12 HFE and federal finances in the longer term

12.1 The need for a longer term vision

The Panel has been conscious that a Review like this comes along infrequently. So, while we have made our inquiries into the present problems detailed, comprehensive and geared towards current circumstances, we have also felt the need to consider a vision for federal fiscal cooperation that might prove valuable for the longer term. Indeed, several contributors of views have argued that the HFE system can only be changed in the long term, preferably when there are other moving parts in play.

As has been addressed earlier in this report, the Review's Terms of Reference state that HFE has served Australia well and is to continue via untied grants from GST revenue. Faced with that constraint, together with the current practical and fiscal realities in a climate where all levels of government face tight budget constraints over the short to medium term, the Panel considers that there is presently little scope for changes that would have substantial (negative) effects on any State's GST revenues. This is particularly so since the changes being argued for are generally in the direction of less HFE and those sorts of changes have a disproportionate payoff when considered as incremental movements from the present position — simply put, they give relatively small benefits to donor States and come at a comparatively high cost to recipient States. For example, while a $500 million gain in GST share is still comparatively minor for donor States, a loss of that degree is very significant for recipient States. The population-weighted value of a dollar between donors and recipients is about 9:1.

For these reasons the Panel has not recommended fundamental change to the HFE system over the short to medium term and has instead focused on recommendations that will improve the system's governance, transparency, stability and simplicity, but will have only minor impacts on any State's GST share. In fact, upon the deep reflection of eighteen months' immersion in HFE and related issues, we have concluded that it will not be viable just to make 'tweaks' to the current system and that, in fact, there is no middle ground between the current system and the alternative.

Our recommendations to reduce the low value threshold for GST applying to internationally purchased goods, along with removal of Inter-governmental Agreement (IGA) requirements to fund all first home buyers, will effectively enlarge the level of GST revenue available to all States, providing some 'breathing space' for State finances. The recommendations around improving the HFE system are aimed at giving States greater confidence and certainty in their shares of GST revenue.

Beyond the medium term, however, further thought needs to be given to how federal fiscal relations should be structured to best manage longer term spending pressures. The Panel considers that a longer term vision need not necessarily include the current concept of HFE, although it will still need to recognise (and accommodate) the needs of the clearly fiscally weaker States.

12.2 Emerging fiscal pressures

State fiscal outlook

An examination of State budget papers indicates that by the end of the forward estimates period, a number of States are expecting to move from narrow fiscal deficits and return to operating surplus. However, this result is based upon conservative expense growth forecasts over the forward years, with the States in aggregate expecting expenses to grow by an average 3.1 per cent per annum, whereas between 2000-01 and 2011-12, expenses actually grew at an average 7.1 per cent per annum. If States are unable to limit expense growth to the budget estimates then continued deficits (and pressure to identify new revenue sources) are likely. For example, if expenses were to continue to grow at 7.1 per cent per annum, the aggregate result instead would be a deficit of 2.3 per cent of GDP in 2015-16.

Long term pressures

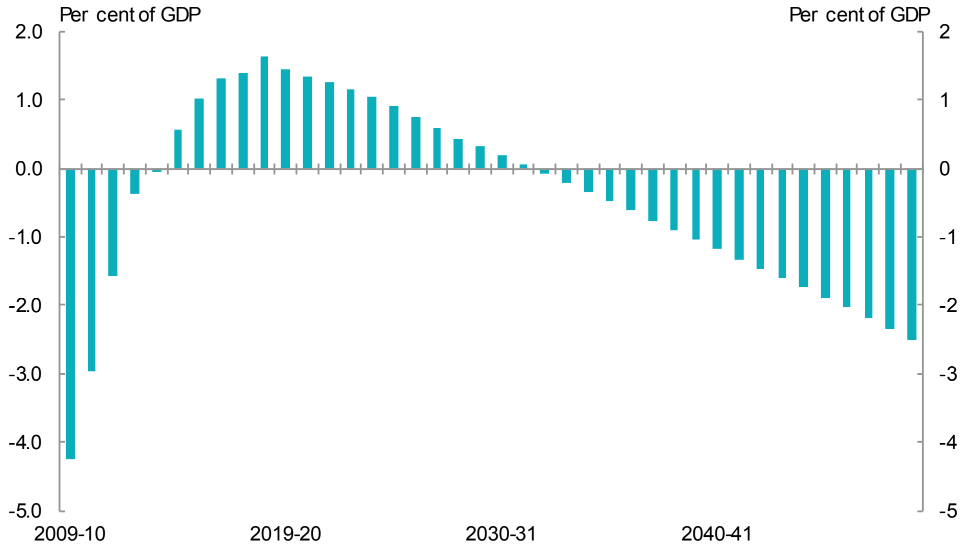
One reason that States may have difficulty in containing expense growth is that they are facing underlying economic and demographic budget pressures. In a recent speech, the Secretary to the Treasury, Dr Martin Parkinson, identified the longer term pressures on fiscal sustainability at all levels of government as:

