MELBOURNE
ECONOMIC FORUM

THE UNIVERSITY OF MELBOURNE

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THOUGHTS ON FEDERAL FISCAL ARRANGEMENTS AND TAXATION PROMPTED BY THE DECEMBER MELBOURNE ECONOMIC FORUM

- Australia has a serious structural budget problem — several percent of GDP nationally (Federal and State) deficit at a time when cyclical activity is nowhere near a low point. The forward estimates have the deficit coming down, but are unrealistic for the following reasons:

--More than $80 billion has been cut from tied grants to States in the forward estimates, without the States funding the gap. The Commonwealth has reinstated a few billion dollars without the remainder of the gap being covered by downward adjustments of expenditure expectations or in other ways. This is a pretend cut in the Federal deficit. Someone—Commonwealth or State—has to fill the gap with tax increases or expenditure reductions.

--The forward estimates still embody unrealistically high expectations on the terms of trade, as they have done in almost every six-monthly statement since 2011, requiring downgrades of budget revenue, with realistic expectations of future iron ore and coal prices requiring another downgrade in a future budget. The realities could be obscured in the May 2016 budget by applying the forward projections recently published by the Commonwealth Department of Industry. This would be imprudent. To follow the Australian Department of Industry would be to close out the information conveyed in Chinese forward markets, which are gross of freight costs.

--The forward estimates embody unrealistically high expectations on nominal GDP growth (beyond the downward pressure on nominal GDP of lower export prices) --overestimating both inflation (and therefore augmentation of revenue from bracket creep) and real output growth. The forward estimates assume a return to historical total factor productivity growth when there has been none for a decade in Australia (and not much in any other developed countries). The fall in business investment from the end of the resources boom has a long way to go. Growth recently has largely come from resource export volumes, housing, consumption and fiscal expansion. Growth in export volumes has been associated with lower export prices and total resource export revenues—Australian incomes would be higher if we had less of this particular growth. And growth in housing investment and private consumption are unsustainable--both will be under pressure in the period ahead.

--Several State budgets are in deep trouble, WA to an extent that has no near precedent. The two stronger State budgets, NSW and Victoria, are buoyed by temporarily high stamp duties from real estate transactions.

-- Prudence in policy requires early national fiscal consolidation to provide protection against that possibility of adverse future developments in the economy and budget.

--The necessary fiscal consolidation at Federal and State levels will in itself be contractionary. This contraction could be offset by stronger growth in non-resource exports from the (still) lower Australian dollar that would come from timely reduction in policy interest rates. This would generate stronger growth in non-resource exports and eventually higher levels of business investment outside resources.

SO:

There has to be a substantial increase in taxes and reduction in expenditures in the national public sector (Commonwealth and State together).

Commonwealth revenue opportunities:

There is a lot of revenue in clearing up the soft concessions introduced in the resources boom—capital gains discount, concessions on super (simply reversing the 2007 changes would make a big difference, but there would be more efficient reforms), enforcement of anti-avoidance laws against hiding offshore income, removing artificial work-related deductions. Do all of these and a bit more and you would make a large contribution to reducing the budget deficit.

State revenue opportunities: Shifting from a land transactions tax to an annual land value tax would generate large economic gains as well as additional revenue with much less distortion than almost any other tax. Modelling by the Victoria University Centre for Policy Studies for the December 2015 Melbourne Economic Forum indicates that an increase in payroll taxes would be less damaging to economic growth and jobs than an increase in GST. Furthermore, there would be large economic efficiency gains from rationalisation of State payroll taxes. There would also be large efficiency gains from replacing state stamp duties on property transfers by annual land taxes. States could generate large national economic efficiency gains and also raise additional revenues at lower costs than many Commonwealth taxes (including the GST) by reforming and raising the rates of payroll and land taxes.

The expenditure side of Federal Fiscal relations: There would be substantial economic gains from removing overlapping jurisdiction between Commonwealth and State Governments. The lowest hanging fruit would be the Commonwealth vacating the transport planning field; strengthen the analytic capacities of Infrastructure Australia; have Infrastructure Australia undertake cost-benefit studies on transport investment proposals suggested by Commonwealth or State Governments; and allow the States and Territories to draw on the Commonwealth balance sheet for borrowing of up to half the capital requirements of a project that has passed the Infrastructure Australia test. This would have large efficiency gains—and remove overlap of Commonwealth and State activities that have been a blight on our Federal democracy in recent years.

