Business Council of Australia

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Submission to the GST Distribution Review

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About this publication

Members of the Business Council of Australia (BCA) are the chief executives of 100 of Australia's largest and most successful businesses. Through the BCA, they apply their skills and experience to develop, explain and promote policies for achieving economic, social and environmental goals that will benefit Australians now and into the future. Our aspiration is for Australia to become the best place in the world in which to live, learn, work and do business.

EXECUTIVE SUMMARY

The Business Council of Australia (BCA) is pleased to make this submission to the GST Distribution Review.

While the methodology for distributing the GST is reviewed every five years, the BCA considers it is timely to consider whether a more fundamental modernisation is appropriate for the particular challenges facing Australia in the 21st century.

As the review terms of reference states, Australia is facing a number of long-term trends that are driving significant structural change in the economy. These include the rise of China and India and continuing globalisation, the challenge of responding to climate change risks, population growth and demographic change, and the continuing effects of innovation and technological change.

Australia will need a strong economy in which wealth is shared effectively throughout the community for it to adequately respond to these opportunities and challenges.

The distribution of the GST is focused on equalising the capacity of the states to provide a broadly similar level of service to their citizens. There is an opportunity with this review to consider how a different GST distribution methodology might enable the federation to operate more effectively in responding to the structural change underway in the economy.

There is an emerging question over whether the current GST distribution methodology adequately supports the capacity of states to drive a stronger economy while fulfilling equity objectives in the most efficient and effective manner possible.

If Australia is to continue to maintain its capacity for growth in the face of its challenges and take advantage of the considerable opportunities presented by our place in the fastest growing region of the world, it is vital all options are explored to improve the efficiency of the federation.

The BCA continues to argue for these types of reforms to be dealt with as part of comprehensive tax reform, with the states having access to more predictable and stable revenue streams including from the GST and a possible share of personal income tax. Such a reform package could also facilitate states reconfiguring their own tax base by removing inefficient taxes and more effectively using their efficient tax bases.

Fiscal challenge for the states

Over the coming decades, the states will bear a significant responsibility for delivering high-demand services such as health care and other services associated with an ageing population. They will have to deliver these services within a fiscal architecture set out by Australia's system of federation that is not keeping pace with the current approach to government spending.

As the BCA highlighted in its submission to the recent national tax forum, research shows Australian governments could end up with a combined annual budget shortfall of five per cent of GDP by 2050 or $70 billion in today's terms. This modelling suggests that demographic and ageing issues will result in significant pressures falling on state budgets. By 2050 it is estimated that the combined shortfall on the primary budget balances of the states will reach almost 2½ per cent of GDP.

Addressing this fiscal challenge facing the states is made more difficult by a range of factors:

- On the expenditure side, there is no commitment at the state level to a 2 per cent real cap in spending as there is at the Commonwealth level.

- There is a high level of vertical fiscal imbalance in the federation, with states responsible for raising around 17 per cent of aggregate tax revenues compared to their responsibility for 44 per cent of all expenditures.
- While there are some opportunities for states to raise revenue more efficiently from their own tax bases, overall the states have a large proportion of inefficient taxes that cannot sustainably provide predictable and growing revenues over the long term.
- The current federal fiscal architecture means that there are limited incentives for states to act to reconfigure their tax systems in the absence of a multilateral agreement between the states and Commonwealth.

The GST pool and the methodology for its distribution are a fundamental element in responding to these challenges.

There are many practical realities associated with this architecture around both the vertical imbalance and horizontal equalisation of finances. Particular issues include the inherent complexity of the system as well as a lack of predictability and stability of state revenues. Recent retrospective methodological changes, the inclusion of unusual items such as the regional rail link funding in Victoria, and the impact of assessments of mining royalties, have all undermined predictability and stability.

An important consequence of the current arrangements is that they can have the effect of reducing governments' accountability to their citizens and can reduce the incentives for states to be more efficient and pursue worthwhile reforms. These represent material challenges at a time when we should be aiming to improve the efficiency of government spending and increase our lagging national productivity performance.

In this submission the Business Council of Australia outlines some views on the effectiveness of the current approach to GST distribution and urges the review panel to consider a number of options that might improve the current arrangements.

This exercise needs to be undertaken cognisant of other processes concerning the reform of state taxes and against the background of a pressing need for comprehensive tax reform in Australia more broadly.

The BCA believes tax reform provides the greatest opportunity to support the next phase of growth, but that comprehensive reform is needed so the tax system raises enough money to pay for the future and so Australia can achieve its growth potential.

Any review of the tax system, including this review, should consider how reforms can better support growth and in doing so meet requirements for equity, simplicity and predictability.

Effectiveness of the current approach to GST distribution

Australia's economy and standards of living across all states have changed considerably since federation. With the opening up of Australia's economy to the world, it became more integrated and competitive, benefiting from strong inflows of capital and labour.

As a result, barriers and costs of interstate migration, transport and communications have fallen, increasing the opportunities for considerable mobility of resources and economic growth across jurisdictions.

While Australia's economy has evolved, we continue to have the most comprehensive equalisation process of any federation in the world. This process redistributes among the states around 8 per cent of total GST revenues. This amounts to an equalisation of just over 1 per cent of all tax revenues in Australia.

We note that the strongest arguments in favour of such a process of horizontal fiscal equalisation (HFE) have a strong equity objective – to ensure that each state has the capacity to provide services at the same standard if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.

The impact of full equalisation on equity at the individual level, however, is relatively small, having around one tenth of the impact that the Commonwealth tax and transfer system has on individual equity – that is, in terms of its effectiveness in redistributing income from the most affluent to least affluent in society.[1]

The relatively small impact on equity comes at the expense of efficiency, simplicity, predictability and stability.

On the basis that the redistribution of GST revenues represents a relatively small part of the overall tax system, the magnitude and consequences of these adverse impacts could readily be underestimated. However, at the state level the impact of GST revenues and their redistribution are material, with GST revenues accounting for over 20 per cent of state revenues.[2]

The current system has relied significantly on data while avoiding a stronger focus on state performance and judgement necessary to ensure more balanced outcomes.

Through its use of averages, the current distribution methodology can distort incentives for states to deliver services more efficiently. In effect, state governments do not always face the full fiscal consequences of their decisions. For example, as illustrated by state government submissions to the review, moving some services to the non-government sector to be delivered at a lower cost could actually see cost savings offset by lower GST revenues received.[3]

At a time when Australia's productivity performance is flat and long-term fiscal challenges are building, we cannot afford to have any state or territory not engaging in policy reform to grow the productive capacity of their economy.

In the past, mechanisms such as national competition payments that financially reward the performance of the states in implementing economic reforms across a broad agenda have proven successful. The GST is not intended to reward high-performing states that grow their economy and their tax base through reform, but at the same time it shouldn't hamper economic efficiency or implicitly reward poor performance.

While narrowly-based reward payments under national partnerships play some role in the current federal fiscal architecture, there is no effective mechanism for distributing national benefits back to high-performing states, the greater share of which flows to the Commonwealth through increased tax revenues. This points to the need for some mechanism outside of the GST distribution – but within the federal fiscal framework – that rewards high-performing states.

In preparing this submission, the Business Council of Australia is of the view that states should be afforded every opportunity to manage a stable budget based on robust revenues and efficient expenditure. However, recent decisions by the Commonwealth Grants Commission (CGC) have delivered outcomes for some states that have undermined predictability and stability for state budgets.

It is a testament to the complexity of the current process that state governments, who understand the equalisation process most effectively outside of the CGC, have difficulty predicting the outcomes of equalisation for their budgets. The current system's undue complexity is well acknowledged, with the ultimate effect of reducing governments' accountability to their citizens and increasing the costs of administration.

