



**Australian Government**

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**Commonwealth Grants Commission**

**2010 REVIEW**

**PAYROLL TAX**

**COMMISSION POSITION PAPER  
CGC 2008/05**

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CGC contact:	Peter Connell, 02 6229 8892, <a href="mailto:Peter.Connell@cgc.gov.au">Peter.Connell@cgc.gov.au</a>
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## **BACKGROUND**

- 1 In 2005, the Heads of Treasury undertook a review of horizontal fiscal equalisation. A conclusion of that review was that Commission processes could be simplified. The 2010 Review terms of reference ask the Commission to simplify its assessments, provided to do so is consistent with the principle of equalisation.
- 2 We consider that simplification and equalisation can both be achieved and that simplification will improve the reliability and robustness of the processes and the acceptability of the outcomes. Both objectives can best be achieved through a rigorous application of the assessment guidelines. These guidelines require the 2010 Review assessment methods to:
  - establish a conceptual case for the assessment;
  - support the conceptual case with evidence, which is both comparable and reliable;
  - develop a reliable assessment method; and
  - demonstrate such an assessment would be material<sup>1</sup>.
- 3 Our intention is to develop these methods jointly with States. For that reason we have chosen an iterative process. This approach provides States with opportunities to contribute to the development of the final assessments.
- 4 The first iteration of the Payroll tax assessment was presented in staff discussion paper 2007/03-S *Proposed Methods for Revenue Assessments*.
- 5 This position paper sets out the Commission’s preliminary decisions on the assessment. These decisions provide the basis on which the Commission seeks to take the Payroll tax assessment forward in consultation with States.
- 6 This paper reflects comments provided by the States during State visits and in State submissions received up until 15 August 2008. Comments received after this date will be considered alongside comments received from States in response to this paper.

## **PROPOSED ASSESSMENT**

### **Overview**

- 7 In discussion paper 2007/03-S, staff proposed that the 2010 Review equalisation budget contain a Payroll tax category comprising revenues raised from payrolls normally taxed by States.
- 8 Staff also proposed assessing capacity using taxable Compensation of Employees (CoE). This was to be calculated by applying weights to CoE data by industry:

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<sup>1</sup> For a category to be deemed material, the average expense or revenue is greater than \$50 per capita, or the assessment is likely to redistribute more than \$30 per capita for any State.

- taxable public sector CoE would be estimated by applying a weight of 0 to the CoE of industries where public sector employment dominated<sup>2</sup>;
- taxable private sector CoE would be estimated by:
  - applying a weight of 1.0 to the CoE of industries where private sector employment dominated and which had an above average proportion of large firms<sup>3,4</sup>; and
  - applying a weight of 0.5 to the CoE of the remaining industries. The lower weight recognised the likelihood that a lower proportion of CoE in these industries would exceed the taxable threshold<sup>5</sup>; and
- in addition, staff proposed reducing the ACT's taxable private sector CoE by 10 per cent to take account of the higher proportion of Commonwealth Government employees in those industries in the ACT.

### State views

9 States supported the proposal to assess capacity using the taxable CoE data. However, most did not support the proposal to apply weights to the CoE data of different industries. Their preference was to calculate taxable CoE using the 2004 Review approach.

### The 2004 Review method

10 The 2004 Review approach is more complicated than the proposed approach because CoE data are not available by sector or by size of employer, so some parts of taxable CoE data have to be estimated indirectly.

11 The 2004 Review approach estimated taxable CoE data using:

- gross earnings for PTEs<sup>6</sup>. These data were obtained from the ABS by way of a customised request; and

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<sup>2</sup> These industries were Government administration and defence; Education; Health & community services.

<sup>3</sup> On average, States have a tax free threshold of \$650 000. This is broadly comparable to the payroll of a firm with 20 employees. So, a large firm was deemed to be a firm with more than 20 employees.

<sup>4</sup> Following discussions with the States, these industries were: Mining; Manufacturing; Electricity, gas and water; Wholesale trade; Retail trade; Transport and storage; Communication services; Finance and insurance; and Cultural and recreational services.

<sup>5</sup> These industries were: Agriculture, forestry and fishing; Construction; Accommodation, cafes and restaurants; Property and business services; and Personal and other services.

<sup>6</sup> The payrolls of PTEs are included in the revenue base because PTEs are subject to payroll tax. In the 2004 Review, the Commission nominated the industries in which PTEs operated. The ABS provided data on the combined public sector gross earning (above the threshold) for the following industries: Agriculture, forestry and fishing, Manufacturing, Electricity, gas and water supply, Transport and storage, Communication services and Finance and insurance. The payrolls of universities were not included in this measure. The ABS can provide details of gross earnings (above the threshold) of higher education employers. They will be included in the PTE gross earnings figures in the 2010 Review. (Gross earnings is essentially a cash based measure of wages and salaries.) On the other hand, with the full privatisation of Telstra and the corporatisation of a number of agricultural marketing boards having occurred since 2001-02, data on the Communication services and the Agriculture, forestry and fishing industries will not be collected.

