Payroll Tax in the Costing of Government Services

Research Paper

Steering Committee for the Review of Commonwealth/State Service Provision

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Contents

Glossary

Payroll tax	Tax levied on employers based on the value of wages and certain supplements paid or payable to, or on behalf of, their employees
Payroll tax base	All items to which the tax rate applies (eg. salaries and wages and in some cases superannuation and fringe benefits)
Exemption	Part or whole of the payroll tax base not subject to taxation
Tax-free threshold	Level of payroll below which no tax is payable
Marginal tax rate	Tax rate that would apply to an extra dollar of the tax base
Average tax rate	Total tax paid as a proportion of the tax base
Clawback arrangement	Tax scheme under which the tax-free threshold is adjusted to be gradually phased out, so above a certain limit (called the upper taper limit) the entire payroll is subject to taxation
Non-clawback arrangement	Tax scheme under which the tax-free threshold is available to all taxpayers
Progressive tax	Increases in the average rate of taxation as the payroll size increases
Taxable organisation	Organisation that pays tax to the revenue office

Key messages

- Payroll tax arrangements for government and non-government delivered services differ considerably across jurisdictions. This can restrict the comparability of reported unit costs, which are used as a key proxy indicator of efficiency in the Report on Government Services.
- Government service providers that are exempt from payroll tax are at a competitive advantage when they compete with other service providers subject to the tax. This source of competitive advantage can be subject to competitive neutrality policy and typically a tax equivalent regime would be applied to ensure that they compete on a more even basis.
- Payroll tax arrangements can differ in terms of:
  - the types of organisations and activities that are exempt;
  - prevailing tax-free thresholds and tax rates; and
  - clawback arrangements.
- Payroll tax exemptions have the greatest effect on unit costs. Exemptions alone can cause differences of around 5 per cent in the reported unit costs of comparable services.
- There are two approaches to account for payroll tax differences. The choice of approach depends on:
  - the availability of payroll tax data from line agencies or State and Territory revenue departments;
  - whether services can identify if payroll tax is included or excluded from the payroll data; and
  - whether the service providers are for-profit, not-for-profit or government owned.
- One approach is to report cost data including estimated payroll tax for all taxable and exempt government services (tax inclusion). This approach requires all government service providers to identify whether they are subject to payroll tax, and for exempt government service providers to estimate a hypothetical tax liability from net payroll data. This approach can be used when the majority of services are taxable, so that it is necessary to improve comparability by adding a hypothetical tax amount to the costs of services that are tax exempt.
- The other approach involves taxable government service providers excluding payroll tax when reporting cost data (tax exclusion). The preferred method to exclude payroll tax from cost data requires taxable government service providers to identify their payroll tax liability separately. When payroll tax data are not available, the amount to be deducted needs to be estimated from gross payroll data (*tax deduction*). This approach will also improve the transparency of unit cost data when the majority of service providers are exempt from payroll tax, so that it is necessary to adjust the costs of the few service providers that pay tax.

1 Introduction

Payroll tax makes up a significant part of the reported cost of many government funded and delivered services. Payroll tax is particularly significant for services with a high proportion of labour costs, and can be around 5 per cent of total service costs.

The effect of payroll tax on reported unit costs varies between jurisdictions and services, reflecting different:

- payroll tax exemptions;
- marginal tax rates and tax-free thresholds; and
- clawback arrangements.

The effects of payroll tax on unit costs are an important issue for the Report on Government Services, which seeks to provide, among other things, comparable cost data for a range of government services (SCRCSSP 1999) (box 1.1). They are also an important issue addressed by the policy of competitive neutrality, which seeks to offset as far as possible net competitive advantages to government service providers that arise solely from government ownership (aiming to ensure government and private sector service providers compete on a more even basis).

Some national data collections do not fully document the differences in payroll tax arrangements for services reporting unit cost data. The objective of this paper is to provide methods to improve the completeness, comparability and transparency of the treatment of payroll tax data in calculating government service costs for the annual Report on Government Services.[1]

This paper is based on information about payroll tax arrangements that was provided by State and Territory Departments of Treasury (see attachment 1) and a review of all the data collections used for the Report on Government Services.

[1] The problems of different payroll tax arrangements also affect reports prepared by other agencies using the same cost data. Examples include the health, housing and community services data used by the Australian Institute of Health and Welfare (AIHW), and the vocational education and training data used by the Australian National Training Authority (ANTA) and the National Centre for Vocational Education Research (NCVER).

Box 1.1 Objectives of the Report on Government Services

The annual Report on Government Services compares government performance in providing key human services. The objective is to better inform judgments and public policy actions, and thus promote continuing service improvement.

One objective of the Report's Steering Committee is to expand the scope of the indicators presented to cover all the key objectives of applicable services. Service performance is measured using a framework of indicators covering both efficiency and effectiveness. Such measurement allows users to make comparisons across jurisdictions (bearing in mind that each government may attach a different set of weights to often competing objectives).

Efficiency measures focus on the relationship between inputs provided by governments and outputs. The main indicator is cost per unit of service. Comparisons of the unit cost of a service are most meaningful for policy decision making where the data are complete — that is, where they accurately account for all government resources consumed in providing the service.

Incomplete performance information should be at least:

- comparable — that is, calculated on a consistent basis across all jurisdictions and modes of service delivery over time; and
- transparent — that is, clearly identifying all significant differences in the treatment of costs (such as excluded cost elements). This includes when a mix of non-government (for example, contracted) and government providers delivers a service.

Complete cost information for government services is also important for other purposes, such as applying competitive neutrality policy.

The Steering Committee, if faced with difficulties and shortcomings in indicators and available data, usually seeks to publish the best available data (even if the initial results are imperfect), then focuses on improving those data over time. The aim of this paper is to apply such an approach to the treatment of payroll tax. Thus, it is important to identify both the desired longer term outcome and intermediate steps for moving towards this outcome.

This paper suggests a solution through:

- documenting and comparing the current payroll tax status of services covered in the Report on Government Services (chapter 2);
- assessing how differences in payroll tax arrangements affect unit cost data (chapter 3); and
- proposing approaches to improve the treatment of payroll tax where current differences in treatment are material (chapter 4).

