Occasional Paper: New GST distribution arrangements

September 2021

Department of Treasury and Finance

Tasmanian Government

Summary

GST is the single largest source of revenue for Tasmania, contributing around 41 per cent of Tasmania's total revenue in 2021-22. As such, GST is an important source of revenue that contributes to the Government's funding of essential services, such as health, education and emergency services. GST is distributed to the States and Territories in accordance with the principle of Horizontal Fiscal Equalisation (HFE).

In 2018, the Australian Government legislated new GST distribution arrangements as part of its response to the Productivity Commission's Inquiry into HFE.

The new GST distribution arrangements will be progressively implemented from 2021-22 and will transition from the current principle of equalising state's fiscal capacities to the level of the strongest state, currently Western Australia, to equalising to the fiscal capacity of the second strongest state (effectively the higher of New South Wales or Victoria).

When the Australian Government announced its response to the Productivity Commission's Inquiry into HFE, it argued, based on a single scenario, that all States would be better off under the new model, both now and in the future.

At the time, most States and Territories, including the Tasmanian Government, argued that the assumptions and modelling upon which the Australian Government built its new arrangements and arguments were flawed and failed to take into account a number of more realistic alternate scenarios.

As a result, the Australian Government agreed to a time-limited binding guarantee that no State would be worse off under the new distribution arrangements over the transition period to 2026-27.

However, it is becoming increasingly apparent that all States, with the exception of Western Australia, will be worse off under the new distribution arrangements.

Indicative modelling undertaken by the Tasmanian Department of Treasury and Finance (Treasury) has estimated that by 2031-32, Tasmania could be up to $755 million worse off (with only around 40 per cent or $302 million of this covered by the guarantee arrangements). In comparison over the same period, Treasury has estimated that Western Australia could be up to $57.5 billion better off from 2019-20.

The Tasmanian Government has consistently argued that the new standard of equalisation would provide Western Australia with a permanent and growing advantage over the other States and that this advantage would enable it to deliver a higher standard of services or lower taxes to its residents compared to all the other States.

The Productivity Commission will review the operation of the new arrangements by December 2026, and Treasury considers that the review will demonstrate that the new arrangements have resulted in entrenched inequality between Western Australia and all other States.

Introduction

The purpose of this paper is to outline the impact of the Australian Government's new GST distribution arrangements on Tasmania's GST revenue.

The paper considers:

- HFE and what it means for Tasmania;
- the Productivity Commission's 2017/2018 review of HFE;
- the Australian Government's response to the Productivity Commission's review; and
- the impact of the new standard of HFE being implemented by the Australian Government.

What is HFE and what does it mean for Tasmania?

GST is distributed to the States in accordance with the principle of HFE, which reflects a belief that all Australians - regardless of which State they live in - should have access to a similar standard of services.

In broad terms, HFE ensures that all States have a similar fiscal capacity to deliver services and infrastructure to their residents to the same standard as any other state, provided they make a similar revenue raising effort. This is particularly important for smaller States that have higher service costs and/or a lower ability to raise revenue compared to the larger States.

If States were not provided with a similar capacity to provide services through HFE, inequality within the Australian community would increase over time, with the stronger States having an ability to provide above national average standards of services and/or lower taxes on an ongoing basis.

GST is the biggest source of revenue for Tasmania representing 41 per cent of general government sector total revenue in 2021-22. Tasmania will receive $1.5 billion more GST revenue than its population share of $1.5 billion in 2021-22 because of HFE.

The nature of the GST revenue pool distribution is a "zero sum game" in that for a State to receive above its population share, another has to receive below its population share.

HFE and the methods used by the CGC in its assessments are discussed in more detail in the Department of Treasury and Finance's paper *Horizontal Fiscal Equalisation: an equitable approach to the GST distribution,* June 2017 published at https://www.treasury.tas.gov.au/gst-distribution-to-tasmania.

