. This 'Ramsey tax' system would result in a multitude of tax rates, require substantial information that is not always easy to obtain and, while theoretically efficient, would fail the simplicity test and may be unfair as it implies 'necessities' will be taxed more than 'luxuries'.

- A system that promotes (vertical) equity by imposing a progressive personal income tax may generate large deadweight efficiency costs.
- Efforts to simplify a tax system, through the use of 'one size fits all' rules of thumb may compromise both efficiency and equity.[21]

Another problem with the application of principles to taxation is that, even if agreement could be found on what comprises each of the principles, it would be very difficult to determine how each should be weighted in relation to one another.

Two notable recent reviews of taxation in Australia – the IPART review of taxation in New South Wales and the Henry Review, have considered the relative merit of key taxes. In both cases, a complex set of calculations were applied to taxes in order to determine the costs and benefits associated with increasing or decreasing taxes.

The Henry Review used information obtained from KMPG using the KPMG Econotech MM900 model. In doing so, the review noted deficiencies of using this model, including that:

> This model contains a high level of tax detail, enabling estimation of the efficiency impacts of a broad range of existing taxes. However, as with all such models, the results are only indicative due to limitations in the way taxes and the economy are represented. For example, the full range of efficiency costs associated with conveyance stamp duties, the complexity of the personal and company income tax bases, and some potential spillover effects of taxes cannot be measured with this type of model. Also, the relative welfare loss associated with a small change in one tax may not be representative of that associated with the removal of that tax or where multiple taxes are changed together.[22]

The model proposed a means by which the relative burden of a five per cent increase in a given tax could be measured. The modelling measured the burden in terms of the loss to the economy from each extra dollar of revenue earned. According to the model, for example, following a five per cent increase in royalties and crude oil excise, each dollar of revenue raised by government would result in a 70 cent loss to the overall economy. As indicated in Figure 2, the taxes associated with least loss in this regard are the petroleum rent tax (no loss); municipal rates (2.5 per cent loss); land taxes (8 per cent) and the goods and services taxes (8 per cent). Taxes available to state governments account for five of the six taxes associated with the most cost from rate increases.

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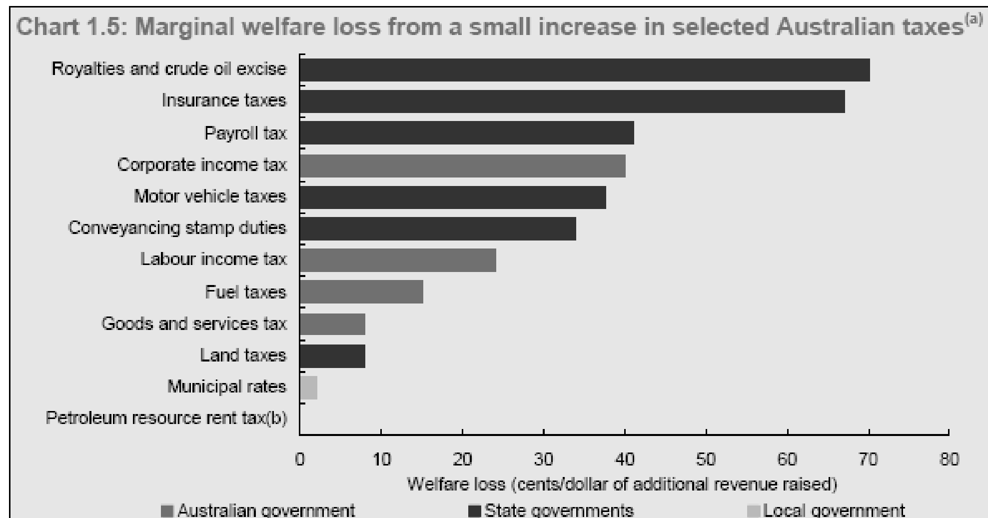
[21] Access Economics, *Analysis of State Tax Reform*, Financial Industry Council of Australia, Sydney, 2008, pp. 5-6.

[22] Australia's Future Tax System Review Panel, *Australia's future tax system: Part one overview*, Commonwealth Treasury, Canberra, 2010, p. 13.

Figure 2: Marginal loss from a five per cent increase in selected Australian taxes.[23]



Contrasting results were obtained in a review of New South Wales taxes by the IPART review in 2008. This review found that, taking a range of tax indicators into account including efficiency, equity, transparency, simplicity, and robustness, payroll tax was the most appropriate tax for state government utilisation.[24] By comparison with the Henry Review, the "least cost" tax available to state governments was found to be land taxes, with payroll tax falling behind conveyancing stamp duties and motor vehicle taxes in this regard. Results from the IPART review are presented in Figure 3.

Figure 3: Ranking of New South Wales taxes against certain factors, 2008.[25]

Tax	Efficiency	Equity	Trans-parency[a]	Simplicity[b]	Robust-ness	Weighted Score	Rank[c] (1 ranks best)
Payroll tax	3	2	4	4	4	3.2	**1**
Land tax	3	2	2	1	3	2.5	**3**
Purchaser transfer duty	2	2	4	3	1	2.1	**8**
Insurance duty	1	3	4	5	2	2.3	**6**
Motor vehicle registration duty	2	3	3	4	2	2.5	**3**
Motor vehicle weight tax	3	2	4	4	4	3.2	**1**
Fire services funding contributions[d]	1	2	3	3	4	2.2	**7**
Gambling taxes	3	1	1	4	3	2.5	**3**

[a] Transparency has been assessed in terms of transparency to the person who ultimately bears the burden of the tax.
[b] Simplicity includes administration costs and compliance costs.
[c] In order from highest to lowest.
[d] Fire Services Contributions in this assessment refers to the statutory contributions made by insurance companies.

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[23] Source: Australia's Future Tax System Review Panel, *Australia's future tax system: Part one overview*, Commonwealth Treasury, Canberra, 2010, p. 13.
[24] Independent Pricing and Regulatory Tribunal, *Review of state taxation*, Independent Pricing and Regulatory Tribunal, Sydney, 2008.
[25] Source: Independent Pricing and Regulatory Tribunal, *Review of state taxation*, Independent Pricing and Regulatory Tribunal, Sydney, 2008, p. 48.

While the ranking of the IPART Review roughly corresponds with findings from the Henry Review, disparities between these analyses demonstrate the difficulties that arise when attempting to compare the relative merits of taxes. Despite these difficulties, the basic principles for taxation provide a useful framework from which to debate the relative merits of individual taxes, and to consider their place in the overall tax system. In Chapter Three and Chapter Four of this report, the Committee refers to these principles while examining some aspects of the Victorian tax system.

2.3 Taxation in the Australian commonwealth

Although the states have some degree of responsibility for taxation and revenue under the Australian system, the Commonwealth Government is the principal collector of taxation revenue. Of the 125 taxes that comprise the commonwealth, state, and local government taxation system, 99 are collected by the Commonwealth Government. These include:

- personal income tax and other withholding taxes
- company tax
- goods and services tax (GST)
- excise duties on alcohol, fuel and tobacco products
- superannuation tax
- customs duties on imported goods
- fringe benefits tax
- petroleum resource rent tax
- wine equalisation tax
- agricultural levies
- luxury car tax
- other licence fees and revenue sourced through regulatory taxes.

In 2008-09, state governments in Australia collected $53.37 billion in taxes, with local governments collecting a further $10.74 billion in taxes. Altogether, these taxes accounted for 18.7 per cent of taxation revenue raised in Australia that year, with the commonwealth collecting remaining taxes.[26]

Collectively, the states (including local government) levy around 26 types of taxes. Of these, the most important for state and local government revenue are taxes on property, which make up 43.4 per cent of state and

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[26] Source: Australian Bureau of Statistics, *Taxation Revenue, Australia, 2008-09*, Australian Bureau of Statistics, Canberra, cat.5506.0, 2010.

local government revenue.[27] Payroll taxes comprise 26.3 per cent of state and local government revenue, with taxes on motor vehicles, gambling and insurance contributing about one quarter of revenues in 2008-09.[28] While the contribution of types of taxes to state revenue is relatively consistent across the states, each state (and local governments within the state) typically has different tax rates and thresholds attached to each type of tax. The diverse application of taxes between jurisdictions can affect taxpayers that operate across of between various states, such as large firms or multinational companies, as complexity associated with tax administration creates additional burdens for taxpayers in tax compliance.

The contribution of taxation types to state revenue in aggregate are provided in Table 1. The composition and contribution of various taxation types to Victorian state revenue are specifically discussed in Chapter Three of this report.

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[27] Source: Australian Bureau of Statistics, *Taxation Revenue, Australia, 2008-09*, Australian Bureau of Statistics, Canberra, cat.5506.0, 2010.
[28] Source: Australian Bureau of Statistics, *Taxation Revenue, Australia, 2008-09*, Australian Bureau of Statistics, Canberra, cat.5506.0, 2010.

Table 1: Relative contribution of tax types to revenue, Australian states and territories, 2008-09.[29]

	2008-09 $m	2008-09 $m	% all taxes
Employers payroll taxes	16,887		
Total		16,887	**26.34%**
Taxes on property			
Land taxes	5,565		
Municipal rates	10,946		
Other	1,101		
Financial institutions transactions taxes	0		
Government borrowing guarantee levies	386		
Stamp duties on conveyances	9,534		
Other stamp duties	305		
Total		27,838	**43.42%**
Taxes on the provision of goods and services			
Agricultural production taxes	0		
Levies on statutory corporations	69		
Taxes on government lotteries	746		
Taxes on private lotteries	438		
Taxes on gambling machines	3,034		
Casino taxes	413		
Race betting taxes	381		
Taxes on gambling n.e.c.	15		
Insurance co. contrib. to fire brigades	1,028		
Third party insurance taxes	371		
Taxes on insurance n.e.c.	3,106		
Total		9,602	**14.98%**
Taxes on the use of goods and performance of activities			
Stamp duty on vehicle registration	2,026		
Other	4,432		
Gas taxes	2		
Petroleum products taxes	0		
Tobacco taxes	0		
Liquor taxes	1		
Other	596		
Total		7,058	**11.01%**
Taxes from public corps and other govt.	2,723		
Total		2,723	**4.25%**
Total all taxes		**64,108**	

[29] Source: Australian Bureau of Statistics, *Taxation Revenue, Australia, 2008-09*, Australian Bureau of Statistics, Canberra, cat.5506.0, 2010. Difference in totals due to rounding.

Major types of taxes levied by the states in Australia include:

- Payroll tax: taxes levied on taxable wages, which include salaries and wages, commissions, bonuses, taxable fringe benefits, and payments to some contractors.[30] All of the states currently apply payroll taxes, with rates applying to all wages above specified thresholds.[31]

- Stamp duty on conveyances: all Australian states also levy duties on the transfer of property, with the duty generally paid by the purchaser of the property on the sale value, or on the market value, if the latter is higher. Stamp duty on property transfer is progressive in all states and territories, although different metrics are used for the calculation of duty in each state.

- Land tax: land taxes are levied on properties on an annual basis, with all of the states except the Northern Territory levying this tax. Land tax is applied as a progressive tax in all of the states and the ACT, although in New South Wales land tax applies at a constant rate above a threshold.[32]

- Insurance taxes: all of the Australian states apply various taxes to insurance premiums, with some states (New South Wales, Victoria and Tasmania) applying taxation on insurance companies or their policies in order to fund fire brigades. With the exception of Western Australia, all states also apply taxes at different rates to life insurance premiums. Most states also apply taxes on third party motor insurance, including Victoria.

- Motor vehicle taxes: all of the states apply various taxes on vehicle registrations and motor vehicle ownership transfers. Stamp duties on transfer of ownership apply to the sale value of the vehicle or its market value (as is the case with stamp duty on conveyances, the higher value determines the quantum of tax). Taxes are generally differentiated according to whether the vehicle is for private use, and in some cases, according to vehicle classifications based on weight or number of cylinders.

- Gambling taxes: all of the states also impose taxes on gambling activity, with taxes differentiated by types of gambling activity, and often moderated by the gross value of gambling undertaken.

- Non-tax resource revenue: this form of revenue includes royalties on mineral and other resources, and tends to be differentiated according to resource type, as well as other variables. In most states, royalties are applied on an *ad valorem* basis for most minerals, with certain low-value minerals and commodities attracting a per-tonne royalty. Royalties are also applied to use of forest resources on public land, and on water use by means of licenses or access charges.

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[30] Government of Victoria, *Submission*, no. 37, 19 October 2009, p. 7.
[31] Australian Treasury, *Architecture of Australia's tax and transfer system*, Australian Treasury, Canberra, 2008, p. 30.
[32] In NSW, for properties of value in excess of $359,000¸ $100+1.60% of value over $359,00.

- Local government rates: local government revenue is raised through the application of taxes (rates) on the value of property. Local governments are relatively autonomous in their capacity to determine the rate of taxation, and the categories of property to which taxes apply. Consequently, there is substantial variation in rates systems for loca government across Australia.

2.3.1 State expenditure in relation to revenue

> The States have substantial expenditure responsibilities – including the provision of services such as health, education, transport and policing – but do not have sufficient own-source revenue to fund these responsibilities. The States have increasing expenditure responsibilities, which will only be exacerbated with an ageing population, while at the same time diminishing sources of revenue under their control. They must rely on financial transfers from the Commonwealth, which controls most of the national tax base, for the additional revenue needed to fund their responsibilities.[33]

While most taxes collected in Australia are paid to the Commonwealth Government, responsibility for expenditure between the commonwealth and the states is more evenly distributed, with the states collectively responsible for 48 per cent of expenditure, local government accounting for 4 per cent, and the commonwealth responsible for remaining expenditure (48%).[34] This disparity between revenue collection and expenditure has been widely commented on, with some analysts suggesting that the disparity between revenue collection and expenditure creates problems in the assessment of which level of government – commonwealth, state or local – is responsible for the delivery of government programs and services. The phenomenon of disparity between a government's revenue and expenditure responsibilities is referred to as vertical fiscal imbalance (VFI).

As discussed below, the development of taxation policy within Australia since Federation, and determinations of the High Court in regard to the power of the commonwealth to levy taxes, has significantly narrowed the range of taxes available to the states. Furthermore, taxes that remain available to the states tend to be relatively inefficient, as noted by the Victorian Government in its submission to the Inquiry:

> The High Court has deemed a number of State taxes to be duties of excise and therefore unconstitutional including franchise fees on tobacco, liquor and petroleum businesses. The Federal Court also recently disallowed an attempt by the Australian Capital Territory government to impose a Utilities Network Facilities Tax on infrastructure passing through public land. Such decisions leave states with few options for moving away from existing taxes even where those taxes are highly volatile or distort behaviour.[35]

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[33] Neil Warren, *Benchmarking Australia's intergovernmental fiscal arrangements*, New South Wales Treasury, Sydney, 2006, p. xxi.
[34] Australian Treasury, *Architecture of Australia's tax and transfer system*, Australian Treasury, Canberra, 2008.
[35] Government of Victoria, *Submission*, no. 37, 19 October 2009, p. 10.

2.4 The development of taxation responsibilities under the commonwealth

The Australian taxation system is a complex multi-layered one that is separated into those taxes that are levied by the Commonwealth Government and those that are able to be enacted by state and local governments. As is the case in a number of federalist-style nations, the distribution of taxation rights is heavily skewed toward those taxes collected by the federal jurisdiction.

Since Federation, the distribution of revenue collection powers between the commonwealth and the states has changed significantly. Prior to Federation, the states largely obtained revenue through the imposition of customs and excise duties, principally because these were the easiest to administer. Upon creation of the commonwealth, certain powers for making laws for taxation were transferred to the Commonwealth Parliament. The key provision of the Constitution Act in this regard is Section 90, *Exclusive power over customs, excise, and bounties*, which states:

> On the imposition of uniform duties of customs the power of the Parliament to impose duties of customs and of excise, and to grant bounties on the production or export of goods, shall become exclusive.
>
> On the imposition of uniform duties of customs all laws of the several States imposing duties of customs or of excise, or offering bounties on the production or export of goods, shall cease to have effect, but any grant of or agreement for any such bounty lawfully made by or under the authority of the Government of any State shall be taken to be good if made before the thirtieth day of June, one thousand eight hundred and ninety-eight, and not otherwise.[36]

Over time, successive interpretations of these powers by the High Court have tended to favour the right of the commonwealth over the states to levy certain taxes. A wider interpretation of the definition of "excise" duties has narrowed the range of taxes that the states are able to impose.

According to a summary of the development of Australia's tax system by the Australian Treasury, until the 1970s the tendency in Australian taxation was toward expanding taxation revenue in order to fund expenditure programs.[37] Opportunities for substantial increases to commonwealth taxation revenue occurred during each of the World Wars, with the introduction of income tax by the Commonwealth Government in 1915, and the removal of tax rebates for shareholders on dividends, and increasing company tax, introduced during the 1940s. During the Second World War the commonwealth assumed control of all income tax, in exchange for further grants to the States, and maintained control of income tax until the present day.[38]

While the commonwealth is the sole collector of income tax in Australia, theoretically the states retain the power to impose their own income taxes.

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[36] Australian Constitution Act 1900 (Cth).

[37] Australian Treasury, *Architecture of Australia's tax and transfer system*, Australian Treasury, Canberra, 2008, p. 191.

[38] Australian Treasury, *Architecture of Australia's tax and transfer system*, Australian Treasury, Canberra, 2008, p. 191.

This circumstance was noted by the Harvey Review of Victorian state business taxes in 2001:

> Under the Constitution, the states and territories can impose an income tax. However, this tax base was ceded to the Commonwealth as a wartime measure in 1942. Since the 1950s, numerous attempts have been made by the states to regain access to the income tax base. However, due to the high political costs of imposing an income tax without the Federal Government making room for such a tax, and the risk of reductions in Commonwealth grants, no state has returned to taxing income. As a result, the Australian states and territories collect a variety of narrowly based taxes, such as certain stamp duties, which are inefficient.[39]

Since the 1970s, however, governments have tended to focus on how to improve the efficiency and equity of taxation, particularly as Australian expenditure and taxation, as a proportion of GDP, tended to stabilise toward the 1980s. In this regard, reforms of the tax system have tended to look toward broadening the base of taxation, while simultaneously lowering the rate of taxation applied.

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[39] State Business Tax Review Committee, *Review of state business taxes*, Department of Treasury and Finance, Melbourne, 2001, p. 5.

Chapter

3

Chapter Three:
An overview of taxation in Victoria

In this Chapter, the role of taxes in the Victorian economy is examined, focusing particularly in the role of individual taxes. The Committee considers some of the suggestions received from submissions and witnesses during the course of this Inquiry on the application of state taxes, and comments on some immediate suggestions for changes to tax administration. Longer term views on the role of Victorian taxation, as well as issues surrounding the distribution of commonwealth and state taxes, are considered in Chapter Four of this report.

