11 Ensuring the GST pool is robust and stable

The primary focus of this Review is to examine the HFE system, by which the GST revenue is divided between the States. Our views on that question are set out in earlier Chapters. However, any rounded assessment of the GST distribution must also take into account the size, predictability and stability of the pool itself. After all, States' budget stability is often more greatly affected by movements in the overall pool than they are by movements in their share of it.

Several issues are addressed in this Chapter:

- First, we briefly recap the dual role played by GST revenue — as both the base for untied grants from the Commonwealth to the States and the vehicle for pursuing horizontal fiscal equalisation between the States.
- Second, we examine whether the existing arrangements have lived up to expectations.
- Third, we explore ways of making the GST pool better suited to the needs and circumstances of the Federation. In particular, we look at options for ensuring the GST pool is as robust and stable as possible in the years ahead.

Through its examination of these issues, the Panel has concluded that several more radical departures from the status quo should be widely debated and carefully considered in the longer term. The Panel sets out its long term vision for the fiscal relationships within the federation in Chapter 12.

11.1 What is the GST pool designed to achieve?

Since its introduction in 2001, the revenue from the GST has been used to perform two important roles:

- It provides the basis for calculating the amount of untied, freely available funds transferred each year from the Commonwealth to the States.
- It provides the mechanism for delivering fiscal equalisation between the States.

It is worth briefly considering the features of the GST that were thought to make it well suited to being used in these ways. We can then assess whether the experience has met those expectations (and speculate as to whether they are likely to be met in the future).

Why is the GST used to determine States' untied Commonwealth grants?

The introduction of the GST from 1 July 2000 was one part of a major suite of changes to taxation and federal financial arrangements, which also included the replacement of Wholesale Sales Tax at the Commonwealth level and, over time, the abolition of several inefficient State taxes.[1] The Commonwealth and the States also agreed to replace the system of financial assistance grants with the revenue collected from the GST.[2]

The decision to adopt the GST as the basis for the level of untied grants from the Commonwealth to the States was made for a range of reasons. From the Commonwealth's perspective, it gave the States a stake in the success of the GST, and so helped secure a level of national support for its politically contentious tax changes. The agreement between the Commonwealth and the States stated that any change to the rate or the base of GST required the unanimous support of the Commonwealth and every State, creating an environment in which any increase in the GST could only be made when there was an overwhelming consensus that it was required. Conversely, although the GST was effectively States' money, States could only allow concessions with Commonwealth approval. Thus, the agreement mechanism served both as political protection against the electorate's concern about the prospect of future rate increases and practical protection against the future erosion of the base.

From the States' viewpoint, having a formal agreement to receive 100 per cent of the GST revenue stream was seen as offering greater security than the previous funding arrangements, which were susceptible to unilateral Commonwealth changes.[3] The primary rationale, though, for providing the GST revenue to the States was to improve their medium term fiscal position, especially in the light of the High Court's recent decision that States' imposition of business franchise fees was invalid.[4] It was widely expected that GST revenues would grow broadly in line with the economy as a whole, in contrast to the taxes it replaced, which tended to grow more slowly and be more volatile. The GST was expected to grow much faster than the financial assistance grants that the States had been receiving, which typically were pegged only to increases in population and consumer prices.[5]

Why is the GST used to deliver fiscal equalisation between the States?

As discussed elsewhere in this report, Australia's approach to the pursuit of HFE has always been to provide States with differing amounts of Commonwealth funds (from one source or another). Transfers directly between States (as occur in Germany, for example) have not been used.

As well as providing the States with a large amount of untied revenue collected by the Commonwealth, in recognition of the large vertical fiscal imbalance between the two levels of government, the GST pool is also used to deliver fiscal equalisation

1 Abolished taxes included accommodation taxes, financial institutions duties, and quoted marketable securities and debits taxes. For further details, refer to GST Distribution Review, *Second Interim Report*, June 2012, pages 7-8.

2 See the (1999) Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, included in Appendix B of Commonwealth Budget Paper No. 3, 1999-2000.

3 A linkage to 100 per cent of GST revenue, as compared with a less than complete linkage to, for example, personal income tax collections, may also have been considered to offer some protection against later Commonwealth reneging.

4 *Walter Hammond and Associates v the State of NSW and others* and *Ha and anor v the State of NSW and others.* Business franchise fees were characterised by the Court as excises, which may not be imposed by States under Section 90 of the *Commonwealth of Australia Constitution Act 1900*. For a brief history of developments, see GST Distribution Review, *Second Interim Report*, June 2012, pages 3-5.

