Appendix 1

Senate Economics References Committee

Terms of Reference

The Structure and Distributive Effects of the Australian Taxation System

The Senate has referred the following matter to the above Committee for inquiry and report by June 2004:

The structure and distributive effects of the Australian taxation system with reference to:

a) the level, extent and distribution of the current tax burden on individuals and businesses;

b) the impact of (a) on taxpayers' families;

c) the use and efficacy of various tax and expenditure incentives to influence social and economic conduct, for instance participation in the workforce;

d) the long term social and economic impact of the current distribution of taxation, government spending and employment including the intergenerational consequences of the tax structure;

e) the respective roles of the Commonwealth and the States in relation to the collection and distribution of taxation revenue; and

f) any other relevant issues which may arise in the course of the inquiry.

COMMONWEALTH FUNDING OF LOCAL GOVERNMENT – A HISTORY

1. Local Government has received general purpose assistance from the Commonwealth in the form of Financial Assistance Grants (FAGS) for over a quarter of a century. These grants are essential sources of funding to local governing bodies and are imperative to their survival. A history of such measures follows.

2. Chart 1 shows how the level of payments since 1974-75, Chart 2 provides a perspective of the true value of these payments by illustrating them as a proportion of Commonwealth taxation receipts.

1975 General Revenue Assistance

3. General revenue assistance was introduced in 1974-75 in recognition of the fact that new demands were being placed on local governing bodies in areas such as health and welfare services. Under *The Grants Commission Act 1973* regional bodies were established to represent and act on behalf of local governing bodies.

4. The aim was for these bodies to apply for a grant to ensure that it or any of the local governing bodies it represented could function at a standard not appreciably lower than the standard provided by other regional bodies or local governing bodies. Despite the existence of the regional bodies the Commonwealth Grants Commission (CGC) provided the grants directly to local governing bodies. Not all local governing bodies received funding, as it was an application based programme.

1976 A Tax Sharing System

5. In 1976 the Commonwealth introduced *The Local Government (Personal Income Tax Sharing) Act 1976.* This act also changed the manner in which local governing bodies received money from the Commonwealth.

6. From this point on all local governing bodies were entitled to a fixed portion of Commonwealth personal income taxation revenue. This percentage was originally 1.52%, it then rose to 1.75% in 1979-1980, and then increased to 2% in 1980-1981. These untied grants were commonly known as PIT's (personal income transfers) and moved in line with Commonwealth tax collections. This was a true tax sharing agreement reflecting changes in national economic activity. Under this arrangement local government would share the benefit in times of economic buoyancy and absorb some of the burden when the economy slowed.

1985-86 General Revenue Funding

7. In 1985-1986 the Commonwealth ceased the tax sharing arrangement with the states, territories and local government. For that year general revenue funding to Local Government was capped and only allowed to increase at a real rate of 2% for that year.

8. Since the ending of the tax-sharing agreement general purpose assistance grants to local government have fallen from 1.0 % of total Commonwealth tax collections to around 0.6 %.

1986 General Purpose Payments

9. In 1986 the Commonwealth accepted the overall findings arising from the *National Inquiry in Local Government Finance.* The inquiry recommended that the Commonwealth should maintain some form of general purpose payments (GPP's) for local government.

10. The Commonwealth introduced *The Local Government Financial Assistance Act 1986.* Increases in funding to local government were linked to increases in GPP's provided to the states.

1992 Incorporation of Tied Local Road Grants

11. In 1991-92 previously tied Commonwealth local road grants became untied and were paid to local governing bodies as a identified local road grants (ILRG's). It was agreed that these funds would remain separately identified and would continue to be distributed on the same principles that had applied to the allocation of such road funds. From 1991-1992 to 1993-1994 GPP's were maintained in real terms.

12. FAGS would now have two components, GPP's and IRLG's.

1994-95 Introduction of a Specific Escalation Factor

13. In 1994-95 the States agreed to have their Financial Assistance Grants (FAG's) indexed via an escalation factor, that took into account changes in population and inflation, this in turn was reflected in FAG's to local government. The Commonwealth Treasurer at each Federal budget determines the escalation factor.

