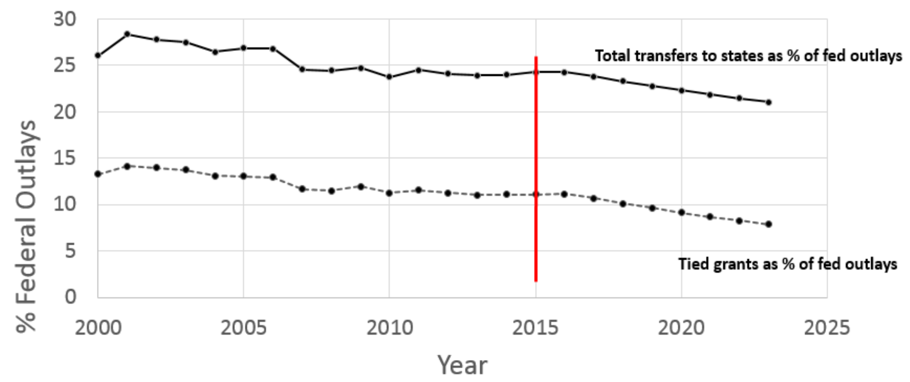
THE DEVIL IS IN THE DETAIL
The distributional consequences of income tax sharing in the Australian federation

Richard Eccleston, Institute for the Study of Social Change, University of Tasmania
and
Neil Warren, UNSW Business School, UNSW

Paper presented at a conference on Looking Forward at 100 Years: Where Next for the Income Tax?' at the Tax and Transfer Policy Institute, ANU, Canberra, 27-28 April 2015. The Authors would like to acknowledge the financial support of the Australian Research Council (Eccleston) and the research assistance of Helen Smith.

The Challenges

Intergovernmental Transfers in Australia: Historical Trends



- **Vertical Fiscal Imbalance: mismatching of expenditure and funding between tiers of government**
  - States fund around half of expenditure responsibilities
  - States rely on Commonwealth for financial support which is being reduced
- **Horizontal fiscal equalisation: redistribution of funding (GST) across tiers on an agreed principle**
  - conflict over response to WA low relativity: 0.29999 in 2015-16
- **Commonwealth Budget deficits**
  - Commonwealth budget deficits leading to reduced state funding for health and education
  - % share of C'wealth expenditure to states to fall by 10% 2001-2014 (approx $40 billion in $2015)
  - Existing own-source taxes inefficient

Inquiries and proposals

Issue subject to constant review and numerous recommendations…but minimal reform

- 2009 Australia's Future Tax System
- 2011 National Tax Forum agreement by States
- 2011 Select Committee on the Reform of the Australian Federation
- 2012 GST Distribution Review (Final Report)
- 2014 Report of the National Commission of Audit
- 2015 White/Green Paper on the Federation?
- 2015 White/Green Paper on Tax Reform?

Common themes

- Increase the GST rate and base
  - *but* a gain for states and pain for the Commonwealth
- Revise HFE arrangements
  - *but* pain for some states
- States access the income base and Commonwealth create state income tax space (AFTS, NCOA, NTF and recently NSW Premier and Liberal federal MPs)
  - *But what about the detail?*….the subject of this presentation

Back to the future: Sharing the income tax base in the Australian Federation

- Tasmania had a general income tax in 1880 and all states by 1907
- Commonwealth introduced its income tax in 1915: States administer the Commonwealth tax
- Uniform base agreed in 1936 but still not enacted by all states by 1938
- 1942 Commonwealth reached agreement with the states that they cede their income taxing powers to the Commonwealth on a ‘temporary’ basis as a wartime measure
- Post war Commonwealth used grant power to prevent States re-imposing income taxes

States persistent in their efforts to access the income base (revenue sharing)

- **1970 Premiers Conference this took the form of a formal request by states for access to the income tax**
- **1976 Fraser's 'New Federalism Policy' saw**
  - the Commonwealth sharing the income tax with states in 1976; and
  - in 1978 passing of legislation to allow states to impose income tax surcharges (and rebates) – but would not make room.
- **In 1991, with support from the States the Commonwealth instigated a *Working Party on Tax Powers***
  - On 8 November 1991 all states signed a communique proposing a 6% surcharge in return for reduced grants and the Commonwealth making room by reducing its income tax.
  - On 20 December 1991, states put a detailed proposal for income tax sharing to the May 1992 Premiers Conference chaired by New PM Paul Keating
  - Keating opposed state income tax base sharing and enabling legislation ultimately repealed.