- an ageing population, leading to slower rates of economic growth as workforce participation rates fall
- higher standards of living, leading to higher community expectations for goods and services delivered by governments, for example new services such as the National Disability Insurance Scheme, and substantial reforms to existing services that could entail more spending (such as the school funding proposals)
- significant structural change in the economy and global economic weakness, meaning that the amount of tax collected for the size of the economy is changing, with revenue growth having slowed and likely to slow further.[1]

At the Commonwealth level, the 2010 Intergenerational Report (IGR) indicated that health care costs are expected to grow five-fold in coming decades, with a substantial portion of this growth being driven by the ageing of the population. Figure 12.1 shows the potential future fiscal gap for the Commonwealth included in the IGR.

1 Dr Martin Parkinson, Secretary to the Treasury, *Challenges and opportunities for the Australian economy*, speech to the John Curtin Institute of Public Policy, 5 October 2012.

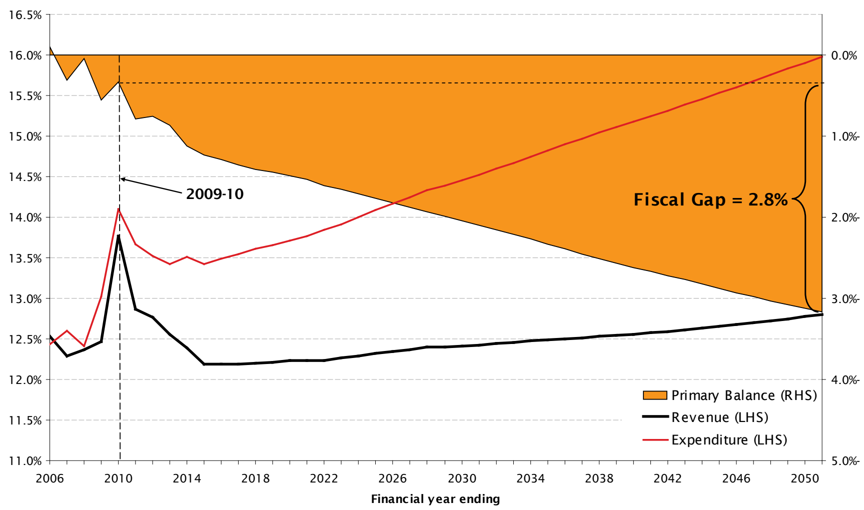
Figure 12.1: Commonwealth fiscal gap to 2050



Note: The fiscal gap is total Australian Government receipts minus total Australian Government payments (excluding interest).
Source: Commonwealth Treasury, Intergenerational Report 2010.

Similar pressures are being felt at the State level. New South Wales produces a Long-Term Fiscal Pressures Report, similar to the Commonwealth IGR, every five years. The 2011-12 report indicates that, in the absence of policy action, underlying economic and demographic factors would result in expenses continuing to grow at a faster rate than revenues over the long term, acting to increase the already existing fiscal gap, as shown in Figure 12.2.

Figure 12.2: New South Wales fiscal projections



Source: NSW Budget Paper No. 6, *NSW Long-Term Fiscal Pressures Report*, 2011-12, page 6-2.

12.3 State tax reform

While a focus on stronger productivity growth and nationwide economic efficiencies will help reduce the fiscal gap, the reality is that in order to manage the longer term fiscal pressures on their budgets, there is likely to be increasing pressure on governments to reform their tax bases. For States, this might translate to increasing pressure for less reliance on inefficient narrow transactions taxes, with greater reliance on more efficient broader-based taxes.