2 Differences in payroll tax arrangements

Payroll tax arrangements differ across jurisdictions as a result of payroll tax exemptions, marginal tax rates, tax-free thresholds and clawback arrangements. Currently, six jurisdictions use a single marginal rate system while two employ progressive tax rates. Maximum marginal tax rates range from 5 per cent in Queensland to 7 per cent in the Northern Territory. Tax-free thresholds range from $456 000 in South Australia to $850 000 in Queensland. Three jurisdictions also use a clawback system.

2.1 Exemptions

Not all service providers are subject to payroll tax. State and Territory governments typically provide exemptions to organisations:

- engaged in particular activities, predominantly within the social welfare, health, religious and educational fields;
- owned by government (particularly in Western Australia and the ACT) or engaged in non-profit activities; or
- whose payroll does not exceed the tax-free threshold. Such organisations typically employ fewer than 20 people.

Differences in exemptions can occur across jurisdictions even when the organisations meet the above criteria. Public acute care hospitals in Tasmania, for example, are not exempt from payroll tax despite the general trend of not taxing not-for-profit or government health services.

Differences in unit costs across jurisdictions can also occur, for a given pattern of exemptions across jurisdictions, when the mix of service providers differs. This is most likely to occur for services where some jurisdictions use private for-profit service providers while other jurisdictions use public or private non-profit service providers.

The Secretariat contacted Departments of Treasury (see attachment 1) in all jurisdictions for information on the exemption status of services investigated for the

Report on Government Services. Their responses (table 2.1) indicate that the exemption status is different across jurisdictions, services and service deliverers.

Exemptions for eleven of the twelve services delivered by government differ across jurisdictions. All services delivered by government agencies in the ACT (except housing) are exempt from payroll tax, whereas no government delivered services are exempt in Tasmania. Government health services receive exemptions across all jurisdictions except Tasmania. No exemptions are granted to housing services delivered by government agencies.

The results also show that services delivered by the private sector receive more uniform payroll tax treatment. The payrolls for services delivered by larger for-profit, private sector providers are generally taxable across all jurisdictions, with exemptions granted only for school education in Victoria, Queensland, South Australia and the ACT.

Most services provided by not-for-profit private sector organisations are exempt, usually under provisions for religious or public benevolent institutions. Exceptions include: vocational education and training (VET) in New South Wales, Western Australia, South Australia, Tasmania and the Northern Territory; housing in South Australia; corrective services in Western Australia; and emergency management in the Northern Territory.

2.2 Marginal payroll tax rates and tax-free thresholds

Differences in marginal payroll tax rates and tax-free thresholds can also affect the comparability of service costs across jurisdictions. Maximum marginal payroll tax rates are highest in the Northern Territory (7 per cent) and lowest in Queensland (5 per cent) (table 2.2). Of the progressive marginal and average tax rate schemes, the minimum tax rates are lowest in Western Australia (3.65 per cent) (table 2.3). Tax-free thresholds range from \$456 000 in South Australia to \$850 000 in Queensland.

Tax-free thresholds have increased in most jurisdictions over the last three years. Since 1 July 1997, increases in tax-free thresholds ranged from \$50 000 in Queensland (\$800 000 to \$850 000 at 1 January 1998) to \$100 000 in the ACT (\$700 000 to \$800 000 at 1 January 1998).

Table 2.1 **Payroll tax status of service providers for selected social services**

	NSW			*Vic*			*Qld*			*WA*			*SA*			*Tas*			*ACT*			*NT*			*Total exemptions*
	G	P	N	G	P	N	G	P	N	G	P	N	G	P	N	G	P	N	G	P	N	G	P	N	
(a) School education[a]	✓	✓	✗	✓	✗	✗	✓	✗	✗	✗	✓	✗	✗	✗	✗	✓	✓	✗	✗	✗	✗	✗	✓	✗	16
(b) VET	✓	✓	✓	✓	✓	✗	✓	✓	✗	✓	✓	✓	✓	✓	✓	✓	✓	✓	✗	✓	✗	✓	✓	✓	4
(c) Health	✗	✓	✗	✗	✓	✗	✗	✓	✗	✗	✓	✗	✗	✓	✗	✓	✓	✗	✗	✓	✗	✗ [b]	✓	✗ [c]	15
(d) Police[d]	✓	..	..	✓	..	..	✓	..	..	✗	..	..	✓	..	..	✓	..	..	✗ [e]	..	..	✓	..	..	2
(e) Court administration[f,g]	✓	..	..	✓	..	..	✓	..	..	✗	..	..	✓	..	..	✓	..	..	✗	..	..	✓	..	..	2
(f) Corrective services	✓	✓	✗	✓	✓	✗	✓	✓	✗	✗	✓	✓	✓	✓	✗	✓	✓	✗	✗	✓	✗	✓	✓	✗	9
(g) Emergency management[h]	✓	✓	✗	✓	✓	✗	✓	✓	✗	✓	✓	✗	✓	✓	✗	✓	✓	✗	✗	✓	✗	✓	✓	✓	8
(h) Aged care	✓	✓	✗	✗	✓	✗	✗	✓	✗	✗	✓	✗	✗	✓	✗	✓	✓	✗	✗	✓	✗	✓	✓	✗	13
(i) Disability services	✓	✓	✗	✗	✓	✗	✓	✓	✗	✗	✓	✗	✗	✓	✗	✓	✓	✗	✗	✓	✗	✓	✓	✗	12
(j) Children’s services	✓	✓	✗	✗	✓	✗	✓	✓	✗	✗	✓	✗	✗	✓	✗	✓	✓	✗	✗	✓	✗	✓	✓	✗	12
(k) Protection and support	✓	✓	✗	✓	✓	✗	✓	✓	✗	✗	✓	✗	✓	✓	✗	✓	✓	✗	✗	✓	✗	✓	..	..	9
(l) Housing	✓	✓	✗	✓	✓	✗	✓	✓	✗	✓	✓	✗	✓	✓	✓	✓	✓	✗	✓	✓	✗	✓	✓	✗	6
Total exempt services	1	0	8	4	1	10	2	1	10	9	0	8	5	1	8	0	0	9	11	1	10	2	0	7	

G = government agency. P = for-profit private sector. N = not-for-profit private sector.

