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For the attention of the GST Distribution Review panel:

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## **GST DISTRIBUTION REVIEW**

This note follows my discussion with you over lunch on 9 July, and your request for me to send an aide memoire summarising the main points from that discussion.

### 1. The Problem

There are serious problems with Federal State financial relations which together are a major source of inefficiency in the Australian political and economic systems. The problems mostly stem from the high extent of vertical fiscal imbalance in the Australian Federation. This has tended and is tending to increase over time as demand for services provided by the States rises more rapidly than other expenditures, as the main sources of State revenues including GST increase less rapidly than the national economy, as successive High Court interpretations of the Constitution have expanded Commonwealth and constrained State taxation powers, and as the Commonwealth has used its preponderance of economic power to expand its revenue-raising activities in areas of overlapping jurisdiction.

The problems have four main dimensions.

(i) The first is extreme lack of transparency in the national political process. It is practically impossible for the residents of a State to allocate responsibility between the State and Federal Governments for good or poor performance on critically important matters of economic management and delivery of services. The consequence is that both State and Federal political parties announce commitments on matters for which delivery depends on complementary action from the other level of Government, and electoral competition focuses on attempts to claim responsibility for apparent successes and to avoid responsibility for apparent failures.

(ii) The second is inefficiency in delivery of services that have been made joint functions as a result of special purpose payments.

(iii) The third is the perverse incentives introduced through the processes of Horizontal Fiscal Equalisation in Australia, on both the revenue and the expenditure sides of State Government activity, and

the deadweight costs of managing the system. The second and third problems interact when, as is usually but inconsistently the case, special purpose payments (sometimes with amounts per person differentiated amongst states for reasons of equity or cost of delivery) are treated as general revenue and subject to equalisation by the Commonwealth Grants Commission.

(iv) The fourth—politically the most prominent but the least important—is a dubious and contentious allocation of public fiscal resources across the various States and Territories which, amongst other things, is associated with an unusually large public relative to private sector in the major recipient States.

## 2. Difficulties of Reform and the Need for Two Reform Time Frames

These large and costly problems have gradually expanded over the past eight decades, since the initially small and uncontroversial introduction of the Commonwealth Grants Commission in the 1930s. They were increased considerably by several developments around the turn of the current century: the Commonwealth Grants Commission's adoption of a more extreme fiscal equalisation objective; the increase in vertical fiscal imbalance associated with the replacement of a number of less efficient State taxes by the Commonwealth's GST; and the application of "equalisation" to a larger proportion of State receipts when the distribution of the GST was made subject to the Grants Commission processes. The problems have become the subject of more intense public disputation as the differences between the per capita entitlements of the largest recipient and donor States have grown with the rapid increase in mineral royalties in recent years.

The system that has accumulated over eight decades is impossible to change by agreement involving all of the States, because any new system would alter expectations of the inter-State distribution of revenues, and jurisdictions that were expected to receive less revenue would be bound politically to object to the change.

The system will be difficult for the Commonwealth to change, even if it has considerable support from a majority of States, because of the high political sensitivity of these matters in other States.

The Review's two Interim Reports do not seek to deal with the fundamental problems. Rather, they seek to improve the existing system incrementally and at the margins. They would leave the essential including the problematic aspects of the current arrangements in place.

I accept that a number of the Interim Reports' suggestions for incremental change would reduce some of the costs and problems of the current system. It would be desirable for some of these suggestions to be accepted by the Commonwealth and implemented immediately.

I also understand and accept that it would be more or less impossible for recommendations for more fundamental change to be implemented in the

immediate future, and that you wish to make suggestions for change that are amenable to implementation.

I therefore suggest that you divide your recommendations into two sets, according to the time frame within which it is anticipated that they could be implemented. One set would be capable of immediate implementation. The other set would involve fundamental reform and would be put on the table for discussion now and for implementation two or more parliamentary terms into the future, in 2020. 2020 is far enough into the future for there to be significant uncertainty about whether a particular State would be a fiscal beneficiary of or loser from change. For example, the Northern Territory or South Australia might become an exceptionally large recipient of mining revenue per person over the next eight years. And 2020 is far enough in the future for Governments, Federal and State, to be able to take decisions either with certainty that current leaders or the parties from which they are drawn would no longer be in power at the time of change, or at least with a high degree of uncertainty about whether they would still be in power.

