

GST: THE WAY AHEAD

A New South Wales Government Proposal

The Australian Government raises \$37 billion per year from the Goods and Services Tax (GST) and transfers this revenue to the states in an attempt to achieve 100 percent equality in the capacity of state governments to provide services.

This revenue equals 13 percent of all taxation revenue in Australia and compares with 15 percent for company tax and 36 percent for individual's income tax. How this revenue is distributed matters.

As a tax-transfer system it is overly complex, non-transparent and inefficient. The Commonwealth Grants Commission (CGC) has itself expressed the view that "... there are grounds for considering whether equalisation is being asked to do too much." (CGC 2004 Review, Report on State Revenue Sharing Relativities, page 84).

The HFE system strives to achieve full equalisation without regard to the efficiency costs and is designed to flatten as much as possible the differences between the States.

The Australian income tax and welfare system moderates income distribution, but it does not attempt to achieve full equalisation. The progressive nature of the income tax system means that those with higher incomes contribute more, but they retain at least some of their extra income.

At the recent meeting of the Council of Australian Governments, the Prime Minister and Leaders of the States and Territories noted that; "Our future prosperity will depend on the ability of all governments – Commonwealth, State, Territory and Local – to embrace reform that addresses the key areas of participation and productivity Australia's productivity performance is under threat, with further reform essential if the economic expansion of the last 14 years is to continue." (COAG Communiqué 3 June 2005.)

Striking a balance between equity and efficiency has become the accepted hallmark of tax-transfer systems all over the world. It is time for that balance to be struck in the way GST revenues are distributed.

The adoption of full equalisation in the distribution of Commonwealth general purpose grants is relatively recent. Prior to the early 1980s, the objective was to provide the few claimant States with the capacity to deliver services that were "not appreciably below" the average – rather than the current objective of "to provide services at the same standard".

Wherever the balance between equity and efficiency is struck, a key requirement of a tax-transfer system is transparency. State Governments, like individual taxpayers, need to understand what are their obligations, what are their entitlements and to have an ability to plan their futures with some confidence in the stability of the tax-transfer system that applies to them. The pursuit of complete equalisation has led to a system with 359 separate expense factor assessments and 37 revenue component assessments. Such complexity undermines the accountability and confidence in the integrity of the system.

In the spirit of the recent COAG meeting, NSW proposes a significant reform of the current GST distribution system with the following characteristics;

- Recognition of the need for cross subsidies to be paid to South Australia, Tasmania and the Northern Territory so they have the capacity to provide State Government Services at a standard not appreciably below the average of the other States and Territories;
- For the measurement of their grant share to be based on the economic and social functions that are shared by all States and Territories;
- Lock in the new relativities for these jurisdictions for a fixed number of years and abolish the Commonwealth Grants Commission;
- Once the shares for South Australia, Tasmania and the Northern Territory are determined, the remaining GST revenue to be shared between the other States and the ACT on an equal per capital basis.

Based on the existing grant shares for South Australia, Tasmania and the Northern Territory, GST revenue for 2005-06 distributed on this basis would result in the following grants and cross subsidies -

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
GST Generated, \$b	13.2	9.6	6.7	3.4	2.6	0.8	0.7	0.3
Grants, \$b	11.4	8.5	6.7	3.4	3.4	1.5	0.6	1.8
Cross Subsidy, \$b	(1.8)	(1.1)	0	0	0.8	0.7	(0.1)	1.5

In effect, in 2005-06 Queensland and Western Australia would receive GST grants equal to the GST generated in their state, South Australia, Tasmania and the Northern Territory would receive the same grants as they do currently, being subsidised by people from New South Wales and Victoria.

- Reinstate competition payments from the Commonwealth, distributed on the basis of evidence-based productivity growth, to be determined by the Productivity Commission.

GST REVENUE SHARING ARRANGEMENTS

Current Economic and Fiscal Positions

Queensland and Western Australia are currently both experiencing very strong economic conditions due to the resources boom. Qld is estimating GSP growth of 4.25 percent in 2004-05 and forecasting growth of 4.25 percent in 2005-06. WA is estimating 4.5 percent growth in its GSP in 2004-05 and forecasting 4.25 percent growth in 2005-06. These growth figures are significantly better than the national average estimate of 2 percent growth in GDP in 2004-05, rising to a 3 percent growth forecast in 2005-06.

