Horizontal Fiscal Equalisation

NSW Business Chamber submission to the Productivity Commission's public inquiry

June 2017

ABN 63 000 014 504

Introduction and overview

The NSW Business Chamber (the Chamber) welcomes the opportunity to provide a submission to the Productivity Commission's (PC) public inquiry into Horizontal Fiscal Equalisation.

As you may be aware, the Chamber is one of Australia's largest business support groups, with a direct membership of more than 20,000 businesses and providing services to over 30,000 businesses each year. The Chamber works with businesses spanning all industry sectors including small, medium and large enterprises. Operating throughout a network in metropolitan and regional NSW, the Chamber represents the needs of business at a local, State and Federal level.

As a representative of NSW businesses, the Chamber welcomes further examination into Australia's system of Horizontal Fiscal Equalisation (HFE), and in particular, whether the current approach to HFE creates disincentives for reform or otherwise impacts negatively on economic growth.

While the Chamber is not aware of any specific examples of where the current model of GST distribution has impeded reform or economic growth, at a theoretical level it can be argued that the current model undermines the benefits that could accrue from competitive federalism.

That being said, the Chamber is highly cautious of some models that are being proposed (or that have previously been proposed) that appear to be reverse engineered to deliver a desired distributional outcome rather than to resolve an underlying deficiency in the system. Specifically, the Chamber does not support proposals which would grant special status to mining royalties as this would have the effect of undermining HFE by delivering windfall gains to resource-rich jurisdictions at the expense of most (if not all) other jurisdictions.

It is also clear that a degree of dissatisfaction with the current system could be resolved if the architecture better catered to volatilities in GST payments so that they are better aligned with jurisdictions' own source revenue.

The Chamber is ultimately of the view that the PC should follow the evidence as it applies to the issues raised in the terms of reference and that any recommendations to adjust the system should be carefully designed to target any deficiencies identified.

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HFE and broader reforms to federal financial relations

The Chamber is broadly supportive of the objectives behind HFE, including the current framework's approach of bringing each jurisdiction's capacity to deliver services to its people up to the leading jurisdiction. However, there are many criticisms that can be made about the current system including (but not limited to):

1. its complexity;
2. lag effects such that it is difficult (in practice and politically) for state and territory Treasurers to responsibly manage their budgets;
3. that it distributes the dividends of economic reform to other jurisdictions, thus having the effect of increasing the cost of reform; and
4. the lack of accountability on jurisdictions to actually deliver on the outcomes that HFE processes are intended to provide.

For a range of reasons, including those mentioned above, the Chamber has previously supported moving to a simpler version of HFE underpinned by a per capita distribution of GST receipts. Recognising that this would have significant detrimental effects on some jurisdictions, this was supported on the basis that alternative payments to jurisdictions with a lower capacity to raise own-source revenue would be needed.

While the Chamber does not wish to re-prosecute this proposal as part of this submission (as such a proposal does not appear within the scope of the terms of reference), we nonetheless wish to emphasise that HFE needs to be considered within a broader context including the range of other tied payments made by the Commonwealth to each jurisdiction. For example, any change to the current model of GST distribution may require adjustments to other national partnership agreements and the broader framework of federal financial relations to compensate for any windfall gains or losses (to maintain a satisfactory HFE outcome).

Further, it is not possible for a single system of HFE to effectively satisfy multiple policy objectives. Some of the concerns raised about the current model might be better addressed through other policies which run parallel to the GST distribution framework.

GST Distribution: A NSW Perspective

NSW has been a consistent net contributor of GST payments to other jurisdictions since the inception of the current model in 2000 (relative to a per capita counterfactual). Before that NSW was also a consistent net contributor under processes of HFE which preceded the introduction of the GST.

Because of this, a self-serving position for NSW might be that any HFE process is not in our state's best interests. Nonetheless, NSW has been a supporter of HFE on the basis that it is in the national interest. While support for the principle of HFE remains strong, there are a number of areas where HFE has habitually underserved the interests of NSW.

For example, NSW has traditionally been expected to rely on a higher proportion of inefficient taxes as a share of its own-source revenue (so as to be able to deliver services at the standard of the leading jurisdiction). More recently, the impact of HFE distributions has meant that NSW has not received the full dividends of reforms including efficiency gains in public service delivery and asset recycling. Meanwhile, other non-reforming jurisdictions have gained (or will gain), at least to some extent, from these reforms.

