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GST Distribution Review
The Treasury
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Dear *Nick, John & Bruce*

Victoria supports the Review as an opportunity to modernise the GST distribution system. A simpler, fairer, more efficient and transparent system of distribution will strengthen the Federation and benefit all Australians.

Since its introduction, the GST has always been distributed as a general revenue grant that does not compromise State policy autonomy. This revenue stream was introduced to replace those inefficient State taxes foregone under the original GST agreement. Victoria opposes any move to tie GST revenue to particular purposes, as suggested in the supplementary terms of reference.

The supplementary terms of reference are also inconsistent with the original terms of reference, which focus on ensuring the Horizontal Fiscal Equalisation methodology appropriately removes barriers and disincentives for reform. In contrast, the supplementary terms of reference introduce the prospect of the Commonwealth unduly influencing State revenue policy through the threat of withholding GST payments.

Further, the supplementary terms of reference distort the focus of the Review by targeting the revenue side of the GST assessment. While Victoria agrees that efficiency should be a key objective of the Review, both the expenditure and the revenue sides of the GST equation should be examined for efficiency gains, especially given that more redistribution occurs due to variations in the cost of service delivery than revenue raising potential.

Finally, the supplementary clauses suggest the Commonwealth is unwilling to engage in cooperative discussion on tax reform. In stating that it 'will not pay' for State tax reform, the

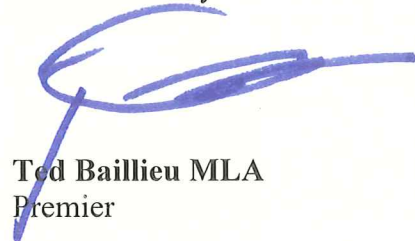


Commonwealth has overlooked the reality of Australia's vertical fiscal imbalance. This is despite the acknowledgment of the Commonwealth's own *Australia's Future Tax System Review* of the necessity of Commonwealth cooperation to reform the broader tax system, including inefficient State taxes.

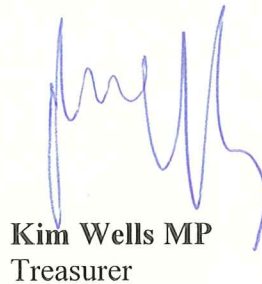
Victoria is concerned that the supplementary terms of reference unfortunately politicise the important work of this Review.

However, Victoria looks forward to the Interim Report on the original terms of reference and a further opportunity to contribute to the Review of GST Distribution.

Yours sincerely



Ted Baillieu MLA
Premier



Kim Wells MP
Treasurer

MARCH 2012

GST DISTRIBUTION REVIEW

VICTORIAN
SUPPLEMENTARY
SUBMISSION



Authorised by the Victorian Government
1 Treasury Place, Melbourne, 3002

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1. INTRODUCTION

The Victorian Government supports the GST Distribution Review (the Review). The original Terms of Reference (ToR) provide the opportunity to reform the GST distribution system to one that is simple, transparent and efficient, leading to a boost in productivity for States and the nation more broadly.

Victoria considers that the best outcome to work towards is one where the GST is distributed on an equal per capita (EPC) basis, with specific policy challenges dealt with separately in a transparent and accountable manner.¹ EPC is the most simple, transparent, stable, and efficient way of distributing the GST. New South Wales also acknowledged the benefits of EPC in its submission to the Review. Significant policy challenges should be treated separately from the GST distribution, through targeted Commonwealth-State agreements.

Victoria recognises that transition to an EPC system would take time. A number of interim options are included in Victoria's first submission to the Review.

Victoria strongly opposes any proposal to use the GST distribution to influence State policy, as is suggested by the supplementary ToR. Converting any part of the GST to a form of tied revenue would impinge on States' autonomy, reducing their capacity to undertake reforms, plan future investment and respond to changing conditions and local priorities. It would also contradict the goal of policy neutrality that underpins the Commonwealth Grants Commission's (CGC) equalisation supporting principles. A move towards EPC (rather than introducing more arbitrary changes to the GST distribution) is the best way to secure efficiency.

This submission sets out Victoria's arguments in relation to the supplementary ToR, which are largely redundant, inconsistent with the original ToR² and distract from the more important considerations set out in the original ToR. For example, introducing explicit incentives to promote State tax reforms undermines policy neutrality and ignores issues relating to expense-related assessments.

The Victorian Government remains willing to work cooperatively with the Commonwealth and other governments on genuine national tax reform. It is unfortunate that the supplementary ToR indicate the Commonwealth has little or no interest in such reform. The Commonwealth is well aware that any major State tax reform requires the support of both levels of Government, given the extreme vertical fiscal imbalance in Australia.

