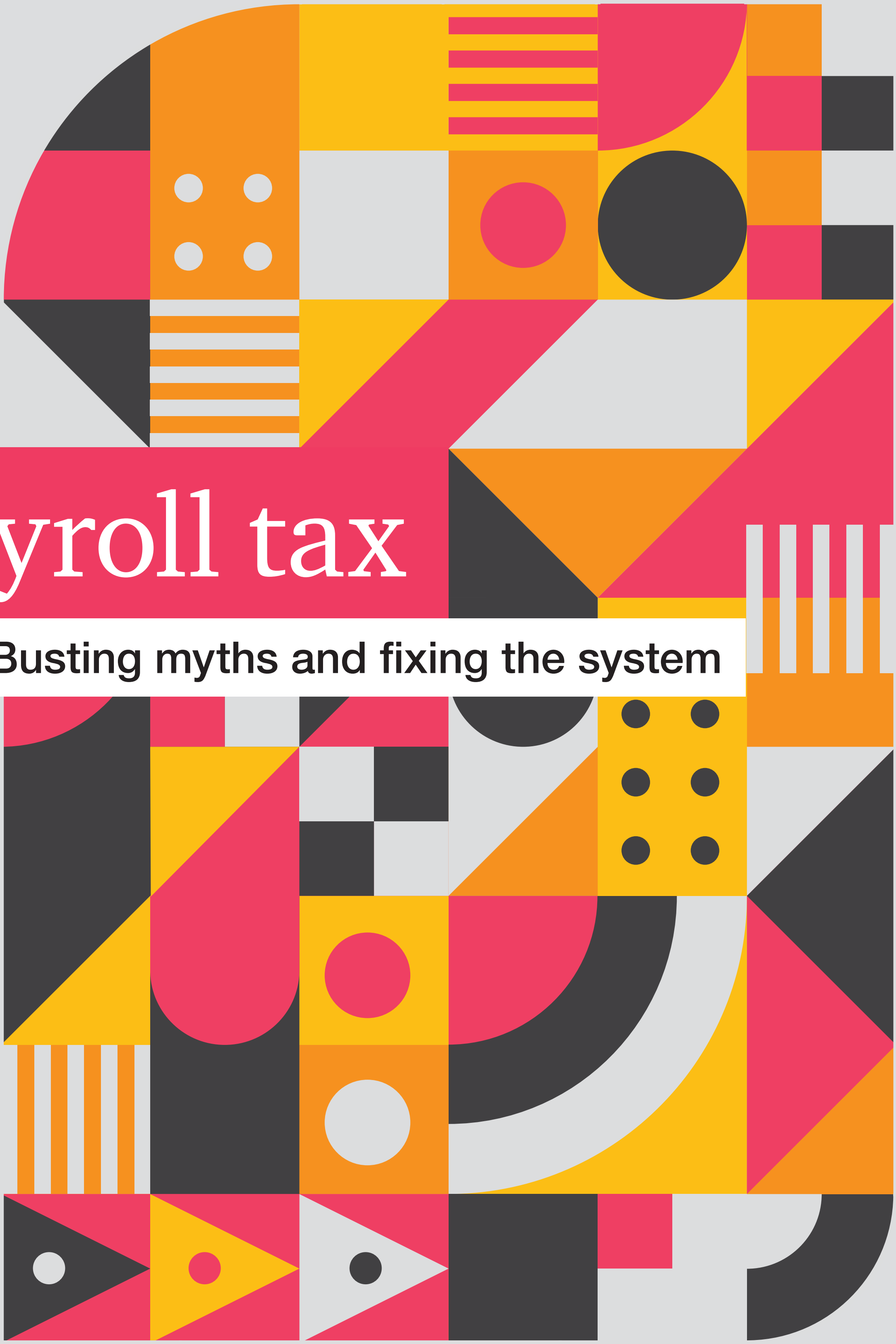

Payroll tax

Busting myths and fixing the system

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Key findings

Payroll tax is possibly the most misunderstood tax levied in Australia.

While the payroll tax is conceptually efficient, the existence of thresholds and exemptions undermines this efficiency and increases complexity for businesses. That is, payroll tax-free thresholds – created by competition between states and territories to attract investment – create distortions which reduce output and employment.[1] Hence, it should be a target of reform.

The logical response is to address these distortions by removing exemptions and lowering the rate.

This tax switch could be achieved by extending the obligation to pay payroll tax to all businesses with employees, while lowering the rate to 3.64% (for a single national rate) or 3.1% - 4.5% (for net no revenue impact in each state and territory).

There is no evidence to suggest that such a reform is likely, or even possible.

Such reform would be perceived as a direct attack on small business and so is unlikely to be achievable. What then is a 'next-best' way to reform payroll tax?

An intermediate approach could be adopted by:

- lowering thresholds rather than completely removing them, and/or
- using a progressive tier of rates (akin to the WA payroll tax model).

The figure below shows two illustrative examples which generate an aggregate level of payroll tax consistent with current tax levels, with example A showing flex so that state tax levels are maintained, while example B shows a nationally consistent approach that has different impacts on states and territories. These are examples only, such options could be designed in a number of ways.

Examples of options to lower thresholds and rates (2018-19 terms)

	Current arrangements		Example A: remove non-government exemptions, $500k threshold, state-by-state revenue neutral		Example B: remove non-government exemptions, two tier rate, national revenue neutral		
	Revenue	Rate	Revenue change	Rate change	Revenue change	Rate 1 (under $1m)	Rate 2 change -(over $1m)
NSW	9386	5.45%	0	-0.36%	-505	1%	-0.66%
Vic	6280	4.85%	0	-0.27%	-71	1%	-0.06%
Qld	4146	4.75%	0	-0.42%	678	1%	+0.04%
SA	1258	4.85%	0	-0.43%	203	1%	-0.06%
WA	3557	5.50%	0	-0.36%	-206	1%	-0.71%
Tas	359	4.00%	0	-0.14%	-14	1%	+0.79%
NT	280	5.50%	0	-0.45%	4	1%	-0.71%
ACT	549	6.85%	0	- 0.58%	-89	1%	-2.06%
Total	**25,815**		**0**		**0**		

These options have the benefit of both moving towards a more efficient outcome, while still retaining some concessions for small businesses.