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[1] See Committee for the Review of Commonwealth–State Funding, *Review of Commonwealth–State Funding Final Report*, August 2002, pp.125–126.
[2] BCA calculations based on ABS, *Taxation Revenue, Australia*, Catalogue No. 5506.0, April 2011.
[3] See for example New South Wales Government submission.

Options for reform

The current system of GST distribution involves an overwhelming level of effort for a relatively low national return. At the same time, this distribution has a material effect on state budgets, particularly for smaller states.

Given the challenges and difficulties with the current system, a strong case can be made to reform the arrangements attaching to fiscal equalisation. In essence, what we require is a system that better equips the federation to deal with 21st-century challenges by supporting incentives for efficiency and reform that bring about strong economic growth while addressing equity through simpler targeted means.

We urge the review not to be constrained in the consideration of options to improve the current methodology for GST distribution.

The BCA has set out a number of options that extend across a range of possibilities from moving to an equal per capita distribution, a partial equalisation approach or more limited reforms to improve the existing methodology.

Working within a fixed pool results in an inherent tension between returning a closer to equal per capita share of the GST to the largest and fastest growing states on the one hand and upholding equity and budget stability for the smaller states on the other. Resolving this tension in the long term would require additional funding, whether it is direct Commonwealth transfers, an increase in the GST pool or access to new tax bases for the states.

We recognise that balancing the objectives of equity, efficiency, simplicity, stability and predictability for all jurisdictions is a difficult task and ultimately the government will need to make tradeoffs in determining the preferred methodology. In order to provide transparency of the trade-offs involved, we believe a number of options should be considered with preliminary estimates of their impact undertaken.

An equal per capita approach in the long term

The BCA's view is that the simplest approach to distributing the GST without compromising efficiency could be to do so on an equal per capita basis. Such an option would seek to reduce the complexity and adverse impacts of the current approach. However, the costs of moving to such an approach in the short term while retaining equity and budget stability for recipient jurisdictions would be significant. In effect, additional funding outside of the current fixed GST pool would be required so that current recipient jurisdictions would not be made worse off.

Recognising the current fiscal constraints, such a fundamental reshaping of the GST distribution is unlikely to be achievable in the short term. However, achieving such reform on a revenue neutral basis may be best achieved as part of comprehensive long-term tax reform including the reconfiguration of state tax bases, removal of inefficient state taxes and possible access to a share of the personal income tax, as proposed by the BCA in its submission to the 2011 tax forum.

Partial equalisation approaches

An alternative to a full equal per capita distribution could involve various forms of partial equalisation that provide a path towards equal per capita distribution in the long term and begin to reduce the scope and complexity of equalisation. Such options for partial equalisation might include:

1. Quarantining a certain percentage of the GST pool for equal per capita distribution (say 25 per cent initially) with the remainder being equalised through a simplified process. This would represent a first step towards long-term equal per capita distribution.

2. The equalisation of expenditures could be confined to focus on comparable levels of service for an identified safety net of services relating to health, education and other agreed services.
3. Removing the ‘indigeneity’ assessment from equalisation and addressing Indigenous disadvantage through targeted financial transfers from the Commonwealth, including clear and transparent performance measures for closing the gap.
4. Territories could be removed from the equalisation process, so that they receive only an equal per capita share of GST. Their remaining revenue requirements would be ‘made good’ through direct transfer payments from the Commonwealth.

Adjusting the current methodology

While the BCA considers that the focus of the review’s attention should be on improving the equalisation process at a structural level, an alternative option would be to retain the current methodology but seek to improve it. Given the fixed pool of the GST, it will be exceedingly difficult to deal with many of the weaknesses within the current system of equalisation, without making particular states worse off or introducing further complexity. Nonetheless, there are a number of areas of adjustment that could at least be considered, including:

- Expenditure assessments could be undertaken against efficient cost benchmarks rather than average expenditure.
- The inclusion of an expenditure category that explicitly recognises the costs borne by the state to support rapid economic growth, particularly in terms of public infrastructure needs.
- On the revenue side, removing disincentives for states to undertake reforms that grow their economies and the associated revenue bases that go with them.
- The inclusion of an expenditure category that explicitly recognises the disproportionate costs of service delivery in large cities (i.e. those comparable with other international cities).
- The exclusion of one-off national infrastructure payments such as those made to the states under the Building Australia Fund so that long-term infrastructure investments are not penalised.

THE FISCAL CHALLENGE CONFRONTING THE STATES

To date the Commonwealth's intergenerational analysis has focused on federal finances. However, the most recent Intergenerational Report (IGR) noted that while the Australian Government provides over 40 per cent of the total health funding (and is the major source of public funds), state and local governments fund around one quarter of the cost of health services, with non-government sources contributing around one third.

Indeed the Commonwealth has acknowledged that the states will face key cost pressures of their own. The New South Wales Treasury has estimated that spending on health will almost double as a share of the state's total budget – from 30 per cent now to around 55 per cent in 2032–33.

As part of its submission to the tax forum in October 2011, the BCA commissioned Deloitte Access Economics to model state finances in a way that mirrors the approach taken in the Commonwealth IGR. States' own-source revenues are assumed to be constant as a proportion of GDP, as are GST revenues. The projections include assumptions about the states having to continue to rely on grants from the Commonwealth and having to find revenue from other non-tax sources. The effect of these assumptions is that over the next four decades, states own-source tax revenue will continue to account for only around one third of states' total revenues.

On the expenditure side, the Deloitte Access Economics analysis notes that unlike the Commonwealth there is no matching assumption that there will be a notable period of expenditure savings from the states (i.e. no commitment to a 2 per cent real cap in spending) before the demographic and non-demographic spending pressures come to bear.

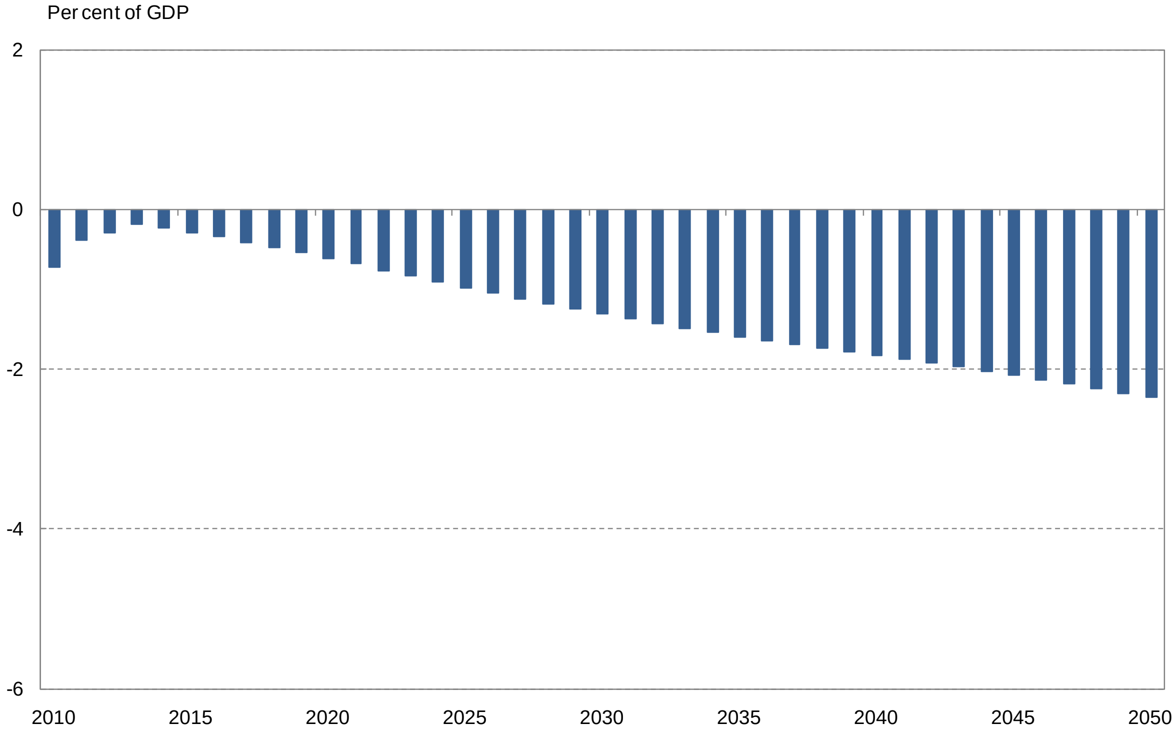
The results of the Deloitte Access Economics modelling show that although pressures on the states are not quite as notable as those on the Commonwealth Government, they are considerable – and have not been widely recognised. The states, for example, bear a considerable load on the health care cost front, even after allowing for recent proposed changes to state arrangements in this area.