Qld's budgetary position is very strong relative to the other states. Queensland's Treasurer said, "We've got the strongest economy in Australia. We all know what Peter Costello said after his Budget; he wished he had our balance sheet. Boy, he'd love it today." (AFR, 8 June 2005, page 8)

Qld's 2004-05 operating surplus of \$2.7 billion (\$2 billion in underlying terms) was the highest of all the states and the 2005-06 forecast of \$934 m is also the highest of all the states.

Queensland's 2005-06 Budget recorded the economic benefits that are flowing from the resources boom. Royalties grew by 40 % in 2004-05 and are forecast to grow by a further 47 % in 2005-06. In WA, royalties grew by 30% in 2004-05 and are forecast to grow by a further 25% in 2005-06.

The strength in resources will lead to increasing investment in that sector, boosting growth further in states such as Queensland and WA relative to NSW and Vic

Qld's net debt position is also the best of all the states, providing further evidence of its strong financial position.

Table 1: Net Debt per capita, 30 June 2006

	Qld	NSW	Vic	WA	SA	Tas
Net debt per capita (\$)	(4406)	(225)	581	68	82	(27)

Source: Qld 2005-06 Budget Paper No 2, page 114.

These differences in relative growth rates and fiscal positions will exacerbate the existing fiscal pressures in NSW and Vic caused by the distribution of grants under the current HFE system.

These factors highlight the need for reform of the current arrangements for the distribution of Commonwealth grants to the States.

The Current System for Distributing Grants

Origins and Evolution of Horizontal Fiscal Equalisation

The Commonwealth Grants Commission was originally set up to recommend grants to financially disadvantaged states. This original purpose has evolved over time into the current arrangements where the Commonwealth Grants Commission presides over a complex system of equalisation encompassing all States, regardless of their economic or fiscal position.

The Grants Commission currently recommends the distribution of GST revenue amongst the States according to their definition of horizontal fiscal equalisation (HFE). This states,

“State governments should receive funding from the pool of goods and services tax revenue and health care grants such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.”¹

This is a very stringent and wide reaching definition of HFE by international standards and has evolved significantly over time.² Initially, when it was set up in the early 1930s, the Grants Commission determined special grants to states in financial need. These grants were determined “by the amount of help found necessary to make it possible for that State by reasonable effort to function at a standard not appreciably below that of other States.”³

Over time the Grants Commission has moved to the current position of attempting to make assessments across almost all areas of States’ revenues and expenditures and attempting to achieve full equalisation of capacity to provide services at the same standard.

This is an extremely ambitious and far reaching role which the Grants Commission has defined for itself.

Practices in Other Federations

The role of equalisation programs differs in other comparable countries⁴.

- In Canada, the objective is “reasonably comparable levels of public services at reasonably comparable levels of taxation across provinces.”
- In Germany, the objective is “to equalise the differences in financial capacity of states.”
- In Switzerland, the objective is “to provide minimum acceptable levels of certain public services without much heavier tax burdens in some cantons than others.”

¹ CGC 2005 Update Report, page 4.

² This discussion is drawn from Garnaut, R and V FitzGerald, “Review of Commonwealth-State Funding – Final Report.”, 2002.

³ Quoted in Garnaut and FitzGerald page 33.

⁴ Presentation by Dr Anwar Shah, World Bank, to Heads of Treasuries forum, 23 September 2004.

The system for distributing grants amongst the States which has evolved in Australia (horizontal fiscal equalisation (HFE)) is a highly complex and data intensive exercise which encompasses 359 expense factor assessments and 37 revenue component assessments.

This system is the most complex and comprehensive in the world, despite Australia having relatively small economic differences across the states. Many federations have some form of fiscal redistribution designed to assist the fiscally weaker states in providing services. However, other comparable countries do not attempt to use as complex or comprehensive a system as Australia. For example, while Australia attempts to equalise both revenues and expenditures, Canada and Germany equalise on the revenue capacity side only.

Cross Subsidies in the HFE System

The GST is estimated to raise around \$37 billion in 2005-06. Around \$3.4 billion is expected to be redistributed against an equal per capita benchmark. This redistribution increases to around \$4.5 billion when measured against the benchmark of the states' GST generating activity.