1 Foreword to the Victorian Submission to the GST Distribution Review, October 2011.

2 Section 6c of the original ToR states that "as per the current arrangements, all the GST revenue will be distributed to the States as "untied" payments". This is contradicted by Section 6A of the supplementary ToR, which contemplate using HFE to provide incentives or disincentives for future State policy decisions.

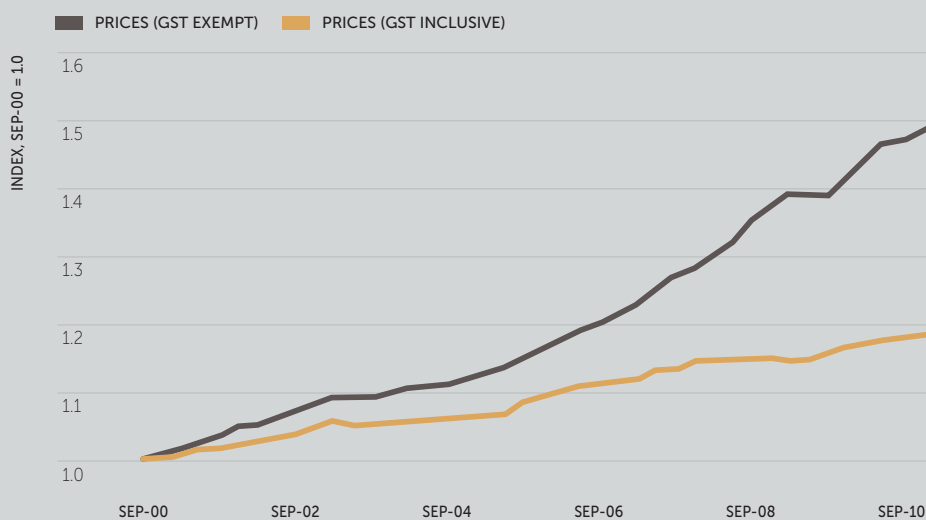
2. MAINTAINING AN UNTIED GST DISTRIBUTION SYSTEM

Victoria strongly opposes any proposal to tie GST revenues. In 1999, the States agreed to abolish a number of inefficient stamp duties under a national reform arrangement in return for receiving GST revenues on an untied basis. This is embodied in the GST Act³ and the 1999 and 2008 intergovernmental agreements on federal financial relations.⁴ Any proposal to tie GST revenues would overturn these commitments and almost 80 years of the CGC determining the allocation of **general-purpose payments** to the States. Further, it would undermine a longstanding principle of the Federation, whereby the Commonwealth provides untied grants to the States in recognition of Australia's significant vertical fiscal imbalance.

The supplementary ToR are inconsistent with the original ToR and risk undermining the untied, policy neutral nature of the GST distribution system by seeking to introduce targeted incentives and institutional arrangements. It could lead to suggestions that GST revenue be explicitly or implicitly tied to achieve certain objectives or outcomes, such as the Commonwealth using it to provide 'reward funding' or to penalise States for failing to undertake reforms it deems efficient. The Commonwealth seeks to define what is efficient and inefficient taxation. Such an encroachment on State policy autonomy is inappropriate, especially as the Commonwealth has significant inefficiencies in its own tax bases, and may not always be an unbiased arbiter of efficiency.

Any tying of the GST would occur while the growth in the GST pool has been fairly modest and below that of total household consumption. In large part, this is due to the exemptions to the GST accepted by the Commonwealth.⁵ Chart 1 shows that the long-term trend rate of growth in the price of GST-exempt consumption is roughly twice that of GST-able consumption.

Chart 1 - Price growth in GST and non-GST consumption



Source: Australian Bureau of Statistics and Victorian Department of Treasury and Finance calculations.

3 A New Tax System (Commonwealth-State Financial Arrangements) Act 1999 (s 7) "The Commonwealth will make GST revenue grants to the States and Territories equivalent to the revenue from the GST subject to the arrangements in this Agreement. GST revenue grants will be freely available for use by the States and Territories for any purpose."

4 1999 – Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations. 2008 – Intergovernmental Agreement on Federal Financial Relations.

5 GST exemptions include basic food, health, education, exports, registered child care centres, religious services and charitable institutions.

Tying GST revenue would also impinge on States' autonomy and reduce Victoria's capacity to undertake reforms, plan future investment and respond to changes in local conditions and priorities. Untied funding enables States to deliver vital services in a way that reflects the needs and priorities of the people who use them.