Policy design issues for income tax base sharing: 4 Models

- **Concurrent state income taxation**
  - Australia 1915-1942
  - US: Possible after the 16th Amendment to the US Constitution affirmed the federal government's right to impose a national income tax. 42 states now have own income taxes (perhaps out of necessity)
  - Canada - Quebec
- **Revenue sharing**
  - Germany: 42.5 per cent of net income tax revenue collected goes to Lander (States)
  - Australia: 1976-77 to 1984-85– initially income tax sharing then total tax sharing
- **Coordinated base sharing**
  - Commonwealth administration with states making decisions as to the rate of their specific state-based levy
  - Administratively efficient, transparent and state accountability
- **State-based surcharge**
  - technical alternative to coordinated base sharing
  - Imposed on fed tax liability <u>not</u> taxable income
  - administratively efficient and preserves vertical equity

Key design considerations other than base and rate

- **Defining residency**
  - Residence based vs source-based taxation
  - Where/when residence: Canada => 31 December
- **Administration and compliance**
  - Single collection agency
  - GST model as precedent
- **Interaction with intergovernmental grant arrangements**
  - Preserving incentive structure for States taking political risk
- **Impediment to Commonwealth national responsibilities**
  - Equity: horizontal and vertical
  - Economic management

Empirical analysis of the distributional of income tax sharing in the Australian federation

States are structurally different

Figure 6.1 Variations in personal income tax and population share across the federation 2011-12

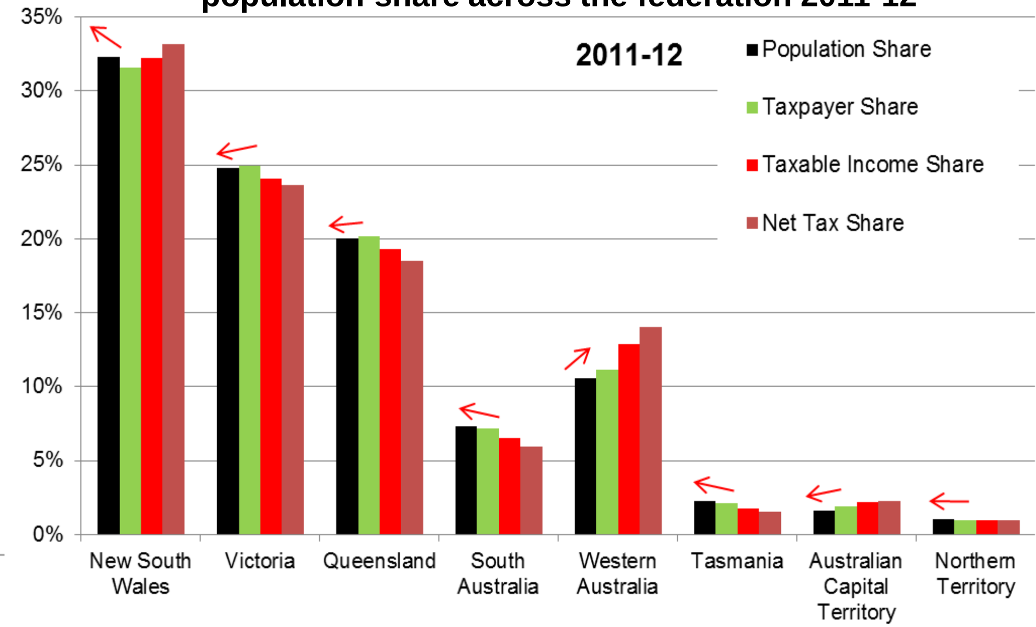
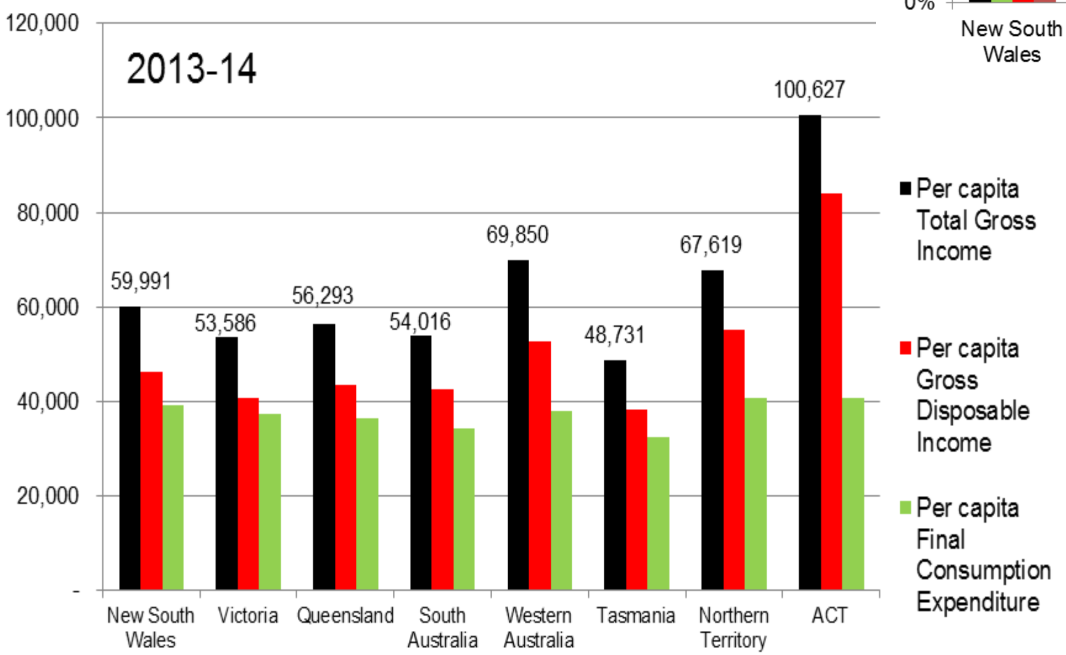


