VCOSS
VICTORIAN COUNCIL
OF SOCIAL SERVICE

Review of State Business Taxes

Submission
to
Department of Treasury and Finance

by
Victorian Council of Social Service

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EXECUTIVE SUMMARY

This submission to the Business Tax Review is underpinned by fundamental values. These values reflect the need to redistribute wealth in the community in order to ensure that social justice prevails and community stability and well being is maintained.

In the following pages, proposals are made to ensure that Victoria's tax base is not changed in ways that will create further hardship for those people most unable to bear it. Indeed, it proposes ways in which the targeting of taxation measures can enhance employment and regional growth. This not only benefits those people in need of assistance, its ultimate benefit is to all Victorians.

It is in this spirit that VCOSS sets out the basic criteria on which to evaluate any proposed changes. Three priorities should govern any cuts to business taxation:

1. provision of benefits to low-income people who depend on business incomes
2. reductions in unemployment and,
3. reductions in regional disparity.

These priorities may be best served by targeted government expenditure, but given a commitment to tax cuts the best option is payroll tax deductions to reward employers who take on people previously among the long-term unemployed, and who provide education and training. In view of the considerable benefits which businesses receive from state services and infrastructure, the state should treat with extreme circumspection proposals for reductions in user charges to business, and indeed any tax reductions which are not justified by benefits to poor businesspeople or by reductions in unemployment or regional disparity, or increased commitments to skills development.

Given that tax payments by struggling small businesses are already low, there is limited scope to assist such businesses by tax cuts. Similarily, given that a major tax (the land tax) is imposed on a base which differentiates metropolitan and country businesses, there is little scope for regional policy via tax cuts. Both assistance to marginal small business and regional development would be better pursued through the expenditure side of the budget.

In this submission, it is also made clear that VCOSS believes that reductions in unemployment are an important part of government actions; that there is no case for any further shift of the state tax burden from business to households, and that government investment in skill development and training is imperative to generate employment.

The Commonwealth's New Tax System does nothing to improve the vertical fiscal imbalance, yet the need for infrastructure, education, health and welfare services is growing. Victoria should accordingly conserve and cultivate its tax base. An immediate action to conserve the base would be to re-impose land tax on high value owner-occupied houses. Victoria should also explore environmental taxes, rather than wait for the Commonwealth to pre-empt the field. The state should relinquish tax bases only after due deliberation, and should continue its search for new revenue sources.

Recommendations

Maintain the tax base

1. Except where already lost as a result of intergovernmental agreement, the existing state tax base should be maintained and improved.

2. The Victorian government should never initiate tax competition.

3. The cost of government services to business should be recouped by user charges where possible. Exceptions should only be made when the charge would be regressive (recoupment from businesses which generate very low incomes) or when the charge would seriously diminish employment or regional development prospects.

4. Gambling taxes should be maintained, but reliance on them should be reduced through discouragement of the activity.

Rebalance the base

5. The role of land tax should be reaffirmed by once again including high-value principal residences in the tax base (though subject to a higher threshold than for other properties).

6. Payroll tax should be retained, but a possible redefinition of the tax base should be explored. Under this redefinition, employers would not have to perform any additional calculations to assess liability beyond those already performed for calculating PAYE, prescribed payments and fringe benefits tax.

7. Environmental taxes should be investigated, but should not be implemented unless (a) the particular environmental tax is progressive or neutral in incidence or (b) the tax is incorporated in a package of overall progressive effect.

Reduce taxes on an incentive basis

8. Tax cuts should take the form of payroll tax concessions for the employment of persons drawn from the long-term unemployed, and for approved training.

9. Where businesses receive tax concessions in anticipation of a quid pro quo, tax should be recouped in the event of the quid pro quo not being realised.

10. To encourage increased managerial expertise and skills development in the small to medium business sector:
    a. specifically targeted tax cuts should be devised for businesses providing staff and management training and development. Reflecting the need for these businesses not to incur negative cash flows, any portion of approved programs which cannot be financed from tax remissions should be financed directly or,
    b. tax cuts should be given in the form of finance for businesses providing staff and management training and development. Reflecting the need for these businesses not to incur negative cash flows, in approved cases finance given may exceed tax paid.

1. INTRODUCTION

In its 2000-01 budget the Victorian Government announced that, subject to maintenance of a budget operating surplus of at least $100 million a year, taxes affecting business would be cut by up to $400 million over three years. A specific task of the Review Committee will be to recommend on the distribution of these cuts. However, the Committee has a wider brief, including power to review user charges as well as taxes, and limited only by the hazy line separating taxes and charges that affect business and those which do not. Taking a general equilibrium view, it is arguable that all state taxes and user charges affect business either directly or indirectly, which allows the Committee to range very widely indeed.

2. IMPROVED EQUITY

The values that VCOSS brings to this submission are unashamedly those of equity, which is listed as term of reference 2(b)(iv). These values translate into support for progressive taxation and for public services to improve the lot of low-income people. In present circumstances there is a particularly pressing need for actions to reduce unemployment, and for actions to counter the trend to increased regional inequality.

VCOSS' credentials in making this submission lie in its members' service to the disadvantaged, and its critical attitude to existing arrangements is based on knowledge gained through contact with disadvantaged people. These contacts give VCOSS's member agencies inside knowledge of the inadequacies of Victorian public services, particularly in the areas of education, health and welfare.

Despite these specific contacts, VCOSS also recognises arguments that improved state services to business (such as marketing assistance for exports) and increased state infrastructure investments would assist in reducing unemployment and regional disparity. VCOSS has no inside knowledge on the effectiveness of such expenditures, but supports them in so far as they can effectively meet these two objectives.

Given the urgency of increases in public expenditure, both in areas where its effectiveness is well known to VCOSS and in other areas of direct concern to business, VCOSS does not give high priority to further tax cuts. In this context, the proviso that tax cuts are dependent on maintenance of the surplus is important.

VCOSS is strongly opposed to any reductions in service expenditure in order to deliver tax cuts in the face of a cyclical decline in revenues, should that occur.