[a] Cost data collected by Ministerial Council on Education, Employment, Training and Youth Affairs and presented in the Report on Government Services are supposed to exclude payroll tax. [b] An exemption applies to public hospitals, although public and community health services are taxable. [c] Public and community health services are taxable. [d] All jurisdictions indicated that police services are not applicable for private sector provision, but some non-core activities are contracted to external providers. [e] The Australian Federal Police are exempt from payroll tax. [f] All jurisdictions indicated that court administration services are not applicable for private sector provision, but court reporting and bailiff services in some jurisdictions are contracted to external providers. [g] The Federal Court and Family Court of Australia are exempt from payroll tax. [h] Ambulance services are contracted out to St John Ambulance in Western Australia and the Northern Territory. **..** Not applicable. ✓ Payroll taxable. ✗ Payroll tax exempt.

Sources: State and Territory Departments of Treasury.

Table 2.2 **Payroll tax systems, as at 1 July 1999**

State/Territory	*Payroll tax scheme*	*Tax-free payroll threshold ($)*	*Maximum marginal rate (%)*
New South Wales	Single marginal rate	600 000	6.40[a]
Victoria	Single marginal rate	515 000	5.75[b]
Queensland	Single marginal rate with clawback[c]	850 000[d]	5.00
Western Australia	Progressive marginal rates with clawback[c]	675 000	5.56
South Australia	Single marginal rate	456 000	6.00
Tasmania	Single marginal rate	600 000	6.35[e]
Australian Capital Territory	Single marginal rate	800 000[f]	6.85
Northern Territory	Progressive average rates with clawback[c]	520 000	7.00

[a] As of 1 July 1999, the marginal rate was reduced from 6.85 per cent. [b] As of 1 July 1999, the marginal rate was reduced from 6.0 per cent. The marginal rate was reduced from 6.25 per cent to 6.0 per cent from 1 July 1998. [c] Table 2.4 outlines the clawback systems for Queensland, Western Australia and the Northern Territory. [d] The tax-free threshold increased from $800 000 on 1 January 1998. [e] As of 1 July 1998, the marginal rate was reduced from 6.6 per cent. [f] The tax-free threshold increased from $700 000 on 1 January 1998.

Sources: PC (1998) and State and Territory Departments of Treasury.

Table 2.3 **Progressive marginal and average tax rate arrangements, as at 1 July 1999**

State	*Annual payroll ($)*	*Tax rate (%)*
Western Australia	0 – 675 000	Nil
	675 001 – 2 700 000	3.65
	2 700 001 – 4 500 000	3.65 – 4.60[a]
	4 500 001 – 5 625 000	4.60 – 5.56[b]
	> 5 625 000	5.56
Northern Territory	0 – 520 000	Nil
	520 001 – 1 250 000	5.00
	1 250 001 – 1 300 000	6.00
	1 300 001 – 10 000 000	6.00
	> 10 000 000	7.00

[a] Tax rate is calculated as: 100 ($98 550 + 6.025 per cent of excess) divided by payroll. [b] Tax rate can be calculated: 100 ($207 000 + 9.4 per cent of excess) divided by payroll.

Source: PC (1998).

Three types of payroll tax rate structures are used across jurisdictions:

- single marginal rate — whereby a uniform rate of tax is applied to the value of the payroll exceeding the tax-free threshold (New South Wales, Victoria, Queensland, South Australia, Tasmania and the ACT);

- progressive marginal rates — whereby the rate of taxation increases with the size of the payroll, and each marginal rate only applies to the portion of the payroll above the tax bracket (Western Australia); and
- progressive average rates — whereby the tax rate varies with the size of the payroll, but the tax rate applies to the entire payroll above the tax-free threshold rather than the payroll above the tax bracket (Northern Territory).

The progressive rate structures (table 2.3) affect the precision of payroll tax estimates using simple formulae based on the single marginal rate structure (chapter 3).

2.3 Clawback arrangements

Single marginal rate schemes are either:

- non-clawback — whereby the tax-free threshold is available to all taxpayers; or
- clawback — whereby the tax-free threshold is adjusted to be gradually phased out, so above a certain limit (called the upper taper limit) the entire payroll is subject to taxation.

Under the non-clawback scheme, all organisations are entitled to the tax-free threshold, irrespective of the size of their payroll. However, under a clawback scheme, a tax-free threshold only applies to organisations with a payroll below an upper limit.

Of the six jurisdictions operating a single marginal rate system, only Queensland operates a clawback system. Western Australia operates a progressive marginal rates clawback system while the Northern Territory operates a progressive average rates clawback system (table 2.4). Tasmania replaced a clawback system with a single marginal rate system on 1 July 1997.

Table 2.4: **Clawback arrangements, as at 1 July 1999**

State	*Annual payroll ($)*	*Taxable payroll*	*Tax rate (%)*
Queensland	850 000 – 3 400 000	Excess[a] + 1/3 (excess)	5.00
Western Australia	675 000 – 2 700 000	Excess[a] + 1/3 (excess)	3.65
Northern Territory	520 000 – 1 250 000	Excess[a] + 2/3 (excess)	5.00
	1 250 000 – 1 300 000	Excess[a] + 2/3 (excess)	6.00

[a] Excess refers to the amount of payroll over the tax-free threshold.

Sources: PC (1998) and Western Australian State Revenue Department (1997).

Clawback systems cut out at different payroll levels across jurisdictions (ranging from $1.3 million in the Northern Territory to $3.4 million in Queensland).

However this is only likely to affect data which include some for-profit providers of aged care, disability and children's services in Queensland, Western Australia and the Northern Territory and for some protection and support services in Queensland and Western Australia[1]. The impact of different clawback systems on unit cost estimates is considered in section 3.3. Most payrolls for government delivered services will be substantially larger than the upper taper limit and not-for-profit providers are usually payroll tax exempt (table 2.1).

1 Unpublished average annual payroll data supplied by the Australian Bureau of Statistics suggests many payrolls for child care and aged accommodation services in 1998 were below the tax-free threshold. However, many payrolls for nursing home services may be large enough so that they are subject to clawback arrangements.

3 Are the differences significant?

Different payroll tax arrangements can potentially affect the comparability of service cost data. This chapter estimates the potential impact of each source of difference (exemptions, marginal tax rates, tax-free thresholds and clawback arrangements) across jurisdictions for government-delivered services[1]. Case studies were selected on the basis of the availability of labour cost data for the *Report on Government Services 1999* (SCRCSSP 1999).

3.1 Exemptions

Payroll tax exemption arrangements differ significantly across jurisdictions, services and providers (table 2.1). The Victorian Department of Treasury and Finance (1997) has suggested that the potential advantage to Victorian public hospitals from exemptions to payroll tax could be up to 5 per cent of total costs.