The suggestions contained in this note would all be part of the recommendations for 2020 implementation.

### 3. Four Challenges Leading to One Solution in Reform of Horizontal Fiscal Equalisation

The elaborate and opaque system of Horizontal Fiscal Equalisation would lead to relatively small departures from a simple equal per capita distribution of Commonwealth transfers to the States if it were not for four particular matters:

(i) The cost of what the Commonwealth Grants Commission calls “indigeneity”. This is above all a transfer from other jurisdictions to the Northern Territory in recognition of what the Commission calculates as the excess cost of providing services to Indigenous communities. While the higher per capita payments to the Northern Territory are in recognition that the costs of services to Indigenous communities are high, there is no requirement that the increased payments be used for this purpose. It would be more transparent and efficient, more effective in the provision of services to Indigenous communities, and more closely aligned with Australian community expectations, if the Commonwealth accepted responsibility directly for meeting the additional costs of “indigeneity”.

(ii) The ACT receives substantially more than its population share of the GST pool, although its per capita income and average household income is far higher than any other State or Territory. This is at first sight anomalous and inequitable, and may be inequitable upon closer inspection. The situation arises because the unusual economic base of the Territory gives it a relatively low capacity to raise revenues in some of the ways in which the other jurisdictions taken as a whole raise their revenue. The reduction of GST payments to the ACT to the average Australian level would require the ACT to make greater use of

the other tax bases that are available to this exceptionally prosperous community. Alternatively, and a point to be debated, it may be appropriate to remove the exemption of sovereign employment from the payroll tax.

(iii) Differences in capacity to raise royalties from minerals production are now the major cause of variations in revenue-raising capacity across jurisdictions, and sit alongside the costs of “indigeneity” as the main source of interstate variation in per capita receipts of GST revenue. The Grants Commission’s approach to Horizontal Fiscal Equalisation effectively distributes royalty revenue across the States in proportion to population with a lag of three years. As a result, the share of Western Australia in the distribution has declined sharply in recent years and will continue to decline to a position in which the State receives less than half—perhaps much less, in the extreme down to zero—of the average Australian grant per person. One consequence of the averaging away of resource revenues is that the States have little incentive to introduce economically rational levels of taxation and royalties on the sector. A consequence of the particular formulae used by the Grants Commission is that the States are fiscally compelled to apply royalties in economically distorting form. An efficient resource rent tax would raise no revenue in the early years of a mine’s life and may never generate revenue from some mines that nevertheless make a positive economic contribution. And yet the State would be penalised if it did not apply ad valorem royalties at standard rates the lower of which would discourage some production from all mines and all production from some economically acceptable mines. The tensions and economic inefficiencies inherent in these arrangements have been exacerbated by the introduction of a Commonwealth Minerals Resource Rent Tax with provision for State royalties to be credited against it. The Second Interim Report of the Review Committee discusses this issue at length. It concludes, soundly, that the issues can only be resolved through agreement, since both the States and the Commonwealth have constitutionally valid claims on the mineral revenue (the Commonwealth through its powers over allocation of grants to the States and probably through its corporate and income taxation powers). In 5 below I sketch a possible basis for agreement on imposition, collection and distribution of minerals taxation.

(iv) Some overheads of Government in each jurisdiction are essential to the preservation of the Federation and significantly raise the costs per person of providing basic services in small jurisdictions. Vince Fitzgerald and I suggested in our Review of Federal-State financial relations for the New South Wales, Victorian and Western Australian Governments in 2002 that this could be handled by a lump sum payment to each State and Territory, of about \$100 million per annum in the dollars of one decade ago. A lump sum payment still

seems to be the straightforward way to handle the exceptional costs per person of the overhead costs of government in small jurisdictions.

I conclude that the elaborate, complex, opaque, distorting and distracting system of Horizontal Fiscal Equalisation could be removed with surprisingly small disturbance of the current interstate-and-territory distribution of untied grants from the Commonwealth by movement to equal per capita grants alongside four other innovations: separate Commonwealth payments to cover the exceptional costs of providing services to Indigenous communities; removal of sovereign exemptions from payroll tax and or acceptance that it is inappropriate to make large transfers to the ACT from States and Territories with much lower average incomes; agreement on reform of mining taxation responsibilities as discussed below; and the introduction of a lump sum payment for overheads to small, low-income States and Territories.