Under the current grants distribution system, NSW and Vic are the donor states, with the other states receiving cross subsidies. The existence of large cross subsidies is clear whether measured against an equal per capita benchmark or against a state of GST generation benchmark. And GST revenue forms a major component of the States' budget revenue.

Table 2: GST Generated and GST Grants, 2005-06

	<i>NSW</i>	<i>Vic</i>	<i>Qld</i>	<i>WA</i>	<i>SA</i>	<i>Tas</i>	<i>ACT</i>	<i>NT</i>
Generated \$b	13.2	9.6	6.7	3.4	2.6	0.8	0.7	0.3
Grants \$b	10.4	7.9	7.7	3.8	3.4	1.5	0.7	1.8
Cross Subsidy \$b	(2.8)	(1.7)	1.0	0.4	0.8	0.7	...	1.5
\$ per capita	(407)	(340)	257	185	528	1,525	54	7,407

Table 3: Impact of the HFE System compared to equal per capita benchmark, 2005-06

	Population share (%)	GST grants share (%)	Cross subsidy, \$m	Cross subsidy, \$ per capita	GST grants as % of budget
NSW	33	28	(2,010)	(295)	25
Vic	25	21	(1,352)	(267)	26
Qld	20	21	413	103	29
WA	10	10	119	58	27
SA	8	9	631	408	32
Tas	2	4	611	1254	44
ACT	2	2	128	394	27
NT	1	5	1,461	7,173	66

In aggregate, the recipient states constitute around 42 percent of Australia's population, yet receive around 51 percent of total GST revenue. Put another way, NSW and Vic constitute around 60 percent of the national economy, yet receive around 50 percent of the GST revenues.⁵

This system is no longer appropriate for the Australian federation and needs to be replaced with a revised system which is more suitable for the challenges of the 21st century.

Efficiency and Equity

The notion of a trade-off between efficiency and equity is commonplace in public policy.

Normally a balance is struck. For example, the personal income tax system promotes equity by being structured as a progressive tax, but the degree of progression is moderated by the need to avoid excessive efficiency costs through disincentive effects.

What makes HFE unique is the degree to which the equalisation objective is pursued at the expense of efficiency. In fact, the system fails to strike a balance in that it strives to achieve full horizontal equalisation without regard to the efficiency costs.

The HFE system is designed to flatten as much as possible the differences between the States. Above average revenues are equalised away and there is no incentive to improve efficiency. There is a disincentive against expanding the revenue base, either through increasing activity in the state or through undertaking additional expenditure to fund economic development, as the increased revenue capacity will result in lower GST revenue.

⁵ GSP figures are 2003-04 estimates from ABS Cat No 5220.0, State Accounts, 2003-04.

Increased property values which may reflect the relative attractiveness and amenities of a city like Sydney are assessed by the Grants Commission as increasing the revenue raising capacity of NSW, leading to a reduced GST grant share. In the 2005 Review, the Grants Commission determined that an above average increase in land values increased NSW' capacity to raise land tax; this reduced NSW' grant share by \$36.8 million in the 2005 Review and increased the total annual loss of revenue from this source to \$436.1 million.

The efficiency costs of HFE take the following form:⁶

- There is a loss in economic efficiency due to the tendency for fiscal transfers to reduce incentives for resources (including people) to move from low productivity locations to high productivity locations.
- The current system can encourage duplication and lack of coordination.
- There is little incentive in the current system for increasing the efficiency of public services due to the focus on cost disabilities in the expenditure assessments.

There is a major contrast between the design and operation of HFE and the income tax/transfer system. The progressive nature of the income tax system, combined with social security and welfare transfers, is designed to reduce inequality in the vertical distribution of income, but without attempting to achieve full equalisation. This system retains incentives and does not fully penalise taxpayers for increasing their income.

Research conducted by the National Centre for Social and Economic Modelling (NATSEM) illustrates the effectiveness of the income tax and welfare system in redistributing income.⁷ This research found that the net impact of the taxes and benefits included in the study was to redistribute income from the most affluent 40 percent of Australians to the less affluent 60 percent. The income tax system led to a substantial redistribution from the top 20 percent to the bottom 60 percent.⁸

However, this redistribution moderates the income distribution, it does not attempt to fully equalise the income distribution. The progressive nature of the tax system ensures that taxpayers retain at least some of the extra income, rather than see it all equalised away. Even after the impact of the tax and welfare system, the income of the top quintile was still around 70 percent of its pre-redistribution level.