Introducing explicit incentives in certain aspects of the Horizontal Fiscal Equalisation (HFE) system would contradict the goal of policy neutrality and change the objective of HFE from equal fiscal capacity to equal fiscal policies. It would also constrain States' ability to independently determine their tax and royalty policy settings. The principle of subsidiarity suggests that States are best placed to determine their own policy settings.⁶

Moving towards an EPC distribution over time would avoid such issues and maximise the efficiency of the GST distribution.

3. REMOVING BARRIERS TO REFORM

Achieving a more efficient HFE system matters for Australia's material wellbeing. In everyday terms, it means higher employment and income and faster growth. As applied to the government sector, it results in better government services and lower taxes. Additionally, increasing the efficiency of State governments and their economies enhances their fiscal capacity, and reduces the need to redistribute funds. In other words, encouraging efficiency is not inconsistent with the equity goals of HFE, but rather enables them to be achieved with less need for redistribution.

While Victoria opposes the Commonwealth being able to tie GST revenue as it sees fit, it considers that there are opportunities to reduce existing more general disincentives for State policy reforms. These matters are covered extensively in Victoria's first submission. Such steps will improve the efficiency of the HFE system.

Changes must remove barriers to ensure real efficiency improvements occur, rather than arbitrarily introducing incentives and disincentives that risk creating distortions and further perverse outcomes.

States need to retain the benefits of reform when they make hard decisions, rather than reacting to potentially arbitrary Commonwealth Government policy objectives. This ensures that the benefits of competitive federalism are realised through innovation and that State reforms are tailored to suit local preferences.

4. IMPROVING BOTH REVENUE AND EXPENDITURE EFFICIENCY

The Commonwealth Government's supplementary ToR primarily focus on potential changes to State taxes, just one element of State policy. While Victoria endorses the importance of tax reform, the GST distribution formula relates to and influences all major State government revenue **and expenditure** decisions. Indeed, the CGC is required to take into consideration all items of revenue and expenditure, to deliver on its objective of equalising fiscal capacity.

Reform of the GST distribution arrangements to increase economic efficiency must consider expenditure issues. For example, Victoria's first submission highlighted that the current system creates few incentives for States to address:

- > service delivery costs due to the current system's focus on average rather than efficient or minimum service costs and standards; and
- > the efficiency of service delivery by reducing relative disadvantage, because the system provides full compensation to average service standards for recipient States and treats high service costs as 'beyond a State's control', even though these costs could be reduced through technology and better policy.

6 Functions should be undertaken by the lowest level of government practically possible.

Table 1 shows that overall more funds are redistributed through expense related assessments than revenue raising assessments.

Table 1 – Difference from an equal per capita distribution of the 2012-13 GST by source

2012–13 (\$million)	Total Redistribution (\$million)
Expense requirements	5,682.5
Investment	695.9
Net lending	231.0
Revenue raising capacity	5,548.9
Commonwealth payments	1,026.5

Source: Commonwealth Grants Commission 2012 Update Report. The redistribution is the total movement from the equal per capita distribution.

As a result, **Victoria argues that significant opportunities for improving the efficiency of the HFE system also exist on the expenditure side of the assessment.** This is supported by the New South Wales Government submission on reforming the schools assessment:

“..the current system of fiscal equalisation can give rise to disincentives to the adoption of efficiency enhancing innovations.”⁷

5. MOVING TOWARDS AN EQUAL PER CAPITA DISTRIBUTION

Victoria’s first submission argued for a move towards an EPC distribution because it would remove barriers to reform and aid transparency. An EPC model, combined with separate arrangements for Commonwealth funding of significant national policy challenges, avoids creating perverse incentives and rewarding inaction.

A number of submissions to the Review supported the Victorian view. For example, the New South Wales Government proposed the total GST pool be distributed to the States on an EPC basis as the base distribution, with any equalising distribution to recipient states being based on a separate pool funded by the Commonwealth. The benefits of the EPC option on simplicity grounds were also noted by the Federal Treasury.

Transitioning to EPC will take time. An appropriate strategy could include:

- > **Short-term:** Undertake methodological reforms and simplification measures such as adopting appropriate global indicators across all assessment categories, assessing to minimum rather than average needs, and distributing on absolute as opposed to relative need.
- > **Medium term:** Fix the proportion of the GST pool to be redistributed. This could be fixed to the average percentage of the pool redistributed in the previous five years and reduced over time. The remainder could be distributed on an EPC basis. States will have greater certainty and Tasmania and the Northern Territory are unlikely to face significant fiscal shocks in the short to medium term.
- > **Long-term:** Distribute GST fully on an EPC basis. The Commonwealth could provide special grants for nationally significant policy challenges.