3.1 An overview of Victorian taxation revenue

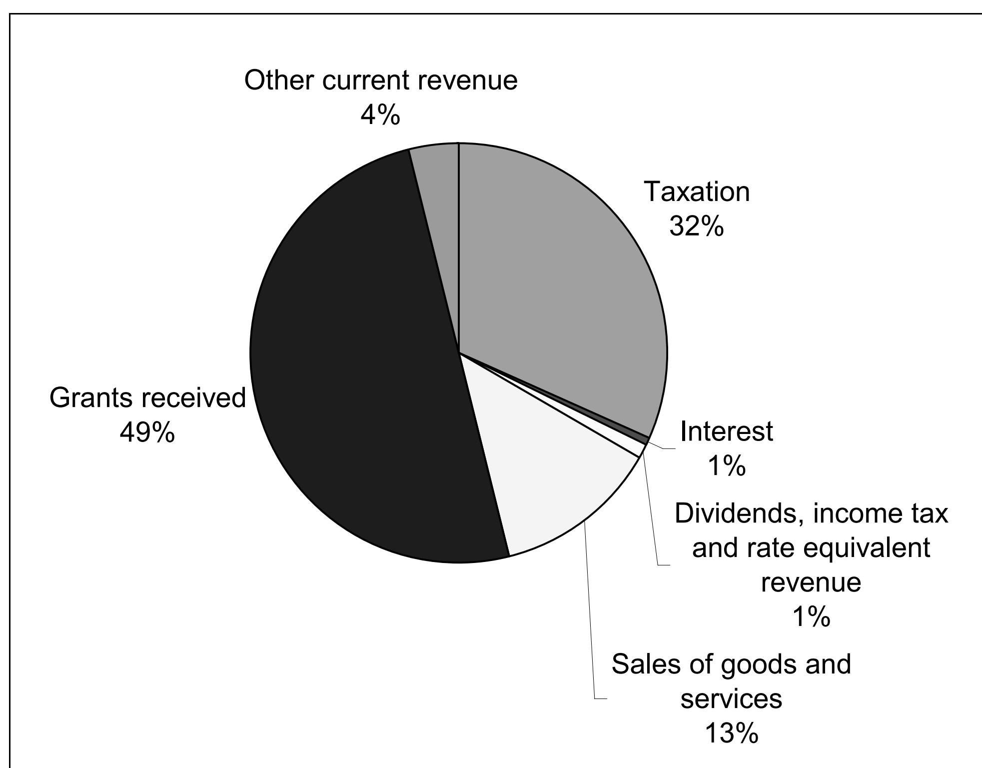
As noted in Chapter Two, revenue for all of the Australian states and territories is substantially reliant on grants from the commonwealth. Between 2008-09 and 2010-11, approximately one half of Victorian government sector revenue was obtained from commonwealth grants, with state taxation accounting for between 31 and 32 per cent of revenue. Table 2 and Figure 4 illustrate the proportion of revenue obtained from major revenue streams.

Table 2: Victorian government sector revenue and grants, 2008-09 to 2010-11 (*$ million*).[40]

Source	2008-09 Actual	2009-10 Revised	2010-11 Budget
Taxation	12626.9	13642.1	14437.8
Interest	378.2	348.5	358.0
Dividends, income tax and rate equivalent revenue	490.4	459.2	504.9
Sales of goods and services	4940.5	5427.9	5847.4
Grants received	18970.0	22111.3	22893.1
Other current revenue	1878.9	1756.5	1718.0
Total revenue from transactions	**39284.8**	**43745.5**	**45759.3**

[40] Source: Government of Victoria, *Victorian State Budget 2010-11: Volume 4, Statement of Finances*, Department of Treasury and Finance, Melbourne, 2010, p. 203.

Figure 4: Victorian government sector revenue and grants, 2010-11 Budget.[41]



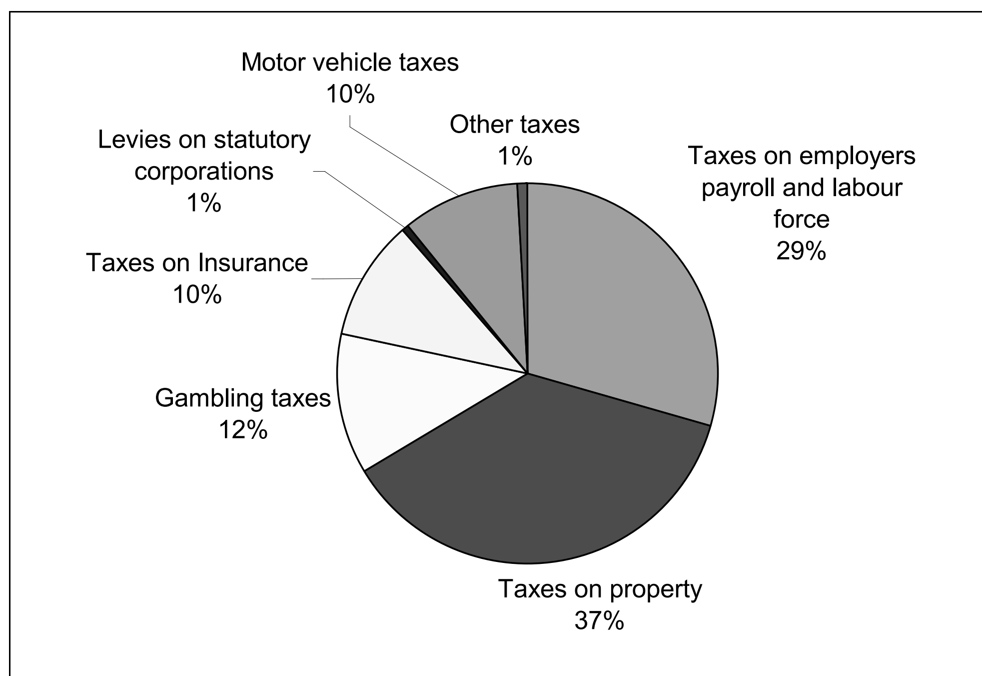
More than two-thirds of taxation revenue is obtained from taxes on property (37%) and payroll and labour force (30%). Motor vehicle taxes, levies on statutory corporations, and gambling taxes make roughly comparable contributions to taxation revenue (see Table 3 and Figure 5).

Table 3: Sources of taxation revenue, Victorian Government, 2008-09 to 2010-11 (*$ million*).[42]

Source	2008-09 Actual	2009-10 Revised	2010-11 Budget
Taxes on employers payroll and labour force	3979.7	4022.9	4258.5
Taxes on property	4269.6	4979.5	5330.9
Gambling taxes	1648.6	1655.9	1722.7
Levies on statutory corporations	1235.4	1400.9	1478.1
Motor vehicle taxes	1323.8	1407.3	1448.8
Other taxes	100.3	102.0	125.0
Total taxation	**12626.9**	**13642.1**	**14437.8**

[41] Source: Government of Victoria, *Victorian State Budget 2010-11: Volume 4, Statement of Finances*, Department of Treasury and Finance, Melbourne, 2010, p. 203.
[42] Government of Victoria, *Victorian State Budget 2010-11: Volume 4, Statement of Finances*, Department of Treasury and Finance, Melbourne, 2010, p. 206.

Figure 5: Sources of taxation revenue, Victorian Government 2010-11 Budget.[43]



Victoria's overall tax revenue has increased in most years since 2003-04. Revenue from payroll and labour force taxation has increased steadily over the last eight years, due to increased employment in the Victorian economy. In comparison, the other major streams of Victorian tax revenue – taxes on immovable property, and on financial and capital transactions – have been subject to much greater fluctuation. This volatility is illustrated in Figure 6, which highlights challenges for government when preparing forward estimates for land transfer duty revenue, for example. This point was emphasised in a document provided to the Committee by the Business Coalition for Tax Reform, which argued that reliance on a variable tax base was undesirable for state governments:

> The States are becoming increasingly reliant on volatile and unpredictable taxes for a large share of their own source revenues. Volatility in the revenue base can be problematic for fiscal management and is a key risk to achieving budget targets.[44]

The most substantial increases in government taxation revenue over the past eight years have been from financial and capital transactions taxes, with payroll and labour force taxes growing relatively consistently over that period. Taxes on immovable property (including land taxes) have also increased, although at a less uniform rate.

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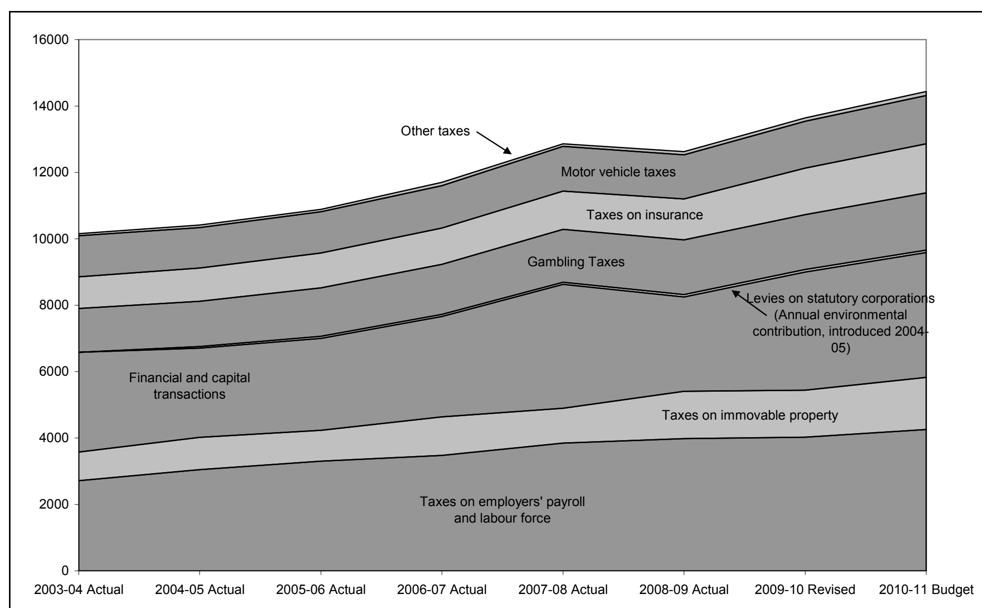
[43] Source: Government of Victoria, *Victorian State Budget 2010-11: Volume 4, Statement of Finances*, Department of Treasury and Finance, Melbourne, 2010, p. 203.
[44] The Centre for International Economics, *State business tax reform*, The Centre for International Economics, Canberra, 2009, p. 51.

Figure 6: Contribution of major taxation categories to taxation revenue, Victoria, 2003-04 to 2010-11.[45]



The Committee also notes that, during the past eight years, a number of taxes have been discontinued by the Victorian Government, largely in accordance with agreements made with the Commonwealth Government in implementing the Goods and Services Tax (GST). These include the Debits Tax (abolished 1 July 2005) which obtained $265.9 million revenue in its last financial year of operation; Mortgage Stamp Duty abolished in 2005-06; and Rental Business Duty abolished on 1 July 2007. The abolishment of these taxes removed an appreciable stream of revenue from the Victorian Government tax base, compensated by its share of GST transfers from the Commonwealth Government. The Committee commends the Victorian Government for being the first of the states and territories to abolish all of the designated by the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations. Victoria and Tasmania are currently the only states to have completely complied with these conditions.

3.1.1 Taxes on property

As noted in Chapter Two, over time a number of constitutional, and historical, constraints have emerged that limit the range of taxes available to the states and territories. These include, for example, the removal of the right to impose excise and customs duties, and franchise fees on

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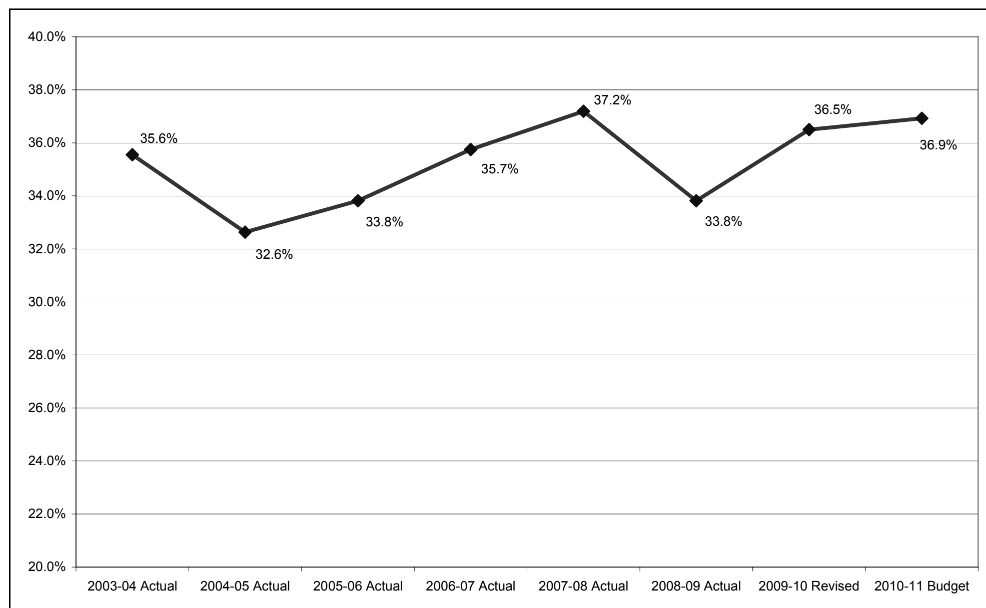
[45] Sources: Government of Victoria, *Annual Financial Report 2003-04*, Department of Treasury and Finance, Melbourne, 2004; Government of Victoria, *Annual Financial Report 2004-05*, Department of Treasury and Finance, Melbourne, 2005; Government of Victoria, *Annual Financial Report 2005-06*, Department of Treasury and Finance, Melbourne, 2006; Government of Victoria, *Annual Financial Report 2006-07*, Department of Treasury and Finance, Melbourne, 2007; Government of Victoria, *Annual Financial Report 2007-08*, Department of Treasury and Finance, Melbourne, 2008; Government of Victoria, *Annual Financial Report 2008-09*, Department of Treasury and Finance, Melbourne, 2009; Government of Victoria, *Victorian State Budget 2010-11*, Department of Treasury and Finance, Melbourne, 2010.

businesses and activities. Consequently, the states and territories have become more reliant on a narrower range of revenue streams.

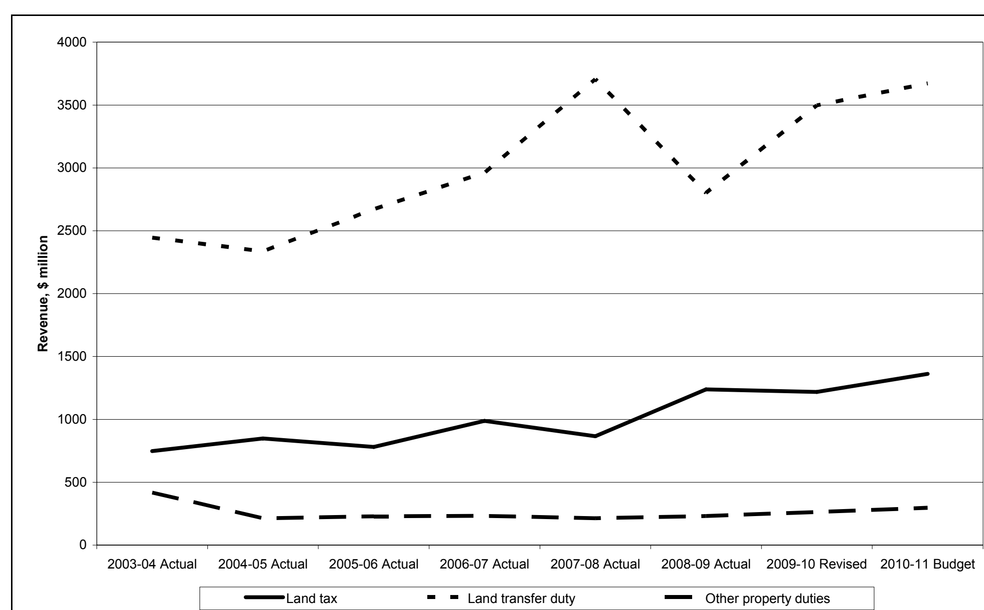
Taxes on property comprise a major revenue stream for the Victorian Government, accounting for 37 per cent of taxation revenue in the 2010-11 budget. As noted about, the contribution of taxes on property is extremely volatile, due principally to fluctuations in land transfer duty, which is directly linked with property value and turnover. Due to this fluctuation, between 2004-05 and 2010-11 taxes on property accounted for between 32.6 per cent and 37.9 per cent of government revenue (see Figure 7). This volatility means that it is very difficult for government to accurately estimate total taxation revenue in a given year, which means that the state budget will be subject to unanticipated surpluses or deficits over time, depending on conditions in the property market. This also means that the government is constrained in its ability to accurately match the revenue it raises to its expenditure, and may consequently affect the efficiency of the economy by regularly extracting more, or less, revenue from the economy than it required. Figure 8 shows that the volatility in taxes on property in Victoria derives from both the land transfer duty and land taxes, although principally on the former.

Figure 7: Taxes on property as proportion of total Victorian Government taxation revenue, 2004-05 to 2010-11.[46]



[46] Sources: see footnote 45.

Figure 8: Property taxes revenue, Victoria, 2003-04 to 2010-11.[47]



3.1.1.1 Land transfer duty

Land Transfer duty (also known as Stamp Duty) is the second largest Victorian state taxation revenue source, and is forecast grow five per cent between 2009-10 and 2010-11. Land transfer duty is levied by the state government on transfers of all land occurring in Victoria, with some exemptions under the *Duty Act 2000*. The duty is charged on the greater of a) the market value of the property; or b) the consideration (price paid) including any GST. The purchaser or transferee is liable to pay the duty within three months of settlement. A concession to the Land Transfer Duty is applied for the purchase of a property where the purchaser will reside (the principal place of residence concession). Rates that apply to market transactions for principal place of residence, and other land transfer transactions, are shown in Table 4 and Table 5:

Table 4: Land transfer duty rates, principal place of residence, Victoria, 2010.[48]

Dutiable Value Range	Rate
$0 - $25,000	1.4 per cent of the dutiable value of the property
$25,001 - $130,000	$350 plus 2.4 per cent of the dutiable value in excess of $25,000
$130,001 - $440,000	$2,870 plus 5 per cent of the dutiable value in excess of $130,000
$440,001 - $550,000	$18,370 plus 6 per cent of the dutiable value in excess of $440,000
$550,001 - $960,000	$28,070 plus 6 per cent of the dutiable value in excess of $550,000
More than $960,000	5.5 per cent of the dutiable value

[47] Sources: see footnote 45.
[48] State Revenue Office of Victoria, 'Duties Rates', viewed 19 August 2010, <www.sro.vic.gov.au>.

