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Summary

State tax reform has the potential to unlock economic and social benefits and achieve more predictable revenue flows. But changes in the tax mix as part of such reforms can also potentially impact on GST distribution aimed at achieving fiscal equalisation among the states.

There is no agreement or definitive evidence that the potential impact on GST distributions is a deterrent to state tax reform. A main consideration in whether to undertake reform is likely to be the extent of the consequent efficiency and equity gains.

The potential GST effects from state tax reform depend on the extent to which changes in tax rates result in changes to tax bases, for example, the extent to which a reduction in stamp duty increases property sales. This is the elasticity effect. To the extent that tax reform increases a state's tax base, it would be assessed to have a stronger fiscal capacity. In the absence of steps to mitigate the impact of the reform on GST distributions, the state would be assessed to have a lower GST requirement. Elasticity effects can result in larger GST effects where a state unilaterally pursues reform, since that state is the only one diverging from the average. The impact on the GST distribution will be smaller if all states implement a similar tax reform.

The elasticity effects are generally larger for inefficient taxes (such as stamp duty on conveyances) and smaller for efficient taxes (such as land tax). This means a switch from stamp duty to land tax could have a large elasticity effect. The extent to which this affects the GST distribution depends on whether steps are taken to mitigate the impact of the reform on such distributions. However, the efficiency and welfare gains from the reform would also be large.

Any state tax reform is likely to be implemented over an extended period, which means any GST impact would also be spread over several years. The timing of any impact on GST distributions would also be tempered by the Commonwealth Grants Commission's (the Commission) three-year averaging approach to assessing state fiscal capacities.

In keeping with the Commission's principle that individual state policy choices should not unduly influence that state's GST share (the policy neutrality principle), the Commission could seek to identify and mitigate any material observed impact of state tax reform on the GST distribution. This would likely involve an element of judgement.

The terms of reference for an update (or review) of the GST distribution by the Commission would need to allow for measures to mitigate the impact of state tax reform, and the approach chosen would be determined in consultation with the Commonwealth and the states.

Introduction

This paper canvasses whether the distribution of GST revenue among the states, which is based on the principle of horizontal fiscal equalisation, may be an impediment to state tax reform. Concern has been expressed that the Commission's approach to assessing GST shares could result in a state losing GST revenues when it undertakes productivity enhancing reforms, such as replacing stamp duty on conveyances with land tax.[1]

The paper outlines the objectives of fiscal equalisation and the role of the Commission, how the Commission assesses states' revenue raising capacity, the possible impact of state tax reform on such assessments, and implications for the distribution of GST. Finally, the paper considers how the Commission might respond to state tax reform initiatives given the principle that the distribution of GST should not be affected by, or influence, individual state policy choices.

Objective of fiscal equalisation and role of the Commission

The Commission provides recommendations to the Commonwealth Treasurer for the distribution of GST revenue among the states based on the objective of achieving fiscal equalisation.

Fiscal equalisation is based on the view that all Australians should have the potential to access a similar standard of state services.

The Commission assesses the fiscal capacities of each state based on the average spending and revenue effort of all states. It assesses the extent to which there are circumstances outside the control of a state that affect its capacity to raise revenue or the cost of providing services. Based on these assessments, the recommended distribution of GST revenue seeks to equalise the fiscal capacity of the states.

Underlying the Commission's approach is the principle of 'policy neutrality', which aims to ensure that the assessment of a state's GST requirement is not affected by, and does not influence, individual state policy choices, such as changes to its tax mix.

1 NSW Review of Federal Financial Relations, Final Report August 2020.

How the Commission assesses state revenue capacity

In assessing state revenue raising capacity, the Commission calculates the amount of revenue each state would collect if it were to apply the average tax rate of all states to the major tax bases (after adjustments to improve comparability).[2]

For example, in the case of stamp duty on conveyances, the tax base assessed by the Commission is the value of property sales. After adjustments for comparability[3], the average tax rate (calculated as national stamp duty revenue divided by the national value of property sales) is applied to each state's value of property sales to assess its revenue raising capacity for that tax.[4]

The Commission's approach to assessing the revenue raising capacity of a state does not make allowance for how a state's tax base may change if it were to apply a different tax rate — such as the average tax rate. This is the elasticity effect — the extent to which changes in tax rates affect economic activity and, in turn, tax bases. For instance, a reduction in stamp duty on conveyances could result in an increase in property sales.