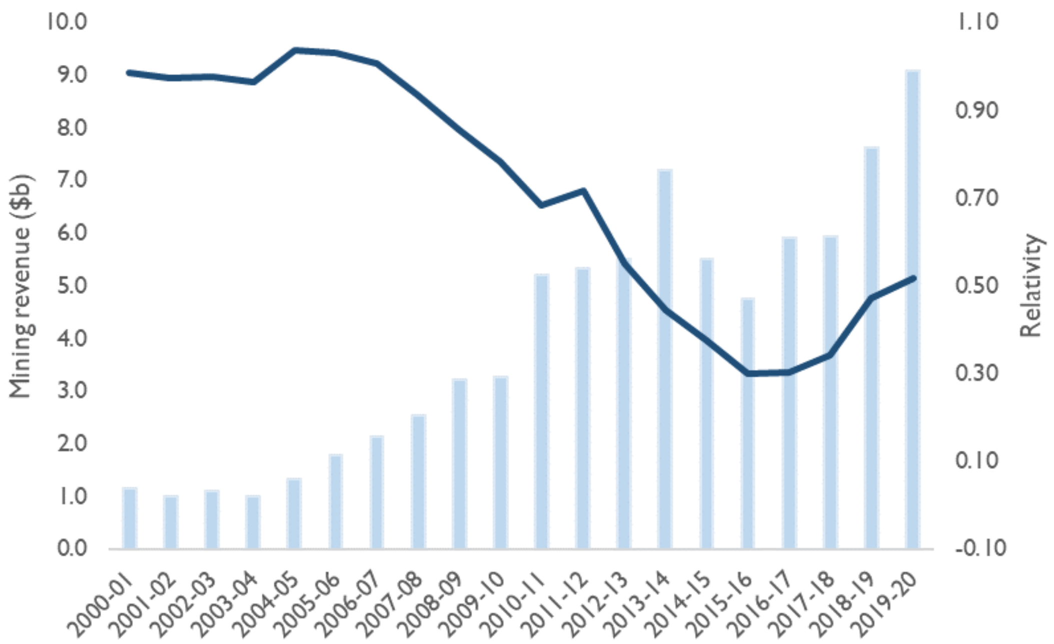
Productivity Commission review of HFE

In 2017, the then Commonwealth Treasurer requested that the PC undertake an inquiry into Australia's system of HFE. The decision to undertake the review was largely driven by ill-informed debate about the integrity of the HFE system primarily driven by the decline in Western Australia's GST share in 2015-16, and lobbying from Western Australian State and Federal Members of Parliament.

Until 2007-08, Western Australia was a beneficiary of HFE - receiving more than its population share of the GST. However, the mining boom in 2009 to 2013 saw Western Australia's mineral royalties rise rapidly. HFE balanced this out by allocating it a smaller share of GST grants.

Chart 1 illustrates the rapid growth in Western Australia's mining revenue and the corresponding decline in its GST share.

Chart 1: Relationship between Western Australia's mining royalty and relativity



While the reduction in relativity was expected - and was highlighted as early as the 2011-12 Western Australian Budget - the Western Australia Government continued to increase recurrent expenditure by historically high levels. Much of this expenditure became structurally embedded in the Budget and was difficult to unwind once GST revenue started to decline.

Notwithstanding that HFE was clearly working as it should, the PC undertook a review which assessed the influence of HFE on productivity, efficiency and economic growth, incentives for States to undertake reform and States' abilities to prepare and deliver annual budgets.

Throughout the PC Inquiry, the Tasmanian Government argued that the system of HFE was not broken and that the PC did not make a convincing case that the system needed changing. It was also considered that the PC did not make a convincing case that HFE was detrimental to national productivity, efficiency and economic growth, and that its conclusions were predicated on assertions, not evidence.

The Tasmanian Government was also of the view that the proposed changes to the benefit of one State at the expense of all other States were unwarranted and would undermine the equitable basis on which the HFE system was built and would lead to growing inequality between the States.

