The Institute of Chartered Accountants in Australia

18 October 2011

Mr Paul McCullough
Secretary
GST Distribution Review
The Treasury
Langton Crescent
Parkes ACT 2600

By email: gstdistributionreview@treasury.gov.au

Dear Paul

Submission in response to GST Distribution Review Issues Paper

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to put forward this submission to the GST Distribution Review Panel (the Panel) in response to the July 2011 Issues Paper.

This submission identifies a number of high-level issues which, in the opinion of the Institute, are critically important to the Panel's capacity to achieve the overarching objectives of the GST Distribution Review (the Review).

Many of the primary issues raised in the context of this Review could be overcome through an examination of the broader policy surrounding the existing GST regime, rather than merely re-calibrating the approach to distribution of GST base revenues. The Institute believes that the carrying-out of this review should serve as a precursor to a broader review of the existing GST base and rate.

There can be no question that a broad examination of the existing GST policy will need to be an integral component of the development of a long-term tax reform agenda for Australia's future. While there would undoubtedly be some significant challenges in moving to a broader GST base or rate in the future, the task of realising important reforms in this area will be more achievable if the case for change begins to be made now.

Background

As part of the introduction of the GST in July 2000, federal, state and territory governments entered into an Intergovernmental Agreement[1] (the Agreement) under which it was established that the GST revenue would be distributed among the States and Territories (the states) in accordance with the principles of horizontal fiscal equalisation (HFE).

GPO Box 9985
in your capital city

Customer Service Centre
1300 137 322

NSW
33 Erskine Street
Sydney NSW 2000
Phone 61 2 9290 1344
Fax 61 2 9262 1512

ACT
L10, 60 Marcus Clarke Street
Canberra ACT 2601
Phone 61 2 6122 6100
Fax 61 2 6122 6122

Qld
L32, 345 Queen Street
Brisbane Qld 4000
Phone 61 7 3233 6500
Fax 61 7 3233 6555

SA / NT
L11, 1 King William Street
Adelaide SA 5000
Phone 61 8 8113 5500
Fax 61 8 8231 1982

Vic / Tas
L3, 600 Bourke Street
Melbourne Vic 3000
Phone 61 3 9641 7400
Fax 61 3 9670 3143

WA
Ground, 28 The Esplanade
Perth WA 6000
Phone 61 8 9420 0400
Fax 61 8 9321 5141

[1] The *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, June 1999

Under the Agreement, the states also agreed to abolish a range of inefficient indirect taxes that were widely regarded as impeding economic activity. The specific taxes identified included: quoted marketable securities duty; bed taxes; debits tax; as well as a range of other indirect taxes that would be abolished once GST revenues were regarded as providing enough fiscal room to do so. A variety of stamp duties – which notably excluded residential property conveyance duty – were to be reviewed for removal in accordance with the terms of the Agreement.

In 2006, the federal government reached agreement with the states on the abolition of the second tranche of taxes, resulting in an agreed timetable for abolition of all but one of the taxes previously identified. To date, conveyance of non-residential real property has not yet been scheduled for abolition.

According to Federal Budget papers,[2] "GST revenues have proved to be a robust source of state revenue that has been growing over time. Furthermore, every State now receives more revenue under current federal financing arrangements than it would have if the previous arrangements had continued." However, as Treasury has observed, despite the states "receiving substantial revenue gains from the Australian Government's reforms", some of the state taxes that were to have been abolished already will not actually be abolished until as late as 2012-13.

The Issues paper identifies that the underlying aim of the GST distribution process – equalising the fiscal capacity of the states – and the way it is done, have given rise to contentious debates between the federal government and the states, and many cases, amongst states.[3] The combined effects of the current mining boom and the global financial crisis have contributed in different ways to substantial changes in the actual distribution of GST revenues amongst states. On average, we understand that 8 per cent of GST revenues is redistributed away from a 'per capita' outcome over the course of the past decade. States receiving more than an equal per capita GST share ('recipient' states) are South Australia, Tasmania, the Australian Capital Territory and the Northern Territory, while the states receiving less than equal per capita GST shares ('donor' states) are currently New South Wales, Victoria, Queensland and Western Australia.