5 In addition, the establishment of a guaranteed minimum amount, based on former financial assistance grants real per capita growth and pre-2000 forward estimates of the State taxes to be abolished, ensured that no State was worse off during the period when States were to abolish certain taxes.

between the States. That is, the GST is distributed on the basis of HFE, as was the case with the financial assistance grants.[6]

Neither its absolute size, nor the average pace of its growth matter greatly when judging the usefulness of the GST pool as a vehicle for pursuing HFE.[7] While such concerns are clearly relevant to States' budgets overall, whether the GST grows at 3 per cent a year or 6 per cent makes no difference to the task of equalising States' fiscal capacities. What does matter though is that the pool used to pursue HFE should be stable and predictable. Changes that improve the stability and predictability of States' GST shares will be of little help though if the pool itself is volatile and unpredictable.

More technically, the way in which States' assessed needs under the current HFE system are translated into GST shares, with a lag and a three-year averaging process, relies for its soundness on the assumption that the pool grows fairly steadily from year-to-year. The more volatile the pool is, the more that States' actual GST shares risk becoming divorced from the needs originally assessed (three to five years earlier) by the CGC.

11.2 How well has the GST pool performed?

The initial expectations of the GST were that it would:

- provide States with a robust source of revenue that grew broadly in line with the national economy, so as to improve States' fiscal positions
- be predictable, so as to assist States in managing their fiscal positions and to facilitate the use of GST pool to pursue fiscal equalisation between States.

These remain good criteria to measure the strength of the current arrangements.

GST revenue trends

When the GST was introduced it was expected to grow (on average over the medium term) by around six per cent per year.[8] Overall, GST revenue has in fact grown exactly in line with this expectation, from $24.4 billion in 2000-01 to $46.0 billion in 2011-12, an average annual growth rate of 6.0 per cent (see Table 11.1). However, this overall figure masks a large difference between the period prior to the global financial crisis and the one after it. Until 2007-08, the GST grew each year by around 8.3 per cent on average, far higher than the average 2.2 per cent increase between 2008-09 and 2011-12 (see Figure 11.1).[9] GST revenue grew very strongly, partly for reasons associated with its start-up, to around GMA levels by 2002-03.

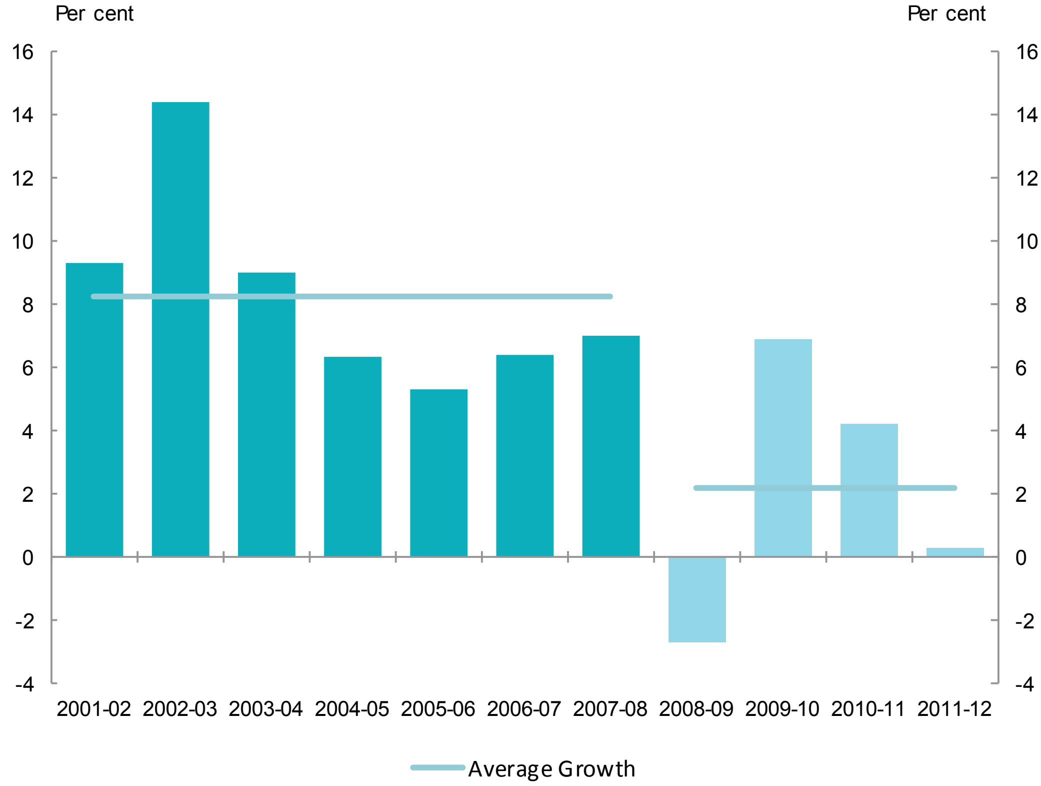
6 Separately from the GST, the Commonwealth makes a range of other payments to the States. Differences in the amounts provided to each State (beyond differences in their populations) are the product of considerations other than HFE (and in fact, the HFE system takes such differences into account in the determination of GST shares). See GST Distribution Review, *Interim Report*, March 2012, Chapter 5 for a full explanation.

