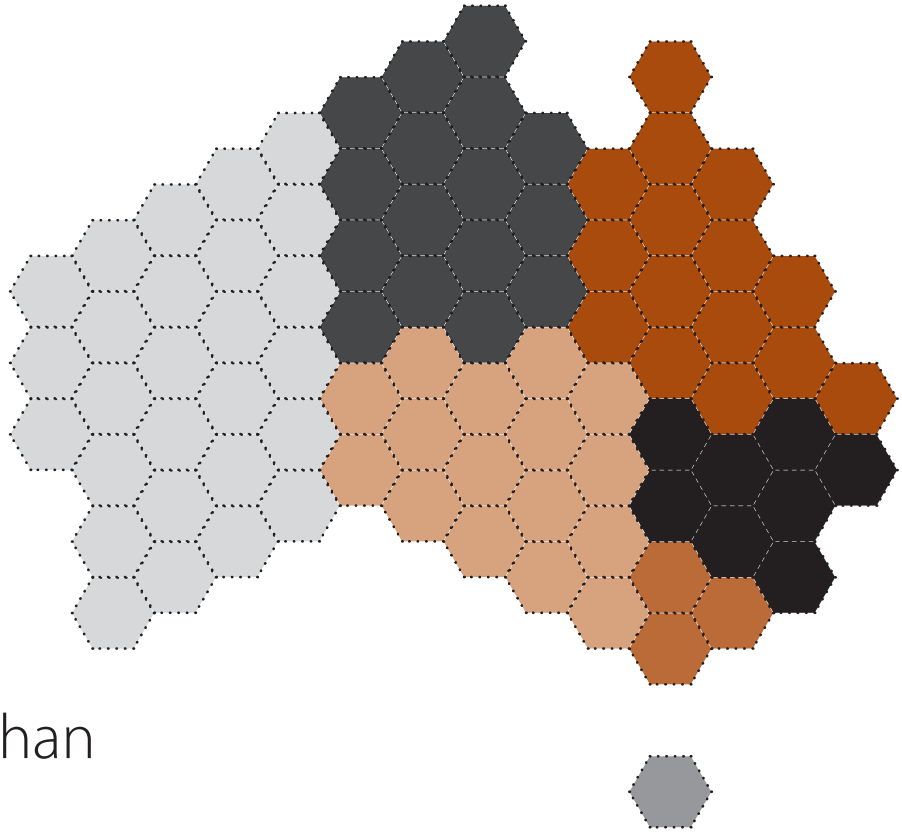
The GST:
Good try, but no banana



Mike Nahan

It has been six years since the introduction of the Goods and Services Tax—the tax that was to revolutionise the Australian tax system and state-federal relations in a single bound.

And the prognosis is not good. Indeed, Peter Costello's claim to have been 'scarred for life by the GST experience' is understandable.

The GST deal gave the States more money, with less responsibility, and they have predictably squandered much of it. The GST, which was supposed to be 'revenue neutral', resulted in a sizeable increase in the total tax take. While the GST did replace a number of particularly onerous taxes, it did not go far or fast enough, or even as far as originally agreed. And, the deal was done in such a way that it cannot be changed.

