

Chapter 1

Introduction

1.1 On 18 October 2018, the Senate referred the provisions of the Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018 to the Economics Legislation Committee for inquiry and report by 8 November 2018.¹

Overview of the bill

1.2 The bill amends the *Commonwealth Grants Commission Act 1973* and the *Federal Financial Relations Act 2009* to give effect to key elements of the government's interim response to the Productivity Commission's Inquiry Report, *Horizontal Fiscal Equalisation*.²

1.3 The key elements of the government's interim response include:

- transitioning the horizontal fiscal equalisation system from full equalisation (equalised to the strongest state or territory) to reasonable equalisation (equalised to the stronger of New South Wales and Victoria);
- introducing a minimum Goods and Services Tax (GST) revenue sharing relativity (GST relativity floor) that may be determined by the Treasurer for any individual State or Territory; and
- permanently boosting the GST revenue pool with additional Commonwealth financial assistance.³

1.4 The following elements of the government's interim response are given effect under existing laws:

- providing short-term transition payments to any state or territory with a GST revenue sharing relativity below a relativity factor of 0.7; and
- providing short-term transition payments to the Northern Territory if its GST revenue sharing relativity falls below its determined relativity factor for 2017–18.⁴

1.5 The bill introduces a guarantee that each state and territory will get the better of the current distribution system or the updated distribution system during the transition period.⁵

1 *Journals of the Senate*, No. 125, 18 October 2018, p. 3994.

2 Explanatory Memorandum, p. 3.

3 Explanatory Memorandum, p. 3.

4 Explanatory Memorandum, p. 3.

5 Explanatory Memorandum, p. 3.

1.6 In addition, the Productivity Commission will be required to conduct an inquiry at the end of the transition period to assess whether the updated system is operating efficiently, effectively and as intended.⁶

1.7 The additional funding, to be contributed by the Commonwealth to support the states and territories to transition to the new benchmark, is nearly \$9 billion over ten years.⁷

Conduct of the inquiry

1.8 The committee advertised the inquiry on its website. It also wrote to relevant stakeholders and interested parties inviting submissions by 24 October 2018. The committee received 13 submissions, which are listed at Appendix 1.

1.9 The committee held a public hearing in Canberra on 26 October 2018. The witnesses who appeared at the hearing are listed at Appendix 2.

1.10 The committee appreciates the efforts of all stakeholders who contributed to the inquiry.

Background

1.11 Since the GST was introduced in 2000, GST revenue has been distributed to the states and territories according to a system of horizontal fiscal equalisation (HFE). This GST distribution system worked in a relatively stable and predictable way in its early years, but the economic shocks of the last decade have resulted in a level of volatility that could not have reasonably been foreseen when the system was introduced. This volatility has reduced community confidence in Australia's HFE system and resulted in the government asking the Productivity Commission (PC) to undertake a thorough review of the strengths and weaknesses of the existing GST distribution arrangements.⁸

1.12 The PC concluded that the HFE system had deficiencies in the following areas:

- the system is not policy neutral which can deter states from improving the efficiency of their tax mixes or expanding their tax bases;
- too little weight is afforded to the importance of fairly rewarding states and territories for their policy efforts; and
- lack of transparency and accountability can lead to misinformation and undermine accountability for decisions and public confidence in the system.⁹

1.13 The PC recommended that, among other things, the objective of the HFE system should be refocused to provide the states and territories with the fiscal capacity

6 Explanatory Memorandum, p. 3.

7 Explanatory Memorandum, p. 7.

8 Explanatory Memorandum, pp. 6–7.

9 Productivity Commission, *Horizontal Fiscal Equalisation*, Inquiry Report No. 88, 15 May 2018, p. 18.

to provide services and associated infrastructure of a reasonable standard. The PC also examined a range of alternative equalisation benchmarks and noted none of these benchmarks is unambiguously superior and there is no 'right' balance before concluding that the HFE system should transition towards equalisation of the average (pre-GST) fiscal capacity of all states and territories, with the remaining GST revenue distributed on a per capita basis.¹⁰

1.14 The government's interim response proposed a plan to update the way the GST is distributed:

The Government's plan involves transitioning to a new HFE system over eight years from 2019–20 in a way that is fair, reasonable and sustainable and that would ensure all States [and Territories] are better off.¹¹

1.15 The plan announced by the government has three steps:

- short-term transition payments;
- phasing in a new HFE system; and
- completing the transition to a new, more stable equalisation standard.¹²

1.16 The bill under investigation enacts the government's transition plan.

Detailed explanation of the bill

Amendments to the Commonwealth Grants Commission Act 1973

1.17 The bill amends the *Commonwealth Grants Commission Act 1973* to require the Treasurer, when framing the terms of reference for a Commonwealth Grants Commission (CGC) inquiry, to pursue the objective of ensuring the states and territories each have the fiscal capacity to provide services at the same standard as the higher of New South Wales and Victoria—that is, the Treasurer is to set the equalisation standard to the stronger of New South Wales and Victoria.¹³

1.18 For the 2021–22 financial year and later financial years, the Treasurer must set the equalisation standard to the stronger of New South Wales' and Victoria's respective fiscal capacities when setting the terms of reference for the CGC's inquiry and report. The CGC will be required to set this as the standard when it makes its assessments using the HFE methodology.¹⁴

1.19 The bill transitions Australia's HFE system over a number of years in a fair, reasonable and sustainable way that would leave no state or territory worse off. To

10 Productivity Commission, *Horizontal Fiscal Equalisation*, Inquiry Report No. 88, 15 May 2018, pp. 18–32.

11 Australian Government, *Productivity Commission inquiry into horizontal fiscal equalisation: Government interim response*, July 2018, p. 16.