Whereas the shortfall on primary balances for the Commonwealth is projected to reach 2¾ per cent of GDP by 2050, the Deloitte Access Economics modelling indicates that the states will see a shortfall of much the same size: almost 2½ per cent of GDP by 2050.

Deloitte Access Economics notes that that does not mean that the effects of pressures such as ageing and health care cost inflation are the same for the states as they are for the Commonwealth. Rather, that the end point in 2050 is also affected by today's starting points, as well as by the federal assumption that spending restraint will occur over the next decade.

Figure 1 depicts the projected primary fiscal balance for the states out to 2050.

Figure 1: Primary Fiscal Balance – Combined State Governments



Source: Deloitte Access Economics, 'An Intergenerational Report for the States', incorporated within the Business Council of Australia Submission to the 2011 Tax Forum.

Running rising fiscal deficits of this nature over the next four decades is simply not a viable option. As Deloitte Access Economics notes, each year that governments run fiscal deficits requires borrowings year in year out, which will mean that borrowings eventually blow out, taking governments' balance sheets with it.

THE FEDERAL FISCAL FRAMEWORK

As noted in the Henry review, the primary consideration in reforming the tax system should be the quality of the tax, but an important secondary consideration is the role of the states in the tax system and the manner in which certain reforms may provide a platform to improve the performance of governments more broadly.

The distribution of the GST is just one element of the overall federal fiscal framework. However, changing the methodology for distribution is one such platform that could have effects on the performance of governments more broadly.

In understanding how the distribution of the GST could achieve such an objective, it is important to understand how it fits within the broader federal fiscal framework and the implications across the federation of altering tax settings in any one area. This is particularly important if the GST and its distribution are to align with comprehensive tax reform across the federation in the decade ahead. Such reform will be critical to meeting the future fiscal challenges.

Vertical fiscal imbalance

The current federal fiscal system is characterised by vertical fiscal imbalance, which sees the Commonwealth collecting more tax revenue than it spends, while the states are responsible for expenditure that far outstrips their own revenues. It also reflects the practical difficulties of matching revenues and expenditures at each level of government in a federation.

In 2009–10, the states were responsible for collecting around 17 per cent of aggregate tax revenues but had responsibility for around 44 per cent of all expenditures.[4] The Commonwealth Government, on the other hand, collected 83 per cent of tax revenues and redistributed over a third of these revenues to the states through the redistribution of the GST and other financial transfers.[5]

As noted by the Henry review, many of the tax bases that the states do have access to are among the most inefficient and narrow bases, with the exception of payroll tax and land tax (the former if it is applied to a broader base).

As noted previously, the states will have a responsibility for delivering high-demand services including health care over the decades ahead. To do this they will require more predictable and stable sources of funding. Figure 2 illustrates the extent to which states own-source tax revenues and the GST fall short of meeting projected spending.

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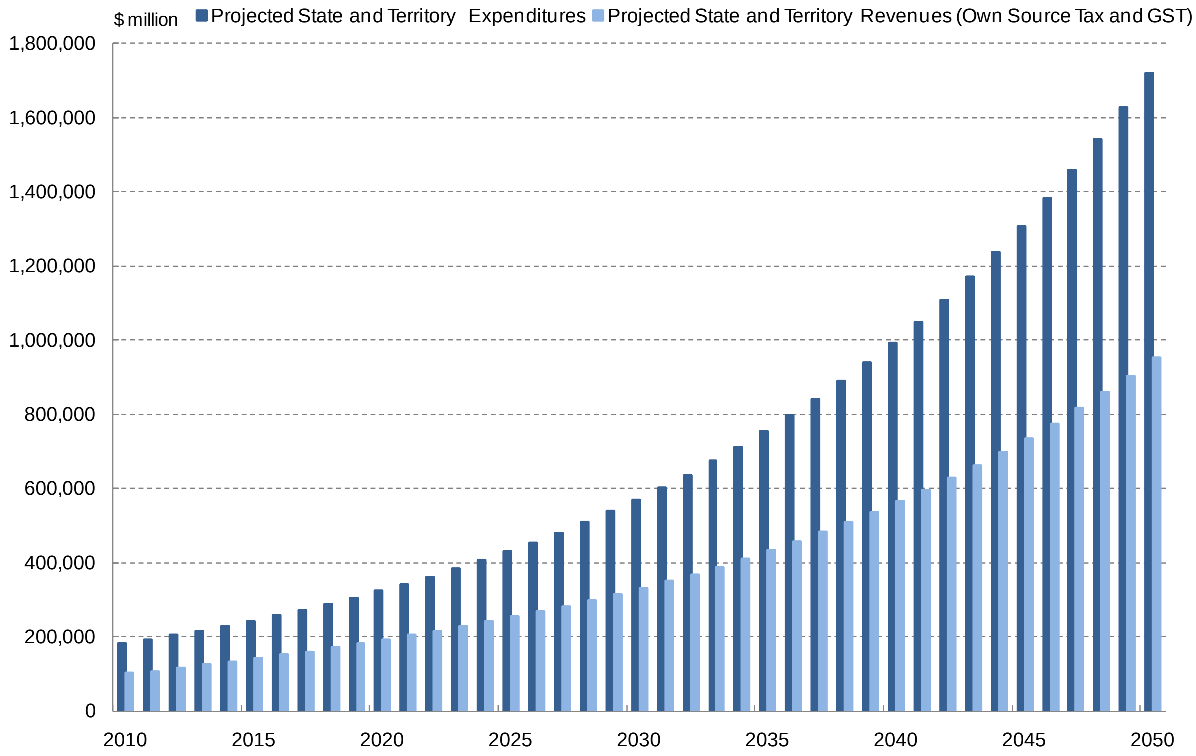
[4] BCA calculations based on ABS, *Government Finance Statistics, Australia*, Catalogue No. 5512.0, April 2011.
[5] ibid.

Figure 2: Projected State Expenditures and Own Source Tax and GST Revenue



Source: Deloitte Access Economics, 'An Intergenerational Report for the States', incorporated within the Business Council of Australia Submission to the 2011 Tax Forum.

One of the risks of vertical fiscal imbalance in the federal–state architecture is that the accountability between the raising of revenue and the responsibility for funding programs can become blurred. For example, the Commonwealth could avoid accountability for expenditure of funds because it is the states that have actual responsibility for disbursing the expenditure. Similarly, states could argue that they are not able to deliver services adequately due to a lack of funding from the Commonwealth.

The Henry review itself noted that 'if a government is not accountable for the revenue it raises, it may not face the full cost of how it spends the revenue and may have less incentive to be disciplined in how it spends that revenue'.[6]

Financial transfers to the states

Under the Intergovernmental Agreement on Federal Financial Relations, Commonwealth financial transfers are made to the states through two primary mechanisms: a redistribution of GST revenues to the states, and through payments to support specific state services through National Specific Purpose Payments (National SPPs), National Partnership Payments and, from 1 July 2012, National Health Reform payments.

GST revenues are distributed on the basis of the advice of the Commonwealth Grants Commission. Its fiscal equalisation approach attempts to distribute the revenue so that when states raise their own taxes at a comparable level of effort, states have the same capacity to provide comparable services to their population.