On the negative side, VCOSS' member agencies have direct contact with people who are suffering as a consequence of legal commercial activity (such as alcohol supply and gambling), illegal commercial supply (such as drugs) and lack of employment opportunities.

VCOSS does not support government promotion of industries with deleterious social consequences; nor does it support heavy expenditures on law enforcement and prisons as an alternative to expenditures on job generation, on services to place unemployed people, and on welfare services for the rehabilitation of those whose lives are blighted by gambling and the supply of legal and illegal drugs.

3. THE PRIORITY OF TAX CUTS

As a consistent advocate of the importance of public expenditure as a means of pursuing social equity, VCOSS has been obliged to respond, over the past two decades, to arguments for cuts in public expenditure based on public choice theory. The expenditure cuts would be passed on to taxpayers as tax cuts. These arguments fall into two classes:

- the argument that people can extract much more personal value from their incomes if they spend them themselves rather than if they are spent collectively, and

- the accusation that the sole (or chief) beneficiaries of public expenditures are service providers, not the public, and that, by extension, advocacy of such programs amounts to self-interest.

Neither of these arguments is new; the contribution of public choice theory simply increases their sophistication of expression. And the second, cynical, argument can be reversed. It is equally consistent with public choice theory that people only advocate tax cuts when they personally benefit from the cuts and do not see the benefits of government services.

The first argument is one of priority and judgment.

VCOSS commends redistributive government expenditures not only for their contribution to equity (understood as a close relative of justice, and among the Committee's terms of reference), but also for their contribution to community cohesion and to the unlocking of human resources.

A second important source of demands for tax cuts over recent decades has been inflation. This has had two aspects.

- Inflation can sometimes be seen as a tax in itself, brought about by excessive government borrowing financed by issue of money. Although over the past decade borrowing has ceased and inflation in consumer prices has declined, inflation of asset values continues, coupled with credit creation by banks. To the extent that money supply is increasing, any tax element is now private. To the extent that asset value inflation is increasing land tax revenues, there are complaints that land tax is increasing in relation to business cash flows. On the other hand, the increase in revenue reflects a capital gain which is otherwise untaxed unless realised, and even then is now taxed concessionally.

- Consumer price inflation results in bracket creep. This applies mainly to Commonwealth taxation, but has minor state effects, for example in exemption levels for payroll tax. Where state taxes are specified in dollar terms, the state can indeed lose real revenue from inflation.

The argument for tax cuts to counter bracket creep was never relevant at the state level, and is now of limited relevance even at Commonwealth level. Arguments that increases in tax collections due to bracket creep encouraged governments to provide services in excess of those really needed are also decades out of date; stringency campaigns have long ago removed any inefficiencies which may have crept in when revenue was growing rapidly due to inflation.

It has also been pointed out that it is difficult, almost by definition, to increase productivity in labour-intensive services. Many government services are of this nature. Divergent productivity trends in the production of public and private goods, coupled with continuing demand for services such as education and health, require an increase in the proportion of incomes taxed. Demographic trends, coupled with the development of expensive treatments, have caused the demand for health services to increase more rapidly than incomes, and similarly globalisation has placed a premium on skills, and caused the demand for education to increase more rapidly than incomes.

4. THE EQUITY CRITERION AND TAX INCIDENCE

VCOSS's concern that the combined effects of taxes and government expenditures should be redistributive, and should assist disadvantaged people, could easily lead to highly abstract calculations of tax incidence. At the very least, general equilibrium analysis is required, and even if incidence estimates can be obtained by this means, they are necessarily dependent on assumptions, such as universal perfect competition, which are of dubious practical relevance.

VCOSS therefore proposes three practical criteria by which to assess the incidence of proposed changes.

1. Will any proposed changes benefit low-income people who depend directly on businesses for their incomes?

2. Will any proposed changes generate employment? and

3. Will any proposed changes reduce regional disparity?

Benefits to low-income self-employed people

The first of this criterion recognises the disparity of business, which within Victoria ranges from multinational corporations whose executives receive salary packages in the million a year range to self-employment at earnings below the poverty line.

VCOSS's member agencies who dispense emergency relief testify to the increasing prevalence of very low-income self-employment, particularly among early retirees who have invested redundancy packages in setting up a business. There is no guarantee that tax cuts which would improve the cash flow of large business will benefit small businesses, particularly those that generate low incomes. It is doubtful if there are any tax cuts which could benefit the low-income self-employed, since few of them would pay much state tax.

Generation of employment

The second criterion should be one of consensus. Any reduction in unemployment increases production through the utilisation of resources previously outside the labour market. It reduces social costs, and even improves the Commonwealth's public account through reduced social security outgoings. Despite these benefits, it is a sad fact that high unemployment has persisted for 25 years now, and there are many who argue for public acceptance of high unemployment levels as the price of economic efficiency, and who favour deliberate engineering of unemployment increases, via macroeconomic policy, as a means of controlling inflation.

VCOSS does not accept these counsels of defeat, and insists that reductions in unemployment are an important part of the assessment of government actions.

These employment effects should include not only employment in the business sector, but also employment by federal, state and local governments and not-for-profit agencies.

Reducing regional disparity

The third criterion has much in common with the second, in that regional depression results in the underutilisation of resources and increases social costs. However, growing disparities between regions are part of a global trend, brought about by reductions in international transport and communications costs. This trend is leading to the concentration of highly paid activity in major cities and the dispersion of routine manufacturing to low-wage countries.

Its Australian manifestation has been high prosperity in parts of Sydney coupled with disappointing economic growth in most other places; its Victorian manifestation has been divergence between places like Stonnington and (at the other extreme) the Latrobe Valley. Given the recency of this trend, it is difficult to know how to counteract it, but without counter-action the social cohesion of the state is at risk.

Two negative criteria may also be proposed.

1. New tax bases

First, in view of the likelihood that there will be a demand for increased public expenditures in the future, the state should relinquish tax bases only after due deliberation, and should continue its search for new bases.

2. User charges to business

Second, in view of the considerable benefits which businesses receive from state services and infrastructure, the state should treat with extreme circumspection proposals for reductions in user charges to business, and indeed any tax reductions which are not justified by benefits to poor businesspeople or by reductions in unemployment or regional disparity.

