

Modelling shows why premiers are wary of Turnbull's tax proposal

Written by The Conversation

If Australian states and territories were to levy an income tax based on residency, the revenue would vary considerably between jurisdictions with wealthier states benefiting more from such a regime compared to poorer jurisdictions, [modelling shows](#) .

Prime Minister Malcolm Turnbull is trying to sell this idea at a meeting of the Council of Australian Governments (COAG), following the 2014 budget decision to cut A\$80 billion in Federal funding from the states health and education over the next decade.

Tasmania is one of the states grappling with the longer-term consequences of the proposed federal funding cuts. [Premier Will Hodgman was cautious about the plan](#) , saying:

“If there’s any suggestion the Federal Government will lower income tax and states like Tasmania will be expected to increase income tax, then clearly that’s not workable, not something we would support.”

At first glance the idea of giving states access to the income tax base has merit. There are numerous precedents for income tax sharing in federal systems. Such arrangements exist in Canada, the United States and Germany. Any new state income tax levies could be harmonised with the existing federal tax and administered by the ATO, minimising administrative and compliance costs.

However, despite this improved accountability, allowing the states to set their own income tax rates creates administrative complexity and has significant distributional implications.

Modelling, completed by Neil Warren and myself, looked at 2011 ATO data (then the latest available) and a hypothetical target of raising \$10 billion dollars. However, reflecting the Commonwealth’s current proposal that the states assume responsibility for funding hospitals and public schools, it is possible estimate the state-level surcharges (based on the Medicare levy) that would be required to raise their share of the \$30 billion of additional revenue required.

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The fact that poorer states would have to impose a surcharge almost twice the level required in the ACT is the Achilles heel of the Malcolm Turnbull's proposal. While there are solutions, such as distributing state income tax revenue by formula, or subjecting it to the [Grants Commission equalisation regime](#), such measures would be at odds with the Prime Minister's all important goal of making the states more financially self sufficient.

More significantly, allowing the states to impose an income tax surcharge might improve accountability in the Australian federation but of itself will do nothing to address the post-crisis funding challenge confronting all levels of government in the Commonwealth of Australia.

The proposal risks forcing states and territories to fend for themselves with a real risk of creating a more fractious federation with poorer public services. Smaller states such as Tasmania and South Australia are especially vulnerable. Not only will they have to impose higher tax rates to raise the equivalent revenue but they also lack the economies of scale of the larger states increasing the cost of service delivery.

Finally, there are legitimate concerns that a combination of competitive pressures will limit the capacity of small states to raise their income tax above the national average. There is a active debate among tax scholars about the extent to which tax rates impact on where business invest and where individuals work and live. What is more clear is that perceptions matter and politicians of all persuasions are loathed to increase taxes above accepted levels.

In theory, a state government could make the case for imposing higher state taxes in return for better services. For example, state taxes in California are twice the level they are in Texas and Californians [get much better public services in return](#). However, Australian premiers don't have a strong track record of putting their neck on the line and making the case for higher taxes. In fact, the opposite is true as premiers demonstrated in the 1970s and 1980s as the states engaged in an active race to abolish death and estate taxes.

Given the concerns of state premiers and the issues outlined above it is difficult to understand what Malcolm Turnbull is trying to achieve with his seemingly ill-fated state income tax proposal. To put the pressure back on the states to develop their own strategies to fund key public services or to leave the door open to revisit increasing the GST post election? The latter option would not be the worst outcome for the federation or the national as a whole.

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