The effect of different payroll tax exemptions across jurisdictions and service providers will be most significant for labour intensive services. Examples of these differences are outlined for current health and corrective services delivered by government. The examples estimate the amount of payroll tax that would need to be deducted for Tasmanian public hospitals, and the estimated payroll tax that would need to be added by Western Australian and ACT corrective services to make their unit costs comparable with other service providers.

Case 1: health services

According to the Departments of Treasury in each of the State and Territories, all public acute care hospital services except Tasmania are exempt from payroll tax. In 1996-97 Tasmanian public acute care hospitals had 6.6 per cent of their payroll exceeding the $600 000 tax-free threshold taxed.

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[1] Payroll tax estimates were calculated on the assumption that payroll tax bases included superannuation. Differences in payroll tax bases may also have a small effect on unit cost comparability.

In 1996-97 labour costs (including payroll tax) for Tasmanian public acute care hospitals were $166 million, or around 80 per cent of total costs. The Tasmanian Department of Treasury and Finance treats Tasmania's public acute care hospitals as a single taxpayer for the purpose of payroll tax, so their combined payroll exceeds the $600 000 tax-free threshold.

Payroll tax paid in 1996-97 was estimated to be $10.8 million. This is equivalent to about 5 per cent of total costs for public acute care hospitals in Tasmania (box 3.1). In terms of unit costs (defined as total costs divided by the number of casemix-adjusted separations) the payroll tax estimate is equivalent to $139. This has had the effect of reducing the costs of Tasmanian acute care public hospitals relative to those of other jurisdictions (figure 3.1).

Box 3.1 **Estimating payroll tax paid by health services from labour cost information**

The payroll tax paid by a service can be estimated by applying equation (1). This requires obtaining the labour cost of the service (including payroll tax) and the relevant jurisdiction's tax-free threshold and marginal tax rate.

$$(1)\quad \textit{Estimated payroll tax} = \textit{labour costs} - \left[\frac{\textit{labour costs} - \textit{threshold}}{1 + \textit{marginal rate}}\right]$$

where $\textit{labour costs} =$ labour costs including payroll tax;

$\textit{threshold} =$ jurisdiction's tax-free threshold; and

$\textit{marginal rate} =$ jurisdiction's marginal tax rate.

Estimating payroll tax paid — Tasmania

$$\textit{Estimated payroll tax} = \$165\ 984\ 000 - \left[\frac{\$165\ 984\ 000 - \$600\ 000}{(1.066)}\right] = \$10\ 840\ 000$$

(around 5 per cent of total costs — $207 480 000)

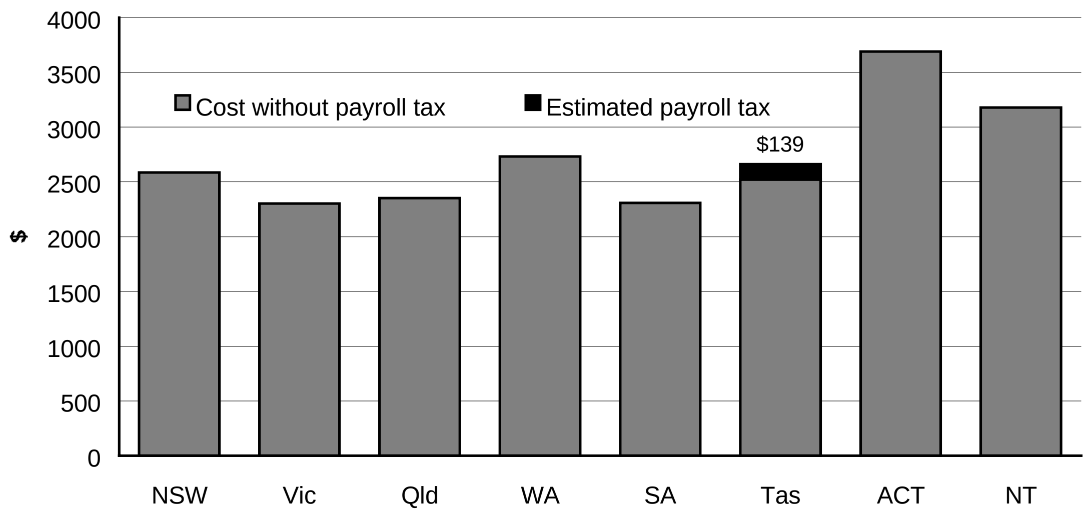
where $\textit{labour costs} = \$165\ 984\ 000$;

$\textit{threshold} = \$600\ 000$; and

$\textit{marginal rate} = 0.066$.

Sources: AIHW (1998), Secretariat estimates and Tasmanian Department of Health and Human Services.

Figure 3.1 **Payroll tax proportion of costs per casemix-adjusted separation, selected public acute care hospitals, 1996-97**



Data sources: AIHW (1998), Secretariat estimates and Tasmanian Department of Health and Human Services.

Case 2: corrective services

Western Australia and ACT Departments of Treasury advised that corrective services in their jurisdictions are exempt from payroll tax. All corrective services in other jurisdictions are taxable under various arrangements (table 2.1).

In 1997-98, total salaries and payments in the nature of salaries (including superannuation) for all community corrections totalled $8 million in Western Australia (around 55 per cent of total expenditure) and $1.5 million in the ACT (around 80 per cent of total expenditure). Assuming that all community corrections in Western Australia and the ACT are each treated as a single taxpayer, their payroll exceeds the respective jurisdiction's tax-free threshold.

If both jurisdictions did not exempt their community corrections from payroll tax, payroll tax would be an estimated $443 000 in Western Australia and $44 000 in the ACT. These estimates are calculated to be about 3 per cent of total costs in both jurisdictions (box 3.2). In terms of unit costs (total expenditure per offender per day), the inclusion of a payroll tax estimate would increase the estimated cost from $8.75 to $9.01 in Western Australia, and from $6.06 to $6.21 in the ACT (figure 3.2).

Box 3.2 Estimating payroll tax liability for exempt services from labour cost information

The amount of payroll tax that exempt services would be liable to pay if they were taxable can be estimated by applying equation (2). This also requires obtaining the labour cost of the service (excluding payroll tax) and the relevant jurisdiction's tax-free threshold and marginal tax rate.

$$(2)\quad \textit{Estimated payroll tax} = (\textit{net labour costs} - \textit{threshold})\ \textit{marginal rate}$$

where $\textit{net labour costs} =$ labour costs excluding payroll tax;

$\textit{threshold} =$ jurisdiction's tax-free threshold; and

$\textit{marginal rate} =$ jurisdiction's marginal tax rate.