Copies of the Tasmanian Government's submissions to the PC Inquiry are available at https://www.treasury.tas.gov.au/gst-distribution-to-tasmania/publications.

As noted by the Commonwealth Grants Commission in its response to the PC Inquiry[1]:

> *"the fiscally strongest State would receive more than it requires to provide the average level of services. If it remained the fiscally strongest State over the intermediate term, it would be able to:*
>
> - *provide services in excess of the average; and/or*
> - *provide services of a higher quality than the average; and/or*
> - *levy lower than average own-sources taxes and charges; and/or*
> - *retire debt at a faster rate than other States."*

Australian Government Response

The Australian Government announced its response to the PC Inquiry in July 2018. The measures announced were subsequently legislated in the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018.*

This legislation introduced a new 'reasonable' standard of equalisation, moving to a benchmark that would ensure the fiscal capacity of all States is at least the equal of New South Wales or Victoria (whichever is higher) rather than equalising to the level of the strongest State (that is, Western Australia).

The new standard of equalisation is being phased in gradually over six years from 2021-22.

Other elements of the Australian Government's response included:

- annual GST pool boosts by the Australian Government of $600 million from 2021-22 and a further $250 million per annum from 2024-25. The boosts will be indexed annually in line with GST pool growth;
- a GST floor of 70 per cent of a state's population share, from 2022-23, rising to 75 per cent in 2024-25; and
- Australian Government top-up payments to Western Australia and the Northern Territory for 2019-20 to 2021-22.

It was also announced that the PC would undertake a review of the new arrangements by December 2026 with a focus on the fiscal implications for each State arising from the reforms and to assess whether the new equalisation arrangements are operating efficiently, effectively, and as intended.

[1] Commonwealth Grants Commission Submission to Productivity Commission Inquiry into Horizontal Fiscal Equalisation Draft Report, October 2017, page 6.

According to the single scenario presented by the Australian Government at the time, every State would be better off under the new arrangements (with Western Australia substantially better off). At that time, the Australian Government estimated that the total cost of the new arrangements would be around $4.6 billion from 2019-20 to 2024-25.

As part of its response, the then Treasurer, indicated a willingness:

> *"to work in cooperation with States to reach a long-term solution - one that leaves Australia with a more stable and predictable source of revenue for all States, while preserving the best features of our HFE system in terms of equity and leaving all States better off"*[2].

It was also stated at a press conference on 5 July 2018:

> *"as the Commonwealth Treasurer, it's my responsibility to ensure there's a better arrangement. At the end of the day, that means ensuring no State is worse off, and, indeed, making sure they're better off"*[3].

Most States did not support the proposed changes at the time. Modelling undertaken by a number of jurisdictions, including Tasmania, suggested that there were a range of feasible scenarios, based on different assumptions and more realistic relativities, which could result from the Australian Government's proposal. The Tasmanian Treasury was of the view that the scenario modelled by the Australian Government was one that was likely to portray a "best case" for the States and significantly understate the probable benefits to Western Australia and the costs to other States on a permanent basis.

Given the significant concerns with the Australian Government approach, the Board of Treasurers wrote to the former Treasurer and sought a binding guarantee that no State would be worse off under the proposed system compared to the current system in perpetuity.

While the Australian Government agreed to a binding guarantee that each state would be no worse off, the guarantee is only in place during the transition period to the new arrangements, that is, 2026-27. This guarantee ensures that no State will be net worse off over the transition period, although it does not necessarily ensure that a State won't be worse off in any particular year during that period.

Notwithstanding the guarantee, the new arrangements will mean that Western Australia has a greater permanent and increasing fiscal capacity than any other jurisdiction, which will enable it to deliver a higher standard of services and/or lower taxes to its constituents compared to all other jurisdictions.

A copy of the Tasmanian Government's submission to the Senate Standing Committees on Economics on the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018* is available at https://www.treasury.tas.gov.au/gst-distribution-to-tasmania/publications.