- taxable wages and salaries of private sector firms. The ABS was able to provide customised data on the non-taxable part of wages and salaries.<sup>7</sup> Taxable wages and salaries were obtained by deducting the ABS customised data from total private sector wages and salaries.

12 Taxable CoE was calculated by:

- starting with total CoE;
- deducting the CoE attributable to members of defence forces and Australian employees of Australian embassies and consulates overseas. They are exempt from payroll tax. They are deducted directly because they are not included in ABS public sector gross earnings; and
- applying the proportion of taxable CoE. This proportion was calculated by:
  - adding the gross earnings of PTEs to the taxable wages and salaries of private sector firms, and
  - dividing by total public sector gross earnings and private sector wages and salaries.

13 The 2004 Review method also contained an adjustment for the Agriculture, forestry and fishing industry because that industry's wages and salaries are not in the ABS private sector wages and salaries data.

### **Commission view**

14 The Commission investigated simpler ways of assessing Payroll tax, but were not convinced that they provided a more reliable or robust measure of capacity.

15 The Commission intends to continue the approach adopted in the 2004 Review.

16 An investigation of two issues was undertaken and these are discussed in the next sections. The issues are:

- whether the adjustment for Agriculture, forestry and fishing is necessary; and
- whether the tax free threshold should be changed.

## **AGRICULTURE, FORESTRY AND FISHING**

### **Analysis**

17 The 2004 Review method includes an adjustment for the Agriculture, forestry and fishing industry. The ABS does not include wages and salaries for this industry in its private sector

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<sup>7</sup> All States exempt employers with payrolls below a certain threshold and allow employers with larger payrolls to deduct the threshold amount from their taxable payrolls. So, the non-taxable part of wages and salaries comprises all of the wages and salaries of those firms whose payrolls are less than the tax free threshold and the tax free threshold for the remaining firms.

wages and salaries figures. The adjustment requires us to assess capacity for this industry separately and then add it to taxable private sector CoE.

- 18 We have used the \$10 per capita materiality threshold to test the materiality of making this adjustment. Table 1 shows that the adjustment is not material. We conclude that the 2004 Review method can be simplified by removing this adjustment.

**Table 1 Financial impact of Agriculture, forestry and fishing adjustment, 2008 Update**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
Redistribution	-0.85	-0.80	0.67	1.52	1.41	3.44	-1.27	2.15	0.49

Source: Commission simulation.

### Commission view

- 19 On materiality grounds, the Commission intends to discontinue the Agriculture, forestry and fishing adjustment.

### THE TAX FREE THRESHOLD

- 20 All States exempt small businesses from payroll tax, but the threshold level differs from State to State. In the 2004 Review, the Commission examined the threshold levels in each State. As CoE was closer in concept to what States tax, it set the tax free threshold in terms of this aggregate. It also calculated a wages and salaries equivalent. It set the tax free threshold at \$650 000 for CoE (\$550 000 for wages and salaries).
- 21 This analysis has been replicated for the 2010 Review.

### Analysis

- 22 Table 2 shows each State's threshold for the years 2001-02 to 2007-08. It confirms that a number of them raised their thresholds after 2001-02. Three States recently announced changes to their thresholds for 2008-09. The ACT increased its threshold from \$1.25 million to \$1.5 million; New South Wales raised its threshold to \$623 000, and will index the threshold annually in line with movements in the Sydney Consumer Price Index; and South Australia increased its threshold to \$552 000.
- 23 Table 2 also shows a weighted average threshold. This was calculated by weighting each State's threshold by its share of CoE.

**Table 2 Payroll tax thresholds 2001-02 to 2007-08**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Ave
	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000
2001-02	600	515	850	675	456	1 000	1 250	600	640
2002-03	600	550	850	675	504	1 010	1 250	600	653
2003-04	600	550	850	750	504	1 010	1 250	600	662
2004-05	600	550	850	750	504	1 010	1 250	800	665
2005-06	600	550	850	750	504	1 010	1 250	1 000	669
2006-07	600	550	1 000	750	504	1 010	1 250	1 250	702
2007-08	600	550	1 000	750	504	1 010	1 250	1 250	702

24 There is a conceptual case for increasing the threshold to reflect the increase in State thresholds. A tax free threshold of \$700 000 threshold for CoE (\$600 000 for wages and salaries) would be consistent with the average shown for last year shown in Table 2.

**Commission view**

25 The Commission intends to increase the tax free threshold in the 2010 Review to reflect increases in State thresholds that have occurred since 2001-02.

26 The Commission intends to set the threshold at \$700 000 for CoE (\$600 000 for wages and salaries) and to update it each year in line with States' actual tax free thresholds.