The Commonwealth Grants Commission could be given the role of assessing which States and Territories qualify for the lump sum payments and for setting the amount of the payment that from time to time cover the minimum necessary overhead costs of Government. This would return the role of the Commonwealth Grants Commission to something like that allocated to it on its establishment in the 1930s.

#### 4. Disciplining the Role of Special Purpose Payments

The pervasive nature of Special Purpose Payments removes almost all exclusive initiative from the States and negates much of the potential value of the Federation. There are widely differing views within the Australian community on the value of a Federation comprising separate States with sovereign powers, compared with the value in modern circumstances of a unitary Australian sovereign state. My own view is that the Federation is potentially of high economic and political and social value to Australia, generating benefits from decentralisation of delivery of services and in some areas of public choices on taxation and expenditure. Others have different views.

Whatever one's views on the potential value of the Federation, we are currently in the worst of all worlds. The States do not have the fiscal freedom through which they can deliver the potential benefits of Federation. And the Commonwealth does not have the capacities for effective central exercise of the powers of Government.

Now, over a century after the Federal compact, is a good time to review thoroughly the distribution of powers between the two levels of sovereign Government. This is unlikely to lead to a shrinking of formal Commonwealth powers; it may lead to an expansion of those powers. If change is impossible, let us confirm the established arrangements and introduce fiscal arrangements that allow them to work efficiently. Whatever the outcome of the Review, confirmed through the Constitutional processes as necessary, let us establish a norm in which the States have unambiguous fiscal capacity to exercise authority within their jurisdictions, and in which the

Commonwealth's intervention in delivery of services and exercise of powers is mostly confined to areas of its own sovereign authority. I say mostly, because the dynamics of politics will from time to time propel the Commonwealth into initiatives in areas of state sovereignty. But let us see such initiatives as deviations from a desirable norm.

A decade ago, Vince Fitzgerald and I recommended that a few services might be designated specifically as jointly provided services, subject to and limited by explicit Commonwealth-State funding agreements. I would now suggest even greater austerity in the joint provision of services than we did a decade ago.

## 5. Minerals Taxation

This is a major problem for our Federation. Fortunately, the problems have become so obvious to so many Australians that there is widespread understanding of the need for fundamental departure from the status quo. The departure cannot be to leave all of the taxation power and revenue with the States: that would be too great a violation of common Australian perceptions of interstate equity. And not only Australian: all countries with major inter-regional variations in minerals revenues have established mechanisms for substantial inter-regional redistribution.

A solution inevitably involves some re-examination of the arrangements that were negotiated with part of the resources industry two years ago. I do not wish to make optimal resource taxation a major focus of this note on Federal financial relations, but it is important for Australian democracy as well as equity and economic efficiency that at some time in the future—comfortably before the implementation of a major reform of Federal-State financial relations in 2020—Australians are able to sustain the cool discussion of the public interest in this important matter that they were denied in 2010.

Simply by way of illustration, let us say that analysis of the public interest identified the optimal form and rate of resources taxation as those of the Petroleum Resource Rent Tax that was legislated for new projects in the mid-eighties and extended to Bass Strait a few years later. This happens to be the form and rate of tax that was extended without public controversy to coal seam gas at the time of introduction of the Minerals Resource Rent Tax.

My suggestion begins with the general application of the “optimal” form of resources tax to all onshore resource projects by the Commonwealth Government, at half the “optimal” rate. If the “optimal” rate were 40 percent, the Commonwealth would apply a rate of 20 percent. In this example, which happens to be just below the rate of 22.5 percent at which the Minerals Resource Rent Tax is now applied. The Commonwealth could therefore be seen as utilising half of the “optimal” taxation capacity of the resources industries. Appropriate transitional arrangements would be introduced for

established mines—taking account of the fact that investors in the resource industries would be given a number of years' notice of the change.

The Commonwealth would invite the States to occupy the other half of the taxation capacity. It would invite the States to request the Commonwealth to collect a surcharge on its own resource tax, at a rate determined by the States. Some or all States and Territories might choose simply to duplicate the Commonwealth's rate of tax, thus exhausting the optimal taxation capacity. This would be a good outcome for economic efficiency. The data would be available reasonably to assess the amount of taxation liability attributed to each jurisdiction in assessment of the distribution of the surcharge. Alternatively, the State could choose to apply a royalty in a form and at a rate of its choosing. Neither the additional resource rent tax nor the additional royalty would be deductible against the Commonwealth resource rent tax. The State would take responsibility for the effects of its charges on the industry within its boundaries. The States would retain all of the revenue from the additional charges.

