



# **COMMONWEALTH GRANTS COMMISSION**

**DRAFT ASSESSMENT PAPER CGC 2003/1**

## **PAYROLL TAXATION**

Prepared for the Commission's 2003 Conferences on Draft Assessments

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## INTRODUCTION

1. This paper presents a draft assessment for the Payroll Tax category for the 2004 Review. It builds on the staff proposals set out in *Discussion Paper CGC 2002/14 Payroll Tax* and State comments on them provided at the 2002 Conferences and in the 2003 Rejoinder Submissions.

2. Commission staff have been consulting with the Australian Bureau of Statistics (ABS) about data sources. Some changes are proposed as a consequence of those discussions. These proposed changes better align the assessment with what States do; reduce the amount of data required by it, simplify the assessment and make it more transparent.

## 1999 REVIEW ASSESSMENT METHOD

### *Description of the category*

3. In the 1999 Review, the Payroll Tax category covered taxes levied on employers' payrolls. Payroll taxes paid by State general government sector agencies were excluded from the category, but taxes collected from public trading enterprises (other than housing authorities, which the Commission treats as welfare agencies)<sup>1</sup> were included.

4. Table 1 shows the revenue standards for payroll tax in dollars per capita and as percentages of own source revenue used in the 2003 Update. It was the largest category of own source revenue with total collections of \$9 695.2 million (an average of \$494.68 per capita) in 2001-02. This represented 19.88 per cent of State own-source revenue.

**Table 1** REVENUE STANDARD ON PAYROLL TAX

	1997-98	1998-99	1999-2000	2000-01	2001-02
Standard revenue (\$ per capita)	428.83	444.66	470.83	492.31	494.68
As percentage of own-source revenues (%)	20.67	18.82	19.45	20.24	19.88

Source: 2003 Update Working Papers, Volume 2, pages 16 and 20.

### *The revenue base*

5. The revenue base was an estimate of the payrolls that would be subject to payroll tax — those of the private sector and public trading sector employers above the taxable threshold. The estimate was based on ABS Compensation of Employees data (formerly wages, salaries and supplements) by State from annual State national accounts.

<sup>1</sup> The ABS uses the term Public Trading Enterprises (PTEs) to include public trading enterprises and public financial enterprises.

Adjustments were made to the base data to better reflect what States actually tax, and improve policy neutrality. The adjustments removed compensation of employees data for:

- (i) members of defence forces and Australian employees of Australian embassies and consulates overseas because their payrolls are not taxed;
- (ii) employees of general government sectors (at all levels of government) so that the base reflects private sector employers and public trading enterprises (PTE) — the so-called *private/PTE adjustment*; and
- (iii) employees of small employer units because it is standard policy to exempt businesses below a payroll threshold — the so-called *threshold adjustment*.

6. A further adjustment was made to take account of differences between States in the size distribution of their employers' payrolls to take account of the progressivity of average payroll taxes — the so-called *value distribution adjustment*.

7. A major problem with the assessment was the number of data sources required to support it. Data came from a number of sources.

- Compensation of employees<sup>2</sup> data were sourced from ABS *Australian National Accounts State National Accounts, ABS 5220.0*. Compensation of employees data are not available by employer size or by the sector and industry as required by the assessment.
- Compensation of employees for defence forces was estimated from annual Department of Defence reports.
- Gross earnings<sup>3</sup> data were sourced from ABS quarterly surveys of employers published in *Employed Wage and Salary Earners ABS 6248.0*. Gross earnings data were available by sector, industry and size of employer unit and were used to calculate the private/PTE adjustment and the threshold adjustment.
- Sample data<sup>4</sup> on taxes collected and taxable payrolls were sourced from the States. These data were provided by wage value range and type of employer and were used to calculate the value distribution adjustment.

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<sup>2</sup> Compensation of employees is the total remuneration payable by an enterprise to an employee — it includes wages and salaries in cash and kind and employers' social contributions such as superannuation contributions and workers compensation premiums.

<sup>3</sup> Gross earnings are essentially cash payments only.

<sup>4</sup> States were not able to provide all their payroll data and they provided a sample instead. For 2001-02, the sample was about 91 per cent of all payrolls. Commission staff adjusted these data to improve interstate comparability and conformity.

8. Table 2 shows the capacities implied by the assessment parameters on average for the 2003 Update.

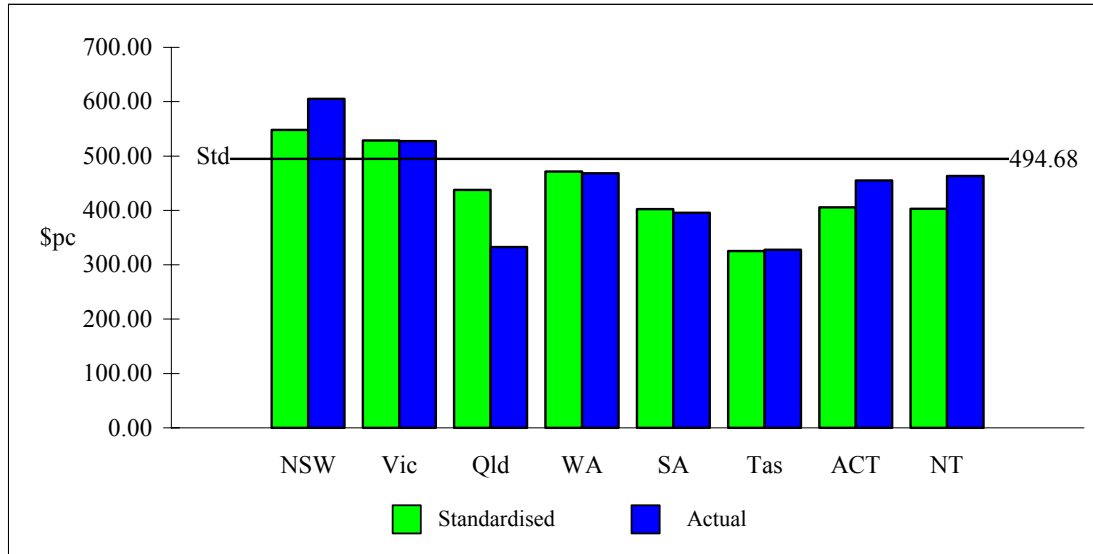
**Table 2** SUMMARY OF AVERAGE IMPLIED CAPACITIES, 1996-97 TO 2000-01

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	%	%	%	%	%	%	%	%	%
2003 Update (average of assessment years)									
Compensation of employees net of defence and embassies	106.46	103.93	88.80	98.04	85.31	76.20	145.31	109.50	100.00
Private/PTE adjustment	102.11	104.88	97.96	100.22	95.66	90.27	54.91	83.81	100.00
Threshold adjustment	98.78	103.23	100.17	97.13	100.56	99.37	89.43	92.90	100.00
Value distribution adjustment	99.55	99.24	102.33	100.86	98.51	100.16	101.68	99.03	100.00
Category capacity <sup>(a)</sup>	106.85	111.54	89.41	96.46	81.05	69.21	72.31	84.84	100.00