7 The main technical concern is to ensure the pool is large enough to prevent any State's assessed GST share falling below zero. This has not been a problem yet with the GST pool.

8 See GST Distribution Review, *Interim Report*, March 2012, page ix.

9 In 2008-09, at the height of the financial crisis, GST revenue *fell* by 2.7 per cent.

Figure 11.1 Two phases of GST revenue growth



Source: Australian Government, Final Budget Outcome, various years.

Table 11.1: Annual GST revenue since its introduction

Year	Revenue ($m)	Annual growth rate (%)	Annual average growth rate to this point (%)
2000-01	24,355		
2001-02	26,632	9.3	9.3
2002-03	30,479	14.4	11.9
2003-04	33,219	9.0	10.9
2004-05	35,323	6.3	9.8
2005-06	37,182	5.3	8.9
2006-07	39,552	6.4	8.5
2007-08	42,330	7.0	8.3
2008-09	41,189	-2.7	6.9
2009-10	44,041	6.9	6.9
2010-11	45,887	4.2	6.6
2011-12	46,037	0.3	6.0
2012-13 (e)	48,250	4.8	5.9
2013-14 (e)	51,000	5.7	5.9
2014-15 (p)	53,700	5.3	5.9
2015-16 (p)	56,400	5.0	5.8

Source: Commonwealth Budget papers, Final Budget Outcome, and Mid-Year Economic and Fiscal Outlook.
(e) — estimate; (p) — projection.

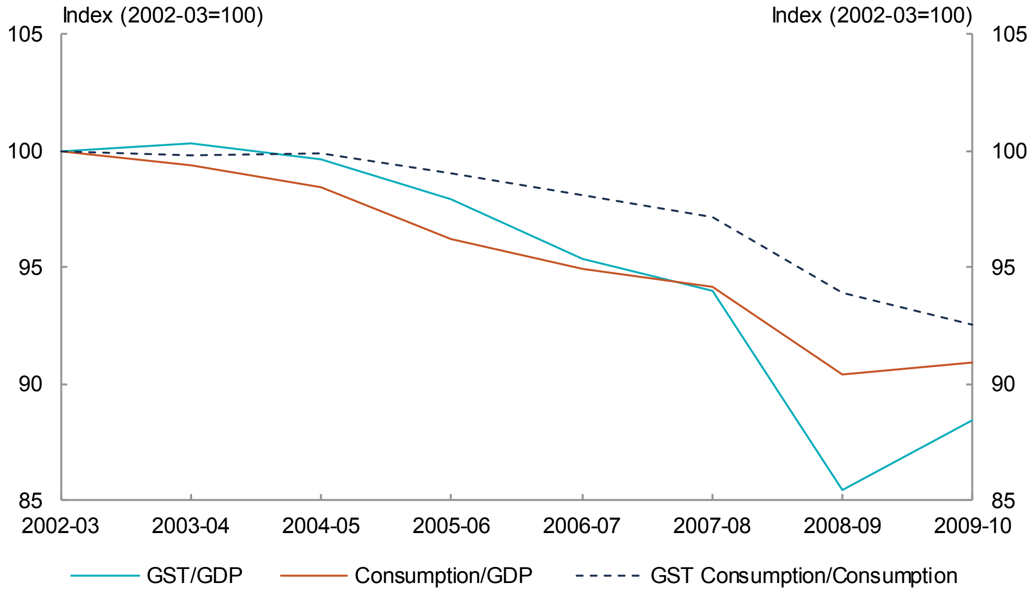
While GST revenue growth is expected to rebound somewhat over the next few years, the outlook for GST revenue to 2015-16 (for annual growth of around 5.2 per cent a year) remains more subdued than before the global financial crisis.

A number of factors are contributing to this weakness of GST revenue. Some are cyclical and therefore likely to dissipate somewhat as economic conditions continue to improve. These include:

- increased household savings by the 'cautious consumer' consolidating the household balance sheet which has contributed to a decline in consumption as a share of GDP
- a slowdown in employment growth in certain sectors, as well as uneven conditions across the economy more generally
- the strength of the Australian dollar.