Figure 6.2 Per capita income and expenditure across the federation



Source: ABS 5220.0 Australian National Accounts: State Accounts

Tax related charts and analysis based on a 2% sample of ATO returns for 2011-12, the most recent year for which figures are available

Income distribution within States is different

Table 6.1 Distribution of income tax paid across the federation

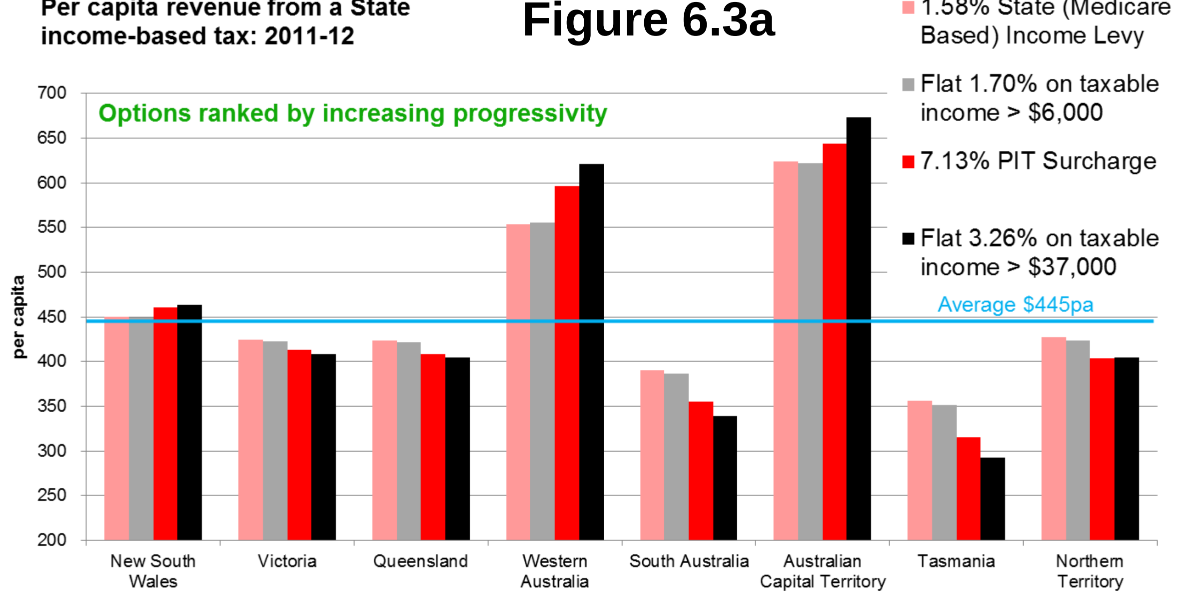
	Decile 1	*Decile 2*	*Decile 3*	*Decile 4*	*Decile 5*	*Decile 6*	*Decile 7*	*Decile 8*	*Decile 9*	*Decile 10*
New South Wales	2.1%	0.2%	0.2%	0.1%	0.1%	-1.3%	-1.4%	-0.6%	-0.5%	0.9%
Victoria	-0.4%	1.3%	1.1%	0.7%	0.8%	0.6%	0.6%	-0.1%	-1.3%	-3.3%
Queensland	0.5%	0.1%	0.3%	0.2%	0.3%	0.6%	0.3%	-0.5%	-0.6%	-1.2%
Western Australia	-1.0%	-1.1%	-1.4%	-1.3%	-1.7%	-1.2%	-0.3%	0.3%	1.8%	5.8%
South Australia	-0.4%	-0.1%	0.4%	0.4%	0.7%	1.2%	0.3%	0.2%	-0.4%	-2.3%
Australian Capital Territory	-0.5%	-0.5%	-0.7%	-0.3%	-0.4%	-0.2%	0.1%	0.5%	1.0%	0.9%
Tasmania	0.0%	0.2%	0.4%	0.3%	0.3%	0.3%	0.2%	-0.3%	-0.4%	-1.0%
Northern Territory	-0.4%	-0.1%	-0.2%	-0.1%	-0.1%	-0.1%	0.2%	0.5%	0.2%	0.0%
Australia	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