[6] Commonwealth of Australia, *Australia's Future Tax System*, 2010, p. 671.

Exhibit 1: Horizontal Fiscal Equalisation (HFE)

State governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.

The reference starting point is to calculate what each state would receive if it received a share of GST revenue equivalent to its share of the population (i.e. equal per capita share). The Commonwealth Grants Commission then considers the fiscal capacity of each of the states in expenses, new investments, net lending, revenue and Commonwealth payments.

- **Expenses**: Calculates assessed differences in terms of costs of providing services to residents in a particular state, against the average costs of providing services. For example, having a large proportion of the population that is ageing or in remote locations relative to other states is likely to increase a state's assessed difference against the average of all states.

- **Investment and net lending**: This is impacted by state population growth with the need for provision of social infrastructure likely to be greater in states where the population is growing most strongly.

- **Revenue**: Assesses the tax bases of different states by looking at what would happen if the average tax policy (eg. the rate of the tax) was applied to the value of relevant transactions and goods in that jurisdiction. A state is assessed as having an advantage if applying the average tax policy, it has a share of the total tax base that is greater than its population share.

- **Commonwealth payments**: Commonwealth payments that support state budgets are included in equalisation. If a state receives below average payments per capita then its share of GST would increase.

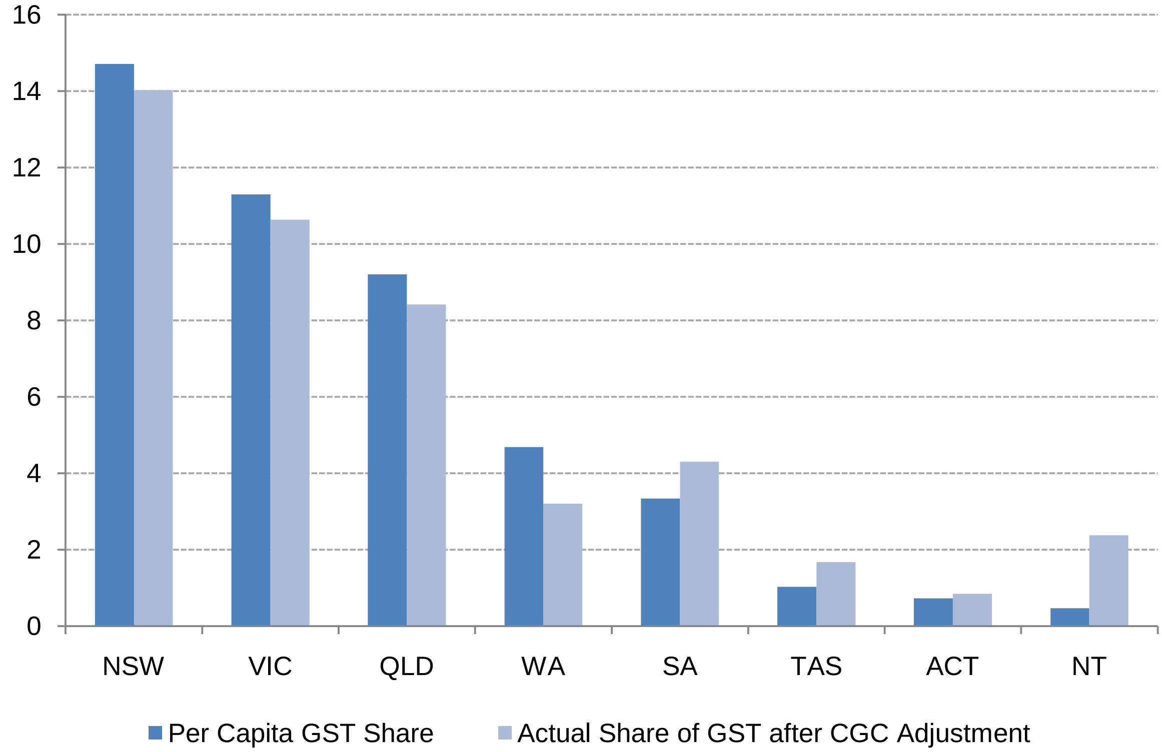
Once all these factors are taken into account, each state is allocated a 'relativity'. A relativity less than one means that a state receives less GST revenue than it would have received on a pure equal per capita basis and a relativity greater than one indicates that a state receives more revenue than it would have received on an equal per capita basis.

Because the GST is a fixed pool of funding, states that have a relativity less than one can be referred to as 'donor' states, while those with a relativity greater than one can be referred to as 'recipient' states.

Source: GST Distribution Review Issues Paper, July 2011.

In 2010–11, GST payments amounted to over $45 billion and were distributed as indicated in Figure 3. Around $3.6 billion (8 per cent) of the total GST pool was redistributed.

Figure 3: GST Distribution 2010–11 ($ billion)



Source: Commonwealth Budget Paper No. 3, Australia's Federal Relations 2011–12.

Mining production and indigeneity have the most significant impact on the CGC's assessed differences in fiscal capacity between the states, as identified in Table 1. This table also demonstrates that over 70 per cent of redistribution occurs in just five areas of assessment.

Table 1: Top 5 Causes of Fiscal Differences between the States (2010–11)

Cause	Gross Distribution ($m)	Proportion of gross distribution (%)	Largest state distributions ($m) Donor/Recipient
Mining production	3,127	25.8%	WA: -2,097 VIC: +1,501
Indigeneity	2,143	17.7%	VIC: -1,426 NT: +1,258
Effects of where people live	1,360	11.2%	VIC: -631 WA: +561
Property sales	1,037	8.6%	QLD: -713 VIC: +436
Other influences on expenditure	1,018	8.4%	NSW: -423 QLD: +416

Source: Commonwealth Grants Commission, Report on GST Revenue Sharing Relativities – 2010 Review, p.97.

It is important to note that the GST has a limited impact on the adverse accountability effects of vertical fiscal imbalance. The states do not have control over the rate or the base of the GST, and the Commonwealth has limited incentives to adjust these settings given that it does not face the expenditure pressures that this revenue funds. The equalisation process further diminishes the level of control and discretion that states have over the revenues that are collected.

As Richard Bird and Michael Smart submitted to the Henry review, if state governments are to act responsibly and in the interests of their residents they should face a so-called 'hard budget constraint'.[7] This means that they are able to increase or decrease spending only by increasing or decreasing their revenues in such a way that they are publicly responsible for the consequences of their actions.

If the expensive and expanding expenditure responsibilities like health and education are to be carried out responsibly, state governments generally need access to significant revenues for which they are clearly politically responsible.

A more efficient method of redistributing GST revenues – and a resolving of (at a high level) roles and responsibilities between the Commonwealth and the states – will be an important precursor to any consideration in future of a greater role for the GST as a part of enhancing state revenue sources.

The remaining financial transfers received by the states come in the form of specific purpose payments, which the Commonwealth provides to pursue national policy objectives in areas administered by state governments including health and education. In 2010-11, these payments are estimated to be $47.4 billion (see table 2 for the top 5 payments).

Table 2: Top 5 Payments for Specific Purposes by Sector 2010–11

Sector	$ billion
Education	17.2
Health	14.3
Infrastructure	3.8
Affordable housing	3.5
Community services	2.8

Source: Commonwealth of Australia, Budget Paper No.3 2011–12, p. 20.

The architecture for these payments was substantially reformed in 2008 through changes to the Intergovernmental Agreement on Federal Financial Relations with the objective of giving states greater flexibility in how they delivered services.

However, it is not clear at this stage that the objectives of this reform have been maintained in practice. The recent proliferation of National Partnership Agreements has in many cases reinstated Commonwealth direction over funding and expenditure.