⁷ New South Wales Government Submission to GST Distribution Review, November 2011, Pg 29.

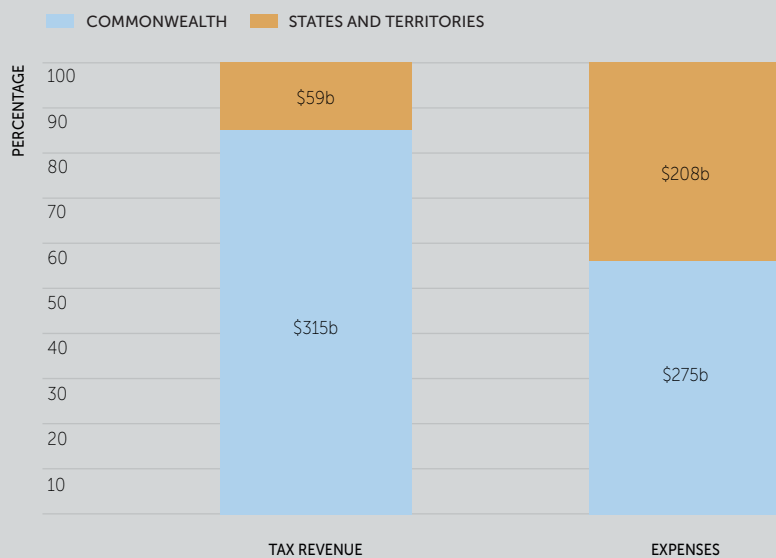
6. TAX REFORM REQUIRES COMMONWEALTH AND STATE GOVERNMENT COOPERATION

Tax reform is critical in building a competitive business environment.

There is a pressing need for the States and the Commonwealth to align revenue raising abilities with current respective expenditure and service delivery responsibilities. There is currently a vast mismatch in Australia between the revenue capacity and expenditure responsibilities of the Commonwealth and State Governments. Chart 2 shows that the Commonwealth collects over 80 per cent of tax revenue in Australia (including GST).⁸ It also has access to the largest, broadest, and fastest-growing taxes. In contrast, it is only responsible for just over half of Australia's total government expenditure.

It is important to note that the Commonwealth also has the opportunity to reform inefficiencies in its tax system. For example, the interaction between personal income tax and the welfare system influences individuals' employment decisions, including hours of work. This subsequently limits the opportunity for productivity improvements and economic growth more broadly.

Chart 2 – Commonwealth and State Government tax revenue and expenditure responsibilities 2011-12



Source: Commonwealth 2011-12 Mid-Year Economic & Fiscal Outlook. State and Territory 2011-12 Budget Papers and Budget Updates.

The last major national tax reform, the GST, involved the Commonwealth and State Governments working together. This reform contributed to national economic growth and achieved a more efficient national tax system. In addition, increased economic activity from the GST reforms has led to increases in Commonwealth tax revenues such as personal income tax and company tax, which apply to a large cross-section of the population and are linked to economic growth. This is likely to occur again if significant national tax reform is undertaken.

Victoria remains willing to work with the Commonwealth to eradicate inefficient State taxes. However, the supplementary ToR make it clear that the Commonwealth will not at present consider a genuine cooperative effort on tax reform. The statement that 'State tax reform will not be financed by the Australian Government'⁹ is not an accepted principle of public finance.

Converting the GST to a tied revenue source would not only undermine the Federation, but also limit the chance of States cooperating with the Commonwealth on future national tax reforms.

8 If the GST is excluded, the Commonwealth collects over 70 per cent of tax revenue in Australia.

9 GST Distribution Review Terms of Reference, 6B(c). [Added to the original ToR on 17 November 2011.]

7. CONCLUSION

Improving the efficiency of the HFE system matters for Australia's material wellbeing. Arbitrarily imposed incentives and disincentives within a section of the HFE system, as proposed by the supplementary ToR, risk creating further perverse outcomes, reducing policy neutrality and undermining States' ability to deliver the services that their citizens need. It is far more appropriate to consider opportunities to improve the efficiency of the HFE system overall, and to continue to focus on both revenue and expenditure issues in the short to medium term.

As outlined in Victoria's first submission, there is a strong case for moving towards an EPC distribution. Coupled with significant policy challenges being separately addressed by the Commonwealth, an EPC model is policy neutral and does not reward inaction by States to reduce their costs or increase their ability to raise revenue.

Victoria looks forward to working with the other States and the Commonwealth to improve the GST distribution system and to identify the next wave of national tax reforms.

Accessibility

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