5. THE SCOPE FOR STATE TAXES

It hardly needs to be stated that, given the Commonwealth Constitution as interpreted by the High Court, the tax base available to the Australian states is limited. It is further limited by the states' identification of rates as a suitable tax base for local government. It has been argued that the lack of state access to income and sales taxation has resulted in retention of unsatisfactory tax bases which would have been abandoned had Australia been a unitary country or one in which states could impose sales taxes.

In the debates leading up to the recent changes at the Commonwealth level, it was proposed that the states should withdraw some of their taxes in exchange for increased Commonwealth grants. It has also been observed that, once one state breaks ranks and abolishes a tax or cuts rates, there is pressure on the others to follow, particularly if the tax base is mobile between states. (This is but an aspect of tax competition more generally: the Commonwealth is also under competitive pressure to reduce tax rates on mobile factors of production, particularly capital.)

Given the risk that the other states will follow suit, Victoria has little reason to cut business taxes for tax competition reasons.

Its payroll tax rates are under those in most states, and its stamp duties on conveyancing and its land tax are of similar order to the other states. The proportion of gross state product (GSP) collected in state taxes (except franchise duties), at 5.1 per cent, is below Victoria's main competitor, NSW (5.5 per cent), though it is above some of smaller states and territories, particularly those favoured by the Commonwealth Grants Commission (e.g. Northern Territory at 3.3 per cent).

Victoria stands out for its heavy reliance on gambling taxes (1 per cent of GSP, as against a national average of 0.7 per cent). However, this is not due to high rates; rather it reflects the encouragement of gambling by the previous government.

VCOSS does not advocate any reduction in the rate of gambling taxes, but advocates reduced state dependence on gambling revenue through discouragement of gambling. This is an important area for forfeiture of revenue, as distinct from tax cuts.

Relinquishment of tax bases, whether through negotiation or as a result of tax competition, results in increased reliance on Commonwealth grants. There are two general arguments against such relinquishment:

- it is irresponsible to increase the vertical fiscal imbalance, and

- old taxes are embedded in the system, are well understood and whatever distortions they may cause to the pattern of economic activity have long ago been incorporated into the market process.

Other arguments for the relinquishment of parts of the tax base apply separately to tax competition and to proposals for changes in the tax mix.

6. CHANGES IN THE TAX MIX

Increased Commonwealth capacity

Much recent discussion of changes in the tax mix has (in default of constitutional change) involved increased Commonwealth collections of supposedly superior taxes, coupled with state relinquishment and increased grants. However, the recent Commonwealth changes have not fundamentally changed the realities of federal finance. States will still be heavily dependent on the Commonwealth, and the role and methodology of the Commonwealth Grants Commission will not greatly change.

The major change is that the Commonwealth tax mix is now less progressive than before, and less adequately compensates for the regressive nature of the state tax base. Vertical fiscal imbalance has increased, and the hypothecation of GST revenues echoes Mr Fraser’s New Federalism. A change of this order and its likely impermanence does not give any state the room for major withdrawal from its remaining tax base.

Given that the recent Commonwealth changes do not give room for changes in the tax mix by relinquishment of state taxes, what about changes within the state base?

State payroll/environment tax trade off

The most far-reaching proposal for tax mix change within the states’ competence has been for substitution of environmental taxation for the payroll tax. This proposal essentially reflects an economic efficiency argument. Abandonment of payroll taxes would reduce unemployment and the imposition of environmental taxes would reduce pollution.

In themselves, these are desirable reductions, but would they be effective in practice?

- The ability of states to impose environmental taxes has yet to be tested before the High Court. It is possible, indeed likely, that the Court will perceive many of the possible environmental taxes as excises to be reserved for the Commonwealth. To the extent that this happens, the proposal becomes one of Commonwealth/state negotiation. The remaining environmental taxes are likely to be a mixed bag, with pronounced industry-specific effects and subject to serious tax competition between the states.

- Though the primary effect of environmental taxes should be to discourage the activity taxed, there may be secondary effects, including regional effects and employment effects. A switch should not be contemplated until these effects have been analysed.

- Similarly, there is some popular expectation that payroll tax reductions should increase employment. The expectation is strongest if payroll taxes are incident on employers, as the Review Committee argues. However, VCOSS is not convinced of this incidence conclusion: there has not been enough variation in payroll tax rates to give bite to any econometric investigation of the incidence of the tax, and *prima facie* the wage flexibility introduced by recent Federal and State governments should increase the incidence of payroll taxes on wages rather than on employers.

  It may also be noted that, in general equilibrium analysis, the incidence of a payroll tax is very similar to a GST. Australian payroll taxes are low compared with Europe, yet even the heavy European taxes have no clear effect on employment outcomes, as the Netherlands example demonstrates. At a more practical level, exemption from payroll tax provides a competitive advantage of small business over large. It is even possible that any employment generation in large businesses which follows payroll tax reductions will be counterbalanced by employment losses in small business.

VCOSS accordingly counsels caution in any approach to a payroll/environmental tax tradeoff.

Payroll tax

A change to the payroll tax base that may be worth investigating would define the base as identical to that used by the Commonwealth in calculating PAYE liability, plus that used in calculating fringe benefit liability and liability for prescribed payments. This would simplify the calculations which businesses have to perform to determine payroll tax liability: the tax could be calculated as a surcharge on PAYE, fringe benefits tax and prescribed payments.

Despite this mode of calculation, it would not be an income tax, since the payments would not be attributed to employees: there would be no individual deductions. The main advantages would be to simplify calculations for employers, and to reduce the cost to business of employing low-wage labour, with possible employment generation at the low-skill end of the labour market.
In so far as the payroll tax is incident on labour incomes, the progressivity of the system would be increased, in partial compensation to the reduction in progressivity resulting from the Commonwealth’s recent changes.

Changes to the definition of the payroll tax base along these lines would make it easier to withdraw the payroll tax threshold.

