



The Hon Dominic Perrottet MP
Treasurer and Minister for Industrial Relations

Mr Alan Raine
Acting Committee Secretary
Senate Economics Legislation Committee
Parliament House
Canberra ACT 2600

Dear Mr Raine,

Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018

Thank you for the opportunity to make a submission on the provisions of the Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018 (the Bill). Please find attached a submission prepared by the NSW Government.

While the GST is collected under Commonwealth legislation, it remains a states' tax. The GST underpins the continued operation of a strong Federation and we must ensure we get these reforms right for this to remain the case.

New South Wales has long argued that the current system of horizontal fiscal equalisation (HFE) is overly complex and is inherently unfair – it punishes states that engage in responsible financial management and productivity-enhancing reform.

The Productivity Commission (PC) acknowledged these concerns in its inquiry into Australia's system of Horizontal Fiscal Equalisation (HFE) and recommended an option to improve fairness – so that states that undertake the hard work of economic reform would retain a greater share of the fiscal benefits through the HFE system.

The reforms as they stand not only perpetuate this unfairness, but add to it. Perversely, they provide the Western Australia Government a competitive advantage that will allow it to fund lower effective tax rates and/or better services than the rest of the country on a permanent basis.

New South Wales accepts that it has a role in supporting smaller states, however it is not responsible for funding states that receive revenue windfalls from its natural resources and fail to plan for the future.

The financial implications of this reform are significant. New South Wales welcomes amendments to guarantee that no state will be worse off during the 6-year transition to the Commonwealth's new HFE benchmark. This will contribute to budget certainty and to maintaining frontline service delivery for the people of New South Wales.

These issues must be considered in the PC's review of the HFE reforms in 2026. The review must examine whether alternative HFE benchmarks would improve the efficiency, effectiveness and fairness of the HFE system, taking into account the real risk that states that do the heavy lifting will miss out over the longer term.

While our submission notes our fundamental concerns with the HFE reforms, it also raises some material flaws with the drafting of the Bill. These are not trivial. Our suggested amendments are designed to reduce the risk of unintended outcomes that could materially affect the future operation of our HFE system.

I thank you for your consideration of our submission. I trust that you will consider what is best for the Federation and look forward to the Committee's recommendations.

Yours sincerely,



Dominic Perrottet MP
Treasurer
Minister for Industrial Relations

24/10/18

Attached: NSW Submission to the Senate Economics Legislation Committee



Submission to the Senate Standing Committee on Economics

Provisions of the Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018

October 2018

Introduction

New South Wales welcomes the referral of the provisions of the Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018 (the Bill) to the Senate Standing Committee on Economics.

While the GST is collected under Commonwealth legislation, it remains a states' tax. The GST underpins the continued operation of a strong Federation. We must ensure this remains the case with the states and territories (states) determining the underlying basis on which these funds are distributed between the jurisdictions.

New South Wales has long argued that the current system of horizontal fiscal equalisation (HFE) is overly complex and punishes states that engage in strong financial management and productivity-enhancing reform.

The Productivity Commission (PC) acknowledged these concerns in its inquiry into HFE and its key recommendation that the HFE should provide reasonable, rather than full equalisation, based on the fiscal capacity of the average state rather than the strongest state. Through this recommendation, the PC also sought to provide greater fairness – so that those states that undertook the hard work of economic reform would retain a greater share of the fiscal benefits through the HFE system.

We maintain our concern that the approach adopted by the Commonwealth will fail to address many of the issues with the current HFE system, and could, along with drafting issues in the Bill, introduce significant and unintended policy impacts on our Federation. Our submission reflects both these policy and drafting issues.

1. Policy issues

1.1 The new HFE benchmark entrenches unfairness in our Federation

The Commonwealth's new HFE benchmark fails to reward policy effort. It perpetuates and, at the same time worsens the unfairness inherent in the current HFE system because it would also provide Western Australia with an ongoing fiscal advantage at the expense of fiscally responsible states such as New South Wales.

The Bill intends, through section 16AB(2), to change the HFE system from one of *full* equalisation (equalisation to the fiscally strongest state) to *reasonable* equalisation (equalised to the stronger of NSW or Victoria). This element of the Commonwealth's reforms seeks to reduce volatility and perceived unfairness with the existing system of full equalisation.

