

Joint Submission

by the States of

New South Wales

Victoria

Queensland

and

Western Australia

to the

GST Distribution Review

August 2012

Introduction

NSW, Victoria, Queensland and Western Australia look forward to the Review recommending reform options that will simplify and restore confidence in the distribution of GST among the States and territories (States).

The current system is seriously flawed – there are elements that are out of date, inefficient, inequitable, complex, opaque and perverse in their outcomes. The opportunity for bold reform of the GST distribution system should be taken so it stands the test of time.

A population based distribution system, with the Commonwealth taking responsibility for funding the additional financial assistance required for States with lower fiscal capacity so no State is financially worse off, is the preferred long term policy position of our four States. However, this objective may not be achievable in the short term. An interim step is to move away from the CGC's interpretative approach of full, comprehensive equalisation to transitional arrangements that begin to appropriately balance equalisation and efficiency in an environment of imperfect information.

Confidence in any system of fiscal equalisation must be built on the imperative that the GST – the largest component of State revenue – remains untied and is distributed in full to the States each year, consistent with the 1999 and 2008 Intergovernmental Agreements (1999 and 2008 IGA).¹ Transferring the full GST revenue to the States provides the flexibility to deliver key programs best suited to local needs and circumstances in a fiscally responsible manner.

The Commonwealth Government tying GST revenues as suggested in the second interim report would impinge on States' fiscal capacity to deliver the desired level of services to their population.

Effective national tax reform will require cooperation between the Commonwealth and States, as reflected in the Australia's Future Tax System review. It is therefore inappropriate for the Commonwealth to withhold any portion of the GST pool to enforce tax reform. Doing so would ignore the broader national tax reform opportunities at Commonwealth and State levels.

The equal per capita goal

An equal per capita (EPC) distribution of GST revenue is closest to the 'ideal' model for GST distribution envisaged by the Review Panel² as:

- it is fair, and can be seen as fair
- it is easily understood (simple and transparent)
- it allows States to plan budgets with greater certainty (predictable).

An EPC distribution would not:

¹1999 IGA - *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*. 2008 IGA - *Intergovernmental Agreement on Federal-Financial Relations*.

²First Interim Report p. 18.

- encourage bad policy
- discourage good policy
- cost more than it needs to or
- detract from States' confidence in the Federation.

In addition to these ideal qualities listed by the Review Panel, EPC is:

- contemporaneous
- stable
- equalising.

As GST payments under EPC distribution are unequivocally based on the population for which States provide services and infrastructure, it is fair, stable, simple and transparent. Importantly, the distribution is not subject to 'judgements' which lead to disagreement and argument. An equal per capita distribution is administratively simple.

An EPC distribution would focus States on good spending and revenue raising decisions rather than having to consider possible impacts on GST share from policy decisions.

An EPC distribution would be contemporaneous. It would not depend on data which can only be produced with, at least, a two-year lag. It would use, as does the current system, current year ABS population estimates, with ex-post adjustment, as is also currently the case for variation of outcomes from population estimates.

Most significantly, though contemporaneous, an EPC system would be stable. Being 'judgement' free and dependent on economic data, its outcomes would not be affected by changing financial or political influences and judgements.

An equal per capita distribution of GST revenue would be 'equalising' as it would automatically redistribute GST revenue from those parts of Australia which generate above average per capita GST revenue to those parts of Australia which generate below average GST revenue per capita.

The Review Panel noted that 'moving the GST distribution to an EPC basis would simplify the distribution of the GST significantly, [but] is practically not achievable in the absence of a further funding source.' The Panel notes those supporting EPC envisage additional Commonwealth payments to recipient States when 'in the medium term at least, there are no additional funds.'³

The Commonwealth already raises over 80 per cent of tax revenue in Australia. Where the major revenue sources are the preserve of the federal government rather than the States, it is appropriate that it rather than States meet the financial costs of further equalising payments (in addition to EPC) thought necessary to ensure all residents of the federation have access to comparable service levels.