***Mike Nahan** is a Senior Fellow with the Institute of Public Affairs.*

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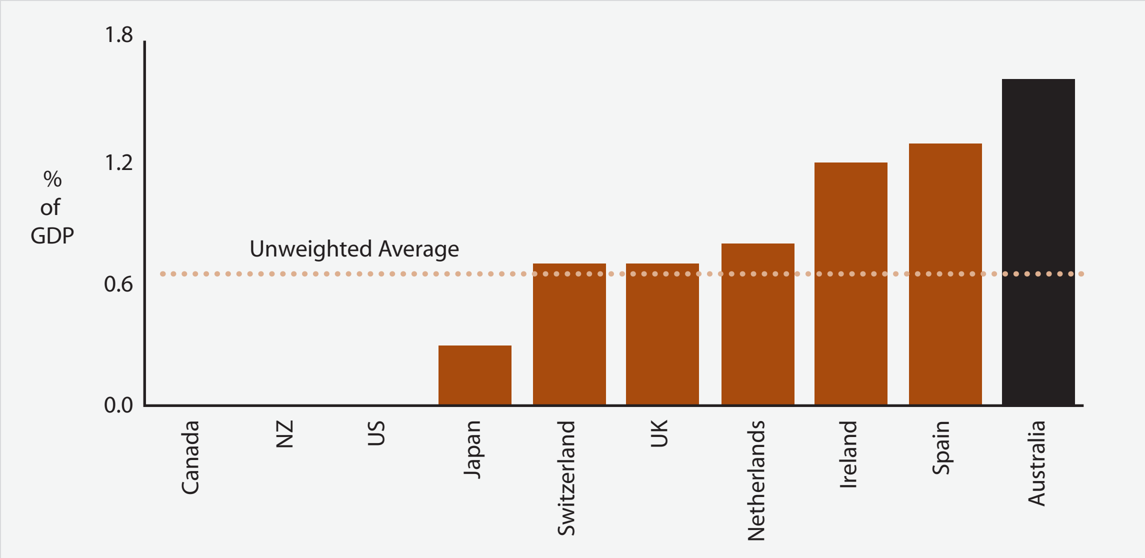
It stands as a warning to tax reformers of how good ideas can so easily be perverted by the political process.

The GST was in fact flawed from its inception, perhaps intentionally so. While the tax is levied by the Commonwealth, it was to be paid in full to the States in exchange for their eliminating a range of their own taxes. As such, it was designed to increase the States' already excessive level of dependence on the Commonwealth and increase the gap between the States' revenue-raising and spending responsibilities. It tied the States more tightly to the 'chariot wheels of the Commonwealth' and reduced their accountability to their own electorates for use of their money.

These flaws were, in turn, exacerbated by the political process. From the start, the GST was promoted as providing a 'growth tax' for the States—a tax base that grew in tandem with, or at faster rate than, the economy as a whole. This the GST did. What is more, the Commonwealth quarantined the States against down-side risks, but gave them the unconditional access to upside risks. That is, the Commonwealth offered a set of guaranteed minimum

Transaction Tax Burden: OECD-10, taxation as a proportion of GDP, 2003



Source: OECD Revenue Statistics, 2005

Note: Revenues from Bank Accounts Debits tax (BAD tax) is included in the total figure for Australia. Under the Intergovernmental Agreement on the Reform of Commonwealth-State Federal Relations, all States and Territories abolished BAD tax by 1 July 2005. (NSW abolished BAD tax on 1 January 2002)

payments so that no State would in any year be worse-off financially from the introduction of the GST, but was silent on whether the States could raise other taxes or what they would need to do if the GST turned out to be a bonanza.

The process was further undermined by the Australian Democrats. Despite the Coalition Government winning the 1998 Federal election with a mandate for its GST package, the Australian Democrats insisted that the tax reform package be altered according to its idiosyncratic whims, and the Howard Government, desperate to get a GST passed, did a deal. The deal included exempting a range of goods and services—fresh food, education and heath—as well as additional spending, much of which had no relevance to the GST. To fund these changes, which were estimated to cost $15.4 billion over the first four years, tax cuts were themselves cut back. This included dropping the promised reduction in the top marginal income tax rate from 47 per cent to 40 per cent and the slower phasing out and, in some cases, the deferral, of cuts to State taxes.

As such, the GST increased the tax take and generated more funds for all levels of governments—and it did so in spades.

Since the tax was introduced in 2000–01, GST collections, which are expected to reach $38 billion in 2005–06, have grown at an average annual rate of 9.1 per cent. This is over twice the growth rate of the economy as a whole and is significantly faster growth than initially projected.

The GST therefore delivered the States a huge sustained boost in overall revenue when introduced in 2000–01 and a subsequent further windfall of just over $11 billion.

Peter Costello has now forced all States to eliminate the agreed set of taxes, though not before 2011. The States, however, will keep the revenue repeated from postponing the cutting of those taxes. Moreover, even assuming that these taxes are eliminated, the GST is expected to provide the States with $14 billion more than they would have received from the system that prevailed before the GST.