GST reform

As noted previously in Chapter 11, the GST is not fully applied to banks, food, health and education. If GST were applied to some of these items, collections would be more buoyant in the long term since some of these items tend to grow proportionally faster as income rises and the population ages. This is likely to be true even though GST would only apply to the non-taxation funded consumption in these areas, such as general practitioner ‘gap’ payments and private hospital charges.

Even if the GST base were strengthened, the reality is that some tax rates would also have to be stepped up from time to time over the next few decades on a revenue positive basis to meet the expected community requirement for a switch in the composition of consumption to publicly provided (tax funded) items — in future there is likely to be relatively more hip replacements and fewer iTunes.

Of course these are contentious matters, and are ultimately for decisions by the Commonwealth and State governments collectively in the course of enhancing federal financial relations. The Panel wishes to do no more than ‘unfreeze’ the debate on the rate and base of GST. Medium term thinking and a national plan for the direction of tax reform (State and Commonwealth) is required. In this spirit, the Panel observes that in OECD terms, the level of consumption tax in Australia is among the lowest. As at January 2012, of the 33 OECD countries that levy a Value Added Tax (VAT), 28 countries imposed a higher rate than Australia. In the period since Australia introduced its GST in 2000, 20 OECD countries have increased their VAT rate.[2]

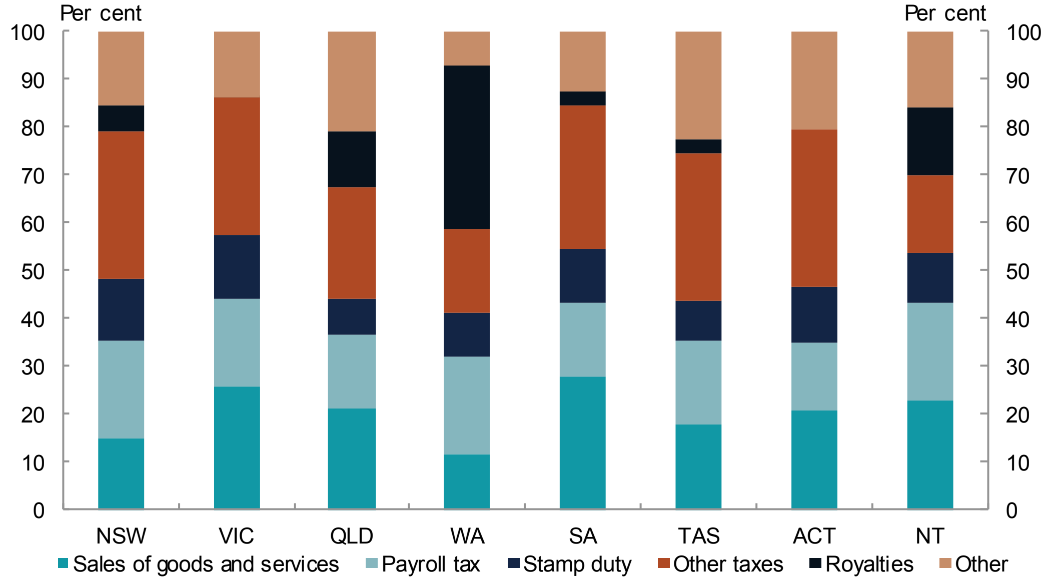
State own source revenue reform

As discussed in the Panel’s second interim report, many of the States’ own source taxes are considered to be inefficient, in the sense that they have relatively high compliance costs, distort investment incentives, or have a large ‘welfare cost’ in comparison to the amount of revenue they raise. The major revenue raising State taxes are payroll tax and stamp duty on conveyances, with mining royalties also particularly important for the mining States.

Figure 12.3 shows the proportion of own source revenue contributed by the major State taxes for each State.

2 All OECD countries except the United States levy a national VAT. A complete table of OECD member country VAT rates from 2000 to 2012 is included in Appendix G.