This reform could be underpinned by a concerted focus on harmonisation and a reduction in administrative costs. Reforms should address, in priority order:

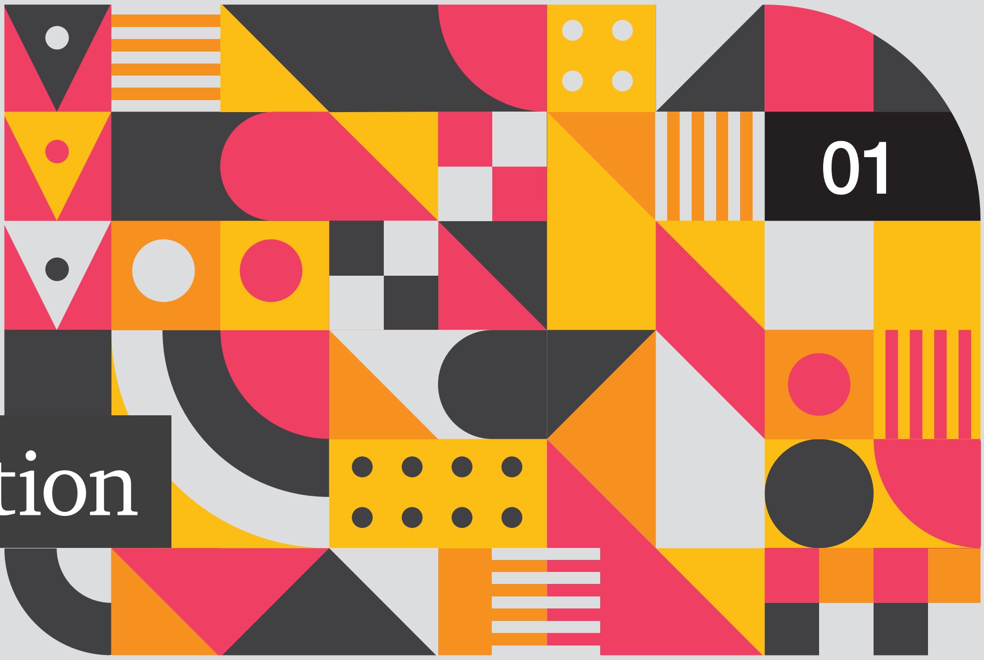
Centralising the administration (i.e. collection) of the tax: Streamline the collection of payroll tax via the ATO through either: Single Touch Payroll reporting; or standardising the tax return forms and lodging them through SBR. Either path provides a foundation for reduced administrative and compliance costs.

Standardising definitions: While there have been some steps to standardising definitions, interpretation gaps still exist (e.g. 'grouping' provisions, and definitions for 'relevant contract' and 'employment agent'), that add complexity for business.

Standardising exemptions: States and territories have a plethora of exemptions that have developed in an ad hoc manner over the years. The states, territories and the Commonwealth should coordinate the process of standardisation and (like the National Competition Policy (NCP) reform legislation review process) the onus should be on those who seek an exemption to justify why such an exemption provides a net public benefit.

Standardising rates: Differentiating tax rates based on size and location across states and territories create distortions which reduce output and employment, penalise employees and consumers of larger businesses.

1. See Industry Commission (1996)



Introduction

In its modern iteration, payroll tax is a levy on income paid within a particular state or territory by employers to, or on behalf of, their employees. In general, the payroll tax base includes wages, salaries and other forms of employee benefits such as bonuses and fringe benefits.

Australian state and territory governments are particularly constrained in terms of the taxes they can levy. The High Court of Australia's interpretation of the Constitution effectively limits the types of taxes which can be applied by States and Territories. Payroll tax provides a relatively broad-based tax for states and territories and is important for reducing vertical fiscal imbalance (VFI).

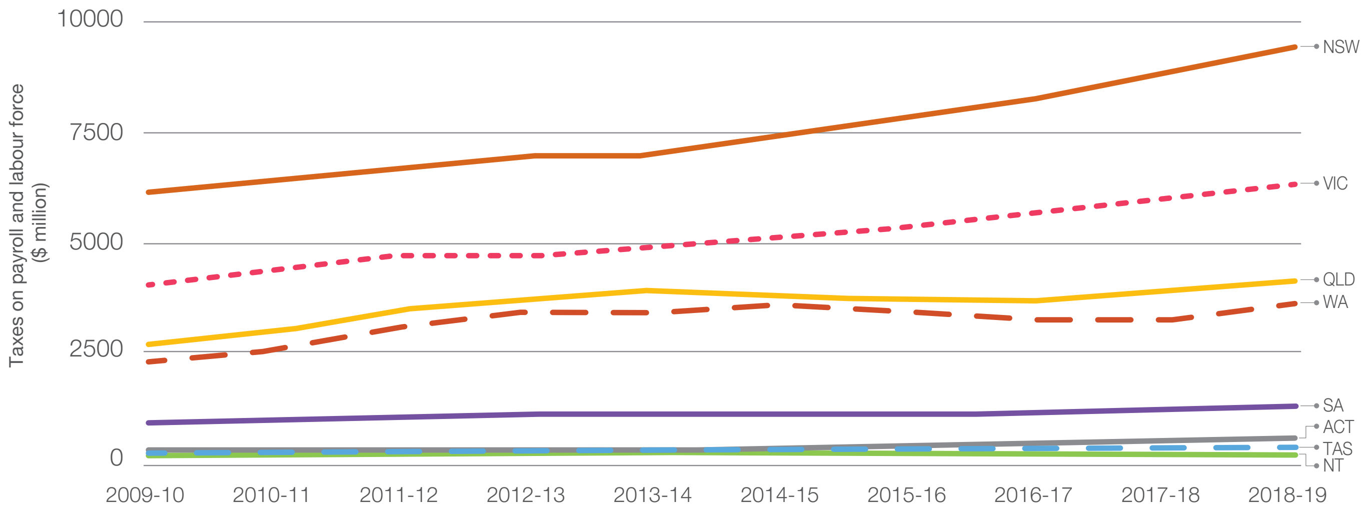
Payroll tax has a long history in Australia. From 1941, payroll tax was initially levied by the Commonwealth on all payrolls at a flat 2.5% rate.[2]

From 1971 onwards (as the Commonwealth recalibrated its tax base to rely more heavily on income tax) the responsibility for payroll tax was passed to the states and territories (as were the benefits).[3]

Over time, the breadth and uniformity of the payroll tax base was unwound according to the specific needs of each State and Territory, as well as inter-jurisdictional competition between them. Today, state and territory payroll taxes range between 2.02% (regional Victoria) and 6.85% (ACT), and each jurisdiction has a range of different concessions and exemptions that apply to various types of employers.

Payroll tax is the largest state and territory-levied tax, providing states and territories with $25.8 billion in revenue in 2018-19 (see figure 1.1), representing 30.1% of tax revenue raised by these governments.[4]

Figure 1.1: Payroll tax revenue by jurisdiction ($ million)



2. Pay-roll Tax Act 1941 (Cth)
3. Freebairn et al (2015, p.13)
4. ABS (2020a)

Australia is one of the few Organisation for Economic Co-operation and Development (OECD) countries that levy a tax on payroll. Australia also collects a relatively large amount of payroll tax as a proportion of its total tax revenue (see figure 1.2).[5]

Unfortunately, despite its importance as an own-source revenue measure for the states and territories, payroll tax is one of the most misunderstood taxes by businesses, politicians and the community.