In 2018, the Commission engaged consultants to provide estimates of the size of elasticity effects for each revenue base it assesses. The result of this research suggested elasticity effects were very small for all but one tax base (stamp duty on conveyances). Even in this case the effects were difficult to estimate reliably. Largely on this basis, the Commission has not incorporated elasticity adjustments in its revenue assessments.

Interaction between state tax reform and GST distribution

State tax reforms often involve changes to the overall state tax mix (that is, the relative importance of each tax base). Changes to the tax mix will affect GST distribution to some degree. Tax rate changes by themselves generally have small GST effects.

2 The Commission uses weighted average tax rates which means that states with larger shares of a tax base have a bigger influence on the average rate for that tax. In addition to mining royalty revenue, the major state taxes are payroll tax, land tax, stamp duty on conveyances, insurance tax, and motor taxes.

3 The Commission makes one adjustment for comparability, it applies a lower rate of duty to land rich transactions by listed corporations to reflect the lower rate of duty states impose on this class of transactions.

4 The same result is achieved if the national conveyance revenues are apportioned based on state shares of the national tax base.

The effects can be positive for some states and negative for others, depending on each state's share of the corresponding national tax base. The largest effects are likely to arise from changes to tax bases in response to changes in tax rates, that is from the elasticity effects.

Tax rate effects

A policy change that changes a state's tax rate affects the assessment of the state's revenue capacity by changing the national average rate.

If a state increases its tax rate, it will increase the national average rate, increasing the assessed revenue raising capacity of states with a relatively large share of the tax base and reducing their assessed GST requirement. Conversely, this reduces the revenue raising capacity of states with a relatively low share of the tax base and increases their assessed GST requirements. There are opposite effects if a state decreases its tax rate.

Except for mining royalties (especially iron ore), the effect of tax rate changes by themselves on GST distributions is relatively small, as no state is dominant in any given tax base.

Mining royalties differ from other state taxes because the distribution of mineral resources (and therefore a state's share of the revenue base) is highly unequal across states and each mineral product has a different effective tax (royalty) rate as they are assessed separately.

Tax base effects

GST effects can also arise when a policy change affects a state's tax base. These changes may be direct (such as increasing compliance for an existing tax base) or indirect (where the tax base responds to changes in the tax rate — the elasticity effect).

For example, a reduction in the rate of stamp duty on conveyances could see the observed tax base rise through an increase in property sales. Any increase in a state's tax base increases its assessed revenue raising capacity relative to other states, which will in turn reduce the assessment of its relative GST requirement.

The number of states engaged in changing their tax mix will affect the size of the GST impact for each state. GST effects are larger when a state adopts a tax mix change unilaterally than when several states undertake a similar change.

In the case of a unilateral change, the elasticity effects are concentrated in one state and that state is the only one diverging from the average. The GST effects are smaller when several states undertake similar changes in their tax mix since there is less divergence between them.

Quantifying the impact of state tax reform on GST distribution

The GST consequences of state tax reform are difficult to quantify as they primarily depend on the extent to which tax bases change in response to changes in tax rates — and this is hard to reliably estimate. Modelled results of the impact of future tax reform on GST distribution are not definitive. As they depend on strong underlying assumptions, these estimates have many limitations.

The actual impact of state tax reform will depend on many factors, including the design of the policy, the transition path and the timeline for the implementation of reforms. How businesses and households respond to the reform and how other states respond are also important.

In addition, there is the challenge of distinguishing the reform's impact on the tax base from other factors influencing the tax base.

The Productivity Commission's 2018 report on Horizontal Fiscal Equalisation included several scenarios estimating the impact on GST payments from state tax reforms.