However, there are also large and growing structural weaknesses in the GST revenue base. Although the GST is more broadly based than the taxes it replaced (most notably, it covers services), it is far from comprehensive, in that fresh food, health and education expenditures are exempt, and banking services are comparatively lightly taxed.[10] As a result, GST revenue will grow more slowly than the economy as a whole if untaxed components take up a larger share of consumption. This is indeed what has been happening in recent years (see Figure 11.2) a trend that is likely to continue in line with the aging of the population.

Figure 11.2: GST as a share of consumption and GDP



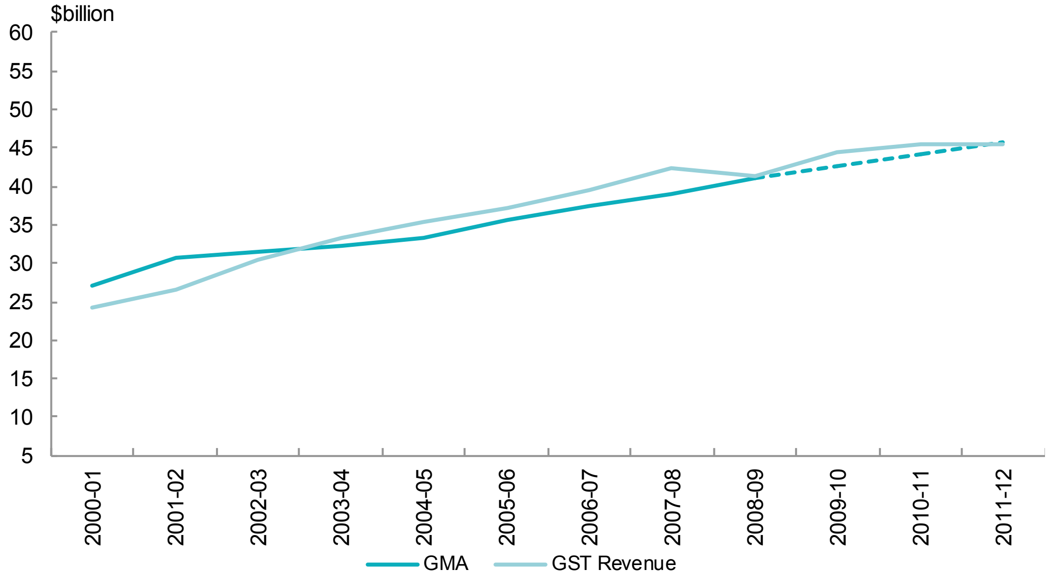
Sources: Australian National Accounts, ABS, Cat. no. 5204.0, 2010-11, Australian Government, Final Budget Outcome, various years and Australian Treasury.

Overall, the record of the GST in improving States' fiscal positions is mixed. For several years in the middle of the last decade GST revenue grew rapidly, faster even than the States had anticipated (which in turn was faster than the growth they would have received under the pre-GST arrangements). Recently though, growth has been decidedly sluggish, and expectations for the future are more subdued than they once

10 Australia's GST is less broadly based than many other countries' value-added taxes (VATs). On one measure compiled by the OECD, Australia's 'VAT coverage ratio' in 2008 was 0.49 (New Zealand's was 0.98). Australia's coverage was broader than only six of the 32 countries included. The average coverage ratio (unweighted) was 0.55. See OECD Consumption Tax Trends, 2010.

were. More than ten years since its introduction, GST collections are barely above the minimum level that the Commonwealth agreed to underwrite (see Figure 11.3).[11]

Figure 11.3: GST revenue and the Guaranteed Minimum Amount



Note: GMA was not in effect after 2009-10. Amounts from 2009-10 estimated by Secretariat.
Source: Australian Government, Final Budget Outcome, various years.

> ***Finding 11.1***
>
> *GST revenue grew fairly strongly prior to 2007-08. Since then, like most other taxes, GST collections have grown only modestly. Some of this softness is cyclical, but it also appears that certain structural factors will continue to dampen GST growth into the future. If left unaddressed, this will place increasing strain on States' budgets.*

Fluctuations in GST collections

For several years, GST collections grew fairly steadily. Setting aside the first few years, where special circumstances relating to the introduction of the tax caused large fluctuations, in five of the six years from 2004-05 to 2009-10 GST revenue grew by between 5 per cent and 7 per cent. Of course, the problem is that this pattern was broken by the sixth year (2008-09) where collections *fell* by 2.7 per cent.