The Productivity Commission has previously noted that the reforms currently before COAG comprise around 325 documents made up of six national agreements, 51 national partnerships, 230 implementation plans and 27 intergovernmental agreements and other initiatives.[8]

Non-taxation revenues

In addition to transfers from the Commonwealth, the federal fiscal system sees states highly dependent on their own non-taxation revenues from the sale of goods and services, interest

[7] R. Bird & M. Smart, *Assigning State Taxes in a Federal Country: The Case of Australia*, paper prepared for the Australia's Future Tax System Review Tax and Transfer Policy Conference, 2009.

[8] Productivity Commission, 'Catalogue of COAG Reforms and Initiatives', Annex to *Impacts and Benefits of COAG Reforms: Reporting Framework*, Research Report, December 2010, pp. 2–3.

and dividend income. This revenue amounts to over $54 billion and has grown nominally at an average annual rate of almost 10 per cent over the last 10 years.[9]

The mining boom means that mining royalties are contributing an increasing share to these other revenues. In 2009–10, states collected approximately $6.5 billion in mining royalties, compared to approximately $1.8 billion in 2001–02.[10]

[9] BCA calculations based on ABS, *Government Finance Statistics, Australia*, Catalogue No. 5512.0, April 2011.

[10] Commonwealth Grants Commission, Presentation by Alan Henderson to the Third Annual Intergovernmental Relations Conference, 16–17 August 2011, p. 10 and Commonwealth Grants Commission, *Mining Revenue – Draft Assessment Paper CGC 2003/13*, July 2003, p. 1.

ISSUES WITH THE CURRENT FORMULA FOR GST DISTRIBUTION

It is important to acknowledge at the outset that fiscal equalisation has played an important part in the evolution of Australia's federation. In addition, there are many elements of the Australian system that have served us well including the independent role of the CGC.

However, the pertinent question now is: given the challenges and context outlined above, will the current form of fiscal equalisation remain effective?

Previous analysis of horizontal fiscal equalisation in Australia and submissions to the review so far reflect a broad acknowledgement that the current process no longer effectively balances the objectives of efficiency, equity, simplicity, predictability and stability.

The BCA recognises the inherent challenges of making tradeoffs between various core policy objectives in all tax and transfer systems. However, the BCA is concerned that while the current system of equalisation has a strong focus on equity, it has a relatively marginal impact on individual equity, which comes at the expense of efficiency, simplicity, predictability and stability.

Our brief assessment of how each of these objectives is working in the current system is provided below.

Equity

The discussion paper suggests that while fiscal equalisation appears 'on the face of it' to be about intergovernmental financial transfers, it has flow-on effects for individuals so as to ensure they are able to access comparable levels of service regardless of the state in which they reside. The focus on individual equity is at the heart of arguments made in support of horizontal fiscal equalisation.[11]

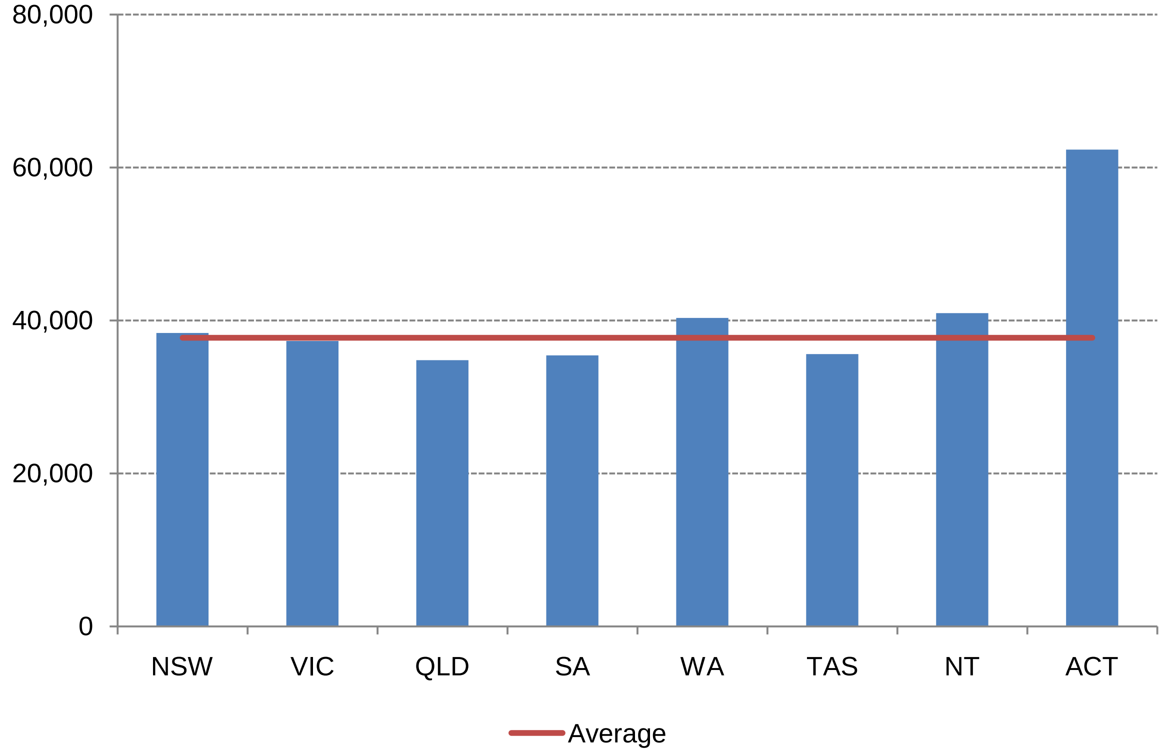
The BCA agrees that there is merit in the general objective of 'comparable levels of service' for individuals, but the differences in living standards between jurisdictions and the effects of fiscal equalisation on individual equity should not be overstated.

Australia's economy and standards of living across all states have changed considerably since federation. Australia's economy has become more open, connected and integrated with the world economy. With this, Australia's domestic economy has also become more integrated and competitive and has benefited from strong inflows of capital and labour. Barriers and costs of interstate migration, transport and communications have fallen, increasing the opportunities for considerable mobility of resources and economic growth across jurisdictions.

As illustrated in Figure 4, disposable incomes (which take into account both income and costs of living) across different states suggest a high degree of equity, with the exception of the ACT with its small concentrated population of relatively high-income residents. This is not to suggest that there aren't longstanding geographic, demographic and other factors which are out of the control of state governments that result in inequities. However, as inequities become less widespread and more easily identifiable, comprehensive equalisation may not be the most efficient and effective mechanism in addressing them.

[11] J. Buchanan, 'Federalism and Fiscal Equity', *American Economic Review* 40, 1950, pp. 583–599.

Figure 4: Gross Household Disposable Income Per Capita ($), June 2010



Source: ABS, Australian National Accounts: State Accounts 2009–10, Catalogue No. 5220.0, November 2010.

In this context, it is worth examining the impact of various mechanisms on equity.

Firstly, as Ergas and Pincus have suggested, a nationally funded health and welfare system delivers a relatively uniform benchmark standard of living for individuals across Australia.[12] Previous modelling conducted by the National Centre for Social and Economic Modelling (NATSEM) confirms the effectiveness of the welfare system, finding that it redistributes income from the most affluent 40 per cent of citizens to the less affluent 60 per cent.[13]

NATSEM modelling undertaken for the 2002 Review of Commonwealth–State Funding found that, at that time, the Commonwealth Government's own expenditures and taxes reduced the inequality of income distribution at over 10 times the rate of fiscal equalisation.[14] At this point in time, Specific Purpose Payments also had a greater impact on equity than equalisation.

This research examined the impact of different policies on Australia's income distribution by looking at the Gini coefficient. The Gini coefficient measures the equality of income distribution with a coefficient closer to zero indicating a more equal distribution and a less equal distribution being equal to one. It found that:

- The Commonwealth Government's own expenditures and taxes reduced the coefficient from 0.52 to 0.297 (a reduction of 0.223).
- Specific Purpose Payments in place at this time then reduced the Gini coefficient from 0.297 to 0.271 (a reduction of 0.026).