Estimating payroll tax liability — WA community corrections

$$\textit{Estimated payroll tax} = (\$7\ 970\ 000 - \$0)\ 0.0556 = \$443\ 000$$

(around 3 per cent of total costs — $14 673 000)

where $\textit{net labour costs} = \$7\ 970\ 000$*;*

$\textit{threshold} = \$0$ (*due to Western Australia's clawback arrangements*); and

$\textit{marginal rate} = 0.0556$.

Estimating payroll tax liability — ACT[a] community corrections

$$\textit{Estimated payroll tax} = (\$1\ 390\ 000 - \$750\ 000)\ 0.0685 = \$44\ 000$$

(around 3 per cent of total costs — $1 715 000)

where $\textit{net labour costs} = \$1\ 390\ 000$;

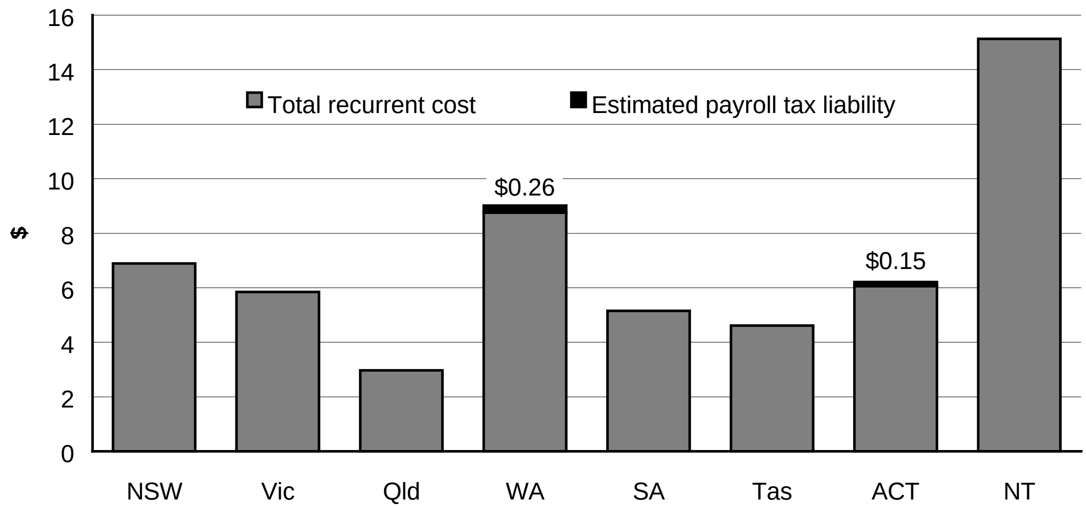
$\textit{threshold} = \$750\ 000$; and

$\textit{marginal rate} = 0.0685$.

a In 1997-98, the tax-free threshold for the ACT was $750 000, since the threshold amount increased from $700 000 to $800 000 on 1 January 1998.

Sources: Secretariat estimates and State and Territory corrective services agencies.

Figure 3.2 **Payroll tax proportion of recurrent costs per offender per day, community corrections, 1997-98**



Data sources: SCRCSSP (1999), Secretariat estimates and State and Territory corrective services agencies.

3.2 Marginal tax rates and tax-free thresholds

In the case of corrective services in section 3.1, the Western Australian and ACT marginal tax rates and tax-free thresholds were used to estimate their hypothetical payroll tax liabilities. These rates and tax-free thresholds were applied to improve the comparability of cost data across jurisdictions. Given that these services are in reality payroll tax exempt, a decision should be made as to the appropriate tax rate and threshold to apply. Table 3.1 and box 3.3 illustrate that the choice of which marginal tax rate and tax-free threshold to apply is less important than the decision to estimate the payroll tax liability.

Corrective services

The estimated payroll tax liability for ACT corrective services can be calculated using either the jurisdiction's own marginal tax rate (6.85 per cent) and tax-free threshold ($750 000[2]) (table 2.2) or the weighted average rate (6.0 per cent) and

[2] In 1997-98, the tax-free threshold for the ACT was $750 000, since the threshold amount increased from $700 000 to $800 000 on 1 January 1998.

tax-free threshold ($623 000) (weighted by population) for all jurisdictions (table 3.1).

The choice of marginal tax rate and tax-free threshold will yield different estimates of payroll tax liability. The extent of these differences are illustrated in box 3.3. Applying the ACT's own marginal tax rate and tax-free threshold effectively decreases total costs by $2 000 (0.1 per cent). Applying the same formula to services with larger payrolls yield effects of a similar magnitude. For example, total costs for police services in the ACT would be about $360 000 (0.6 per cent) higher using the weighted average rate and tax-free threshold.

This finding can be generalised to all other jurisdictions, as illustrated by table 3.1 where the difference between the actual marginal tax rate and the weighted average rate of 6.0 per cent varies by 1 per cent in Queensland and the Northern Territory, and by less than 1 per cent in all other jurisdictions. Similarly, the difference between the actual tax-free threshold and the weighted average threshold varies by around $230 000 in Queensland and less than $200 000 in all other jurisdictions.

Table 3.1 **Differences in marginal payroll tax applications**

	Jurisdiction rate (%)	*Weighted average rate[a] (%)*	*Difference (%)*	*Jurisdiction threshold($)*	*Weighted average threshold($)*	*Difference ($)*
NSW	6.40	6.00	+0.70	600 000	623 000	-23 000
Vic	5.75	6.00	–0.25	515 000	623 000	-108 000
Qld	5.00	6.00	–1.00	850 000	623 000	+227 000
WA	5.56	6.00	–0.44	675 000	623 000	+52 000
SA	6.00	6.00	0.00	456 000	623 000	-167 000
Tas	6.35	6.00	+0.60	600 000	623 000	-23 000
ACT	6.85	6.00	+0.85	800 000	623 000	+177 000
NT	7.00	6.00	+1.00	520 000	623 000	-103 000

[a] The weighted average rate is calculated by multiplying a population weight (as a proportion of the total national population) for each jurisdiction to the jurisdiction's maximum marginal tax rate, then summing all weighted tax rates.

Sources: ABS (1999) and PC (1998).