Modelling work undertaken by NATSEM for the Garnaut/FitzGerald Report provides some further illustration on the impact of the income tax/welfare system and HFE on equity.⁹

This study found that the Commonwealth's own-purpose expenditures and taxes have had the greatest impact on improving income equality.

⁶ Much of this discussion is taken from R Garnaut and V FitzGerald, 2002, Chapter 10.

⁷ Harding, A, Lloyd, R and Warren, N, "The Distribution of Taxes and Government Benefits in Australia", paper presented at the Conference on the Distributional Effects of Government Spending and Taxation, The Levy Economics Institute, 15 October 2004.

⁸ Harding et al, 2004, page 24.

⁹ Garnaut and FitzGerald, 2002, pages 124 - 129.

Household weighted results showed a reduction in the Gini coefficient from 0.520 to 0.297 as a result of the Commonwealth's own-purpose expenditures and taxes (a Gini coefficient closer to zero represents a more equal distribution of income than a coefficient closer to one). This is due to the effect of the progressive nature of the income tax system and social welfare transfers.

Income equality was further increased due to the effect of specific purpose payments (SPPs), with the Gini coefficient declining from 0.297 to 0.271, a reduction of 0.026. The impact of redistributing GST revenue among the States was found to have the smallest impact on changing income inequality. This reduced the Gini coefficient from 0.271 to 0.252, a reduction of 0.019.

The NATSEM modelling also found that changing the current HFE distribution of GST revenue grants to either an equal per capita distribution or a state of origin distribution would not increase inter-personal inequality compared to the current system.

These results clearly show that the income tax and social welfare system is the most effective contributor to increasing income equality in Australia. However, it does not attempt to generate a fully equalised outcome.

The HFE system, by contrast, attempts to equalise the capacities of state governments to provide services. While this system does not address inter-personal equity, it does impose significant efficiency costs in its quest for full equalisation of state governments' financial capacities.

Scope and Degree of Equalisation

The scope of the expenditures that are included within the HFE framework has expanded over time so that it now covers almost every area of recurrent expenditure in the states' budgets. The Grants Commission attempts to abstract from the impact of policy differences across states in its assessments, but this can become very difficult in areas of non-core service provision, such as national parks.

There are certain core economic services which state governments need to provide, such as health and education. It may be appropriate that the transfer system have as one of its objectives equalising service provision in those core functions. However, in most other areas of expenditure, the amount spent, including the decision to include that area in the budget at all, is a policy decision in itself and should not be included in any consideration by the Grants Commission.

As well as being too wide in scope, the factors which the Grants Commission takes into account in its assessments are backward looking. Isolation and dispersion are still major influences on grant shares despite the emergence of new technologies. Congestion costs are not adequately recognised. The Grants Commission does not adequately allow for the cost of replacing infrastructure in Sydney.

For example, the Commission did recognise that only cities with a population greater than 2 million people require an underground rail system. But their assessment does not adequately capture Sydney's needs. Sydney has \$1.761 billion more urban transport infrastructure than the Commission believes is necessary to deliver the average standard of services.

The Grants Commission does not adequately recognise the impact of urban congestion on police services. Despite some allowance for the additional cost of policing due to urban congestion, NSW spends \$78 million more on police services than the Commission considers necessary to provide the average standard of service.

Wages input costs is another area where the Grants Commission does not adequately recognise the costs faced by NSW. The Commission undertook substantial econometric modelling to determine the factors underpinning higher wages in NSW during the 2004 Review.

The Commission found that the wages are influenced by features of where the work is performed (such as the cost of living and the relative inherent attractions of the location), as well as by the productive characteristics of the employees. The Commission concluded that those influences are beyond the control of State governments.

However, despite the strong econometric results and other evidence, the Commission decided to discount the results of their analysis. Grants to NSW would have been around \$70 million higher in 2004-05 if the Commission had given full recognition to the higher wage costs in NSW.

As well as increasing the number of assessments undertaken, the Grants Commission's role has extended to assessing grants to all states, not just considering states in financial difficulty.