Table 5: Land transfer duty rates, other than principal place of residence, Victoria, 2010.[49]

Dutiable Value Range	Rate
$0 - $25,000	1.4 per cent of the dutiable value of the property
$25,001 - $130,000	$350 plus 2.4 per cent of the dutiable value in excess of $25,000
$130,001 - $960,000	$2,870 plus 6 per cent of the dutiable value in excess of $130,000
More than $960,000	5.5 per cent of the dutiable value

Over the past two decades changes to tax rates for land transfer duties have mainly been obtained through property value threshold adjustments. From January 1988, for example, the highest land transfer duty rates (5.5 per cent) applied to land purchases in excess of $760,000, with this threshold raised to $870,000 in April 1998, and $960,000 in May 2008.[50]

A range of concessions and exemptions are also allowed under the *Duties Act 2000 (Vic)*. These include (but are not limited to) exemptions for the transfer of farms to relatives; concessions or exemptions for certain pensioners, depending on purchase value of the property; concessions for first home purchasers with families; and concessions for off the plan sales.[51]

Stamp duties, particularly duties applied to the sale and purchase of property, were a concern raised by witnesses and in submissions.[52] The Australian Banker's Association described stamp duties as "among the least efficient taxes in Australia".[53] Westfield Ltd argued that stamp duties and property taxes were: volatile and unpredictable revenue sources; difficult and costly to manage; "deadweight" taxes that impede business efficiency and drag on the economy; unequally and unfairly applied; and harmful to business competitiveness.[54] The Real Estate Institute of Victoria (REIV) also noted the difficulties for government in attempting to estimate revenue from land transfer duties, showing that between 2003-04 and 2007-08 the State Budget had understated revenue by an average of

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[49] State Revenue Office of Victoria, 'Duties Rates', viewed 19 August 2010, <www.sro.vic.gov.au>.
[50] State Revenue Office of Victoria, 'Duties Rates', viewed 19 August 2010, <www.sro.vic.gov.au>.
[51] State Revenue Office of Victoria, 'Duties Rates', viewed 19 August 2010, <www.sro.vic.gov.au>.
[52] Australian Bankers' Association, *Submission*, no. 3, 24 September 2009; Australian Unity, *Submission*, no. 30, 12 October 2009; Brotherhood of St Laurence, *Submission*, no. 40, 27 October 2009; Business Coalition for Tax Reform, *Submission*, no. 6, 28 September 2009; CPA Australia, *Submission*, no. 19, 5 October 2009; Glenne Drover, *Submission*, no. 12, 1 October 2009; First National Real Estate, *Submission*, no. 39, 21 October 2009; Government of Victoria, *Submission*, no. 37, 19 October 2009; Nanette Griffiths and Morrie Griffiths, *Submission*, no. 22, 2 October 2009; G Lloyd-Smith, *Submission*, no. 23, 25 September 2009; Master Builders' Association of Victoria, *Submission*, no. 21, 6 October 2009; Owners Corporations Victoria, *Submission*, no. 2, 22 November 2009; Property Council of Australia, *Submission*, no. 17, 2 October 2009; Schiavello Group of Companies, *Submission*, no. 13, 5 October 2009; Eu-Jin Teo, *Submission*, no. 11, 1 October 2009; The Real Estate Institute of Victoria, *Submission*, no. 20, 5 October 2009; Victorian Farmers' Federation, *Submission*, no. 18, 2 October 2009; Westfield Management Limited, *Submission*, no. 9, 1 October 2009.
[53] Australian Bankers' Association, *Submission*, no. 3, 24 September 2009, p. 4.
[54] Westfield Management Limited, *Submission*, no. 9, 1 October 2009, p. 3.

$517million, and that furthermore, the revenue itself during that period was very volatile.[55]

The REIV suggested that land transfer duty was discriminatory, because it only applied to people at the point of property purchase, arguing that "just because someone has bought a home does not mean they have the capacity to incur this additional cost."[56] The REIV also suggested that the land transfer duty could put people off moving homes, even when there was a need for them to do so, due to the cost incurred through moving, and as such was discriminatory particularly for larger families who needed to shift into larger properties.[57]

The REIV also noted that Victoria, Queensland and the Northern Territories were the only three Australian jurisdictions that applied higher land transfer duties to purchases of properties for purposes other than as primary place of residence.[58] The REIV suggested that this provided a disincentive for investment in rental properties, and that increased costs were borne by investors and by the people who rented their properties.[59]

3.1.1.2 Land tax

Not all the submissions regarded all property taxes as inherently inefficient – the Insurance Council of Australia (ICA) and CPA Australia both argued that land tax, as contrasted with land transfer duties, had the potential to be relatively efficient. Other commentaries on taxation, such as the Henry Review and the IPART review of NSW taxes, suggest that there is potential for land tax to be applied as a broad-based, relatively low rate measure to provide governments with a stable, immobile revenue base. The Henry Review noted that:

> When applied uniformly across a broad base, land tax is one of the most efficient means of raising revenue. This efficiency arises from the immobility of the tax base and, unlike most other taxes, levying different rates of land tax in different States has very low efficiency costs.[60]

The Henry Review further suggested that differentiated tax rates could apply to land tax, based on the per-square-meter value of land, rather than on the value of a discrete property. This would allow land used for purposes such as agriculture, could be exempted from land tax, or pay a lower rate, due to the lower per-square-meter value of the land.[61]

Currently, however, a range of exemptions from land tax liability, including for land used for certain purposes, or for land valued below a threshold, mean that land tax in Victoria is relatively inefficient from a taxation perspective.

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[55] The Real Estate Institute of Victoria, *Submission*, no. 20, 5 October 2009, p. 3.
[56] The Real Estate Institute of Victoria, *Submission*, no. 20, 5 October 2009, p. 3.
[57] The Real Estate Institute of Victoria, *Submission*, no. 20, 5 October 2009, p. 3.
[58] The Real Estate Institute of Victoria, *Submission*, no. 20, 5 October 2009, p. 4.
[59] The Real Estate Institute of Victoria, *Submission*, no. 20, 5 October 2009, p. 4.
[60] Australia's Future Tax System Review Panel, *Australia's future tax system: Part one overview*, Commonwealth Treasury, Canberra, 2010, p. 48.
[61] Australia's Future Tax System Review Panel, *Australia's future tax system: Part one overview*, Commonwealth Treasury, Canberra, 2010, p. 49.

While the land transfer duty applies to all land property sales in Victoria, land tax is subject to a number of exemptions based on property use and value. Land tax is applied to the unimproved value of land, as assessed by the relevant municipal council, as at midnight 31 December of the relevant calendar year. Land uses that are exempt from the tax include: primary place of residence; land used for primary production (such as farming); land used and occupied primarily for rooming houses; retirement villages, aged-care establishments and nursing homes; and land used by religious and charitable institutions. Land tax is based on a sliding scale of rates, and applies above values of $250,000, although a surcharge is also applied for land held by trusts below a value of $3,000,000. Relevant rates for 2009 and 2010 are shown in Table 6 and Table 7.

Table 6: Victoria Land Tax General Rates, 2009 and 2010.[62]

Total taxable value of landholdings	Land tax payable
< $250,000	Nil
$250,000 to < $600,000	$275 plus 0.2% of amount > $250,000
$600,000 to < $1,000,000	$975 plus 0.5% of amount > $600,000
$1,000,000 to < $1,800,000	$2,975 plus 0.8% of amount > $1,000,000
$1,800,000 to < $3,000,000	$9,375 plus 1.3% of amount > $1,800,000
$3,000,000 and over	$24,975 plus 2.25% of amount > $3,000,000

Table 7: Victoria Land Tax Surcharge Rates for Trusts, 2009 and 2010.[63]

Total taxable value of landholdings	Land tax payable
< $25,000	Nil
$25,000 to < $250,000	$82 plus 0.375% of amount > $25,000
$250,000 to < $600,000	$926 plus 0.575% of amount > $250,000
$600,000 to < $1,000,000	$2,938 plus 0.875% of amount > $600,000
$1,000,000 to < $1,800,000	$6,438 plus 1.175% of amount > $1,000,000
$1,800,000 to < $3,000,000	$15,838 plus 0.7614%* of amount > $1,800,000
$3,000,000 and over	$24,975 plus 2.25% of amount >$3,000,000

Where multiple liable properties are owned, the value of all properties are aggregated in order to determine taxable value. This means, for example, that a person holding two properties worth $400,000 each will be taxed on a total property value of $800,000 ($4,688) rather than two lots of $400,000 ($3,577). Under certain circumstances, the holdings of corporations may also be grouped for the purpose of determining land tax liability, where it

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[62] State Revenue Office of Victoria, '2009 & 2010 Land Tax Rates', viewed 19 August 2010, <www.sro.vic.gov.au>.

[63] State Revenue Office of Victoria, '2009 & 2010 Land Tax Rates', viewed 19 August 2010, <www.sro.vic.gov.au>.

can be shown that one corporation (or its owner) substantially controls another corporation. This removes the incentive for persons of corporations to deliberately distribute land holdings into parcels in order to avoid land tax liability.

The Committee notes that over time, land tax thresholds and rates have been reduced in Victoria. In 2001, for example, land tax was payable on properties with unimproved value greater than $85,000, with a top rate of 5.0 per cent on the value of properties above $2,700,000, By comparison, the current threshold for land tax liability is $250,000, and the top land tax rate is 2.25 per cent on the value of properties above $3,000,000.

According to a number of analyses, land taxes are among the most efficient and equitable taxes that can be levied by governments.[64] However, as with all forms of taxation, the efficiency of a given tax is strongly influenced by the extent to which it is applied universally, or whether thresholds or other means by which liability for tax payment apply.

Some of the factors that favour the implementation of land tax for revenue raising include that the object of the tax is immobile, and that it is not levied on occasional activities (such as the sale of land). Some of the factors that must be considered when applying the tax include: whether the tax applies to the land value alone, or to the capital value (land plus improvements); whether a land (or capital) value threshold should apply; and whether land used for specific purposes (such as farming) should be exempt from land tax, or be taxed at a lower rate.

In the latter case, the Committee notes the Victorian Farmers' Federation (VFF) recommendation that taxes on property only be applied to the value of improvements, rather than the value of land and improvements.[65] However, the Committee also recognises that taxing only improvements may also be problematic, where buildings are subject to depreciation that may not be reflected in market value. In practice, a differential rate for certain activities, such as farming, is likely to provide the best means to ensure the fair application of land taxes. There is, however, potential for the tax to increase its base, to apply to more properties, and offset more inefficient state taxes, such as land transfer duty, and the fire services levy. These issues are discussed further in Chapter Four.

3.1.2 Taxes on payroll and labour force

Payroll tax is levied on taxable Victorian wages, which are defined to include salaries and wages, commissions, bonuses, taxable fringe benefits, and payments to some contractors. Payroll tax of 4.90 per cent is currently levied on businesses with a taxable total wage bill above an annual tax free threshold of $550 000. While the threshold for payroll tax has been maintained since 2002-03, the rate has been periodically

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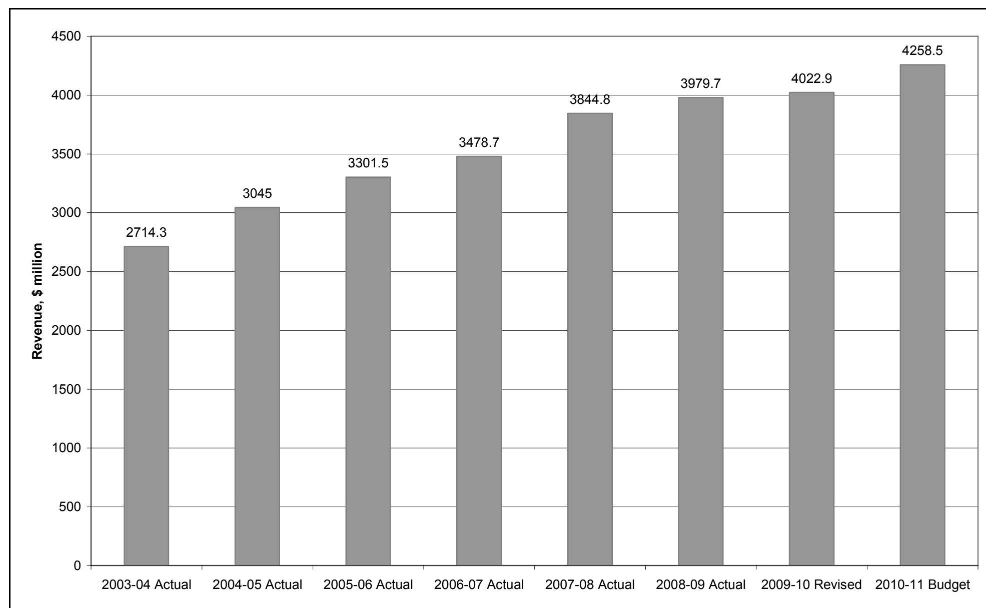
[64] Australia's Future Tax System Review Panel, *Australia's future tax system: Part one overview*, Commonwealth Treasury, Canberra, 2010; Independent Pricing and Regulatory Tribunal, *Review of state taxation*, Independent Pricing and Regulatory Tribunal, Sydney, 2008; Insurance Council of Australia, *Submission*, no. 38, 16 October 2009; Alex Sanchez, General Manager, Insurance Council of Australia, *Transcript of evidence*, Sydney, 29 October 2009; Prof. Neil Warren, Head of School, Australian School of Taxation, University of New South Wales, *Transcript of evidence*, Sydney, 29 October 2009.

[65] Victorian Farmers' Federation, *Submission*, no. 18, 2 October 2009

reduced, from 5.35 per cent in 2002-03 to 4.90 per cent in 2010-11. The trend in Victoria over time has been toward lower rates of payroll tax – in 1997-98 the payroll threshold was $515,000, with a tax rate of 6.25 per cent.[66]

Payroll and labour force taxation has increased from around $2.7 billion in 2003-04 to $4 billion in 2008-09, with the 2010-11 budget currently estimating payroll and labour force taxation revenue at $4.259 billion, an increase of $236 million (5.9 per cent) over the 2009-10 revised estimate. According to the Victorian Government, this growth "reflects increasing employment and wages, as well as an expected recovery in average hours worked per employee, moderated by the reduction in the payroll tax rate."[67]

Figure 9: Payroll and labour force taxation revenue, Victoria, 2003-04 to 2010-11.[68]



The Committee heard a number of views from witnesses, and in submissions, about the appropriate role of payroll and labour force taxation in Victoria. Some witnesses and submissions expressed concern that current tax levels inhibit Victoria's competitiveness with other states, and have a negative impact on employment within the state.[69] One submission suggested that harmonisation of payroll tax levels across the eight jurisdictions would reduce costs for business.[70]

However, some witnesses and submissions argued that payroll taxation was relatively efficient, compared to volatile taxes such as property transfer

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[66] State Revenue Office of Victoria, 'Duties Rates', viewed 19 August 2010, <www.sro.vic.gov.au>.
[67] Government of Victoria, *Victorian State Budget 2010-11: Volume 4, Statement of Finances*, Department of Treasury and Finance, Melbourne, 2010.
[68] Sources: see footnote 45.
[69] Australian Bankers' Association, *Submission*, no. 3, 24 September 2009; Business Coalition for Tax Reform, *Submission*, no. 6, 28 September 2009; Schiavello Group of Companies, *Submission*, no. 13, 5 October 2009.
[70] RSM Bird Cameron, *Submission*, no. 1, 11 September 2009.

duties, and that the state government should consider redistributing its tax mix to collect more payroll tax, provided it was levied on a broader base, by bringing down the tax threshold. The ICA, for example, argued that:

> …the Victorian economy would be significantly improved if Victoria was to embark on a tax mix switch away from transaction taxes (including general insurance stamp duties) and towards more efficient State taxes, such as gaming, land and payroll. In other words, overall economic welfare in Victoria can be enhanced if Victoria was to reduce its dependence on stamp duties and increase the reliance on the other, more efficient taxes such as gaming, land and payroll.[71]

Others argued, however, that payroll tax had deleterious effect on the economy, and so were not desirable. Prosper Australia suggested that payroll taxes differed from other taxes because they provided a disincentive for employment:

> Defenders of payroll tax claim that it is passed on in prices and is therefore equivalent to a consumption tax, like the GST. This argument conveniently considers only the downstream shifting of taxes. But when demand for inputs is elastic, taxes are also shifted upstream. When payroll tax and GST and shifted downstream, they indeed tax consumption. But when GST is shifted upstream, it taxes production, whereas when payroll tax is shifted upstream, it taxes employment—as all employers, broadcasters, barbers and taxi drivers know![72]

This view was not universally supported however, with the Insurance Council of Australia drawing the Committee's attention to a review that suggested payroll tax did not adversely affect employment:

> …the economic effect of a broadly based payroll tax is similar to a broad consumption tax or a flat-rate income tax, concluding that the view that payroll tax is a tax on employment is not supported by the evidence.[73]

The ICA argued that, of the taxes available to state governments, payroll tax was a relatively efficient state tax (comparable to a value added tax), with its efficiency reduced to the extent that there are exemptions to the taxation base.[74]

As noted in the previous chapter, analysts of tax efficiency and effectiveness have various views about the utility of payroll tax as a means to raise revenue. The Henry Review argued that state payroll taxes were inefficient in their current form, and should be replaced. Part of the inefficiency of payroll taxes for the Henry Review was derived from the application of a threshold to these taxes, which influenced (and possibly limited) business size.[75] More generally, the Henry Review proposed

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[71] Insurance Council of Australia, *Submission*, no. 38, 16 October 2009, p. 21.
[72] Prosper Australia, *Submission*, no. 15, 2 October 2009, p. 7.
[73] Insurance Council of Australia, *Submission*, no. 38, 16 October 2009, p. 5.
[74] Insurance Council of Australia, *Submission*, no. 38, 16 October 2009, p. 9.
[75] Australia's Future Tax System Review Panel, *Australia's future tax system: Part one overview*, Commonwealth Treasury, Canberra, 2010, p. 13.

moving from taxes on factors of production (including payroll tax) toward taxes on consumption.[76]

The 2001 *Review of State Business Taxes* by the State Business Tax Review Committee (the Harvey Review) in Victoria also advocated eventually moving away from the use of payroll taxes, but regarded this form of revenue raising as relatively efficient in the short- to medium term:

> The [Harvey Review] Committee sees payroll tax as an efficient form of taxation. However, for a number of reasons, the State is forced to rely too heavily on payroll tax as a source of revenue. Access by the State to the revenue from the GST will eventually rectify this problem — but only over the longer term. In the short to medium term, payroll tax will remain one of the principal revenue sources for the State.[77]

In New South Wales, the IPART Review of state taxation found that:

> Payroll tax is one of the most efficient of the State taxes in its current form, and there is significant scope to improve its efficiency and equity by reducing the tax-free threshold and the number of exemptions. It also performs well against the robustness, simplicity and transparency criteria.[78]

In contrast to the Henry Review, the IPART Review was directed toward ensuring that tax reform for NSW ensured that the state retained a solid revenue base over which it had control. For this reason, it recommended the retention of payroll tax, as one of the most efficient taxes *available to state governments*. The IPART Review nevertheless noted that the efficiency of payroll tax could be substantially improved by reducing or removing threshold exemptions.[79]

The Committee notes these concerns, and also acknowledges actions by the Victorian Government to reduce the rate of payroll tax, as recommended by the Harvey Review. The Committee also notes that payroll tax forms an important revenue stream for the Victorian Government, and is also relatively more efficient than some other major taxes employed in the state, such as the land transfer duty (below). Consequently, the Committee regards the current structure for payroll tax as adequate, although in the longer term the Committee commends actions to reduce the burden of payroll taxes on business.