Putting to one side any views about NSW's position as a perennial contributor to other jurisdiction's budget bottom lines, there is a more nuanced argument that can be made about

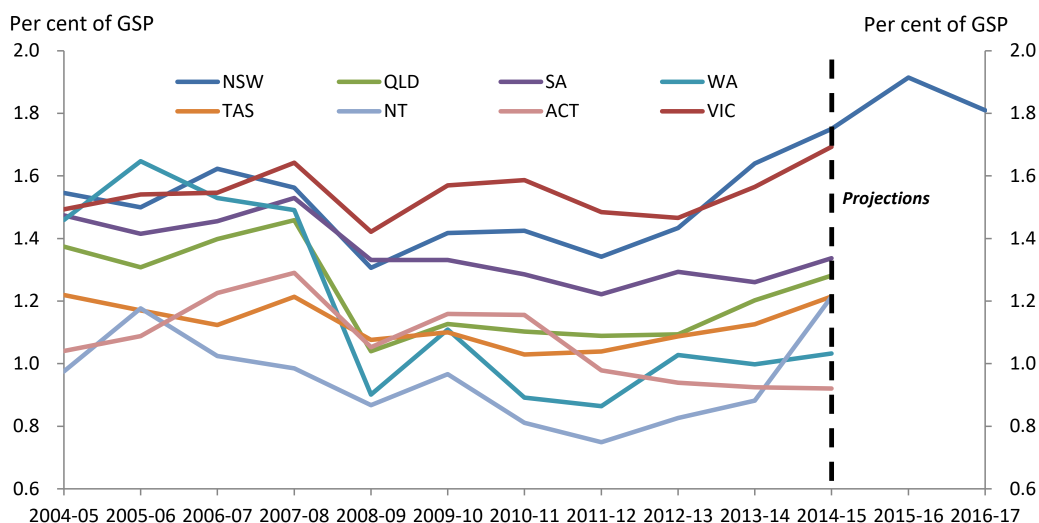
how NSW is impacted by the current system. Specifically, NSW must bear higher economic costs to collect the same amount of revenue, while the NSW Budget is not fully rewarded for proactive steps taken by NSW governments to improve outcomes for the people of NSW.

The efficiency of NSW taxes

Each jurisdiction has varying tax bases reflecting the structural composition of their respective economies. As part of the 2015 GST review[1], NSW was assessed as having above average revenue raising capacity for payroll tax, stamp duty and insurance taxes. These happen to be among the most inefficient taxes that a state or territory government could be expected to rely on.

A particular concern is the significant amount of stamp duty revenue collected in NSW. NSW is more reliant on stamp duty than any other state or territory as a share of Gross State Product. On this measure NSW is around twice as reliant as South Australia, Tasmania, the ACT and Queensland; and around three times as reliant as Western Australia and the Northern Territory. The impact of this is that the NSW tax system is relatively inefficient when compared with other jurisdictions (Chart 1 refers).

Chart 1 - The efficiency cost of state taxes



Source: NSWBC estimation based on ABS and NSW Government data together with KPMG estimates of the average excess burden of major Australian taxes. Does not include mining royalties.[2]

Note: the Y-axis is an estimate, presented as a percentage of GSP, of the welfare losses (also known as the excess burden of taxation) associated with state-based taxes. Between 2008-09 and 2016-17, the increase in this measure is equivalent to the estimated welfare losses associated with increasing transfer duty receipts.

The NSW Government estimates that, in the case of conveyancing stamp duty, the state-wide economic cost for every million dollars of stamp duty revenue is around $800,000 over and above the revenue generated.[3] This compares with virtually zero (or even negative) for more efficient forms of land tax.[4]

[1] 2015 GST Review, Commonwealth Grants Commission.

[2] Mining royalties are conceptually different to taxes as they are , in effect, a fee payable from the beneficiaries of a resource (mining companies) to the owners of that resource (the public) whereas taxes are applied to activity measures. This has significant welfare implications when considering the efficiency of taxes in this context and so are excluded from this analysis.

[3] 2015 Intergenerational Report, NSW Government, Box 5.1, p.70.

[4] 2015 Understanding the Economy-wide Efficiency and Incidence of Major Australian Taxes, Commonwealth Treasury, p.45.