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[2] Australian Government interim response to Productivity Commission Inquiry into Horizontal Fiscal Equalisation, July 2018, page 2.

[3] The Hon Scott Morrison, Press Conference, Canberra, 5 July 2018, 'All States and Territories better off from a fairer way to share the GST', https://ministers.treasury.gov.au/ministers/scott-morrison-2015/transcripts/press-conference-canberra-20

What is the impact on Tasmania of the new arrangements?

The inequity embedded in the new GST distribution is rapidly becoming apparent.

The 2021-22 Australian Government Budget forecasts that all states, except Western Australia and the Northern Territory, will be worse off under the new arrangements across the Forward Estimates. Australian Government estimates suggest that Tasmania will be better off in 2021-22 under the new arrangements, but worse off from 2022-23.

The Australian Government has forecast that states will require guarantee payments totalling $7.6 billion to 2024-25 (shown in Table 1). This is largely attributable to the rapid growth in Western Australia's mineral royalties since 2017-18.

Table 1: Australian Government forecast Guarantee Payments

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
	$m	$m	$m	$m	$m	$m	$m	$m
2021-22	52.2	47.0	24.1	0.0	0.0	0.0	1.2	0.0
2022-23	838.4	701.4	529.1	0.0	164.5	36.6	42.2	0.0
2023-24	872.8	735.8	553.3	0.0	171.7	44.6	43.9	0.0
2024-25	992.0	844.3	626.5	0.0	189.5	46.5	49.2	0.0
Total	**2 755.4**	**2 328.5**	**1 733.0**	**0.0**	**525.7**	**127.7**	**136.6**	**0.0**

The cost to the Australian Government has significantly increased since its original estimates, with the Australian Government now forecasting the cost of the new arrangements (including top up payments, pool boosts, and guarantee payments to the States) to be $15.6 billion over six years from 2019-20 to 2024-25. This is significantly in excess of the $4.6 billion estimated by the Australian Government just three years ago.

Treasury has undertaken indicative modelling to illustrate the impact on Tasmania of the new GST distribution arrangements. For the purposes of the modelling, Treasury has held States' relative fiscal capacities constant from 2023-24 to 2031-32 and assumed growth in the GST pool and States' population to be consistent with the Australian Government's forecast growth in 2024-25.

This indicative modelling indicates that Western Australia is by far the main beneficiary of the new arrangements and that Tasmania (and the majority of other jurisdictions) will be worse off under the new arrangements.

When the guarantee ends in 2027-28, Treasury has forecast that Tasmania's GST revenue will decrease by $83 million in that year under the new arrangements or $147 per person. In comparison, Western Australia is expected to gain $5.6 billion, or $1 945 per person, in GST revenue in 2027-28 under the new arrangements (shown in Chart 2).

Chart 2: Estimated States' per person change in GST revenue in 2027-28 after the guarantee ends