Figure 12.3: State own-source revenues, 2012-13

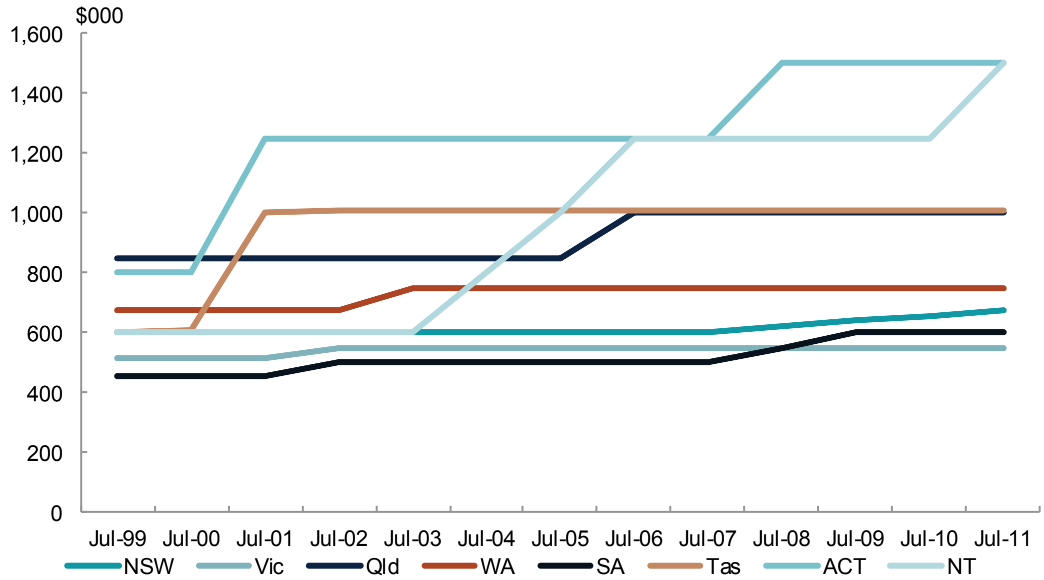


Source: State 2012-13 budgets (except ACT figures which are sourced from 2012-13 pre-election update).

The thrust of the national tax reform debate at present is that, in the long term, it may be better if taxes are able to be rationalised, removing the 'worst' and placing greater reliance on the 'best'.

Dr Parkinson observed that while States have made good progress in harmonising their payroll tax bases, almost every State budget this year saw a cut in the payroll tax rate and a narrowing of the base, as shown in the charts. This has considerably reduced the effectiveness of, and the revenue collected from, this tax source.[3] Figures 12.4 and 12.5 show the increase in payroll tax exemption thresholds and decrease in payroll tax rates respectively across States over the past ten years.

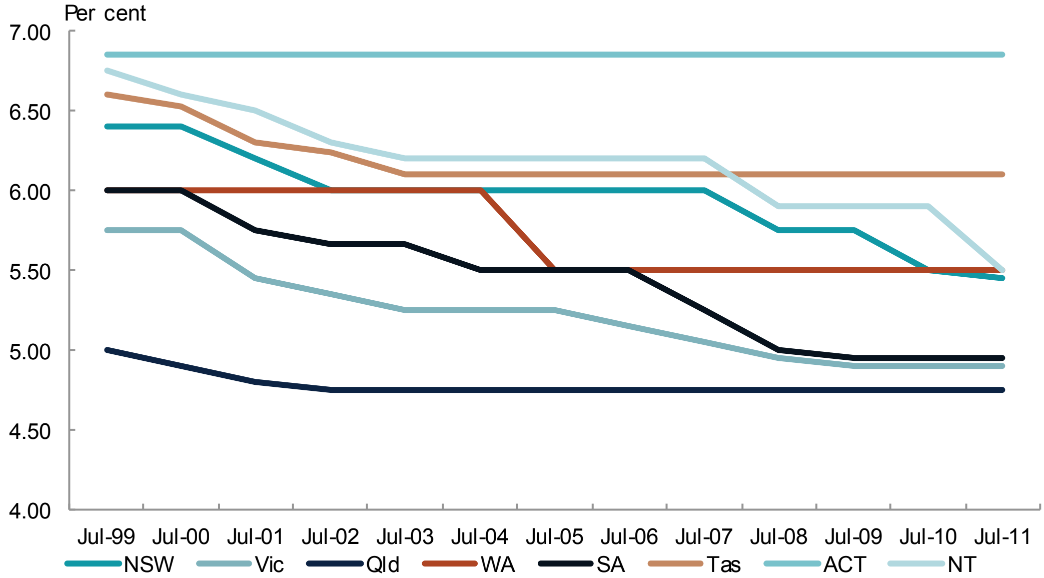
Figure 12.4: Payroll tax exemption thresholds 1999 to 2011



Source: New South Wales Treasury, New South Wales Interstate Comparison of Taxes.