(a) Category capacity is approximately the product of the other parameters.

9. Figure 1 shows the assessment for 2001-02 from the 2003 Update.

**Figure 1** PAYROLL TAX: STANDARDISED, ACTUAL AND STANDARD REVENUES PER CAPITA, 2001-02



**Importance of the category**

10. Table 3 shows that, compared with an equal per capita assessment, the payroll tax assessment redistributed \$563.4 million in the 2003 Update.

**Table 3** GRANT DISTRIBUTION OF PAYROLL TAX COMPARED WITH EPC DISTRIBUTION, GST RELATIVITIES

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT redistributed	Total
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Change in grant	-272.8	-290.6	220.9	42.8	160.3	79.8	42.6	17.0	563.4

### MAJOR DEVELOPMENTS SINCE THE 1999 REVIEW

#### *Changes in tax provisions*

11. Since the 1999 Review, States have generally moved to:
  - (i) reduce the rate of tax;
  - (ii) increase the threshold exemption limit for businesses; and
  - (iii) broaden the tax base by including non-salary employee benefits such as employer superannuation contributions, eligible termination payments and the (grossed-up) value of fringe benefits.
12. Table 4 shows recent tax rates and thresholds.

**Table 4** CHANGES IN PAYROLL TAX RATES AND THRESHOLDS

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Rate of tax (maximum)	%	%	%	%	%	%	%	%
1997-98	6.85	6.25	5.00	5.56	6.00	6.60	6.85	7.00
2001-02	6.20	5.45	4.80	6.00	5.75	6.30	6.85	6.50
2002-03	6.00	5.35	4.75	6.00	5.67	6.24	6.85	6.30
Threshold	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000
1997-98	600	515	800	675	456	600	700	520
2001-02	600	515	850	675	456	1 000	1 250	600
2002-03	600	550	850 <sup>(a)</sup>	675 <sup>(a)</sup>	504	1 010	1 250	600

Source: Commonwealth Grants Commission Reports and Interstate Comparison of Taxes 2002-03, NSW Treasury.

(a) There is no threshold deduction for payrolls above \$3.4 million in Queensland or payrolls above \$5.625 million in Western Australia.

### ***Changes in data availability***

13. In 2002, ABS revised the way it collected and reported its economic statistics to make better use of data available from the taxation system. This has changed the availability of gross earnings data.

14. As noted above, the private/PTE adjustment and the threshold adjustment were based on published and unpublished gross earnings data. These data were sourced from the quarterly publication *Wage and Salary Earners 6248.0*. However, from March 2002:

- *Wage and Salary Earners ABS 6248.0* will report public sector data only. The ABS plans to discontinue this publication, but will continue to provide the Commission with electronic access to public sector gross earnings data.
- Private sector labour cost data will be published in *Economic Indicators ABS 5676.0* using estimates from the *Quarterly Business Indicators Survey (QBIS)*. The labour cost data in that publication are 'wages and salaries'. ABS advises that, other than being on an accrual basis, wages and salaries are conceptually the same as 'gross earnings'.

15. Commission staff have discussed data availability issues with the ABS. The ABS advises that some data will no longer be available (specifically, the special tabulations of branch offices in private sector units of less than 20 employees). However, the ABS will be able to supply new and detailed data, which provide an opportunity to simplify the assessment and remove the need for States to provide sample data. These issues are discussed below.

### **CATEGORY DEFINITION FOR 2004 REVIEW**

16. There is general support for the existing scope of the category and the Commission has found no reason to change it. The category will continue to comprise payroll taxes levied on private sector employers and public trading enterprises (including public financial enterprises). It will continue to exclude payroll tax paid by State general government sector agencies.

### **MAIN ISSUES FOR THE 2004 REVIEW**

17. The main issues were:

- (i) whether the assessment can be simplified;

- (ii) whether there is a better way of assessing PTE capacity;
- (iii) whether a broad (sub-global) capacity measure should be used;
- (iv) whether an elasticity adjustment should be assessed; and
- (v) whether a cross border adjustment should be assessed for the ACT.

## **SIMPLIFYING THE ASSESSMENT**

18. In all States, small businesses whose annual payroll is less than a specified threshold level pay no payroll tax — a tax-free threshold is standard policy. In most States, larger businesses with annual payrolls in excess of the threshold level are only liable to pay payroll tax on the excess amount. In the 1999 Review, the threshold adjustments sought to standardise the threshold level and the value distribution adjustment sought to account for the differences in the size distribution of taxable employers (including the deduction of the \$650 000 threshold). The separate adjustments in the 1999 Review reflected data limitations at the time.

19. However, the availability of new data from the ABS suggests that there may no longer be a need for two separate adjustments.

### ***Threshold adjustment***

20. In the 1999 Review, the Commission calculated the threshold adjustment using ABS published data on the gross earnings of private sector units of less than 20 employees. In making that adjustment, unpublished ABS data were used to remove the payrolls of branch offices from the published data on the gross earnings of private sector units of less than 20 employees. This was done because payrolls of branch offices were liable for payroll tax because they were part of the payroll of a non-exempt business.

21. ***State views. South Australia*** said the use of businesses with less than 20 employees was an inadequate proxy for the threshold because each State defined it in terms of dollars. Because average wages differed across States, the Commission's approach implied the Commission was using a different value threshold for different States. It proposed that the Commission either make an adjustment (for example, increase the firm size used) for States where wage levels were below average or discontinue the threshold adjustment.