## 6. The Special Problem of Transport Infrastructure

The political distortions and economic costs of the current Federal fiscal arrangements are nowhere greater than in the provision of urban transport infrastructure. Competing Federal political parties promise funding for major transport infrastructure projects at election time, each statement motivated strongly by local politics and demanding matching contributions from the State Government. State political parties make different announcements, again with public demands for matching payments from the other level of Government. The promises are rarely based on careful analysis of the value that the investments would add to integrated transport systems. For the most part, neither Federal nor State promises are delivered, with the public explanation usually being that the other level of Government did not meet unilaterally declared expectations. When Commonwealth promises are delivered, the payments are usually taken back with a lag by the Commonwealth Grants Commission's equalisation of revenue; but sometimes the Commonwealth says that the payments are to be excluded from Grants Commission equalisation.

The dysfunctional nature of the political discourse on infrastructure—especially urban transport infrastructure where political interest is most intense—is one factor behind the gradual reduction of the efficiency of our large cities, and especially of our largest cities. Sydney and Melbourne account directly for a high proportion of national economic output, and provide essential inputs into all other economic activity in Australia. They are gradually grinding to a standstill.

There is another problem with public policy on major infrastructure which is not caused by the framework of Federal financial relations, but which could

be eased considerably as part of a major adjustment to Federal financing of infrastructure. Australian Governments can borrow over long periods from the Australian community or from abroad at low rates of interest—on average for ten years at around two percent per annum in real terms, and at less than that today. It is not obvious that the “riskiness” of applying funds to carefully assessed infrastructure projects is less than that of spending money in other ways and accepting the risk—indeed, the certainty—of continued deterioration in the efficiency with which our cities deliver services to their residents and to others. And yet assessments of public investment in transport infrastructure typically apply discount rates that are several times as high as the real cost of borrowing to Government. The use of private funding for public infrastructure imports high discount rates more directly.

At the real discount rates currently applied to evaluation of infrastructure projects in Australia, no transformational structural change ever seems worth doing. All major structural change in transport takes many years to implement, and most of the benefits are discounted to trivial values by the use of high discount rates. These are sometimes called market interest rates, although we know that the real market rate at which Governments can borrow is more like 2 than 7 or 8 percent.

For the States, one reason for caution about borrowing for infrastructure is that modest increases in debt may trigger a ratings downgrade and so increase the cost of past debt as well as imposing political costs.

My suggestion is that the States resume full responsibility for planning and execution of urban transport infrastructure, but that a new Commonwealth funding mechanism be introduced to lower the cost of state borrowing for major projects that have been approved by the Commonwealth. The funding facility would be available for projects that have been accepted by the Commonwealth as having passed a rigorous and appropriately structured cost-benefit analysis. They would take the form of loans at the Commonwealth’s borrowing rate that would match State expenditure on approved projects. The rate of matching would normally be 50 percent, but could be varied as an instrument of Commonwealth macro-economic management. The matching loans would be on the Commonwealth’s balance sheet alone, but would be serviced by the State. The matching loans would be available whether the State was funding infrastructure directly or through the private sector. Where the latter was the case, the cost of the project would be lowered by the reduction in the amount of expenditure that had to be funded at a high private sector discount rate.

## 7. Reducing the Vertical Fiscal imbalance

The chronic imbalance between the States' expenditure responsibilities and access to efficient taxation bases will increase over time, and require periodic adjustment of some combination of the revenue mix or service delivery responsibilities. The GST pool will need to be augmented from some source to make up for the reduction in special purpose payments. A fixed percentage of a set of Commonwealth revenue sources would do the job reasonably well. The anticipated decline in GST revenue relative to the economy could be reduced by finding a means to extend the impost to internet purchases. Widening the GST base to remove established exclusions would help. The proceeds of the Commonwealth's tax on onshore resource rents would be suitable for inclusion, and may facilitate the reform of resource rent taxation arrangements. In addition, it is highly desirable that the States be provided with the opportunity to vary (within modest boundaries, so as not to introduce distortions into residential location decisions) the rates of some forms of Commonwealth taxation, and to take responsibility for the revenue and political consequences of the variations.



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