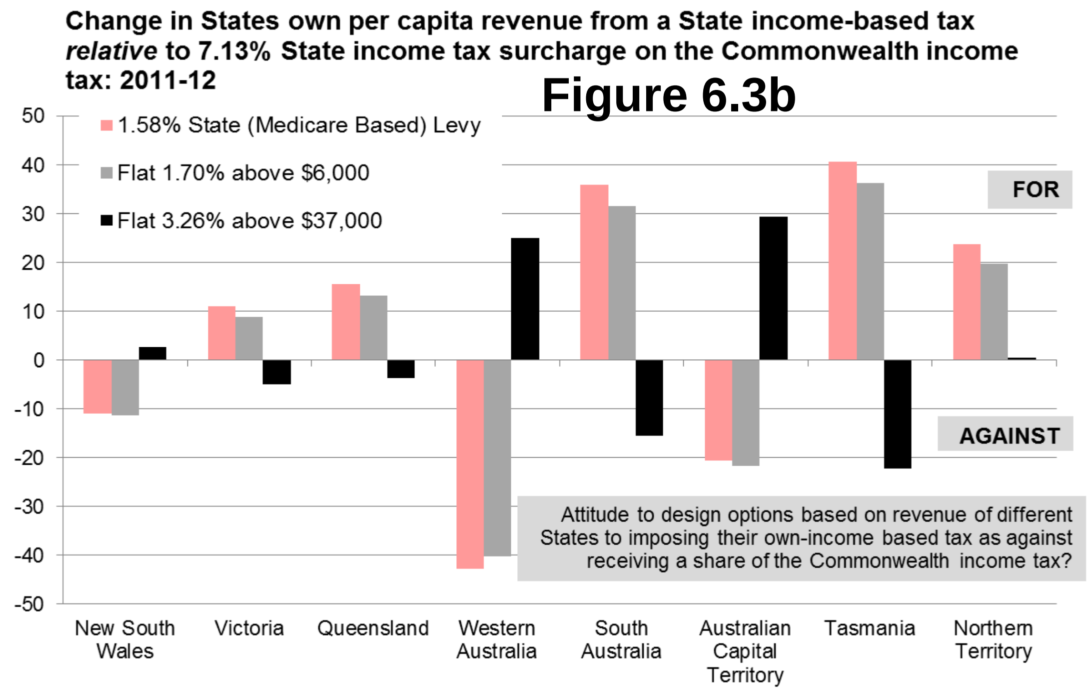
Implications of different income tax sharing models for states