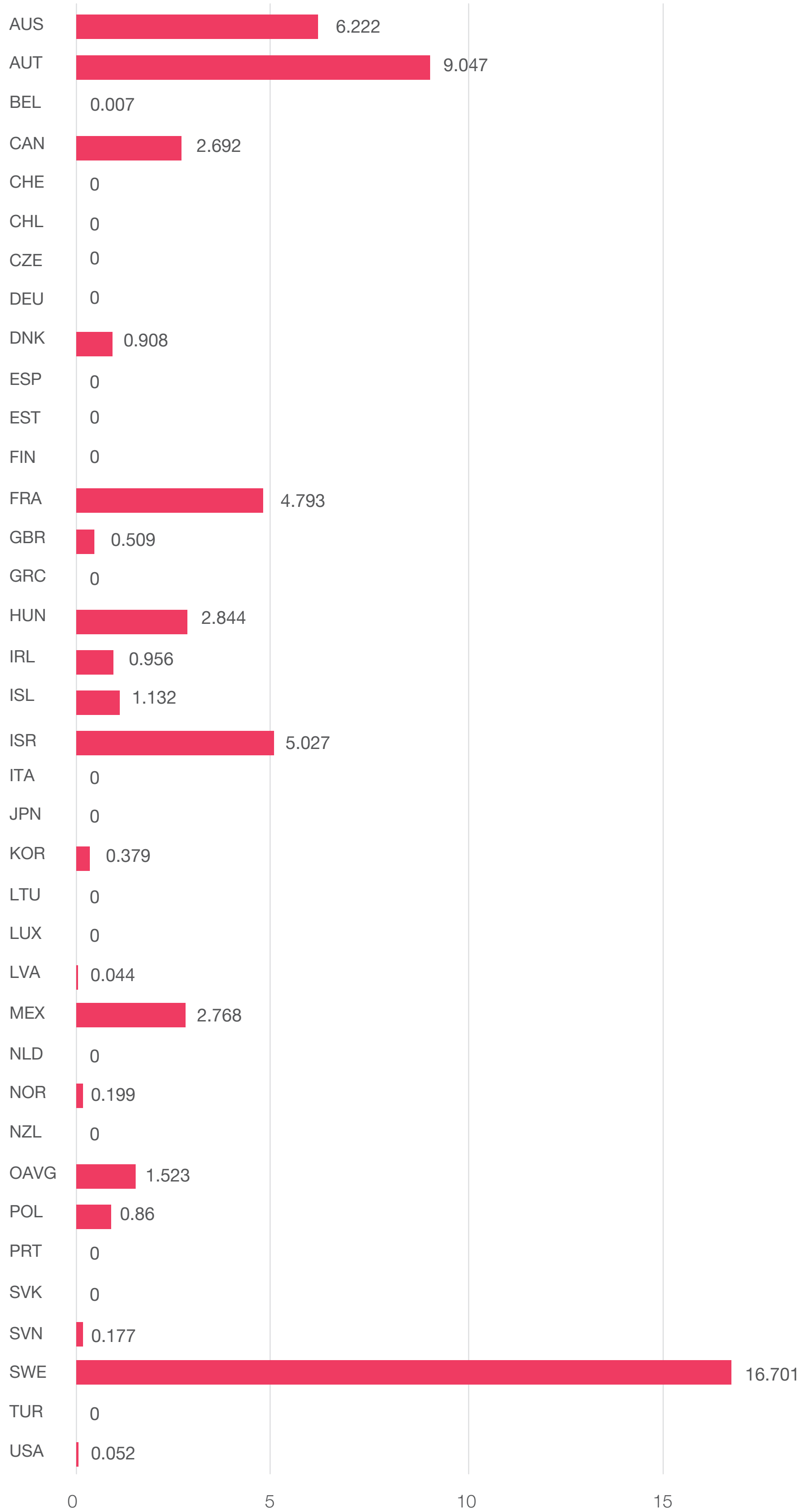
Common misconceptions about payroll tax include:

- payroll tax primarily impacts small business
- payroll tax is a 'tax on jobs' and reduces employment
- payroll tax is efficiently collected
- payroll tax has been successfully harmonised across states and territories.

These misconceptions mean that there are calls for reform that are often misguided or inappropriate.

Having said that, we believe state taxes provide some of the greatest opportunities for reform. In this report, we address the key misconceptions about payroll tax and consider reforms to improve Australia's payroll tax system.

Figure 1.2: Payroll tax as a percentage of taxes raised (latest available - 2017 and 2018)[6]



5. Most other OECD countries levy social security contributions. These social security contributions are similar to payroll tax but are generally hypothecated to fund social benefits, such as unemployment benefits, illness and maternity leave, mobility leave, family allowances and pensions
6. OECD (2020)

02

Common misconceptions about payroll tax

2.1 Myth: payroll tax is a small business issue

Small businesses and their representatives are common critics of payroll tax.

The reality is that relatively few small businesses have a payroll tax liability.

As shown in figure 2.1, each state and territory has a payroll tax ‘threshold’. The precise threshold mechanism may differ between jurisdictions. However, the broad effect is that an entity will be exempt from payroll tax obligations if it (aggregated with any entities that are ‘grouped’ with it) has a quantum of wages that falls beneath the identified number. For these purposes, ‘wages’ may mean either wages paid specifically in that jurisdiction or wages paid nationally.