The proposed HFE benchmark continues many of the faults associated with the current HFE system – most importantly, the lack of incentives to promote economic reform and economic efficiency. The new HFE benchmark will be equivalent to a system of equalisation to the second strongest state. In its report on HFE the PC found this model to have minimal efficiency benefits over the current system and far less than the PC's preferred model of equalising to the fiscal capacity of the average state.

Further, the proposed Commonwealth system entrenches a new form of unfairness and instability in the HFE system. The planned HFE benchmark of New South Wales or Victoria risks providing a new source of competitive advantage for Western Australia to the detriment of other states. Within a decade, if not a few years, this is likely to mean that Western Australia would be able to provide its residents with the lowest tax burden and/or the highest standard of services in the country on a permanent basis. New South Wales has always played a key role in supporting the smaller states, however it is not responsible for funding states that receive revenue windfalls from its resources and then fail to plan for the future.

In addition to being inherently unfair, the new benchmark replaces one form of volatility with another. If Western Australia's mining sector strengthens, its windfall from the new HFE benchmark increases substantially. This results in more GST needing to be redistributed by Victoria or New South Wales to fiscally weaker states (that is, it simply shifts the fiscal burden between states).

New South Wales recommends the PC review examine fairness of distributional outcomes across states, as well as whether the new HFE system is working efficiently and effectively as part of its 2026 review.

1.2 The no-worse off guarantee does not apply beyond 2026-27

Scenario modelling undertaken by Victoria indicates most states will be exposed to the risk of significant and growing GST losses beyond the transition period.

The Commonwealth's preferred model of equalising to the stronger of New South Wales or Victoria would have major impacts on state revenues. Scenario modelling was conducted by Victorian Treasury and Finance in consultation with New South Wales and other states, and discussed at the Council for Federal Financial Relations meeting on 3 October 2018. This modelling has now been reviewed by Deloitte Access Economics and shows that there are many reasonable economic scenarios that would result in the GST pool top-ups specified in section 8(A) being inadequate to cover states' GST losses.

It was on this basis that the Board of Treasurers (the Board) wrote to the Commonwealth Treasurer in August 2018 seeking a binding, enforceable and ongoing agreement that no state would be worse off under the new HFE system.

New South Wales welcomes the Commonwealth's decision to legislate a guarantee that no state will be worse off during the 6-year transition to the new HFE standard. This will contribute to budget certainty and to maintaining frontline service delivery.

New South Wales recommends that the PC consider fiscal impacts on states associated with the Commonwealth's new HFE benchmark alongside alternative HFE benchmarks as part of its Review.

1.3 Scope of the 2026-27 PC review is unclear

There is little clarity on the scope and purpose of the proposed PC review, including the meaning of efficiently and effectively.

Amendment 4(1)(a) requests the PC to review whether the amendments implemented are operating efficiently, effectively and as intended.

There is little clarity on the nature of this review, including the meaning of efficiently and effectively, and the basis for comparison. In its HFE inquiry, the PC also considered the notion of fairness, or reward for policy effort, and its impact on reform incentives. It was largely on this basis that the Commonwealth's preferred model (equivalent to equalisation to the second strongest state) was rejected.

Further, the current drafting of the Bill is ambiguous as to whether the objectives of the reforms relate to service standards, fiscal capacity, or both (see section 2 below).

New South Wales recommends that the Bill include additional detail to ensure the subsequent PC review considers alternative HFE benchmarks that would improve the efficiency, effectiveness and fairness of the HFE system.

1.4 Scope for ministerial discretion

Greater clarity is sought on the decision-making powers and process for the Commonwealth Treasurer's determination of no worse off payments to states.

Under the Bill the responsible Minister (i.e. the Commonwealth Treasurer) is required to form an opinion on various matters that can have a direct financial bearing on the states. Significantly, for example, section 5(3) provides for the Treasurer to form an opinion on the quantum of no worse off payments to states.