- 1.58% flat levy on all income (Medicare levy based)
  - $19,405 (single) threshold which is clawed back as income increases
- 1.70% levy on all taxable income above $6,000
- 3.26% levy on all taxable income above $37,000
- 7.13% surcharge on Commonwealth tax liability

Relative nominal benefits of the 4 alternative models to each state when each model raises $10billion in 2011-12

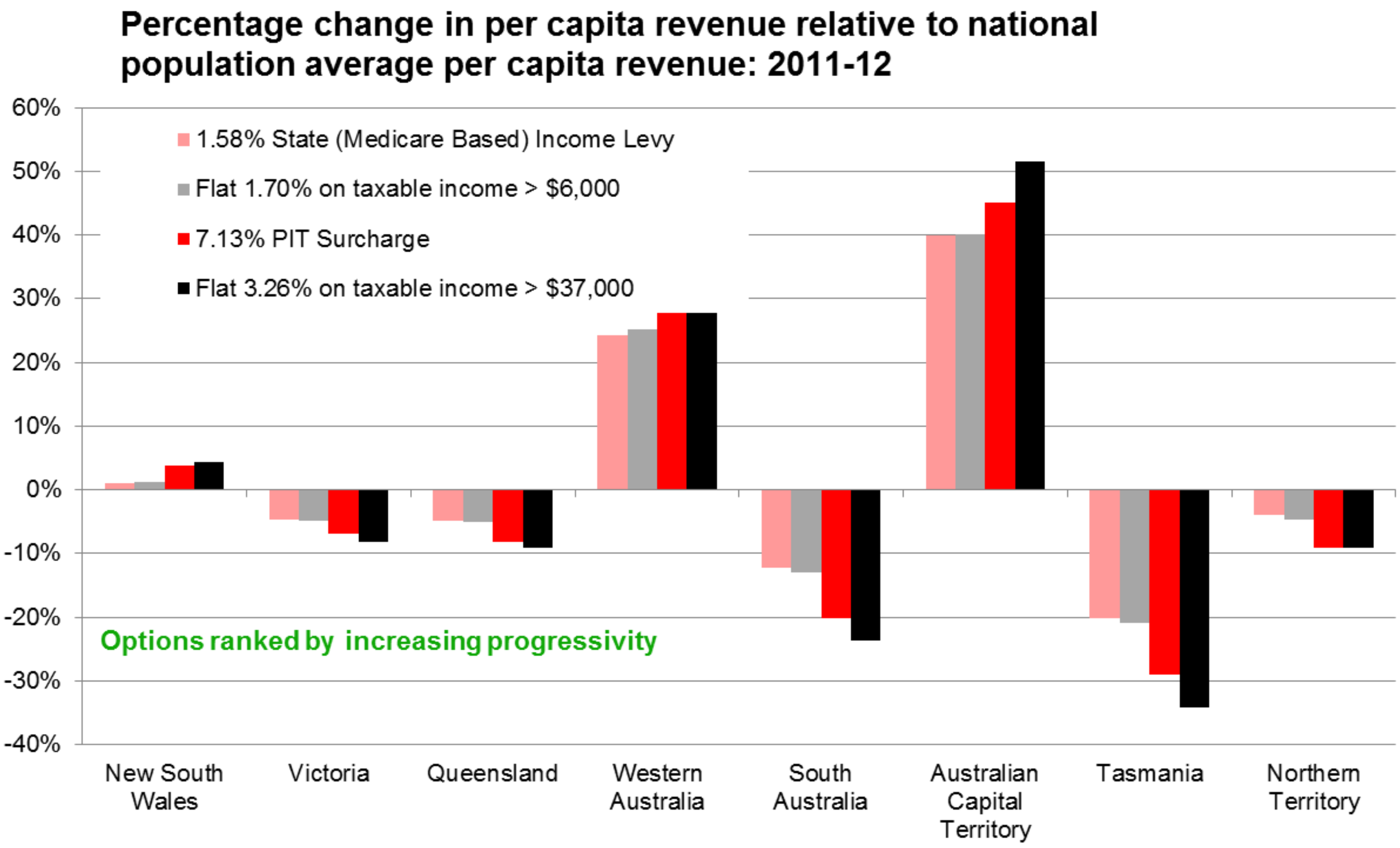
- Scenario: relative benefits of the 4 alternative base-sharing models to each state when each model raises $10billion in 2011-12.
- With differing income levels (Figures 6.1 and 6.2) and income distribution patterns (Table 6.1), the progressivity of the tax option adopted assumes real importance (Figure 6.3)
- The more progressive the option the more the high income states benefit (WA/ACT) (6.3a)
- Contrasting distributional implications of the various models of income tax base sharing for States