3.3 Clawback arrangements

Only Queensland, Western Australia and the Northern Territory operate clawback schemes. Generally these arrangements only apply to small to medium payroll sizes; across all three jurisdictions, clawback arrangements apply to a payroll range of $675 000 in Western Australia to $3.4 million in Queensland (table 2.4). The

Box 3.3 **Differences in payroll tax estimates for corrective services using a weighted average marginal tax rate and tax-free threshold**

The difference in payroll tax estimates using a weighted average marginal tax rate and tax-free threshold and the actual jurisdiction's marginal tax rate and tax-free threshold can be estimated by applying equation (3). This requires obtaining the labour cost of the service (including payroll tax) and the relevant jurisdiction's tax-free threshold and marginal tax rate.

(3) $\mathit{Difference} = \mathit{jurisdiction's\ estimated\ payroll\ tax} - \mathit{weighted\ average\ payroll\ tax}$

where

$$\mathit{jurisdiction's\ estimated\ payroll\ tax} = (\mathit{net\ labour\ costs} - \mathit{threshold})\ \mathit{marginal\ rate}$$

$\mathit{net\ labour\ costs} =$ labour costs excluding payroll tax;

$\mathit{threshold} =$ jurisdiction's tax-free threshold; and

$\mathit{marginal\ rate} =$ jurisdiction's marginal tax rate.

$$\mathit{weighted\ average\ payroll\ tax} = (\mathit{net\ labour\ costs} - \mathit{weighted\ average\ threshold})\ \mathit{weighted\ average\ rate}$$

$\mathit{weighted\ average\ threshold} =$ weighted average tax-free threshold ($623 000);

and

$\mathit{weighted\ average\ rate} =$ weighted average marginal tax rate (6.0 per cent).

ACT[a] community corrections

$$\mathit{Difference} = [(\$1\,390\,000 - \$750\,000)\,0.0685] - [(\$1\,390\,000 - \$623\,000)\,0.06]$$

$$= -\$2\,000 \text{ (around 0.1 per cent of total costs — \$1 715 000)}$$

where $\mathit{jurisdiction's\ estimated\ payroll\ tax} = \$44\,000;$ and

$\mathit{weighted\ average\ payroll\ tax} = \$46\,000.$

a In 1997-98, the tax-free threshold assumed for the ACT was $750 000, since the threshold amount increased from $700 000 to $800 000 on 1 January 1998.

Sources: SCRCSSP (1999) and Secretariat estimates.

payroll size for Western Australia corrective services was large enough not to be affected by Western Australia's clawback arrangements in box 3.2.

The effect of operating a clawback scheme is investigated using the same approach used in box 3.2 for a range of hypothetical payrolls (table 3.2). The exercise involves calculating the difference in payroll tax estimates between a single

Table 3.2 **Differences in payroll tax estimates using clawback and non-clawback arrangements[a,b]**

	Qld			*WA[c]*			*NT[c]*		
Payroll	*Tax paid under clawback arrangement ($)*	*Estimated tax paid using single marginal rate formula ($)*	*Extent to which estimate understates actual tax paid (% of payroll)*	*Estimated tax paid using existing clawback arrangement ($)*	*Estimated tax paid using single marginal rate formula ($)*	*Increase in payroll tax estimates using existing clawback arrangement (% of payroll)*	*Estimated tax paid using existing clawback arrangement ($)*	*Estimated tax paid using single marginal rate formula ($)*	*Increase in payroll tax estimates using existing clawback arrangement (% of payroll)*
520 000	0	0	0	0	0	0	0	0	0
675 000	0	0	0	0	0	0	18 100	10 900	1.1
850 000	0	0	0	13 000	9 700	0.4	38 500	23 100	1.8
1 250 000	26 700	20 000	0.5	42 600	32 000	0.9	85 200	51 100	2.7
1 300 000	30 000	22 500	0.6	46 300	34 800	0.9	91 000	54 600	2.8
2 700 000	123 300	92 500	1.1	150 100	112 600	1.4	189 000	152 600	1.3
3 400 000	170 000	127 500	1.3	189 000	151 500	1.1	238 000	201 600	1.1
3 500 000	175 000	132 500	1.2	194 600	157 100	1.1	245 000	208 600	1.0
4 000 000	200 000	157 500	1.1	222 400	184 900	0.9	280 000	243 600	0.9
5 000 000	250 000	207 500	0.9	278 000	240 500	0.8	350 000	313 600	0.7
10 000 000	500 000	457 500	0.4	556 000	518 500	0.4	700 000	663 600	0.4
20 000 000	1 000 000	975 500	0.1	1 112 000	1 074 500	0.2	1 400 000	1 363 600	0.2
50 000 000	2 500 000	2 457 500	0	2 780 000	2 742 500	0	3 500 000	3 463 600	0

a Payroll tax estimates have been made using each jurisdiction's maximum marginal payroll tax rate for all payrolls. **b** Estimating payroll tax using the simple marginal rate formula would underestimate payroll tax actually paid. This would affect the adjustments outlined in Chapter 4 in the following ways: if the *tax addition* method was used, the single marginal rate formula would underestimate payroll tax and therefore actual unit costs; if the *tax deduction* method was used, the single marginal rate formula would underestimate payroll tax and therefore overstate actual unit costs. **c** The actual tax paid is affected by the progressive marginal and average tax rate arrangements.

Sources: PC (1998), Secretariat estimates and Western Australian State Revenue Department (1997).

marginal rate scheme and the appropriate clawback scheme. The maximum marginal rate for each jurisdiction is applied in each case.

These differences show that estimating payroll tax using the clawback scheme will overstate payroll tax estimates by less than 2 per cent of labour costs for most payroll sizes. Across all three clawback systems, the difference in payroll tax estimates is highest (2.8 per cent) for the clawback system used in the Northern Territory. The maximum difference for the other two systems is 1.4 per cent in Western Australia (for a payroll of $2.7 million). The effect of these differences on total unit costs is even less.

3.4 Conclusions

Different payroll tax arrangements are a significant issue when measuring service unit costs for the Report on Government Services. Payroll tax exemptions have the most significant effect, particularly where labour costs make up a significant proportion of the service cost. Labour costs represent, for example around 80 per cent of inpatient costs of public acute care hospital services (based on National Hospital Cost Data Collection cost modelling).

The inconsistent treatment in costing labour inputs of public acute care hospitals across jurisdictions has led to significant difference in the reported unit costs. Only Tasmanian public acute care hospital services used to report labour costs inclusive of payroll tax in the Report on Government Services. All other jurisdictions' public acute care hospital services were exempt[3]. Currently, different exemptions affect police and government delivered health services unit costs by up to 5 per cent.