However, VCOSS does not recommend such withdrawal, either under the present or proposed tax bases, for fear of regressive effects on small businesses yielding low incomes for their proprietors.

7. TAX COMPETITION

Other proposals for relinquishing parts of the state tax base, and for reducing tax rates, have more to do with tax competition. Particular targets are stamp duties, apart from land transfer stamp duty. This last is relatively immune from tax competition, since transactions cannot be transferred out of Victoria's tax jurisdiction. However, stamp duties on marketable securities and insurance are vulnerable to such transfer, and have already been subject to a degree of interstate tax competition. They have also been criticised as interfering with financial markets and encouraging the invention of artificial tax-avoiding legal instruments.

Stamp duties

However, a strong defence of stamp duties on financial transactions, levied at a low rate, has arisen in the literature on the Tobin tax, which would, in effect, levy stamp duties on international financial transactions. Stamp duties do not appear to be regressive, and their removal is unlikely to reduce unemployment (indeed, the Tobin literature argues the reverse). They are old taxes, which limits their distorting effects, and many of them can be assessed electronically.

VCOSS advocates their retention.

Environmental taxes

In so far as tax competition, both between states and internationally, requires that states forgo mobile tax bases, the implication is that they should shift their tax collections towards immobile bases. Environmental taxes may be suitable for this purpose, since environmental externalities are often located at particular places. (An important partial exception is greenhouse gas emissions, which are emitted in particular places but whose adverse effect is global.)

Part of the deliberate incentive structure of environmental taxation is to move the externalities elsewhere, though this raises moral questions, and VCOSS does not favour the export of environmental costs to poor countries.

Land taxes

The major immobile tax base, however, is already subject to state and local taxation: land, and transactions in land. Though both land tax and real estate stamp duties impinge on the cash flows of businesses (and in the latter case households), the standard economic analysis is that they are incident on capital values. It follows that any relief will result in a windfall gain for sitting owners.

VCOSS opposes such relief. Indeed, in view of the failure of the Commonwealth to include owner occupied housing in its capital gains tax, VCOSS believes that land tax should be re-extended to high-value places of principal residence (including provision for postponement of payment until sale of the property or death of the owner).

Ideally this could take the form of a capital gains tax, but administratively it would be simpler to extend the existing land tax. The value cut-off should be high, so as to include not more than ten per cent of owner-occupied properties and, as with business land taxes, the tax schedule should be progressive to avoid major tax increases at the threshold.

A further reason for opposing any cuts to land tax is that these would benefit the metropolitan area, where most high-value properties are located, at the expense of country Victoria.

8. THE BENEFITS OF STATE SERVICES TO BUSINESS

Most if not all of the services provided by the State of Victoria are of benefit to business as well as to the people of the state more generally. Indirectly, they help to create an environment in which business may both produce and sell its products and services, and sometimes the contribution is far more direct.

The road transport industry cannot survive without state highways; the securities industry without state commercial law, and few industries could survive for long without state contributions to education and training. State health services contribute to the productivity of the working population, and also to the capacity of households to consume business products. Police and welfare services reduce business costs by their contribution to general peace and security.

In addition to these general benefits, the government has from time to time struck bargains of benefit to particular businesses. Relationships between the state and the business sector are numerous and complex and, in many cases (as with recent privatisations), have been of a one-off nature. It is often difficult for the public to know whether any given transaction between the state and business is fully commercial and at arm's length, though the extensive bureaucratic procedures governing state contracting endeavour to ensure that this is so.

It is also current practice that, in pursuit of economic development policy and in lieu of tax competition (and contrary to the spirit of national competition policy), states offer tax concessions and/or special infrastructure and service support to attract footloose industries to their state, quite frequently from overseas. Given the realities of international tax competition, some of these bargains can be defended, according to VCOSS' value system, for their contribution to employment and perhaps to regional development. However, there is a serious danger that concessions may be provided without quid pro quo, such as when a location decision is subsidised even though it would have been made anyway, or when subsidies are granted in anticipation of technology transfer and training which does not eventuate. There is a strong case for the inclusion of provisions for review in any such direct bargains, including provision for tax recoupment in the event of the beneficiary failing to provide the anticipated benefits.

More generally, given the benefits which business receives from governments, there is no case for any further shift of the state tax burden from business to households (always assuming that we know what would be meant by this. As remarked above, the ultimate incidence of state taxes is so uncertain that it would be difficult to arrange any such re-balancing).

9. THE BENEFIT PRINCIPLE, STATE TAXATION AND USER CHARGES

Not only does business benefit from the provision of state services in general; the principle may be applied to individual state taxes and user charges. Whether it is regarded as incident on business or labour, payroll tax may be defended on the benefit principle as part-payment for state services in education and health; stamp duties as contributions towards the administration of the law of contract, motor vehicle taxes as partial payments for roads, and property taxes as payments for local services and infrastructure. User charges are similarly justified as payments for particular goods and services.

Road user charges

The borderline between taxes and user charges, and hence the strength of application of the benefit principle, is particularly hazy in the case of road user charges.

Roads in Victoria are financed from local government rates, Commonwealth grants and state registration fees. Heavy vehicle registration fees are set by agreement with the Commonwealth and other states, and are interpreted as a user charge. Expenditure from local government rates on local access may perhaps be justified on the benefit principle, but not expenditure on through-traffic roads. Commonwealth fuel taxes and state registration fees are frequently defended as user charges for roads, but they are far from perfect because they do not reflect the costs associated with the use of any particular road.

Recent work on road costs by Howard Pender indicates that these various imposts, in total, more or less covered the costs of road provision in the mid-1990s (including a business return on capital and land invested), but did not cover environmental costs. Nor were they accurately balanced to recover the costs imposed by the use of any particular road at any particular time.

Recent Commonwealth tax changes have reduced road cost recovery (despite recent increases in petrol excise reflecting increases in world oil prices). The position is further complicated in that roads are both an important business input and an important input to household consumption.

Attempts to impose direct user charges for roads through tolls date back to Colonial times, but have generally been frustrated by the high cost of collection and by road-user opposition. However, developments in electronic toll collection greatly reduce the cost of collection, making road use a candidate for the extension of direct user charges.