14. The determined escalation factor is based on the estimated change of the population and inflation. This is then adjusted for the difference in the estimate and the outcome of the actual factor in the previous year.

2000-01 Commencement of the New Tax System (NTS)

16. In 2000-2001 the States and Territories began to receive the full proceeds from the Goods and Services Tax (GST). This change removed the link between growth in assistance to the States and Territories and the growth in the assistance to local government. *The Local Government Financial Assistance Act* 1995 was amended to include the details on how the escalation factor was to be calculated.

2001 Review of the Act by the Commonwealth Grants Commission

17. In 2001 the CGC reviewed the Act on request from the Treasurer (with a limited terms of reference) and recommended restructuring the payment of FAGS. This would see the whole pool split into three categories:

- a per capita pool;
- a local roads pool; and
- a relative need pool.

18. At the point of writing the recommendations were still with the Commonwealth.

Chart 1
Financial Assistance Grants to Local Government

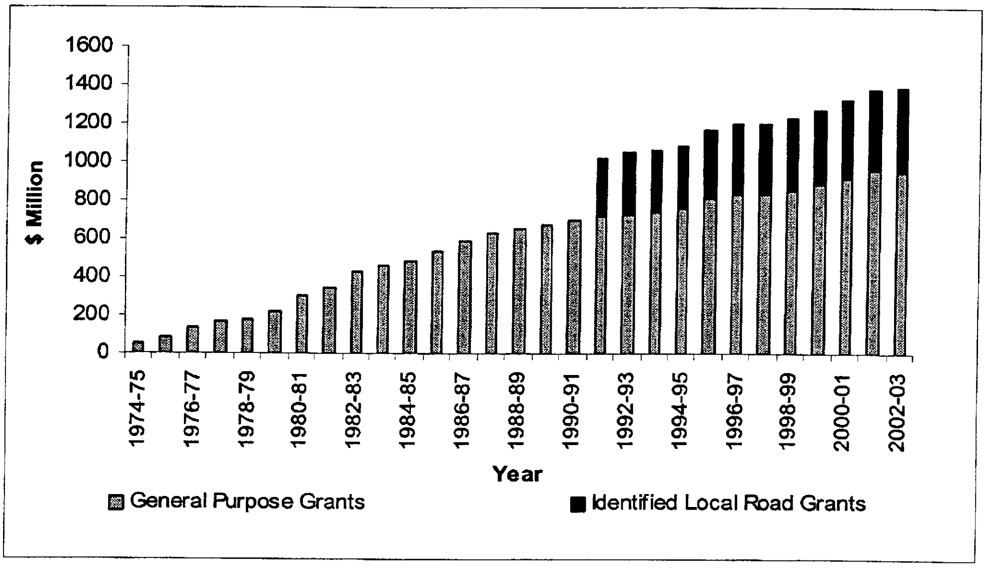
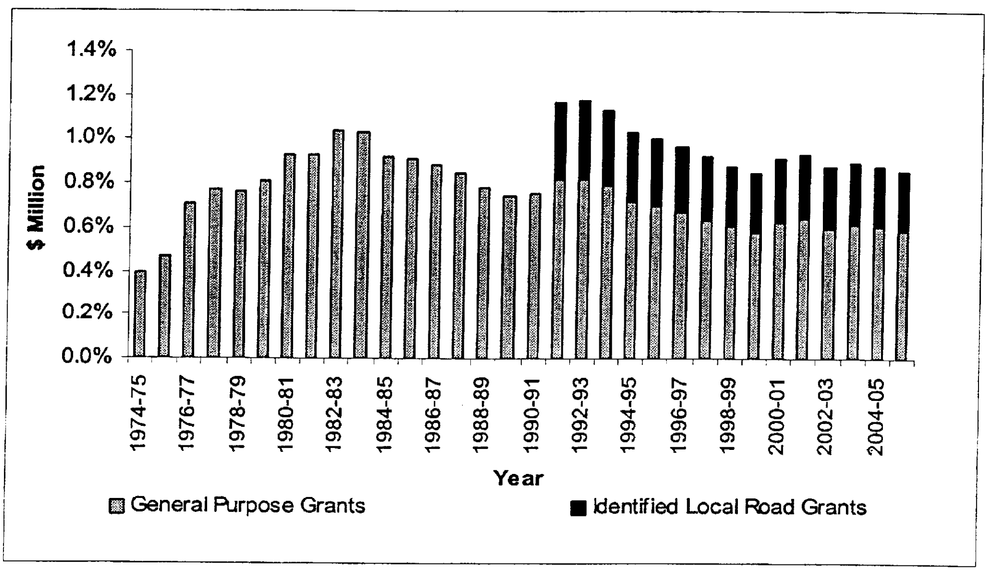