RELATIVE PERCENTAGE BENEFITS OF THE 4 ALTERNATIVE MODELS TO EACH STATE WHEN EACH MODEL RAISES $10BILLION IN 2011-12

Figure 6.4 Redistributive consequences of income tax sharing models across the Australian Federation



NOMINAL PER CAPITA DIFFERENCES BETWEEN STATES IN REVENUE FROM THE 4 ALTERNATIVE MODELS: 2011-12

Table 6.2 Percentage change in State tax rate necessary to yield national average per capita revenue: 2011-12

	1.58% State (Medicare Based) Levy	7.13% PIT Surcharge	Flat 1.70% above $6,000	Flat 3.26% above $37,000
New South Wales	4	17	5	19
Victoria	-21	-31	-22	-36
Queensland	-22	-36	-23	-40
Western Australia	108	152	112	177
South Australia	-55	-89	-58	-105
Australian Capital	178	200	178	229
Tasmania	-90	-129	-93	-152
Northern Territory	-18	-40	-21	-40
Australia	0	0	0	0
National per capita	445	445	445	445

- NSW, Victoria and Queensland generate revenue only marginally different from a per capita distribution
- Western Australia and the ACT are major beneficiaries on a per capita basis from having access to the personal income tax base
- Why? the dominant role of NSW and Victoria in the federation and in impacting the average across Australia
- For SA and Tasmania, their lower incomes unsurprisingly results in revenue well below the national average
- There are significant distributional consequences of common base sharing and state-based surcharge models across the federation.

Per capita revenue equivalent State rates of income tax

Table 6.3 State tax rates yielding an equal per capita revenue of $445 per capita: 2011-12

	State (Medicare Based)	PIT Surcharge	Flat rate above $6,000	Flat rate above $37,000
New South Wales	1.56%	6.87%	1.68%	3.12%
Victoria	1.65%	7.66%	1.79%	3.55%
Queensland	1.66%	7.76%	1.79%	3.58%
Western Australia	1.27%	5.31%	1.36%	2.33%
South Australia	1.80%	8.92%	1.95%	4.27%
Australian Capital Territory	1.13%	4.92%	1.21%	2.15%
Tasmania	1.97%	10.05%	2.15%	4.94%
Northern Territory	1.64%	7.84%	1.78%	3.58%
Australia	1.58%	7.13%	1.70%	3.26%

- Ceteris paribus, Tasmania would have to impose an income tax surcharge 41% above the national average to raise the national average revenue compared to the ACT where a rate 31% lower than the national average would raise equivalent per capita revenue.

or

- Tasmania would have to impose a 10.1% surcharge to raise an average of $445 per capita whereas the ACT would achieve this result with a levy of 4.9% of income, less than half the rate in Tasmania. For South Australia, their rate would need to be 8.9% or 81% higher than the ACT or 68% higher than that in Western Australia.

Conclusion

- Models for sharing the PIT base in federal systems have real merit.
- PIT remains an effective, efficient, growing and progressive income tax base and state governments in other federal jurisdictions are increasing their reliance on income taxes.
- **But** A State income tax poses:
  - **Technical challenges**: careful consideration needs to be given to defining income tax residency within the federation.
  - **Distributional impact challenges**: significant variation in the distribution of revenue from state income tax levies and surcharges across the federation may mean
    - Poorer states may be reluctant to embrace sharing the personal income tax base BUT
    - They may be willing to accept such a political bargain in return for a commitment to preserve the HFE of GST revenue.
  - **Political considerations**
    - May act as a circuit breaker in the current tax/federalism debate
    - PIT sharing more palatable to the left of Australian politics concerned about regressive nature of expanded GST
    - Perhaps best growth tax with potential to promote competition and accountability

But

- Major political risk for states (perhaps hypothecation)
- Need to create tax space and link to broader funding and state tax reform agendas