³First Interim Report, p. 60.

As the intention of this proposal is to ensure that no State is financially worse off, the Commonwealth would provide the required additional financial support to recipient States (that is, States with GST relativities above 1).

The Commonwealth has the best fiscal capacity of any government in Australia to raise additional funds. The Commonwealth is forecasting total receipts of \$369 billion in 2012-13. The equalising amount, above equal per capita, in the 2012-13 GST distribution is only around \$4 billion – or just over 1% of the Commonwealth's total receipts.

The Commonwealth's fiscal outlook is far stronger than the States'. The Commonwealth expects revenue to grow by 7.5 per cent per annum over the budget and forward estimates, which is higher than the States. High revenue growth will see Commonwealth general government net debt eliminated by 2020-21, which is a stronger position than the States. Medium term projections suggest the Commonwealth's taxation share of GDP will rise above its committed cap of 23.7 per cent by around 2018-19. The Commonwealth could translate its strong revenue position into increased support for service delivery in the States.

Furthermore, the Commonwealth receives a fiscal dividend from productivity enhancing reforms, including through its broad tax bases. This was recognised by the Review Panel in its second interim report in the context of State tax reform, and applies equally to Horizontal Fiscal Equalisation (HFE) reform.

The distribution of GST on an EPC basis with the Commonwealth providing additional funding to recipient States is the recommended long term position of our four States⁴. This is a long term objective (five to ten year horizon) and transitional arrangements may be necessary to meet it.

New South Wales, Victoria, Queensland and Western Australia acknowledge that it may not be possible to move to this EPC objective in the near term.

Accordingly, we propose a number of transitional measures which could be implemented in the short term, and which can be readily expanded into a full EPC distribution.

Transitional Measures

The following section provides examples of some transitional measures that could be taken. These measures are:

- Distribute a proportion of the GST pool EPC with the remainder distributed using relativities.
- Equalise to a comparable standard of service delivery rather than attempting full equalisation to the 'same' standard.

Consistent with the longer term model, the Commonwealth would provide the additional financial assistance required to ensure that no State or Territory is worse off.

⁴ A variant of this reform would be for the Commonwealth to take responsibility from its own budget for all of the GST funding received by the Australian Capital Territory and Northern Territory, leaving the full GST pool available for distribution on an EPC basis among the six States.

These transitional measures would not be implemented alone but would complement other reforms detailed in the individual submissions of our four States.

Partial equalisation based on a smaller pool

‘Something considerably less than pursuit of absolute equality between jurisdictions can result in a fair outcome and produce confidence in Federal financing arrangements.’⁵

Prior to the introduction of the GST, relativities were applied to a substantially smaller pool of funding, the Financial Assistance Grants (FAGS) pool.

In 2000, the relativities began to be applied to a GST pool which was significantly larger than the FAGS pool.

This Review provides the opportunity to commence the long run transition to EPC by resizing the GST pool used for redistribution by distributing part of the pool EPC and applying relativities to the remainder.

As a starting point, the ‘FAGS component’ of the GST pool has been on average around 60 per cent of the total GST pool since 2000. This proportion of the pool could be subject to relativities (calculated using 100% of the pool) with the remaining 40 per cent returned on a population share basis.

The share that is distributed EPC can then increase to 60 per cent, with 40 per cent distributed using relativities.

The share that is distributed on an equal per capita basis can be progressively increased to achieve the long term goal of the whole pool being distributed equal per capita, with the Commonwealth contributing to the redistribution.

Partial Equalisation based on a ‘comparable’ level of services

An alternative transitional arrangement is to change the objective, with HFE directed to equalising fiscal capacity so that all States can deliver services of ‘a comparable standard’, rather than the ‘same’ standard.

An approach based on a comparable level of services would better place Australia to meet the economic and social challenges it is facing. This approach would promote a better balance of equalisation and efficiency considerations and encourage greater State responsibility and self-sufficiency.

In this regard our four States support the ‘definition’ of HFE published in recent Commonwealth Budget papers:

⁵GST Review First Interim Report, p. 22.