This volatility in tax collections is not limited to the GST. Collections from all other taxes also suffered in the wake of the financial crisis.[12] The GST pool exhibits similar variability to States' other sources of revenues, particularly stamp duty on property transactions.

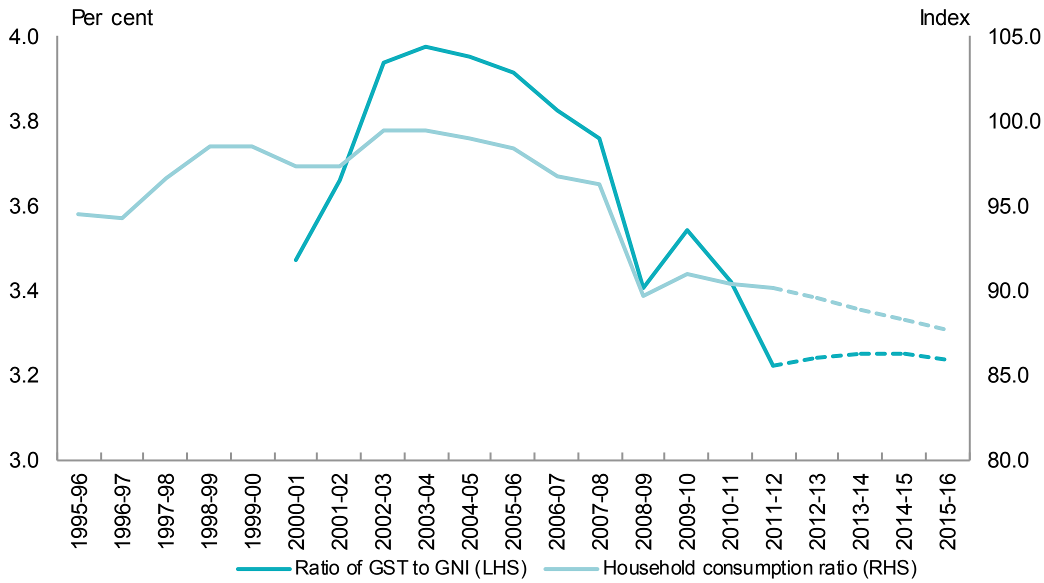
However, it does mean that when the economy is weak across the board and States' own source revenues are weaker, GST payments, for all States, also tend to be weaker, at a point when the States' budgets are under the most pressure.[13]

11 Budget balancing assistance to make up any shortfall in GST was abolished in the 2008 IGA, with effect from 2009-10. However, in 2011-12 it is likely that GST payments are still not much above GMA levels.

12 For example, the Commonwealth's company tax revenue, which had increased by 78 per cent over the four years to 2007-08, then declined by 6 per cent and a further 12 per cent in the following two years.

More technically, the particular form of GST used in Australia (an 'invoice credit model') can also be prone to short term volatility and unpredictability, especially around turning points in the economic cycle. Figure 11.4 shows that GST collections (shown as a share of gross national income) are more volatile than consumption spending (shown as the household consumption ratio).

Figure 11.4: Movements in GST and household consumption



Sources: Australian National Accounts, ABS, Cat. no. 5206.0, June 2012, Australian Government, Final Budget Outcome, various years and Australian Treasury.

Finding 11.2

The GST revenue pool received by the States grew fairly steadily until 2007-08. Since then it has been highly volatile, contributing to the difficulties faced by States in managing their fiscal positions.

11.3 Making the GST pool more robust and stable

As shown above, GST collections have been both less buoyant over the medium term and more volatile than expected when the GST was introduced. These circumstances have driven the Panel to question whether the current arrangements, namely the use of the GST pool to provide untied revenue assistance to all of the States as well as pursuing fiscal equalisation between them, will remain in the best interests of the Federation.

Specifically, the Panel believes that, in the longer term, the national debate around matters such as the rate and the base of the GST, and public financing arrangements more generally, needs to be 'unfrozen'. Even if it is accepted that the current arrangements have served the States well in the past, it should not automatically be assumed that they will continue to best equip the Federation to meet its future challenges. The Panel sets out its own views on these longer term issues in Chapter 12.

13 In contrast, if a slump is concentrated in one State, say in the local property market, then the HFE system will see that State's share of the GST pool rise and partially offset its revenue slump. Of course, this does not happen if all States' revenues are weak at the same time.

However, having a frank debate about federal financial relations over the longer term should not obscure the case for taking specific actions to improve matters in the shorter term. Having recognised that weaknesses exist in the GST pool, the remainder of this Chapter sets out our views on what should be done to make the pool both more robust and more stable.

