NSW Business Chamber

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GST Distribution Review
The Treasury
Langton Crescent
PARKES ACT 2600

Submission to the GST Distribution Review

The NSW Business Chamber welcomes the opportunity to make a submission to the GST Distribution Review. The NSW Business Chamber represents the interests of around 30,000 companies across NSW and the ACT, ranging from owner-operators to corporations and from manufacturers to service providers.

The NSW Business Chamber has been calling for reform of the GST distribution process for some time. In our 2010 policy blueprint – *10 Big Ideas to Grow NSW,* we called on the Government to simplify the GST distribution formula to improve transparency, reduce costs to Government, and create a closer link between program funding and delivery. [1]

In our submission to the Senate Select Committee on Reform of the Australian Federation, we again noted the perverse incentives that the current Horizontal Fiscal Equalisation process was creating, and called on the Government to commission an independent review of the current system.[2]

For this reason we welcome the Government's appointment of a GST Distribution Review Panel to investigate the issue and report back with recommendations for improvement. This Review provides a real opportunity for the Government to implement the reforms to the GST distribution process which are necessary to ensure that the system does not continue to create perverse outcomes and undermine incentives for the States to independently undertake broader tax reform.

Our submission to the GST distribution review focuses on three main themes.

- The current system of horizontal fiscal equalisation;
- Weaknesses of the current arrangements; and
- Proposed improvements to the system.

NSW Business Chamber Limited
140 Arthur Street
North Sydney NSW 2060

ABN 63 000 014 504

Locked Bag 938
North Sydney NSW 2059

DX 10541 North Sydney

t 13 26 96
f 1300 655 277
e navigation@nswbusinesschamber.com.au

Regional Offices ACT, Mid North Coast, Western Sydney, Northern Rivers, Hunter, Murray/Riverina, Illawarra, Southern Sydney, Northern Sydney, Central Coast

[1] NSW Business Chamber, *10 Big Ideas to Grow NSW*, 2010, p. 24.
[2] NSW Business Chamber, *Submission to the Senate Select Committee on Reform of the Australian Federation*, 2010, pp 8-9.

The current system of horizontal fiscal equalisation

Significant vertical fiscal imbalance exists between the States and the Federal Government. The States have significant expenditure responsibilities relative to their capacity to raise this revenue, while the Federal Government has a relatively narrow range of responsibilities supported by a much deeper tax pool. This situation means that the States are reliant on transfers from the Federal Government to finance a significant proportion of their activities.

One of the most significant transfers from the Federal Government to the State Governments is the distribution of the GST revenues. In 2011-12, the Federal Government will provide the States with a total of $95 billion in payments for specific purposes and general revenue assistance.[3] More than half of this amount is made up of GST transfers ($48.4 billion).[4] Given that the GST distribution represents such as significant proportion of total Federal transfers to State Governments, it is critical that the distribution mechanism is effective and appropriate.

Each State and Territory has a different capacity to raise revenue and deliver services. For example, States with larger endowments of natural resources may find it easier to raise additional revenue, while States with a highly dispersed population may find it more expensive to deliver the same level of services as a densely populated state. The process of horizontal fiscal equalisation seeks to adjust transfers to the States to address these inequities. This is an issue which is common to a number of Federations around the world, and many of them use distributional mechanisms to equalise State capabilities.

In allocating the GST revenue in Australia, the Commonwealth Grants Commission (CGC) applies a formula designed to achieve horizontal fiscal equity. Under the current arrangements, the amount of GST revenue received per capita in each State differs significantly. For example, in 2011-12, the Federal Government estimates that Western Australia will receive roughly $1,400 per capita in GST transfers, while the Northern Territory will receive GST transfers of more than $10,000 per person.[5]

Weaknesses of the current arrangements

The formula used by the CGC involves over 400 measures and is generally seen as being overly complex and convoluted. The framework applied is very technical and is well understood by few people.

The complexity of the system was well summarised by the previous Treasurer when he said, "The State Governments spend huge resources putting their cases to the Commonwealth Grants Commission... In fact, State Treasuries probably spend more time on this than practically anything else."[6] The complexity of the current system leads to high implementation costs, as governments employ teams of staff to argue for interpretations of the rules which lead to the most favourable outcomes for their jurisdiction.