Figure 2.1: Simplified current payroll tax rates and thresholds by jurisdiction

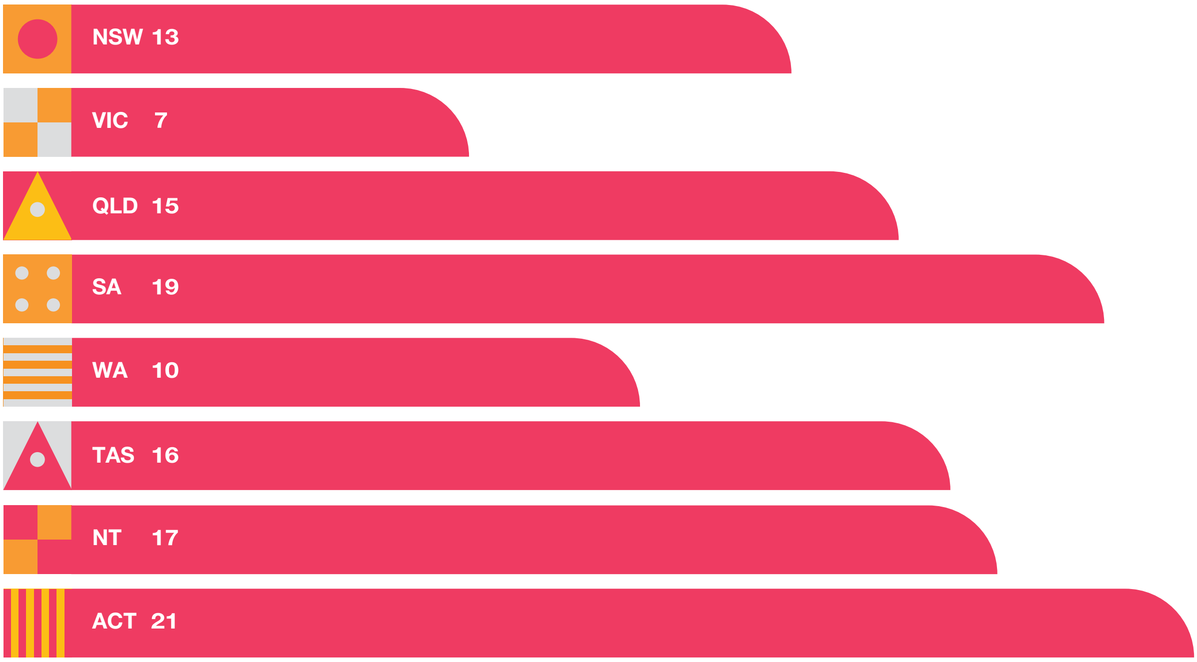
	Payroll tax rate	Exemption threshold (wages)	Temporary changes or COVID exemptions
NSW	4.85%	$1,200,000	Options for payment deferment and a reduction for businesses with grouped wages of less than $10 million in 2019-20 financial year
VIC	4.85% (2.02% for regional employers)	$650,000	Payroll tax credits are available for businesses for 2020-21 financial year
QLD	4.75% - 4.95% (depending on Australian taxable wages)	$1,300,000	Deferred payment options available in 2020
SA	2.5% - 4.95% (depending on Australian taxable wages)	$600,000 for lowest rate and $1,700,000 for highest rate	Deferral and waiver are possible for businesses that are experiencing a reduction of turnover
WA	5.5% - 6.5% (depending on WA taxable wages)	$1,000,000	Change to threshold was moved earlier than originally planned. Certain waivers available for March to June 2020
TAS	4-6.1% (depending on Australian taxable wages)	$1,250,001 for lowest rate and $2,000,000 for highest rate	Rebates and waivers available to small to medium businesses meeting criteria
NT	5.5%	$1,500,000	Deferral and waivers available to businesses experiencing a reduction of turnover
ACT	6.85%	$2,000,000	Deferral and waivers available to businesses experiencing a reduction of turnover

For ease of reading, in figure 2.1 we have not depicted every rate that may apply to a business in each jurisdiction. However, it is worth noting that once a business passes the payroll tax threshold, several states have a gently progressive tax rate that increases with the relevant wage base (e.g. Queensland, South Australian and Western Australia). Some states additionally provide targeted concessions (e.g. regional businesses in Victoria and Queensland). Likewise, figure 2.1 does not incorporate the various payroll tax relief measures provided by states, such as temporary payroll tax exemptions over short periods of time, or specific COVID-19 relief measures.[7]

The consequence of the exemptions and progressive tax rates is that many small businesses will be exempted or bear a much lower rate of taxation than implied by the published headline rate.[8] For each jurisdiction, figure 2.2 shows the average number of employees that can be employed before a business becomes liable for payroll tax.

This shows small businesses are unlikely to be liable for payroll tax (given that a business is considered small if it employs fewer than 20 people).[9]

Figure 2.2: Number of staff before payroll tax required to be paid[10]



2.2 Myth: payroll tax is a tax on jobs

Possibly the most common criticism of payroll tax is that it is a tax on jobs and so reduces employment.

Payroll tax, like personal income tax and fringe benefits tax (FBT), is a tax that is levied on employment income and benefits. Like FBT, payroll tax is legally imposed on the employer. However, it is important to distinguish between the following impacts of payroll tax:

- **Legal incidence:** This refers to the party legally responsible for paying the tax. In the case of payroll tax, the legal incidence falls on the employer who must pay the liability (although this liability is partially reduced by the fact that payroll tax is a deduction for corporate income tax purposes).
- **Economic incidence:** This refers to who finally bears the tax. As with other taxes, the economic incidence of payroll tax can shift along the production and distribution chain.

7. For example, it is acknowledged that the NSW Budget 2020-21 had a two-year temporary decreased payroll tax rate after which there will be a threshold increase
8. There are also complications created by the interplay of thresholds in different jurisdictions for multi-state businesses
9. Australian Small Business and Family Enterprise Ombudsman (2019, p.7)
10. Wages are calculated by multiplying the average total cash earnings per employed person in each jurisdiction (ABS 2020b) by 52 weeks. Total cash earnings increased in May 2020 as a result of COVID-19, primarily affecting low income earnings which skew these results

In the case of payroll tax, the legal incidence is not aligned with the economic incidence and so while employers bear the legal costs, there are several possible economic impacts of payroll tax.

There are three main parties that could bear the economic impact of payroll tax:

The employer (or owner of capital)

If the employer bears the cost of the payroll tax, this results in lower than optimal productivity for the business, seen in lower profits or lower use of labour.

The employee

If the employee incurs the economic incidence of the payroll tax, this results in reduced wages. That is, the employer still receives their optimal amount of labour but the employee supplies it for lower cost (such that the cost to employer remains the same).

The consumer

If the consumer incurs the cost, this results in higher prices. (That is, the labour transaction between employer and employee remains the same and all additional costs are passed on in higher prices.)

Which of these three players incurs the cost of payroll tax depends on the interaction between the labour market and businesses. For example:

- In the long run, labour market conditions mean the tax burden is more likely to fall on the employee than the employer, resulting in lower wages.[11] This is because labour is less mobile than capital (which can be redistributed to manage taxes or reductions in productivity).
- In the short run, however, it may not be possible to pass payroll tax changes onto labour. (Wages may be inflexible, for instance, due to enterprise bargaining agreements). Additionally, businesses may not be able to reallocate capital as quickly in the short term and so the business (or the consumer) may bear the burden of the tax.

The burden of any change to payroll tax, therefore, comes down to whether capital or labour is more mobile in response to the tax.

Over time, as markets adjust, the burden is gradually removed from the employer. This will vary market by market, but analysis of payroll taxes in Canada showed no evidence of the burden being borne by the employer (i.e. no change in level of employment, productivity or profit), but rather that the tax was almost entirely passed through to employees in reduced wages.[12]

Similarly, the ability to pass the tax burden onto the consumer depends on individual markets, and whether consumers can substitute different goods or services or reduce their consumption.