3 Payroll tax is the largest single source of State tax revenue, accounting for around one-third.

Figure 12.5: Payroll tax rates 1999 to 2011



Source: New South Wales Treasury, New South Wales Interstate Comparison of Taxes.

The direction in which States are heading with regard to payroll tax is the reverse of that recommended in the AFTS review, which said that greater efficiencies would be gained by removing (not raising) payroll tax thresholds. The clear implication from Dr Parkinson's observations is that any attempt to manage State revenues more generally is likely to require 'major' or 'structural' tax reform on behalf of the States, as well as the Commonwealth.

Perhaps due to its unique circumstances of having both State and local government characteristics, the Australian Capital Territory is the only jurisdiction to have attempted to introduce a major long term reform of its tax mix. In its 2012-13 budget, the ACT government announced that it was moving to remove the inefficient stamp duties on conveyances and insurance taxes, replacing them with expanded property taxes (rates). The long term nature of such reforms is evidenced by the government planning on a 20-year transition period to complete the tax mix change.

12.4 Roles and responsibilities

These fiscal pressures are likely to lead to a debate about the size and scope of government, both at each level of government and between the levels of government.

The impact of vertical fiscal imbalance

There is currently an imbalance, known as the vertical fiscal imbalance (VFI), between the taxing powers and spending obligations of the Commonwealth and State governments. By international standards, Australia's VFI is high. In the longer term, a more preferable outcome may be if States are able to match their expenditure more closely with their own revenues and become less dependent on the Commonwealth, while the Commonwealth matches its revenues more closely to its own needs.

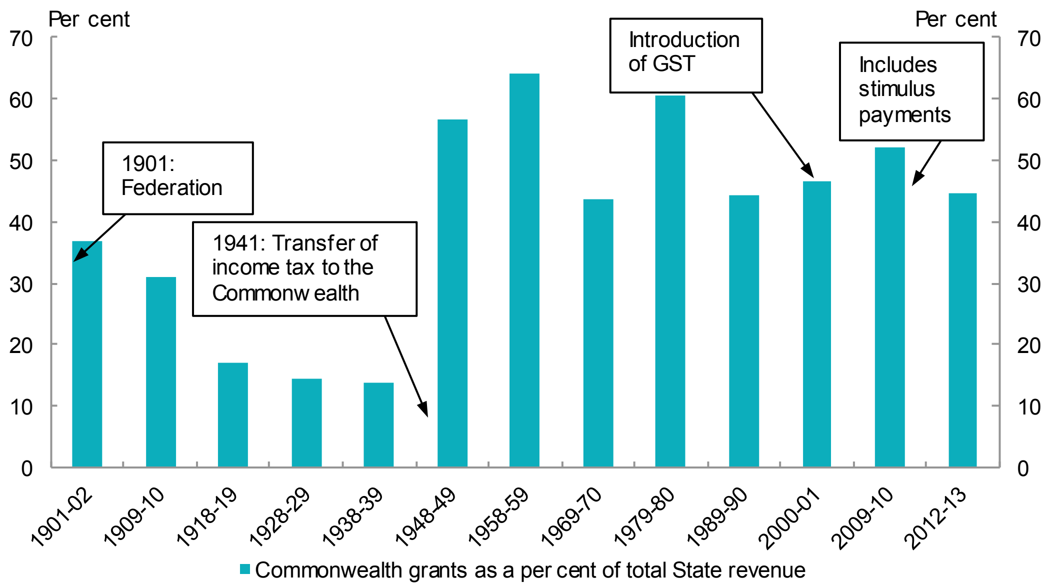
As detailed in the Panel's second interim report, developments since federation have changed the relative revenue raising powers between the two arms of government in favour of the Commonwealth.[4] At the same time as the States' revenue sources were reducing in comparison to the Commonwealth's, the nature of the assistance from Commonwealth to States has changed from providing limited grants to assist States in special circumstances, through addressing broadly-defined fiscal need, to the present concept of horizontal (interpersonal) fiscal equalisation.

Some submissions to the Review have suggested that nothing short of major reform to the responsibilities of the different arms of government or the arrangements by which they are funded will do to put the Federation on the right path. Others call for significant reform of the nation's taxes as a step to remedying the VFI 'problem'.

Shared funding responsibilities

The high level of VFI means in practice that Commonwealth transfers to the States comprise a large proportion of State budgets (at present on average across States around 50 per cent). Figure 12.6 shows grants from the Commonwealth as a proportion of total State revenue over time.