Professor Garnaut notes that by subjecting GST distributions to the CGC process, "What had been a minor idiosyncrasy became a central part of the Australian fiscal system, profoundly affecting incentives for sound financial management in the Federation."[7]

[3] Commonwealth Treasury, *2011-12 Budget,* Budget Paper 3, p. 1.
[4] ibid., p. 103.
[5] ibid., p. 108.
[6] AB News, *Transcript of interview with Peter Costello,* August/September 2005
[7] Ross Garnaut, *speech – Climate Change, China Booms and Australia's Governance Struggle in a Changing World*, August 2010

In addition to being overly complex, the current arrangement can create perverse outcomes, and encourage States to defer reform decisions which would otherwise be in their best interest. This could act as an impediment to the implementation of a number of the State tax reforms recommended in the Henry review.

For example, under existing arrangements, those States which maintain numerous taxes with narrow bases can expect to receive a greater share of untied grants than those States which streamline their tax systems.[8] The focus on capacity to raise funds means that, in some instances, states that cut their taxes are penalised via the CGC distribution. Professor Neil Warren has also noted that the HFE process undermines State tax reform, finding that "…most of the benefit arising from State policy reform will flow through to the other States (through its impact on HFE grants) and to the Commonwealth…"[9]

Australia's process of HFE continues to compare poorly with other federations. In particular, in reviewing Australia's intergovernmental fiscal arrangements, Professor Warren identified the following weaknesses:[10]

- Australia attempts to equalise both revenue capacities and expenditures, instead of revenues only;
- Australia's mechanism of allocation is more complex than that of other federations; and
- The Australian equalisation process relies more on variables that are endogenous (such as revenue capacity and specific expenditure costs) than those that are exogenous (such as population and gross state product).

Proposed improvements to the system

The current HFE process is designed to "to compensate jurisdictions for demographic, economic, social and geographic disadvantages over which they have no control and which would otherwise render them incapable of providing, with reasonable levels of efficiency, a standard of public services comparable to that which other jurisdictions can and do provide."[11]

The benefits of such an approach are minor – there is little difference between the economies of NSW, Victoria, Queensland, Western Australia and the ACT. While some of the smaller States will require higher levels of Federal Government support, there is little justification for the Government to discriminate between the economies of NSW and Queensland in transferring GST revenue. At the same time, the costs of the current process are significant, both in terms of administrative costs to governments and through distorting behaviour and undermining incentives for reform.

In its current form, the costs of HFE outweigh the benefits, and Australia would be better served by moving to a different system of GST distribution. However, minor changes to the ways the current process operates will not be able to address the existing disincentives to reform, nor will such changes be able to significantly simplify the process.

The NSW Business Chamber believes that the distribution of GST funding should not be equalised, and that instead funds should be distributed among the states on an equal per capita (EPC) basis. Such an approach would remove the incentives to game the system which currently exist, and create significant administrative savings for governments. This change would also remove the disincentive that the GST distribution currently provides in relation to State tax reform.

In addition, the move to a per capita model would provide States with greater certainty around their GST revenue forecasts, which would assist with their fiscal planning. The States that currently donate GST

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[8] IPART, *Review of State Taxation: Final Report to the Treasurer*, October 2008, p. 38.
[9] Warren, Fiscal equalisation and State incentive for policy reform, September 2011, p. 7.
[10] Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements: Final Report, NSW Government*, 2006, pp. 89-90.
[11] Ergas & Pincus, *Reflections on Fiscal Equalisation in Australia*, 2011, p. 3.

revenue (including NSW) would have greater fiscal autonomy and far less cause to blame poor service delivery on a lack of Commonwealth funding.

While recommending a move to a per capita distribution, the NSW Business Chamber also recognises that Tasmania, South Australia and the Northern Territory will need additional funding, over and above the per capita allocation of GST, as a means of honouring the Federation’s commitment to economic fairness and equality. These needs should be met with separate transfers from the Federal Government to the States, which lie outside of the GST transfer system.

Should you require further information or clarification on any of these matters, do not hesitate to contact Mr Micah Green, Economist on (02) 9458 7259 or via e-mail at micah.green@nswbc.com.au.

Yours sincerely

Paul Orton

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Director, Policy and Advocacy