As such, it is reasonable to conclude that:

> **Some stakeholders criticise payroll tax on the grounds that it is a tax on employment and as such acts as a drag on economic activity. However, in practice, the cost of paying the tax can be passed on either to employees (through lower wages) or to consumers (through higher prices).[13]**

11. See discussion and evidence from empirical tests in Bennmarker (2008)
12. Deslauriers, J, et al (2018)
13. IPART (2008, p.57)

Given that only larger businesses are subject to payroll tax (see section 2.1), payroll tax is best described as an impost on the workers of large businesses, or on consumers who purchase goods and services from larger organisations. The most impacted sectors (either from a lower wage result or higher price result) are shown shaded in figure 2.3. These are sectors where the industry pays relatively more payroll tax than the number of employees would suggest.

Figure 2.3: Percentage of payroll tax paid by industry, compared to total employees and large businesses (2018-19)[14]

	% payroll tax (of national total)	% total employees (of national total)	Approximate number of large businesses (200+ employees)
Agriculture, Forestry and Fishing	1%	4%	100
Mining	6%	2%	150
Manufacturing	12%	7%	450
Electricity, Gas, Water and Waste Services	3%	1%	100
Construction	9%	10%	200
Wholesale Trade	5%	5%	300
Retail Trade	12%	12%	350
Accommodation and Food Services	3%	9%	350
Transport, Postal and Warehousing	7%	5%	250
Information Media and Telecommunications	3%	1%	100
Rental, Hiring and Real Estate Services	3%	4%	100
Professional, Scientific and Technical Services	15%	10%	300
Administrative and Support Services	10%	8%	600
Public Administration and Safety	1%	0%	50
Education and Training	1%	4%	200
Health Care and Social Assistance	5%	11%	350
Arts and Recreation Services	1%	2%	100
Other Services	2%	4%	50

Note: Does not include 'Financial and Insurance Services' and only the private sector (and not public sector) component of the following industries: 'Public Administration and Safety'; 'Education and Training'; and 'Health Care and Social Assistance' in terms of payroll and number of employees. May not sum due to rounding.

14 ABS (2020c) and ABS (2020d)

2.3 Myth: payroll tax is efficient

While payroll taxes could be relatively efficient, it is a misconception that current payroll tax arrangements are efficient.

In theory, a payroll tax is considered to be a relatively efficient tax, 'akin to that of either a flat rate income tax or broad-based consumption tax'.[15]

In practice, however, payroll tax in Australia is less efficient and more complex than it should be. This is due to:

- tax-free threshold exemptions (i.e. payrolls under a certain amount do not pay tax, see section 2.1)
- activity exemptions (i.e. certain business activities are exempt from the tax)
- payment exemptions (i.e. wages of certain employees are not included in payroll tax calculations)
- different approaches to grouping arrangements and definitions for 'relevant contract' and 'employment agent' across jurisdictions
- differences in interpretations across jurisdictions
- differences in reporting obligations across jurisdictions.

The breadth and complexity of these activity and payment exemptions is evident when you look at a single jurisdiction. In NSW, for example, exemptions and rebates are provided for a range of employees. These exemptions can be permanent or temporary, and may include the following (although, this list is not exhaustive):[16]

- wages paid to apprentices or employees in an approved non-profit group apprenticeship scheme
- wages paid to trainees or employees in an approved non-profit group traineeship scheme
- maternity leave payments for a period of up to 14 weeks, or its equivalent at a reduced rate of pay
- the Commonwealth tax-free part of a genuine redundancy or approved early retirement scheme payment
- wages paid to employees of non-profit charitable, benevolent, patriotic or philanthropic organisations where the employees are engaged exclusively in the normal work of these institutions
- wages paid by non-profit private hospitals to persons engaged exclusively in work of a kind ordinarily performed by a hospital
- wages paid to persons engaged exclusively in the normal work of public hospitals, Local Health Districts and Ambulance Service of NSW
- wages paid to an employee who is on leave from employment by reason of service in the Defence Force
- wages paid to persons employed under the Community Development Employment Project administered by Aboriginal and Torres Strait Islander Corporations
- wages paid by the Australian-American Fulbright Commission
- wages paid by the Commonwealth War Graves Commission
- wages paid to members of the official staff by a consular or other non-diplomatic representative of another country or by a Trade Commissioner in Australia representing any other part of the Commonwealth of Nations
- wages paid for a joint government enterprise that has the function of allocating funds for water saving projects
- wages paid by the Governor of a State
- wages paid to employees while the employees are providing volunteer assistance to the State Emergency Services or Rural Fire Brigades (but not in respect of wages paid or payable as recreation leave, annual leave, long service leave or sick leave)
- adoption leave payments for a period of up to 14 weeks
- paternity leave payments for a period of up to 14 weeks
- additional wages paid to employees to meet the JobKeeper wage condition.[17]

The proliferation of thresholds and exemptions can be distortionary and limit economic growth in a number of ways:

- In theory, tax-free thresholds reduce incentives for small businesses to grow to their optimal size, as the gains from expanding are reduced (or even lost) to increased tax liabilities.[18] For example, where a growing business is operating close to the tax-free threshold, this may influence their hiring decisions. This is because, while ordinarily the marginal benefit provided by the additional employee would outweigh the marginal cost (i.e. additional revenues would outweigh the additional wage payments), where that additional employee increases wages above the payroll threshold this exposes the business to additional tax liabilities and related compliance costs. In practice, however, there is evidence of this effect in only a couple of jurisdictions.[19]
- Exemptions may prevent individuals being employed in their most productive jobs. By subjecting some companies to payroll tax (i.e. larger companies) and exempting others (i.e. smaller companies), the mix of employment across businesses is distorted, moving some workers away from jobs where they would be more productive in the absence of the tax.[20] Specifically, smaller firms tend to be less productive than larger businesses and abolishing thresholds and exemptions would encourage economic activity to move towards larger, more efficient firms.[21]

15 IPART (2008, p.57)
16 NSW Treasury (2020, pp.A5-9 - A5-10)
17 NSW Treasury (2020, pp.A5-9 - A5-10)
18 NSW Treasury (1999) and Ralston (2018)
19 Ralston (2018) suggests that there is some evidence of this in two states (Victoria and Western Australia)
20 Commonwealth of Australia (2009)
21 Daley et al (2013)

- Different arrangements across jurisdictions increases compliance costs for businesses operating in multiple jurisdictions.[22] While steps have been taken in recent years to harmonise payroll tax legislation across states and territories, the rates and exemptions applied by each government remain disparate and as such, much complexity remains in the system.

