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Institute of Public Affairs

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GST Distribution Reform Inquiry
Productivity Commission
GPO Box 1428
CANBERRA ACT 2601

Dear Commissioners,

The only fair and sustainable solution to the GST distribution system is to abolish equalisation

The ongoing debate about whether the 2018 changes to GST distribution were 'fair' or not to Western Australia is irrelevant and unhelpful. The foundations of the current system, based on horizontal fiscal equalisation principles, are fiscally unsustainable, throttle economic growth, and increase fiscal uncertainty.

The Institute of Public Affairs recommends that governments should not look towards minor reform, but should abandon horizontal fiscal equalisation entirely.

GST redistribution is not 'fair' – it punishes economic reform and creates perverse outcomes

HFE as practised hubristically seeks to distribute GST so that each state can "deliver the average level of services if it makes the average level of effort to raise revenue". Such abstract concepts inevitably lead to unintended consequences whereby jurisdictions game the formula to increase their GST allocation rather than pursue intrinsically beneficial economic reforms.

Under HFE, the Commonwealth Grants Commission applies a complex formula to 'equalise' the states, based on the three most recent years of data pertaining to how much the states need to spend to provide the average national level of services and infrastructure, and how much revenue the states could raise by themselves. In other words, pro-growth economic reform that expands a state's tax base would mean that state would be entitled to less of the GST pool. This forms a powerful incentive for states to maximise GST revenue.

As the IPA has repeatedly argued since 2011, distributing the GST based strictly on population shares or alternatively based on the location of taxable transactions would be a far more economically efficient and transparent arrangement.[1] Disadvantaged states could receive top-up grants from the Commonwealth for specific purposes, and the opaque and costly process of HFE could be abandoned.

This isn't a fringe view. The 2002 review of GST distribution by economists Ross Garnaut and Vince Fitzgerald recommended a per capita distribution in the interests of simplicity and to free states from the penalties they endure for pro-growth policies.[2]

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Former state premiers Nick Greiner and John Brumby, a decade later in their review of the GST distribution, similarly found a per capita distribution would be optimal, as did the Abbott government's Commission of Audit.[3]

The prevailing system has delivered some egregious anomalies such as a consistently high GST relativity of well above 1 for the ACT, the highest-income jurisdiction, which arises from the federal government's anomalous exemption from payroll tax.

Moreover, the Northern Territory's consistently very high GST relativity arises from its large remote Aboriginal communities, creating potential perverse incentives. 'Closing the gap' would see it lose GST payments.

GST redistribution reinforces inefficient and destructive state taxes

HFE has self-evidently failed to elicit efficient revenue raising. This is due to complexities in how state revenue raising capacities are measured.

For instance, laudable efforts by the New South Wales state government to shift gradually to land tax, often considered the most efficient tax, failed in part because the HFE formula ignores the economic impact of property taxes on the property tax base.

In other words, Victoria, for instance, is deemed to have a weaker property tax base and therefore revenue-raising capacity than NSW, when part of that discrepancy stems from Victoria's decision to levy higher property taxes.

As a consequence, states continue to rely heavily on stamp duty on property transfers, arguably the most economically destructive tax.

GST redistribution reinforces Australia's pervasive fiscal imbalance between Canberra and the states

Ultimately, how the GST is distributed can't be viewed in isolation from the rest of the tax system. The overarching problem with Australia's fiscal arrangements remains a massive vertical fiscal imbalance, whereby states avoid the political and economic cost of raising their own revenue.

Excessive reliance on federal grants has encouraged excessive public spending at the state level. Indeed, the combined budget deficits of the three largest states by population total $42 billion, higher than the federal government's $37 billion budget deficit.

Indeed, the widespread perception the GST is a 'state tax' is a fiction. Not only is the GST collected and distributed entirely by the Commonwealth at its discretion, there is no rational basis why a 10 per cent consumption tax levied on a shrinking share of spending should match states' constitutional responsibilities.

Indeed, the 2018 reforms included an arbitrary federal promise to 'top up' the GST pool by $600 million in 2021, a sum that has been indexed by the growth in the GST pool itself, severing the link between GST collected and the 'GST pool'.

Individuals, households and businesses are in the best position to assess and maximise their productivity as they see fit. Spending one's money on oneself inevitably produces the best and most productive results.

Recommendations

The only 'fair' solution to HFE is to abolish HFE. In the event that some form of HFE is retained, it should be dramatically simplified.

Basing distribution solely on a handful of permanent structural disadvantages governments cannot alter, such as geography, demography and natural resource endowments, would ensure the system does not reward inefficient administration or regulations that artificially restrict economic activity.

The Commission should explore ways the existing formula could be changed to encourage states to introduce more efficient forms of taxation.

In an ideal world, states would be far more fiscally independent from Canberra. Failing that, the PC would do well to propose new arrangements better informed by economics that don't invite political band-aids.

Regards,

Adam Creighton
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[1] See Mikayla Novak, *Beyond its use by date: Australia's system of discal equalisation, and how to reform it* (Institute of Public Affairs, 2011); Morgan Begg, *Time to End GST Redistribution* (Institute of Public Affairs, 2017); Begg, *Time to End GST Distribution: 2018 Update* (Institute of Public Affairs, 2018).
[2] Ross Garaut and Vince FitzGerald, *Review of Commonwealth-State Funding: A review of the allocation of Commonwealth Grants to the States and Territories* (Final Report, August 2002).
[3] John Brumby, Bruce Carter, and Nick Greiner, *GST Distribution Review Final Report* (October 2012); National Commission of Audit, *Towards Reponsible Government* (Phase One Report, February 2014).