Australian Government
The Treasury

Discussion Paper

Taxation Options for Norfolk Island

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This paper has been prepared for the Norfolk Island Government by the Australian Department of the Treasury. It does not necessarily reflect the views of the Treasurer or of the Australian Government.

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REQUEST FOR ADVICE ON TAXATION

In May 2003, the then Administrator of Norfolk Island, Mr A J Messner, wrote to the Australian Government seeking assistance in the design and implementation of a new taxation regime for the Norfolk Island Government. Officers of Treasury and the Department of Finance and Administration had previously provided more general advice on budgetary matters.

As a first step in response to the Administrator's request, Treasury agreed to provide assistance by developing a technical paper on taxation options for consideration by the Norfolk Island Government. However, Treasury has not committed to doing further work until such time as the Norfolk Island Government has adopted a specific proposal. Treasury will then be able to consider what will be necessary to provide detailed technical design and implementation assistance.

In the past years, the Norfolk Island Government has become increasingly aware of the need to address financial concerns regarding the administration of the Island. The most recent comprehensive public analysis of the economic circumstances of Norfolk Island is the Commonwealth Grants Commission *Report on Norfolk Island* completed in 1997 (CGC Report). This report assessed the Island's economic capacity, financial and administrative arrangements and government services. This report found that the untapped taxing capacity was more than $3000 per capita,[1] and arises largely from the narrower range of taxes and charges imposed.

At around the same time, an Access Economics paper titled *Norfolk Island: Recent Economic Performance, Present Situation, And Future Economic Viability. Is There A Case For Change?* (AE Paper) was completed in March 1997. The report analysed, among other things, Norfolk Island's current economic position and its future economic viability. It concluded that:

- the existing taxes and charges are biased against tourism — this makes Norfolk Island a less competitive tourist destination and poses a threat to its prime export income base;
- there were insufficient provisions for long term liabilities associated with ageing, the replacement of depreciated assets and the provision of new infrastructure;
- there was a heavy reliance on dividends from government business enterprises;
- the Financial Institutions Levy discourages savings.

At the 5 June 2002 Legislative Assembly Meeting, the Norfolk Island Finance Minister, Mr Graeme Donaldson, announced the formation of *Focus 2002* to provide a comprehensive

1 This is based on rates and the tax base in 1995-96 and represents differences in tax rates and the tax base between Norfolk Island and mainland Australia, although this comparison was based on the tax base and rates applying in mainland Australia before the tax reform that commenced in 2000.

review of the Island's fiscal and economic sustainability. This review found that little more could be done to reduce expenditures by the Government on the provision of services and benefits to Islanders and that changes to the taxation arrangements were needed.

The Joint Standing Committee on the National Capital and External Territories published the first part of its report *Quis custodiet ipsos custodes? Inquiry into Governance on Norfolk Island* in December 2003. This report found that 'Norfolk Island is in deep and growing trouble and needs help'. Amongst other things, it recommends a reassessment of the Federal Government's policies of exclusion from Commonwealth programmes and services so that there can be a consistent rationale for Commonwealth funding and assistance, a means of assessing its financial needs and determining any preconditions to receive assistance. In this context, the policy of exemption from Commonwealth taxation is questioned.

The Treasury report examines the tax reform options available to the Norfolk Island Government with an assessment of their impact and effectiveness. In preparing this report Treasury has examined the above reports and two officers visited the Island in October 2003. Discussions have been held with:

- Norfolk Island Government Ministers and members of the Norfolk Island Legislative Assembly;
- Senior members of the Administration of Norfolk Island;
- Norfolk Island's Chamber of Commerce;
- the Department of Transport and Regional Services and the Department of Finance and Administration.

NORFOLK ISLAND'S ECONOMIC AND LEGISLATIVE FRAMEWORK

CONSTITUTIONAL POWERS

Norfolk Island is an external Territory under the authority of the Commonwealth of Australia, with a degree of self-government broadly comparable to that of the other self-governing Territories, the Australian Capital Territory and the Northern Territory.

Norfolk Island's current self-government arrangements are the result of a decision by the Federal Parliament and given effect by the *Norfolk Island Act 1979* (Cth). The second reading speech for that legislation states the Government's intention 'to try to develop for Norfolk Island an appropriate form of government involving the Island's own elected representatives, under which the revenue necessary to sustain that government will be raised internally under its own system of law'.

The *Norfolk Island Act* confers wide ranging powers on the Legislative Assembly to make laws for the 'peace, order and good government of the Territory'. These powers encompass local government, State and some Commonwealth responsibilities (such as immigration, customs and quarantine). They also include wide powers for 'the raising of revenues …' [2]

Apart from those law making powers specifically excluded at section 19 of the Act (coinage, the raising of defence forces, the acquisition of property on other than just terms and euthanasia), the Assembly's legislative powers extend beyond the matters listed in Schedules 2 and 3 of the Act. Once a law is passed, and dealt with according to its categorisation as Schedule 2 (assent by Administrator), Schedule 3 (subject to instructions from the Territories Minister)[3] or non schedule (action by the Governor-General),[4] the Norfolk Island Government has full executive powers and responsibility to administer, fund and enforce legislation and to deliver government services.

The referral process for Schedule 3 and non schedule legislation is meant to ensure that there is no unintended policy conflict between the laws of Norfolk Island and the Commonwealth of Australia or with Australia's obligations under international law.

The Australian Parliament has chosen not to extend all Australian laws to Norfolk Island.[5] Section 18 of the *Norfolk Island Act* provides that Australian Commonwealth legislation does

2 Item 1 in Schedule 2 and subsection 19(3) of the Norfolk Island Act.
3 Schedule 3 of the *Norfolk Island Act*.
4 In respect of matters that are not dealt with in Schedules 2 and 3 of the *Norfolk Island Act.*
5 Under sections 51 and 122 of the Australian Constitution, it is not legally constrained to extend its powers to Norfolk Island.

not extend to Norfolk Island unless it expressly applies — in which case it will override Norfolk Island legislation.

HISTORY

From 1788 to 1855, Norfolk Island was largely a British penal colony. In 1856, the British Government agreed to the relocation to Norfolk Island of the descendants of the mutineers on the Bounty and their Polynesian families from Pitcairn Island.[6]

From 1856, Norfolk Island was a separate British Crown colony administered by its own Governor, who was also the Governor of New South Wales (NSW), and from 1897 it was transferred to the administration of the Governor of the colony of NSW. In 1914, the British Government ordered that Norfolk Island be placed under the authority of the Commonwealth of Australia. Until 1979, it was governed by an Australian appointed Administrator who was supported by an Advisory Council.

Following a Royal Commission headed by Sir John Nimmo in 1975, Norfolk Island was granted self-government under the *Norfolk Island Act 1979* (NI Act). The move to self-government involved the replacement of the advisory Council with an elected Assembly comprising 9 members.

ECONOMY

Norfolk Island has an ordinarily resident population of around 2,000 (1,600 being permanent) and about 600 tourists on the Island at any one time. Tourist numbers are estimated at between 42,000 to 45,000 per annum, mainly from mainland Australia and New Zealand. The ordinarily resident population comprises:[7]

Those working in a job or business	1,229	60 per cent
Retired	199	10 per cent
Students/child not at school	464	23 per cent
Home duties and other	145	7 per cent
Total residents	**2037**	
Tourists	Averages 600 at any time	

Norfolk Island's gross domestic product has been estimated at between $80[8] to $100 million[9] and its economy is highly dependent on tourism. Most of the 349 businesses exist principally because of the tourism trade — 84 provide accommodation, 96 provide tours and 169 are retailers. Traditionally, Norfolk Island was a shopping destination and shopping businesses

6 Around half of NI's total population trace their ancestry to the Pitcairn Islanders.
7 Norfolk Island 2001 census.
8 Commonwealth Grants Commission pp 32-33.
9 Estimate by Administrator, May 2003, correspondence with Treasury.

did quite well. More recently, tourist packages are being sold which comprise airfares, accommodation and island tours. It would appear less tourism money is spent on shopping. The profile of the tourist is, in the main, older persons (over 80 per cent are older than 50).[10] Norfolk Island's reliance on tourism means that even a small decrease in tourist spending could have a significant impact on the economy's financial stability.

Norfolk Island is also heavily dependent on imports. In 2000-2001, it imported approximately $41 million worth of goods. Norfolk Island's main export income comes from tourism. There is limited agriculture and manufacturing industry on the Island and in the main, retailers are also the importers. Therefore, there is not a distinct wholesale/retail supply chain.

In 2000-2001, the Norfolk Island Government consolidated revenues and expenditures were $22.7 million and $21.4 million respectively. These figures include government businesses, such as Norfolk Telecom, the Liquor Bond and electricity services. It appears that, where possible, cost recovery for services provided to residents is in place, for example, in respect of telecommunication and postal services, electricity, lighterage and sewerage and waste services.

The more recent *Focus 2002* review, confirmed that in recent years, government expenditure had risen at a greater rate than revenue, and that the financial situation of Norfolk Island was not sustainable. *Focus 2002* identified that Norfolk Island's financial stability was vulnerable to certain factors. In particular, volatility in tourism, instability of air services to Norfolk Island, and loss of Norfolk Island's relative price competitiveness or duty-free appeal since the introduction of a Goods and Services Tax and tariff reforms in Australia and New Zealand.