In this Review, the Panel has been asked to consider whether the current form of HFE used to determine the distribution of the GST amongst the states will appropriately position Australia to respond to the significant structural changes currently taking place across the economy and to maintain public confidence in the financial relationships within the Australian Federation. The Panel is required to have regard to the principles of efficiency, equity, simplicity, and predictability/stability in its analysis of the key issues relevant to the review of GST revenue distribution.

Key comments

The Institute's views set out below relate to the objectives of ensuring that Australia's federal taxation system is appropriately positioned to respond to the significant structural changes and associated economic, social and environmental challenges that lie ahead over the coming decades.

General comments – GST and the tax mix

In September 2011, the Institute released an updated tax policy paper entitled *'Tax reform: laying the foundations'*, which was prepared in conjunction with KPMG. In that paper, the Institute outlined its position in respect of the future design and implementation of a more sophisticated tax system that addresses some of the fundamental imbalances that exist within the existing tax system. The paper also makes some important points about the long-term journey that typifies the implementation of major tax reform in Australia.

---

[2] Australian Government, Budget Paper No.3, Overview of Federal Financial Relations, Budget 2007-08. See http://www.budget.gov.au/2007-08/bp3/html/bp3_main-02.htm (last viewed on 14 October 2011)
[3] Australian Government, The Treasury, *GST Distribution Review Issues Paper July 2011*, at pp. 1-3

In the paper, the Institute stated that the need for Australia to achieve revenue adequacy in the longer-term may prove difficult to achieve unless the existing tax mix is rebalanced towards a greater degree of reliance on consumption taxes.

Australia's ageing population will lead to a decline in workforce participation rates over the coming decades, and as a consequence, there will be significant pressures on the capacity of the income tax system to generate the revenues required to fund future government activities. The Institute believes that Australia's primary consumption tax base, the existing GST system, will need to do more 'heavy lifting' as part of the design of the nation's future tax system.

Keeping open the option of broadening the existing GST system is likely to have the benefit of generating additional revenues and reducing complexity for taxpayers in the longer-term. These results can be achieved through simultaneous changes in other policy areas that maintain appropriate equity outcomes for those in the community who need support.

Specific issues

1. GST revenues

As noted previously, GST revenues have proved to be a strong and growing source of state revenue over time. However, as Australia's budgeted government revenues from income taxes decline into the future, the importance of making greater use of the GST system as a central taxing base becomes more pronounced. The GST is likely to be able to better respond to the expenditure demands that will be placed on the federal budget in the future.

The existing challenges around the distribution of GST revenues are also likely to be exacerbated in coming years as the share of revenues allocated to the states become smaller, relative to their total revenue needs [which will continue to grow at exponential rates].

The Institute considers that many of the GST distribution issues outlined in the Issues Paper could be, and in fact will need to be, overcome by reviewing the overall quantum of GST revenue collected which is then available to be shared between the states. In our view, the size of the 'GST pie' is the fundamental constraint that lies at the heart of current concerns about the distribution of revenues amongst the states.

In the Issues Paper, it is recognised that fiscal equalisation represents the 'glue that holds the federation together'; adequate revenues are transferred to states to ensure that all states have an equal capacity to provide their residents with the same uniform standard of services. In order to realise such outcomes, the overall GST revenues collected must be sufficient to allow each of the states to receive an appropriate allocation to meet the shortfall between own-source revenues and total expenditure commitments.

On this basis, the Institute believes that a compelling case is now beginning to build around the need for a holistic review into the existing GST base and rate. The Review Panel should therefore consider making recommendations to the government, at the conclusion of the distribution review, about the importance of a broad-sweeping analysis of the existing GST base and rate. Recommendations along this line would be entirely consistent with the themes espoused in the *Future Tax System Review* (the AFTS Report), which as we know, was barred from making specific recommendations about the existing base or rate of GST as part of their work.

Our high-level comments and observations in relation to the existing GST base and rate are set out in the sub-sections below.