A measure of a tax's efficiency is its marginal burden. The total marginal burden on households from a government raising an additional dollar of revenue from a tax includes both the one dollar of tax payment plus the marginal excess burden (MEB) from the inefficient activities undertaken in reaction to the tax increase. The MEB, which is borne by consumers, arises from the disincentive effects of taxes on labour supply, investment, saving and other economic decisions.

The MEB of various taxes is shown in figure 2.4. Note:

- increasing payroll tax collections under current arrangements means a MEB of 33 cents per additional dollar of revenue
- broadening the base of payroll tax by reducing the small business threshold (and therefore reducing associated inefficiencies) leads to a lower MEB of 24 cents per additional dollar of revenue.[23]

Figure 2.4: The marginal excess burden of selected taxes (from better to worse)[24]

Broaden GST base to include fresh food	10%
Reduce franking credits	16%
Personal income tax bracket creep	18%
Raise GST	18%
Municipal rates	23%
Reduce payroll tax threshold	**24%**
Raise payroll tax rate	**33%**
Personal income tax surcharge	41%
Land tax	48%
Insurance taxes	58%
Increase corporate income tax from 15% to 20%	68%
Residential conveyancing duty	87%
Increase corporate income tax from 20% to 25%	96%
Increase corporate income tax from 25% to 30%	139%
Commercial conveyancing duty	196%

Figure 2.4 shows that, while payroll tax is a relatively efficient tax in theory, the existence of thresholds (and exemptions) undermines this in practice. Payroll tax would be more efficient if we removed thresholds and flattened the rate across a broader number of businesses.[25]

2.4 Myth: payroll tax has been harmonised across the states and territories

Since 2007, state and territory governments have undertaken a process of payroll tax harmonisation,[26] including:

- enactment of legislation aligning provisions in eight areas agreed to by state and territory treasurers (i.e. timing of lodgement of returns; motor vehicle allowances; accommodation allowances; a range of fringe benefits; work performed outside a jurisdiction; employee share acquisition schemes; superannuation contributions for non-working directors; and grouping of businesses)
- in most jurisdictions (i.e. NSW, Victoria, Tasmania, NT and SA) enactment of identical payroll tax legislation, apart from 'minor' differences identified in schedules to the legislation. Queensland has also passed legislation to establish harmonisation with those jurisdictions.

However, the payroll tax administration has not been harmonised. Employers who operate across multiple jurisdictions still have to deal with multiple:

- revenue agencies
- payment obligations
- thresholds and rates
- reporting obligations.

This lack of harmonisation in administration places additional compliance burden on cross-jurisdictional employers compared to businesses with employees only in a single state.

Indeed, in our review of payroll tax administration arrangements in NSW, PwC explicitly called out the need to:

- standardise monthly lodgement forms (or online calculators) and the annual reconciliation forms
- align payroll tax definitions across jurisdictions, including employee and contractor definitions.[27]

22 Commonwealth of Australia (2009)
23 Murphy (2016)
24 Murphy (2016)
25 Also see Nassios (2019)
26 Australian Revenue Offices for the States and Territories of Australia (2020)
27 PwC (2018)

03

Reforming payroll tax: Is there a better way?

Having identified misconceptions and shortcomings in the previous chapter, our attention now turns to possible reform of payroll tax.

3.1 Option 1: remove thresholds and exemptions, and lower the rates

Recommendation 57 of the Henry Review stated that:

State payroll taxes should eventually be replaced with revenue from more efficient broad-based taxes that capture the value-add of labour.

Reducing the payroll tax rate and broadening its base has the potential to rectify many of the economic inefficiencies associated with the current payroll tax system. It would provide:

- efficiency gains (because distortions as to the choice of business organisation are removed)
- a more equitable wage outcome for employees of larger and smaller businesses
- simpler tax administration and compliance for organisations (although small businesses will bear a higher cost unless options discussed in 3.2 are implemented).

While calculated with different approaches that are not necessarily transparent and are not necessarily consistent, state and territory governments annually report the value of subsidies provided to advantaged groups through lower thresholds and the application of exemptions (see figure 3.1).

Figure 3.1: Payroll tax related tax expenditures ($m, latest years)[28]

	Tax expenditures related to tax-free threshold	Tax expenditure related to other exemptions and rebates	Total reported tax expenditures
NSW	Not reported[29]	2336	2336
VIC	154.0 (regional businesses only)	1377.0	1531.0
QLD	1373.0	1181.0	2554.0
SA	508.0	368.5	876.5
WA	1258.7	868.1	2126.8
TAS	154.6	40.9	195.5
NT	Not reported	Not reported	139.9
ACT	Not reported	Not reported	199.7

28 NSW Treasury (2020, p.A2-1); Victorian Treasury (2019, p.186); Government of Western Australia (2020, p.277); Queensland Treasury (2019); Government of South Australia (2020, p.173); Tasmanian Treasury (2020, p.88); NT Treasury (2019, p.78), ACT Treasury (2020)

29 The tax-free threshold is not treated as a tax expenditure because the benchmark is set as an entity with a payroll above the threshold. In this way, the headline result understates the tax expenditure relative to most other jurisdictions. It appears that Victoria is similar in its under-reporting

Figure 3.2: Effect of removing payroll tax threshold and exemptions (2018-19 terms)

	Current arrangements		Remove threshold and non-government exemptions, retain rates		Remove threshold and non-government exemptions, state-by-state revenue neutral		Remove threshold and non-government exemptions, national revenue neutral	
	Revenue	Rate	Revenue	Rate	Revenue	Rate	Revenue	Rate
NSW	9386	5.45%	13,125	5.45%	9386	3.90%	8769	3.64%
VIC	6280	4.85%	8388	4.85%	6280	3.63%	6297	3.64%
QLD	4146	4.75%	6396	4.75%	4146	3.08%	4903	3.64%
SA	1258	4.85%	1939	4.85%	1258	3.15%	1456	3.64%
WA	3557	5.50%	4925	5.50%	3557	3.96%	3274	3.64%
TAS	359	6.10%	660	6.1%	359	3.32%	394	3.64%
NT	280	5.50%	420	5.50%	280	3.67%	278	3.64%
ACT	549	6.85%	836	6.85%	549	4.50%	444	3.64%
Total	25,815		36,708		25,815		25,815	

These expenditures show that there is scope to remove the threshold and exemptions while lowering the rate across all businesses.

This tax switch could be achieved by extending the obligation to pay payroll tax to all businesses, and correspondingly lowering the rate to 3.64% (for a single national rate) or 3.10%-4.50% (for net no revenue impact in each state and territory).