3.1.3 Gambling taxes

Gambling taxes provide a substantial revenue stream for the Victorian Government, estimated at ten per cent of state taxation revenue or $1,722.7 million in the 2010-11 Victorian Budget, from $1,648.6 million in

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[76] Australia's Future Tax System Review Panel, *Australia's future tax system: Part one overview*, Commonwealth Treasury, Canberra, 2010, p. 20.

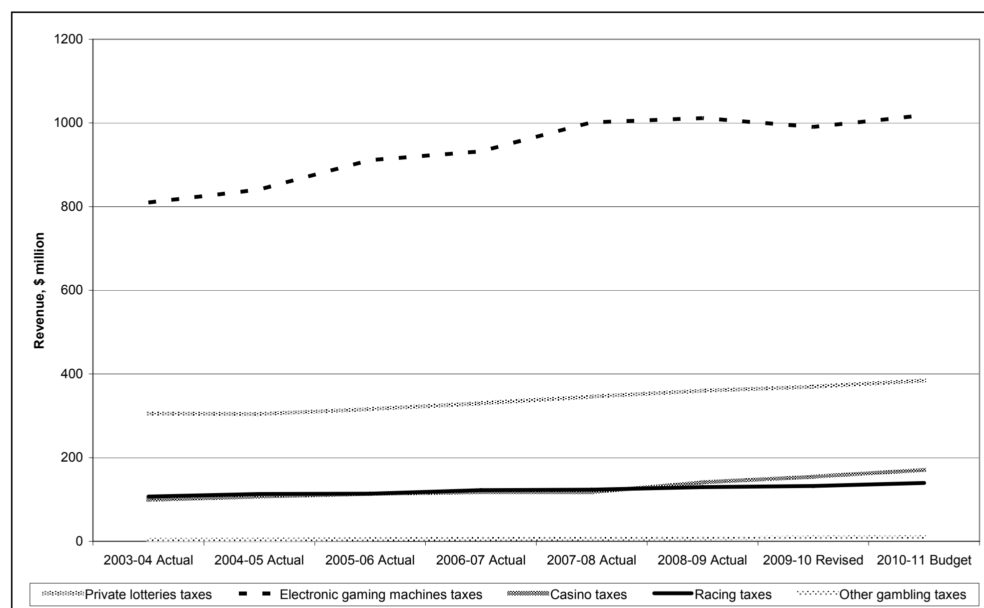
[77] State Business Tax Review Committee, *Review of state business taxes*, Department of Treasury and Finance, Melbourne, 2001, p. 68.

[78] Independent Pricing and Regulatory Tribunal, *Review of state taxation*, Independent Pricing and Regulatory Tribunal, Sydney, 2008, p. 57.

[79] Independent Pricing and Regulatory Tribunal, *Review of state taxation*, Independent Pricing and Regulatory Tribunal, Sydney, 2008.

2008-09.[80] Most revenue comes from electronic gaming machine taxes, although this revenue has been relatively stable since 2007-08.

Figure 10: Gambling taxes revenue, Victoria, 2003-04 to 2010-11.[81]



Gambling activities in Victoria are largely governed by the *Gambling Regulation Act 2003 (Vic)* which defines minimum returns to players from various gambling activities, types and rates of taxes applying to gambling licensee activities (such as supervision charges, and taxes determined in reference to player loss). For some gambling activities, an hypothecated amount is paid out of the Consolidated Fund for specific purposes – a quantum equivalent to the public lottery tax in Victoria, for example, is paid to the Hospitals and Charities Fund, and the Mental Health Fund.

Some aspects of gambling taxes may be appropriate because taxes provide a means for the government to extract economic rent from excess profits generated through government restrictions on the gambling industry. In its submission to the Inquiry, the ICA noted comments in the Australian Treasury background paper for the Henry Review regarding the extraction of economic rents by means of gambling taxation:

> Unlike most other activities, the States restrict the supply of gambling providers in an attempt to reduce social problems associated with some gambling. These restrictions generate “rents” to gambling operators, as they are able to earn higher profits without the fear of competitors entering the market. As a tax on rents, gambling taxes have the potential to be efficient and redistribute above normal returns to the community at large.[82]

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[80] Government of Victoria, *Annual Financial Report 2007-08*, Department of Treasury and Finance, Melbourne, 2008; Government of Victoria, *Victorian State Budget 2010-11*, Department of Treasury and Finance, Melbourne, 2010.
[81] Sources: see footnote 45.
[82] Australian Treasury, quoted in Insurance Council of Australia, *Submission*, no. 38, 16 October 2009, p. 5.

The use of gambling taxation for state revenue raising is partly problematic due to the incidence of problem gamblers, for whom price increases (such as through the application of taxes) do not affect consumption decisions. In many cases, the effect of taxes on returns tends also to lack transparency to consumers, due also in part to the fact that returns from gambling to the consumer are typically all-or-nothing, and because people generally have a biased perspective of risk in such situations. The Committee also notes views in some sectors of the community suggesting that a high portion of gambling revenue is obtained from people addicted to gambling. They argue there is a risk that if gambling taxation forms a substantial proportion of government revenue, there may be insufficient incentives for the state to introduce measures to reduce problem gambling. Alternatively, taxation on gambling may also be regarded as an appropriate means to introduce a price signal to discourage sustained or increased gambling by the public. These are complex topics that require dedicated research and enquiry, and so the Committee does not propose to recommend specific actions for government regarding gambling taxation in this report. The Committee did not receive evidence suggesting that government policy sustains or encourages problem gambling.

3.1.4 Levies on statutory corporations

This category of taxation refers to the environmental contribution tax paid by water supply authorities under the *Water Industry Act 1994 (Vic)*. Under the Act, environmental contributions by water authorities are five per cent of revenue in respect of Regional Urban Water Authorities, and two per cent in respect of Rural Water Authorities.[83] In the 2010-11 Budget, revenue from these taxes was estimated at $73.7 million.

3.1.5 Taxes on insurance

Taxes on insurance comprise a significant proportion of state tax revenue, accounting for ten per cent ($1.478 billion) of all state tax revenue in the 2010-11 budget. In Victoria, under the *Duties Act 2000 (Vic)*, insurance taxes are levied at the rate of ten per cent of all premiums paid on general insurance, which includes any kind of insurance that is applicable to property in Victoria, or a risk, contingency or event concerning an act or omission that, in the normal course of events, may occur within, or partly within, Victoria. Certain types of insurance are exempt from the tax, including medical benefits insurance, certain types of accident compensation or workers compensation insurance, reinsurance, and so on. Life insurance is tax free for insured amounts under $200, is taxed at six per cent for insured amounts below $2000 and above $200, and is taxed at twelve per cent for insured amounts above $2000.

Under Section 77A of the *Country Fire Authority Act 1958 (Vic)* and Section 37 of the *Metropolitan Fire Brigades Act 1958 (Vic),* insurance companies are also required to contribute 75 per cent of the Metropolitan Fire and Emergency Services Board estimated expenditure and 77.5 per cent of the Country Fire Authority (CFA) annual estimated expenditure. This revenue is collected by insurance companies through a cost percentage levied on insurance premiums. In 2009-10, the fire services

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[83] Government of Victoria, *Victorian Government gazette*, Government of Victoria, Melbourne, 10 July 2008.

levy (FSL) accounted for $509.2 million[84] of $1,400.9 million taxes on insurance collected that financial year.

Of all of the taxes administered by the State of Victoria, insurance taxes attracted the most comments in submissions provided to the Committee. In part, this is because of what was referred to as the 'cascading' effect of separate taxes on insurance products – most particularly, in the case of property insurance, which attracts the GST, the Victorian FSL, and the Victorian insurance stamp duty.[85]

Many submissions suggested that the high rate of the FSL in rural and regional Australia led to an 'under insurance' issue, particularly in fire prone areas. Mr Geoff Crick, Farm Business and Regional Development Committee Member of the VFF, told the Committee that:

> …rural businesses pay 84 per cent tax on their insurance to cover fire services. It affects not only farmers but all regional businesses. As a consequence of that a significant sector of the community chooses not to insure, and we saw classic examples of that last summer in the unfortunate fires that we had at that stage…[86]

The REIV informed the Committee that:

> …[r]eports following the Black Saturday bushfires suggest that only 70 per cent of affected households and property owners had adequate levels of insurance.[87]

Most submissions suggested the key problem with the FSL is that the burden of funding fire authorities only falls on those who choose to take out insurance. This means that people who take out insurance are, effectively, paying for a fire service that provides protection for everyone – insured or uninsured.[88] In its submission, the VFF recommended that this situation be rectified by:

> …the State Government…commit(ing) to replacing the Fire Services Levy and conduct an inquiry into developing a new system of funding the fire Authorities based on building asset value and a motor vehicle charge…[89]

The ICA, Insurance Australia Group, CGU, Owners Corporations Victoria, National Community Titles Institute and the Royal Automobile Club of

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[84] Victorian Department of Treasury and Finance, *Fire Services Levy Green Paper*, Victorian Department of Treasury and Finance, Melbourne, 2009.

[85] Australian Unity, *Submission*, no. 30, 12 October 2009; Tom Hanks, Consultant, National Insurance Brokers Association, *Transcript of evidence*, Sydney, 29 October 2009; Insurance Australia Group, *Submission*, no. 5, 28 September 2009; Insurance Council of Australia, *Submission*, no. 38, 16 October 2009; National Insurance Brokers' Association, *Submission*, no. 8, 5 October 2009; Phil O'Sullivan, Senior Policy Adviser, Economics and Taxation Directorate, Insurance Council of Australia, *Transcript of evidence*, Sydney, 29 October 2009; Alex Sanchez, General Manager, Insurance Council of Australia, *Transcript of evidence*, Sydney, 29 October 2009; Nicholas Scofield, General Manager, Corporate Affairs, Allianz Australia, *Transcript of evidence*, Sydney, 29 October 2009; David Wellfare, Senior Advisor, Economics and Policy, Insurance Australia Group, *Transcript of evidence*, Sydney, 29 October 2009.

[86] Geoff Crick, Past Chairman, Farm Business and Management Committee, Victorian Farmers' Federation, *Transcript of evidence*, Melbourne, 30 November 2009, p. 2.

[87] The Real Estate Institute of Victoria, *Submission*, no. 20, 5 October 2009, p. 6.

[88] CGU Insurance, *Submission*, no. 7, 28 September 2009, p. 7.

[89] Victorian Farmers' Federation, *Submission*, no. 18, 2 October 2009, p. 12.

Victoria (RACV) suggested that the FSL be replaced by a property or land tax, as a means to ensure all property-owners were required to contribute to the fire services protection for their properties.[90]

The Committee notes that in 2009, the Victorian Government released the document *Fire services and the non-insured Green Paper* for public comment. The paper refers to data collected by the Insurance Council of Australia and compiled by the Australian Bureau of Statistics suggesting that approximately 13 per cent of residential properties lost in the fires were uninsured. The paper also proposes policy options to address the issue of under-insurance in fire-prone areas.

In July 2010 the final report of the 2009 Victorian Bushfires Royal Commission was released, which considered (among other things) the appropriateness of the current FSL as a means of raising revenue for fire services. The Royal Commission made the following observations in regard of the FSL:

> The current model's claimed benefit is that the insurance premium is a good way of linking the charge for fire services to the fire risk of individual properties. Evidence suggests, however, that this link is at best tenuous. Fundamentally, the Commission considers that the current funding model lacks transparency and is inequitable since people who are not insured or are under-insured do not make a fair contribution to the funding of fire services.
>
> The Commission takes the view that the lack of equity and transparency in the current arrangements constitutes a good reason for moving to another system. Several other Australian states and territories already require all property owners to contribute to fire services via a levy on property, as opposed to insurance, and the Commission proposes that Victoria also move to replace the Fire Services Levy with a property-based levy.[91]

The Committee agrees with this view, and with the views expressed to it in submissions and by witnesses, that a property-based levy provides a more appropriate mechanism for raising revenue for the provision of fire services. The Committee also notes the announcement of the Premier Hon John Brumby MP on 27 August 2010 that, following the Victorian Government's consideration of the 2009 Victorian Bushfires Royal Commission report, the Victorian Government supported in principle the introduction of a property based levy in place of the FSL by 1 July 2012.[92] The Government announced that the following features would apply to the new levy:

- a progressive property-based levy;
- provide the same level of funding as the existing FSL to the CFA and MFESB respectively;

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[90] Royal Automobile Club of Victoria, *Submission*, no. 29, 9 October 2009.&7

[91] 2009 Victorian Bushfires Royal Commission, *Final Report Summary*, 2009 Victorian Bushfires Royal Commission, Melbourne, 2010, p. 19.

[92] Victorian Government, *Government adopts recommendation to replace FSL,* www.premier.vic.gov.au, viewed 28 August 2010.

- collect no more revenue than would be collected under the current model; and

- provide a 50 per cent concession to low income earners.

The Victorian Government announced that it would consult with stakeholders to determine the best model for the new levy, and release a white paper considering various options for implementation in February 2011.

The Committee also notes evidence from the VFF, suggesting that between 15 and 22 per cent of annual callouts for the CFA involve motor vehicle accidents. In response, the VFF suggested that in addition to a property-based levy, it would be appropriate to introduce a small levy on motor vehicles to cover fire services operating expenses.[93]

The Committee agrees with this recommendation in principle, as a means to ensure that people who benefit from fire services callouts to motor vehicle accidents are the ones who pay for that service, provided an increased levy for fire services can be efficiently added to existing motor vehicle levies.

Recommendation 1: That the Victorian Government consider, as part of its review of fire services funding arrangements, introducing a levy on motor vehicles sufficient to fund the proportion of fire services expenditure related to motor vehicle-related incident responses.

3.1.6 Growth Areas Infrastructure Contribution

The Growth Areas Infrastructure Contribution (GAIC) is a flat rate charge per hectare of land which is to be imposed on transferees or owners of specified land in a defined contribution area. The GAIC rates for the 2010-2011 financial year are $80,000 or $95,000 per hectare, depending on when the land in question was brought into the Urban Growth Boundary or Urban Growth Zone. It is triggered in a narrow range of circumstances for certain "GAIC events" and payable only once. Affected land is identified on maps lodged in the Central Plan Office and will have a recording placed on title to indicate that the GAIC may be payable. Once the GAIC is paid this recording on the title is to be removed.

Liability to pay GAIC is activated by the first of any one of the following trigger events (GAIC event) that occurs in respect of land in the contribution area:

- the issue of a statement of compliance for a plan of subdivision;

- the making of an application for a building permit in respect of substantive building works; or

- the occurrence of a dutiable transaction relating to the land, for example a land transfer or a significant acquisition of an interest in the land rich landholder holding land in the contribution area.

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[93] Victorian Farmers' Federation, *Submission*, no. 18, 2 October 2009

Legislation provides a number of "exclusions" for certain types of events that would be otherwise treated as GAIC events. There are also certain circumstances in which GAIC will not be imposed. These include for the sale of land holdings of less than ten hectares, where subdivision of the land does not take place. There is also provision for deferral of a proportion of payments under certain circumstances.

The GAIC is to be used to provide financial assistance for or with respect to capital works for wholly or partly state funded infrastructure including public transport infrastructure, community infrastructure, environmental infrastructure, and economic infrastructure. Revenue collected from growth areas must be spent in and for the benefit of growth areas.

In August 2009, when the Committee issued its call for submissions for the Inquiry, legislation for the GAIC had not been passed by the Victorian Parliament. Submissions received by the Committee were largely concerned with the effects of the GAIC on farm owners, and other property owners in the specified regions[94] When the legislation received assent on 1 June 2010, significant components of the original Bill had been amended. At this stage insufficient time has passed for the effects of the GAIC on farmers in the defined areas to be assessed. The Committee also notes that an inquiry by the Outer Suburban/Interface Services and Development Committee (OSISDC), *Impact of the State Government's Decision to Change the Urban Growth Boundary*, specifically examined issues surrounding the Urban Growth Boundaries and the GAIC, and that the Government response to this report argued that the OSISDC's recommendations were largely addressed by subsequent amendments to legislation considered by the Parliament's Dispute Resolution Committee.

3.1.7 Motor vehicle taxes

None of the submissions received by the Committee commented on the role and/or appropriateness of motor vehicle taxes by the Victorian Government. In Victoria, a transfer duty is applied to motor vehicles based on the greater of sale or market value, and an annual registration fees is also applied to vehicles. In the 2010-11 Victorian Budget, revenues from transfer duties were estimated at $561.7 million, and revenues from registration fees estimated at $887 million, for a total of $1,448.8 million (including rounding), or approximately ten per cent of total Victorian Government taxation revenue.

Generally, motor vehicle taxes are regarded as broadly efficient, as these taxes link the beneficiaries of vehicle use to infrastructure and other costs to the state associated with motor vehicles. Transfer duties on motor vehicles tend, however, to be subject to fluctuation, due to external effects on demand which governments are not always able to easily anticipate. For this reason, and similarly to land transfer duties, commentaries on taxation such as the Henry Review and the IPART review of New South

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[94] Neil Gaghan and Rachael Gaghan, *Submission*, no. 33, 12 October 2009; Chris Janson, *Submission*, no. 28, 2 October 2009; Zoyee Kartalis and Teresa Kartalis, *Submission*, no. 25, 2 October 2009; Emmanuelle Pannuzzo and Lorenza Pannuzzo, *Submission*, no. 31, 13 October 2009; Property Council of Australia, *Submission*, no. 43, 25 November 2009; Victorian Farmers' Federation, *Submission*, no. 18, 2 October 2009; Xuereb and Galea Family, *Submission*, no. 24, 27 September 2009.

Wales taxes have recommended moving away from transfer duties toward broad-based taxes. The IPART review, for example, recommended that for NSW:

> In the medium term, motor vehicle registration duty for all vehicles and the weight tax for non-commercial vehicles should be replaced with a revenue-neutral annual motor vehicle charge.

3.1.8 Congestion levy

The *Congestion Levy Act 2005 (Vic)* was introduced to impose a levy on long stay parking spaces in the central business district and inner Melbourne to reduce traffic congestion. In the 2010-11 Victorian Budget, the congestion levy was estimated to raise $45.8 million, and so comprised a minor proportion of overall state taxation revenue. All public and private parking spaces within an area around central Melbourne city are covered by the congestion levy, with exemptions available for certain parking spaces, including those used exclusively by a resident to park their car while they are at home. In 2010 the base rate for each leviable parking space was $860 per annum.

In May 2010 the Department of Treasury and Finance completed a review of the congestion levy. The purpose of the review was to examine the effectiveness of the congestion levy in reducing congestion in Melbourne's inner-city area and its associated negative impacts, by reference to changes in parking supply and demand, traffic trends, public transport patronage, air pollution emissions, and other relevant factors.