Ensuring the GST pool is as robust as possible

A very important part of ensuring the adequacy of the GST pool is the ongoing 'care and maintenance' of the existing revenue base, including vigorously responding to Court cases that can provide the opportunity for the emergence of unintended loopholes. Beyond this, the Panel has identified two specific opportunities for augmenting the pool of untied funds received by the States in the short term, namely:

- preventing the leakage of GST revenue from online imports
- revisiting States' obligations to fund the current First Home Owners Scheme.

Vigilance is needed to protect the intended GST revenue base

Queensland's submission to the Review draws attention to an unusual feature of the current arrangements, namely that the Commonwealth Government has responsibility for GST compliance and legislative protection of the intended base, while the revenue consequences of this tax base protection are felt fully by the States.

Queensland goes on to claim that the Commonwealth's response to several recent Court decisions with adverse consequences for GST revenue has been 'less than timely'. The Panel forms no conclusion on this point, but recognises that the incentives of the two levels of government seem to be misaligned. This creates at least a risk that the GST could slip in terms of legislative priority and vigour of compliance effort.

A similar situation exists in relation to administration costs. The amount received by the States is reduced by the size of the Commonwealth's costs (through the Australian Taxation Office) incurred in collecting the GST on their behalf. These amounts are far from trivial — in 2012-13 the GST administration budget is $681 million. Again, while the Panel does not suggest that these costs necessarily are excessive, the current arrangements may not be optimally designed to keep administration costs as low as possible, as the Commonwealth's costs are billed to the States.

The proposal outlined at the end of this Chapter to 'stabilise' the GST pool would, at the margin, also serve to better align responsibility for protecting the GST base with the fiscal incentive to do so.

> **Recommendation 11.1**
>
> *As the Commonwealth exercises its responsibility for GST compliance and protection of the base on behalf of the States it should ensure that it vigilantly approaches this task. GST compliance should not be cross-negotiated with other Commonwealth-State issues.*

Preventing the leakage of GST revenue from online imports

High priority should be given to measures that reduce the erosion of GST collections from overseas internet purchases. Not only does the current situation place domestic suppliers at a competitive disadvantage, this loophole is costing the States hundreds of millions of dollars in lost revenue.

The Panel's views on how this issue should be addressed are set out below, in two parts:

- First, the current low value import threshold could (and in the Panel's view, should) be at least halved. This could be done almost immediately and would ameliorate the problem without requiring any structural changes to either the existing GST law or customs arrangements.

- Secondly, the Panel urges both the Commonwealth and the States to consider how best to bring Australia into line with international practice in this area. Over the medium term, innovative ways of ensuring a level-playing field and preventing revenue loss need to be found. One option worth close consideration would be to replace the current approach to collecting GST 'at the border' with one that imposed a GST liability directly on overseas suppliers of goods and services to Australians.

Physical goods purchased online from overseas suppliers

In 2011 the Commonwealth Government established a taskforce to examine this issue. The Taskforce's report (the Report of the Low Value Parcel Processing Taskforce, or LVPPT) was published in July 2012 and a response from the Commonwealth is awaited at the time of finalising this report. During the deliberations of the LVPPT, this Panel made available to them an analysis commissioned by us on the issue of collecting GST on low value imports. This work suggested various ways to reduce the GST base erosion.

The current threshold of $1,000 is out of line with overseas standards[14] and seems open to flagrant abuse. The Panel has become aware of a number of practices, including overseas arrangements for parcelling purchases in amounts that will not trigger the threshold. Expensive cameras, for example, costing much more than the threshold can currently be purchased in their component parts and assembled by the purchaser without incurring any GST as long as each component (such as the body, lens, motor, battery and filters, etc.) can each be purchased for less than $1,000. Anything other than a very low tax free threshold is exposed to such practices.

The final report of the LVPPT suggests that if the low value threshold were reduced to (say) $500, the additional GST collected would exceed the additional administration costs that would be incurred. There would be a net revenue benefit as a result, but it may not be large — perhaps around $30 million per annum. Beyond this, according to the LVPPT, lowering the threshold further would generate additional revenue, but administrative costs would increase by more, making that approach less attractive from a net revenue point of view.

14 Australia's threshold is far higher than many other comparable countries. For example, Britain's and Canada's are equivalent to around $20. New Zealand's threshold, while also higher than many other countries, is still only about one-third of Australia's.