Should the Commonwealth or the States do the heavy lifting on budget repair?:

As Cheryl Saunders explained to the December Melbourne Economic Forum, the Federal Constitution would work better of the States took more responsibility for their revenue raising. The F ederation would work better politically if it was clearer who was responsible for what, and had responsibility for the taxes that fund what is being spent by the States. The High Court's interpretation of the Constitution has left the bulk of revenue powers with the Commonwealth, but that does not preclude the Commonwealth raising some taxes for which the States take full responsibility and receive the revenue.

Elements of a reform package:

(i) Recognise that there is a big budget repair job for the Commonwealth and States between them—a few percent of GDP over a few years. The Commonwealth will do its part by removing its deficit gradually, by raising the revenue share of GDP and reducing the expenditure share in some combination. It will stick by a large part of the $80 billion cuts in grants to the States—recognising that this puts a heavy adjustment on the States, but observing that it is better for the Federal system and the efficiency of the economy if they do so.

(ii) It is up to the States to decide how to raise revenue, but the Commonwealth can note the opportunity for efficiency gains as well as increased revenue from reform and raising the rates of some State taxes, notably payroll and land taxes.

(iii) The Commonwealth could offer to assist the States in the administration and even in the Constitutional authority to raise any taxes if there were no problem in differential rates across States and if it were clear that the States were taking responsibility for the tax changes. There would be no need for the Commonwealth to suggest any possibilities, but it may choose to do so, and in any case the possibilities would include:

--A request from all of the States and Territories to increase the rate or broaden the base of the GST. (The requirement for unanimous support for any change, which is unlikely ever to be met, comes from the Howard-Costello agreement with the States that nothing would change unless all States and Territories agreed. Perhaps the States and Territories could be asked now to agree unanimously that this constraint should be relaxed at some specified date in the future to a variation of the "referendum rule", so that a change could be made by the votes of a majority of States and Territories with a majority of the Australian population).

--The Commonwealth could offer to levy at the request of and on behalf of some or all States a surcharge on the excises on any excisable product (petroleum products, tobacco, alcohol) and rebate the proceeds to the State if a State requested it. (These could be set at different rates for different States, or be applied uniformly if the States agreed among themselves). There is an especially attractive opportunity now with petroleum products after the collapse of global prices over the past 18 months.

--The Commonwealth would allow the Clean Energy Regulator to levy a charge on carbon emissions if requested by any State, and pass the proceeds to the State, using the administrative systems and data basis still maintained by the regulator.

(iv) Announce some rationalisation of Commonwealth and State responsibilities with resulting cost savings. The star in this firmament would be the revision of responsibilities for transport discussed above. The Commonwealth could add one twist consistent with the PM's interest in "value capture" as proposed by Peter Newman at Curtin university: Infrastructure Australia would be asked to assess the increase in Commonwealth revenue (if any) that would follow from the implementation of an approved project, and provide a grant to the project over time, equal in value to a specified proportion of the expected increase in Commonwealth revenue.

(v) There should be explicit acknowledgement that the Commonwealth and State fiscal consolidation would be contractionary, and that the efficient way of counteracting this would be through an easing of interest rates associated with a fall in the exchange rate and larger net exports. It would be up to the RBA to judge whether and the extent to which an easing of monetary policy should accompany the tightening of budget policy.

The 2016 COAG meeting has been held in Canberra since the December 2015 Melbourne Economic Forum. The Prime Minister's proposal to reduce the Commonwealth's rates of income tax alongside commensurate reductions in specific purpose payments to the States was consistent with one theme of the Forum's discussion: the value to economic efficiency within the Federation of aligning State sources of and responsibility for taxation revenues more closely to expenditure responsibilities. The original proposal, allowing for differentiated income taxation rates at the discretion of State Governments, was supported by only one Head of Government and rejected by COAG. A variation on this theme has been kept alive for further discussion: the allocation of a proportion of income taxation revenue to the states on alongside an equivalent reduction in Commonwealth special purpose payments to the States, without State discretion or opportunity for differentiation across states on rates of taxation. Such a reform could make a positive contribution to increased fiscal responsibility within the Federation.

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