Broadening the GST base

According to the AFTS Report, a tax system which will be capable of supporting Australia in making the most of the opportunities and meeting the challenges of the 21st century will need to raise revenue from efficient and sustainable tax bases. It is widely regarded amongst leading economists and tax policy experts that private consumption represents one of the most efficient and sustainable tax bases available.

The AFTS Report further states the Australia's GST base is relatively 'narrow', when compared to a potential broader base. Data indicates that the existing GST base in Australia covers only 57 per cent of final private consumption, which in contrast to the much broader-based New Zealand GST system, accounts for a modest fraction of possible private final consumption that could be subject to tax.

As a result of the trade-offs negotiated in 1999 to secure parliamentary support for introduction of the GST regime, a number of base-limiting measures were adopted in key areas such as food, education, and healthcare. It is thought that these exclusions amount to potential foregone GST revenues of an estimated $11.45 billion per annum.[4]

Increasing the GST rate

Australia's GST rate is low by international standards. The unweighted OECD average value added tax (VAT) rate was 18 per cent in 2010.[5] Much of Europe has VAT rates that exceed 20 per cent; Ireland has a 21 per cent VAT, Poland 22 per cent, and Sweden, Norway, Iceland, Denmark and Hungary each have VAT rates of 25 per cent.

GST is generally viewed as a regressive tax from an economic perspective, while income tax is seen as capable of being more progressive. Therefore, increasing the rate of GST and reducing income tax rates, coupled with appropriate compensatory measures for low income households, could lead to additional revenues being generated to fund future government expenditure commitments.

The AFTS Report sought out to make recommendations that achieve the goals of making Australia's corporate income tax system more competitive, promoting higher labour participation rates, simplifying the compliance obligations under the tax system, and reducing undesirable economic distortions.

By way of a text-book case study example in achieving GST and broader tax reform, the New Zealand government has recently raised its GST rate from 12.5 per cent to 15 per cent from October 2010, while simultaneously lowering its corporate income tax rate from 30 per cent to 28 per cent, and reducing its top marginal income rate for individuals from 38 per cent to 33 per cent.

2. Reform of inefficient state taxes

Consistent with the 1999 Intergovernmental Agreement, the Institute urges the federal government to work with the states to fulfil their undertakings to abolish the final agreed state tax, non-residential real property conveyance duty. It is disappointing that to date not one state has met its commitment to abolish this duty, or has even specified a timetable for achieving such an outcome.

Recent commitments by the Queensland and New South Wales Governments at the October 2011 Tax Forum to examine state tax harmonisation opportunities should serve as the basis for adoption of a reform pathway which leads to the abolition of inefficient state taxes such as stamp duty on residential property, as well as insurance taxes and fire services levies.

---

[4] Australian Government, The Treasury, *Tax Expenditures Statement 2010-11*, at p. 7
[5] OECD, *Rates of value added tax (general sales tax)* (Table IV.1 - updated with 2011 data) in effect in OECD countries. See http://www.oecd.org/document/60/0,3746,en_2649_34533_1942460_1_1_1_1,00.html#vat

Progressing reform in these areas will undoubtedly lead to a need to examine the adequacy of revenues collected at state government level, which in turn leads again to a discussion about the existing base and rate of the GST regime, as well as other potential options such as the sharing of the income tax base or the re-assignment of expenditure responsibilities as between the commonwealth and state governments.

Conclusion

The Institute encourages the government and Treasury to regard this Review of the GST distribution as a precursor to a broader review of the GST, as an integral part of shaping Australia's future tax reform agenda. Commencing a dialogue with the states to demonstrate the benefits of making the GST system work harder will be critical to achieving first-level consensus amongst governments, prior to then taking the case to the community at-large.

A shift in the tax mix from income tax to GST will be unavoidable over the coming decade. It will encourage higher labour participation rates through a lowering of the income tax rates, and reductions in economic distortions.

If you have any questions regarding this submission please do not hesitate to contact Ms Donna Bagnall on 02 9290 5761 in the first instance.

Yours sincerely

Yasser El-Ansary
Tax Counsel
The Institute of Chartered Accountants in Australia