Figure 12.6: Vertical fiscal imbalance over time



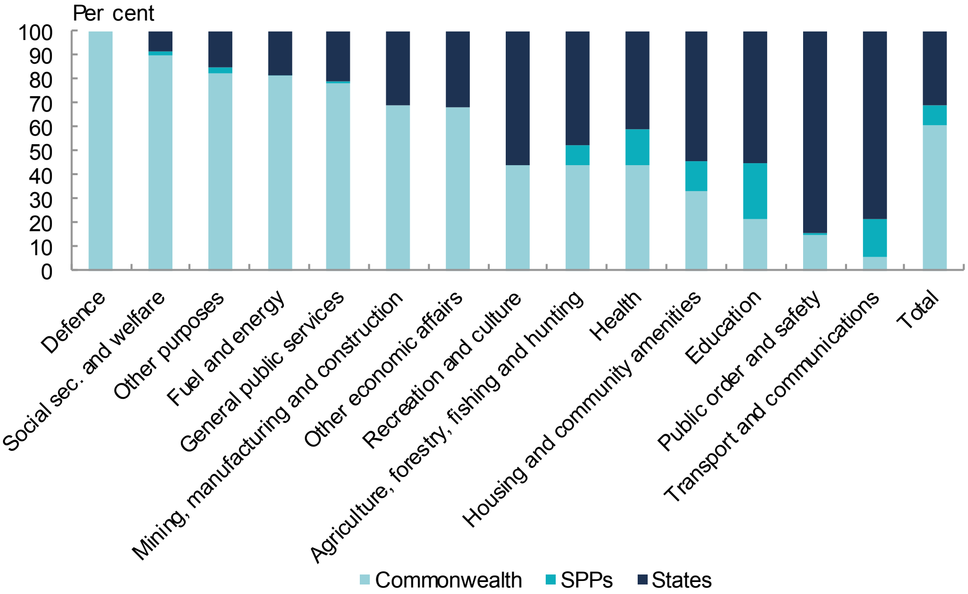
Source: Calculations based on data contained in the AFTS architecture paper (Chart 10.5), State budget papers and 5512.0 Government Finance Statistics, Australia, 2010-11.

As a result of the high level of transfers from the Commonwealth to the States, the Commonwealth plays a significant role in areas of traditional State responsibilities, such as health and education. The 2008 Intergovernmental Agreement on Federal Fiscal Relations aimed to clarify the respective responsibilities of the Commonwealth and the States. However, in the six major National Agreements, 45 responsibilities are assigned to the Commonwealth, 38 responsibilities to the States, while 58 responsibilities are listed as shared. Similar issues can be found in National partnerships.

Figure 12.7 shows the relative share of spending between the Commonwealth and the States across a range of sectors.

4 GST Distribution Review, *Second Interim Report*, June 2012, Chapter 1, Section 1.2.

Figure 12.7: Shared Commonwealth and State responsibilities, 2012-13



Source: State Budget papers, Commonwealth Mid-Year Economic and Fiscal Outlook, 2012-13.

VFI and HFE

The high level of VFI means that the pool of funds available for horizontal fiscal equalisation can also be relatively large (on average across States GST revenue represents around 25 per cent of State revenues). A consequence of the large pool of funds available for HFE is that, no matter how fiscally strong a State becomes, the pool will likely be sufficient to bring other States to that capacity. This is different to Canada, for example, where the amount of equalisation funding is only sufficient to bring the fiscally weaker States up to a minimum level.

Equalising to the level of the strongest State can lead to very large proportions of the equalisation pool being required for equalisation, in turn leading to a wide divergence in States' shares of equalisation funds (that is, GST revenue). This is the issue being experienced currently in the case of Western Australia. In 2012-13, around 45 per cent of the GST will be required to bring the other States to Western Australia's fiscal capacity, compared with around 28 per cent in 2011-12 and the long run average through the 2000's of around 15 per cent.[5]

12.5 Commonwealth assistance to States in the longer term

Any realignment of national tax bases and service responsibilities is likely to result in a continuation of some, albeit ideally reduced, level of VFI. If this occurred, VFI could be largely addressed through general revenue assistance, with the reduction in Commonwealth transfers to States being achieved through reductions in tied funding. Such an approach would act to mitigate one of the major irritants for the larger States with the current system.