One scenario involved a state halving in one year its stamp duty on property and replacing the lost revenue in the same year with a new land tax.

As an example of this analysis, the Productivity Commission assessed that such unilateral tax reform by New South Wales would reduce its GST distribution by between $337 million and $1,281 million. This range reflected the variation in estimates of the possible elasticity effect from the reform.

Importantly, the Productivity Commission's estimates assumed that the full impact on GST distributions would occur in the year the reform was implemented.

It is more likely that such tax reform would be phased in over an extended period, as would any impact on GST distribution. For example, the ACT is currently implementing a similar reform program over 20 years.

New South Wales is currently consulting on a tax reform proposal that involves gradually replacing land tax and conveyance duty with an annual property tax. Under the reform, buyers would be given a choice at the time of purchase between paying stamp duty and land tax or the new property tax. The proposed reform is gradual, taking decades to complete.

The consultation paper released by the New South Wales Government states that after 20 years the option to pay stamp duty would likely remain for more than half of all properties. This suggests the potential impact on GST distribution is likely to be gradual.

The timing of any effects on GST distribution would also be tempered by the Commission's use of a 3-year moving average in estimating states' fiscal capacities. This means that any GST effects from the reform would be smoothed over successive years.

In addition, the use of lagged data means that any GST effects would not emerge until two years after the reform commences and the full effect would not be evident until five years after the introduction of the reform.

Views on whether fiscal equalisation affects state incentives for tax reform

This issue has been the subject of several inquiries over the past decade, including the GST Distribution Review in 2012[5] and the Productivity Commission's 2018 Inquiry on Horizontal Fiscal Equalisation.[6]

There was no agreement on whether fiscal equalisation is a disincentive to state tax reform. The GST Distribution Review concluded that while the equalisation process creates perverse theoretical incentives in some instances, there is little evidence they have any effect in the real world.

The Productivity Commission noted that there is widespread disagreement on the occurrence and magnitude of disincentive effects and that, unsurprisingly, conclusive evidence is scarce. Some of the state submissions to the Productivity Commission's inquiry argued that the GST effects of tax reform have no influence on state behaviour, which is primarily influenced by a wide range of other considerations, including community support, social impacts and economic factors. Other states suggested the effects can be pervasive and accumulate over time.

How the Commission could respond if state tax reform had a material impact on GST distribution

The Commission's policy neutrality principle seeks to ensure state policy choices have minimal effect on its assessments and, in turn, the assessments have minimal impact on state policy choices.

If the reform policies of an individual state were having a material effect on its GST share then, under its policy neutrality principle, the Commission could seek to mitigate such effects.

Whether and how the Commission could intervene would depend on several factors including the nature of the reform, the size of its effects and the number of states engaging in the reform.

5 The Australian Government, GST Distribution Review, Final Report, October 2012.

6 Productivity Commission, Report 88, Horizontal Fiscal Equalisation, Canberra 2018.

If the reform was spread over a long period, the annual changes may be incremental, and GST effects may not be material for several years.

Should the impact of the reform on GST distribution be material, the Commission could seek to identify and remove the impact.

This would involve seeking to identify separately the impact of the reform from other influences, such as economic conditions or the stage of the state-specific property cycle (in the case of any change to conveyancing duties).

Any response by the Commission to mitigate the impact of state tax reform would have to be permitted under the terms of reference issued for an update (or review) of the GST distribution, and the approach chosen would be determined in consultation with the Commonwealth and the states.

It is likely that a degree of judgement would be required, including the practicality of making such an adjustment.

Conclusion

Should state tax reform have a material impact on GST distributions, the Commission could be asked to seek to identify and mitigate this impact. This will have its challenges. The larger the difference in elasticity effects between the taxes subject to tax reform, the larger the likely social welfare gain, but also the potential GST effects if a state undertakes unilateral reform.

And the overriding consideration of tax reform should be the long-term benefits coming from the reforms, such as the efficiency gains and social welfare gains, as well as the benefits of less volatile tax bases.