The Chamber's 2016 ***Thinking Business Report: Taking on Tax***[5] presented modelling by KPMG that demonstrates the weight that conveyancing stamp duty has on the NSW economy. The report indicated that reform of conveyancing stamp duties in NSW could:

- boost Gross State Product by more than 1 per cent;
- create around 10,000 jobs; and
- support more than $1,400 in additional consumption for the average household each year.

Clearly there are very high economic costs associated with relying on stamp duty and good policy would dictate that governments move towards less onerous stamp duty regimes. It is arguable whether the current system of GST distribution provides any disincentives against state-based tax reform, but even so the current system requires NSW to collect more stamp duty than any other jurisdiction in order to deliver the same level of services.

In the 2015 GST review[6] NSW was judged to have an above average stamp duty revenue raising capacity of 1.171 requiring $952 in annual stamp duty revenue to be collected per capita (the highest among all jurisdictions). In the 2016[7] and 2017[8] updates, NSW lost the equivalent of around $120 per capita in GST due to additional property market activity and the associated impact on stamp duty collections.

The current system of HFE is agnostic about the relative efficiency of a tax, and when judging 'effort' (to collect tax from a given tax base), only the dollar value of the tax is considered. Taking a broader view, collecting a dollar of stamp duty does not represent the same 'effort' as collecting a dollar from more efficient taxes such as land tax given stamp duty comes with a significantly higher deadweight loss to the economy.

For this reason, the Chamber urges the PC to give consideration to whether adjustments to the current model of HFE could be made in recognition of this. In practice, adjustments could be made so that the assessed revenue raising capacity of a given tax is in some form adjusted to recognise that any revenue collected over and above a certain point would be suboptimal.

The Chamber accepts that integrating such an approach into the current framework of HFE could become overwhelmingly complicated and come with significant uncertainties in assessing the efficiency of different taxes. However, within a broader context of federal financial relations it is worthwhile to consider whether there are changes outside the current model of GST distribution that could be used to dis-incentivise reliance on inefficient taxes. For example, it is an interesting proposition to consider whether a system of Commonwealth payments could initiate state-based tax reform by providing an opportunity to reduce some of the most inefficient state-based taxes.

Competitive federalism and distribution of the dividends of reform

There is also an argument that can be made about the fairness of other jurisdictions sharing in the dividends of another jurisdiction's reforms. This is not a NSW-centric argument and can apply equally to all jurisdictions. Indeed, across the history of the current model of GST distribution it could be argued that NSW has benefited from reforms in other jurisdictions during certain periods.

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[5] 2016 Taking on Tax: Reforming NSW Property Taxes; https://www.nswbusinesschamber.com.au/NSWBCWebsite/media/Policy/Thinking%20Business%20Reports/FINAL-NSWBC-NCOSS-Taking-on-Tax-Report.pdf.
[6] 2015 GST Review, Commonwealth Grants Commission, p.60.
[7] 2016 GST Update, Commonwealth Grants Commission, p.16.
[8] 2017 GST Update, Commonwealth Grants Commission, p.7.

While this argument may have both merits and challenges, it could be suggested that it is only fair for any additional revenue (both own-source revenue and GST) to flow solely to the government that implements the reform, even if GST distribution was not influential in the decision to reform. This is because other jurisdictions could always opt to receive an equivalent revenue boost by implementing similar reforms.

An example that comes to mind is efforts taken to leverage state and territory balance sheets to fund productivity enhancing infrastructure via asset recycling. In this example, jurisdictions that do nothing benefit from the reforms of proactive governments. In effect, this increases the budgetary costs of delivering reform.

While the broader argument may operate somewhat contrary to a full and comprehensive system of HFE, it is consistent with forms of competitive federalism which apply in a range of other areas such as regulatory and tax policy.

The PC must grapple with whether a system of HFE ought to deliver equal outcomes per se, or equal opportunity for state and territory governments to deliver those outcomes. The Chamber would posit that the purpose of HFE is to counteract that different jurisdictions have different endowments which affect their capacity to deliver the same level of services to its people. It is not to counteract differences in the effectiveness of governments in making the most of those endowments (as recognised by many features within the current framework).

In this context the Chamber distinguishes between examples where revenue (both own-source revenue and GST) is boosted due to government initiated reform and windfall gains that aren't precipitated by a decision of government (such as a terms of trade adjustment which boosts the value of a jurisdiction's mineral endowments).

Specifically, investments made to unlock and realise the economic benefits of changes in the value of an endowment, such as mineral resources, are not reforms in and of themselves. Nonetheless, it is appropriate that the costs of such investments, where they are publicly funded, be factored in as part of the HFE process as the Commonwealth Grants Commission (CGC) has done in the past.