A switch to such charges would probably benefit business. The value of time savings from reduced congestion is likely to outweigh the tolls paid, especially if tolls were implemented in conjunction with reductions in registration fees and (with Commonwealth cooperation) fuel taxes. However, piecemeal application of charges (as on CityLink) results in highly inefficient diversion of traffic to alternative routes. The equity effects are also unfavourable: accessibility for poor motorists is greater if scarce road space is rationed by congestion (as now) instead of tolls.

In addition to these criticisms of road pricing, VCOSS has been critical of other recent shifts to user charges. In particular

- the shift from rates to user charges for water has disadvantaged low-income families with young children (though not necessarily all low-income families), and has also disadvantaged agencies which care for young children;

- the rebalancing of electricity tariffs prior to privatisation likewise disadvantaged low-income families, in this case to the benefit of urban business users, and

- the introduction of charges for health, education and welfare services (and increases in charges where previously there were none) threatens the redistributive purpose of these services, and hence their contribution to social equity.

In all these cases VCOSS was critical of user charges that reduced the real incomes of poor households. It is not, however, critical of the application of user charges to business. The only case where VCOSS would wish to query the application of user charges and benefit-principle taxes to business would occur if a charge or tax depressed low household incomes derived from business.

However, this is not true of the major state taxes: small business is exempt from payroll tax, and poor business owners do not pay land tax. A possible case is road hauliers, who may complain that their low incomes would be increased if registration charges were reduced. However, in this case it is more likely that competition would force freight rates down to the benefit of shippers rather than the hauliers themselves, and the main result would be reduced cost recovery.

10. TAX CUTS TO REDUCE UNEMPLOYMENT

If there is little scope for reductions in state taxes to increase the incomes of people in small business earning low incomes, the two principles to guide any tax cuts should be employment generation and regional growth. First, we consider reductions in unemployment.

Reductions in payroll tax

The first principle has already been noted in discussing changes in the tax mix where it has been suggested that payroll tax cuts will generate employment. VCOSS is very doubtful of the effectiveness of such a policy. However, it would be most effective if it applied in Victoria alone, improving the state's chances of attracting employment from interstate. But any such cuts in Victoria would almost certainly be matched by other states.

The effect of the tax cuts in reducing the relative competitiveness of small business could lead to employment losses that would at least partially offset employment growth in large business. In any case, the extent of employment growth in large business is disputed, since the sensitivity of employment to real wage rates is uncertain. In some industries it is very low; in other industries it may be moderate.

Finally, general measures to increase employment across the board do not reduce unemployment as effectively as measures targeted on unemployment reduction.

Enhancing skills

VCOSS' preferred method of encouraging reduction in unemployment via tax relief starts from the observation that much unemployment is related to lack of skills.

These include skills acquired through on-the-job training, through formal training, or through a combination of both.

The demand for many types of highly skilled personnel has intensified over recent decades, yet in some specific skills the supply has weakened due to inadequate provision for training. On the demand side, low-skill jobs have been exported to low-wage countries, while technological change has increased the skill levels required in many of the remaining jobs.
Technological developments have undermined demand for yet other skills, so bringing home to workers the personal risks inherent in skill acquisition.

On the supply side, tax cuts have constrained the ability of governments to provide education and training, while increases in the intensity of competition between businesses have reduced the returns which an individual business can expect from training. It is far too likely to have its investment in trained personnel poached by competitors. This reality becomes even more acute if the business time horizon is short, since the time horizon for returns to education is measured in decades.

It is frequently proposed that the poor incentives for businesses to invest in training do not matter, since individuals have the incentive to make the investments themselves in anticipation of future rewards. However, it is undesirable to rely on this mechanism, for two reasons:

- by comparison with state financing of education and training, it depends on an inegalitarian income distribution, and

- it loads the risks of skill investment on individuals. The (necessary) absence of insurance against technological deskilling and against the normal vicissitudes of career results, in the presence of risk-aversion, in an undersupply of skills required by employers.

The only solution is government investment in skills, on behalf of the whole community.

Even at the government level, labour mobility presents a potential problem. Jurisdictions that under-invest in education may poach skilled workers from other jurisdictions – this indeed has been a conscious aim of Australian migration policy. However, geographic mobility is much less than inter-firm mobility, and state governments can therefore absorb risks in education where individuals must necessarily remain exposed, and therefore under-invest.

Though VCOSS would prefer government expenditure on education and training to be financed from taxes, and hence would prefer tax maintenance coupled with increased on-budget expenditure, tax cuts can used in lieu. The payroll tax lends itself to such use, including the following.

- Payroll tax exemption, possibly involving more than 100 per cent deductibility, may be given for employment of people previously long-term unemployed. The exemption could be available for a year, and could possibly taper away for a further year. The rationale would be to assist in paying the costs of on-the-job training.

- Part of the cost of approved training schemes could be made payroll-tax deductible.

These deductions could be available whether or not the payroll tax base is changed from the existing base to the revised base discussed above.

VCOSS also appreciates that investment in human capital is not the only form of capital investment that may help to generate jobs. Victoria is in competition with other jurisdictions to attract investment, particularly investment with high multiplier effects – for example, investment that adds to an industry cluster with international competitive strength.
However, many factors go into the discernment of which particular investments to encourage, and such discernment is best left to the expenditure side of the budget.

11. TAX CUTS FOR REGIONAL DEVELOPMENT

Tax cuts may also be used to encourage investment in regional development. The Victorian state tax system already has an element that encourages such development. To reduce or completely avoid land tax a business merely has to move to areas where land values are low. The tax relief suggested above to encourage training and the employment of previously unemployed people could be applied more generously to businesses operating in areas of high unemployment.

Beyond this point, it is difficult to use state taxes as an instrument of regional development policy. Tax concessions could be introduced for taxpayers outside Melbourne. But, for a revenue loss the size of the foreshadowed tax cuts, the change in incentives to locate business outside Melbourne would be minimal.