12 Australian Government, *Productivity Commission inquiry into horizontal fiscal equalisation: Government interim response*, July 2018, pp. 20–22.

13 Explanatory Memorandum, p. 13.

14 Explanatory Memorandum, p. 14.

give effect to the transition period for the adoption of the updated equalisation standard, the Treasurer is to frame the terms of reference for a financial year that occurs during the period 2021–22 to 2025–26, so as to require the CGC, to make necessary adjustments to its principles, categories and methods of assessment to make an appropriate and even transition from the old equalisation standard to the new equalisation standard.¹⁵

1.20 During the period 2021–22 to 2025–26, the terms of reference are to involve the CGC applying a methodology that uses both the old and updated HFE systems to recommend a new set of relativities that combine the results of both systems in the way set out in Table 1.¹⁶

Table 1: Methodology to transition to an updated HFE system

<i>Financial year</i>	<i>Transitional methodology</i>
2020-21	<i>old factor</i>
2021-22	$transition\ factor = \left(\frac{5}{6} \times old\ factor\right) + \left(\frac{1}{6} \times new\ factor\right)$
2022-23	$transition\ factor = \left(\frac{4}{6} \times old\ factor\right) + \left(\frac{2}{6} \times new\ factor\right)$
2023-24	$transition\ factor = \left(\frac{3}{6} \times old\ factor\right) + \left(\frac{3}{6} \times new\ factor\right)$
2024-25	$transition\ factor = \left(\frac{2}{6} \times old\ factor\right) + \left(\frac{4}{6} \times new\ factor\right)$
2025-26	$transition\ factor = \left(\frac{1}{6} \times old\ factor\right) + \left(\frac{5}{6} \times new\ factor\right)$
2026-27	<i>new factor</i>

Where: *old factor* means the relativity derived from the old HFE system; and *new factor* means the relativity derived from updated HFE system

Amendments to the Federal Financial Relations Act 2009

1.21 The bill amends the *Federal Financial Relations Act 2009* to introduce a 'minimum' or 'floor' in relation to the Treasurer's power to determine the GST revenue sharing relativity factor for particular states or territories for a financial year. The floor would initially be set at a relativity of 0.7, before moving up to 0.75. These floors are intended to be an additional safety net and, as such, are scheduled to come into effect at a time when the relativities of all states and territories are projected to be, and projected to remain, above these relativities.¹⁷

15 Explanatory Memorandum, p. 15.

16 Explanatory Memorandum, p. 16.

17 Explanatory Memorandum, p. 17.

1.22 In addition, the size of the annual funding pool from which GST grants are made will increase by incorporating into the annual pool amount calculation a 'pool top-up' which will be sourced from Commonwealth revenues not related to GST.¹⁸

1.23 An additional \$600 million will be placed in the GST distribution pool from 2021–22, the first years of transition to the new equalisation standard. This additional contribution will be indexed at the rate of growth of GST collections; that is, the expanded GST pool would continue to grow at the same rate as GST collections each year.¹⁹

1.24 In 2024–25, a further \$250 million will be added to the GST distribution pool and future Commonwealth contributions to the GST distribution pool will be indexed to grow in line with GST collections on a permanent basis.²⁰

1.25 In calculating indexation for a particular year, the amount of indexation cannot be less than zero and cannot be less than the amount of indexation included in the pool top-up from the immediately preceding year.²¹

1.26 The bill introduces a guarantee that each state and territory will get funding at least equal to the better of the current distribution system or the updated distribution system during the transition period. This is achieved by providing additional financial assistance if a state or territory's cumulative grant entitlements under the updated distribution system, calculated from the beginning of the transition period, is less than the entitlements they would have received under the current distribution system.²²

Review of the operation of the bill after enactment

1.27 The bill contains a requirement for the Treasurer to refer to the PC for inquiry, a review into the operation of the bill which would assess whether the updated distribution system is operating efficiently, effectively and as intended. In undertaking the inquiry, the PC would be required to focus on the fiscal implications for each state and territory arising from the updated HFE system and related reforms to the *Federal Financial Relations Act 2009*. The PC must complete its inquiry and provide its report to the Treasurer by 31 December 2026.²³

Compatibility with human rights

1.28 The bill is compatible with human rights as it does not raise any human rights issues.²⁴

18 Explanatory Memorandum, p. 17.

19 Explanatory Memorandum, pp. 17–18.

20 Explanatory Memorandum, p. 18.

21 Explanatory Memorandum, p. 18.

22 Explanatory Memorandum, p. 19.

23 Explanatory Memorandum, p. 20.

24 Explanatory Memorandum, p. 24.