22. ***Preliminary proposal.*** In *Discussion Paper CGC 2002/14 Payroll Tax*, Commission staff said that a threshold adjustment was necessary because it reflected the standard policy. Staff acknowledged South Australia's point, but concluded that data were not available to support a refinement in the adjustment, nor was it obvious how estimates of a possible refinement or its impact on the assessments might be made.

23. ***Further State views. New South Wales*** doubted differences in the average

wages of employees in small businesses would be the same as the differences in the average wage for all employees.

24. **Victoria** said that the threshold adjustment should be retained because the threshold and value distribution adjustments were the only mechanisms by which policy effects were removed from the assessment.

25. **Queensland** said that the threshold adjustment was material and should be continued. It said the question of whether to further refine the adjustment involved a trade off between accuracy and complexity. It was questionable whether the refinement would be material.

26. **Western Australia** agreed with South Australia about the need to adjust for differences in average wages, but asked whether it could be done in a practical manner. It said deleting the adjustment altogether would reduce fiscal equalisation.

27. **South Australia** suggested adjusting for differences in average wages using an index of average weekly ordinary times earnings (AWOTE) ratios. It said States with below average AWOTE should have the gross earnings of employees with less than 20 employees increased to reflect average AWOTE.

28. **Tasmania** supported the threshold adjustment. It also supported making an adjustment for differences in earnings and differences in business size. It asked the Commission to investigate other sources of data on business size (Australian Tax Office or State departments) that might assist in determining the level of adjustment necessary to reflect differences in the impact of earnings and business size on the threshold level.

29. The **ACT** supported the current threshold adjustment and said using businesses of less than 20 employees was a reasonable approximation for the threshold value.

30. The **Northern Territory** supported the current threshold adjustment and said that adjusting for differences in wage levels would be difficult.

### ***Value distribution adjustment***

31. In the past, States in effect imposed progressive rates of tax through a mix of exemption thresholds, surcharges and rebates. To account for differences in the States' value distribution of payrolls, the Commission assessed a value distribution adjustment using sample data provided by States.

32. **State views.** The **Northern Territory** highlighted potential problems with the payroll data used in the value distribution adjustment. It noted some States were shown as having taxable employers with payrolls below their threshold level and that including them in the calculations could bias the outcome.

33. **Preliminary proposal.** In *Discussion Paper CGC 2002/14 Payroll Tax*, Commission staff said a value distribution adjustment was warranted because the tax-free threshold meant payroll tax was effectively levied on a progressive basis.

34. The discussion paper also noted that there were problems in ensuring comparability of sample data provided by States, particularly classification of employers to value ranges based on Australia-wide ranges. Commission staff made adjustments to improve the consistency of the data.

35. **Further State views.** *New South Wales* said it was not aware of any discrepancies in its sample data. It said any concerns over data reliability and quality could be avoided if the current approach were replaced with a simple and more transparent global measure.

36. *Queensland* said the value distribution adjustment should be removed or at least a smaller range of values should be used. It was confident that Queensland's sample data were reliable, but was concerned about anomalies in the calculation of the value distribution adjustment.

37. *Western Australia* said that it had worked with its Office of Revenue to fix the problem of reliability of its sample data. It said that classification problems were likely to relate mainly to employers operating in more than one State that had not been correctly allocated on the basis of national payrolls.

38. *South Australia* said that attempts have been made to improve the quality of payroll data provided to the Commission. It said that sample data for the 2001-02 year were unavailable because it had decided to audit all end of year adjustments to annual payroll tax returns following the changeover from one payroll tax reporting system to another.

39. *Tasmania* proposed that the Commission seek to strengthen the surveys of employers' payroll tax returns provided by each State revenue office.

40. The *Northern Territory* supported the value distribution adjustment.

### ***Analysis and evaluation***

41. Both the threshold adjustment and the value distribution adjustment address the issue of States applying different rates of tax to different payroll values. The threshold adjustment removed the payrolls of non-taxable small businesses from the revenue base. The value distribution adjustment took account of the fact that the payroll exemption was available for large businesses — they were allowed to deduct the exemption threshold from their payrolls — and that States imposed multiple rates of tax above the threshold level.

42. The adjustments were material, as shown in Table 5.

**Table 5** GRANT SHARE EFFECTS OF THRESHOLD AND VALUE DISTRIBUTION ADJUSTMENT, 2003 UPDATE

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total redistributed
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Change from Update 2003	-36.9	49.0	44.5	-30.0	-7.2	0.6	-11.6	-8.2	94.0

43. Attachment B shows States' payroll tax regimes from 1 July 2002. It shows that six States impose a single marginal rate of tax above their threshold values. Queensland and Western Australia have multiple marginal tax rates but a flat rate (no deductions) for payrolls in excess of \$3.400 million and \$5.625 million respectively. Commission staff conclude that a progressive rate structure is no longer the standard policy. A single marginal rate above a specified threshold is the standard policy.

44. During discussions on data availability, the ABS said that it could provide wages and salaries data by value range. This would allow the Commission to deal with the threshold exemption in one adjustment (as opposed to the two adjustments in the 1999 Review).

45. ***Calculating the threshold adjustment for small businesses.*** The ABS have provided data on private sector units in each State with wages and salaries of less than \$650 000<sup>5</sup>. The advantages of this approach are that:

- the same threshold value is used for all States;
- no branch office adjustment is necessary — because the ABS has classified branch offices according to their employer's Australian-wide wage level.

46. Table 6 shows the grant share impact of changing the current approach (gross earnings of businesses of less than 20 employees) to a \$650 000 threshold.

**Table 6** GRANT SHARE EFFECT OF USING ANNUAL PAYROLLS OF LESS THAN \$650 000, 2001-02

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total redistributed
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Change from 2003 Update	-5.5	1.4	9.5	-11.8	8.0	0.0	0.3	-1.9	19.2

47. ***Calculating the threshold adjustment for large businesses.*** The ABS can provide data on the number of businesses with payrolls in excess of \$650 000. These data can be used to estimate the size of exempt payrolls for large businesses. Once these are removed, there is no need for a value distribution adjustment because it is standard policy to tax the remaining payrolls at a single marginal rate.