The Panel accepts that the driver of overseas purchases is not necessarily GST, as often the direct import overseas price including GST would be less than the local purchase price. We are under no illusions that lowering the threshold would be a panacea to local retailers, as has sometimes been suggested. But to some extent this is beside the point. We can see no reason why the GST should not be paid on this category of domestic consumption as long as the costs of collection are lower than the tax paid. We therefore think that the GST low value import threshold should be lowered immediately to the lowest practical level that would increase the overall (net) size of the GST pool.

Recommendation 11.2

That the low value import threshold for GST be lowered to prevent the ongoing erosion of the GST pool.

Initially, the threshold should be lowered so that it does not exceed $500. This should occur as soon as practicable.

Other overseas supplies

The LVPPT noted that overseas suppliers may already agree to voluntarily pay GST (on parcels worth more than $1,000) to facilitate streamlined importation and processing of goods through customs. However, it dealt only tangentially with a number of proposals for making this mandatory — that is, overseas suppliers to Australian residents would be made directly liable for Australian tax.

The Panel is inclined to the view that collecting GST and other taxes on imports physically at the border is not the long term solution. This is a product both of the rapidly increasing volume of relatively low-value physical goods that are imported after being purchased by individuals online, as well as the growing consumption of intangible goods and services (such as ebooks, for example). The amount of money at stake for the States is already significant and, if left unaddressed, could continue to increase.

Ultimately, only placing direct liability on overseas suppliers will address the avoidance of GST on intangible imports such as online purchases of music, videos and other software. If this occurred, then the administratively costly collection of GST at the border would no longer be required for 'GST paid' imports of any value.

The Panel considers that the cooperation of overseas suppliers could be forthcoming for the bulk of transactions, but accepts that incentives for compliance would need to be put in place with the direct liability approach.[15] The Panel notes that if compliance is at its most problematic for low value items, the incentives for non-compliance are also least for such items. Likewise, the possible hardship or unfairness from confiscation of tax unpaid items is limited for low value items.

15 For example, imports on which the GST has not been paid could be made subject to confiscation. Depending on the circumstance and the value of the package it could then be released to the purchaser only after the payment of some penalty, in addition to the GST and any import duty owing.

Recommendation 11.3

That the Commonwealth and the States jointly examine as a matter of priority ways to secure the GST revenue base against its continuing erosion through the growth in imports purchased online.

This examination should include considering amendments to the GST law so as to make overseas suppliers to Australian residents liable for remittance of GST on all supplies of both goods and services that would otherwise be subject to GST if purchased from a domestic supplier. Such an approach would enable the GST exemption threshold for physical parcels to be reduced to a nominal level, no more than $20 or $50.

States' obligation to fund the First Home Owners Scheme (FHOS)

While not part of the GST base, the FHOS is a related impost on State budgets. All States are obliged under the intergovernmental agreement with the Commonwealth to fund and administer the FHOS, and to do so according to a range of specific conditions.

The FHOS payment of $7,000 was introduced at the time of the introduction of the GST on grounds of intergenerational equity. Whereas, prior to the GST, home construction was subject to Wholesale Sales Tax (WST) on certain components and inputs only, the sale of new homes became subject to GST, effectively raising the price of the new homes by the extra tax amount. The difference in tax was calculated as $7,000 in 2000 and was expected to flow through to the existing house market. For this reason, the $7,000 FHOS was included in the tax reform package as compensation for those who happened to be outside the housing market at the time of introduction of the GST. It was not indexed as those not in the housing market at the time were expected to benefit over time from the income tax cuts and other measures that accompanied the GST and the FHOS 'compensation' was intended to diminish in real terms over time.

In this context, and given States' tight fiscal positions, it is far from clear that the States should still be obliged to make payments of $7,000 to every first home purchaser. The Panel notes that both New South Wales and Queensland have recently announced changes to limit their assistance through the scheme to first home buyers purchasing newly constructed homes only. While this would appear to be in breach of the intergovernmental agreement, many will think this is a good policy reform, and in any case has not been objected to by the Commonwealth Treasurer.

Recommendation 11.4

The Panel recommends that the States be relieved of the obligation to make a universal FHOS grant. It should become a matter for States' own policy decisions as to what financial assistance should be offered for new home buyers.

Potential savings from targeting assistance for first home buyers

Although somewhat volatile, the burden of the FHOS on States' budgets averaged around $1 billion per annum between 2005-06 and 2010-11. This is equivalent to around 2 per cent of the GST pool. Payments in the future are likely to be somewhat lower than this, perhaps in the order of $750 million a year, following the removal of the First Home Owners' Boost. Considering the prevailing difficult budgetary conditions faced by the States, the requirement to make universal FHOS payments is a source of inflexibility for States.