This leaves it open to the Treasurer to make a decision contrary to that intended by the Commonwealth's announcement on 16 October 2018. The broad scope provided to the Treasurer is a source of fiscal uncertainty and therefore risk to the states.

New South Wales recommends that the decision-making powers of the Treasurer be amended so that states have greater fiscal certainty.

2. Legislative drafting

Subsection 16AB(2) of the Bill is unclear and open to competing interpretations that could result in outcomes inconsistent with the Commonwealth's policy intent.

The current drafting of section 16AB(2) states:

“... that the States, the Australian Capital Territory and the Northern Territory each have the **fiscal capacity to provide services (including associated infrastructure)** at a **standard that is at least as high** as the standard for whichever of New South Wales and Victoria has the higher standard.”

This is unclear and open to competing interpretations that could result in outcomes inconsistent with the Commonwealth Government's policy intent. In particular the definition of fiscal capacity is ambiguous, the service standard is policy driven rather than policy neutral, and fiscal capacity and service standard may not align.

Fiscal capacity is ambiguously defined

The intent of the Commonwealth's new HFE model, as demonstrated by its modelling framework shared with the states, is to equalise states' fiscal capacity to the higher of New South Wales or Victoria.

Fiscal capacity is currently defined to take into account expenditure requirements of states to provide services and infrastructure to an average standard as well as the capacity of states to raise their own revenues, based on average revenue raising effort. This is articulated in the current HFE definition (upon which this subsection is modelled) adopted by the CGC in 2010. This provides:

“State governments should receive funding from the pool of goods and services tax such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.”¹

This intention is not consistent with the current wording of section 16AB(2), which as drafted suggests that equalisation would only encompass expenditure for services and infrastructure. Under an 'expenditure-only' equalisation model, revenue raising capacity could be excluded and equalisation would only compensate for differences in service delivery and infrastructure costs. Such a model was briefly considered (and dismissed) by the PC as part of its inquiry into Australia's system of HFE.²

¹ Commonwealth Grants Commission, *The Principle of HFE and its Implementation*, Commission Position Paper, CGC2017-21, p. 1.

² Productivity Commission, *Horizontal Fiscal Equalisation*, Draft Report, October 2017, pp. 162-66 & 228-9.

In practice, New South Wales would expect that the CGC will continue to apply the equalisation principle to the revenue side of state budgets.

The proposed service standard is inconsistent with policy neutrality

The wording of section 16AB(2) could also be interpreted as requesting the CGC to provide states with the fiscal capacity to provide the same standard of service and infrastructure provision as New South Wales (or Victoria), provided that each state applies the same tax rates as New South Wales (or Victoria). This approach appears equally inconsistent with 'reasonable equalisation' described in the Explanatory Memorandum to the Bill³.

This interpretation of section 16AB(2) would see the distribution of GST between states becoming determined by the specific expenditure and revenue policies adopted by New South Wales (or Victoria) rather than the fiscal capacity of these states. This departs from the current approach which sees no one state being in this dominant position and does not accord with a fundamental tenet of HFE which supports policy neutrality.

For example, if New South Wales increased spending to raise its standard of services, the equalisation task would increase as all states would need the fiscal capacity to provide that higher standard. This means New South Wales would bear the direct cost of lifting service standards in its own state and also forego a greater share of GST.

Service standards may not align with fiscal capacity

A further, alternate interpretation of section 16AB(2) is where the relationship between fiscal capacity and service standards is severed. Under this interpretation, New South Wales could have the higher fiscal capacity of the two benchmark states while Victoria offers a higher standard of services. HFE conducted on this basis would have unknown outcomes that would clearly be inconsistent with the Commonwealth's policy intent.

NSW recommends that section 16AB(2) be redrafted as follows

"... that the States, the Australian Capital Territory and the Northern Territory each have the **fiscal capacity** that is at least as high as the higher of New South Wales and Victoria."

Further information and contacts

For further Information or clarification on issues raised in the discussion paper, please contact: Monica Tudehope, Policy Director, t. 02 8574 6909, e. monica.tudehope@treasury.nsw.gov.au.

³ House of Representatives, *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018 Explanatory Memorandum*, paragraph 1.38.