Differences in service delivery mix across jurisdictions also influence the significance of these effects, because government and private sector service deliverers often treat exemptions differently (as explained in chapter 2). The significance of differences in unit costs will be less than 5 per cent when comparisons are made across jurisdictions with different service delivery mixes. The effects of differences in marginal tax rates, tax-free thresholds and clawback schemes are much less significant. Clawback arrangements would overestimate unit

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[3] The Steering Committee identified this anomaly and Tasmania provided adjusted data for the *Report on Government Services 1999*. The subsequent edition of *Australian Hospital Statistics*, the series from where the data are drawn, also made a similar adjustment. No adjustments were made in previous editions of the Report or other AIHW publications, although *Australian Hospital Statistics 1996-97* (AIHW 1998) noted the anomaly in payroll tax treatment.

cost comparisons for payrolls below $4 million by less than 1 per cent in Queensland and Western Australia and by up to 2 per cent in the Northern Territory, while the impact of different marginal payroll tax rates and tax-free thresholds on unit costs is insignificant.

4 Accounting for differences in payroll tax exemptions

There are two approaches to account for differences in the treatment of payroll tax exemptions across jurisdictions. Both make the simple assumption that the full cost of the payroll tax is passed on to the consumer. They also assume that the wages and salaries service providers are prepared to pay do not change, regardless of whether the agency is subject to payroll tax.

The first approach is to report cost data including actual and estimated payroll tax. This involves separately identifying which government service providers contribute payroll tax and estimating a hypothetical payroll tax liability for exempt service providers.

The second approach is to report cost data excluding payroll tax. Two methods can be used for this approach. The preferred method requires taxable services separately to identify payroll tax and to exclude this amount when reporting cost data. When payroll tax data are not available, another method requires taxable service providers to estimate payroll tax separately from cost data.

The choice of whether to report unit costs inclusive or exclusive of payroll tax depends on a range of considerations including the extent to which they address current shortcomings in:

- comparability (comparing like goods and services);
- completeness (accounting for all economic costs); and
- transparency (clarifying what is being compared with what).

In most cases, the decision to include or exclude payroll tax will be based on whether most private service providers are subject to payroll tax. It is generally easier to adjust the cost estimates of government providers than the cost estimates of private providers. Typically there will be fewer government providers and access to their cost data raises fewer concerns.

If most private service providers do not contribute payroll tax (either because of exemption status or because their payrolls are smaller than the tax-free thresholds) then government service providers should report unit costs exclusive of payroll tax. Similarly, if most private service providers contribute payroll tax then government service providers should report unit costs inclusive of payroll tax.

Finally, if there is no private service provision (for example, police and court administration services) the choice of approach should reflect a balance between each of the above criteria.

4.1 Approaches to adjust costs for payroll tax differences

The approaches to adjust costs for payroll tax differences involve two basic methods — *tax deduction* and *tax addition*. The choice of the most appropriate method depends on the availability of data across jurisdictions.

Tax deduction

Tax deduction provides a method used to adjust costs for different payroll tax arrangements. This method can be used to report cost data excluding payroll tax when a government service provider is liable for payroll tax and is able to identify its payroll tax liability separately from labour costs. This method reports unit costs excluding payroll tax.

Provided the cost of obtaining this information is small, this option meets all of the criteria for an ideal method to accounting for differences in payroll tax arrangements: it can be applied consistently across all taxable services; it provides an accurate account of the amount of payroll tax paid by taxable services; and it identifies payroll tax as a separate cost of service provision.

There may be instances where taxable government service providers are unable to separately identify their payroll tax liability, or where the collection of payroll tax data imposes an unnecessary burden on data collectors. The amount of payroll tax to be deducted can be estimated from gross (tax inclusive) payroll data.

An estimate of payroll tax for this method requires:

- aggregate payroll data (payroll tax base and payroll tax) from taxable service providers;
- the number of taxable service providers; and
- the jurisdiction’s tax-free threshold and marginal payroll tax rate.

This method requires taxable government service providers to report their combined payroll tax and payroll costs. The payroll tax will be estimated separately, as described in the method below. The derived estimates of payroll tax and payroll costs (net of tax) can then be used to adjust the service provider's unit costs.

Taxable government service providers may continue to report their combined payroll tax and payroll costs (and thus be subject to this approach) until they are able to report payroll tax separately (*tax separation*). The advantage of the following method is that it does not impose any additional burden on agencies.

Method

The following calculation can be used to estimate payroll tax:

$$\textit{Estimated payroll tax} = \textit{labour costs} - \left[\frac{\textit{labour costs} - \textit{threshold}}{1 + \textit{marginal rate}}\right]$$

where $\textit{labour costs}$ = estimated payroll tax base (for example, salaries and superannuation) plus payroll tax;

$\textit{threshold}$ = jurisdiction's tax-free threshold; and

$\textit{marginal rate}$ = jurisdiction's marginal tax rate.

Tasmanian public acute care hospitals illustrates an application of this approach (box 3.1 and figure 3.1). Tasmania's cost per casemix-adjusted separation data (figure 4.8 and table 4A.11 in *Report on Government Services 1999*, SCRCSSP 1999) provide an example of the appropriate *tax deduction* treatment of unit costs.

Tax addition

Tax addition provides a method for reporting unit cost data including payroll tax for exempt government service providers. The Victorian Department of Treasury and Finance (1997) uses this approach for implementing competitively neutral pricing principles, and the National Competition Council's (1997) report on competitive neutrality outlines this approach.

Calculations for this option require:

- aggregate payroll data (payroll tax base) from all service providers that have payrolls over the tax-free threshold, and that are either exempt from payroll tax or unable to provide payroll cost data including payroll tax;
- the number of these service providers; and

- the jurisdiction's tax-free threshold and marginal payroll tax rate.

The choice of tax rate to use (the jurisdiction's marginal tax rate or the weighted average marginal tax rate) is explored in section 3.2. The decision does not appear to significantly affect the payroll tax estimate. For consistency across services within each jurisdiction, the jurisdiction's relevant tax rate should be applied.

Under this option, tax exempt government service providers would report their payroll costs. A hypothetical payroll tax amount is estimated, as described in the method below. The derived estimates of payroll tax and payroll costs (net of tax) can then be used to adjust the service provider's unit costs. Unit costs may include or exclude payroll tax, depending on the adjustments made to estimates of other jurisdictions.