Regional policy would do far better to concentrate on investments in infrastructure and education. Indeed, it is arguable that the cause of regional development should be pursued by investment financed from tax increases; for example, increases in land tax. A land tax surcharge in the metropolitan area, used to finance infrastructure investments in that area, would also release general funds for expenditure in the rest of the state.

12. CONCLUDING COMMENT

This submission has focused on specific targeting measures in order to enhance equity and employment opportunity in Victoria.

However, notwithstanding this approach, VCOSS supports any proposals for change that aim to maintain and improve a robust state tax base.

13. RECOMMENDATIONS

Maintain the tax base

1. Except where already lost as a result of intergovernmental agreement, the existing state tax base should be maintained and improved.

2. The Victorian government should never initiate tax competition.

3. The cost of government services to business should be recouped by user charges where possible. Exceptions should only be made when the charge would be regressive (recoupment from businesses which generate very low incomes) or when the charge would seriously diminish employment or regional development prospects.

4. Gambling taxes should be maintained, but reliance on them should be reduced through discouragement of the activity.

Rebalance the base

5. The role of land tax should be reaffirmed by once again including high-value principal residences in the tax base (though subject to a higher threshold than for other properties).

6. Payroll tax should be retained, but a possible redefinition of the tax base should be explored. Under this redefinition, employers would not have to perform any additional calculations to assess liability beyond those already performed for calculating PAYE, prescribed payments and fringe benefits tax.

7. Environmental taxes should be investigated, but should not be implemented unless (a) the particular environmental tax is progressive or neutral in incidence or (b) the tax is incorporated in a package of overall progressive effect.

Reduce taxes on an incentive basis

8. Tax cuts should take the form of payroll tax concessions for the employment of persons drawn from the long-term unemployed, and for approved training.

9. Where businesses receive tax concessions in anticipation of a quid pro quo, tax should be recouped in the event of the quid pro quo not being realised.

10. To encourage increased managerial expertise and skills development in the small to medium business sector:
    a. specifically targeted tax cuts should be devised for businesses providing staff and management training and development. Reflecting the need for these businesses not to incur negative cash flows, any portion of approved programs which cannot be financed from tax remissions should be financed directly or,
    b. tax cuts should be given in the form of finance for businesses providing staff and management training and development. Reflecting the need for these businesses not to incur negative cash flows, in approved cases finance given may exceed tax paid.

APPENDIX

STATE TAX REVIEW: ANSWERS TO QUESTIONS POSED IN THE ISSUES PAPER

Definitions: what is a tax, and what is a business tax?

The first question in defining the scope of the review is to define a tax. The committee's definition is implicit in the list in Table 1. The problem is that there are numerous borderline cases.

- Taxes are not regulatory fees or fines; but it is arguable that driver's licence fees (shown on Table 3 as a tax) are actually a regulatory charge. The same is at least partly true of vehicle registration.

- Taxes are not revenue from sales of goods and services (user charges). However, the borderline between taxation and user charges can vary, so that services which were previously provided out of taxation can be provided from user charges, and vice versa. An important recent switch was from taxation (rates) to user charges for water and sewerage. Despite its justification on environmental and efficiency grounds, this switch penalised certain types of low-income households, such as pensioners with gardens and households with small children requiring much washing, and also penalised many welfare agencies.

- Similarly some items which are identified in Table 3 as taxes might be alternatively classified as user charges. The obvious examples are vehicle taxes (a contribution towards road costs) and the metropolitan improvement rate (a contribution towards parks etc).

- Similarly, taxes are not income from public authorities. But what is the justified income of public authorities? Their charges can be used as hidden taxes. By contrast, any subsidies to public authorities tend to be transparent, and included in the budget.

- Finally, businesses themselves may be authorised to tax. The current major example is national superannuation, a federal matter, but it is possible that there may be state examples. A possible state example is part of the income of gambling service providers. The incomes of these businesses are heavily regulated, and the regulation may allow them to keep a greater share of takings than is required to provide a return on their investment.

If it is hard to define a tax, it is even harder to define a business tax. Indeed, it is hard to define a business. VCOSS represents many not-for-profit organisations which produce services, generate employment and pay state taxes, yet are not considered part of the business sector. It is submitted that such organisations should be considered businesses for the purposes of the review.

Strictly speaking, Victoria does not impose any taxes on business. It imposes taxes some of which happen to be paid by business. The committee provides, in Table 3, estimates of the proportions of each tax paid by business. The estimates are highly contestable, which means that the subject of the review (business taxes rather than all taxes) is also highly contestable.

In one extreme sense, virtually all taxes are paid by business, in the sense that they are collected by businesses before they are handed over to the state. This is as true of PAYE income tax (customarily regarded as a non-business tax) as it is of payroll tax and it is as true of GST and gambling taxes as it is of stamp duty on marketable securities. The relatively few taxes which are paid direct by households include driver's licences and vehicle registration (if these be taxes) and local government rates.

In the opposite extreme case, one could argue that no taxes are paid by business. As the issues paper remarks, tax costs are generally passed on to consumers. In other words, taxes ultimately reduce somebody's income, just as provision of each government service ultimately increases somebody's real income. In this sense business taxes and service benefits pass through businesses to households, not all of which are Victorian: some are interstate and overseas.

In an intermediate sense, taxes and services may be said to be incident on business if they have incentive effects on business behaviour. This means, in most cases, that they have potential to affect business incomes and profitability, at least in the short run (ie either the tax affects business incomes in both the short and long run, or there are delays in shifting the tax to non-business households). The meaning of short and long run is generally vague.

What, then, of the various taxes listed in Table 3?

Payroll tax

Payroll tax is listed as a completely business tax. This is the basis of arguments that it is a 'tax on employment' and that if it is reduced business will employ more labour. There are two alternative views: if it is passed forward to consumers it is rather like the GST, and if it is passed backwards to labour it is a tax on labour income (the interpretation preferred in Europe, where payroll taxes are used to finance social security). The issues paper agues against this latter interpretation ('it is unlikely that producers effectively pass back some of the cost of indirect taxes to employees through lower wages'); this is a conventional business view, but it may be argued that the erosion of awards under recent labour relations reforms has allowed exactly this.