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[12] H. Ergas & J. Pincus, 'Reflections on Fiscal Equalisation in Australia', paper presented at the State Funding Forum, September 12–13, 2011.

[13] A. Harding, R. Lloyd & N. Warren, '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.

[14] See Committee for the Review of Commonwealth–State Funding, *Review of Commonwealth–State Funding Final Report*, August 2002, pp.125–126.

- Horizontal fiscal equalisation had the smallest effect, reducing the Gini coefficient from 0.271 to 0.252 (a reduction of 0.019).

The most recent ABS measure of the Gini Co-efficient in 2009–10 for Australia was 0.338.[15]

While equity is most often cited as the strongest argument for full fiscal equalisation, its impacts are seemingly small and at the margin, compared with the more substantial role played by the broader tax and transfer system. While this in and of itself may not be a cause for great concern, its impact on individual equity does not appear to warrant the trade-off with adverse efficiency impacts of equalisation, including the resources involved in maintaining such a complex methodology.

Efficiency

Studies on the efficiency impacts of horizontal fiscal equalisation are largely divided, with some suggesting a positive impact on efficiency and others suggesting it has a negative impact on efficiency. In the Australian context, arguments in favour of the current system of fiscal equalisation tend to suggest that the costs from an efficiency perspective are likely to be small. This position is on the basis of previous empirical studies and also taking account of the relatively minor effects on incentives for states given the small impacts on relativities of taking various policy decisions at the state level.

The BCA acknowledges that in certain instances the effects of HFE on efficiency may appear small, however, the impacts of HFE must be considered more broadly. In particular:

- The impact on incentives from HFE for a particular state will depend on its position in relation to the ‘average’. In some areas variation from the average will be small but in other areas it will be much larger. While many of these positions may not change for a considerable period of time, economic and other circumstances can change very rapidly and begin to have a significant effect on a state’s GST distribution.
- In general, the research that has been undertaken to estimate the impact on state incentives has involved a static analysis that doesn’t properly account for the dynamic impact on incentives.
- The impact on incentives at the state level is cumulative, coming on top of the effects of vertical fiscal imbalance and the broad federal fiscal architecture.
- As a general principle, governments should as far as possible be accountable for the full fiscal consequences of their decisions. If a government does not receive the full fiscal benefits of reforms it undertakes due to consequential redistribution, then this can erode goodwill for reform (even if the amount redistributed is small).

Use of averages

The current methodology redistributes the GST based on the degree to which a jurisdiction’s cost of service provision differs from the ‘average’ cost of providing services. In other words, benchmarking occurs on the basis of ‘what states do’ on average rather than ‘what states ought to do’ if they are delivering services to an efficient standard.

For recipient jurisdictions this reduces the incentive to engage in reforms that increase the efficiency of service delivery. In effect, some of the gains of reducing service delivery costs would be redistributed away from the state with a reduction in the extent to which that state’s costs exceed average costs.

Similarly, states that raise less tax revenue than the revenue that would be raised applying the average tax policy for a particular base could have an incentive to increase their revenue

[15] See ABS, *Household Income and Income Distribution, Australia 2009–10*, Catalogue No. 6523.0, August 2011.

collections for that tax base, even if it is a relatively inefficient to do so compared with other tax bases.

Incentives for economic reform and development

In many cases, horizontal fiscal equalisation simply reinforces the adverse impact that vertical fiscal imbalance has on states' incentives to engage in economic reform and to develop their economies.

The process does this by further limiting the level of autonomy that states have over efficient tax bases (in this case, the GST), and reducing the fiscal dividend received by the state for growing the state's economy.

Neil Warren has illustrated the potential adverse distribution of fiscal dividends from reform with an example of what could happen if New South Wales unilaterally undertook tax reform that directly contributed to a one per cent increase of its economy. In summary, the effects are that:

- Taxes collected within the state would increase by $868 million – GST revenue increases by $144 million, personal income tax revenue increases by $660 million and payroll tax increases by $64 million.
- Of these increased revenues, New South Wales receives $106 million, including:
  - $42 million as its share of higher GST collections (equal per capita with no equalisation)
  - the full $64 million of extra payroll tax revenue.
- The other states receive $102 million in increased GST revenue.
- The Commonwealth receives an additional $660 million in personal income tax revenue.[16]

The most critical additional impact of the GST distribution arrangements is that in absence of similar reforms from other states, it can reduce the reforming state's share of GST revenue under the equalisation process. The reforming state is effectively recognised as not fully exploiting the revenue raising potential of its own tax base, particularly if the base expands, as intended by the reform, after the tax reduction.

Conversely, economic policy decisions that lead to slower economic growth on an ongoing basis will be compensated through equalisation of revenue disabilities. It has been suggested that this effect could reinforce growth-inhibiting policies in the most grant-dependent states.[17] Put simply, the equalisation process could diminish incentives for smaller states to proactively develop and exploit the economic potential of their jurisdiction. At a time when Australia's productivity performance is flat and there are growing long-term fiscal challenges for the states, we cannot afford to have any state or territory not engaging in policy reform to grow the fiscal and productive capacity of their economy.

Effects on composition of transfers

In addition to the effects already outlined, HFE also has the overall impact of changing the proportion of federal transfers received by different jurisdictions that are untied compared to an equal per capita basis of distribution. In effect, it results in the larger state economies such as Victoria, Queensland and Western Australia receiving more of their Commonwealth

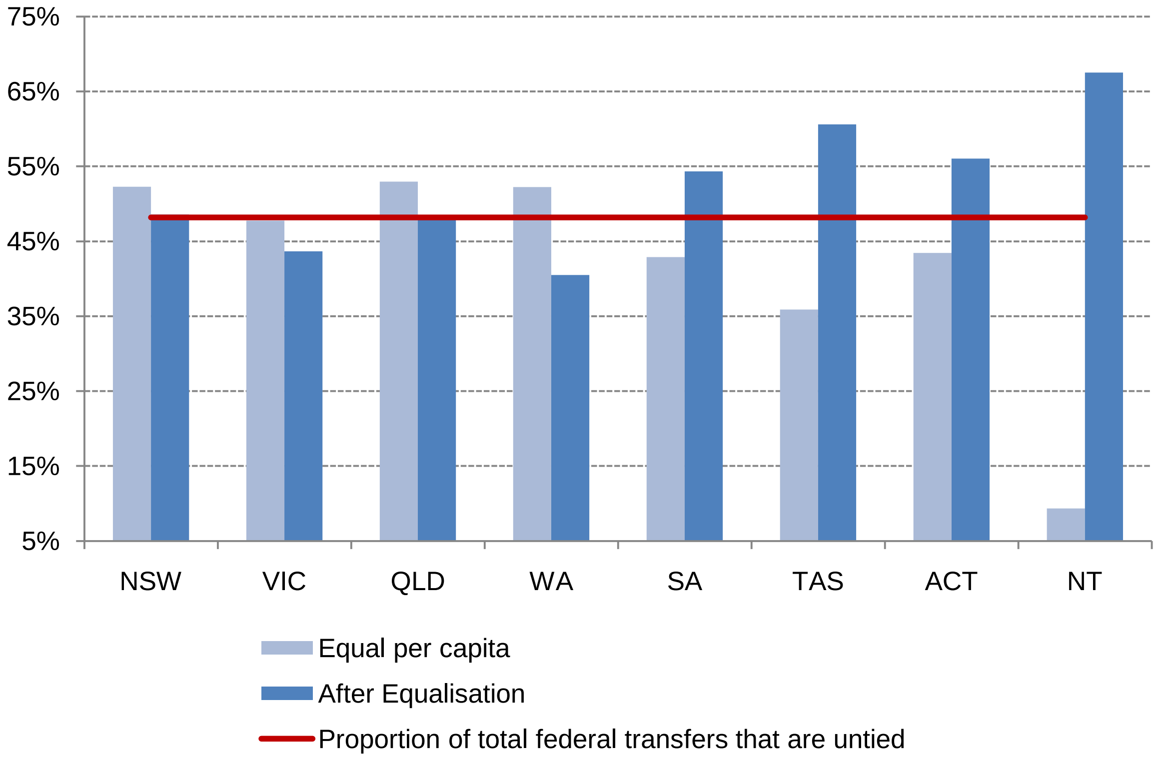
[16] N. Warren, 'Intergovernmental Fiscal Arrangements as a Constraint on State Tax Reform under Henry', paper presented at conference on Australia's Future Tax System: A Post-Henry Review, 21–23 June, 2010.
[17] R. Garnaut & V. Fitzgerald, *Issues in Commonwealth–State Funding*, 2002.