It may be that there is no practical mechanism to deal with such notions of fairness, that it may be better dealt with outside of a system of HFE, or that they would be immaterial to GST distribution outcomes in any event. Nonetheless the Chamber encourages the PC to consider this issue in the context of its terms of reference.

Incentives for reform

Separate from any fairness arguments that can be made within a competitive federalism context there is also the proposition that the current system of GST distribution weakens reform incentives.

Previous reviews have found that while there may be some disincentives at the margin, there are few (if any) observable circumstances in which these have influenced government decision-making. The Chamber accepts that the current framework generally works to minimise any mal-aligned incentives that could work against a government's desire to reform. Indeed, policy independence (whereby decisions of government do not influence GST distribution outcomes) is a key pursuit of the existing architecture.

Further, any impacts on GST distribution would be relatively small compared to other benefits such as increased employment, economic growth and greater prosperity which are arguably more important drivers of electoral success than marginal amounts of GST that would be lost if a particular reform were pursued (particularly given GST would only be partially lost upon expanding a revenue base). For example, while the Chamber does not support the

moratorium on coal seam gas, it is clear that this decision was influenced by factors other than GST distribution and that any impact on NSW royalties (if those resources were developed) would not affect GST distribution in any event. As noted recently by the CGC:[9]

> *The existing moratoriums and bans do not currently have a material effect on the relevant State's assessed mining capacity.*

That being said the Chamber remains of the view that the full dividends of reform ought to flow to the states as a matter of principle and fairness to the jurisdictions that implement reform.

Treatment of mining royalties

The Chamber is not convinced by arguments suggesting need for a fundamental adjustment in the way that mining royalties are treated as part of HFE.

The Chamber is highly cautious of some models that are being proposed (or that have previously been proposed) that appear to be reverse engineered to deliver a desired distributional outcome rather than to resolve an underlying deficiency in the system. As noted above, jurisdictions' policies that impact on resource development have only an insignificant impact on GST distribution, yet this argument is used to justify models which would reallocate large amounts of GST away from those jurisdictions.

Getting back to first principles, the purpose of HFE is to equalise the capacity of jurisdictions to deliver an equivalent level of services to its people. If this is to be achieved it is essential that each jurisdiction be brought up to the capacity of the leading jurisdiction. Failing to do this would, by definition, mean that this purpose is not achieved.

While there may be a visceral reaction to the low levels of GST distributed to jurisdictions with significant resource endowments (WA in particular), this outcome is only produced because of the significant windfall gains in mining royalties earned by those jurisdictions. Consistent with the purpose of HFE, the system necessarily has to balance one with the other otherwise the fiscal capacities of jurisdictions are not equalised. It is also an internally inconsistent position for a jurisdiction to be satisfied with a system of HFE when it is a net recipient yet be unsatisfied when a net contributor. When taking an inter-temporal view, arguments about contemporary low levels of GST distribution among resource rich jurisdictions become particularly weak given they have been net beneficiaries in the past.

One particular claim made is that, as the dominant mining jurisdiction, WA loses policy independence as there is no counterfactual upon which to assess the level of iron ore mining royalties that it receives (whereas for other tax bases the CGC can refer to average levels among all jurisdictions). While this poses a policy dilemma, it is essential to recognise that equalisation is itself a higher policy priority than policy independence. Trading-off equalisation to grant policy independence would be to lose sight of the overarching purpose of HFE. As a result, arguments in favour of models that only partially equalise mining royalties to restore a degree of policy independence are unconvincing.

A related claim is that the current system provides significant disincentives for resource development because jurisdictions would lose a portion of GST for additional royalties that could be raised upon developing that resource. There are several deficiencies with this argument:

1. Decisions regarding resource development are not made on the basis of GST distribution but rather threshold issues associated with economic development, environmental impacts, and broader political considerations.

[9] 2017 Staff Research Paper: State Mining Policies, Commonwealth Grants Commission, p.6.

2. Conceptually this argument can be applied to any industry. It is equivalent to arguing that a jurisdiction has no incentive to implement a combination of policies which would promote an industry (such as tourism, financial services or manufacturing) because it would lose a portion of GST as it collects more payroll tax. It therefore becomes a theoretical argument which has no natural limit or counterfactual upon which to base.