48. The advantages of this approach are:

- it better aligns with how States levy payroll taxes;
  - it eliminates the requirement for States to supply sample payroll data;
- and

<sup>5</sup> \$650,000 was used because it was the weighted average of State threshold values. The ABS can provide data for any value.

- it simplifies the assessment by removing the value distribution adjustment.

49. Table 7 shows the combined impact of excluding small businesses below the \$650 000 threshold and the first \$650 000 of wages of large businesses for 2001-02.

**Table 7** GRANT SHARE EFFECT OF EXCLUDING THE FIRST \$650 000 OF WAGES OF ALL BUSINESSES, 2001-02

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total redistributed
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Change from 2003 Update	-44.3	2.3	25.8	3.2	4.4	3.1	2.6	3.0	44.4

50. The redistribution shown in Table 7 is based on ABS data, some of which were estimates. The ABS has advised that it will be able to supply data that will eliminate the estimates. Commission staff will continue to consult with ABS on data issues.

51. **Commission decision.** The Commission accepts that the standard policy is to exempt payrolls below a threshold value from payroll tax and to tax payrolls in excess of this value at a single rate of tax. The Commission concludes that this presents a strong case for removing the value distribution adjustment. ABS data are available to support this approach from 2001-02. The Commission is confident the use of a single set of ABS data will result in a simpler and more accurate assessment of the threshold adjustment. The ABS is unable to provide data for years prior to 2001-02. Therefore, the Commission proposes to phase in this change. The current approach would be retained for earlier years and the threshold value approach would be used for 2001-02 and beyond.

52. The Commission has decided to:

- retain the threshold adjustment for the 2004 Review but to assess it by exempting the payrolls of small businesses whose annual payrolls are equal to or less than \$650 000 and exempting the first \$650,000 of payrolls of large businesses;
- discontinue the value distribution adjustment; and
- because of data limitations to phase-in this new approach from 2001-02.

### ***Reducing the number of data sources***

53. **Preliminary proposal.** In *Discussion Paper CGC 2002/14 Payroll Tax*, Commission staff proposed simplifying the assessment by not using compensation of employees data. Rather than using gross earnings data to adjust compensation of earnings data, the proposal suggested basing the assessment on gross earnings data. The main difference between compensation of employees and gross earnings is that the former is the

total remuneration payable to an employee — it includes wages and salaries in cash and kind and employers' social contributions such as superannuation contributions and workers compensation premiums — whereas the latter related only to the cash component. Staff said that the proposal would make the assessment more robust by greatly reducing the amount of arithmetic involved.

54. **Further State views.** Some States supported the proposal. *New South Wales* said gross earnings did not include fringe benefits and employer's superannuation contributions, but said the adjustments to include these elements were simpler than the numerous adjustments in the current assessment.

55. *Victoria* supported the proposed simplification of the revenue base.

56. *South Australia* said that a change could be justified if the change in grant shares was small. It acknowledged that mixing of data sources was a problem with the current assessment.

57. The *ACT* said that while gross earnings excluded fringe benefits and employers' superannuation, this had to be weighed up against the disadvantages of the current method.

58. The *Northern Territory* supported the proposal, but suggested the Commission make an adjustment for fringe benefits and superannuation benefits on the grounds that it is standard policy to tax those items.

59. The other States opposed the simplification. *Queensland* said that superannuation contributions and fringe benefits did contribute to differences in State capacities. It noted that the proportions of gross earnings to compensation of employees had been volatile in recent years, with trends emerging in some States. An adjustment would be needed for employers whose total salary packages included elements not included in gross earnings. It proposed using State sample data as an alternative to compensation of employees data because payroll tax provisions were broadly similar across States with the exception of tax rates and small business thresholds.

60. *Western Australia* opposed the proposal because superannuation and fringe benefits were important parts of the base and they varied significantly between firms, industries and States. It said the grant share implications of the change would be material for Western Australia.

61. *Tasmania* said that ease of calculation was not necessarily an end in itself. The assessment should capture fringe benefits and employers' superannuation benefits because the degree to which employers used fringe benefits might differ between States. Fringe benefits were more likely to be used in head offices and jurisdictions with higher wage levels.

62. **Analysis and evaluation.** Table 8 shows the ratio of gross earnings to compensation of employees. While the ratio is about 85 per cent on average, it varies between States over time.

63. The standard policy is to apply payroll tax to benefits other than cash entitlements (for example, employers' superannuation contributions and fringe benefits), suggesting that compensation of employees is closer to the payrolls that States tax than gross earnings.

**Table 8** GROSS EARNINGS AS A PROPORTION OF COMPENSATION OF EMPLOYEES (GE/CE excluding CE of defence and embassies)

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	%	%	%	%	%	%	%	%	%
1997-98	86.9	83.6	82.4	84.3	82.2	87.5	80.6	81.3	84.5
1998-99	86.7	83.7	86.6	86.3	84.6	86.1	83.6	78.4	85.6
1999-2000	82.4	84.4	87.3	84.8	84.0	86.6	82.0	86.6	84.2
2000-01	80.3	86.9	86.2	87.3	84.1	85.1	82.4	89.7	84.1
2001-02	84.5	85.8	86.8	86.6	87.5	88.0	83.9	80.3	85.6
<b>Average</b>	<b>84.2</b>	<b>84.9</b>	<b>85.9</b>	<b>85.9</b>	<b>84.5</b>	<b>86.7</b>	<b>82.5</b>	<b>83.3</b>	<b>84.8</b>

64. The grant share impact of the proposal is material and the separation of ABS data for public and private sector labour costs affects the simplification that could be achieved. Simplification is achieved from the new method of allowing for taxable thresholds.

65. **Commission decision.** The Commission accepts that the conceptual case for moving from compensation of employees to gross earnings has not been established. Compensation of employees is closer to the definition of taxable payrolls than gross earnings and is conceptually a better measure. The Commission has decided to continue to use compensation of employee data.

## OTHER ISSUES

### *A broader assessment*

66. **State views.** In their main submissions, *New South Wales* and *Western* supported a broader measure of capacity for all revenue assessments.