The GST has not been the State sector's sole or even main source of windfall revenue. At the start of this decade, the States predicted that their own-tax revenue would decline over the next five years because of the GST deal and slow growth. As it turned out, the States reneged on their tax cuts and the economy boomed, particularly in those areas in which the States tax most heavily—housing, jobs and capital purchases. This resulted in the States receiving $28 billion more in own-tax revenue than they expected at the start of the decade.

What did the States do with their revenue windfall? One thing is clear: they did not use it to reform their remaining tax systems, or cut taxes in a meaningful manner, or begin a new round of economic reform.

While all States have fiddled with their tax systems under the banner of tax cuts, in reality they have at best

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done nothing more than give back a bit of bracket creep while at the same time clawing in more revenue through a widening of the tax base. At the same time, many have actually increased selected tax rates or introduced new taxes. No State has undertaken a systemic reform of its tax system, despite the urgent need to do so.

Arguably the main object of the GST was to reform the indirect tax base and specifically to eliminate a range of State transaction taxes. The GST has resulted in the cuts to some of these taxes.

Yet, despite these cuts, Australia, through the States, relies more heavily on transactions taxes than any other developed country. (See Chart. Note that the data in this chart are for 2003, three years after the GST was introduced with the expressed aim of reducing transaction taxes.)

Moreover, the largest and most destructive of such taxes—stamp duties on conveyances, insurance and motor vehicles—not only remain but have been made worse. Indeed, none of these taxes was ever included in the list of taxes to be cut as part of the GST deal—a serious omission.

What is worse, the GST has inflated these taxes. The stamp duties are levied on top of all other taxes and charges, including the GST. Thus in the case of all new vehicles, insurance products and new homes, the GST inflated the effective rates duty by 10 per cent through double taxation.

The GST also left the States with a smaller range of taxes. While the States have two potential 'growth taxes' in the form of payroll tax and land tax, they have decreased their dependence on them. Instead, they have increasingly relied on stamp duties. They have done so for all the wrong reasons. Stamp duties are less transparent, have a narrow base, are paid infrequently and as a lump sum, and are often simply added to the credit card rather being paid out of regular income.

The only economic reforms undertaken by the States over the last decade have been those directed and paid for by the Commonwealth through the National Competition Policy process. Led by Victoria, the States have recently begun to champion an ambitious but vague process of reform labelled the Third Wave Reform Agenda. Despite their riches and their claim that their reform agenda will provide massive gains to the economy, the States are demanding that the Commonwealth pay them to reform with an additional $10 billion over ten years.

Instead of pursuing reform to tax and service delivery, the States have spent their tax windfall on more of the same: more highly paid staff, more services, more programmes, more studies, more publicity and more infrastructure. Value-for-money has become a forgotten concept.

The failure of the States to use their tax bonus well should come as no surprise. Australia's fiscal federal system has long inculcated a mendicant mentality among the States, and the GST deal has made this worse.

The Commonwealth has become the States' main paymaster and has become directly and indirectly involved in just about every function of the States. The GST increased this by replacing a range of State taxes with the GST and by having the Commonwealth directly assume responsibility for raising a 'State tax' in all but name and for determining the composition of State taxes.

Despite these concerns, the States accepted the GST in the end as it gave them more money with fewer responsibilities. The GST also gave them the scope for hand-balling responsibility for their own taxes over to the Commonwealth—as witnessed by the need for the Commonwealth to force them to meet their tax-cutting obligations under the GST.

The quality of the States' fiscal decisions is also undermined by the structure of their tax systems. The principle of a good tax is that it is levied on as broad and as predictable a base as possible, with as few rates as possible. The broader the base, the fewer the exemptions, the greater its transparency and the more it is shared amongst the electorate. The States' remaining tax systems violate these principles—both in the terms of the tax mix and the structure of individual taxes.

The GST deal really did not reform the State tax system. All it did was replace some State taxes with a Commonwealth tax, leaving most of the destructive State taxes intact.

It is tempting to argue for the renegotiation of the GST deal. But the fact is that the deal is effectively set in stone. It is the subject of an Inter-governmental Agreement which, in turn, is enshrined in Commonwealth law. Under this law, any change to the tax base, or to the rate, or to means by which it is distributed to the States requires the unanimous support of governments at both levels and of both houses of the Australian parliament.

The moral of the GST story—get the reform right or do not do it at all.

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