5 Figure 3.1 (Chapter 3) shows the changes over time in the relative fiscal capacity of the strongest State and the proportion of GST pool required for equalisation. The proportion has increased in recent years and is expected to continue to do so over the forward estimates period.

Conditions for imposing assistance to States

Because the GST replaced several State taxes, the States understandably feel a proprietary relationship to it, to the extent that, when relativities change in a way negative to any of them, that one sees its revenue stream as being eroded. Under the large States' proposal (discussed in Chapters 2 and 3), even if it ultimately resulted in no additional dollars for them, they would gain control of a larger share of untied GST to count as their revenue, rather than having to rely on the Commonwealth 'granting' additional revenue to them, subject to whatever conditions (such as matching State funding for the project) they may desire.

For similar reasons all States are sensitive to base erosion, from several directions. They are worried that the incentive is not there for the Commonwealth to act swiftly when the base is threatened by legal challenges or administrative action. They are also conscious that the taxable share of consumption seems to be declining as a proportion of the whole (albeit perhaps not as quickly as might have occurred under the Wholesale Sales Tax and the State taxes repealed).

The fact that most Commonwealth payments to States for special purposes (for example, SPPs and NPPs) are formally tied, while GST payments are not, means that the greater the percentage of the former, the less flexible the State's budget (in theory, at least). Large States find this perverse in that, the more recipient States are given GST to assist their needs, the less of their budget as a proportion is tied to achieving those ends. Conversely, donor States, who have less 'need' for GST, find that more of their budget is tied. Victoria's submission suggested that 48 per cent of Commonwealth transfers to donor States are tied, compared to only 36 per cent for recipient States. If States received more untied GST and less tied other grants, they would have greater discretion over a larger proportion of their own budgets. The counterview is that, as the decrease in untied grants only comes about because of an increase in untied own source revenue, there is no issue.

HFE in the longer term

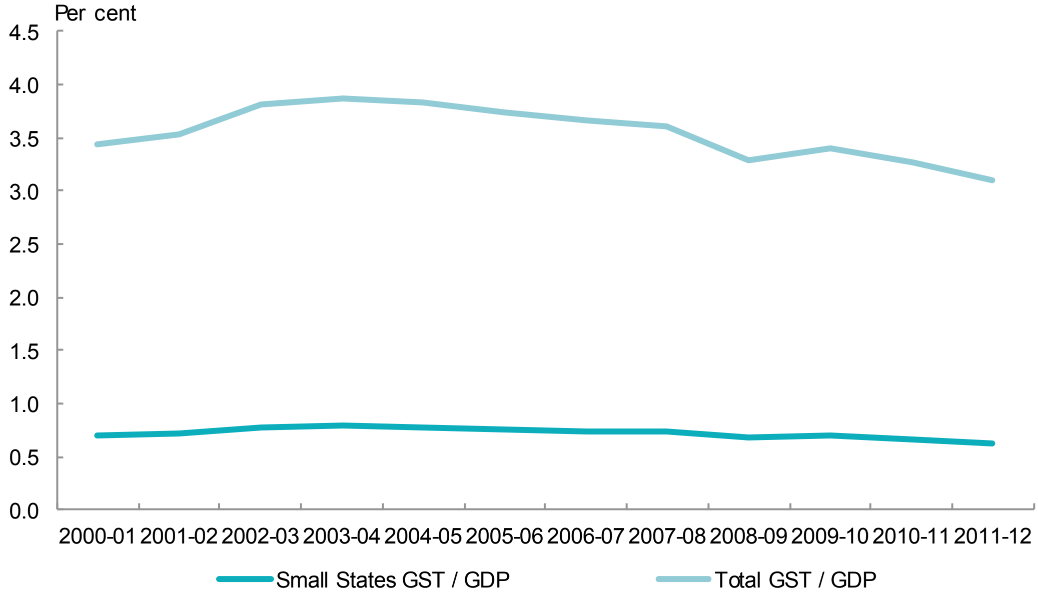
In a future world where there has been a realignment of national tax bases and service responsibilities, resulting in a reduced level of VFI, the constraints that led to our conclusions in Chapter 3 would no longer apply. Therefore, this future need not necessarily include the current concept of HFE. However, any replacement would still need to recognise and accommodate the needs of the clearly fiscally weaker States.