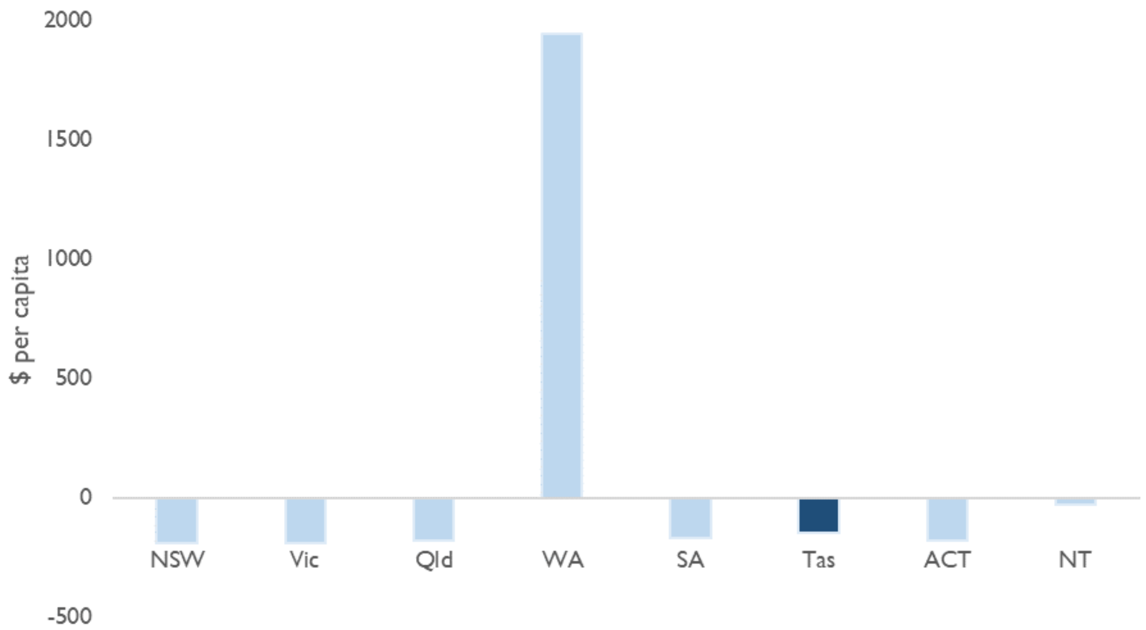
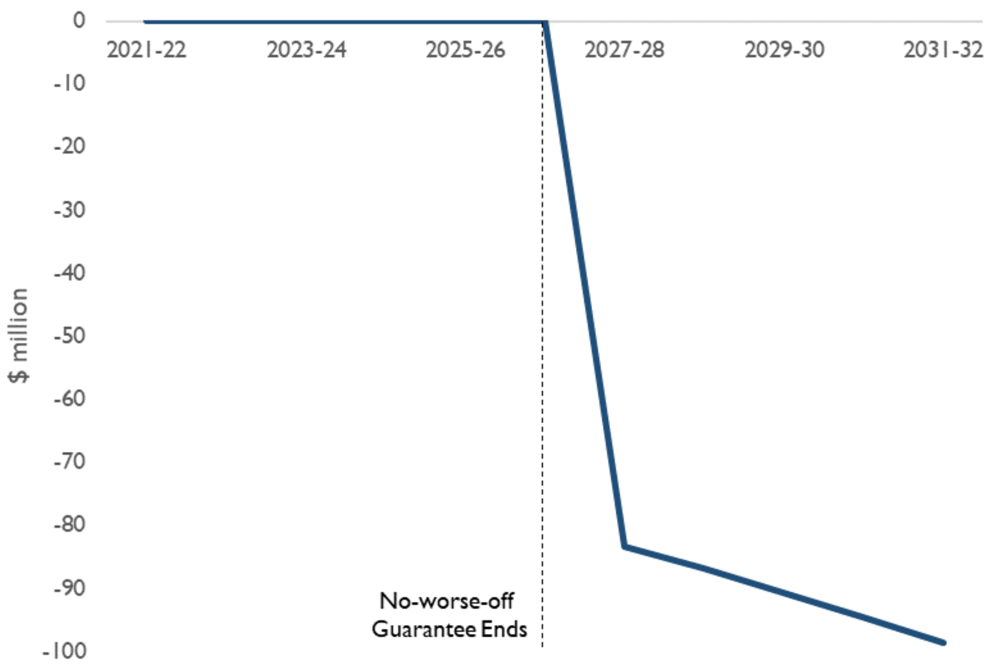


Chart 3 shows Tasmania's annual loss in GST revenue under the new arrangements from 2021-22 to 2031-32, compared to the previous full HFE distribution.