Our modelling (see page 13 for an overview of the modelling approach) shows the effect of removing the current exemptions (i.e. removing thresholds and all exemptions except for government/public entities) to payroll tax in 2018-19 terms:

- If rates are held constant then an additional $11 billion of revenue will be generated. This approach will expose a range of organisations to payroll tax and will significantly increase government revenues.
- If total revenue is held constant (i.e. a revenue neutral approach), the average effective rate of payroll tax can be reduced significantly.

In practice, the outcome will likely be somewhere between the two extremes shown in figure 3.2. That is, it is more reasonable to suggest that total revenues may be increased somewhat via a broadening of the taxpayer net, and the effective tax rate can also be lowered somewhat for existing payers of payroll tax. Similarly, while the most efficient tax arrangement may be one with broad applicability (i.e. no exceptions), political realities suggest that there will still be some exceptions, further reinforcing that the possible outcome of any reform would lie somewhere between the extremes shown in figure 3.2.

Modelling approach

- The modelling presented above is based on a profile of current payroll taxes by industry and state constructed using data from ABS Count of Business, Taxation Statistics, Australian Industry, State Accounts and Average Weekly Earnings.
- That profile is used to estimate the current wage bill per business by size and then estimates liability per business.
- This profile is an aggregate picture (adjusted to actual collections by state and industry) but does not capture the nuance of individual businesses – so results (especially in terms of count of businesses with a payroll tax liability) should be seen as order of magnitude only.
- Our modelling does not attempt to account for cross-jurisdiction businesses – rather it assigns businesses only to the state that ABS Count of Business places them in. This is suitable in the aggregate (as it is adjusted to actual collections by state and industry) but may have granular issues – such as industries that have a main office in a different jurisdiction to the majority of their workforce.
- Our modelling examines the following existing thresholds and exemptions: thresholds for total exempt wages by business, exemptions for public entities, and exemptions for not-for-profit private health sector. However, it does not examine exemptions that cannot be identified at industry level (such as exemptions for apprentices). Scenarios that remove thresholds and exemptions are assumed to (at a high level) only retain the exemptions for government/public entities.
- For this modelling, we have taken the main rate for each jurisdiction, noting that this is a simplification as five jurisdictions have more than one rate depending on size or location of business.
- The modelling does not take into account any behavioural change in response to a tax change (i.e. wages changes, employees willing to supply more or less labour, employers demanding more or less labour).

There are currently over 60,000 businesses with at least 20 employees (all of which are likely to have a payroll tax liability), and another approximately 820,000 businesses with between one and 19 employees (some of which will have a payroll tax liability). We estimate that removing thresholds would increase the number of businesses with payroll tax liabilities by almost 750,000. Under the state-by-state revenue neutral scenario, these businesses that previously had no payroll liability would pay a little over a third of payroll tax, with the approximate 130,000 businesses that were previously liable paying the majority of the tax. The approximate 1.5 million businesses with no employees would continue to pay no payroll taxes.

As shown in figure 2.4, such a tax switch would enhance the efficiency of the tax system by lowering the MEB from 37% to 24%.[30]

While this approach makes sense on some levels, it would represent a considerable impost on thousands of small businesses who are currently exempt from the tax due to not meeting the thresholds.

Clearly, this poses a political challenge to mobilising support for change, especially in the current economic environment.

This could be mitigated by lowering thresholds rather than removing them, or ensuring small businesses pay a lower rate as part of a progressive tiered approach. These options have the benefit of moving towards a lower MEB, while still retaining some ‘concessionary approach’ for small businesses. For example, lowering the threshold allows very small businesses to hire their first employees without incurring additional taxes, but broadens the base to make the tax in general more efficient. A tier rated would also allow for a broader and more efficient base for the tax, while ensuring that the majority of the burden remains on larger businesses and small businesses contribute comparatively less.

30 Murphy (2016)

Figure 3.4: Effect of removing payroll tax threshold and exemptions (2018-19 terms)

	Current arrangements		Example A: Remove non-government exemptions, $500k threshold, state-by-state revenue neutral		Example B: Remove non-government exemptions, two tier rate, national revenue neutral		
	Revenue	Rate	Revenue	Rate	Revenue	Rate 1 (under $1m)	Rate 2 (over $1m)
NSW	9386	5.45%	9386	5.09%	8881	1%	4.79%
VIC	6280	4.85%	6280	4.58%	6209	1%	4.79%
QLD	4146	4.75%	4146	4.33%	4824	1%	4.79%
SA	1258	4.85%	1258	4.42%	1461	1%	4.79%
WA	3557	5.50%	3557	5.14%	3351	1%	4.79%
TAS	359	4.00%	359	3.86%	345	1%	4.79%
NT	280	5.50%	280	5.05%	284	1%	4.79%
ACT	549	6.85%	549	6.27%	460	1%	4.79%
Total	25,815		25,815		25,815		

Figure 3.4 shows two illustrative examples (but new tax structures could be designed in many different ways). Both examples in figure 3.4 generate an aggregate level of payroll tax consistent with current tax levels.

Example A shows a nationally consistent and lowered threshold, but different rates so that state tax levels are maintained.

Example B showing a nationally consistent approach of removal of thresholds replaced with a two tiered rate (with a notional $1 million threshold between rates - which could be set at any level).

There will also be practical process challenges, as these approaches require all states and territories to change their payroll tax arrangements simultaneously, which would likely require coordination through the Commonwealth. This coordination would also need to be structured to ensure that individual states and territories are not incentivised to move back to individual arrangements for competitive advantage.

3.2 Option 2: replace payroll tax with an expanded GST

An alternative option is to replace payroll tax with an expanded GST. As shown in figure 2.4, a switch from payroll tax to the GST would be an efficiency improvement, with the MEB for raising the GST rate at 18%, compared to the 24% for reducing payroll exemptions and 33% for increasing the rate.

As we recently identified, $25 billion in additional GST revenue could be generated by:

- increasing the GST rate to 12.5% for existing goods and services that fall within the tax
- taxing goods and services that were previously exempt (food; childcare; education; health; and water, sewerage and drainage – at 5%).

If none of that additional GST revenue was returned to consumers through compensation mechanisms, this is an almost one-for-one replacement of total payroll receipts. While this presents an interesting view of a tax switch for efficiency, there are two significant practicality considerations:

- The economic incidence of the two current taxes is unlikely to be the same.
- Compensation will therefore likely be needed for lower income households that are disproportionately impacted by the change in incidence.

These considerations would be very complex to analyse and understand, because they involve the intersecting issues of:

- which employees (by industry and state) currently have wages that are lower than they would be with a payroll tax removal (i.e. where employees currently bear the economic incidence of payroll tax) and the income level of the households those employees live in
- which products (by industry, by state produced in, and by state consumed in) currently have prices that are higher than they would be with a payroll tax removal (i.e. where consumers currently bear the economic incidence of payroll tax) and which households consume them
- which households (by state and income level) will have different consumption impacts from a GST change.