transfers on a tied basis than would be the case under an equal per capita distribution of the GST. Ergas and Pincus note that:

> … somewhat perversely, greater equalisation has tended to reduce the fiscal resources of higher productivity jurisdictions, making them more dependent on transfers from the centre. The resulting pattern is one in which the higher a jurisdiction's long-term per capita GSP, the greater has been the equalisation 'tax' and the larger the share of tied funding in its total revenues.[18]

Figure 5 identifies the proportion of federal transfers received by each jurisdiction that are untied before and after equalisation and the total proportion of federal funds that are transferred on an untied basis.

Figure 5: Proportion of Federal Transfers Received That Are Untied (2009–10)



Source: Commonwealth Budget Paper No. 3, Australia's Federal Relations 2011–12.

On the one hand, it could be argued that these outcomes simply reflect both the increased cost of service provision and lower revenue raising capabilities of the recipient states. If we also take own-source revenues into account, state governments collectively have access to around 77 per cent of untied funds, with Victoria (around 72 per cent) and the ACT (at around 82 per cent) the only major outliers.[19]

However, it is also reasonable to question why the larger economies would receive less of their federal transfers on an untied basis than other states while the Northern Territory and Tasmania would receive considerably more of their transfers as untied funds. This could potentially work against the most efficient allocation of resources. For example, the Northern Territory receives significant compensation through equalisation on the very specific account

[18] H. Ergas & J. Pincus, 'Reflections on Fiscal Equalisation in Australia', paper presented at the State Funding Forum, September 12–13, 2011, p. 6.

[19] BCA calculations based on ABS, *Government Finance Statistics, Australia*, Catalogue No. 5512.0, April 2011 and *Taxation Revenue, Australia*, Catalogue No. 5506.0, April 2011.

of relatively high assessed expenditure needs of its Indigenous population. However, as it is untied there is no requirement that this revenue be spent on services most relevant to this population. These issues raise questions about what should be equalised and whether the current approach to full equalisation is too extensive.

Accounting for urban population growth

The current methodology places significant emphasis on recognising the cost impacts of providing services in more remote areas where populations are more dispersed. However, it does not recognise the potential for increasing costs of service delivery in more densely populated areas, with the exception of transport-related costs.

It may be reasonable to expect that there are some economies of scale in service provision in more densely populated urban areas, but it is likely to be equally the case that there are diseconomies of scale – for example recent increased expenditure by some states on policing in cities.

In addition, Australia's cities are home to a higher migrant population which also presents different demands on service delivery. Garnaut and Fitzgerald have previously noted the negative effects of not recognising this within the equalisation process:

> Sydney, Melbourne and Perth have much higher proportions of overseas-born to total population than the rest of Australia. This generates many challenges of adjustment, the meeting of which makes demands on public services … Measures to provide more and better public goods outside New South Wales, Victoria and Western Australia, at the cost of higher taxation or poorer services in the "migrant cities" can have large effects on growth in other regions as well as on the national economy, through their effects on levels and composition of migrants.[20]

If governments are to plan for and effectively manage population growth, then policy and funding frameworks must be conducive to this. Unfortunately the current methodology does not adequately recognise the fiscal requirements of state governments in taking steps to manage population growth.

Accounting for economic growth

Similar to the challenges involved in managing strong urban population growth, there are also particular challenges in funding the infrastructure necessary to support strong economic growth in particular states. Productive capacity is necessary to fully exploit opportunities flowing from strong demand for natural resources in the mining states and also to put states on a sustainable path for continued growth of their economies.

In theory, the public infrastructure necessary could be funded from the fiscal dividend from economic growth received by the state in the form of increased own-source revenues. However, vertical fiscal imbalance means that the Commonwealth will receive a substantially larger share of increased revenues flowing from this, and GST revenues are not redistributed in a manner that recognises these challenges. The analysis presented here suggests that those states experiencing significant economic growth may instead receive lower GST revenues on account of their assessed increase in fiscal capacity relative to the per capita average.

Simplicity

There appears to be broad acknowledgement from the states that the equalisation process has become more complex over time with ever increasing data requirements.

[20] R. Garnaut & V. Fitzgerald, *Issues in Commonwealth–State Funding*, 2002, p. 10.

It should be acknowledged that the CGC has itself previously questioned "whether equalisation is being asked to do too much".[21]

The CGC has also taken some steps to simplify the current methodology. For example, its 2010 review saw it move from 29 sub-categories for revenue assessments down to 13 and on expenditure assessments it moved from 171 components and 344 disabilities to 43 components and 93 disabilities. [22]

Notwithstanding previous acknowledgement of this issue and some moves to simplify the methodology, a high level of complexity remains with associated disadvantages:

- Governments are less accountable to their citizens, as it is difficult to understand in practice whether the GST revenues a government receives do in fact allow them to provide a reasonably comparable level of service. It is important to remember that this is in addition to the potential for blurred accountabilities that result from the relatively high level of vertical fiscal imbalance.
- As noted below, complexity is an impediment to predictability of revenues for states.
- Complexity is likely to increase the costs of administration at both the Commonwealth and state levels.

The BCA also acknowledges that reconciling simplicity with other objectives could be challenging – for example, addressing the issues raised here in relation to efficiency while making the current methodology simpler could prove difficult.

Predictability and stability

If state governments are to grow their economies, accommodate population growth and meet the fiscal challenges outlined previously, then it is clear that achieving maximum revenue predictability and stability will be critical.

It is a testament to the complexity of the current process that state governments, who understand the equalisation process most effectively outside of the CGC, have difficulty predicting the outcomes of equalisation.

Distributing a fixed pool of revenue subject to both expenditure and revenue relativities in and of itself presents the potential for significant changes in distribution from year to year. This is further exacerbated by a number of methodological issues with the retrospective application of changes to data on previous years' assessments adding significant uncertainty to the revenue received by jurisdictions.

Recent examples of issues impacting on the predictability of state revenues include the treatment of certain Commonwealth infrastructure payments to the states and the impact of assessments of mining royalties.

Treatment of infrastructure payments

The BCA is concerned that CGC assessments of certain infrastructure payments could work against the predictability of GST distributions and effective investment in long-term infrastructure. The CGC's decision to include Commonwealth funding for the Regional Rail Link in Victoria (just over $3 billion) has resulted in the state losing around $1.4 billion over its forward estimates. In effect, the state has been penalised with lower and more volatile revenues on account of their investment in long-term infrastructure.

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[21] Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities — 2004 Update*, 2004, p.84.

[22] Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities: 2010 Review*, 2010, p. 85.

Mining royalties

In areas where the revenue base for assessment is dominated by a small number of jurisdictions (e.g. mining), policy changes can have a disproportionate effect on distributed revenues. For example, a recent decision by the Western Australian Government to remove iron ore 'fines' royalty concessions would have led the CGC to move these revenues into the high royalty rate category for assessment. This policy decision on its own would have increased royalties in the state by about $300 million but would have seen a loss in GST revenue of around $1 billion per annum. This outcome was prevented through the intervention of the federal Treasurer.[23]

The BCA is of the view that states should be afforded every opportunity to manage a stable budget based on robust revenues and efficient expenditure. With GST revenues making up a substantial share of state revenues (over 20 per cent), the methodology for redistributing it should not unduly impair states' capacity for effective long-term budget management.