*HFE provides the necessary budget support so that all States have the capacity to provide services at a comparable standard, while ensuring that interstate transfers are not so large that they would significantly distort economic behaviour and reduce productivity growth.*⁶

This could be achieved by setting the standard for determining the redistribution of GST revenue across all assessments at the minimum levels of effort of jurisdictions in major expense categories and redistributing GST to meet that standard, rather than the average standard.

This standard would base the GST redistribution on minimum standards and minimum efforts, scaling down assessed expenses and revenues, thereby reducing the amount of GST redistributed. Revenues as well as expenses would need to be subject to the same discount to ensure the balance between the two is retained.

The assumption that underlies this approach is that all States currently provide a satisfactory level of services in all major services delivery areas.

It is important to note that a jurisdiction with the 'minimum' effort does not necessarily mean that that State has a lower standard of service outcome. It may mean that the State achieves the service standards of the other States more efficiently.

This would provide an incentive for efficiency, but still allow all jurisdictions to fund service provision consistent with acceptable levels.

Governance Issues

In its first interim report, the Panel noted that it 'sees merit in separating responsibility for determining the objectives of the GST distribution and the definition of HFE from the responsibility for interpreting and implementing HFE. It also 'sees merit in subjecting HFE outcomes to independent review from time to time'⁷.

Our four States support the Panel's view.

The limited role played by the States is a critical issue in the current HFE system. An increased role for the States, possibly through the Standing Council for Federal Financial Relations, would be consistent with an improved model of federalism in Australia.

The Commonwealth controls the relevant legislation, appoints the Commissioners, frames the terms of reference for CGC reviews and makes the final determination of the GST distribution.

States' input into the terms of reference for CGC inquiries is limited and controlled by the Commonwealth. The terms of reference do not provide adequate direction to the CGC on what they should do. Consultations with the CGC during the course of its methodology reviews are effectively restricted to data and methodological issues and, by

⁶Commonwealth Budget Paper No 3, 2012-13, page 123.

⁷First Interim Report, p. 132.

the time the Treasurer consults with the States on the recommended relativities, it is too late for meaningful change.

This marginalisation of effective State involvement in the system weakens State ‘ownership’ and support.

The lack of direction given to the CGC by governments has meant the CGC is the chief architect and de facto custodian of the HFE framework. It determines the definition of HFE (and the extent to which it is pursued), oversees the implementation of processes for the calculation of GST relativities based on principles and models of its own choosing, and makes decisions that materially affect equalisation outcomes, often with justification based on limited evidence.

Governments – especially State governments – should have the clear responsibility to determine the objectives and extent of HFE, to ensure that the system is actually meeting the objectives laid down for it and, where this is not the case, to determine what action is required.

More specifically, a strengthened governance system should be designed to:

- ensure greater and more effective input by State governments into the formulation of the objectives of the HFE system and its relationship to other aspects of the system of federal financial relations
- provide independent periodic reviews of CGC processes and models to assess whether the methodologies meet academic standards.

Protecting the GST base

Because GST-taxable items have fallen as a proportion of consumption and consumption has fallen as a proportion of gross domestic product (GDP), the ratio of GST to nominal GDP has been in decline. As a result, the GST pool is proving not to be the ‘growth tax’ it was originally envisaged it would be.

This has been exacerbated by erosion of the GST base in other ways.

- There have been a number of court cases in recent years which have undermined the GST base.
- The increase in online overseas purchases suggests that the \$1,000 Low Value Threshold for importation of goods free of GST should be reconsidered if a cost effective method for collecting the payments can be determined and the overall benefit to Australian consumers and businesses justifies it.

At the same time that the community and the Commonwealth are expecting more services to be delivered, a situation where States are having to share a stagnant or slowly growing pool of GST funding will make the reform task more difficult and the potential for equitable outcomes less certain. A failure to properly protect the GST base will exacerbate the situation. Any reform arising from the Review will have a better chance of success if the GST pool is robust.