Those three considerations will lead to different household impacts depending on individual circumstances. For example:

- Even though two households with the same income may have similar impacts from a payroll-to-GST switch in terms of their consumption (i.e. cost of some goods go down due to removal of payroll and cost of others goes up due to change in GST), if one household get their income from working for a small business and the other from a large business, then their wage impacts will be different (even at the same income level).
- If the households are in different states, their wage impacts may be different. Households with different income levels will likely have different impacts both across consumption and wages.

It will therefore be very difficult to understand the impacts at a macro level and design compensation, at least for the lowest income households, for the increased consumption taxes they are paying (as recommended in our GST analysis). The likely need for a compensation mechanism (depending on the exact impact interactions) will also then mean that the tax swap would result in a net reduction in tax collections.

In addition to the difficulty in analysing the household level impacts, there will also be governmental impacts to understand, particularly in that:

- the distribution of payroll collections and GST grants is likely to differ across states and territories (a direct swap would not have the same result for each jurisdiction which would likely have to be addressed by the Commonwealth Grants Commission)
- although the GST is technically a state tax, using an enhanced GST to offset a state tax restricts the Commonwealth to use GST changes to offset reform of Commonwealth taxes and further entrenches vertical fiscal imbalance.

The complexity of both household and governmental impacts means that this option is unlikely to be introduced.

3.3 Option 3: standardise administration

As noted earlier, the states and territories have been on a 13-year payroll tax harmonisation process.

Now could be the time to bring this journey to a conclusion.

While not addressing the relative inefficiency of payroll taxes, administrative costs borne by businesses could be greatly reduced by:

- standardising definitions and liability for payroll tax
- streamlining payroll tax collection via the Australia Taxation Office (ATO) through either: Single Touch Payroll reporting; or standardising the tax return forms and lodging them through Standard Business Reporting (SBR). In this case, employers could make one payment that is then dispersed by the ATO to the various state and territory governments. Rather like the arrangements regarding GST payments, this could be done for a minimal fee, with states and territories achieving administrative savings in their revenue offices.[32]

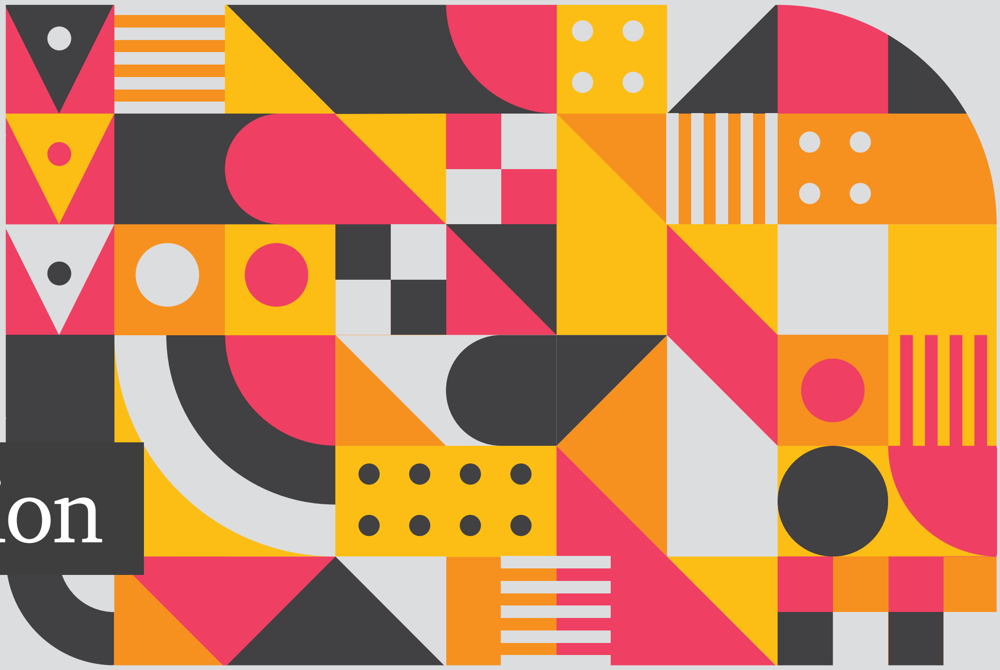
Such an approach is not novel,[33] but the development of Single Touch Payroll makes it more practical.

Under this approach, it could be designed such that jurisdictions could vary (within limits) the rate applied to their residents so that some revenue raising remained autonomous. While this could aid adoption, it would be at the sacrifice of some efficiency.

A step further would move beyond standardised administration to abolish state payroll tax regimes with a Commonwealth ‘employee wage tax’. The employee wage tax would be similar in nature to a payroll tax regime, levied on the employer’s wage bill and paid by the employers, but it would be administered by the Commonwealth via the ATO and the Commonwealth would set the rates.

This option seems unlikely to be adopted given the state and territory Governments’ preference for using payroll tax as an investment attraction tool.

32 This approach is consistent with the Australian Small Business and Family Enterprise Ombudsman’s recommendation that small businesses be able to make a single payment to the ATO to cover PAYG(W), superannuation guarantee and GST payments in line with their Single Touch Payroll reporting - ASBFEO (2020)
33 Commonwealth of Australia (2009)



Conclusion

Recommendations for a palatable way forward

Payroll tax is possibly the most misunderstood tax in Australia, and it's not helped by disparate and inconsistent features across state and territory lines. But while there are numerous avenues towards reform available, the challenge is to find one that is both politically viable - and viable for small to medium businesses.

Clearly, small businesses in Australia have had a challenging year, and it's a reality that many will continue to face these challenges for some time yet.

While possible reforms such as the removal of thresholds and exemptions and, in turn, implementing a lower uniform rate across the country make sense, the impact on small businesses at such a time as this makes such options unviable.

Similarly, replacing payroll tax with an expanded GST is a proposed reform that makes sense on some levels, but is ultimately unlikely due to the complex impacts of such a change on households and government.

Therefore, the most achievable reform appears to be a move towards standardising the administration of payroll tax and a more simplistic, consistent, nation-wide approach to collection.

The administrative costs borne by businesses could be significantly reduced by standardising the definitions and liability for payroll tax and streamlining payroll tax collection via the ATO.

This approach could be designed to allow jurisdictions a reasonable degree of control over varying rates that are applied to residents, therefore retaining their autonomy over revenue raising.

All things considered, we believe this approach is, for now, the most feasible way forward when it comes to reforming payroll tax to make the system easier for businesses, make it simpler to understand and comply with across state and border lines, and to drive efficiency.

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