Chart 2
Financial Assistance to Local Government as a Proportion of total Commonwealth Tax



LOCAL GOVERNMENT - PROPERTY RATES

1. Traditionally local government provided a limited range of property related services, as a result, the allocation of local property taxes (property rates) to local government provided a strong nexus between revenue and expenditures.

2. Local property rates are a relatively efficient tax base for local government, particularly because:

   - the tax base is easily attributable to each local government area;
   - the taxation of the consumption of housing services is relatively low in Australia (some states do tax on property as well); and
   - the tax base cannot readily migrate in response to competing tax rates among local governing bodies.

3. Despite the enormous changes to local government services the major (and only) taxation source available to local government remains property rates. Property rates as a proportion of local government expenditure have become less significant. In 1961-62 the figure was 57%, in 2002-03 this figure stood at 41%, (mainly because of increased expenditure activity). As a result, local government has had to pursue other forms of own source revenue, and seek increased assistance from other spheres of government to finance the increasing funding gap.

4. Since federation, property rates have become a less significant proportion of total taxes (and the economy), this is clearly illustrated in Table 1.

Table 1
Taxation by level of government[1]

% of total taxes collected by:	01-02	29-30	48-49	64-65	74-75	85-86	93-94	99-00
Commonwealth	63.6	54.2	88.2	82.2	80.4	79.9	74.4	77.7
State	18.4	31.5	7.9	11.8	15.7	16.3	21.4	19.2
Local	17.9	14.3	3.9	6.0	3.9	3.8	4.2	3.1
Total taxes as a % of GDP	***6.3***	***13.7***	***23.8***	***23.4***	***28.4***	***30.7***	***29.2***	***31.2***

5. Total revenue from local government rates on property as a proportion of gross domestic product (GDP) is now below 1.0%[2], these are the lowest levels experienced since World War II.

[1] Access Economics Unpublished work
[2] Has been at this figure for 4 years

MAIN SOURCES OF REVENUE FOR LOCAL GOVERNMENT

1. The Australian Bureau of Statistics (ABS) estimates that local government will receive $17.9 billion in revenue in 2002-2003.[1] The three major sources are:

   - rates on property ($6.9 billion) ;
   - receipts from the sales of goods and services ($5.7 billion) ; and
   - funding from other spheres of government ($2.2 billion).

Local Government Property Rates

2. As the only source of general taxation revenue the major function of property rates is to finance local government for the provision of services to local communities, many of which should be considered public goods (e.g. local roads, street cleaning, drainage infrastructure, parks, libraries and environmental health) that should not be financed solely through direct user charging.

3. Property rates have always been a traditional local government tax (in most developed nations because of the need for government to finance services to property (e.g roads, drainage and water). The provision of such amenities improved the value of the land, as a result rates are often calculated on the value of a property (improved or unimproved).

4. Property rates are the most visible tax regularly paid by Australians. Many other taxes are either embedded in the consumption of a good or service, or deducted in the course of earning wages (income tax). This visibility increases the accountability of local government in regard to expenditures resourced from property rates.