3. A restriction on resources development can be conceived as a delay in economic activity as the underlying resources assets remain in place for future development. The opportunity cost (in terms of royalties) is not the same as for restrictions on other forms of economic activity (where potential tax receipts are lost forever). In any event, the flipside of a restriction on one type of activity is that resources (land, labour and capital) are reallocated to another activity, which expands other associated tax bases, and so the opportunity costs are not equivalent to hypothetical royalties forgone.

4. Bans on resource development are in place in most (if not all) jurisdictions.[10] Further, it would be open to argue that resource-rich jurisdictions should be doing more to develop their remaining resources (as the value of untapped resources would be the greatest in those jurisdictions). An implication of this argument could be even lower levels of GST distribution for resource-rich jurisdictions depending on the counterfactual upon which they are assessed.

5. Models proposed to address this grievance (such as excluding a portion of mining royalties from equalisation) do not actually address the underlying concern. If there were evidence of an issue the appropriate solution would be targeted to reduce disincentives associated with the development of new projects rather than delivering windfall gains by excluding a share of royalties earned from existing resource projects.

That being said it is correct for the CGC to consider the best approach to address concerns around policy independence so that GST distribution does not dis-incentivise reform should disincentives be found to exist (including, but not limited to, the removal of moratoriums or bans on resource development). Subsequent to this, any implications regarding GST distribution should be based on a comprehensive assessment (including of second-round effects) rather than a partial analysis based solely on the impact to a single potential revenue source (such as mining royalties).

The Brumby-Greiner review[11] highlighted a number of practical changes that could be made while the CGC has continually examined and adjusted their assessment of mining royalties to ensure that jurisdictions are not disadvantaged. The Chamber notes that these issues will again be considered in more depth as part of the GSC's 2020 Review. The Chamber considers that the current framework provides sufficient flexibility for the CGC to make appropriate assessments to address these concerns and that no fundamental changes to the current model are warranted.

Ultimately arguments supporting fundamental changes in the treatment of mining royalties boil down to arguing that residents of resource rich jurisdictions should benefit more from those endowments than residents of other jurisdictions. This is a difficult proposition to justify in the context of a federated commonwealth.

Smoothing out GST payments

It is clear that a degree of dissatisfaction with the current system could be resolved if the architecture better catered to volatilities in GST payments so that they are better aligned with

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[10] Including mining states such as a WA's uranium mining ban and coal mining ban around Margaret River township.

[11] 2012 The Australian Government, GST Distribution Review Final Report

jurisdictions' own source revenue. This presents two issues for responsible budget management:

1. GST transfers are not aligned with fluctuations in a jurisdiction's own-source revenue; and

2. associated volatility in GST transfers can exacerbate existing volatility in own-source revenues which may not always be foreseeable.

There are a number of trade-offs associated with simplicity (and arguably transparency), accuracy and timeliness which account for the less than perfect arrangements which currently exist. While it can be argued that government revenue (as a combination of own-source revenue and GST transfers) is stable over the medium term, recent experience demonstrates that this is not true in the short term.

In a perfect world GST transfers would adjust to reflect the strength or weakness of a jurisdiction's own-source revenue such that a Treasurer can be broadly confident of stable revenue in any given year. However, this clearly cannot be achieved given the time horizons associated with collecting and assessing the data required to fully assess each jurisdiction's final share of GST under the current model.

Previous reviews have considered ways to resolve this issue. Broadly speaking there are two approaches that could be taken. The first is to add further complexity to the system by smoothing government budgets before making ex-post adjustments commensurate with their share of GST as determined once data becomes available. The second is to simplify the system so that GST distribution can be based on proxy measures which are contemporarily available so that assessments can be made in a more timely fashion. The Chamber considers that both of these approaches, or a combination of both, should again be considered by the PC.

While the Chamber accepts the arguments made in previous reviews that there is no easy solution, it also considers that a broader view is required. A strict policy lens might suggest that the timeliness of GST payments is a non-issue as governments can always plan for lumpy revenues by leveraging a jurisdiction's balance sheet. However, this ignores the political lens through which these issues will almost certainly be viewed within government.

Indeed, this very inquiry has been precipitated by public perceptions of fairness around the shares of individual jurisdictions, WA's in particular. Failing to work out a solution to this challenge serves to heighten the risk that suboptimal (or inherently unfair) policy choices will be made by politicians in addressing the concerns of aggrieved constituents.