Focus 2002 also identified that Norfolk Island has an ageing population and is running down its infrastructure. These observations were also noted in the Grants Commission and Access Economics reports. In general, some significant trends in increased expenditure from June 2001 to June 2003 include:

- Welfare — from $1.4 million to $1.6 million;
- Education — from $1.7 million to $2.1 million; and
- Hospital subsidy — from $457,500 to $970,000.

Exemption from Australian taxes

Although Norfolk Island is a territory of the Commonwealth of Australia under section 122 of the Constitution, Section 18 of the *Norfolk Island Act 1979* provides that Commonwealth legislation does not apply to Norfolk Island unless it is expressly stated to do so.

10 Based on data from the Norfolk Island Census of Population and Housing, 1 August 2001.

Under income tax laws, Australia's offshore Territories, including Norfolk Island, are treated as part of Australia — this means that their residents are treated as residents of Australia for tax purposes and Territory-source income is given an Australian source. However, since 1972, special exemptions have been available to Norfolk Island residents (a person who ordinarily resides on Norfolk Island), companies (a company incorporated in Norfolk Island wholly owned and controlled by its residents) and trustees of the deceased estate of a resident or a trust that will pass income only to residents.

In general terms, Norfolk Island residents, companies and trusts are exempt from Australian tax on income derived from foreign income and sources within Norfolk Island[11] and are only assessable to Australian tax on income derived from mainland Australia. Residents of Norfolk Island are also exempt from the Medicare levy.

The Commonwealth of Australia only raises revenue indirectly from Norfolk Island sources, for example, on the earnings of Australian companies exporting to or operating on Norfolk Island. The Commonwealth Grants Commission estimated this revenue to be around $1 million in 1995-96.

Under the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act), the definition of 'Australia' does not include any external Territory — including Norfolk Island. Therefore, GST does not apply to supplies made in Norfolk Island.

STRUCTURE AND IMPACT OF NORFOLK ISLAND'S TAXES AND CHARGES

Cultural and political issues

Norfolk Island has a more limited range of taxes and charges than on the Australian mainland. There is a feeling that new taxes have developed over time, as revenue increases have been needed to fund new services or maintain existing services. History and culture would appear to play a part in the development of taxes.

During the consultations, there were strong views expressed by some residents that taxation, especially personal income taxes, should not be levied on the Island and that taxes on individual's wealth, such as land, would be abhorrent. In particular, it was reported there is a view among those Pitcairners (who comprise 48 per cent of the permanent population) that their land is an inheritance and legacy for future generations, not a commodity for trade and monetary investment and therefore should not be subject to any taxation. It has not been possible for Treasury to assess how representative of the total population are these views.

11 The rules for determining whether income has a Norfolk Island source are broadly as follows: (a) dividends must be paid by a Norfolk Island company out of profits from Norfolk Island or foreign sources; (b) income from employment must be derived from duties principally performed on Norfolk Island; and (c) interest must be on deposits with a Norfolk Island branch of an Australian bank. Interest or royalties does not have a Norfolk Island source to the extent that the principal or the property giving rise to the interest or royalty is used in Australia and the outgoing is an expense of a mainland Australian business.

Tourists currently bear the burden of a range of existing taxes such as the departure tax, landing fees and the accommodation levy. They also pay a share of the expenditure based taxes (for example, import duties embedded into the prices of restaurant food, accommodation and retail outlets). It is noted that in 1995-1996 tourists comprised about 26 per cent of the population, but contributed in the order of 40 per cent of the revenue.[12]

While there appears to have been an expressed preference by Norfolk Islanders for the tourists, rather than residents, to contribute more by way of taxes, additional taxation directly targeted at tourism is likely to discourage tourists — the life blood of Norfolk Island.

There is also a range of interests that need to be balanced in developing a new taxation regime. Norfolk Island is small and many of the residents may have multiple interests, for example, politicians and government officials who will be involved in deciding on a new tax regime may also own land and business interests. Although the majority of the population are low to middle income earners who could be expected to benefit from a switch in taxes to a more equitable income tax system, a small number of very wealthy residents may oppose the removal of the 'tax free status' they have enjoyed to date.

In recent years, the Government has introduced specific new levies/taxes to support new expenditures, for example on roads. It appears that the use of levies is intended to deal with a broader antipathy to new taxes. It was noted that once these projects were completed the levies are built into other charges and remain in the Government tax base. There seemed to be some resentment to this.

Progressivity/redistributive issues

Norfolk Island's current taxation regime does not appear to have regard to progressivity or any explicit redistributive objectives. The taxes levied are generally flat, across the board, meaning that lower income earners pay a higher proportion of their income on taxation than higher income earners. In 1995-1996, Norfolk Island raised only 4 per cent of its tax revenue from income and wealth, compared to 54 per cent in mainland Australia.

Without an income tax system, wealth distribution in society between the wealthy 'haves' and the 'have nots' can be achieved through the welfare system. There would appear to be some of this happening within the welfare system, for example, the payment of the age pension.

One of the single largest areas of expenditure increase over past years has been in welfare, which includes Hospital and Medical Assistance (HMA) including the payment of Social Services Benefits. HMA payments are made for the medical expenses of people in receipt of a Social Services Benefit including age, widow and special benefit.

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12 Commonwealth Grants Commission pp 149.

Payments of Social Services Benefits (pensions) rose over 66 per cent between 1997 and 2001.[13] In 2000, a 20 per cent increase in benefit rates made payments equivalent to Australian pension rates. In 2001-02, the cost had escalated to $652,000 primarily because more people became eligible for the age pension benefit.

Government monopolies

Government owned business enterprises generate significant revenues in the form of dividend payments. These appear to be a substitute for taxation revenue.

An example of this is monopoly pricing of the Liquor Bond which has exclusive rights to import liquor. Import duties are applied on the invoice cost of beer, wine and spirits (in 2002 when the rate was uniformly applied at 18.5 per cent, $275,000 was raised).[14] The Liquor Bond then sells the liquor to the public (including restaurants) with a substantial mark-up, generating a significant dividend to the Government ($1.2 million in 2001-2002).

Prima facie a monopoly for liquor would seem unnecessary if adequate revenue is available from other sources. Withdrawing from the market would allow Government to consider appropriate taxation of alcohol taking into account any taxation and/or social policy issues without the distortions that may arise from the need for dividends. Further, Government may benefit through the transfer of the costs of the Liquor Bond (for example, wages, rents, capital, etc) to private businesses. Allowing competition in the liquor market would generally be expected to benefit consumers through either lower prices or product innovation (for example, broadening the range of products available). The Norfolk Island Government could, therefore, consider a review of this issue.

There is probably a better case to maintain Norfolk Telecom as a monopoly given the small customer base and that large infrastructure costs would be a deterrent to new entrants in the market. It is not clear from the available information whether the profits of Norfolk Telecom would be abnormally high in an economic sense, where, essentially the profits contain an element of 'taxation'. Further, it is noted that local calls on the Island are free.

13 This apparent increase is partly due to an accounting change between entities; nevertheless, there has been a considerable increase.

14 Import duty rates have recently been increased to 20, 25 and 30 per cent on beer, wine and spirits respectively.

Table 1: Government taxes and charges FY 2001-02

Source of revenue	Amount $	Percent of total revenue fund income Per cent
Customs Duty	3,644,716	32
Telecom Dividend	1,336,000	12
Liquor Bond Dividend	1,206,706	10.5
Departure Fees	868,535	7.5
Financial Institutions Levy	778,235	7
Accommodation Levy	582,863	5
Land Title Fees	429,535	3.8
Vehicle Registration & Licences	424,323	3.7
Fuel levy	364,395	3.2
Rentals Admin. Properties	138,984	1.2

In addition, the Government generates about $10 million per annum, to recover the cost of services such as electricity and postal services, airports and water.

Customs Duty

Customs duty is imposed on all imported goods and is levied on the invoice price of the goods. The rate on most imported goods is 10 per cent, with food at 6 per cent, beer at 20 per cent, wine at 25 per cent, spirits at 30 per cent, tobacco at 500 per cent and motor vehicles/cycles at 15 per cent. Approximately $3.7 million is raised per annum. Customs duty is effectively a broad based consumption tax on goods. If a mark up of around 100 per cent is assumed on imports, then that would equate to about 5 per cent of the retail price of most goods.

Like other consumption taxes, duties are regressive in that they are levied at a flat rate. The only way to avoid broad based duties like these is to save income or spend off shore. People on lower incomes typically spend more of their income and therefore will be taxed more as a proportion of their income.

Customs duties also impact on business in that they must meet the cost of the goods and associated duties up-front and bear the opportunity cost of tying up funds in duty until the stock is sold to the final consumer. Businesses would obviously prefer to meet the tax cost after the sale, not before. Any further rises in the rates of duties could impact on the viability of a marginally profitable business, especially for those retail businesses that have longer stock turn around times.

Tourists also bear the impact of import duties as many imported goods are, either directly or indirectly, supplied to them, for example, shopping, restaurant food and beverages, or used up in making supplies to them, for example, car hire, accommodation.