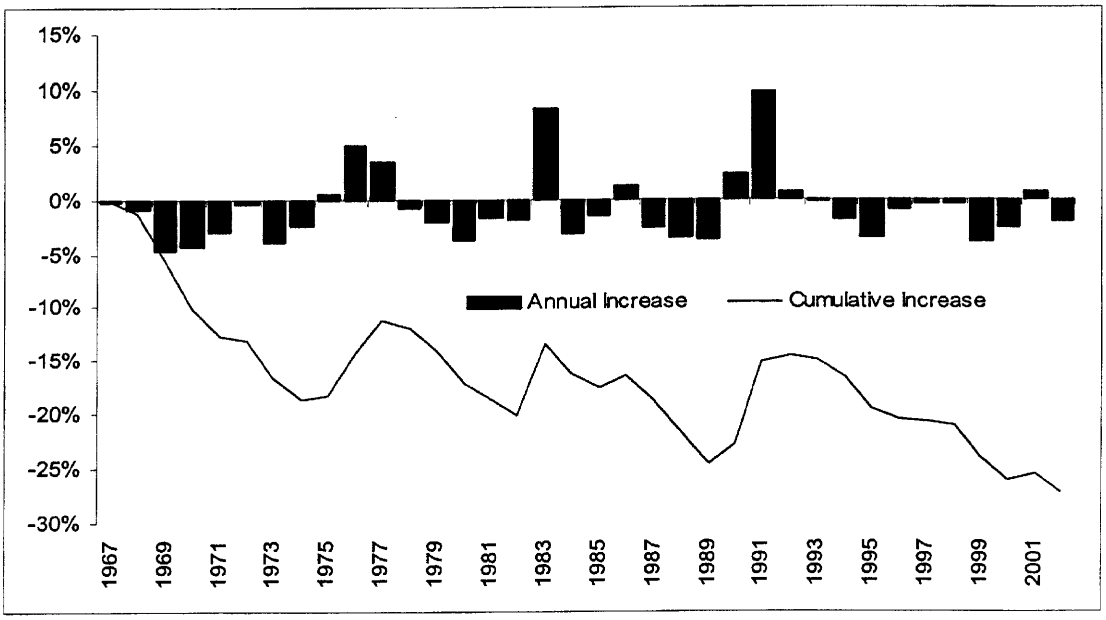
5. There is no doubt that property rates are a stable tax base for local government. However, property rates do not grow in real terms, which is a major concern for local government. Between 1966 and 2002, total rate collections by local government fell by 27% in real terms, [2] as is clearly shown in Chart 1.

---

[1] Cat. No. 5501.0.55.001 Government Financial Estimates, All Australia Electronic Delivery - 2002-03 (Table 11. All Australia, Operating Statement - Local Government Sector)

[2] Local Government total rates as collected by the ABS . Real calculations utilise the Non Farm GDP deflator.

Chart 1
Total Rate Collections by Local Government
Change in real terms June 1967 to June 2003[3]



Receipts from the Sales of Goods and Services

6. A growing and important revenue source for local government comes from the sale of goods and services. Table 2 shows local government user charges as a share of operational spending (including allowance for the depreciation of assets). This provides an indication of the local sector's "cost recovery ratios". These are significantly higher than the other two spheres of government.

7. The majority of the revenue in this category are from service charges for services that are provided by local government, such as domestic waste removal and water supply.

Table 2[4]
Cost Recovery by Government
User Charges as a Proportion of Operating expenses

	1998-99	1999-2000	2000-01	2001-02	2002-03
Local Government	37.0%	35.7%	36.0%	35.8%	35.8%
All Spheres of government	16.1%	15.3%	15.5%	15.2%	15.0%

8. Total user charges for the local sector have increased over time. Wider adoption of "user pays" pricing of services as a result of continual microeconomic reform within the sector has seen a higher share of local sector revenues coming from

[3] The two large increases in 1983 and 1991 are explained by periods of slow economic growth which the deflator is lower, the nominal increase in total rates collected for those years were consistent with previous years.
[4] Cat. No. 5501.0.55.001 Government Financial Estimates, All Australia Electronic Delivery – 2002 Table 1. All Australia, Operating Statement - General Government

fees and charges. Many services operate on a self-funding basis independent of local sector taxation revenues.

Funding from other Spheres of Government

9. Local government receives funding from the Commonwealth, the states and the Government of the Northern Territory. The Commonwealth, however, is the major provider of funding, through the provision of:
   - specific purpose payments (SPP's); and
   - financial assistance grants (FAGS).

