Simpler and More Efficient GST Distribution

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Introduction

The Review panel has issued two interim reports outlining a number of issues and its view on some of them. It has called for comments and submissions. The panel is expected to release its final report by the end of the year.

I personally think this review should be an important opportunity to reform the GST distribution to reflect the contemporary Australia today and to be consistent with the many successful and far reaching reforms that Australia has had in other areas over the last three decades. Such an opportunity does not come very often and should not be wasted.

This submission, while addressing some of the main issues in both interim reports either directly or indirectly and the fundamental objective of the review, is focused on presenting practical ways forward for future GST distribution that will enable the achievement of the main objectives set in the terms of reference for the review. Any of the methods proposed here, if adopted, will represent a significant reform to GST distribution to make it simpler and more efficient while retaining its fairness.

By doing so, this paper suggests that providing no meaningful progress would not be a satisfactory outcome out of such a high level review, and should and must be avoided.

I am hopeful that the review will produce a measurable and lasting contribution to better GST distribution in the future.

Key considerations

The current GST distribution is an extreme in horizontal fiscal equalisation in the world as argued by some parties and Professor Garnaut. Many interested commentators have lamented its complexity and incomprehensiveness.

It is undoubtedly the most comprehensive including both revenue and expenditure assessments while in most other federations only revenue is assessed. Over the past three decades it has continuously expanded its scope and developed into a full equalisation to the maximum degree practically possible and includes many minor differences in the assessments which may often offset each other.

The system has become very complex and is difficult for people to understand. As a result, many people have lost faith in it, irrespective it still suits its purpose or not.

The process of GST distribution as practiced by the Commonwealth Grants Commission (CGC) has had a single and sole focus, that is fiscal equalisation and does not or has been unable to take into account other important national objectives. This is not satisfactory in contemporary Australia where the focus has increasingly been on incentive, efficiency and productivity to make it more competitive in a globalised world.

While I may not necessarily have the same view as many other interested parties have, I nevertheless recognise the importance of reforming the GST distribution to make it simpler and more efficient but still retaining its fairness.

It can be reformed to make it simpler and more efficient but still retaining fairness between the states by one of the following:

- Adopt a comparable rather than the same standard in fiscal equalisation.
- Focusing on either extreme differences in disabilities and capacities.
- A combination of them – a preferred approach by this author.

Focusing on significant differences between the states and territories

In his recent submission, Professor Garnaut has proposed to focus on some most important differences between the states and territories. He has listed the following large differences and proposed different ways to deal with or overcome them:

- Indigenous population – the high costs in providing services to Indigenous people who are significantly left behind many other Australian in many areas such as health and education.
    - ➢ The CGC past assessments have consistently shown that the costs to service Indigenous population are much greater.
    - ➢ There are significant advantages in explicitly distributing the funding for servicing Indigenous people to close the gaps with other Australians.
    - ➢ It will make any other assessments of costs of service provision much simpler and easier to understand.
- The large differences in population size between the states and territories – the impact on service costs of economies of scale due to minimum administrative requirement.
    - ➢ The population in the states and territories varies between less than a little over a fifth of a million in the Northern Territory to near several millions in New South Wales.
    - ➢ Irrespective its population size, each state or territory has to have the minimum administration to be functional as a state level government.
    - ➢ To provide these minimum fixed costs goes a long way to equalise fiscal capacities between the states and territories.
- Mining revenue – mineral resources distribution between the states and territories is very uneven.
    - ➢ There are very large mineral deposits in Western Australia but there is none in the ACT.
    - ➢ Mineral royalties are now a very significant source of state own revenue.
    - ➢ But minerals are non-renewable and the royalties on mineral production represents a loss of non-replaceable assets. There are arguments for and international practice (Canada is said to only include 50 per cent of mining

revenue in its fiscal equalisation) of a partial assessment/inclusion of mining royalties in state and territory fiscal capacities.

- The ACT anomaly – its revenue raising capacity is limited by the current state own revenue sources and the existing governmental arrangement, even though it has a high per capita income:
    - it does not have the power to collect payroll tax (and also some land tax) from the Commonwealth.
    - the Commonwealth is a very large employer with a total payroll representing a large part of the ACT economy.

I personally would add the following significant factors to Garnaut's list:

- Differences in income levels – the impact on the total revenue capacities due to lower income in states such as Tasmania and South Australia.
- Remote population – the significantly higher costs in servicing people living in remote and very remote areas. The relatively small population in remote and particularly very remote areas further compounds the higher costs in transportation.
- Government schools – the state and territory governments are obliged to provide and fund public schools but there are the large difference in the proportion of children attending public schools between the states and territories.