Payroll tax rates have been fairly stable, and there is therefore no experience on which to base econometric analysis of incidence. The arguments generally proceed by assumption. In any case, the relevant question in the current context is likely to concern payroll tax cuts: are they likely to benefit current employees (through increased wages), consumers (through reduced prices) or business (through increased profits), and if the latter are they likely to issue in increased employment? There is much scope here for exercise of prior judgement, and not much real evidence for any of the propositions, however passionately they are argued.

An important attribute of payroll tax is its exemption of small business. Whatever view is taken on employment generation, argument is likely to concentrate on the effects of any changes to payroll tax on competition between small and large business. It is even possible that any employment generated in large business by payroll tax cuts would be counterbalanced by losses as small business contracts.

Land tax and metropolitan improvement rate

By the above definition, land tax is a business tax because it is incident on business capital values. Any reduction would increase the capital value of property-owning businesses, at the expense of new entrants to such business, and the recipients of state services. The question is what good this windfall gain would serve. Land tax (and municipal rates) is mainly incident on economic rents (ie unearned incomes in the economic sense). This incidence, and the immobility of the base, can be used to support arguments for gradual increases rather than decreases.

Gambling taxes

The Committee judges that these are paid by households, though it is theoretically possible that to some extent they are incident on the incomes of gambling service providers. In any case this 'industry' is so heavily regulated that the division of the spoils is a state responsibility.

Insurance taxes

Insurance taxes are imposed on a financial service which is not otherwise much taxed. It is a moot point whether they are borne by the insurer or the insured; however like all other taxes which raise the price of a service they discourage purchase.

Motor vehicle registration, stamp duty and driver's licence fees

The Committee assumes that these are taxes and not (as agued above) regulatory fees or user charges, and classifies them as business or non-business taxes according to the ownership of the vehicle. As usual with business taxes, they may be passed on to consumers through prices (which is completely appropriate, according to neoclassical theory, if they are a user charge) or perhaps backward into wages.

It should be noted that vehicle taxes are the subject of Commonwealth/state agreements, especially as regards vehicles used in interstate trade. In any case State fees cannot get too far out of line without precipitating a rush to register in the cheapest state.

The Importance of Taxation and Dependence on Commonwealth Grants

From a broad national point of view, Commonwealth control of the major tax bases allows a degree of redistribution which would not be possible under a more decentralised tax regime. The downside is the perpetual dialogue of mutual blame: Commonwealth politicians gain kudos from tax cuts and blame the resulting service cuts on the states. But the Constitution is engraved in stone, as are the High Court's privileges.

Question 1:
Does Victoria's dependence on the Commonwealth for revenue seriously impede flexibility to establish a best practice tax system?

The knee-jerk answer is that Victoria does not have the flexibility to establish a best practice tax system for a subordinate jurisdiction, since it does not have access to sales taxes. However, it does have access to the most suitable of local taxes, land taxes and some (at least) environmental charges, and so should not complain too much.

Question 2:
How should changes to Victoria's tax system take account of the fact that Victoria will not benefit from the GST until 2007-8,whereas Queensland will benefit from 2002-3?

Victoria is doubtless envious of Queensland, which unlike WA continues to be favoured by the Commonwealth Grants Commission. This is galling, given that Brisbane has risen to be a serious competitor with Melbourne in some location decisions. The implication is that Victoria should match Queensland's tax rates. However, if this requires cutting services the net effect may not be so favourable.

More generally, this question raises the matter of interstate and international tax competition.

Three comments:

- such competition affects footloose tax bases more than physically fixed; financial transactions more than land,
- as affects locational decisions (as distinct from avoidance by shifting the legal location of the tax base) competition is in respect of complete tax/service packages, and
- concerning such packages, it may be possible to limit the effect of interstate tax competition to specific deals involving large footloose employers. These deals are not merely interstate in scope, but very much a matter of putting together packages which are internationally competitive. Much as the theoretical economist may deplore this reality, and much as National Competition Policy might attempt to prohibit it, there is a lot to be said for keeping tax rates relatively high in order to provide scope for deals when necessary.

Victoria's current range of taxes

Assuming that the answers will be within constitutional limitations, the Committee asks a number of questions about Victoria's tax mix.

Question 1:

Is Victoria's tax mix suitable for our modern economy?

It would be very easy to answer that Victoria's tax mix is not suitable for a modern economy and then blame the constitution. More constructively, the 'modern' characteristics of the economy which have intensified over the past few decades include the effects of reduced transport and telecommunications costs. This puts a premium on immobile tax bases, such as land. As local governments well know, land is the one tax base which cannot shift as a result of differences in tax rates, and for this reason alone one would expect it to be increasing in importance as a tax base. However, mobility of the tax base comes at a cost, and this cost may provide some tax margin for state governments. For example, there is a high convenience factor in small-scale financial transactions, and taxing them has much smaller effects on the tax base than taxation of larger transactions. Unfortunately, taxation of small, local financial transactions associated with the receipt of income and consumption is regressive. Taxation of financial transactions generated in short-run pursuit of capital gains—in old fashioned terms, speculation—is, unfortunately, much harder due to the readiness with which such transactions can be shifted. This problem is addressed in the international literature on the Tobin tax proposal, and many of the same arguments apply as regards domestic financial flows. VCOSS sees merit in taxes on financial transactions where the impact on receipt of incomes and exchange of goods and services is low, but the impact on short-period capital gains is high.

Question 2:

Is the increasing share of State revenue, which is likely to be derived from payroll tax, a reason for concern to business? If so, what other taxes should be relied upon to generate the required revenue?

The question of payroll taxes, as remarked above, is likely to generate controversy between large and small businesses, with interventions from those who believe that reduced rates will generate employment. None of the arguments, pro or con, are well supported by data. It is similarly hard to be confident as to the business-attraction effects of withdrawing the small business exemption and lowering the rate.