Financial Institution Levy (FIL)

This is a levy of 1 per cent on the value of receipts into accounts held with financial institutions located on Norfolk Island. The rate has been progressively increased over the past few years (originally 0.15 per cent). While the rate has increased, revenue from the levy has been declining. Apparently, it is easily avoided, as residents move their funds to offshore bank accounts, for example, mainland Australia. The removal of banking business to avoid FIL has also had a detrimental effect on the local bank branches and services have reportedly been downgraded.

Again this charge lacks progressivity as it is charged at a flat percentage rate and it appears higher wealth individuals have been avoiding the charge by moving their funds offshore. Lower income individuals and businesses that cannot avoid using accounts to bank cash takings and cheques are likely to be bearing the burden of this charge. There would be some merit in abolishing this disincentive to bank on-shore and replacing the charge with another form of tax that is more difficult to avoid.

Departure fee and landing fees

Each person leaving Norfolk Island through the airport is required to pay a departure fee of $30. In the main, this is an impost on tourists as proportionately a smaller number of local residents travel offshore.

Landing charges are payable by the airline companies that use the Norfolk Island Airport. The charges per landing are very high in comparison to larger airports.[15] Consequently, this would make the cost of travelling to Norfolk Island more expensive than some other destinations. This will be an issue for an economy that relies primarily on tourism income.

Accommodation Levy

This is effectively a bed tax payable by accommodation businesses. The bed tax is $1 per cold bed (that is, occupied or not) per night and the rate has not been adjusted recently. The cost of this is passed on to consumers being tourists and other visitors to Norfolk Island.

Tourists, essentially, therefore bear the final burden of the accommodation levy, departure fees and airport landing fees.

Health Care Levy

There is a flat rate health levy of $250 every six months for each adult resident, including temporary residents (but not tourists) — there is a low income exemption. The levy essentially provides catastrophe insurance as each family is required to pay the first $2,500 of their health care costs per annum. After that, the scheme covers approved costs only.

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15 Access Economics reported in 1997 that charges for Norfolk Island were $4000 per aircraft rotation compared to $1200 for Brisbane and $1500 for Sydney, see pp 11-12.

This levy is highly regressive in that all residents pay the same amount irrespective of income. Thus, low income individuals pay a significantly higher proportion of their income in taxes. This contrasts with the application of the Medicare Levy in mainland Australia which is 1.5 per cent of taxable income if your income is above the threshold which is calculated depending on individual circumstances. Thus, for example, the threshold for a single person is currently $15,062 and $30,085 for a family with two children. Medicare provides free or subsidised medical treatment and free access to public hospital services, including emergency services.

Fuel Levy

We understand the fuel levy was introduced to meet expenditure on specific road projects but has been increased and retained after the project was completed. As fuel is also subject to the general rate of customs duty, it would be more efficient to increase the duty rate and remove the separate fuel levy. However, this would impose an additional cost burden on importers who pay the duty up-front compared to the levy which is raised at the retail stage. This may not be a serious problem as fuel stocks are likely to turn over quickly compared to many other products.

The fuel levy is borne by both residents and tourists (through the costs of tour operators and hire cars).

DESIGNING A TAX SYSTEM

TAXATION PRINCIPLES

The main objective of a taxation system is to raise revenue to support the objectives of the community — including the financing of public infrastructure, services and a social welfare system.

A good taxation system is one that supports a broader objective of positive economic performance and well being. The following three principles provide high level guidance for the design of a good taxation system:

- Optimising efficiency;
- Ensuring equity; and
- Simplicity.

Optimising efficiency

In raising revenue, the taxation system should cause minimum economic distortions. This will enable resources to be used so as to optimise long term economic growth.

In particular, an efficient taxation system will not influence business decisions unnecessarily. It should treat investments neutrally irrespective of the type of business or how it is undertaken.

Ensuring equity

The idea of an equitable tax system is one that ensures fairness to taxpayers. There are two measures of equity:

- Horizontal Equity — individuals in similar circumstances are taxed in similar ways; and
- Vertical Equity — tax burdens should depend upon ability to pay with individuals that are more able to pay bearing a larger relative proportion of the tax burden.

The principle of equity can also be achieved through measures operating in other parts of the welfare system. For example, welfare payments to lower income earners to compensate for flat rates of personal taxation can achieve overall fairness.

Concerns about the fairness of transitional and administrative arrangements must also be considered in designing a new tax system.

Simplicity

The objective of the principle of simplicity is to collect taxes without imposing unduly high administrative burdens on the community. The objective of simplicity can be achieved through both:

- the operation of tax which is clear, certain and consistent in its application — thus minimising the cost of interpretation and disputes; and
- an administrative system that is not unduly onerous for taxpayers or authorities — and thus promotes high levels of voluntary compliance.

Relationship between the principles

In evaluating the design of a tax system, it needs to be recognised that the three principles might not be fully achieved at the same time. Rather, judgements need to be made about how to achieve the most desirable balance between these individual objectives.

Nonetheless, having regard to the small scale of the potential tax base, it could be undesirable to implement a complex tax regime, even if this produced significant efficiency and/or equity gains.

Applying good taxation principles to Norfolk Island's system

In rethinking its taxation system, Norfolk Island should take into account the principles of efficiency, equity and simplicity and apply them in a way that is meaningful given their specific circumstances, and the desired outcomes for the wellbeing of their economy and residents.

This Options Paper recommends that the following five broad objectives serve to provide guidance:

- Reduce, or at least not increase, the taxation burden placed on tourists, given the significant economic dependence on tourism;
  - This is particularly so given most tourists attracted to Norfolk Island seem to be price sensitive;
  - Generally, this would suggest reducing indirect taxes and charges and increasing direct taxes.
- Reduce the taxation burden and charges falling on the less well-off residents and increase the revenue contribution made by well-off residents;
  - This introduces the principle of equity and applies to all taxes and charges borne by residents.
- Reduce monopoly rents extracted from government enterprises;

  - These should be set at competitive levels which provide the capacity for future capital expenditure.

- Broaden the taxation base to increase the capacity to collect revenue;
  - This will also reduce the ability to avoid taxation particularly by the well-off changing the way they undertake their activities, including by moving transactions offshore.
  - Norfolk Island's revenue needs are estimated to be an additional $2 to $6 million per annum, but new taxes should target a larger revenue raising capacity to enable inefficient and inequitable taxes to be removed.

- Ensure that the tax regime is one that Norfolk Island can administer;
  - Norfolk Island has a small administration and would only have the capacity to collect taxes under a relatively simple tax system;
  - Similarly, residents and/or businesses paying the taxes are likely to have simple accounting systems and it will be important to ensure that the system does not unnecessarily add complexity and cost to business operations.

OPTIONS FOR TAX REFORM

The following options are presented for consideration:

- Option 1 — Adopt Australian Tax System;
- Option 2 — Modify Existing Taxes;
- Option 3 — Introduce a Consumption Tax;
- Option 4 — Introduce Land Rates or Taxes;
- Option 5 — Introduce a Norfolk Island specific income tax regime; and
- Option 6 — Introduce a Payroll Tax.

For each option, the paper considers:

- mechanisms for collecting each form of tax;
- winners and losers;
- impact on tourism and the economy;
- revenue impacts at a high level (specific revenue modelling would require more detailed information and some key design decisions to be made, for example, rates of taxes); and
- implementation issues.

OPTION 1: ADOPT AUSTRALIAN TAX SYSTEM

Description

Australia imposes a comprehensive taxation system that applies to the income of individuals and companies, as well as to their final consumption. Linked with the taxation system are compulsory superannuation arrangements and the Medicare levy. Australia does not directly tax the wealth base of individuals. Inclusion in the Australian tax system would, importantly, be a key to providing access for Norfolk Island residents to the welfare system and an ability to derive benefits from the expenditure side of the Australian Budget.

If Norfolk Island chose to enter the Australian tax system, its residents — both individuals and companies — would be subject to Australian taxes and administered by the Australian Taxation Office. This would require Norfolk Island residents to comply with similar tax requirements as taxpayers in the rest of Australia. If this option is adopted, decisions would be required on how to integrate Australian taxes with the existing Norfolk Island tax regime. To avoid double taxation, it is likely that most of the existing Norfolk Island taxes would be removed, though some minor charges applied by Norfolk Island, that is, those akin to local government charges, might be retained. Transitional arrangements would need to be established in moving from the Norfolk Island tax system to the Australian tax system.

There is also a question about whether all Australian taxes should apply to Norfolk Island. A relevant comparison can be made with the Indian Ocean Territories — Christmas Island and Cocos (Keeling) Islands — both external territories of Australia — which are subject to Australian taxes, but are not presently subject to GST, excise duties and customs duties. The policy rationale for providing these indirect tax exemptions has been stated to be partly as compensation for the higher cost of freight and travel; to assist the growth of the tourism industry; and for administrative convenience.[16] For the purposes of this option, it is assumed that the present policy of exempting these indirect taxes would be extended to Norfolk Island.

There is a separate question about the extent of State-type taxes and charges including user charges that would be levied.

Participation in the Australian tax system cannot be considered in isolation. The taxation burden that would be borne by Norfolk Island residents needs to be assessed against the benefits they could obtain from having access to the outlays side of the Australian budget, including the provision of Commonwealth and State-type government services, local government services and entitlements under the welfare system.