67. **Victoria** said the current capacity measure was affected by State policies because the size of payrolls and the structure of its businesses were sensitive to States' payroll tax regimes. It concluded the best method of removing the effects of these policies was to assess payroll capacity using a broad economic indicator (such as unadjusted compensation of employees, gross household disposable income or State population). It considered a broader measure would not be as affected by State policies on the threshold levels or tax rates.

68. **Preliminary proposal.** In *Discussion Paper CGC 2002/14 Payroll Tax*, Commission staff did not support a broad assessment. They said a broad economic indicator would not approximate the payroll tax base actually used by States. For example, total compensation of employees paid within a State would not take into account differences across States in the proportions of general government sector activity or in the types of employers who were taxable. This was particularly significant for the ACT and the Northern Territory, which have a high presence of Australian Government departments and agencies.

69. Staff proposed to continue to measure the payroll tax revenue base using an estimate of payrolls subject to tax because:

- (i) this reflected what States do; and
- (ii) while some estimates had to be made, the data were reasonably robust.

70. **Further State views.** *South Australia* opposed a broad approach because the broad measures were open to the influence of State policies affecting economic development and employee payrolls.

71. *Tasmania* also opposed a broad approach. It said there was no empirical evidence that payroll tax rates impacted on the level of employment, or the structure of industry. It said that a broad approach would not ensure policy neutrality, and would not reflect what States did.

72. **Analysis and evaluation.** The use of a broad assessment of capacity, such as unadjusted compensation of employees, would not take account of State differences in the sector and industry structure of employers or State differences in the proportion of small businesses below the taxable thresholds. It would attribute States with capacity that no State was accessing. It would not reflect what States actually do in raising revenue. In particular, it would overstate the payroll capacity of the ACT and the Northern Territory because these States have a high presence of Commonwealth departments and agencies.

73. **Commission decision.** The Commission considers that a conceptual case for using a broad assessment of payroll capacity has not been established. The Commission is not convinced that a broad assessment would produce a better equalisation outcome than the current approach of using the estimated value of payrolls subject to tax. For this reason, the Commission has decided not to adopt a broad assessment approach for payroll taxation.

### ***Elasticity adjustment***

74. **State views.** *Victoria* said an elasticity adjustment of  $-1$  should be introduced if the Commission decided to retain the existing approach to measuring payroll revenue capacity. It said an elasticity adjustment was required because the payrolls in each State were affected by the payroll tax regime and the influence of that policy choice should be removed from the revenue base.

75. It noted that the growth in payrolls of businesses with less than 20 employees was much larger in New South Wales than Victoria, despite the fact that the growth in

employment was roughly the same. It concluded this was due to the combined effects of the higher threshold and the higher tax rate in New South Wales.

76. **Preliminary proposal.** In *Discussion Paper CGC 2002/14 Payroll Tax*, Commission staff did not support the introduction of an elasticity adjustment because differences in payroll tax rates were relatively small and there was no empirical evidence that those differences had a material effect on the revenue base.

77. **Further State views. New South Wales** supported consideration of an elasticity adjustment in principle. However, it did not accept that payroll tax rates and thresholds influenced the size and structure of firms because payroll taxes were passed on to consumers through prices. It also noted that payroll tax rates and thresholds were similar in New South Wales and Victoria.

78. **Victoria** provided a study from the Centre of Policy Studies at Monash University<sup>6</sup> to support its case for an elasticity adjustment. The study concluded that:

- States could significantly alter their capacity to raise payroll revenue by imposing different thresholds and tax rates;
- the existence of a threshold encouraged business to keep their wage bill below the tax-free threshold; and
- while payroll tax design had limited impact on a State's total wage bill, it impacted heavily on the size distribution of firms.

79. Victoria concluded that the size and distribution of firms by size was greatly affected by State policy choices and, therefore, that an elasticity adjustment was justified. It said the study supported an elasticity adjustment of -0.7 for Victoria.

80. **Western Australia** doubted there were any significant tax rate elasticity impacts because employers had the capacity to pass on the incidence of payroll tax in higher prices.

81. **South Australia** opposed the introduction of an elasticity adjustment because there was insufficient empirical evidence to support it.

82. **Tasmania** opposed the introduction of an elasticity adjustment for payroll taxation because it would introduce a distortion. The case for an adjustment was based on largely unsubstantiated assertions. It said the differences between the actual tax rates in each state and the standard tax rate was relatively insignificant.

83. The **Northern Territory** did not support an elasticity adjustment. It said:

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<sup>6</sup> *The impact of payroll tax thresholds on firm size and Commonwealth Grants Commission funding*, Dixon, Picton and Rimmer, Centre of Policy Studies, Monash University, October 14 2002 reproduced in Victoria's Rejoinder Submission, February 2003.

- differences in State policies regarding payroll tax would have an immaterial, if any, effect on revenue capacity; and
- there was no robust evidence to support the existence of, nor the extent of, an elasticity effect on the revenue base and any adjustment would be heavily reliant on judgement.

84. ***Analysis and evaluation.*** The Commission accepts the conceptual case that State expenditure and taxation regimes affect the level of economic activity. However, to be able to analyse this effect properly, the Commission would require a general equilibrium model of State economies, which it does not have. In the absence of such models, it is not convinced that selective elasticity adjustments would move equalisation in the right direction or by the right magnitude. So, the Commission is not attracted to making selective elasticity adjustments for differences in State rates of tax.

85. ***Commission decision.*** The Commission does not accept the conceptual case has been established for assessing selective elasticity adjustments. There is no doubt that State expenditure and taxation regimes affect the levels of economic activity. However, it is not at all clear that these effects could be estimated with any reliability (in respect of either direction or the magnitude) by a series of selective adjustments. For these reasons, the Commission has decided not to assess an elasticity adjustment in the Payroll Taxation category.

### ***Changing the method of measuring the PTE sector***

86. The payrolls of PTEs are left in the revenue base because under national competition policy, all PTEs are subject to the same tax regimes as private employers.

87. In the 1999 Review, the Commission measured the size of the PTE sector using gross earnings for those sectors where government activity was predominantly commercial: Mining; Manufacturing; Electricity, Gas and Water Supply; Transport and Storage; Communication services; and Finance and Insurance<sup>7</sup>. PTE activity in other industries was excluded. This approach had the advantages of simplicity and transparency because the data were published.