Method

The following calculation can be made to estimate payroll tax:

$$Estimated\ \ payroll\ tax\ =\ \left(net\ labour\ costs - threshold\right) marginal\ rate$$

where $net\ labour\ costs =$ estimated payroll tax base (for example, salaries and superannuation) less payroll tax;

$threshold =$ jurisdiction's tax-free threshold; and

$marginal\ rate =$ jurisdiction's marginal tax rate.

Corrective services in Western Australia and the ACT (box 3.2 and figure 3.2) exemplify applications of this method. This method provides a simple way to improve the comparability of service costs across jurisdictions, and it can be applied to exempt services.

4.2 Recommendations

Table 4.1 summarises the main findings for each of the services covered in the Report on Government Services. It illustrates how unit costs are to be reported, what changes are necessary and the reasons for those changes. As noted in chapter 1, the objective of this paper is to improve, among other things, the comparability of cost data.

Reporting cost data excluding payroll tax is recommended where most providers are payroll tax exempt or are government providers for whom it is easy to get payroll data. This approach is preferred because it avoids the effects of differences in

Table 4.1 **Summary of recommendations for reporting the treatment of payroll tax in calculating unit costs of government service providers in the Report on Government Services**

		Proposed treatment of certain unit costs		
	Approach to reporting unit costs	*Affected jurisdictions*	*Recommended adjustment approach*[a]	*Reasons for recommendations*
School education	*Tax exclusive*			Unit cost data already exclude payroll tax. Most service providers across both government and private agencies are payroll tax exempt.
Vocational education and training	*Tax inclusive*	ACT	*Tax addition*	Most service providers across both government and private agencies are taxable.
Health	*Tax exclusive*	Tasmania	*Tax deduction*	Most service providers across both government and private agencies are payroll tax exempt.
Police	*Tax exclusive*	NSW, Victoria, Queensland, SA, Tasmania, NT	*Tax deduction*	All service providers are government agencies.
Court administration	*Tax exclusive*	NSW, Victoria, Queensland, SA, Tasmania, NT	*Tax deduction*	All service providers are government agencies.
Corrective services	*Tax inclusive*	WA, ACT	*Tax addition*	Most service providers across both government and private agencies are taxable.
Emergency management	*Tax inclusive*	ACT	*Tax addition*	Most service providers across government agencies are taxable. Not-for-profit private providers in NT are also taxable.
Aged care	*Tax exclusive*	Tasmania, NT	*Tax deduction*	The number and taxable status of private service providers are uncertain, with the likelihood that most are below the tax-free threshold or are exempt from payroll tax as not-for-profit providers. A number of government service providers across jurisdictions are exempt from payroll tax.
Disability services	*Tax exclusive*	Queensland, Tasmania, NT	*Tax deduction*	as above
Children's services	*Tax exclusive*	Queensland, Tasmania, NT	*Tax deduction*	as above
Protection and support	*Tax exclusive*	NSW, Victoria, Queensland, SA, Tasmania, NT	*Tax deduction*	as above
Housing	*Tax inclusive*			Unit cost data already include payroll tax across all jurisdictions.

[a] This adjustment would only be applied if data, excluding payroll tax, was not available from the line agencies concerned

marginal tax rates, tax-free thresholds and clawback arrangements across jurisdictions. However, this approach may hinder comparisons across some services, for example between schools (where payroll tax is excluded from reported cost data) and VET (where payroll tax is included in reported cost data). It may also not be appropriate for competitive neutrality costing purposes.

It is recommended for vocational education and training, for example that unit costs include payroll tax. The ACT is the only jurisdiction that exempts government vocational education and training service providers from payroll tax and most service providers (government and private) are taxable, so comparability is achieved by applying the *tax addition* method to that Territory. Similarly, in the case of corrective services, the majority of service providers (government and private) are taxable. As Western Australia and the ACT currently exempt government service providers from payroll tax, these services should also be subject to the *tax addition* method.

Most court administration providers are taxable. However, the table recommends that unit costs exclude payroll tax, because relatively little effort is needed to apply the *tax deduction* method to New South Wales, Victoria, Queensland, South Australia, Tasmania and the Northern Territory. As there are no private providers of court administration services, there is no need to apply the *tax addition* method for competitive neutrality purposes. For the purpose of comparability in the Report on Government Services, it is preferable to estimate an actual amount of tax paid for these jurisdictions (*tax deduction*) than to estimate a hypothetical amount that the remaining court jurisdictions would have paid (*tax addition*).

It is not obvious which of the two approaches should be used for aged care, disability, children’s and protection and support services. However, on balance the recommended approach is the *tax deduction* method for these government service providers because available evidence suggests that most private service providers are exempt (having payrolls under the tax-free threshold or receiving exemptions as a religious or public benevolent organisation) and a number of government service providers are also exempt.

Again, this approach minimises the effects of different tax rates, tax-free thresholds, exemptions and clawback arrangements on the comparability of unit costs. In some cases, it may be necessary to revise the approach adopted in the future due to changes in the mix of providers. For example, an increase in the level of for-profit delivery of services would favour a move to tax inclusion as it is more complex to estimate the tax paid by these providers.

Attachment 1

State and Territory Treasury contact phone numbers

New South Wales Treasury

Phone: (02) 9689 6426

Website: www.osr.nsw.gov.au

Victorian State Revenue Office

Phone: (03) 9628 6480

Website: www.dtf.vic.gov.au

Email: sro@vicnet.net.au

Queensland Office of State Revenue

Phone: (07) 3227 8528

Website: www.osr.treasury.qld.gov.au

Email: enquiries@osr.treasury.qld.gov.au

Western Australian State Revenue Department

Phone: (08) 9262 1300

Website: www.wa.gov.au/srd

Email: stampduty@srd.wa.gov.au

RevenueSA

Phone: (08) 8226 3800

Website: www.treasury.sa.gov.au/tax.html

Tasmanian Department of Treasury and Finance

Phone: (03) 6233 3465

Website: www.tres.tas.gov.au

Email: return@tres.tas.gov.au

ACT Revenue Office

Phone: (02) 6207 0087

Website: www.act.gov.au/ti

Northern Territory Treasury

Phone: (08) 8999 7987

Website: www.nt.gov.au/ntt/revenue

Email: ntrevenue.treasury@nt.gov.au

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