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16 Chapter 10, *Report on the Indian Ocean Territories*, Commonwealth Grants Commission Report, 1999. In 1978, the Government's policy on Norfolk Island was to provide an exemption for wholesale sales tax because of concerns of the likely effect on the tourist industry — Ministerial Statement by the Minister for Home Affairs, the Hon R J Ellicott QC MP, 11 May 1978.

What would Inclusion of Norfolk Island in Australia's tax system mean?

Norfolk Island would need to negotiate with the Commonwealth of Australia on its rights and obligations in moving into the Australian tax system. Of particular interest to Norfolk Island would be the benefits that it could derive from the expenditure side of the Commonwealth's budget.

It would also be expected that significant change would be required to the existing Norfolk Island tax base to avoid duplication and provide efficiencies in collection and administration. A decision on this would also be required.

A decision by Norfolk Island would need to balance the possible costs and benefits that participation in the Australian tax system could bring.

On the cost side for Norfolk Island would be:

- the direct cost of residents and companies contributing income taxes under the Australian system;
- the transitional cost of having the new taxpayers understand how the Australian tax system applies to them and move away from the existing tax base; and
- the ongoing compliance costs of fulfilling their obligations under the Australian tax system.

On the benefits side could be:

- direct outlays to fund Commonwealth and State-type services, and local government services, on Norfolk Island;
  - this would fund a range of services including school education, vocational education, health, public safety, welfare services, environment protection, utilities supply, public transport, roads and tourism.
  - it could be expected to include the provision of public health services on the same basis as those provided on the mainland, thereby enabling the removal of the flat rate health levy. For example, the Commonwealth operates the Indian Ocean Territories Health Service which provides hospital, clinic and community based health and dental services, to both the Cocos (Keeling) Islands and Christmas Island.
- access to a range of services funded directly by the Commonwealth;
  - Commonwealth services include air and shipping services, postal services, telecommunications, broadcasting, immigration, customs, quarantine, fisheries management and meteorology. It is noted that the Commonwealth currently funds and provides some services on Norfolk Island (these include management of the National Park and Botanic Gardens, fisheries surveillance, Coastwatch, a major funding contribution to the conservation works in the Kingston and Arthur's Vale Historic

Area, a percentage of the costs of police services, justice and legal aid, Crown land administration etc).

- entitlements under the Australian social welfare system, including Aged Pension, Disability Support Pension, Youth Allowance, Newstart Allowance, Family Allowance, Family Tax Payment, Parenting Payment and Childcare Assistance.

Comparison with Christmas Island

A useful benchmark for Norfolk Island is to look at the fiscal position of Christmas Island, which is subject to Australian income taxes (but is exempt from Commonwealth indirect taxes) and receives funding and services from the Australian budget. (Similar arrangements apply to Cocos (Keeling) Islands, which have a smaller population base than Christmas Island.)

Christmas Island is a remote Australian Territory — located in the Indian Ocean — and has a similar size population to Norfolk Island and some dependence on tourism.

In the 1980s, Christmas Island moved towards a policy of normalisation, that is, a policy for conditions and services to be similar to those on the mainland, and for Island residents to be no better or worse off than residents in comparable remote communities on the mainland. Most, but not all, Commonwealth legislation extends to the Territories and relevant Commonwealth agencies have a direct responsibility for service provision in the Territories, for example, services provided by Centrelink and Customs. The Commonwealth is responsible for the delivery of Commonwealth and State-type services to the residents and for the payment of local government grants to the Shires. It also collects all taxes and charges on the Territories, except those raised by the Shires.

In 1999, the Commonwealth Grants Commission prepared a '*Report on Indian Ocean Territories*' that reviewed the conditions and standards of Christmas Island and Cocos (Keeling) Island with those in comparable communities in the rest of Australia. Overall, the report concluded that: Commonwealth services were of a similar standard to comparable mainland communities; the funding for local government services was consistent to that of comparable communities; but some improvements could be made in delivering State-level services.

The Government objectives for the delivery of 'State Government' equivalent services have been, for a number of years, to:

- align conditions and standards in the Indian Ocean Territories with those of comparable communities in the rest of Australia;

- provide the residents of the Territories, over time, with rights, opportunities and responsibilities equal to those of their fellow Australians; and

- enhance economic development, protect the natural and cultural heritage and deliver government services efficiently, effectively and equitably.

In August 2000, the Government determined that its preferred course for the Indian Ocean Territories is their incorporation into an existing state or self-governing territory, with Western Australia being the preferred option.

The revenue and service arrangements for Christmas Island are broadly as follows:

- Revenue — Individuals and businesses on Christmas Island pay Commonwealth income tax, company tax, fringe benefits tax, capital gains tax and the Medicare levy. It is Commonwealth policy not to apply GST, excise duty and customs duty. The Commonwealth also collects a range of State-type taxes and user charges,[17] applying the rates and provisions that apply in Western Australia. Commonwealth taxes apply at uniform mainland rates with the same rebates and concessions that apply to taxpayers in other remote areas of Australia, such as the zone tax offset ('Special area', zone A).[18]
  - All Commonwealth taxes and charges, and some State-type taxes, are credited to the Commonwealth's consolidated fund.
  - Revenues in the nature of user charges are credited to fund services on the Territories — (Section 31 revenues). These include sewerage charges, water connection fees, electricity charges, housing rents (for government housing), marine charges and airport charges. Charges for utilities are based on Western Australian charging regimes for remote communities.
  - The Shires also apply user charges, particularly general rates and garbage collection fees.
- Funding Arrangements — All Commonwealth and State-type government expenditure is funded by the Commonwealth. The Commonwealth also funds local government activities by providing separate grants. The level of Commonwealth expenditure each year is decided through the Commonwealth Budget process.
  - The Shires are funded largely by general revenue grants and road grants from the Commonwealth and the taxes and charges the Shires impose.
  - The appropriate level of grants to the Shires is assessed by the Western Australian (WA) Local Government Grants Commission using the same principles to assess general purpose and road grants for WA local government authorities.
  - The total direct outlays allocated to Christmas Island in the Commonwealth Budget for 2002-03 was approximately $49 million, including for local government services.

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17 The State-type taxes include payroll tax, stamp duties, vehicle registration fees and charges, land tax, and debits tax — charges apply to tobacco and alcohol but petroleum is exempt. Other charges include liquor licence permits, boat registrations and firearm licences.

18 Residents of 'special areas' within the zones are entitled to a tax offset of $1,173 plus an additional amount if the taxpayer maintains various dependants.

- Service Provision — Some Commonwealth services are provided directly by the relevant Commonwealth agency, for example, Centrelink; Customs.
  - Alternatively, the Commonwealth outsources the delivery of government services, including with the Western Australian Government, for the provision of many State-type services; with other Commonwealth agencies for the provision of some services; with the Shires (for example, for road maintenance), or to the private sector (for example, capital works).
  - The Shire of Christmas Island provides a wide range of local government services to the community.
- Ownership and management of assets — the Commonwealth owns most of the public infrastructure, and is responsible for maintenance and capital renewal funding.

How could Norfolk Island be included in the future?

Norfolk Island could be included in the Australian tax system if it expressed its desire to be included and if the Commonwealth of Australia agreed.

The mechanism for making this change would be to amend a range of Australian tax laws which presently exclude Norfolk Island from the tax base. Norfolk Island residents could be made subject to Australian tax laws by removing the present exemptions from relevant Australian tax laws. If the present policy of exempting Indian Ocean Territories from Australian indirect taxes is to be applied to Norfolk Island, the relevant legislation for those taxes would retain their existing exclusions for Norfolk Island. A range of consequential amendments would also need to be considered. The legislative amendments would need the passage of both Houses of the Australian Parliament and to receive Royal Assent. If the Australian tax system were applied, legislative amendments would be needed to remove the Norfolk Island taxes that would be replaced by Commonwealth taxes.

The extension of the Australian services to Norfolk Island might also require legislative amendment, on the same basis as tax legislative amendments. Further, it would require the arrangement of appropriate administrative arrangements — possibly via outsourcing contracts.

Winners and losers from adopting the option

As discussed above, the actual fiscal framework would depend on negotiations between the Commonwealth of Australia and Norfolk Island. However, the following assumptions can be made about the likely winners and losers from the adoption of the Australian tax system (particularly if the current Norfolk Island arrangements are disbanded):

- Improved Efficiency — the Norfolk Island economy would benefit by replacing an inefficient set of taxes with a growing, more efficient source of revenue derived from an income base. This would mean businesses would be neutral between locating in mainland Australia or Norfolk Island, about where to undertake their transactions and what investments to make. For instance the removal of the financial institutions levy would not influence the transfer of financial transactions.

  – The improvements to the efficiency of the tax base could be increased if income tax revenue was used to partially replace the more inefficient indirect taxes levied by Norfolk Island.

  – There are administrative efficiencies of collecting revenue as part of an established tax system with a large base compared to administering a separate tax system with a small base.