In this longer term model of federal funding, general assistance grants might most simply be distributed on an EPC basis, with the continuing larger Commonwealth budget — which has the greatest capacity — taking on the task of horizontal fiscal equalisation and ensuring that the smaller States are able to provide a comparable level of services to the larger States. This is the approach adopted in Canada, where responsibility and funding of equalisation payments resides with the national government.

The question in that scenario would be: what level of funding should be provided by the Commonwealth to the smaller States for the purpose of horizontal fiscal equalisation? As a starting point, since the introduction of GST revenue as the vehicle for HFE, the smaller States have collectively received consistently just over 20 per cent of the GST pool, or around twice their population share. Alternatively, if GST collections are not expected to keep pace with general economic growth (and there are indications of this), then perhaps a guaranteed share of GDP would be a more sustainable benchmark.

Figure 12.8 below shows the HFE share of the GST revenue pool as a proportion of GDP since the introduction of the GST. It shows that, after a high in 2003-04 (of close to four per cent of GDP), the proportion of GDP represented by the GST pool has been steadily declining to now stand at just over three per cent of GDP.

Figure 12.8: GST pool as a proportion of GDP



Sources: GST Distribution Review, Issues paper; Commonwealth Final Budget Outcome, 2010-11 and 2011-12; Mid-Year Economic and Fiscal Outlook, 2011-12.

While the actual level of support to the fiscally weaker States would be subject to negotiation between those States and the Commonwealth, if a proportion of GDP approach was adopted, a reasonable guaranteed proportion of HFE revenue for the smaller States (on present indications) could be between 0.7 to 0.75 per cent of GDP.

Thus, in the longer term, the Commonwealth could make equalisation payments to the smaller States equal to the difference between their collective EPC share of general assistance grants (GST revenue) and the guaranteed proportion of GDP. This assistance could then be tied to particular service areas, depending upon the policy priorities at the time. In order to be able to reflect changing fiscal circumstances between the smaller States over time, the CGC could have the task of recommending how the equalisation funding should be allocated across the smaller States.

By definition, the larger States, currently being donors in the HFE system, would be better off by receiving an EPC share of general assistance grants. In addition, they generally have a larger proportion than the smaller States of their overall revenues as own source revenues compared to GST revenue and hence, in the longer term, consistent with reform of State taxes, would be in a better position than the smaller States to access revenues that grow in line with general economic growth. Therefore, in this longer term federal fiscal relations world, no equalisation payments would be required for the larger States.

Finding 12.1: The long term vision

In the longer term, citizens must make important decisions about the size of the government sector they expect and the taxes they pay for it. Maintaining government service delivery at about the same levels as currently will place increasing pressure on governments to raise taxes. On the other hand, maintaining taxes at about the same levels as currently will place increasing pressure on governments to reduce services.

In any future where revenues are tight, ensuring the most efficient and effective combination of taxes is vital to maximising the citizens' return from taxation. Tax reform — at State and Commonwealth level — to put greater focus on more efficient taxes and reduce reliance on less efficient taxes, would be an important response.

Along with decisions about the size of government overall, roles and responsibilities for services and revenue-raising may need to change between the levels of government. A closer matching of revenue-raising capacity with expenditure responsibilities could lead to improvements in the efficiency of service delivery and make all levels of government more accountable and responsible for their actions. Such a change in roles and responsibilities would likely lead to, or could complement, a reduction in the Federation's VFI.

While the Commonwealth continues to have greater budget capacity than the States it would be best placed to take on the funding of equalisation payments to the smaller States to ensure they continue to have the capacity to provide comparable (State) services to those of the larger States. Commonwealth transfers to States could then largely address VFI, and be weighted more towards general revenue assistance (funded by GST) than tied funding (PSPs). In such a world, the simplest way of allocating the general revenue assistance would be on an EPC basis. No additional Commonwealth support need be provided to the larger States, other than that consistent with Commonwealth policy priorities.

The amount of equalisation funding for the smaller States could be a guaranteed proportion of GDP. The Commonwealth would fund the smaller States collectively the difference between this guaranteed amount of GDP and their EPC share of general revenue assistance. The expectation would be that this funding would be tied, depending upon policy priorities at the time. In order to reflect changing circumstances between the smaller States, the CGC could recommend how the guaranteed equalisation funding should be allocated across the smaller States.