

State tax competition could lead to a race to the bottom

Written by The Conversation USA

Australia's federal government initiated two major reform processes after the last election: a tax reform process and reform of the Federation. [Prime Minister Malcolm Turnbull's plan](#) to hand income taxing powers to the states sits at the intersection of the two.

Under the Constitution, the states already have the right to levy income taxes. They effectively conceded this power to the Commonwealth after the Uniform Tax Cases, in wartime [1942](#) and affirmed in

[1957](#)

. Both held that the Commonwealth use of the grants power was valid.

The Turnbull proposal is based around the Federal Government cutting income tax rates, then allowing the states to raise income tax directly from residents of that state.

The first challenge is the administration of such a proposal. The Commonwealth took over the collection of state income taxes in 1923 when the states agreed to the [national collection of income tax](#) . This led to

the introduction of the

[Income Tax Assessment Act 1936](#)

, which ensured income tax laws were applied uniformly across Australia.

[Turnbull has said](#) the Commonwealth would continue to collect the tax for the states to avoid compliance costs. The Coalition government has campaigned against red tape, implementing a range of initiatives to reduce overlapping reporting requirements. These include the single touch payroll system that allows employers to report income tax and superannuation obligations in real time. The tax receipts that were issued to accompany tax assessments in the 2015 year would presumably be modified to show the share that was levied by the state.

The biggest challenge that would emerge is if states chose to exercise the right to increase or decrease their income tax rates. Accountability is one of the reasons being put forward for the proposal, on the basis that if the tax is more transparently related to services delivered by the state, the state government will use those taxes more wisely.

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However tax competition can also lead to a race to the bottom: if one state lowers its taxes, other states are likely to follow.

Uniformity dominates

If tax competition results in lower income taxes in one state than another, interstate migration could increase, putting more pressure on the states that have not reduced their income tax rates. We have seen the problems that national governments are encountering regarding the appropriate jurisdiction to levy taxes: it can be expected that similar issues would emerge between the states, requiring a range of residency tests to attribute the residency of itinerant or technology-based workers.

Increasing migration between states would put pressure on state governments to reduce their own tax rates. Recent history shows that when the Queensland government reduced state taxes and abolished death duties in the late [1970s](#) all other states and the Federal Government followed. A general lowering of tax rates would defeat the stated intention of allowing states to raise additional funding for health and education.

It would not be surprising to see mobile workers relocating to low tax states, while people more reliant on good health and education services, who may be at a stage in their life when they do not pay tax, would remain in states with better services.

Recent tax policy initiatives in Australia have focused on tax harmonisation as an antidote to tax competition. For example, since 2007 the states have implemented a [harmonisation agenda](#) to ensure that the administration of payroll tax is consistent across the country: however it does not extend to rates and thresholds.

There is also a question over what is meant by accountability: is it code for cost shifting? The Prime Minister has already acknowledged that states such as South Australia and Tasmania, which have a weak economic base, would have to be protected. Does this mean that if other states experienced a downturn in economic conditions they could also apply for assistance?

In his announcement the Prime Minister referred to this as the most significant change since World War II. History shows that it has been tried before: in 1978 the Fraser government

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introduced [legislation](#) that allowed the states to levy income tax. It did differ in the detail, but allowed states to impose surcharges or allow rebates. This legislation remained in force for 21 years without being applied by any states, partly due to changes in the political and economic environment.

As it stands the reaction from the premiers on the current proposal has been lukewarm. It would seem that a GST style agreement would be advisable to ensure passage through all relevant parliaments.

While both the formal tax and federation reform processes appeared to have stalled, it seems the government is putting them firmly on the election agenda.

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