**PRELIMINARY ASSESSMENT**

27 The Commission is proposing to continue the 2004 Review assessment method for the 2010 Review with three amendments:

- removing the adjustment for the Agriculture, forestry and fisheries industry;
- increasing the tax free threshold from \$650 000 to \$700 000 for CoE; and
- updating the tax free threshold every year in line with States actual tax free thresholds.

28 The following tables set out the assessment for 2006-07. Table 3 shows the derivation of the proportion of taxable CoE. Table 4 sets out the calculation of the assessed revenue base and Table 5 shows the category assessment.

**Table 3 Calculation of proportion of taxable compensation of employees, 2006-07**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
A. Total public sector gross earnings	29 620	19 035	18 270	8 629	6 830	2 397	5 933	1 512	92 227
B. Taxable PTE gross earnings <sup>(a)</sup>	4 586	1 890	2 915	916	484	293	216	107	11 407
C. Total private sector wages and salaries	109 851	81 615	58 967	32 805	19 859	5 065	4 179	2 609	314 950
D. Wages and salaries of exempt employers <sup>(a)</sup>	24 611	17 958	14 843	7 131	4 304	1 340	957	520	71 662
E. Exempt wages and salaries of non-exempt employers <sup>(a)</sup>	10 781	9 491	7 968	3 748	2 283	569	648	415	35 903
F. Taxable private sector wages and salaries [F = C - D - E]	74 459	54 165	36 157	21 926	13 272	3 157	2 575	1 674	207 385
G. Taxable proportion of CoE (%) [G = (B + F) / (A + C)]	56.7	55.7	50.6	55.1	51.5	46.2	27.6	43.2	53.7

(a) Customised ABS data.

Source: Private sector data are from ABS *Business Indicators June Quarter 2007*, cat. no. 5676.0 Table 15. Public sector data are from ABS *Wage and Salary Earners June Quarter 2007* cat. no. 6248.0.55.001.

**Table 4 Calculation of assessed revenue base, 2006-07**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
A. Compensation of employees	173 220	123 920	92 869	50 815	32 561	8 904	13 378	5 231	500 898
B. CoE attributable to defence forces	1 524	532	1 106	346	244	13	453	486	4 701
C. CoE attributable to embassies	0	0	0	0	0	0	332	0	332
D. Net compensation of employees [D = A – B – C]	171 696	123 388	91 763	50 469	32 317	8 891	12 593	4 746	496 196
E. Taxable proportion of CoE (%) [Row G in Table 3]	56.7	55.7	50.6	55.1	51.5	46.2	27.6	43.2	53.7
F. Assessed revenue base [F = D x E]	97 308	68 719	46 420	27 823	16 657	4 110	3 476	2 052	266 564

Source: CoE data are from ABS *Australian National Accounts State Accounts cat. no. 5220.0 2006-07*, Table 32. Defence force data are derived from Department of Defence Annual Reports. CoE Embassy data are from customised ABS data.

**Table 5 Payroll tax, 2006-07**

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
A. Population (persons)	6 855 811	5 167 516	4 135 619	2 082 041	1 576 644	491 648	336 691	212 802	20 858 772
B. Assessed revenue base (\$m) [Row F in Table 4]	97 309	68 719	46 420	27 823	16 657	4 110	3 476	2 051	266 564
C. Actual revenue (\$m)	5 654	3 479	2 232	1 587	845	219	220	128	14 364
D. Average tax rate (%) [ $D_{Aust} = C_{Aust} / B_{Aust}$ ]									5.39
E. Assessed revenue (\$m) [ $E = B * D_{Aust}$ ]	5 243	3 703	2 501	1 499	898	221	187	111	14 364
F. Assessed revenue per capita (\$pc) [ $F = E / A$ ]	764.82	716.57	604.83	720.08	569.27	450.44	556.23	519.56	688.62
G. Category factor [ $G = F / F_{Aust}$ ]	111.07	104.06	87.83	104.57	82.67	65.41	80.78	75.45	100.00

Source: Actual revenue data provided by State Treasuries, classified to the 2010 Review category structure by the Commission.

## CONCLUSIONS

- 29 The Commission intends to continue to assess payroll capacity using the 2004 Review method, with some modifications. Revenue capacity would continue to reflect the payrolls that are subject to payroll tax — those of the private sector and PTE employers above a specified threshold.
- 30 Capacity would be measured using:
- aggregate compensation of employees;
  - removing the compensation of employees attributable to defence forces and Australian embassies and consulates; and
  - removing other non-taxable compensation of employees. This would be estimated using the proportion that taxable PTE gross earnings and taxable private sector wages and salaries comprise of total public sector gross earnings and private sector wages and salaries.
- 31 The modifications are that an Agriculture, forestry and fishing adjustments would no longer be assessed and the taxable threshold for employers would be set at \$700 000 for compensation of employees (\$600 000 for wages and salaries), and updated every year in line with States actual tax free thresholds.