[23] See clause 11 of Terms of Reference on p.vii of Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities: 2011 Update*, 2011.

OPTIONS FOR FURTHER CONSIDERATION

We believe that the review is taking the right approach by undertaking a high-level merit review of the current methodology and developing options for its interim report. In identifying options as part of its interim report, the BCA urges the review not to be constrained in the consideration of options to improve the current methodology for GST distribution.

We recognise that balancing the objectives identified above for all jurisdictions is a difficult task and ultimately the government will need to make tradeoffs in determining the preferred methodology. In order to provide transparency of the trade-offs involved, we believe a number of options should be considered with preliminary estimates of their impact undertaken.

While options for reform can be proposed by those submitting to the review, the review's secretariat will be in the best position to inform the debate about options by publishing estimates of the revenue and other impacts on different jurisdictions that would result if various options were implemented. This would include high-level options that would structurally change the nature and scope of the equalisation process through to more detailed adjustments to the existing methodology.

The BCA considers that a high-level, top-down approach to options is likely to be the most effective approach to progressing reform at this stage. A bottom-up approach focused on detailed adjustments risks an unproductive focus on the 'winners' and 'losers' across a wide range of revenue and cost categories. It is likely to be more beneficial at this stage to develop options for a high-level architecture and how any transition to a new model could be managed while maintaining predictability and stability of state revenues.

If the process of equalisation is to be fundamentally reformed over time, then it is likely that Commonwealth central agencies will need to play a stronger role in oversight and transitioning of the equalisation process.

The independent role of the Commonwealth Grants Commission remains important, but a broader perspective on the effective distribution of the GST will be necessary within the context of state tax reform and the need for comprehensive tax reform to meet the considerable long-term fiscal challenges that all levels of government confront.

High-level options

Much like the heightened level of vertical fiscal imbalance, Australia has a relatively pronounced form of horizontal fiscal equalisation by international standards. For example, Canada applies a representative tax system (RTS) that only equalises revenue capacity, while Germany has a system of partial equalisation. The United States does not have an explicit equalisation system.

While either of these systems would not necessarily be suitable in the Australian federation, it is not clear that Australia's particular circumstances relative to other federations imply a strong case exists for full equalisation. The assessment of full equalisation outlined here suggests that it introduces significant complexity, undermines predictability and stability of state budgets and can erode incentives for efficient performance, all while delivering relatively small gains in individual equity.

The simplest approach to distributing the GST without compromising efficiency could be on an equal per capita basis. In the long term the government could move to a full equal per capita distribution of the GST. Such a system could be configured so that current donor jurisdictions would receive an equal per capita share. Recipient jurisdictions could be compensated with a greater than equal per capita share through targeted arrangements separate to the GST so that they are no worse off.

The costs of moving to such an approach in the short term would be high and require a complex set of negotiations and an intergovernmental agreement. Achieving an outcome where current recipient jurisdictions are no worse off and donor jurisdictions receive an equal per capita share would cost around $3.6 billion based on redistributions in 2010–11 to South Australia, Tasmania, the ACT and Northern Territory. Achieving such reform on a revenue neutral basis may be best achieved as part of comprehensive tax reform including the reconfiguration of efficient state tax bases, removal of inefficient state taxes and possible access to a share of the personal income tax, as proposed by the BCA in its submission to the 2011 tax forum.

The BCA urges the review to consider options for moving to an equal per capita distribution system over the longer term as part of comprehensive state tax reform.

A number of options for moving to a system of partial equalisation in the medium term could also be explored as outlined below.

Partial equal per capita approaches

As an interim transitional step, one approach could be to examine options to quarantine a certain percentage of the GST pool for equal per capita distribution with the remainder being equalised through a simplified assessment process. This could be implemented through a gradual increase in the percentage of the pool that would be distributed on an equal per capita basis – for example, a starting point could be 25 per cent.

Confined cost equalisation

Equalisation could focus on a smaller number of core expenditure items such as health and education, which should be the focus of a reasonably comparable set of safety net services. Consideration could also be given to removing categories such as indigeneity and addressing these assessed disabilities through more targeted means. This approach would have the advantage of considerably simplifying the methodology. However, this approach would also need to be accompanied by a mechanism to encourage efficient service delivery, otherwise it would retain the problems of the current system in relation to incentives for efficient service delivery.

Removal of territories from equalisation

It is worth considering whether the marginal benefit of including the two least populous jurisdictions in the equalisation process is outweighed by the costs in terms of increased complexity and administration. The territories could receive a straight equal per capita payment from GST revenues, with their remaining revenue requirements made up through transfer payments from the Commonwealth. This would require additional funds or the reprioritisation of expenditures at the Commonwealth level. Such an option could be explored as one way of simplifying the assessment process and lowering administration costs. Such an approach is not without precedent, with Canada targeting its territories' fiscal capacities outside of the equalisation process.

Options for adjustment to current methodology

While the BCA does not favour a detailed bottom-up approach to options focused on detailed adjustments to the existing methodology, we nonetheless see value in exploring how different mechanisms could be incorporated in the methodology to address some of its weaknesses. Given the fixed pool of the GST, it will be exceedingly difficult to deal with many of these weaknesses within the current system of equalisation, without making particular states worse off or introducing further complexity. Nonetheless, if such a course of action is pursued as part of the review, then the following matters could be considered.

- **Use of efficient cost benchmarks**: The most effective way in which to improve the incentives for more efficient service delivery is through a move away from assessment against average costs. Establishing a form of efficient cost benchmarking could prove challenging, although the current process the New South Wales Government is undertaking to benchmark its public service costs may provide valuable input. One possible approach would be to establish an efficiency factor that is discounted from the average. It should also be noted that the BCA is not advocating a performance-based reporting approach as part of such a benchmark.
- **Remove disincentives for economic development and reform**: On the revenue side, disincentives for states to undertake reforms that grow their economies and the associated revenue bases that go with them should be removed.
- **Urban growth costs**: Cost assessments should take account of the potential diseconomies of scale in delivering services in rapidly growing cities.
- **Economic growth costs**: The GST distribution should recognise the costs associated with rapid economic growth, including the public infrastructure necessary to fully exploit opportunities flowing from strong demand for commodities from resource states.
- **Infrastructure payments**: Additional transport infrastructure payments made by the Commonwealth to the states should be neutral in their treatment of different modes. One-off payments for long-term infrastructure projects such as those made under the Building Australia Fund should be excluded from assessment. States should not be penalised with lower and more volatile revenues on account of their investment in long-term infrastructure.

CONCLUSION

The process of horizontal fiscal equalisation is just one of a complex range of Commonwealth–state financial issues. This review is being undertaken in the immediate aftermath of the tax forum and at the same time that a state taxes review is underway. Underlying all of these processes is the very significant issue of the states having accountability for delivering high-demand services but with insufficient tax revenue of their own. Keeping this issue within the frame of each state tax reform process will significantly improve the prospects of achieving well-integrated reforms that strengthen the performance of governments across the federation.

The Business Council of Australia does not underestimate the challenges involved in designing and implementing reforms to Australia's system of horizontal fiscal equalisation. However, this task will be greatly assisted by thorough and considered analysis of a range of options and their impact.

A commitment to substantial long-term reform of the system for distributing the GST could provide a platform for pursuing more comprehensive reform of state taxes. Such reform could deliver greater fiscal autonomy for the states with stronger and more efficient taxes to address their long-term fiscal challenges, along with clearer accountabilities for delivering efficient services and strong incentives to grow their economies to meet these challenges.

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