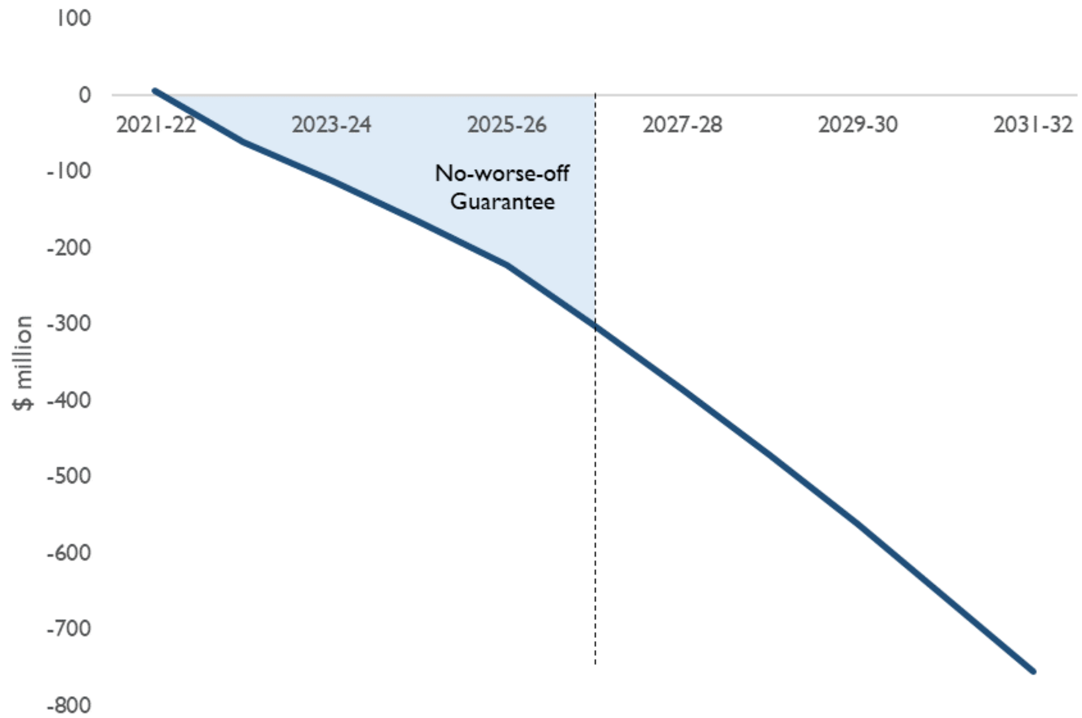
Chart 3: Tasmania's annual loss in GST revenue to 2031-32 under the new arrangements



From 2031-32, Tasmania is estimated to be $100 million per annum worse off on an ongoing basis. This may significantly impact Tasmania's ability to provide essential services, such as health, education and emergency services.

Chart 4 shows Tasmania's cumulative loss in GST revenue under the new arrangements from 2021-22 to 2031-32, compared to the previous full HFE distribution.

Chart 4: Tasmania's cumulative loss in GST Revenue to 2031-32 under the new arrangements



By 2031-32, Treasury's illustrative modelling has estimated that Tasmania could be up to $755 million worse off (with only around 40 per cent or $302 million of this covered by the current guarantee arrangements). In comparison over the same period, Treasury has estimated that Western Australia could be up to $57.5 billion better off from 2019-20.

Conclusion

Tasmania has consistently argued that the new arrangements will create a system that entrenches a gap between the fiscally strongest State (Western Australia) and the other States.

At the time the GST distribution changes were announced, Tasmania argued that the risk of being worse off under the new arrangements will be ongoing and therefore the no-worse-off guarantee should be a permanent arrangement.

As the impact of the new arrangements has become increasingly apparent, most States have raised concerns about the new distribution arrangements and the impact on their GST revenue.

When the PC undertakes a review of the operation of the new arrangements prior to December 2026, it is clear that this will demonstrate that the new arrangements have:

- resulted in Tasmania, and the majority of other States, being worse off under the new arrangements; and
- provided Western Australia with a greater, permanent and increasing fiscal capacity which will enable it to deliver a higher standard of services and/or lower taxes to its constituents compared to all other jurisdictions, continuing to entrench inequality between the States.