- Improved Equity — the introduction of a progressive income tax system will improve equity. This is because the present tax system relies largely on indirect taxes that apply irrespective of the capacity of individuals to pay. In particular, only 4 per cent of the present Norfolk Island revenue comes from direct taxes compared to 54 per cent in mainland Australia.[19]

  – This will mean that individuals earning less than the threshold ($6000 in 2003-04) will not pay income tax and those that earn above the threshold will pay income tax on the basis of a progressive rate structure.[20] Individuals receiving the average annual salary of $27,000[21] would pay a maximum income tax of $3,504 (after entitlement to the zone tax offset is taken into account).

  – This progressive income tax structure would replace some or all of the flat taxes applied to individuals (for example, healthcare levy) and might result in reduced utility prices if a revenue trade-off allows a reduction on the premium rents charged to utility providers.

- Significant benefits would be obtained from accessing services funded by the Australian budget, including the health and education systems, and deriving rights under the Australian welfare system, for example, to age pensions.

  – This would also contribute significantly to providing an equitable outcome for the residents of Norfolk Island.

  – The benefits could be expected to extend to the Commonwealth assuming funding responsibility for maintaining and upgrading vital infrastructure on Norfolk Island — which generally has been underfunded and required special funding, such as through loans from the Commonwealth.

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19 Chapter 7, Commonwealth Grants Commission Report, 1997.

20 The medicare levy threshold is $15,062 (from 2002-03) for a single person, but different thresholds apply for couples, couples with children and senior Australians.

21 Based on Average Annual Salary in the 'Exploratory Calculation on Potential Income from a GST', Minister for Finance, Norfolk Island, 8 Aug 2003. From these figures around 6 per cent of the population aged > 15 years, would have income below the threshold. The tax calculation is based on tax rates for 2003-04 and assumes no deductions, and entitlement to Special Zone A rebate.

- Simplicity — replacing a number of specific indirect taxes with an income tax would improve the simplicity of the overall tax system.
  - However, Norfolk Island taxpayers entering the tax system might find the detail of the arrangements to be complex, especially upon transition, but they are likely to become used to dealing with the parts of the system that commonly apply to them. Some of the detail of specific parts of the tax legislation, such as the superannuation system or capital gains tax, can be complex.
  - Employers would face additional compliance costs — through compulsory superannuation contributions for employees (9 per cent of basic wages/salaries) and through implementation of systems to collect and remit withholding taxes for income taxes payable by employees. If a Commonwealth payroll tax were levied, as a substitute for a State tax, further compliance burdens would eventuate.

Impact on tourism and Norfolk Island economy

A switch to the Australian tax system should lighten the tax burden on Norfolk Island tourists, assuming the majority of existing indirect taxes levied by Norfolk Island are removed. Under current arrangements around 40 per cent of the total revenue is collected from tourists even though the tourist population comprises an average of 26 per cent of the people on the Island.[22]

If Commonwealth indirect taxes (GST, customs and excise) are not applied, and if Norfolk Island lessens its indirect taxes, tourists could face lower indirect taxes on Norfolk Island than under a competing Australian or New Zealand holiday destination. If the Commonwealth were to agree to exempt Norfolk Island from indirect taxes so as to help encourage tourism, consistent policy measures should be taken on Norfolk Island charges, particularly by:

- Removing the accommodation levy and the departure tax;
- Reducing the landing charges and international telephone call rates to more internationally competitive levels.

However, tourists will continue to make their travel choices on a range of factors, including price. The fall in tourism export earnings in the period to 1997[23] suggests the price sensitivity of tourists travelling to Norfolk Island and the increased competition Norfolk Island faces from other holiday destinations — especially lower cost destinations. Any tax system that shifts the tax burden away from tourists is likely to be beneficial in encouraging increased spending by tourists and thus increase tourism export earnings.

The current removal of money out of Norfolk Island might be curtailed if the Financial Institutions Levy were removed.

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22 Chapter 7, Commonwealth Grants Commission Report, 1997
23 Fall in real terms by 2.2 per cent pa over the 5 years to 1997, Access Economics Report

Some high income earners who have taken residence in Norfolk Island to take advantage of the current exemptions from income tax may relocate. High wealth individuals may provide significant economic benefits to the Island, for example, employment. (However, we do not have any information on the extent of this).

Revenue Impact

The overall revenue impact would result from a combination of:

- the grants received from the Commonwealth to fund government services — at each level of government;
- the reduction in Norfolk Island revenue from the reduction in taxes and charges; and
- the transfer of financial responsibility to the Commonwealth to meet ongoing and capital costs for infrastructure.

Implementation Issues

If Norfolk Island sought to progress this option, there are a number of implementation issues that would need to be resolved including the following:

- An agreement between Norfolk Island and the Commonwealth on revenue sharing and the timing of the transfer to the Commonwealth's system;
- Amendments to the relevant Commonwealth tax and other legislation to remove the exclusions and exemptions that are presently available for the Norfolk Island (other than for GST, excise and customs duties), and to extend coverage to Norfolk Island;
  - Sufficient lead time would be required ahead of the proposed commencement date to enable drafting of the amendments, passage in Parliament and Royal Assent.
- Amendments to the Norfolk Island Act and Norfolk Island legislation to revoke revenue raising powers that would conflict with the role of the Australian Government and to remove existing taxes that are to be replaced by Australian taxes;
  - The timing would need to be coordinated with the start date of the amendments to the Australian tax legislation.
- Compliance training to advise Norfolk Island residents of their rights and obligations under the Australian tax system;
  - Information about the new tax system could be provided by the Australian Tax Office (ATO) in advance of the introduction of the new system; and
  - The Norfolk Island Government would need to be involved in advising on the arrangements to phase out existing taxes.

- The Commonwealth would also need to make arrangements for service delivery of other Commonwealth Services and outsourcing contracts to deliver other government services.

- The Norfolk Island administration would also need to adjust to the new arrangements, including through receipt of local government funding and service delivery, and possible delivery of other government services on a contract basis.

It would be reasonable to require a lead time of a few years from the time a decision was made to have the new system up and running. The transfer to the Commonwealth systems for the Indian Ocean Territories was phased in over four years.

As the Australian tax system is administered by the ATO, its extension to Norfolk Island residents would also be administered by the ATO. Compliance costs would also be borne by taxpayers, including the initial education process and ongoing compliance, for example, where taxpayers use accountants to compile tax returns.

Option 2: Modify existing taxes

Description

Norfolk Island's existing revenue is predominantly derived from a taxation system that targets transactions rather than profits or income. In particular, customs duties make up around one-third of revenue collections, with most goods imported to Norfolk Island attracting the duty. The general rate of duty, applied to most goods, is 10 per cent with rate variations for general food products at 6 per cent; motor vehicles and motor cycles at 15 per cent; beer at 20 per cent; wine at 25 per cent; spirits at 30 per cent; and tobacco products at 500 per cent.[24]

A simple revenue raising option would be to increase the customs duty rate. Such an increase has the advantage of using the revenue collection regime that is already in place, not placing an additional administrative burden on taxpayers, and it could be introduced quickly.

For example, the general rate of duty (not including food) could be increased from 10 per cent to 15 per cent. This rate increase is estimated to provide an increase in revenue of around $1.23 million per annum.[25]

There are other options that could also be considered including extending the rate changes to other taxes and charges including the departure tax, accommodation levy, fuel levy and vehicle registration and licences.

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24 The duty rates for alcohol and tobacco have recently been increased from 18.5 per cent and 250 per cent respectively.

25 Estimate is based on data of duty collected at year ended 30 June 2002.

In addition, extensions to the tax base could be considered, including the introduction of a Services Tax, an Income Tax and a Payroll Tax — which are dealt with as separate options.

Winners and losers

The main advantage of the option to increase duty rates is that it would be simple to implement and administer.

However, this option enhances the negative aspects of the present tax arrangements, in particular:

- Inefficiency — the option retains the inefficiencies of a narrow tax base and imposes higher capital costs on importers who would need to finance a larger tax component on tax-paid stock; and
- Inequity — low and middle income earners would pay a larger share of their income on tax paid goods.

Impact on tourism and Norfolk Island economy

This option could be expected to impact negatively on tourists as goods consumed on Norfolk Island would become more expensive. Price rises would also be expected by service providers if they are able to pass on the tax increases to consumers, including tourists. It could result in changed behaviour by tourists — including reduced spending. This would have a broader adverse impact on the economy.

The Norfolk Island Government could consider introducing measures that lessen the impact of further tax increases on tourists. For example, many countries have tourist refund arrangements whereby taxes can be reclaimed by tourists on significant purchases.[26]

Any duty increase could, however, result in a reduction in consumption of some goods, especially luxury goods. This could adversely affect businesses selling those goods and might lead to revenue targets not being met.

Revenue impact

The revenue would increase through a general rate increase, but there may be some change in consumption behaviour, by both residents and tourists, that might lead to revenue being lower than expected. This would be so where the tax increase is dramatic and the duty is on goods which are not necessities.

26 In Australia, tourists can claim refunds of GST for goods if the purchase is over $300 in one transaction.

Implementation

As discussed above, implementation and administration of this option are relatively straightforward, but would require some changes to Norfolk Island legislation. To minimise the opportunity for tax planning (for example, importers of tobacco pre-purchasing ahead of the tax rise coming into effect) the measure should become effective from the time of announcement.