88. However, data availability has increasingly become a problem with this approach. Data confidentiality restrictions meant the ABS are unable to provide data for a number of industries (particularly the communications industry). The Commission estimated the confidential data in the 2003 Update but was concerned that over time, its estimates would become less reliable. Also, the current approach's advantage of transparency has disappeared because the data are no longer published.

89. ***Preliminary proposal.*** In *Discussion Paper CGC 2002/14 Payroll Tax*, Commission staff proposed to assess the PTE part of the Private/PTE adjustment using aggregate gross earnings of employees of all public trading and public financial enterprises.

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<sup>7</sup> Any general government sector activity in these industries was included with PTE activity.

90. **Further State views.** No State commented on this proposal.

91. **Analysis and evaluation.** The 1999 Review approach is unsustainable because of the data confidentiality problems. Moreover, it excludes data for PTEs in industries where the public sector is a minor player. The proposal to define the PTE sector as all public trading enterprises and public financial enterprises, irrespective of industry, is a conceptually more accurate measure. This definition would also overcome the confidentiality restrictions on ABS.

92. Table 9 compares gross earnings data for the previous and the new approach. ABS has provided data for all years of the assessment period. Table 10 shows the grant share effects of using the new data.

**Table 9** COMPARISONS OF PTE GROSS EARNINGS

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
<b>2003 Update data</b>									
1997-98	4 323.7	2 403.2	2 390.3	959.0	847.3	245.9	287.8	90.9	11 548.1
1998-99	4 044.0	2 290.8	2 342.2	890.1	685.7	252.0	298.9	89.6	10 893.3
1999-2000	3 807.0	2 118.5	2 309.5	888.1	671.1	230.1	256.5	87.2	10 368.0
2000-01	3 592.7	1 629.1	2 381.5	823.5	491.1	228.3	223.1	88.9	9 458.1
2001-02	3 785.4	1 757.5	2 316.7	715.4	451.0	230.1	209.7	101.4	9 567.1
<b>Revised data</b>									
1997-98	4 614.0	2 344.7	2 344.6	985.2	880.5	148.0	242.1	47.5	11 606.6
1998-99	4 563.9	2 257.6	2 302.3	918.2	723.2	140.8	261.9	47.7	11 215.6
1999-2000	4 407.7	2 030.2	2 166.7	923.3	694.1	132.7	241.1	49.6	10 645.4
2000-01	4 268.2	1 683.3	2 178.9	873.6	524.4	228.8	237.3	91.0	10 085.5
2001-02	4 394.8	1 889.1	2 185.1	796.3	532.4	238.5	221.6	105.8	10 363.6

**Table 10** GRANT SHARE EFFECT OF USING THE INSTITUTIONAL DATA FOR PTEs

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total redistributed
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Change from 2003 Update	-27.2	8.0	12.5	-0.3	-1.0	4.5	1.5	2.0	28.5

93. **Commission decision.** Including the payrolls of all PTEs in the assessment provides an estimate of the revenue base that is close to what States actually tax. That is, it represents a more complete and conceptually better approach. In addition, the ABS can provide the necessary data for all years and using the new data will have a material impact on State budgets. The Commission has decided to:

- (i) to use the gross earnings data of public trading enterprises (PTEs) to calculate the private and PTE sector adjustment because this a conceptually better approach; and
- (ii) because data are available, to use the new data for all years of the assessment period

### ***Cross border adjustment for the ACT***

94. ***State views.*** The *ACT* said that it experienced a ‘leakage’ of payroll tax to New South Wales because payrolls of ACT branch offices were often administered from head offices in Sydney. By doing this, the business avoided the additional costs and complexity of lodging two separate payroll tax returns and avoided the higher ACT payroll tax rate. The ACT said the extent of the problem meant prevention of the leakage was not within the bounds of a standard compliance effort and there was little likelihood of reversing it. Based on a sample of its compliance records, the ACT estimated a leakage of two per cent of revenues. It asked the Commission to reduce its base by two per cent and increase New South Wales’ revenue base by the same amount.

95. ***Further State views.*** *South Australia* said the nature of the disability was unclear and required further justification and empirical support.

96. ***Analysis and evaluation.*** The ACT said an adjustment should be assessed because of the difficulties it faces in enforcing its provisions. This is either a compliance issue or one for interstate negotiation on an alternative administratively simpler approach. In either case, it is not an equalisation issue.

97. ***Commission decision.*** The Commission does not consider that a conceptual case exists for assessing disabilities for compliance issues. Compliance issues are not matters for equalisation. The Commission has decided not to introduce an adjustment for the difficulties the ACT faces in enforcing its provisions.

## **PROPOSED ASSESSMENT METHOD FOR THE 2004 REVIEW**

98. The Commission’s assessment method for the 2004 Review will be broadly similar to that used for the 1999 Review. The revenue base will continue to be an estimate of the payrolls that would be subject to payroll tax — those of the private sector and public trading sector employers above the taxable threshold. The estimate will continue to be based on compensation of employees. But it will be adjusted to take account of:

- (i) non-taxable employers including the general government sector, Australian Government employees, members of defence force, and employees of embassies and consulates; and
- (ii) a threshold exemption of \$650 000, which would include all payrolls of those taxable employers below the threshold and the

first \$650 000 in payrolls of taxable employers above the threshold.

99. Due to data limitations, this method will be phased in from 2001-02.

***Calculating the revenue base***

100. The calculation of the proposed revenue base for 2001-02 is shown as Attachment A. The attachment shows the revenue bases for the previous years which follow the 1999 Review assessment method, adjusted to reflect the revised method of estimating the size of the PTE sector.

**2004 REVIEW DRAFT CALCULATIONS**

***Grant share effects***

101. Table 11 shows the grant share effect of the proposed method of assessment. The changes are due to the changed assessment method for 2001-02 and the new method of estimating the PTE sector for previous years. Both changes mean the assessment better reflects what States do in imposing payroll tax.