The review found that the congestion levy had achieved its purpose, by contributing to reduced congestion in the central city area, and encouraging increased use of public transportation. The review also examined outcomes from a 2007 review of administrative arrangements for the levy, reporting that recommendations for decreasing the administrative burden of the levy, and for making it easier to understand and comply with, had all been implemented.[95]

3.1.9 Other duties

Duties are also applied to the sale of cattle, sheep and goats, and swine in Victoria. Rates for these duties are provided in Table 8, Table 9, and Table 10. The Committee did not receive any evidence, either from submissions or during public hearings, suggesting that changes to these duties were necessary.

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[95] Victorian Department of Treasury and Finance, *Review of the effectiveness of the congestion levy*, Victorian Department of Treasury and Finance, Melbourne, 2010, p. 3.

Table 8: Duty on sale of cattle, Victoria, 2010.[96]

Sales of live cattle are dutiable at the rate of $0.05 for every $20 or part of the total purchase money (excluding GST) for cattle sold in one lot, provided that duty for any one head of cattle does not exceed $5.00.
Sales of calves are dutiable at a flat rate of $0.15 each.
Carcases up to and including 250kg attract a flat rate of $0.90 each.
Carcases greater than 250kg are dutiable at a flat rate of $1.30 each.

Table 9: Duty on sale of sheep and goats, Victoria, 2010.[97]

Sales of live sheep and goats, and sheep and goat carcasses, are dutiable at a flat rate of $0.12 each.

Table 10: Duty on sale of swine, Victoria, 2010.[98]

Duty is payable on the sale of any swine at the rate of two cents ($0.02) for every $5.00 or part of $5.00 of the amount of the purchase money for one swine sold singly, or the total amount of the purchase money of swine sold in one lot.
The maximum amount of duty in respect of the sale of any one pig (whether sold singly or as part of a lot) is 16 cents ($0.16).

3.1.10 Cascading taxes

As noted above, the Committee received evidence from some witnesses about what they regarded as the disadvantages of taxes that were calculated, at least partly, on the value of other taxes.[99] This includes, for example, current arrangements for calculating taxation on insurance in Victoria, where the FSL is applied to insurance premiums, the GST is calculated on the premium plus the FSL, and the insurance stamp duty is consequently calculated with reference to the premium, FSL and GST. Mr John Hanks, Consultant, of the National Insurance Brokers Association told the Committee:

> There are three taxes and charges that apply to insurance policies taken out by Victorian residents and businesses, namely the fire services levy, GST — as you know, levied by the Commonwealth government which

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[96] State Revenue Office of Victoria, 'Duties Rates', viewed 19 August 2010, <www.sro.vic.gov.au>.

[97] State Revenue Office of Victoria, 'Duties Rates', viewed 19 August 2010, <www.sro.vic.gov.au>.

[98] State Revenue Office of Victoria, 'Duties Rates', viewed 19 August 2010, <www.sro.vic.gov.au>.

[99] Australian Unity, *Submission*, no. 30, 12 October 2009; Tom Hanks, Consultant, National Insurance Brokers Association, *Transcript of evidence*, Sydney, 29 October 2009; Insurance Australia Group, *Submission*, no. 5, 28 September 2009; Insurance Council of Australia, *Submission*, no. 38, 16 October 2009; National Insurance Brokers' Association, *Submission*, no. 8, 5 October 2009; Phil O'Sullivan, Senior Policy Adviser, Economics and Taxation Directorate, Insurance Council of Australia, *Transcript of evidence*, Sydney, 29 October 2009; Alex Sanchez, General Manager, Insurance Council of Australia, *Transcript of evidence*, Sydney, 29 October 2009; Nicholas Scofield, General Manager, Corporate Affairs, Allianz Australia, *Transcript of evidence*, Sydney, 29 October 2009; David Wellfare, Senior Advisor, Economics and Policy, Insurance Australia Group, *Transcript of evidence*, Sydney, 29 October 2009.

> distributes the funds to the states — and stamp duty, which is levied by the Victorian government. These three taxes and charges are cascading — that is, one tax is applied to another. There are, in fact, taxes on taxes on taxes.[100]

The Committee notes that other Victorian taxes and duties – such as the land transfer duty – also apply to the value of the good or service plus GST, under certain circumstances. While the Committee does not regard the imposition of taxes upon taxes as a critical issue, it does note that the observation of 'cascading' taxes may create a negative impression on tax payers, who may object in principle to paying government charges on government charges. Furthermore, because some key state taxes are applied, at least in part, to the GST, it is possible that changes in Commonwealth tax policy – through, for example, offering exemptions to certain services, goods, or classes of tax payer – will have repercussions for Victorian tax revenue. In the Committee's view, the Victorian Government should ideally retain as much direct control over its own tax revenues as possible.

The Committee recognises that, in practice, the existence of cascading taxes may have little more than a minor effect on tax revenue, or on Victorian tax revenue sustainability. Nevertheless, in principle, the Committee is of the view that the use of cascading taxes should be minimised where possible.

Recommendation 2: That, where possible, the use of cascading taxes by the Victorian Government be minimised.

3.1.11 Tax exemptions, concessions and transfers

A number of mechanisms are employed by governments to provide relief from taxation for specified groups. These may include measures such as tax exemptions, tax deductions, tax offsets, concessional rates of tax, or deferral of a tax liability. In Victoria, some form of exemption, concession or transfer is applied to all of the major categories of taxation except insurance.

In some cases, provision for exemptions, concessions and/or transfers are able to obtain specific policy objectives, however, in many cases it is difficult to anticipate who will bear the incidence of an exemption, concession or transfer. There is debate, for example, about the extent to which First Home Owners grants provide financial benefit to first home purchasers, or increase the general market price for housing.

Apart from exemptions and concessions on state taxes, the state government also provides a range of direct concessions. These include, for example, concessions on utilities, working with children checks, and duty exemptions for pensioners. An overview of these direct concessions, by category, are provided in Table 11.

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[100] Tom Hanks, Consultant, National Insurance Brokers Association, *Transcript of evidence*, Sydney, 29 October 2009, p.2.

Table 11: Estimated direct concessions by category, Victoria, 2008-09.[101]

Concession category	2008-09 estimate ($ million)
Energy, municipal rates, water and sewerage	309
Education	200
Health	506
Hardship assistance	22
Transport	258
Total	1.294

[101] Public Accounts and Estimates Committee, *Report on the 2008-09 Financial and Performance Outcomes*, Parliament of Victoria, 2010, p. 104.

Chapter
4

Chapter Four: Adjusting Victoria's taxes for the 21st century

The Terms of Reference for the Inquiry required the Committee to report on the impact and effectiveness of increased state government taxation on Victorian development, competitiveness, sustainability, employment, job creation, and small businesses. Under the Terms of Reference, state government taxation included (but was not restricted to) land tax, payroll tax, stamp duties, and state government charges and taxes and development levies.

Analysis of these issues is complex, in part because a most of the recommended changes to state taxation raised in submissions and by witnesses suggested actions that simultaneously reduced one tax while increasing another (for example, abolition of the Fire Services Levy and replacing it with a broad-based land tax). Furthermore, other submissions and witnesses, and external reviews such as the Henry Review and the IPART Review in New South Wales, suggested measures that were revenue neutral, or that decreased the tax rate while increasing the number of people or businesses it would apply to (for example, reducing the payroll tax rate and the threshold at which businesses become liable for it). Other recent taxation and levy changes, such as the Growth Areas Infrastructure Contribution (GAIC) are designed to transfer the cost of infrastructure development from the general public (such as Victorian tax payers or rate payers) to the people who benefit from the infrastructure (i.e. people or businesses who develop new residential properties in designated growth areas). Arguably, none of the measures considered by witnesses and in submissions in this context recommended that the overall quantum of state government taxes be increased, but rather that the distribution of tax burden be altered.

Of course, in real terms, the quantum of state government taxation revenue has increased throughout the last decade, with the exception of a slight fall between 2007-08 and 2008-09, due to the effects of the global financial crisis. In interpreting the Terms of Reference, however, the Committee has taken the view that the intention was not for the Committee to examine gross increases in revenue, which are affected by multiple factors outside government control, such as inflation, balance of trade, exchange rates, market and business confidence, and personal and business income and trade.

Furthermore, although the Terms of Reference require the Committee to examine the effects of *increased* state government taxation, the Committee notes that most of the major movements in state government taxation in

recent years have been towards reduced rates of taxation. As discussed in previous chapters, this includes reductions in payroll tax, land tax, land transfer duty, and motor vehicle duty. Furthermore, as part of the Intergovernmental Agreement for the Goods and Services Tax (GST), that *increased* commonwealth taxes, the Victorian Government has abolished the debits tax on cheque accounts, and duties on financial institutions, quoted marketable securities, non-residential leases, non-quoted marketable securities, mortgages, rental business, and hire purchase. Decisions in the High Court have also removed some state taxes, such as franchise fees on tobacco, alcohol and petroleum businesses.

In this context, the Committee has instead elected to consider which state government taxes can be most effectively used to raise revenue, with least burden on the tax payer. In considering these issues, the key principles of taxation discussed in Chapter Two are useful.

4.1 Future pressures on tax revenue.

While the trend over the past decade in Victoria has been toward decreasing rates of state taxation with increasing revenue, in the long term taxation revenue growth will likely be more restrained, while pressures will develop for increased government spending. For this reason, although there is no substantial immediate pressure for improving tax system efficiency and sustainability, there would nevertheless be substantial benefit to the state government from undertaking actions to improve taxation efficiency, equity, simplicity, and sustainability.

In its comprehensive analysis of Australian taxation, the Henry Review panel was concerned to contextualise the need for changes to the taxation system in terms of expected economic, demographic and environmental changes over the next decades. Notwithstanding current debates surrounding immigration policy, in 2010 the Australian Treasury estimated that the population of Australia would be 35.9 million by 2050, and that the proportion of older Australians would increase substantially over that time – Australians 65 years and older will likely comprise 22 per cent of the population, from 13 per cent today, and the proportion of Australians aged 85 years and older would treble to five per cent.[102]

In this context, the *Intergenerational Report 2010* noted that work participation rates would decline over the next four decades, and that the old age dependency ratio would increase from 5.0 people of working age for each person aged 65 and over, to just 2.7 people of working age for each person aged 65 and over.

These demographic changes are expected to lead to substantially increased government expenditure on aged care and aged health costs, although technology advances are also expected to increase health irrespective of changes in aged demography. Due in part to reduced workforce participation rates, economic growth until 2050 is expected to slow to 1.5 per cent of gross domestic product (GDP) from 1.9 per cent of GDP over the past 40 years. As a consequence of these and other

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[102] Australian Treasury, *Intergenerational Report 2010*, Australian Treasury, Canberra, 2010, p. viii.

changes, given current arrangements for Australian taxation, government spending is expected to exceed revenue by 2.75 per cent of GDP by 2050:

> Ageing and health pressures are projected to result in an increase in total government spending from 22.4 per cent of GDP in 2015–16 to 27.1 per cent of GDP by 2049–50. As a consequence, spending is projected to exceed revenue by 2¾ per cent of GDP in 40 years time.[103]

Due to these fiscal pressures, the Commonwealth Government has undertaken to exercise "fiscal restraint" on expenditure in order to maintain a preferred tax-to-GDP ratio of 23.6 per cent or less (equivalent to the 2007-08 tax-to-GDP ratio) until 2050.[104] This is expected to result in a permanent structural improvement in spending of around 1 per cent of GDP. Nevertheless, by 2050 some structural adjustment will be required because, as noted above, government spending is expected to be 27.1 per cent of GDP versus tax revenue of 23.6 per cent of GDP.

The response of the Commonwealth Government to this circumstance through the *2010 Intergenerational Report* is to undertake measures to:

- improve labour force participation rates;
- manage population growth;
- manage spending pressures of the ageing population;
- undertake early action on climate change;
- improve human and social capital.

The Commonwealth Government undertook to achieve these goals through a range of measures, including: improving education, and vocational and tertiary education; undertaking national infrastructure programs; introducing energy, transport and water reforms; working toward inter-jurisdictional harmonisation; and supporting innovation.

In this context, the Henry Review made the following observations:

> If these projections prove correct, government budgets will need to change. One option would be to reduce other areas of government spending. Another would be to increase revenue. The latter would present particular problems for the States, whose existing taxes are relatively inefficient and have limited revenue-raising capacity. It would therefore be prudent to design a tax system now that would be capable of delivering higher tax revenues efficiently in future decades, should that prove necessary. Increasing the revenue-raising capacity of the tax system would require a greater emphasis on broad-based taxes.[105]

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103 Australian Treasury, *Intergenerational Report 2010*, Australian Treasury, Canberra, 2010, p. x.
104 Australian Treasury, *Intergenerational Report 2010*, Australian Treasury, Canberra, 2010, p. xi.
105 Australia's Future Tax System Review Panel, *Australia's future tax system: Part one overview*, Commonwealth Treasury, Canberra, 2010, p. 5.

As noted by the Henry Review, and in the *2010 Intergenerational Report*, over the long term government spending will most likely need to increase substantially – according to the Henry Review, by 2050 the finances required to fund projected increases in government spending would be equivalent to the entire revenue raised by the GST. For this reason, the Henry Review recommended development of a more efficient, broad-based taxation system, concentrated on the following four robust and efficient tax bases:

- personal income;
- business income;
- private consumption; and
- economic rents from natural resources and land.

The Henry Review also suggested the maintenance of other taxes could also be warranted, where they efficiently addressed social or economic costs associated with use or consumption, including costs associated with tobacco and alcohol consumption, gambling, environmental costs, and road user taxes or charges.[106]

As noted in previous chapters, a significant issue for the states and territories in this regard is that taxes available to them tend to be narrow, and relatively inefficient. Consequently, according to the Henry Review, "increasing the rates of existing state taxes would not be an efficient or sustainable way of funding services in the future."[107] Over the long term, if a program of overall Australian taxation efficiency is to be pursued, the commonwealth – states tax transfer arrangements will likely have to be expanded, and/or the states will have to consider moving toward greater use of broad-based land-taxes to raise revenue. Either course of action will require significant consideration of implementation issues and the repercussions of changing the tax base – in the case of increased tax transfers to states from the commonwealth, due to the effect on state sovereignty from decoupling the power to raise revenue from expenditure responsibilities; and in the case of reconfigured state taxes, from the significant revenue, economic, bureaucratic and cultural challenges involved in substantially changing the tax system.

4.2 Long term re-weighting of the Victorian tax system

In considering potential changes to the arrangement of the Victorian state taxation system, the Committee is cognisant that many of the issues raised in the context of the Henry Review are yet be carefully considered in a national context, such as through the Council of Australian Governments (COAG) or another intergovernmental forum. These discussions, when or if they occur, will likely substantially affect the complexion of the overall Australian taxation system.

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[106] Australia's Future Tax System Review Panel, *Australia's future tax system: Part one overview*, Commonwealth Treasury, Canberra, 2010, p. xviii.
[107] Australia's Future Tax System Review Panel, *Australia's future tax system: Part one overview*, Commonwealth Treasury, Canberra, 2010, p. 70.

Given the complex range of issues that must be considered in examining the interrelationship between state and federal tax systems, and given that substantial discussions on future directions in state and federal taxation are likely to occur during the term of the 57th Victorian Parliament, the Committee recommends that a parliamentary committee be provided with a reference to consider these issues in depth during the next Parliament.

Recommendation 3: That the Victorian Government consider providing a reference to a Parliamentary Committee in the 57th Parliament examining the interrelationship between federal and state taxation, in the context of the proposed 2011 tax summit and other recent taxation reforms, including those arising from the Australia's Future Tax System Review.

In the following discussion the Committee does not address all of the individual taxes employed in Victoria, but provides a view on the overall direction for future development of the taxation system in order to address anticipated challenges to taxation revenue during coming decades.

4.2.1 Land transfer duty and land tax

4.2.1.1 Land transfer duty

While land transfer duties provide substantial revenue to the Victorian and other State governments, this form of taxation also has a number of disadvantages, which have been discussed in previous chapters. These include that, because duties are dependent on sale of property, they tend to be quite volatile, and fluctuate from year to year. However, from a taxation perspective, the most substantial disadvantage of land transfer duty is that it potentially dissuades people and businesses from relocating, even when it would be in their interests to do so. This may means that people and businesses are potentially living or operating out of premises that do not suit their needs, or are distant from work or markets. From an equity perspective, while a land transfer duty is nominally a duty on property, it is in effect a duty on movement for land owners. Consequently, the main burden of the tax is on people who voluntarily, or involuntarily, move premises. This may include, for example, older people who need to shift into smaller properties, or people undergoing a divorce, for example. In these circumstances, land transfer duty may add to the costs of people who are not ideally suited to pay. On the other hand, people who do not move will not contribute at all to that portion of state revenue.

4.2.1.2 Land tax

During its overseas investigations, the Committee was told by Dr Asa Johansson, Senior Economist, Structural Policy Analysis Division, Economics Directorate of the Organisation for Economic Cooperation and Development (OECD) that land and property taxes were among the most efficient taxes available to all governments.[108] In particular, Dr Johansson told the Committee that the most efficient and growth-promoting tax

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[108] Dr Asa Johansson, Senior Economist, Structural Policy Analysis Division, Economics Directorate, OECD, *Meeting*, Paris, 12 February 2010.

strategy is a revenue-neutral shift away from income and transfer taxes towards consumption and property taxes.[109]

In its analysis of Australian taxation, the Henry Review found that land tax was potentially among the most efficient taxes available to governments. In the Henry Review's essentially economic-analysis of the effect of taxation, because land has a fixed supply and is immobile, existing owners of land bear the burden of any new or increased land tax as a reduction in land values.[110] While most of the Henry Review's argument in support of land tax was based on economic theory, the review panel also referred to empirical research by Dr Johansson suggesting a one per cent switch to land or property tax (but not to taxes on transactions) away from income tax would improve long-run GDP per capita by 2.5 per cent.[111]

The 2001 Harvey Review of Victorian state taxation argued in favour of a greater role for land tax in state tax revenue, recommending that a flat land tax rate be applied to all business properties, with no value threshold, and based on unimproved land value.[112] The Harvey Review suggested that this tax could be used to offset business stamp duties and the metropolitan improvement levy.

In its review of the advantages and disadvantages of land tax, the Henry Review argued that the efficiencies of land tax in enhancing economic growth would be best realised only if the value of the land, rather than any capital improvements on it, were taxed; and if few or no exemptions were available from land tax. The former condition, according to the Review, is required in order to ensure that the tax did not act as a disincentive for capital improvement, and the latter condition, in order not to bias land use to non-taxable activities.

However, while a land-value only, no exemption land tax is desirable from a taxation-efficiency perspective, the application of such a tax would involve some equity and transitional issues. In regard of equity, the primary issue concerns the ability of low-income land holders to pay the land tax. In these cases, a policy response may be to allow land tax payments to be deferred until sale of the property. The main transitional cost would be to land owners at the point of introduction of land tax rates – as land values could be expected to fall as the value of land is repriced by purchasers to align with returns.