OPTION 3: INTRODUCE A CONSUMPTION TAX

Description

Norfolk Island currently applies customs duties on import prices which are passed through the selling chain to the final consumer. This means that the tax impost is built into the cost base for importers/wholesalers and retailers and is only recouped at the end sale. It also means that the tax base applies to the lower-value import price and does not capture any mark-ups applied by upstream wholesalers or retailers.

There are alternative forms of consumption taxes that would provide greater revenue raising capacity because a broader tax base is applied or because a larger portion of the price mark-up can be captured. These are various types of consumption tax including:

- A **Wholesale Sales Tax** (WST) applying to goods at the final wholesale stage. The WST does not apply to services which are generally part of a retail transaction. Therefore, the WST has a narrower base than a goods and services tax (GST) and a higher rate of tax is required to collect the same level of revenue than if tax was collected on a broader base. Theoretically, a larger number of businesses would be involved in collecting taxes, than under a Customs duty system, where only importers are involved. However, on Norfolk Island, where there is little manufacturing undertaken, importers are essentially the only wholesalers.

- **Value Added Tax** (VAT) a multi-staged sales tax generally applied to goods and services. This is a more comprehensive tax base than any tax at an earlier stage in the production or supply chain, for example, customs duty or WST. Tax is levied on the amount of value added (profit margin) at each stage in the production and distribution chain of supply. A crediting system is used to allow businesses to claim refunds (input tax credits) for GST paid on their business inputs (purchases) to ensure that the final retail price effectively bears a single layer of tax. The VAT requires all businesses to be registered and to lodge periodic returns that net out their tax obligations and credit entitlements. Businesses will bear the cost of the tax until either they sell the goods or receive a refund for input tax credits. VAT is more costly to administer than a single stage consumption tax, particularly because of the Input Tax Credit arrangements. The Australian and NZ GSTs are both VAT type taxes.

- A **Retail Sales Tax** (RST) is levied on the retail value of goods and services at the point of sale to the final consumer. The impost of the tax is borne by the consumer and there would be no capital cost to the seller, as tax is not collected until the stock is sold. The retail sales tax is a single-stage consumption tax and is thus simpler to administer than a multi-stage consumption tax, such as the GST. For example, it would overcome the need for the input tax credit mechanism that applies in the GST system. Provided the same rate and base of tax are applied, the revenue collected from applying a GST or a RST is the same. It involves a smaller number of businesses to be registered than a GST but a larger number than a WST or customs duty.

- A specific **Services Tax** could be developed to bring services into the taxation net. This could operate alongside the existing customs duties system. One model that could be considered is that used in East Timor[27] where a 10 per cent services tax applies to hotels, restaurants, telecommunications and the rental of motor vehicles, aircraft and boats. Such a narrow scope would clearly impact disproportionately on the tourist industry. A broad scope would apply the tax to all services provided on Norfolk Island.

Implementation Issues

There are four key decisions that need to be taken in designing a consumption tax system:

1. What is the scope of the tax? Will it be broad or narrow? Does it apply to goods and services? What exemptions should there be?

Generally, the broader the scope the more economically efficient and more equitable the tax will be. A broad scope will better provide for growth over time and spread compliance risk. Exemptions are often used for policy purposes – in Australia, for example, basic food, healthcare services and education are generally exempted from GST. It should be noted however that exemptions inevitably lead to complexity and increased compliance costs for both businesses and tax administrations.

Put simply, the broader the scope of the tax, the more revenue would be raised with a given tax rate or alternatively the lower the rate will need to be to meet a given revenue target.

2. What is the appropriate collection mechanism?

The collection system chosen should be based upon the good taxation principles as set out earlier in this document. In particular, it is important to contain costs for business and to establish a system within the administrative capacity of the revenue authority.

3. What other taxes should be retained or abolished?

Any broad based tax on goods should replace the existing customs duties with the probable exception of duties on goods such as tobacco and alcohol which could be retained for health policy reasons. Other specific duties could be retained, for example on motor vehicles, for other policy reasons.

27 See United Nations Transitional Administration in East Timor Regulation 2000/18, available at http://www.gov.east-timor.org/old/fbea/2000.18.pdf

Under a broad based tax including services, accommodation services would be taxed. Therefore, the separate Accommodation Levy could be removed. Specific user charges and the fuel levy could also be removed to streamline the tax system and to avoid multiple taxes falling on the same goods or services. Consideration could also be given to removing the more inefficient taxes such as the Financial Institutions Levy and reducing the Departure and Arrival taxes.

4. What is the rate?

The rate of the tax should be based upon revenue requirements and the agreed scope and take into account the revenue impact of any changes to other taxes and charges.

Discussion

An RST may be the preferred form of consumption tax for a small economy such as Norfolk Island. An RST can provide the revenue raising capacity of a comprehensive tax base but involves simpler administrative requirements than a GST.

All retailers would need to be registered under a RST as part of the compliance and administrative procedures. Approximately 349 retailers would need to be registered in Norfolk Island at the commencement of the new tax system, with any new businesses registering at the time they commence and deregistered if they cease to trade. To ensure consistency in the treatment of the sale of goods for final consumption it would also require importers who sell directly for final consumption, rather than to other wholesalers or retailers, to pay tax on those transactions. Sellers would need to be educated to charge tax on all final consumption transactions, some of which will be self-evident when purchased by another business.

There may be transitional issues arising from customs duty already paid on stock on hand. This could be dealt with through a phase in process or a system of refunds for stock.

Policy decisions are also required on the breadth of the tax base. For the sake of simplicity, it is proposed that all goods and services be included as far as possible in the tax base and at a uniform tax rate. There are a few services that are difficult to tax in a consumption tax model, especially financial services, so exceptions might be made on administrative grounds.

To reduce the inequity of further indirect taxation, low-income earners could be compensated through welfare payments.

Winners and losers

Applying an RST would have the following broad outcomes, particularly if its introduction enabled the removal of a range of the inefficient indirect taxes presently applying:

- Efficiency — as a broad based indirect tax that applies to all goods and services, the RST is a relatively efficient tax. This is because all supplies are subject to the same form of tax, particularly if it is collected at a uniform rate. However, as noted above, the single-stage collection point does provide some scope for tax minimisation. It is also more efficient to collect the same type of tax on all goods and services than to apply specific taxes, for example, the accommodation levy. The pricing effects on various goods would depend on the relative tax changes that are made and could result in some demand effects.

- Equity — the RST would not improve the overall equity of the tax system as low to middle income residents of Norfolk Island would pay indirect taxes on a broader range of their consumption items. If the revenue raised is significantly more than that raised from the present indirect taxes flowing through to residents, there will be a reduction in the equity of the tax system. However, the equity can be improved if direct compensation is provided to low-income earners for the effects of any major tax increase.

Impact on tourism and the Norfolk Island economy

As tax would apply to all goods and services consumed on Norfolk Island it would still impact on tourists. The impact on tourists relative to that under the present mix of indirect taxes would depend on the rate of RST and the extent of the reduction of taxes that fall most heavily on tourists, such as the departure tax.

Norfolk Island residents will also pay tax on a larger range of goods and services they consume which might adversely affect demand from the less affluent residents.

Revenue Impact

Specific modelling would need to be undertaken to assess the likely revenue consequences, having regard to the removal of some existing taxes that could be undertaken at the same time.

Implementation issues

It would be expected that the current system of customs duty could be extended to bring additional retail businesses within the tax net. Many of the importers are also likely to be retailers and are thus part of the existing tax system, with additional retail businesses having to register. Although an RST would involve more businesses remitting tax, it is likely that its collection and administration could be handled within existing (or perhaps with a modest increase to) Government administration resources.

OPTION 4: INTRODUCE LAND RATES OR TAXES

Description

Land taxes are generally taxes on wealth held in the form of land. Land rates are essentially funding systems for local government types of services. Land rates and taxes are generally assessed on the value of the land holding — either the improved or unimproved value.

These systems can be designed to be a progressive form of tax, in so far as those with more valuable land holdings will pay a higher proportion of the total tax burden.

On mainland Australia taxes and rates are levied by State or Territory Governments and local councils. The main features of their systems are:

- Site value or unimproved value is the standard base for determining charges — however, such a tax could be levied on improved values if desired (this might better reflect capacity to pay);
- Rate scales are generally progressive, meaning that tax rates increase in some proportion to the value of the land (for example, a 1 per cent rate could apply for the first $100,000, then 2 per cent for amounts above);
- States/Territories may levy a land tax in addition to rates for land used for rental properties or for commercial properties. There could be exemptions for land used for charitable, religious and educational purposes;
- Revenue from rates is usually used to fund services provided directly to residents, such as waste management, and other services, such as roads; and
- Land tax is usually more closely related to revenue raising for general purposes.

Norfolk Island could broaden its tax base by imposing rates and/or land taxes similar to those imposed on mainland Australia. A study by the Commonwealth Grants Commission[28] has shown that there is capacity for Norfolk Island to tax wealth. The report showed that in 1995-96, Norfolk Island raised $58,571 from its Absentee Landowners Levy. The same report estimated that if the Norfolk Island Government were to impose a tax of 2 percent on the value of residential land (the same rate as the Absentee Landowners Levy) and a tax of 5 per cent on the value of commercial land, it could increase revenue collection from land to $544,000.