**Table 11** GRANT SHARE EFFECT OF THE PROPOSED METHOD OF ASSESSMENT, GST RELATIVITIES

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT redistributed	Total
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
2003 Update	-272.8	-290.6	220.9	42.8	160.3	79.8	42.6	17.0	563.4
2004 Review draft	-342.9	-280.8	257.2	45.8	164.2	87.8	46.5	22.3	623.7
Change	-70.1	9.8	36.3	3.0	3.9	7.9	3.9	5.3	70.1

***Revenue raising capacity ratios***

102. Table 12 shows the revenue raising capacity ratios for the proposed 2004 Review assessment method for 2001-02, as compared with those in the 2003 Update.

**Table 12** REVENUE RAISING CAPACITY RATIOS

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
2003 Update	1.1078	1.0694	0.8851	0.9529	0.8133	0.6582	0.8198	0.8142	1.0000
2004 Review Draft	1.1726	1.0645	0.8174	0.9369	0.7848	0.5910	0.7415	0.6775	1.0000

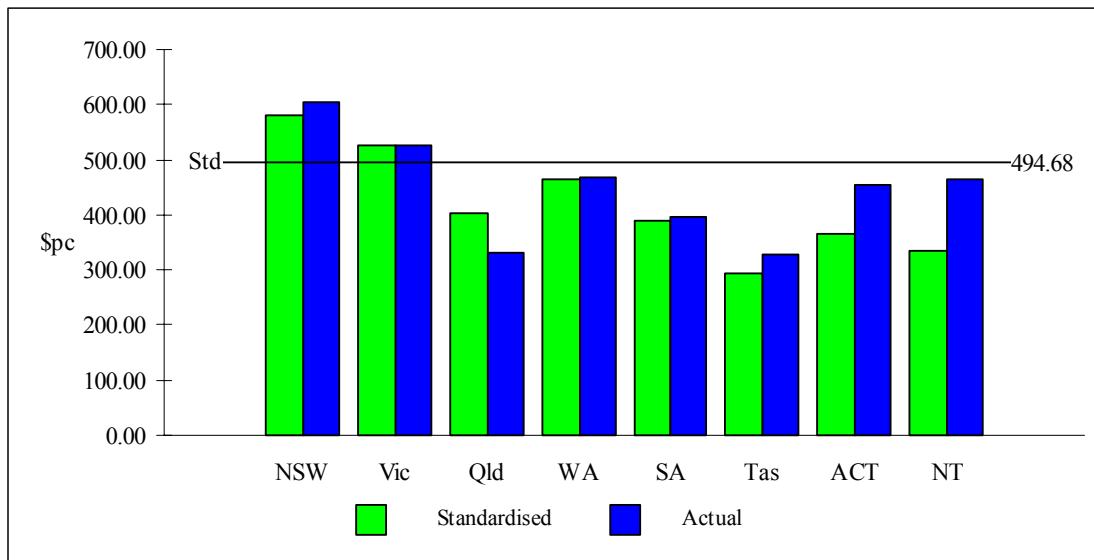
**Standardised revenue**

103. Table 13 shows the actual and standardised revenues under the proposed 2004 Review assessment method for 2001-02, as compared with those in the 2003 Update. Figure 2 presents the actual, standard and standardised revenue for 2001-02 under the new assessment method.

**Table 13** ACTUAL AND STANDARDISED REVENUES, 2001-02

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Std
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
<b>Actual revenue</b>									
2003 Update	605.46	527.37	332.41	468.25	395.81	327.75	455.15	463.48	494.68
2004 Review Draft	605.46	527.37	332.41	468.25	395.81	327.75	455.15	463.48	494.68
<b>Standardised revenue</b>									
2003 Update	547.98	529.02	437.84	471.39	402.33	325.60	405.54	402.75	494.68
2004 Review Draft	580.05	526.61	404.35	463.46	388.22	292.38	366.81	335.16	494.68

**Figure 2** PAYROLL TAX: STANDARDISED, ACTUAL AND STANDARD PER CAPITA, 2001-02



**Reality check**

104. The results show that standardised revenues are consistent with actual revenues for most States allowing for the differences in revenue effort. As shown in Attachment B, Queensland had the lowest rate of payroll tax of all States in 2001-02; the ACT had the highest. The Northern Territory also had a relatively high rate of tax.

### *Updateability*

105. The proposed Payroll Taxation assessment uses the estimated value of payrolls subject to tax. For each new update, compensation of employees and gross earnings data will be sought for the latest year. These data are provided by the ABS.

106. For the draft calculations, we have used a threshold value of \$650 000 for 2001-02 as a weighted average of State's thresholds. This value may need to be changed from time to time as States' change their threshold values.

**ATTACHMENT A**

**CALCULATION OF THE DRAFT REVENUE BASE FOR 2001-02**

**Table A-1**    **CALCULATION OF REVENUE BASE – COMPENSATION OF EMPLOYEES, 2001-02**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
A.    Total Compensation of Employees (CE) (a)									
2001-02	122 962.0	86 219.0	56 200.0	32 647.0	21 901.0	5 922.0	8 559.0	4 104.0	338 514.0
B.    Estimated CE of embassies and consulates (b)									
2001-02	0.0	0.0	0.0	0.0	0.0	0.0	180.0	0.0	180.0
C.    Salaries and superannuation of defence forces (c)									
2001-02	1 048.0	471.2	877.5	253.3	170.1	8.1	330.8	355.1	3 514.0
D.    CE of Agriculture, forestry and fishing industry (d)									
2001-02	1 327.0	893.0	1 114.0	646.0	359.0	186.0	5.0	65.0	4 595.0
E.    CE net of above (A less B, C and D)									
2001-02	120 587.0	84 854.8	54 208.5	31 747.7	21 371.9	5 727.9	8 043.2	3 683.9	330 225.0

Sources: (a) ABS *Australian National Accounts: State Accounts 2001-02, 5220.0*, Table 17.

(b) ABS unpublished information.

(c) Defence Department *Annual Reports*.

(d) ABS *Australian National Accounts, State Accounts 2001-02, 5220.0*, Tables 18-26.