The Grants Commission has also increased the scope of equalisation by its attempts to achieve full equalisation, compared to the more limited and achievable objectives of other federations mentioned earlier.

Complexity and Data Requirements

These developments, increasing the scope of assessments across all the states to generate full equalisation, have led to significant increases in the complexity of the assessments.

Complexity has a number of disadvantages.

- It can reduce accountability because of the general inability to understand how the system works.
- Complexity can also lead to increasing costs in administering the system.
- There is difficulty in evaluating performance.

Comprehensive equalisation undertaken across almost every expenditure and revenue component of the state budgets requires an enormous amount of data. This data needs

to be available across all states and, in many cases, also needs to be available at a high degree of disaggregation.

The Grants Commission has expressed doubts about data requirements of the current system. “We think there are grounds for considering whether equalisation is being asked to do too much.” (CGC 2004 Report, page 84) “We remain uncertain that some of the data we are using are as robust and reliable as we believe is necessary. We may be pushing the data too far in some of the ways we use them.” (CGC 2004 Report, page 87).

The extent of the difficulties in obtaining all the necessary data often leads the Grants Commission to rely on judgement in forming its assessments.

Proposals for Reform

COAG agreed at its recent meeting that, “Australia’s productivity performance is under threat, with further reform essential if the economic expansion of the past 14 years is to continue”.

Reform of the system for distributing Commonwealth grants should be seen in this context.

This proposal entails:

- Replacing the current system with a simpler, transparent system which increases economic efficiency.
- Applying simplified relativities to SA, Tas and NT, based on a narrow range of core economic functions.
- All other states moving to an equal per capita distribution.
- Competition payments being distributed on the basis of evidence-based productivity growth.

In line with the practice in other comparable countries, Australia needs to move away from attempts to undertake full equalisation and move towards a system based on a narrower scope and definition of HFE.

The Grants Commission’s assessments are too complex and non-transparent. The assessments rely too heavily on data of questionable quality and judgement. The current system does not promote an efficient allocation of resources.

There needs to be a simpler and more transparent basis for the distribution of the GST revenue among the States.

NSW accepts the need for assistance to be given to those states with a narrow economic base, such as SA, Tas and NT. This would be a return to something closer to the original role for the Grants Commission and is consistent with earlier comments about narrowing the scope of the Grants Commission.

However, NSW does not believe that there is any justification for paying a large cross subsidy to Qld, WA and ACT.

The grants to SA, Tas and NT should reflect simplified relativities, based on assessments covering the core areas of service provision which states need to provide, such as education and health.

The remaining states should then receive grants on an equal per capita basis from the remaining GST pool. This would ensure that the cost of the cross subsidy to the three recipient states was equally shared among the five other states.

The effect of this proposal, using the current relativities for SA, Tas and NT, compared to GST generated in each of the States is shown in table 4.

Table 4: GST Generated and Proposed Grants, 2005-06

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
GST Generated, \$b	13.2	9.6	6.7	3.4	2.6	0.8	0.7	0.3
Grants, \$b	11.4	8.5	6.7	3.4	3.4	1.5	0.6	1.8
Cross Subsidy, \$b	(1.8)	(1.1)	0	0	0.8	0.7	(0.1)	1.5

The effect of this proposal currently is to redistribute grants in Qld and WA broadly in accordance with the amount of GST revenue generated in those States. However, this result can vary over time.

This proposal would significantly improve the transparency and simplicity of the grants distribution. The data requirements would be significantly lessened. It would also improve efficiency and economic growth as it would remove the disincentives in the existing system against economic reform and productivity improvement.

The allocation of grants under this proposal would be much simpler and the CGC could be abolished.

The removal of the distortions caused by the CGC would provide the opportunity to increase the focus on productivity. Competition payments from the Commonwealth provide an incentive to the states to undertake productivity-enhancing reforms and redistribute the fiscal benefits that flow from higher productivity back to the states that have done the work.

Competition payments need to be re-introduced as an added incentive to reinvigorate Australia's productivity performance. Competition payments should then be distributed on the basis of evidence-based productivity enhancement, such as the nation's ports and their interaction with other transport infrastructure such as road and rail. The Productivity Commission should undertake this role.

Under this proposal, states would be rewarded for increasing efficiency and improving productivity, rather than see the benefits equalised away. This would provide much greater incentive and underpin Australia's economic development.