While the exact proportion varies between States and over time, roughly 20 per cent of first home purchases are newly constructed dwellings. As such, if the existing rate of the incentive ($7,000) was maintained, but limited only to these purchases, then States would realise a budget saving of around 80 per cent of their budgeted expenditure, approximately $600 million a year overall.

Alternatively, if the targeting of the assistance to new homes was coupled with a doubling of the incentive to this group (to $14,000), then the overall saving would be lower, but still substantial (perhaps around $450 million overall).

Table 11.2: Potential savings from limiting assistance to new homes

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Average FHOS spending in recent years ($m p.a.)	326	266	193	116	70	21	19	8	1,019
Indicative future FHOS spending ($m p.a.)	240	196	142	85	52	15	14	6	750
Guide to potential saving from limiting assistance to newly constructed homes									
$7,000 payment	190	160	110	70	40	10	10	5	600
$14,000 payment	140	120	85	50	30	10	10	5	450

Note: Amounts may not add due to rounding.

Ensuring the GST pool is as stable as possible

There is value in exploring options to ensure that the funding pool available to the States is as stable and predictable as possible,[16] for a range of reasons including:

- assisting States' budgeting and management of their fiscal position
- ensuring that the GST is an appropriate vehicle for delivering HFE, including that assessment year needs are translated into actual GST shares in a sensible way
- insulating State governments, with their large service delivery responsibilities, from the fiscal effects of short term macroeconomic fluctuations.

While the States' access to the GST pool provides them with some advantages, the Panel has heard that the volatility of grants based on GST collections can be difficult for States to manage. Although fluctuations in the GST cannot be eliminated, there are several possible ways their effects on State budgets could be smoothed.

16 In addition to ensuring that States' shares of the pool are not subject to undue volatility (see Chapter 6).

The Panel has looked closely at several ways in which the stability of the pool of grants received by the States from the Commonwealth could be enhanced. These all contemplate a softening or breaking of the direct link between States' grants and the amount of GST collected in a given year such as:

- applying an 'automatic stabiliser' to the GST pool
- applying a growth floor to the GST pool
- completely delinking States' grants from the GST pool.[17]

In doing so, the Panel has been mindful that, in recent years, the downward revisions to States' GST-based grants that have caused them such alarm have, in most cases, arisen as much from revisions to the *total* GST pool, as revisions to their *shares* of the pool.

Applying an 'automatic stabiliser' to the GST pool

While fluctuations in the GST cannot be eliminated, there are several possible ways that their effects on State budgets could be smoothed. Since the Commonwealth is responsible for estimating GST and has a much bigger budget than the States, it seems feasible that the Commonwealth absorb excessive fluctuations of revenue, or departures from estimates.

If, for example, the forward estimates of GST were not linked to forecasts and projections of consumption and economic activity, but set at a slightly conservative, but steady growth rate — for example, real growth per capita plus 1 per cent — the States would have a definite grant amount for planning purposes. If the actual end of year collection dipped below that in a given year, the Commonwealth could provide interim top up support for States, but claw that back in future years. If the actual end of year collection rose above the growth rate in a given year, the Commonwealth could first use that to claw back past years overpayments (if any) or balance any current year shortfalls, or top up support for States. Under this approach, any Commonwealth budget impact and benefit to States would be fully recouped. Effectively the Commonwealth would act as automatic banker to the States in respect of downwards volatility in GST collections. GST based payments to the States would be smoothed over time, with the larger Commonwealth budget accepting the volatility risk.

A variation on the approach described above would be for the Commonwealth to provide a slightly higher minimum growth guarantee, in exchange for 50:50 sharing of upside beyond the guarantee. Again, the rationale is that fiscal volatility is best incurred and handled by the Commonwealth with a macroeconomic management perspective, and not by the States who have an ongoing service delivery requirement. This option would give a better alignment at the margin between legislative and compliance burden and the revenue result.

A third approach would be to sever the link between the GST and the size of the general purpose grants to the States. The Commonwealth and States could agree a growth rate from a starting point GST/general purpose grants level. If general purpose grants were guaranteed to grow at real per capita plus x%, there may be an x% that would be satisfactory to both levels of Government.

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17 The options examined by the Panel are outlined in Appendix E.

Recommendation 11.5

That the Commonwealth and States jointly consider modifying existing arrangements to provide States with increased short-term certainty regarding the GST pool.

One potentially useful approach would be for the Commonwealth to underwrite a growth in the pool each year of no less than the increase in population and consumer prices (that is, maintenance in real per capita terms). Any additional funds transferred from the Commonwealth to the States in this way would then be recouped in future years, by withholding some part of the growth in GST collections above the base level.