As Norfolk Island does not levy an income tax, the land tax or rates could be an indirect means of taxing wealth. In the absence of other progressive taxes, this could be a desirable objective, the greatest improvements to the equity of the tax system would be made by imposing a progressive rate structure. A system that levied a flat amount per land holding would not be progressive. While a system based on a flat percentage rate would entail some progressivity (in that the more valuable land you hold the more tax you pay), a system with increasing rates would have more impact on vertical equity. This could also be designed to exclude very small land holdings to reduce administrative costs and improve equity or compensation could be provided to low income earners.

28 Chapter 7, Commonwealth Grants Commission Report 1997.

Winners and losers

All landholders will bear this additional tax impost with the possibility of relief being extended to low income earners, or to some types of land use, for example, charities. However, there are benefits for the economy and community.

- Efficiency — it is an efficient tax as it applies to all land which is an immobile asset. The revenue that it can collect is far more than that under many of Norfolk Island's current indirect taxes. This would provide the Norfolk Island Government the capacity to abolish some of these inefficient taxes in order to boost its tourism industry and hence, the economy in general.

- Equity — individuals with larger and more valuable land holdings will bear a higher proportion of the tax, especially if a progressive rate structure were imposed. If other indirect taxes were reduced, there would be an overall improvement in the equity of the tax system.

- Simplicity — the tax is not very complex even if a progressive rate scale is used. It would require land valuations to be undertaken periodically so that the revenue base is maintained, rather than eroded with inflation. The overall tax system could also be made simpler if other inefficient taxes were replaced with the land tax.

Land taxation would provide the Norfolk Island economy with a stable and potential growing source of revenue, particularly if rates were adjusted regularly based on some uplift factor. Because land is immobile it would be difficult for a land tax to be avoided. Also, it has been shown from experience in mainland Australia that land taxation does have long term ability to raise revenue. The tax has had least impact on the level of economic output.

Impact on tourism and Norfolk Island economy

If land rates/taxes were applied, it is expected that:

- non-commercial resident land owners will be making an additional contribution to Norfolk Island revenue requirements;

- business costs could increase and this may be reflected in higher prices that consumers will pay for goods and services — ultimately some costs are going to be passed onto tourists. This cannot be avoided, as tourists will bear some proportion of any additional revenue impost on Norfolk Island as they purchase goods and services on the Island.

Revenue impact

Based on the study by the Commonwealth Grants Commission, land tax could be used to collect at least half a million dollars revenue per year for the Norfolk Island. The revenue base would expand with increasing valuations of land over time. However, more information is required from Norfolk Island to properly assess the extent to which land could be taxed and the actual revenue implications.

Implementation issues

Land tax systems can be relatively simple to administer, especially on Norfolk Island where there are only 2,200 portions of land to rate. A computerised system that provides automatic assessment of a landholder's liability would be relatively simple to establish. The tax would also be simple to collect — a quarterly or annual bill could be sent to each landholder.

Another factor to consider is the need to value land holdings — either improved or unimproved. Currently, it is understood Norfolk Island uses valuers from mainland Australia to value landholdings for the purpose of determining the absentee land holders levy. Having to initially value all land holdings will mean the Norfolk Island Government incurs some additional costs. Further, properties may need to revalue only every five years to keep the revenue base up to date.

The Norfolk Island Government could provide some relief to lower income earners through the welfare system — to counter the argument that they will suffer income reduction.

OPTION 5: INTRODUCE A NORFOLK ISLAND SPECIFIC INCOME TAX REGIME

Description

The present Norfolk Island tax system applies no direct taxes to the income of resident individuals or companies. The Australian tax system generally does not apply to the income of Norfolk Island residents.

Applying tax to the income of resident companies and individuals would provide a broader base of taxation than the heavy reliance on indirect taxes on a narrow range of goods and services. It would also provide a basis of taxation that generally reflects the capacity to pay.

There are a range of design issues that would need to be determined, particularly relating to the appropriate measure of income to be included in the tax base. The most comprehensive taxation base would include both:

- ordinary income, for example, a return to labour or capital that is normally earned and received periodically;[29] and
- statutory income, which is explicitly included in the tax base because it is not ordinarily regarded to be income, for example, capital gains.

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29 Common items of ordinary income are: (a) salary, wages, bonuses, commissions, gratuities, allowances and benefits derived in the capacity of employee; (b) earnings, commissions, fees, allowances and gratuities received for services rendered; (c) pensions, superannuation allowances, retiring allowances and retiring gratuities; (d) business proceeds, bounties or subsidies received in carrying on a business; (e) profit from the sale of property acquired for trading; and (f) interest, rent, dividends and royalties. The types of payments that are not generally regarded as ordinary income, and are thus not subject to taxation, include payments to oneself (for example, subscriptions from club members), an intangible benefit, a gift, a windfall gain, lottery winnings, and gains from the disposal of property.

Applying tax only to ordinary income can provide scope for tax to be minimised, for example, by deriving more income as capital gains. Specifically, listing particular exclusions or inclusions can limit compliance costs.

In addition, the design of an income tax system would need to consider:

- whether any specific type of income or type of taxpayers are to be made explicitly exempt;
- whether deductions/credits are to be allowed, and if so the types of allowable deductions/credits; and
- any concessions that are to be provided and the form of the concession.

In designing an income tax for individuals, there are various design issues relating to rates that need to be considered — particularly, how to protect low income earners and whether a progressive or flat rate structure should apply. For equity reasons it would be preferable to design the income tax with a progressive rate structure with:

- either a tax free threshold or an income tested rebate to protect very low income earners; and
- higher rates cutting in at levels exceeding average income, so that very high income earners contribute more to the economy's revenue.

In its simplest form, an income tax would apply to the ordinary income of all individuals and entities and would allow deductions for expenses incurred in earning income. Complexity is introduced by providing deductions, exemptions and other concessions but a trade off could be made by applying lower rates and denying deductions, exemptions and concessions, for example, for particular types of income or classes of taxpayers.

There are also design issues about the interaction of the corporate and individual income tax system, especially how to treat taxed income that is distributed to individuals by a company. This problem of double taxation can be overcome by introducing imputation arrangements that pass tax credits to individuals that receive taxed corporate income. However, for the sake of simplicity in a small economy, these problems might be best dealt with by having relatively low tax rates.

Decisions would also be required about which indirect taxes to retain or remove, especially as an income tax system might apply taxes to activities that are subject to specific taxes. For example, interest from bank accounts would become taxable even though those savings would presently be subject to the Financial Institutions Levy.

Winners and losers from adopting the option

The extent of the winners and losers depends in part on the mix of taxes that would apply in Norfolk Island in addition to an income tax. A broad assessment of the winners and losers of introducing an income tax is as follows:

- Efficiency — applying taxes to an income tax base will expose the returns from capital and labour to tax on an equal basis. This is a more efficient outcome than applying a narrow indirect tax base to selective goods and services, which distorts the use of resources by encouraging greater use in lighter taxed activities.

- Equity — the introduction of a personal income tax will improve equity as it can be based on the taxpayer's capacity to pay as measured by annual income. The extent of the improved equity will depend on the degree of progressivity of the rates and whether low income earners are exempted, for example, by a zero-rate threshold. Importantly:
  - very high income earners will contribute more towards Norfolk Island revenue than if their contribution is restricted to their consumption base, especially as such residents are able to transfer a proportion of their expenditure offshore, thereby avoiding Norfolk Island taxes, such as customs duty; and
  - the equity benefits to low and middle income earners will be increased if the introduction of an income tax system is matched by a reduction of indirect taxes, which fall more harshly on lower income earners.

- Simplicity — the degree of simplicity depends on the design detail. A simple income tax system could be developed that relied on the ordinary concepts of income and did not seek to deviate from that base by providing exemptions, concessions or including capital gains. Whilst this would be simpler than a comprehensive tax base that dealt with a range of special circumstances, even the concept of 'ordinary income' leaves open some questions at the fringe about whether certain types of income are included or excluded from the base.

Impact on tourism and Norfolk Island economy

Applying an income tax to Norfolk Island residents would shift the tax burden away from tourists to the extent that all or part of the additional revenue is used to reduce the indirect taxes and charges applied to tourists although businesses may seek to pass on the impact of their income taxes to consumers in the form of higher prices. If there is a net price reduction from the tax change, tourists could increase their spending whilst holidaying on Norfolk Island. This would lead to increased income for Norfolk Island residents.

Therefore, a partial shift from indirect taxes to direct taxes would shift the burden away from tourists and could be expected to result in an increased income base for Norfolk Island.

Revenue impact

It would be expected that an income tax that applied to corporate entities and individuals would result in an overall increase in the revenue, particularly if the rates were set at modest levels to avoid driving taxpayers to lower tax jurisdictions.

The specific revenue impact would need to be assessed depending on the new mix of taxes and the rates.

Implementation issues

As no State or Territory of Australia currently imposes its own income tax, the Australian Government would need to consider the broader implications of having Norfolk Island apply its own income tax. In particular, a range of issues could arise around the interaction of the Australian and Norfolk Island income tax systems. Although *Schedule 2* of the *Norfolk Island Act 1979* specifies that consultation is not required on 'the raising of revenues for purposes of matters specified in this Schedule', the Commonwealth is likely to have an interest in the introduction of an income tax as such a measure could be expected to impact on *Schedule 3* and non-schedule matters. This would also recognise that the Norfolk Island Legislative Assembly does not have an unrestricted revenue raising power under the Act (such a power was sought in the past but not granted).