10. SPP's are payments relating to particular functional activities (e.g. health and education). SPP's made direct to local government, amounted to $332.1 million in 2002-03.[5] The main payments in this category relate to the *'Roads to Recovery'* programme, child care programmes administered by local governments on behalf of the Commonwealth and funding for aged and disabled persons' homes and hostels.

11. FAGS have been provided to local government since 1974-75. Under current arrangements, the Commonwealth provides FAGS to local government in the form of general purpose assistance and untied local road funding. This assistance is paid to the states and the Government of the Northern Territory as an SPP on the condition that all of the funds are passed on to local government. FAGS are untied, and can be spent by local government on any purpose. Distribution within jurisdictions is determined by the State Local Government Grants Commission (SLGGC)

FAGS are provided under the *Local Government (Financial Assistance) Act 1995* (the Act). The Act provides for the Treasurer to determine the annual increase in FAGS through an escalation factor with reference to population growth and the consumer price index (CPI). Local government is estimated to receive $ 1,447.5 million in FAG's in 2002-03.

[5] Federal Financial Relations 2002-03

NATIONAL COMPETITION POLICY REVENUE – SHARING THE GAIN FROM THE PAIN

1. The NCP reform package was designed to improve the efficiency of the Australian economy, leading to lower prices for consumers and higher living standards for all Australians. Local government activities were specifically referenced in the agreement between the Commonwealth and the states and territories. NCP reforms have and will continue to make significant demands on local government across Australia.

2. NCP payments are intended to reflect the share of additional revenue through the Commonwealth tax base as a consequence of the higher economic growth resulting from the implementation of effective competition reform. Only the Queensland, Victorian and Western Australian state Governments share this revenue with local government. This is despite continual recommendations from the National Competition Council (NCC) to share such payments.

3. There is still a lack of recognition of NCP reform at the local government level in New South Wales, Tasmania, South Australia and, the Northern Territory. In these jurisdictions local government has kept up with the reform agenda (enabling those Governments to receive their full competition payments) but as yet they have not been able to share with those states and the Government of the Northern Territory in the direct benefits of NCP.

4. Payments are not made directly from the Commonwealth to local government (who is an active participant) despite the fact that the NCP principles explicitly mention the participation of local government in NCP reforms.

5. Local government has made significant reforms since the inception of NCP. Some these include water pricing on a user cost basis, and structural reforms of local government businesses to ensure they are competitively neutral. As a participant in NCP, local government is subject to the same oversight and complaint mechanisms as are the states and territories and the Commonwealth.

CAN LOCAL GOVERNMENT HELP ITSELF

1. Local government continues to investigate improved own source revenue options. It has done this and there are limited options available to local government (which are continually looked at), these are:

   - increasing the level of local government borrowings;
   - making optimum use of the rating base;
   - increasing the levels of user charging;
   - introduction of new taxes; and
   - sharing taxation bases.

2. For the most part, the local government sector runs a moderate net operating surplus, (this is usually) in order to internally fund capital spending.

3. Borrowing to fund capital spending has not been common practice for local governments across Australia, with the exception of Queensland (where local government has broader responsibilities such as the provision of water and sewerage necessitating higher levels of capital expenditure). Whilst borrowing for capital creation may be an economically and financially legitimate strategy, past years have seen an actual decline in this type of activity. This is mainly as a result of:

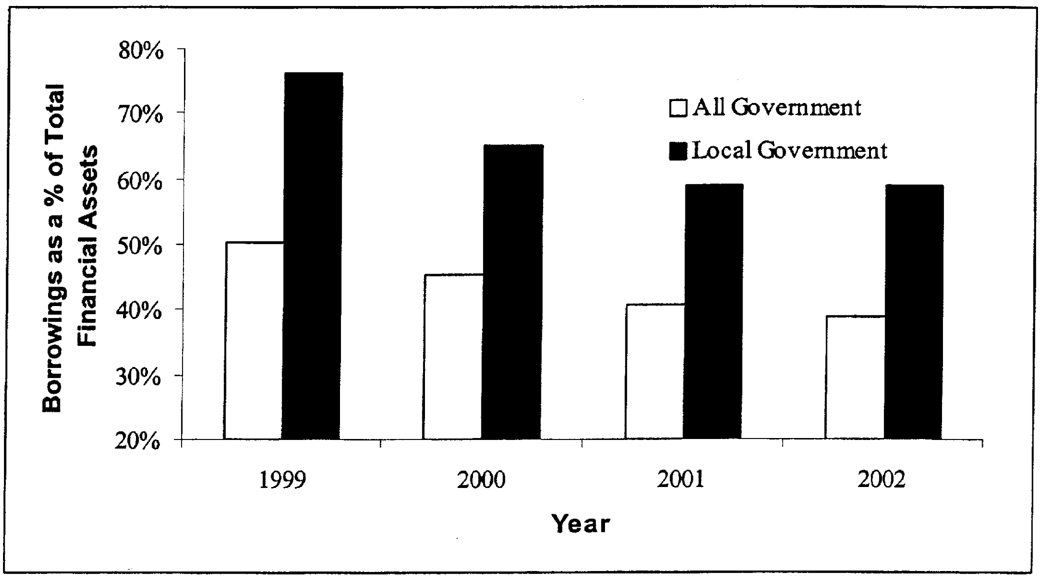
   - pressure from other governments and citizens for the local sector to further reduce debt;
   - a lack of recurrent income producing assets to effectively pay for the cost of debt; and
   - the adoption of "zero debt" objectives as part of local government financial planning.

Table 1
Debt and debt servicing, 1999-00, local sector[1]

	Debt ($m)	Financial assets ($m)	Debt payback period [(a)] (years)	Interest paid ($m)	Interest cover [(b)] (times)
New South Wales	1,464	3,774	0.9	118	5.5
Victoria	647	1,450	1.2	48	-0.1
Queensland	3,025	1,688	1.8	218	4.6
South Australia	120	161	0.6	37	0.6
Western Australia	209	752	0.5	13	4.2
Tasmania	224	192	1.8	12	1.1
Northern Territory	16	44	0.3	2	6.5
Australia	**5,705**	**8,061**	**1.2**	**448**	**3.9**

4. Queensland and Tasmania are the only states where local sector debt exceeds the stock of financial assets. In other jurisdictions, debt is quite low (in comparison). In fact, the local government sectors in NSW and WA were substantial net creditors in 1999-00. However, local government is still a higher borrower (as a proportion of total financial assets), than the three spheres of government combined, as shown in Chart 1.

Chart 1
Government Borrowings as a Proportion of Total Financial Assets[2]



[1] Source: ABS, 5512.0, June 2001 and ABS, Government Finance Statistics, unpublished
(a) Interest cover is measured by interest paid as a multiple of the pre-interest net operating surplus, indicating the number of times interest expense is covered by the local sector's pre-interest (or 'primary') net operating surplus.
(b) Debt payback period is measured by total debt as a multiple of the pre-depreciation net operating surplus, indicating the number of years it would take to pay off debt from the net cash flow generated by operations.

[2] Cat. No. 5501.0.55.001 Government Financial Estimates, All Australia Electronic Delivery - 2002-03

5. Local governments property rates are subject to constant scrutiny (due to the clarity and the inability to evade them) and frequent review in Australia. Local governments will often take a practical approach to the setting of rates and will closely assess the communities capacity to pay, thus ensuring the tax is not excessively burdensome in its nature.

6. Local government's cost recovery ratio is also much higher than those for the Commonwealth and state and territory sectors. In the main, this reflects considerable variation in the responsibilities of the different spheres of government, with the local sector in a better position to recover costs for the services it delivers. This is shown in Table 6.

Table 2
Sale of Goods and Services as a Proportion of Operating Expenses[3]

	Local	State	Commonwealth	All Spheres
Proportion	34.6%	9.6%	2.2%	8.9%

7. There are limits on the extent to which local government can increase its cost recovery efforts without impacting on the equity in the provision of services to the local community.

8. Of course, maximum fiscal independence and efficiency would be achieved if local government had guaranteed access to a broader tax base. Local government has little scope in which to broaden its tax base. While, there are limited practical opportunities to providing local government with new taxes, often mentioned options include:

   - poll taxes;
   - local income taxes; and
   - local fuel taxes.