While arguments in favour of the relative efficiency of an increased role for land tax are strong from the perspective of the state, the immediate benefits of increased tax efficiency to the general public may not be easily recognised by them, particularly at the point where land taxes are introduced and/or increased. Even a revenue-neutral move toward land tax

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[109] Dr Asa Johansson, Senior Economist, Structural Policy Analysis Division, Economics Directorate, OECD, *Meeting*, Paris, 12 February 2010.
[110] Australia's Future Tax System Review Panel, *Australia's future tax system: Part two volume one*, Australian Treasury, Canberra, 2010, p. 248.
[111] Australia's Future Tax System Review Panel, *Australia's future tax system: Part two volume one*, Australian Treasury, Canberra, 2010, p. 248.
[112] State Business Tax Review Committee, *Review of state business taxes*, Department of Treasury and Finance, Melbourne, 2001, p. 60.

may result a redistribution of tax burden, so that some people pay more tax than they were previously.

The Committee recognises that in practice, increasing the base of land tax would need to be conducted in a staged approach, which clearly demonstrated the benefits from increased taxes on tax from tax efficiencies, and from the reduction of other state taxes. In his appearance before the Committee, Professor John Warren of the Australian School of Taxation pointed out that just because a particular tax is efficient it does not mean it will be accepted by the community:

> We have got about 2.7 to 2.8 million property holders, if you like — units of property in New South Wales. With the current land tax about 520 000 are subject to land tax. When they dropped the threshold it jumped to about 1.2 million. When people talk about broadening the base of the land tax, which is going to be floated, they are talking about a lot of people who are not currently paying tax. You can see the sensitivity of it in what happened in New South Wales when you doubled that number. That is the territory you have to go into if you are going to talk about conveyancing duty and your concerns about its impact on holdings in property and the immobility of individuals as a result of those stamp duties…[113]

One of the main challenges for the state government will be convincing the public of the desirability of replacing a large, occasional tax that is to some extent 'hidden' in the significant expenditure required to purchase a house (the land transfer duty), with a smaller but regular tax that affects people who do not move properties often, as well as those who do (land tax).

Nevertheless, the Committee recognises that of all of the taxes available to state governments, land taxes are likely to be the most sustainable and efficient. For this reason, the Committee recommends that the Victorian Government review current land tax arrangements, with a view to increasing utilisation of the tax through a revenue neutral transition. An initial issue for consideration could be the potential to replace the Fire Services Levy (FSL) with a broad based land tax, and this proposal may be discussed in the white paper the Victorian Government intends to release in February 2011 in consideration of a new levy to replace the FSL. In the long term, however, it would likely be in Victoria's interests to replace a wider range of taxes with land tax through a revenue-neutral transition process.

Recommendation 4: That the Victorian Government conduct a review of the long term costs and benefits of enhancing the contribution of land tax to State revenue through a revenue-neutral transition process.

4.2.2 Payroll taxes

Taxes on labour income are among the most stable taxes available to governments. Taxes on labour are thought to be relatively efficient, because except in the case of high taxes, the imposition of labour income tax does not usually reduce labour market participation. In its review of payroll tax, the Henry Review argued that over the long term, the burden of

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[113] Prof. Neil Warren, Head of School, Australian School of Taxation, University of New South Wales, *Transcript of evidence*, Sydney, 29 October 2009.

a labour income tax will tend to fall on workers through reduced wages, although over the short term changes to tax rates will tend to affect employers.[114] This position was also supported by the IPART Review of NSW Taxes:

> …although employers are liable for payroll tax, in practice, they are able to pass its cost on either to consumers (through higher prices) or to employees (through lower wages). In this case, the economic effect of a broadly based payroll tax is similar to a broad consumption tax or a flat-rate income tax respectively. Therefore, the commonly held view that 'payroll tax is a tax on employment' is not supported by the evidence.[115]

As noted in Chapters Two and Three, all of the Australian states and territories currently employ payroll taxes, and all provide exemptions from the tax in certain circumstances – such as for payrolls below a threshold, or for certain kinds of businesses or activities. This has the effect of reducing the efficiency of the tax, by increasing the complexity of tax administration, and by changing patterns of distribution within the labour market.

As noted in Chapter Three, the recommendation of the Henry Review was that state payroll taxes be replaced by more broad-based taxes that capture the value-add of labour – including measures such as cash-flow taxes, that tax the difference between cash flows into a business (income) and cash flows out of a business (purchases, but including wages). However, while such tax measures are efficient, they would also likely fall under commonwealth powers, rather than the states.

Consequently, along with land tax, payroll tax is potentially among the most efficient taxes available to state governments. In its examination of state taxes, the IPART Review made a number of recommendations to increase the contribution of payroll taxes to state revenue, including by removing exemptions for municipal authorities, decreasing the threshold, and seeking to decrease the rate in line with neighbouring jurisdictions.[116] The IPART Review recommended that increased revenues from changes to payroll tax be used to abolish more inefficient taxes, such as stamp duties on insurance and fire service levies.[117]

The Committee also believes that over the long term, options for improving the efficiency of payroll tax, and its role in Victorian revenue raising, should be examined. While significant changes over the short-to-medium term are unlikely to be welcomed by businesses in Victoria, given the likely points of pressure in the future capacity of the state to raise revenue, the Committee believes that a long-term analysis of the costs and benefits from enhancing the role of payroll tax in Victoria would be of considerable merit.

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[114] Australia's Future Tax System Review Panel, *Australia's future tax system: Part two volume one*, Australian Treasury, Canberra, 2010, p. 297.
[115] Independent Pricing and Regulatory Tribunal, *Review of state taxation*, Independent Pricing and Regulatory Tribunal, Sydney, 2008.
[116] Independent Pricing and Regulatory Tribunal, *Review of state taxation*, Independent Pricing and Regulatory Tribunal, Sydney, 2008.
[117] Independent Pricing and Regulatory Tribunal, *Review of state taxation*, Independent Pricing and Regulatory Tribunal, Sydney, 2008.

> Recommendation 5: That the Victorian Government conduct a review of the long term costs and benefits of enhancing the contribution of payroll tax to State revenue through a revenue-neutral transition process.

4.2.3 Taxes on insurance

In Chapter Three, the Committee discussed the effect of the FSL on insurance practices, and discussed the FSL's worth as a measure to raise revenue for services used by the general public, noting the Victorian Government's announcement that the FSL would be replaced with a new property-based levy.

As noted in Chapter Three, the stamp duty on insurance also attracted considerable attention from submissions and witnesses to the Committee. All of the evidence received by the Committee recommended abolishing the insurance stamp duty, as well as the FSL. The principal argument for abolishing the stamp duty was that, because the stamp duty did not apply to all goods and services, it raised the relative cost of insurance to consumers, and therefore altered their decisions about whether to obtain insurance or not. There is, consequently, a risk that taxes on insurance lead to under-insurance, which may incur costs for government, as has been suggested for the Black Saturday Bushfires.[118]

The Committee notes that the Henry Review recommended that stamp duties on insurance be abolished.[119] The IPART Review in NSW also suggested that over time taxes on insurance be abolished, while noting that the importance of these taxes to NSW state government revenue would require that they be retained in the short to medium term.[120]

The Committee believes that opportunities for abolishing stamp duties on insurance should be seriously examined by the Victorian Government. The Committee acknowledges, however that, as in New South Wales, the amount of revenue raised through insurance taxes complicates efforts by Government to reduce or remove this tax. Therefore the Committee recommends that a review of the role of taxes on insurance in Victoria form part of the reviews of land taxes and payroll taxes from Recommendation 4 and Recommendation 5.

> Recommendation 6: That the Victorian Government consider how state taxes on insurance may be minimised or abolished over the long term.

4.3 Equity issues

While the changes to the Victorian taxes suggested above will go some way to securing tax revenue flows to the state over the long term, the Committee is aware that many of the advantages of these taxes from a fiscal perspective – their stability, simplicity, and tendency not to distort resource allocation decisions – may create tensions with the role of

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118 Victorian Department of Treasury and Finance, *Fire services and the non-insured Green Paper*, Victorian Department of Treasury and Finance, Melbourne, 2009, p. 13.
119 Australia's Future Tax System Review Panel, *Australia's future tax system: Part one overview*, Commonwealth Treasury, Canberra, 2010.
120 Independent Pricing and Regulatory Tribunal, *Review of state taxation*, Independent Pricing and Regulatory Tribunal, Sydney, 2008.

government in the provision of equity to citizens and residents of Victoria.[121] This is because the implementation of efficient taxes – such as those with few exemptions, no thresholds, and flat rates of taxation – will tend to affect people with low incomes more than those with high incomes, because people with low incomes will have less discretion over spending.

Of course, the government has a range of tools at its disposal to facilitate fair treatment of citizens other than through tax concessions, including for example through the provision of services, facilities, or simply by means of cash transfers. The careful introduction of an increased role for efficient taxes should be complemented by policies that ensure the equitable treatment of Victorians.

Over time, it is very likely that the various taxation revenue streams available to the Commonwealth will make a greater contribution to State revenues, through the grants and transfer system. This will occur due to the fact that many of the most efficient taxes are controlled by the commonwealth, including the GST, company, and Pay As You Go (PAYG) taxes. In particular, as the PAYG system is likely to remain as a progressive tax system (that is, with higher incomes taxed at higher rates), there may be potential for Victoria to work closely with the commonwealth to facilitate equitable outcomes through the personal income tax system, rather than through each state and territory individually.

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[121] Dr Asa Johansson, Senior Economist, Structural Policy Analysis Division, Economics Directorate, OECD, *Meeting*, Paris, 12 February 2010.

Chapter
5

Chapter Five:
The role of commonwealth grants

Commonwealth grants comprise around half of Victorian Government income, and so decisions about commonwealth grants can have a substantial effect on the capacity of the state government to undertake its functions. In this Chapter the Committee considers some issues arising from the relationship of the states and territories to the commonwealth, and distribution of funds through specific purpose and general purpose payments.

5.1 The role of horizontal fiscal equalisation in Australia

The commonwealth and the states and territories have all agreed that the principle of horizontal fiscal equalisation (HFE) should be applied to the distribution of Good and Services Tax (GST) revenues to the states and territories. The objective of HFE within the Australian federation is to ensure that all of the jurisdictions within Australia have the same capacity to deliver services to Australian citizens, and that capacity should not be diminished by local factors that are independent of policy decisions. This means, for example, that states and territories with higher numbers of indigenous people, young people, or with dispersed populations (among a range of other factors) receive a larger per-capita share of the GST redistribution in order to offset increased costs associated with providing services and facilities. By contrast, states and territories with more capacity for the provision of services and facilities receive a smaller share of the GST redistribution. The Committee agrees with this principle.

In general, and as discussed below, the inclusion of most forms of commonwealth grants in determining state and territory income for the purpose of determining the redistribution of GST revenues, means that the vast majority of Commonwealth Government grants to the jurisdictions operate according to HFE principles.

The method used in Australia to determine horizontal fiscal equalisation appears to be largely successful in achieving its objective. The Committee was told by Mr Hansjörg Bloechliger, Senior Economist, Structural Policy Analysis Division of the Organisation for Economic Cooperation and Development (OECD) that in comparison to other federal jurisdictions that practice some form of horizontal fiscal equalisation, the Australian model appears to completely level out inequalities between Australian states.[122] This is demonstrated in Table 12, which compares the fiscal capacity of selected federations before and after fiscal equalisation has been carried

[122] Hansjörg Bloechliger, Senior Economist, Structural Policy Analysis Division, Economics Directorate, OECD, *Meeting*, Paris, 12 February 2010.

out. In this regard, the Committee notes that the methodology employed by the Commonwealth Grants Commission (CGC) appears to be doing well in meeting its objective under the Intergovernmental Agreement on Federal Financial Relations (FFR).

Table 12: The effect of fiscal equalisation policies on selected federations.[123]

Country	Before equalisation (%)				After equalisation (%)			
	Variation coefficient	Gini coefficient	Highest capacity	Lowest capacity	Variation coefficient	Gini coefficient	Highest capacity	Lowest capacity
Australia	16.8	5.0	103.8	79.8	0.0	0.0	100.0	100.0
Austria					4.2	2.0	106.9	93.2
Canada	29.8	10.0	177.1	75.0	20.1	7.0	156.9	92.9
Germany	13.0	6.0	116.5	67.2	2.7	2.0	104.5	97.4
Italy	39.0	21.0	146.0	24.0	6.0	10.0	115.0	89.0
Spain	26.5	5.0	142.2	67.2	10.1	4.0	117.4	83.7
Switzerland	31.8	15.0	173.0	46.0	23.2	11.0	159.0	64.0

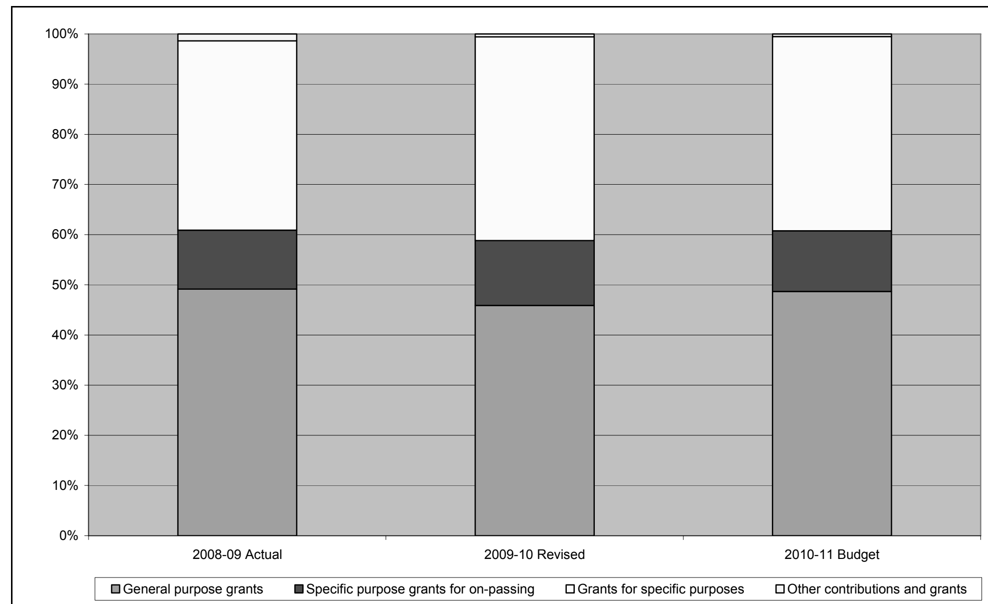
While the Committee heard that Australia's system for horizontal fiscal equalisation was particularly successful, the Committee was also told that the effectiveness of HFE could have costs, including through discouraging, or removing incentives for, improving efficiencies within the jurisdictions. One of the consequences of this could be, for example, that HFE creates disincentives for regional development, as local inefficiencies are compensated through the general purpose payments (GPPs).[124]

5.2 Commonwealth grants and payments

As noted in Chapter Two, grants to the states play a significant role in state revenue. Over the past three financial years, grants from the commonwealth to Victoria accounted for between 48.2 per cent to 50.5 per cent of all state revenue. Of commonwealth grants received by the State of Victoria, around half were in the form of GPPs derived from the GST. Figure 11 shows the sources of grants from the commonwealth to the State of Victoria between 2008-09 and 2010-11.

[123] Hansjörg Bloechliger, Senior Economist, Structural Policy Analysis Division, Economics Directorate, OECD, *Meeting*, Paris, 12 February 2010.
[124] Hansjörg Bloechliger, Senior Economist, Structural Policy Analysis Division, Economics Directorate, OECD, *Meeting*, Paris, 12 February 2010; Prof. Neil Warren, Head of School, Australian School of Taxation, University of New South Wales, *Transcript of evidence*, Sydney, 29 October 2009.

Figure 11: Commonwealth Grants to the State of Victoria, 2008-09 to 2010-11.[125]



There are two main types of payment made by the commonwealth to the states and territories – specific purpose payments and GPPs.

The power of the commonwealth to make specific purpose grants derives from section 96 of the Constitution, which allows the commonwealth to place conditions on payments made to the states:

> **Section 96: Financial assistance to States** - During a period of ten years after the establishment of the Commonwealth and thereafter until the Parliament otherwise provides, the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit.

Under the FFR, the Council of Australian Governments (COAG) agreed that payments from the commonwealth to the states and territories would comprise the following three categories of payments:

- National Specific Purpose Payments (SPPs) in respect of key service delivery sectors;
- National Partnership Payments, of the following types:
    - Project payments;
    - Facilitation payments; and
    - Incentive payments;
- General revenue assistance, comprised of:

[125] Sources: Government of Victoria, *Annual Financial Report 2008-09*, Department of Treasury and Finance, Melbourne, 2009; Government of Victoria, *Victorian State Budget 2010-11*, Department of Treasury and Finance, Melbourne, 2010.

- Goods and Services Tax (GST) payments; and
- Other general revenue assistance.

These types of payments are discussed below.

5.3 Specific purpose payments and partnership payments

The FFR provides a mechanism for the commonwealth to make a number of grants and payments to the states and territories, on agreed terms. The FFR was agreed to by COAG in December 2008 and set out a number of the conditions and principles under which funds could be distributed to the states and territories.

In Victoria between 2008-09 and 2010-11, grants for specific purposes accounted for approximately three-quarters of specific purpose payments, with specific purpose grants for on-passing accounting for the remaining one quarter of payments. Overall, SPPs accounted for approximately one quarter of Victorian state revenue over that period.

5.3.1 National specific purpose payments

Specific purpose payments are provided by the Commonwealth Government to the states and territories in the following service delivery areas:

- healthcare;
- schools;
- skills and workforce development;
- disabilities services; and
- affordable housing.

The condition of these payments is that the funds must be expended in the service sector relevant to the SPP, although the state or territory government retains full budget flexibility to allocate funds within the sector to achieve mutually agreed objectives. Each state and territory treasurer is required to provide a report to the Ministerial Council for Federal Financial Relations prior to the end of each financial year, describing gross expenditure, and SPP expenditure for each of the service delivery areas listed above.

SPP funding for service sectors is determined on aggregate, and distributed to all the states and territories on a per-capita basis. Following a base funding determination in 2009-10, SPP funding to each sector is increased by a service-specific growth factor, determined in reference to specific variables defined for each sector. For example, the growth factor for the healthcare SPP is the product of:

(a) a health specific cost index (the Australian Institute of Health and Welfare health price index);

(b) growth in population estimates weighted for hospital utilisation; and

(c) a technology factor (Productivity Commission derived index of technology growth).[126]

The 2009-10 national SPP base funding, distributed to all states and territories on a per-capita basis, is set out in Table 13 below:

Table 13: National SPP base funding, 2009-10.