A Norfolk Island income tax system would need to be developed with regard to the design issues referred to above. Decisions would need to be taken about the interaction with other existing taxes, including whether some of those taxes should be removed, for example, the Financial Institutions Levy. Legislation would need to be drafted, introduced and passed in the Norfolk Island Legislative Assembly in respect to the new tax and amendments to existing taxes. Given the significance of the introduction of an income tax to both Norfolk Island and the Commonwealth of Australia, a whole of government approach would be needed before any decision concerning such legislation could be made by the Territories Minister or the Governor-General.

Decisions on how the Norfolk Island income tax system would interact with the Australian tax regime, including how to deal with the potential double taxation of individuals or entities that might be subject to both regimes, would be required.

A decision would also be needed on who would administer the tax system, the training required before the system was introduced and the additional resources that this would involve. Compliance training to advise Norfolk Island residents of their rights and obligations under the income tax system, and other changes to the tax system, would be desirable.

It would be reasonable to require a lead time of about two years from the time a decision was made to have the new system up and running.

OPTION 6: INTRODUCE A PAYROLL TAX

Description

Payroll taxes are levied on the value of wages paid by an employer — the tax base might be comprehensively defined to include employer superannuation contributions, payments made on retirement and fringe benefits. In mainland Australia, State and Territory governments levy payroll taxes at rates varying from 4.75 per cent to 6.85 per cent, but generally the rate applies above an exemption threshold (for example, lowest threshold of $500,000) to enable small businesses to be excluded from the tax system.

The payroll tax is an indirect means of taxing the wage income of employees. However, it places the onus of collection and administration on employers. The incidence of the tax will ultimately fall on employees.

The design of the tax would need to reflect the profile of employers on Norfolk Island.

- If an exemption threshold is set at the level used in Australian States and Territories, the payroll tax would be ineffective for revenue raising as the majority of employers would be excluded. For example, only two employers on Christmas Island paid payroll tax, raising around $1 million per annum, with the remainder falling below the $675,000 threshold — equivalent to about 22 employees at average weekly earnings of $600.[30]

- Further, consideration should be given to exempting government payrolls to avoid the government taxing itself.

Winners and losers from adopting the option

The payroll tax system could be expected to have the following outcomes:

- Increased efficiency — the payroll tax taps into a new source of revenue by indirectly taxing wages. Therefore, the revenue base grows broadly in line with wages. However, it is biased against labour-income compared to other forms of income and therefore is much less efficient than a comprehensive income tax.

- Equity — the payroll tax will not improve equity as the wages of all employees will be subject to the tax irrespective of their individual capacity to pay, and wealthy residents who derive income from sources other than employment will not bear the tax.

- Simplicity — as employers are already subject to the workers compensation levy, it would be relatively simple to extend their tax obligations to include payroll taxes. It is a relatively simple tax to administer.

Impact on tourism and Norfolk Island economy

The tax would be borne directly by residents of Norfolk Island. Also, some part of the final incidence of the tax may be borne specifically by employees, in the form of reduced salary/wages. Tourists may also share some of the cost burden of the new tax through higher prices for goods and services.

Businesses may also employ fewer employees as a result of being less profitability.

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30 '*Report on the Indian Ocean Territories*', Commonwealth Grants Commission, 1999.

Revenue impact

A payroll tax of 4 per cent on the value of wages paid by employers (assuming no exemption thresholds apply) could provide Norfolk Island an estimated increase in revenue of $1.68 million per annum.[31]

Implementation issues

A Norfolk Island payroll tax system would need to be developed with regard to questions about the base, which employers should be included and excluded, whether a threshold should apply, the frequency of collection and the rates of tax. The design issues are more straightforward than the design of an income tax and there is less interaction with the existing taxes, particularly as income is barely taxed at present.

Legislation would need to be drafted, introduced and passed in the Norfolk Island Legislative Assembly in respect to the new tax. A decision would also be needed on who would administer the tax system, the training required before the system was introduced and the additional resources that this would involve.

Compliance training would be advisable for Norfolk Island employers.

It would be reasonable to require a lead time of at least one year from the time a decision was made to have the new system up and running.

31 Estimate based on data available in the Norfolk Island Census of Population and Housing, 7 August 2001.

SUMMARY

- It has not been possible in this report to undertake detailed revenue analysis of the various options. This is due in part to the lack of adequate data on the Norfolk Island economy. In turn this reflects the rudimentary nature of the existing Norfolk Island tax system. Further, analysis would be necessary once decisions about preferred options have been made.

- Given the small population and the significance of the tourism industry to the economic viability of Norfolk Island, the best solution would appear to be for Norfolk Island to come into the taxation and welfare systems of the Commonwealth of Australia. This would provide a more efficient and equitable outcome for residents particularly as it would enable them to access the health and welfare systems of mainland Australia. Whilst this would require a redistribution of some powers between the Norfolk Island Government and the Government of Australia, it could be seen as a modification of self-government that is driven by the need to improve the wellbeing of its residents and which would be more on par with other comparable self-governing territories.

  – Even if Norfolk Island could increase its revenue base, that base will remain constrained by the small population base and price vulnerability of its vital tourism sector. Therefore, it will always be difficult for Norfolk Island to provide services at equivalent standards to those provided by three levels of government in mainland Australia — local, State and Commonwealth.

  – This would require the extension of the taxation system of Australia to Norfolk Island, but this could be applied on a modified basis — perhaps similar to the arrangements that apply to Christmas Island and Cocos (Keeling) Islands. In particular, this might mean that the GST, customs and excise duties are not applied. It is also likely to require transitional arrangements, perhaps to phase-in the new taxes and phase-out Norfolk Island taxes, over a period of time.

  – The benefits received by residents of Norfolk Island and the economy are likely to be much more significant than the contributions that economy would make to Australia revenue. That is, it would be expected that such a shift in the government model, with a transfer of responsibilities for the provision of services to the Commonwealth of Australia, would involve a welfare transfer from other Australians to Norfolk Island.

  – The details would need to be negotiated between the two governments and would be subject to a range of legislative amendments. Therefore, the implementation period would be at least 2 years.

- However, if Norfolk Island prefers to make its own revenue base more robust, either an income tax or a land tax system should be preferred for the following reasons:

  - The imposition of an income tax would represent a much needed improvement in equity, by bringing presently untaxed income into the base and taxing more on the basis of capacity to pay. This would mean that wealthier residents of Norfolk Island make a more significant contribution to the revenue of Norfolk Island than under the existing tax system — which is predominantly based on consumption taxes. If the income tax system was set at progressive rates, and an allowance made for very low income earners, these individuals would not bear much of the impost. If the introduction of an income tax enabled a reduction in the existing indirect taxes, there would be further improvements to equity and the taxes on tourists could be reduced, which would have overall benefits for the economy. The introduction of a relatively simple income tax system, that is progressive in design, is preferred over the introduction of a consumption tax or the modification of customs duty rates.

  - The equity benefits would also be obtained by the introduction of a more comprehensive system of taxing land — either rates or a land tax. This is a less direct means of taxing the wealth base of residents, but has the benefit that the taxed asset cannot be relocated offshore to avoid tax. The land tax system can also be designed on a progressive basis, for example, with increasing rates, possibly on a zero-rated threshold. The land tax system would be a relatively simple tax to implement and administer, and would provide an expanding tax base if land valuations are regularly updated. On the grounds of simplicity, the land tax would be preferred to an income tax, though it is less comprehensive as other forms of wealth and income are not captured.

- The original request for assistance was based upon a proposed broad based consumption tax. Such a tax could be developed for Norfolk Island but is not the preferred model. Nevertheless,

  - An extension of the consumption base would be the simplest change to make as it could be built upon the customs duty base. Of the alternative consumption tax systems available, it would be preferable to have the most comprehensive tax base without imposing undue compliance difficulties. A Retail Sales Tax would satisfy this criterion. Decisions would need to be made about whether the customs duty is retained, possibly at a reduced rate. As the tax base is comprehensive under a RST, a number of existing indirect taxes could be removed, including the Accommodation Levy, the Fuel Levy and the Financial Institutions Levy. However, any extension of the consumption tax base suffers the disadvantage of enhancing the inequity of the present tax system and continuing to impose taxes directly on tourist spending. For this reason, an extension of the consumption tax base is a less preferred option.

  - A payroll tax would indirectly tax the income of employees. It is a poor substitute for the introduction of an income tax, as it excludes non-employment income and wealth. Therefore, it is more likely to tax low to middle income earners and thus be less equitable than an income tax — or even a land tax. Overall, the impact is likely to fall on a similar group of residents to those most affected by consumption taxes. Therefore, on simplicity grounds, reform of the consumption taxes would be preferable, given that an indirect tax system is already in place compared to the administrative cost of establishing a new payroll tax system.

- Given the mounting financial pressures, there is an urgent need to make a decision in principle about the preferred revenue solution so that the detailed design solutions can be developed. This is particularly so as the implementation time could be several years for any reform of this nature to be up and running, and the benefits available to the residents of Norfolk Island.