9. The economic, social and political practicalities of these are poor, particularly in the highly centralised taxation environment of Australia.

[3] ABS Government Finance Statistics 2000-2001 catalogue 5512.0 Note all governments includes the multijurisdictional sector

FUEL EXCISE - INVESTMENT IN AUSTRALIA'S ROAD NETWORKS

1. Excise is often levied on certain goods and services for two reasons. They are related to benefits of public services, (e.g., taxes on motor vehicles and motor fuels used to finance construction and maintenance of roads and highways) or to public costs imposed by private actions (e.g. taxes on tobacco products and alcoholic beverages used to defray the costs of health care related to smoking and the excess consumption of alcoholic beverages).

2. There are major benefits for governments in imposing an excise. Goods and services with an embedded excise are usually price inelastic. This means that any increase in the price is not accompanied by a corresponding decrease in the consumption or good. Usually leading to a major revenue windfall to the taxing government. A major example of this is the Commonwealth's excise on petroleum products.

3. The excise on petroleum products (commonly referred to as fuel excise) has become a major general revenue source for the Commonwealth. The original intent of the excise was to establish a direct link (as a proxy user charge) between road users and generation of revenue required to fund construction and maintenance of Australia's road infrastructure.[1]

4. That linkage has been dissolved over time to an extent where there is now no correlation between the excise on petroleum products paid to the Commonwealth by the road user and the amount of money reinvested back into the road network by the Commonwealth.

5. Fuel excise revenue has been a windfall for the Commonwealth. Local government has consistently advocated the position that fuel excise (as a proxy charge for road use) should be used as a mechanism to ensure road users contribute adequate funds for reinvestment into their own road network.

6. The hypothecation of any form of tax is not a popular policy with Treasuries or governments. It is often seen as a constraint to governments who prefer a general revenue pool where money is spent according to fluctuating priorities. Nevertheless, motorists appreciate a transparent approach where a certain amount of excise they are paying is identified, separated and then reinvested back into the road network.[2]

7. In 2002-2003 Australian motorists will provide the Commonwealth Government with an estimated $13.1 billion in excise duty on petroleum products. Although

[1] Fuel Inquiry Secretariat <u>*Issues Paper 18 August 2001*</u> *Page 34*

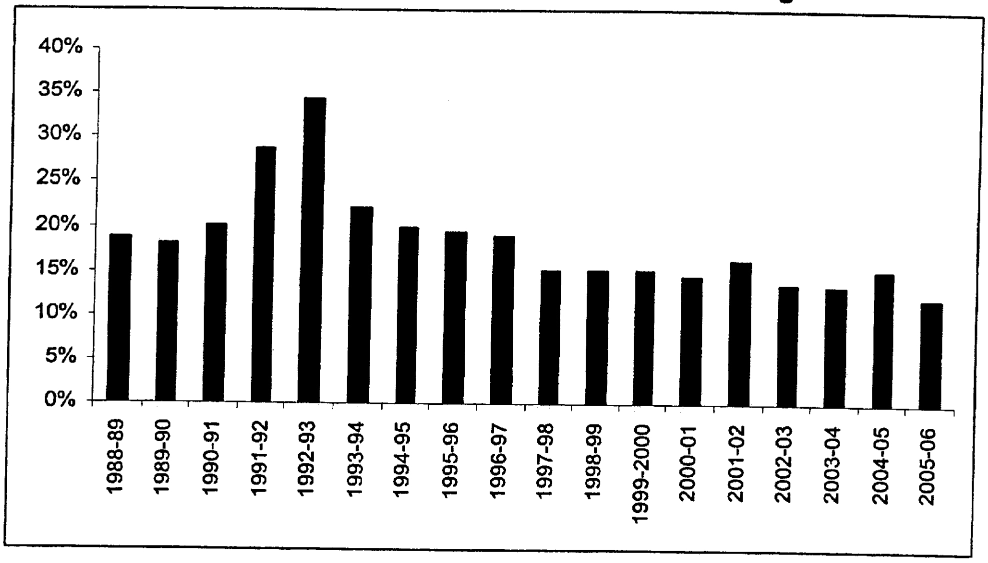
"fuel excise revenue was hypothecated to fund road construction and all diesel fuel used off-road was exempt from excise when first applied in 1957"