National SPP	Commonwealth contribution
Healthcare	$11,244,185,000
Schools	$ 3,286,594,000
Skills and workforce development	$ 1,317,877,000
Disabilities services	$ 903,686,000
Affordable housing	$ 1,202,590,000

5.3.2 National partnership payments

National partnership payments are payments to the states and territories to support the delivery of specified outputs or projects, or are payments to facilitate reforms, or are payments to jurisdictions that deliver nationally significant reforms. The FFR states that certain principles should apply in the development of a partnership payment by the commonwealth, namely that it:

(a) is closely linked to a current or emerging national objective or expenditure priority of the Commonwealth — for example, addressing Indigenous disadvantage and social inclusion;

(b) has 'national public good' characteristics — where the benefits of the involvement extend nationwide;

(c) has 'spill over' benefits that extend beyond the boundaries of a single State or Territory;

(d) has a particularly strong impact on aggregate demand or sensitivity to the economic cycle, consistent with the Commonwealth's macro economic management responsibilities; or

(e) addresses a need for harmonisation of policy between the States and Territories to reduce barriers to the movement of capital and labour.[127]

Currently active national partnerships include programs in preventative health, social housing, indigenous services and economic participation, and smarter schools.

5.4 General purpose payments

With commonwealth grants accounting for up to half of state revenue, and with the GST distribution accounting for half of commonwealth grants, the

[126] Council of Australian Governments, *Intergovernmental Agreement on Federal Financial Relations Schedule D*, Canberra, 2008, pp. D-3.
[127] Council of Australian Governments, *Intergovernmental Agreement on Federal Financial Relations Schedule E*, Canberra, 2008.

Victorian Government has a substantial interest in ensuring that it receives a fair share of GST and other commonwealth revenues.

Under the FFR, two types of GPP may be employed by the commonwealth. Of these, the GST payments are the most substantial, with other general revenue assistance making a small contribution to grants overall. Within the context of this Inquiry, issues surrounding the redistribution of the GST attracted the most attention, with the Victorian Government submission drawing the Committee’s attention to problems it perceived in the way GST was distributed to the states and territories. The Victorian Government submission suggested that Victoria has been disadvantaged because it was the first state to abolish the taxes all states agreed to discontinue under the 1999 Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations (RCSFR), and that the equalisation process does not take this into account.

5.4.1 GST general purpose payments

With the introduction of the GST in 1999, the Commonwealth Government agreed to make payments to the states and territories equivalent to the revenue received from the GST. In exchange, the states and territories agreed to abolish a range of taxes and levies, as described above.

According to the FFR, the GST GPPs are equivalent to the sum of GST collections less commonwealth refunds of GST that has been paid. In contrast to conditions under which SPPs are granted, the distribution of the GST payment to the states and territories is not made on a flat per-capita basis. Instead, the terms and conditions attached to the distribution of moneys obtained from the GST require that “the Commonwealth will distribute GST payments among the States and Territories in accordance with the principle of horizontal fiscal equalisation.”[128]

Horizontal fiscal equalisation describes an approach where grants are distributed in a manner that reflects the differential capacity of different jurisdictions to offer the same level of services, or conduct the same activities. In the *Report on GST Revenue Sharing Relativities — 2010 Review*, the CGC applies the following definition of equalisation:

> State governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.[129]

While the quantum of grants to be distributed in any one year does not change, as it is determined by the quantum of GST revenue, the distribution, or ‘relativities’ between the sates and territories is recalculated by the CGC annually. The CGC undertakes a complex process in order to

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[128] Council of Australian Governments, *Intergovernmental Agreement on Federal Financial Relations Schedule D*, Canberra, 2008, pp. D-6.
[129] Commonwealth Grants Commission, *Report on GST revenue sharing relativities - 2010 review*, Commonwealth Grants Commission, Canberra, 2010, p. 34.

recommend appropriate relativities to the Australian treasurer, the merit of which is typically the subject of much debate by the affected jurisdictions.

5.4.2 Changes to the 2010 distribution of GST revenue

The CGC's 2010 report on revenue relativities recommended a number of changes to the way that horizontal fiscal equalisation should be implemented through the GPP process. One of the more significant of these was the adoption of a three-year period for estimating relativities, rather than a five-year period as was previously the case. This change means that the distribution of GST revenue between the jurisdictions should better reflect current fiscal circumstances in future.

Suggested changes to the 2010 relativities also make greater provision for the impact of, and expenses associated with, high population growth within jurisdictions. The distribution of the GST is now intended to better reflect infrastructure and other costs associated with providing services and amenities to a growing population.

Overall, the effect of these changes has worked to Victoria's advantage, with the per-capita relativities for the state increasing from 0.91875 in 2009-10 to recommended per-capita relativities of 0.93995 in 2010-11.[130] Overall, according to the CGC, changed methodologies and data use for the 2010-11 financial year will result in Victoria receiving 23.3 per cent of GST revenue in 2010-11, compared with 22.8 per cent in 2009-10.[131]

5.4.3 The calculation of per-capita relativities for GST redistribution

In calculating relativities for the distribution of the GST, the CGC undertakes a methodology that is, in its opinion, policy neutral. This is achieved principally through including average tax rates or spending levels above a certain threshold:

> We consider the average policy is not to impose a tax or provide a service, unless a majority of States do so and it affects a majority of the aggregate tax base or relevant population. If that threshold is met, the average policy is based on the average observed effective tax rate or level of spending. If the threshold is not met, any revenue or expenses are treated in a way that does not differentially affect State GST requirements.[132]

In general, the Committee regards changes to the methodology of the CGC in calculating expense relativities to be largely satisfactory. The Committee notes that concerns expressed by Victoria to the CGC, including in regard to the cost of urban infrastructure, population growth, and the application of a three year assessment period, rather than a five year period, have been largely accommodated in the new methodology.

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[130] Commonwealth Grants Commission, *Report on GST revenue sharing relativities - 2010 review*, Commonwealth Grants Commission, Canberra, 2010, p. 19.
[131] Commonwealth Grants Commission, *Report on GST revenue sharing relativities - 2010 review*, Commonwealth Grants Commission, Canberra, 2010, p. 2.
[132] Commonwealth Grants Commission, *Report on GST revenue sharing relativities - 2010 review*, Commonwealth Grants Commission, Canberra, 2010, p. 46.

In the Committee's view, however, there is potential for measures to be introduced in the CGC's calculation of income relativities that could encourage the states to improve their taxation systems. The CGC applies the following methodology to revenue assessments:

> Revenue assessments estimate the per capita revenue each State would raise if it applied the State average tax rates to its tax bases.
>
> - Each State's tax base is measured using the value of transactions in the State that would be taxed under the average tax policy. In doing so, no account is taken of potential tax elasticity effects (the potential change in the level of activity caused by the difference between the tax rate actually imposed by the State and the average rate).
> - The average tax rate is an effective rate measured by dividing the total tax collections in all States by the total revenue base.
>
> In most cases, the revenue base for each State tax is clearly evident from an examination of State tax policies….
>
> Under these processes, a State has a revenue raising advantage (often described as an 'above average revenue raising capacity') if the per capita value of its tax base exceeds the national value. Consequently, applying the average tax rate (that is, making the average tax effort) would yield above average per capita revenue.[133]

The revenue base categories currently measured by the CGC in this context are: payroll tax, land tax, mining revenue, stamp duty on conveyances, insurance tax, motor taxes, and other revenue.[134]

While Chapters Two and Three of this Report have considered, among other things, the relative efficiency of certain taxes, the Committee notes that the calculation of per capita relativities for the redistribution of GST revenues has no mechanism to take the relative efficiency of taxes into account. As noted above, this has been a deliberate decision by the CGC, in order to maintain a methodology that maintains a 'policy neutral' approach, and does not seek to unnecessarily constrain a jurisdiction's autonomy over its GPP.

While the Committee understands the rationale for this approach by the CGC, the Committee also notes that in an environment where different policies have different outcomes, there is no such thing as a 'policy neutral' approach. With the current methodology of the CGC treating all taxation revenue as effectively equivalent, on a per-capita basis, there is no *direct* incentive for the states to refocus their tax bases toward more efficient revenue streams. While there may be downstream revenue gains to individual states from moving toward more efficient taxes, estimating the value of these in the context of the GST redistribution, and with the movement of other revenue variables, is difficult, and likely provides weak incentives for the implementation of change in state taxation policy.

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[133] Commonwealth Grants Commission, *Report on GST revenue sharing relativities - 2010 review*, Commonwealth Grants Commission, Canberra, 2010, pp. 47-48.
[134] Commonwealth Grants Commission, *Report on GST revenue sharing relativities - 2010 review*, Commonwealth Grants Commission, Canberra, 2010, p. 48.

Issues surrounding the conservative effect of the GST redistribution methodology on tax reform were also noted in the IPART review of New South Wales taxation:

> …the fiscal incentives created by the CGC's approach to HFE can influence a State's fiscal policies, and act as a constraint to tax reform. This is because a State's taxes and expenditures can affect the parameters of the CGC's grant formula. Therefore, the States can respond by changing their policies in such a way as to maximise their grant. Alternatively, if they pursue policies that increase their own-source tax revenue base, the CGC's approach means that any benefits these policies create will be eroded by reductions in their General Purpose Grant.[135]

The IPART Review also argued that the weighting of tax revenue based on 'average' state revenue policies for the calculation of per capita relativities had the potential to discourage tax reform, and in particular discourage movement toward more efficient taxes.[136]

The Committee notes that while the Henry Review made a number of recommendations for the commonwealth and the states to move toward a more efficient and sustainable tax base, that report did not consider the conservative effect that existing practices, such as through the GST redistribution grants, may have on restructuring the tax base. In the Committee's view, there is a need for the commonwealth and the states and territories to develop explicit signals to encourage the restructure of state taxes toward a more efficient and sustainable base.

While the Committee accepts that substantial negotiation would be required in order for COAG to agree on how efficiency and sustainability in various taxes should be measured and weighted, the Committee believes that in the current environment, where tax reform is emerging as a high-profile issue, there are opportunities for all of the jurisdictions to introduce mechanisms to encourage, but not require, tax reform.

Recommendation 7: That the Victorian Government request that the Council of Australian Governments consider developing mechanisms to encourage the restructure of State taxes toward a more efficient and sustainable base.

As noted above, the application of the 'average policy' approach by the CGC was also raised as an issue in the Victorian Government's submission to the Inquiry, because taxes that the states agreed to abolish under the RCSFR may not contribute to the assessment of state income for the purpose of determining per capita relativities, but still in fact contribute to the revenue base of states that have not yet abolished those taxes. According to the Victorian Government submission:

> Under the [RCSFR], states were eligible for Budget Balancing Assistance until 2008-09 if their GST distribution from the Commonwealth fell below a Guaranteed Minimum Amount (GMA)…. The calculation of the GMA

[135] Independent Pricing and Regulatory Tribunal, *Review of state taxation*, Independent Pricing and Regulatory Tribunal, Sydney, 2008, pp. 39-40.
[136] Independent Pricing and Regulatory Tribunal, *Review of state taxation*, Independent Pricing and Regulatory Tribunal, Sydney, 2008, p. 40.

> included costs to the states such as the revenue forgone by states from eliminated grants and abolished taxes and additional costs related to the *First Home Owners Grant*. While the GMA should have ensured that states were no worse off under the IGA than if they had not abolished their stipulated taxes, this may have not been the case for Victoria for two key reasons.
>
> - *GMA does not include State taxes forgone until abolished by all States* – Revenue is only considered forgone once all states have abolished that tax. Since Victoria has abolished all taxes stipulated in the [RCSFR] and several other states have repeatedly deferred abolition of these taxes, Victoria has been penalised for leading the federation on state tax reform.[137]

According to the Victorian Government, the failure of states within the federation to abolish taxes under the RCSFR has resulted in diminished net revenue to the state of Victoria. According to the Victorian Government, "had Victoria delayed tax reform by following the New South Wales timetable, it is estimated that Victoria would have received around $1.4 billion extra revenue over the last nine years and around $400 million over the next three years".[138]

The Committee believes that the threshold for the aggregation of some taxes by the CGC could be lowered in specific cases – such as for taxes that the states agreed to abolish under the RCSFR, but which some states continue to levy – in order to further encourage the abolishment of certain taxes.

While the Committee acknowledges that this approach will likely introduce a level of complexity into the determination of per-capita relativities, in contrast to recent calls for simplicity in the determination of relativities, the Committee also believes that this approach will provide an important means for encouraging national tax reform at state and territory level.

Recommendation 8: That the Victorian Government request that the Council of Australian Governments consider requiring the Commonwealth Grants Commission to revise the inclusion threshold for taxes that were to be abolished under the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, to ensure taxes that were to be abolished under the Agreement contribute to the assessment of per-capita relativities.

5.4.4 The effect of other commonwealth grants on general purpose payments

In determining GST relativities for the distribution of GPPs to the States and Territories, the FFR requires the CGC to include SPPs and partnership payments for projects as revenue for each jurisdiction. Other general revenue assistance from the commonwealth, excluding GST payments, are also counted toward the jurisdiction's revenue for this purpose. Payments for facilitating or providing incentives under the partnership

[137] Government of Victoria, *Submission*, no. 37, 19 October 2009, pp. 3-4.
[138] Government of Victoria, *Submission*, no. 37, 19 October 2009, p. 3.

payment provisions are not considered part of the jurisdiction's revenue for the purpose of relativity calculation.

Payments from the commonwealth to the states that are related to commonwealth purchases from the states, or where payments flow through the state budgets with no state discretion and have no impact on their fiscal capacities, are excluded from assessments by the CGC. In most cases, however, payments from the commonwealth do have an effect on state fiscal capacities.[139]

The Committee also told that there should be opportunities to examine the overall structure and composition of the way that horizontal fiscal equalisation is implemented in Australia.[140] Professor Neil Warren referred the Committee to work he had done examining the effect of SPPs on GST revenue grants, which had the effect of reducing fiscal autonomy among the states:

> [SPPs] serve as a vehicle for the extension of Commonwealth policy into areas for which the States are held accountable. In some cases, they are little more than a mechanism for the Commonwealth to direct funds towards the Commonwealth's areas of priority rather than pursue matters of higher priority to a particular State…. The level of State funds becoming tied up in SPP agreements is significant, constituting around 15 per cent of States' total revenues. However, through their matching and maintenance of effort conditions, SPP agreements can control up to 33 per cent of State budget outlays. This has a significant impact on States' budget flexibility.[141]

Another recent and substantial change in the grants structure for redistribution of the GST is the implementation of National Health and Hospitals Network Agreement (NHHNA), discussed below. Under the NHHNA, a proportion of Victoria's GST GPP will be 'dedicated' toward health care expenditure. However, the 'dedication' of these funds will occur after the horizontal fiscal equalisation calculations have been completed, and so do not affect the overall allocation of GST revenue to the states, although the states no longer retain autonomy as to which service sector is the recipient of those funds.

5.5 Other changes to commonwealth payments

5.5.1 National Health and Hospitals Network Agreement

In April 2010, COAG agreed to introduce measures to change the arrangement of government funding for various categories of health care. These changes affect the proportion of discretionary funds available to the states and territories (except Western Australia) through GPPs, although from a state perspective, in practice the actual expenditure of funds may not alter substantially.

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[139] Commonwealth Grants Commission, *Report on GST revenue sharing relativities - 2010 review*, Commonwealth Grants Commission, Canberra, 2010, p. 8.
[140] Prof. Neil Warren, Head of School, Australian School of Taxation, University of New South Wales, *Transcript of evidence*, Sydney, 29 October 2009.
[141] Neil Warren, *Benchmarking Australia's intergovernmental fiscal arrangements*, New South Wales Treasury, Sydney, 2006, pp. xxxviii-xxxix.

On 20 April 2010, COAG with the exception of Western Australia, agreed to sign the NHHNA. The intention of the NHHNA was to provide a "national unified and locally controlled health system" by:

> a. establishing the Commonwealth Government as:
>
> i. the majority funder of public hospital services;
>
> ii. the level of government with full funding and policy responsibility for General Practice (GP) and primary health care; and
>
> iii. the level of government with full funding, policy, management and delivery responsibility for a national aged care system; and
>
> b. establishing the States as:
>
> i. responsible for system-wide public hospital service planning and performance, purchasing of public hospital services and capital planning; and
>
> ii. key partners supporting the Commonwealth's responsibility for system-wide GP and primary health care policy and service planning coordination.[142]

From a tax and grants revenue perspective, the major change for Victoria introduced through the NHHNA was that from 2011-12 a proportion of the GST would be dedicated to supplement commonwealth healthcare SPP funding of various healthcare services up to a level of:

- 60 per cent of the national efficient price of every public hospital service provided to public patients;
- 60 per cent of recurrent expenditure on research and training functions funded by States undertaken in public hospitals;
- 60 per cent of block funding paid against a COAG-agreed funding model, including for agreed functions and services and community service obligations required to support small regional and rural public hospitals;
- 60 per cent of capital expenditure, on a 'user cost of capital' basis where possible; and
- over time, up to 100 per cent of the national efficient price of 'primary health care equivalent' outpatient services provided to public patients.

From 2014-15, the proportion of GST dedicated to commonwealth healthcare funding responsibilities will be fixed, and indexed at the rate of overall GST growth. The NHHNA also requires the Commonwealth Government to make "top up payments" of not less than $15.6 billion between 2014-15 and 2019-20. The dedicated healthcare GST will be treated as part of overall GST pool by the CGC.

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[142] Council of Australian Governments, *National Health and Hospitals Network Agreement*, Canberra, 2010, p. 4.

Given the wide range of variables affecting both health care costs and GST revenue, the specific effects of the NHHNA over time on Victorian revenue and expenditure are yet to be determined. However, the Committee received evidence from the Victorian Treasurer, the Hon. John Lenders MLC, that health cost growth was estimated to lie between 7.5 per cent and 8.2 per cent per annum from 2014-15 for the purposes of the NHHNA.[143] Similarly, GST growth from 2014-15 to 2019-20 was expected to be approximately 5.2 per cent per annum.[144]

The Committee recognises that as health care expenditure increases, particularly with an aging population, the quantum of expenditure required by both state and commonwealth governments is likely to be equivalent to a substantial proportion of GPPs, regardless of whether that revenue is 'dedicated' or otherwise.

The requirement under the NHHNA for the Commonwealth Government to meet 60 per cent to 100 per cent of specified healthcare over the long term, coupled with an effective 'cap' on the proportion of GPPs retained for that purpose from 2014-15, means that the state will likely be in a stronger position to sustain expenditure over health care in the long term. Ultimately, however, the sustainability of healthcare provision in Victoria will depend on its cost, regardless of which level of government is responsible for funding.

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[143] The Hon. John Lenders MLC, *Correspondence*, 9 September 2010.
[144] The Hon. John Lenders MLC, *Correspondence*, 9 September 2010.

Chapter

6

Chapter Six: The role of state debt

This Inquiry comes at a time when governments world-wide are embarking on major fiscal expansion policies to stimulate economies in the wake of the largest global economic downturn in recent history. The onset of the Global Financial Crisis has seen a return to fiscal policy heavily influenced by Keynesian theory, which focuses on closing output gaps caused by the economic downturn through the stimulation of aggregate demand, with varying degrees of success. This action contrasts with the worldwide tendency over the past two decades to rely on a combination of monetary policy and automatic stabilisers to absorb the shock of shallow economic slowdowns, rather than readily employing fiscal solutions. Each policy response has benefits and costs that are effective in particular circumstances.