**Table A-2** CALCULATION OF REVENUE BASE — TAXABLE PROPORTION OF WAGES AND SALARIES/GROSS EARNINGS

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
F. Wages and salaries of private sector (a)									
2001-02	64 220.7	44 807.7	25 785.8	15 357.9	10 587.3	2 221.4	2 106.5	994.1	166 081.3
G. Non-taxable wages and salaries of private sector									
2001-02	9 741.1	7 183.2	4 776.2	2 346.5	1 892.1	289.2	511.2	140.2	26 879.6
H. Taxable part of wages and salaries of private sector (F - G)									
2001-02	54 479.6	37 624.5	21 009.7	13 011.3	8 695.1	1 932.2	1 595.4	853.9	139 201.8
I. Gross earnings of PTE sector (b)									
2001-02	4 394.8	1 889.1	2 185.1	796.3	532.4	238.5	221.6	105.8	10 363.6
J. Non-taxable gross earnings of PTE sector (Commission estimate)									
2001-02	754.8	333.4	377.8	176.3	71.6	57.5	34.9	21.9	1 827.9
K. Taxable gross earnings of PTE sector (I - J)									
2001-02	3 640.2	1 555.7	1 807.3	620.0	460.8	181.0	186.7	83.9	8 535.7
L. Taxable wages and salaries/gross earnings of Private and PTE sector (H + K)									
2001-02	58 119.8	39 180.1	22 817.0	13 631.5	9 156.0	2 113.0	1 782.0	938.0	147 736.9
M. Total wages and salaries/gross earnings (a)									
2001-02	102 974.4	73 602.7	48 039.2	28 061.7	19 010.2	5 206.1	6 754.9	3 009.0	286 658.2
N. Taxable wages and salaries/gross earnings as a proportion of total (L / M)									
2001-02	0.5644	0.5323	0.4750	0.4858	0.4816	0.4059	0.2638	0.3117	0.5154

Sources: (a) Unpublished ABS data

**Table A-3** CALCULATION OF REVENUE BASE — TAXABLE COMPENSATION OF EMPLOYEES

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
O. Adjusted taxable wages and salaries/gross earnings (E * N)									
2001-02	68 060.3	45 169.9	25 747.2	15 422.0	10 293.5	2 325.0	2 121.9	1 148.1	170 287.8
P. CE of Agriculture, forestry and fishing industry									
2001-02	1 327.0	893.0	1 114.0	646.0	359.0	186.0	5.0	65.0	4 595.0
Q. Non-taxable CE of Agriculture, forestry and fishing industry (P * (G + J)/(F + I))									
2001-02	203.0	143.7	205.3	100.9	63.4	26.1	1.2	9.7	753.2
R. Taxable CE of Agriculture, forestry and fishing industry (P – Q)									
2001-02	1 124.0	749.3	908.7	545.1	295.6	159.9	3.8	55.4	3 841.8
S. Revenue base ( O + R)									
1997-98 <sup>(a)</sup>	57 185.6	41 037.8	24 697.6	14 798.7	10 003.4	2 722.2	1 670.9	1 253.0	153 369.2
1998-99 <sup>(a)</sup>	59 828.4	44 684.5	26 676.9	15 469.2	10 304.3	2 818.9	2 046.9	1 345.9	163 175.0
1999-2000 <sup>(a)</sup>	61 470.6	48 311.4	28 113.8	15 807.1	10 712.2	2 708.5	1 960.7	1 285.4	170 369.7
2000-01 <sup>(a)</sup>	66 096.4	51 383.2	30 036.3	16 653.9	11 250.4	2 866.7	2 348.5	1 753.7	182 389.1
2001-02	69 184.3	45 919.2	26 655.9	15 967.0	10 588.9	2 484.8	2 125.8	1 203.6	174 129.6

(a) 2003 Update with revised method of measuring PTE sector.

## STATE PAYROLL TAX REGIMES

Table B-1 STATES PAYROLL TAX REGIMES 2001-02

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
<b>Basic Flat Rate:</b>	6.2% effective from 1.1.01  6.0% effective from 1.7.02	5.45% effective from 1.7.01  5.35% effective from 1.7.02  5.25% effective from 1.7.03	4.8% effective from 1.7.01  4.75% effective from 1.7.02	6% top marginal rate effective from 1.1.02	5.75% effective from 1.7.01  5.67% effective from 1.7.02	6.30% effective from 1.7.01  6.24% effective from 1.7.02	6.85%	6.5% effective from 1.7.01
<b>Method of calculation of tax:</b>	Single marginal rate.	Single marginal rate.	Deduction system.	Increasing marginal rates.	Single marginal rate.	Single marginal rate.	Single marginal rate.	Single marginal rate.
<b>Tax Scale and Small Business Concession:</b>	First \$600 000 exempt.	First \$515 000 exempt.  First \$550 000 exempt from 1.7.02.	First \$850 000 exempt. For payrolls between \$850 000 and \$3.4m, deduction of \$850 000 reduces by \$1 for every \$3 payroll exceeds \$850 000. No deduction for payrolls in excess of \$3.4m.	First \$675 000 exempt. <b>\$0.675m-\$2.7m:</b> 4.867% of excess <b>\$2.7m-\$4.5m:</b> \$98 550 + 6.025% of excess <b>\$4.5m-\$5.625m:</b> \$207 000 + 11.6% of excess <b>Greater than \$5.625m:</b> 6% flat.	First \$456 000 exempt.  First \$504 000 exempt from 1.7.02.	First \$1 000 000 exempt from 1.7.01.  First \$1 010 000 exempt from 1.7.02.	First \$1 250 000 exempt from 1.7.01.	First \$600 000 exempt.
<b>Inclusions in the tax base:</b>	Employer superannuation contributions included in the base.	Employer superannuation contributions included. Eligible termination payments and the grossed up value of fringe benefits included in the base from 1.7.01.	Employer superannuation contributions included from 1.1.00. Eligible termination payments and the grossed up value of fringe benefits to be included in the base from 1.7.02.	Employer superannuation contributions included. Grossed up value of fringe benefits included in the base from 1.1.02.	Employer superannuation contributions included. 'Eligible termination payments' (as defined for income tax purposes) and the full grossed up value of fringe benefits included in the base from 1.7.02.	Employer superannuation contributions and non-grossed up value of fringe benefits included in the base.	Employer superannuation contributions included in the base.	Employer superannuation contributions and fringe benefits included in the base.