The CGC has included many other factors in its assessments, but all other differences between the states are relatively small in comparison with the above listed ones.

Focusing on these significant differences and providing each government the capacity to overcome them will achieve fiscal equalisation to a comparable standard with a much simpler formula.

The following presents such an approach. It should have three components.

1. An Indigenous component similar to Garnaut's idea but being dealt with within the GST distribution as opposed to moving it to the Commonwealth.
    a) Set aside either a small proportion or a fixed amount of the GST revenue.
    b) Distribute it by the number of Indigenous population in each state or territory.
    c) Adjusted for remoteness only if there is no separate assessment for remoteness.
2. An equal amount for each and every state to account for the minimum administration needs, similar to Garnaut's proposal but let the CGC to determine the appropriate amount.
3. And a simplified equalisation component

a) only assessing payroll and part of mining revenue from the revenue side with much simpler methods, to be supplemented with another assessment based on average income such as GSP, and

b) possibly assessing remoteness and school education in the expenditure side where only the relevant population numbers but no other complex factors are included.

The first two components can address a significant degree of differences in the costs of providing services between the states. Separating them out can make the rest assessments more easily be simplified.

The last component further enhances the fairness of such a simplified GST distribution.

A discount approach to achieve comparable standard

There have been debates on what a change to the HFE definition from the same to a comparable standard means and whether doing that can achieve anything meaningfully different or not. This is also manifested by the following confusion seen in this review

- the review panel seems being attracted to a comparable standard, but
- the CGC appears to be saying that its current assessments are only to a comparable not the same standard.

What that indicates is that the same definition means differently to different people. This kind of ambiguous and tautological debate has been going on for a long time without a meaningful progress. It should be avoided from preventing a progress again in this review.

One way to overcome that kind of ambiguity in the interpretation of the same definition is to define a comparable standard by explicitly referring to a clear benchmark, say, 50, 70, 80, 90 or 95 per cent of the standard the CGC has normally used in the past.

I have previously outlined the discount approach. To explicitly set a comparable standard in this way is equivalent to discount the assessments or the relativities the CGC has calculated in its traditional approach. As a result, a discount approach can be an operational application of a comparable standard.

Such an approach would be able to achieve other objectives which are set in the terms of reference of the review, such as fairness, efficiency, stability and predictability, with simplification as the only exception.

While this approach itself does not necessarily mean any simplification, a mechanism could be introduced that will guarantee simplification is achieved and maintained. For example, one mechanism is limiting the capacity to carry out complex assessments by the CGC. If it does not have the capacity to do complex assessments, it has to do simpler ones.

A preferred approach

While the above two approaches have their merits, the combination of them may add further advantages. For example, all the factors included in the first option may be discounted to a degree. For example, the following may be illustrative benchmarks:

- Mining revenue be discounted to 50 per cent to be similar to the Canadian assessment of mining revenue in its fiscal equalisation.
- All others be discounted to 90 per cent.

A new governance arrangement

The past experience in GST distribution and HFE shows that the current arrangement, though having significant merits, has also significant shortcomings, such as

- sits narrow focus on equalisation with no or little regard to other national objective
- its inability to reform to be consistent with other contemporary aspects of Australia
- the lack of a clear accountability for measuring the outcomes of the CGC assessments.

This indicates that a better governing structure or approach should be in place to ensure that the GST distribution will not be done single-minded only for HFE, but will also be capable to account for and achieve other important national goals.

An alternative could be to move the determination of important principles in HFE (that are reflected in some of the parameters such as the discount factors and/or the scope of equalisation in this submission) to a joint body by the commonwealth and state governments and relieve the CGC from its current difficulty and agony in balancing HFE and other national objectives.

The Minco for federal financial relations could be such a body. There should be an effective and efficient voting mechanism to form resolutions to relevant issues. For example, a combination of the senate (each state and territory has the same weight) and the representative (a state's weight is represented by its population) systems will provide a working mechanism. The two parts should be given an equal weight. The Commonwealth will have the casting vote if the vote is a tie although the late is unlikely to occur.

Mineral taxes

I have previously argued for a unified mineral rent tax based on mining profit to replace the current state mining royalties and the narrowly based and incomplete MRRT, and leaving the revenue to the states and territories.

Such an arrangement would retain the merits of a rent type tax on minerals and at the same time would also reduce the current vertical fiscal imbalance in the federation. It would need agreement between the commonwealth and all state and territory governments, that is to say, a new intergovernmental financial arrangement.

However, the mineral tax issue, while an important national and economic issue, should not distract the main objective of the review.