Within Australia, a range of policy responses to economic conditions have been announced by the commonwealth and by the states and territories. These include the Commonwealth Government's *Nation Building* stimulus plan, which focused on a range of infrastructure projects and, following the 2007-08 financial year, a one-off payment to selected recipients.[145] In Victoria, the State Government also invested in infrastructure and skills development, in part to ameliorate the effects of economic conditions.[146]

6.1 Accountability in expenditure and debt

6.1.1 Parliament and legislation

Australian governments, including the Victorian Government are subject to high levels of scrutiny on matters of budget, finance and the implementation of fiscal policies. In Victoria, a number of mechanisms exist through which public expenditure by the state government is held to account. This includes, for example, by the Victorian Parliament and the Auditor General, and within the Parliament, the Public Accounts and Estimates Committee, and in the Legislative Council, the Standing Committee on Finance and Public Administration.

A range of requirements for accountability and process in government expenditure in areas of public finance are also governed by four main Acts:

- *Public Authorities (Dividends) Act 1983 (Vic)*

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[145] Australian Government, 'Nation building - economic stimulus plan', viewed 19 August 2010, <www.economicstimulusplan.gov.au>.

[146] Government of Victoria, *Submission*, no. 37, 19 October 2009, p. 5.

- *Monetary Units Act 2004 (Vic)*
- *Financial Management Act 1994 (Vic)*
- *Borrowing and Investment Powers Act 1987 (Vic).*

In December 2009, the Victorian Government introduced legislation to Parliament that would supersede and consolidate current legislation into one Act. The *Public Finance and Accountability Bill* covers the areas of planning, procurement, borrowing and investing and budget management, all with a view to improve public finance and its governance.[147] Key features of the Bill are that it provides a differential framework for public bodies on the basis of size, complexity and risk profile; that it sets out public finance and accountability principles that will apply to public finance and procurement arrangements in Victoria; and that it requires government planning, budgeting and accountability processes to focus on the achievement of outcomes.

At the time of tabling this report, the Bill had passed its 2nd reading in the Legislative Council, but had been referred to the Public Accounts and Estimates Committee in order for the Auditor General to provide evidence on the Bill.

In addition to the Parliament and legislation, a number of management frameworks for public finance are also practiced. According to the Department of Treasury and Finance, these include mechanisms to support accountability listed below.

6.1.1.1 Integrated management cycle

The Victorian Government Integrated Management Cycle (IMC) aligns resource management, planning, decision making, monitoring and reporting processes. The IMC is comprises four elements which form a continuous cycle of planning, resource allocation, service delivery and accountability:

- planning processes, which specify desired outcomes and strategic priorities, and guide planning by departments and entities;
- resource allocation;
- service delivery by departments;
- internal and external processes to evaluate, review and report on performance at the whole-of-government, department and entity level.

6.1.1.2 Output management framework

Victoria's public finance system is based on an 'output' management framework, under which resource allocation decisions about the nature and mix of outputs are based on each output's expected contribution to

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[147] Victorian Department of Treasury and Finance, 'Reforming Victoria's public finance legislation', viewed 19 August 2010, <www.dtf.vic.gov.au>.

government outcomes. Output performance measures (stated in terms of quality, quantity, timeliness and cost) describe each department's agreed service delivery performance, with results reported annually in the budget papers and in departmental annual reports.

6.1.1.3 Asset management framework

The Asset Management Framework includes a series of strategies and planning tools that assist government to manage the state's assets over the longer term.

6.1.1.4 Financial management compliance framework

The Financial Management Compliance Framework is a mechanism to satisfy the government that departments and entities have fulfilled their financial management obligations under the Financial Management Act, and ministerial directions. The framework is based on best practice in financial management, underpinned by an annual certification process.

6.1.1.5 Victorian Government risk management framework

The Victorian Government Risk Management Framework supports good public sector risk management by providing information on governance policies, accountabilities and roles and responsibilities. The framework also provides for a minimum standard of risk management for public sector entities.

6.2 Government debt

The Terms of Reference for the Inquiry required the Committee to examine the effect of increased state government debt on a range of issues pertaining to Victorian employment, business and growth. In practice, the effect of increased debt is principally determined by how it is spent, although of course the terms and source of funds can also affect outcomes over the longer term. Ideally, if debt is acquired, it should be expended on measures that contribute to the acquisition of assets that will maintain value to the state beyond the period for which the debt is acquired. In practice, most debt that has been incurred by the Victorian Government to date has been spent on the construction or development of infrastructure, and so satisfies this requirement.[148] Consequently, the acquisition of debt by the Victorian Government has, at least in the short to medium term, supported state development, employment, job creation and, through the stimulus effect on the economy, small businesses. The question that remains is whether these effects of increased acquisition of debt will be maintained over time (that is, its sustainability), and whether increased debt will affect the competitiveness of businesses in Victoria.

The issue of government debt was not widely discussed in submissions to the Inquiry. In cases where the issue was discussed, none of the organisations making submissions expressed and in-principle opposition to

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[148] Government of Victoria, *Submission*, no. 37, 19 October 2009; Government of Victoria, *Victorian State Budget 2010-11*, Department of Treasury and Finance, Melbourne, 2010; Public Accounts and Estimates Committee, *Report on the 2008-09 Financial and Performance Outcomes*, Parliament of Victoria, Melbourne, 2010, pp. 185,187.

the government using debt to finance spending.[149] In some submissions, there was support for the use of government borrowings to fund infrastructure and other growth-related spending. Regarding this issue, the Property Council of Australia stated that:

> …infrastructure spending itself is likely to have a positive impact on Victoria's GSP [Gross-State product], and creates an environment that will help to attract further private sector investments.[150]

A submission from the Tenants Union of Victorian suggested that fiscal prudence is of primary importance, and that changes to debt policy should only be made with a view to the state government having increased fiscal capacity in the future.[151] Similarly, the submission from CPA Australia directly tied the need for debt-financed fiscal stimulus to efficient taxes, where it stated that:

> …the replacement of Victoria's currently inefficient taxes with more efficient taxes would assist in facilitating the state's adjustment in future to the impact of events such as the GFC…[152]

6.2.1 Changes in state net debt

Net debt is a commonly cited measure of the financial strength of government. According to the Victorian Department of Treasury and Finance, net debt is the sum of:

> …deposits held, advances received, government securities, loans and other borrowing less the sum of cash and deposits, advances paid and investments, loans and placements, and investment in general government sector entities using the equity method.[153]

General government net debt grew from $2.2 billion at the end of the 2007-08 financial year to $5.3 billion at the end of the 2008-09 financial year, an increase from 0.8 per cent of GSP to 2.0 per cent of GSP. According to the Victorian Department of Treasury and Finance, additional general government sector net debt allowed Victoria to undertake a substantial capital investment program, to protect employment and ensure the state's recovery through the global financial crisis.[154]

In its submission to the Inquiry, the Victorian Government indicated that it expected general government sector net debt to increase to 5.1 per cent of GSP by the end of the 2012-13 financial year. The ratio of net financial liabilities to GSP was also projected to increase from 13.4 per cent of GSP to 16.1 per cent of GSP by the end of the 2011-12 financial year, but was

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[149] Government of Victoria, *Submission*, no. 37, 19 October 2009; G Lloyd-Smith, *Submission*, no. 23, 25 September 2009; Master Builders' Association of Victoria, *Submission*, no. 21, 6 October 2009; Property Council of Australia, *Submission*, no. 17, 2 October 2009.
[150] Property Council of Australia, *Submission*, no. 17, 2 October 2009.
[151] Tenants Union of Victoria, *Submission*, no. 42, 24 November 2009, p. 1.
[152] CPA Australia, *Submission*, no. 19, 5 October 2009.
[153] Victorian Department of Treasury and Finance, *Financial report for the state of Victoria 2008-09*, Victorian Department of Treasury and Finance, Melbourne, October 2009, p. 27.
[154] Victorian Department of Treasury and Finance, *Financial report for the state of Victoria 2008-09*, Victorian Department of Treasury and Finance, Melbourne, October 2009, p. 202.

then expected to fall to 15.5 per cent of GSP by the end of 2012-13. In its submission the Victorian Government noted that:

> While these ratios are above recent levels, they remain prudent and are not expected to affect the State's triple-A credit rating. This is attributed to the Victorian Government's sound management of the State's balance sheet, ongoing fiscal discipline and the State's diverse economic base.[155]

In October 2009, the Department of Treasury and Finance confirmed that Moody's Investment Services had reaffirmed Victoria's triple-A rating.[156]

6.2.2 Changes in general government sector and state borrowings

Between the end of the 2007-08 and 2008-09 financial years the level of general government sector borrowings increased from $7.8 billion to $10.6 billion. Most borrowings were obtained from the Australian market, with 83.7 per cent of borrowing obtained domestically. During the same period state borrowings increased from $18.0 billion to $25.8 billion, with borrowings from the Australian market accounting for 69.3 per cent of all borrowings.

In its consideration of increased borrowings by the State of Victoria, the Public Accounts and Estimates Committee (PAEC) noted that increases in borrowing were largely due to "the raising of additional finance to fund, in part, the State's record capital infrastructure program."[157] Noting the increase in state borrowings to $25.8 billion, the PAEC enquired about the government's debt management strategy for retiring debt over time. The Department of Treasury and Finance responded that, despite borrowings, debt ratios were expected to decline given forecast continued state government surpluses to 2012-13, increased revenues, and increased GSP.[158]

The existence of positive net government debt is by no means unusual for developed economies. The United States of America (US), for example, has an historical debt level averaging around 36 per cent of Gross National Product (GDP), with public indebtedness in the US currently approaching 70 per cent of GDP.[159]

The Committee also notes that by international standards, public debt in Australia is very modest. In the international context, for example, it is unlikely that the current quantum of debt will have a deleterious effect on the competitiveness of Australian businesses. Figure 12 demonstrates the relatively sound position of Australia relative to most other developed nations. In particular, Australian public indebtedness compares favourably

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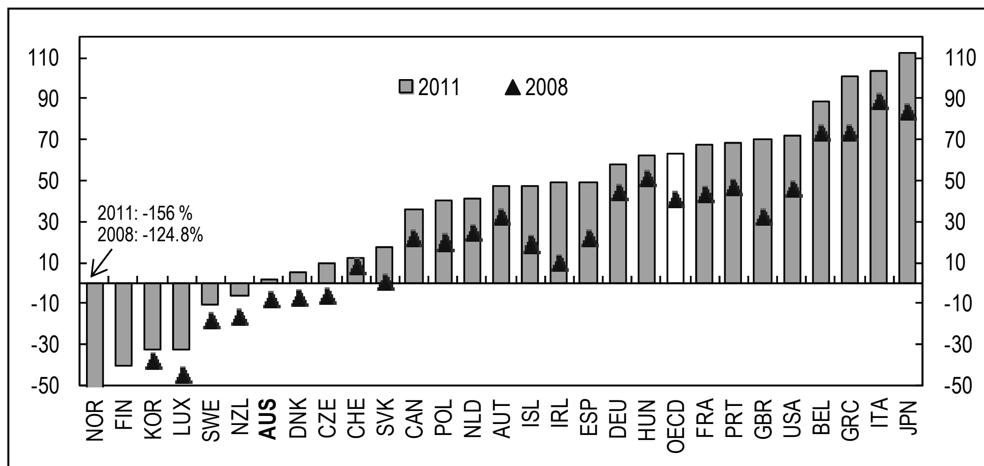
[155] Government of Victoria, *Submission*, no. 37, 19 October 2009, p. 5.
[156] Victorian Department of Treasury and Finance, *Financial report for the state of Victoria 2008-09*, Victorian Department of Treasury and Finance, Melbourne, October 2009, p. 26.
[157] Public Accounts and Estimates Committee, *Report on the 2008-09 Financial and Performance Outcomes*, Parliament of Victoria, Melbourne, 2010, p. 187.
[158] Public Accounts and Estimates Committee, *Report on the 2008-09 Financial and Performance Outcomes*, Parliament of Victoria, Melbourne, 2010, p. 187.
[159] Claude Giorno, Senior Economist, Country Studies Division (Australia), Economics Directorate, OECD, *Meeting*, Paris, 12 February 2010.

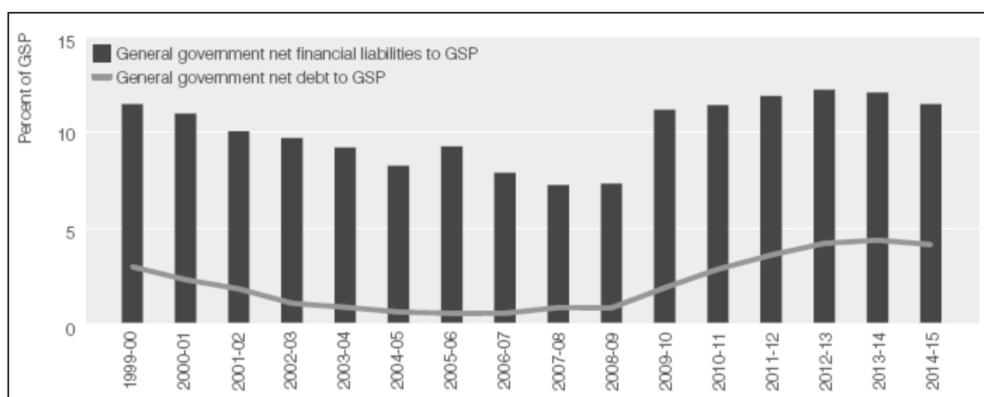
with the OECD average, with the latter estimated at around 63 per cent of GDP by 2011.

Figure 12: Public indebtedness, by per cent of GDP, 2008 and 2011.[160]



The financial security of a number of developed nations is further threatened by high current levels of deficit spending, with all countries in the European Union but Bulgaria expected to run budget deficits in excess of three per cent of GDP in 2010 and 2011, and ten member states expected to run budget deficits in excess of seven per cent during those years.[161] By contrast, the Victorian Government expects to run a budget surplus of $100 million in the 2010-11 financial year, and to provide surpluses over the next three years averaging $1.2 billion. Furthermore, and as illustrated in Figure 13, general government net debt to GSP is not expected to exceed 5.1 per cent over the foreseeable future.

Figure 13: Net financial liabilities and net debt, State of Victoria, 1999-00 to 2014-15.[162]



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[160] Claude Giorno, Senior Economist, Country Studies Division (Australia), Economics Directorate, OECD, *Meeting*, Paris, 12 February 2010.
[161] Roland Eisenberg, Senior Economist, Directorate General for Economic and Financial Affairs, European Commission, *Meeting*, Brussels, 15 February 2010.
[162] Government of Victoria, *2010-11 Budget Overview*, Government of Victoria, Melbourne, 2010, p. 7.

Victoria has maintained a strong position in the context of current global economic conditions, within Australia and in international comparison. While the precise quantum of economic benefits from increased infrastructure and other spending by the Victorian Government in the wake of the global economic crisis may be subject to debate, the effect of that spending almost certainly supported local industry and employment during the initial effects of the GFC. The level of Victorian Government debt is modest by international standards, and the fiscal position of Victoria appears to be strong in the foreseeable future, so that regardless of perspectives on the worth of benefits arising from state debt, it seems unlikely that state debt will become unmanageable, or impose an appreciable drag on the Victorian economy.

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Appendix One: List of submissions

Australian Bankers' Association Inc

Australian Custodial Services Association (ACSA)

Australian Finance Conference

Australian Unity

Brotherhood of St Laurence

Brotherhood of St Laurence, Footscray Community Legal Centre, West Heidelberg Community Legal Service and Consumer Action law Centre

Business Coalition for Tax Reform

CGU Insurance

Construction Forestry Mining and Energy Union of Australia (CFMEU) – Victorian Branch

CPA Australia

Drover, Glenne

Financial Planning Association of Australia Ltd

First National Real Estate

Gaghan, Neil and Rachael

Griffiths, Morrie and Nanette

Insurance Australia Group

Insurance Council of Australia

Janson, Chris

Kartalis, Zoyee and Teresa

Lloyd-Smith, G

Master Builders' Association of Victoria

National Community Titles Institute

National Insurance Brokers' Association

Owners Corporations Victoria

Pannuzzo, Lorenza and Emmanuelle

Property Council of Australia

Prosper Australia

Royal Automobile Club of Victoria (RACV) Ltd

RSM Bird Cameron

Schiavello Group of Companies

Shadow Treasurer and State Member for Scoresby

Stanhope, Jack

Tenants Union of Victoria Ltd

Teo, Eu-Jin

The Australia Institute

The Geelong Chamber of Commerce

The Institute of Chartered Accountants in Australia

The Real Estate Institute of Victoria Ltd.

Totally Integrated Financial Planning Pty Ltd

Victorian Farmers' Federation

Victorian Government

Westfield Management Limited

Xuereb and Galea Family

Appendix Two: List of witnesses

Public hearings

Sydney 29 October 2009

Mr John Hanks	Consultant **National Insurance Brokers Association**
Professor Neil Warren	Head of School Australian School of Taxation **University of New South Wales**
Mr Nicholas Scofield	General Manager, Corporate Affairs Allianz Australia
Mr David Wellfare	Senior Adviser, Economics and Policy Insurance Australia Group
Mr Alex Sanchez Mr Phil O'Sullivan	General Manager, and Senior Policy Adviser Economics and Taxation Directorate **Insurance Council of Australia**

Melbourne 30 November 2009

Mr John Spasojevic	Secretary **Commonwealth Grants Commission**
Mr Enzo Raimondo Mr Robert Larocca	Chief Executive Officer Policy, Research and Communication Manager **Real Estate Institute of Victoria.**
Mr Geoff Crick	Member, Farm Business and Regional Development Committee,
Mr Graeme Ford Mr Darryl Harrison	Executive Manager, Policy Policy Adviser **Victorian Farmers' Federation.**

Appendix Three: List of briefings

Briefings

Paris 12 February 2010

Mr Claude Giorno	Senior Economist
	Country Studies Division (Australia), Economics Directorate, Organisation for Economic Co-operation and Development.
Dr Asa Johansson	Senior Economist
Mr Hansjörg Bloechliger	Senior Economist
	Structural Policy Analysis Division, Economics Directorate, Organisation for Economic Co-operation and Development.
Mr Andrew Davies	Head
	Regional Competitiveness and Governance Division, Public Governance and Territorial Development Directorate Organisation for Economic Co-operation and Development.

Brussels 15 February 2010

Mr Roland Eisenberg	Senior Economist
	Directorate General for Economic and Financial Affairs, European Commission
Jean-Pierre de Laet	Head of Unit
Gaetan Nicodeme	Head of Section
	Directorate General Taxation and Customs Union, European Commission

Frankfurt 18 February 2010

Mr Philippe Moutot	Deputy Director General Economics
Mr Ad Van Riet	Head of Fiscal Policies Division
Mr António Afonso	Principal Economist, Fiscal Policies Division
	European Central Bank