A precondition for withdrawing the small business exemption would be simplification of collection. A possibility would be redefine the payroll tax base to be identical with the Commonwealth PAYE income tax base, plus fringe benefits (and possibly plus superannuation and prescribed payments); negotiations with the Commonwealth could then be started to collect the tax as a surcharge, not attributed to individuals, to the Commonwealth PAYE and fringe benefits taxes. An obvious date for introduction would be immediately after a Commonwealth income tax cut.

Question 3:
How can the State Government best ensure that revenue collections will grow in line with the inflation rate and population growth?

There is no reason why any of the present taxes cannot be growth taxes, especially if land tax is allowed to grow with (real) property values and vehicle charges are indexed.

Question 4:

How much dependence can the State Government afford to have on cyclical tax revenues?

There is no doubt that dependence on cyclical revenues is an accounting inconvenience, though it may be noted that in Keynesian days such revenues were defended as 'automatic stabilisers', a defence which is still valid. Indeed there is a case for an increase in rates during booms, in order to dampen speculative trading. Trading in financial instruments is too easily moved offshore for it to be possible for states to do this for such instruments, but they could apply penalty duties on property transfer. This may be preferable to the increase in interest rates which is generally applied to dampen a property boom, particularly if the boom is confined to a small geographic area.

The obvious management of such revenues is to use them for debt reduction during booms and make up by borrowing during depressions. State governments will object that they are not in charge of macroeconomic management, yet management of a boom in a particular property market may assist rather than hamper long-run economic development.

Question 5:

Are there taxes the State Government does not currently apply which it should consider?

Two additional revenue sources are frequently suggested.

- With the transfer of water and sewerage to user charges, the main remaining area where user charges could be imposed is road use (sometimes termed congestion charges). These could be imposed by a generalisation of e-tags, and could be raised both by the state and by local government (which could use the revenue to reduce rates). The case for road user charges is an impeccable piece of neoclassical economics, though there is serious dispute about the total amount which would constitute a fair user charge (ie about the extent to which road users cover their infrastucture costs). The economic case against road user charges rests on the distributional effects: would road user charges hit the poor? Certainly they would in themselves, but the final effect would depend on the use to which the revenue is put.

- Environmental taxes overlap with road user charges (since road use is a significant source of pollution and other externalities). Some environmental taxes resemble sales taxes and the High Court may reserve them for the Commonwealth: this could apply to carbon taxes or to taxes on fuels designed to discourage emissions of lead, sulphur and other pollutants: the result is that states have generally approached these areas by regulation rather than by taxation. Other environmental charges like taxes on water use or on native forest logging and taxes on effluents are more securely within the state province. The main environmentally deleterious activity which is in the household sector is motoring; most other environmental taxes would impinge on businesses in particular industries (and not usually on business as a whole: some businesses may benefit from a reduction in environmentally costly activities, eg tourism would benefit from a reduction in old-growth logging).

Environmental taxes in turn overlap with user charges, and also with permit fees. In the past few years a permit scheme has been set up for rural water; effectively the revenue has been used to compensate farmers giving up their water rights. There are economic efficiency arguments for increased government charges for rural water (whether by way of increased revenue from permits, or by direct charges); however before the charges can be increased the effect on low-income rural producers must be addressed. As the need for rationing of irrigation water tightens, this question will become more acute; and as low-income farmers leave the industry the case for non-taxation of the water rights of the remainder will decline.

There is a current argument as to whether tradable emissions permits for greenhouse gas abatement should be grandfathered or auctioned; if the latter, the state governments should put in a strong case that the revenue is in their province and not that of the Commonwealth.

In the long run, it may be possible to develop a general resources-rent regime for access to limited renewable resources (as distinct from the outright sale of state-owned non-renewable resources such as minerals). This could cover water and emissions, and possibly state lands as well.

Which Taxes and Charges Affect Business?

Questions 1-3:
How important are State taxes to the consideration of investment and location decisions? Do they rank highly among all the factors considered?

What are the key factors business takes into account in deciding whether to invest in a business activity in Victoria as distinct from elsewhere?

What are they key factors which business takes into account in deciding to invest in metropolitan Melbourne or regional Victoria?

The importance of state taxes in business decisions may be taken as a practical matter, to be determined by focus groups of businesspeople. However, thus posed, there is a danger that the respondents will overestimate the importance, in the hope of tax cuts. It is also likely that replies will be affected by political fashion: maybe a case study approach to actual location decisions would yield more reliable results.

Question 4:
How serious a concern is the complexity of the Victorian tax system to business?

This question pre-judges the issue: maybe the system is not complex (as such systems go). And perhaps it has the virtue of age (that is, the system is well known and therefore can be operated as a matter of habit). Maybe the real trouble is constant change. One should beware of knee-jerk answers suggested by the wording of the question.

Question 5:
How important would it be if the States were to achieve greater uniformity in their tax design, to reduce complexity across state boundaries?

There will doubtless be a chorus in favour of uniformity. However, one should beware of a race to the bottom, with states vying to reduce their tax bases forgetful of the consequent service reductions.

Who is ultimately affected by state taxes?

Question 1:
Do Victorian businesses pass on State taxes forward to consumers and/or back to wage earners?

It is very difficult to estimate the extent to which 'business taxes' are ultimately incident on business profits, on wages or on consumers. The difficulties arise both at the theoretical and practical level. Even if the usual economic methodology (marginal analysis using a general equilibrium model) is adopted, there is very little real evidence to give the model bite.

Question 2:
Do State taxes significantly impact on prices, and therefore on demand for products and services?

It is therefore difficult to estimate the extent to which state taxes impact on prices. The further impacts on demand introduce further difficulties. (General equilibrium models estimate this using elasticities, which are notoriously unreliable. The estimate also depends on a long list of unverifiable assumptions.)

Question 3:
Do Victoria's taxes have more or less impact on businesses than taxes in other States?

Whether Victoria's taxes have greater impact than those interstate (or internationally) can be investigated as matter of business opinion, though the opinions collected may well be strategic; ie businesses may overstate the effect of tax differences in the hope of cuts. It should be noted that the tax comparison is only one ingredient in business location decisions, the quality of tax-financed services being another. This question collapses into question 1 of the preceding round.