[2] *A good example was the 3 x 3 programme by undertaken by the NSW government in the early 90's. Most states have run similar schemes.*

indexation of excise on petroleum products was ceased, this figure will rise to $13.6 billion in 2005-2006. An average increase of $173 million a year.[3]

8. In return the Commonwealth Government in 2001-2002 spent $2.0 billion on roads, which is projected to fall to $1.6 billion in 2005-2006[4]. The discrepancy between revenue extracted from road users and reinvestment in the road network by the Commonwealth is illustrated in chart 4.

Chart 1
Commonwealth Excise on Petrol and Road Funding[5]



---

[3] 2002 –2003 Mid Year Economic and Fiscal Outlook.
[4] Mid Year Fiscal Economic outlook and Budget Strategy and outlook 2002-03 (includes IRLG's)
[5] Unpublished ABS data and various budget documentation, road funding includes Identified local road grants to local government.

WHY GOVERNMENTS TAX AND THE ATTRIBUTES OF A GOOD TAX SYSTEM

1. The primary objective for governments to levy taxes is to finance their operations and functions. Taxes are also powerful economic and financial tools, altering the distribution of income and the levels of spending in an economy. In addition, they have significant social impacts impacting on individual and corporate behaviour (e.g. excise on tobacco reducing smoking).

2. Governments require a wide variety of tax instruments to fulfil their revenue requirements. A broad base ensures the taxation burden is not carried by a particular sector, or activity within the economy. It also goes some way to reducing the incentive to evade the responsibility of paying tax.

3. In addition to taxes, governments also raise revenue by directly charging consumers. Governments need to choose the balance between taxation for a general revenue pool, and direct charging for services. This requires a judgement on what is:
   - efficient;
   - equitable; and
   - effective.

4. The effective financing of government requires access to a
   - robust;
   - Stable; and
   - growing source of revenue.

5. An effective taxation system (in the whole of a country) should exhibit the following attributes:
   - administrative efficiency;
   - fiscal (horizontal and vertical) equity; and
   - transparency and accountability.

6. A nation's tax system must be administratively efficient, ensuring the costs of collection and compliance are kept to a minimum for both the taxpayer, and the government collecting the tax. There are fixed costs associated with the collection of any tax, as a result the assignment of taxes between spheres of government must take into account various efficiency issues.

7. Australia has progressed in the direction of a highly centralised taxation system. This is appropriate response for a country with such a dispersed population across a large area. Whilst some forms of tax competition are good for the economy,

local government prefers to prevent predatory tax competition between jurisdictions. An extreme example is the Canadian GST and sales tax, where ten provinces administer five different sales tax regimes.

8. Fiscal equity occurs horizontally and vertically and relates to the distribution of the tax burden in the economy.

9. Horizontal equity ensures that people in similar financial positions are treated in an equitable manner in regard to taxation. Vertical equity ensures people pay tax according to their capacity to pay (this is commonly referred to a progressive taxation regime).

10. To ensure transparency and accountability, revenue means should be matched as closely as possible to expenditure needs. Tax instruments intended to further specific policy objectives should be assigned to the level of government having the responsibility for such a service. This needs to be traded off against the efficiency of such a system. In a country such as Australia where taxation is highly centralised a vast amount of redistribution is required to match revenue with expenditure needs.

11. The Commonwealth Treasury defines effective government taxation arrangements as follows:

> *"Taxation measures should meet revenue objectives (or other public policy objectives) and have regard to the principles of economic efficiency, horizontal and vertical equity, certainty and transparency whilst minimising compliance and administrative costs. By meeting these aims, taxation measures contribute to the wellbeing of Australians, either directly or by providing the revenue base to finance government services."*[1]

[1] Treasury Portfolio Budget Statement 2002-03 (http://www.budget.gov.au/2002-03/budget_pbs/html/02_treasurypartc-01.html)