

Reform of Commonwealth-State Financial Relations

As part of A New Tax System (ANTS) the Commonwealth will introduce a Goods and Services Tax (GST) on behalf of States and Territories (States). The GST revenues accruing to the States will provide a robust source of revenue that will replace Commonwealth Financial Assistance Grants (FAGs) and Revenue Replacement Payments to the States, as well as the revenue from nine inefficient State taxes. Under these arrangements, States will have access to a more robust tax base that can be expected to grow over time. Reflecting their significantly stronger financial position, States will assume full responsibility for local government funding and for the operation of a First Home Owners Scheme.

BACKGROUND

The need for the reform of Commonwealth-State financial relations was recognised in the five principles of taxation reform announced by the Prime Minister in launching the Government's tax reform exercise in August 1997. Measures to achieve this objective were subsequently included in the Government's 13 August 1998 ANTS package. Consideration of these measures by Commonwealth, State and Territory Heads of Government, including at a Special Premiers' Conference on 13 November 1998, resulted in the signing of an *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* on 9 April 1999.

Why a reform?

States have limited taxing powers

States are restricted by the Constitution in the type of taxes they can levy. In particular, they cannot levy excises (taxes on goods), customs duties (taxes on imports and exports) or taxes on Commonwealth property.

Since Federation, a series of developments has restricted the taxation powers of the States. Significantly, in 1942, to help the war effort, the States passed their income tax powers to the Commonwealth. Although initially intended as temporary, this arrangement has persisted with the result that States have no direct access to income taxes.

More recently, the High Court has found that the Constitution does not allow States to levy business franchise fees (taxes on petroleum, liquor and tobacco) or

levy certain taxes on Commonwealth owned places (for example, an office building or a military establishment). At the request of the States, the Commonwealth has altered its own tax arrangements to raise, on behalf of the States, sufficient revenue to replace the revenue lost by the States from these decisions.

The States' limited tax base restricts their ability to raise revenue and hence their ability to fund services to their residents.

States have to rely on inefficient taxes

States currently raise almost one quarter of total taxation revenue in Australia, but do this through up to 35 different taxes in each jurisdiction. The major State taxes are payroll tax, land taxes, financial transactions taxes, and taxes on motor vehicles and gambling. Taxes on the sale of petroleum, tobacco and liquor are also a major State revenue source, although, as noted above, these revenues are now collected by the Commonwealth on behalf of the States.

Some State taxes, such as payroll and land tax, are applied, or capable of being applied, to a broad base. However, many State taxes are narrowly based and have the potential to induce businesses and consumers to distort planning decisions for tax reasons. This can result in a less efficient allocation of resources within the economy.

Such taxes can also result in inequitable treatment of taxpayers. For example, debits tax and Financial Institutions Duty (FID) are levied on a relatively narrow range of financial transactions and can unfairly burden the less affluent in our community. In particular, because debits tax rates are specified as fixed dollar amounts per transaction, those undertaking smaller transactions often pay relatively more tax than those who make large transactions.

The States levy a wide range of stamp duties on transactions and transfers, including property conveyances, mortgages, leases, marketable securities, insurance and hiring arrangements. As States have different tax bases and rates this imposes significant compliance costs, particularly for those businesses that operate in more than one jurisdiction. Stamp duties on marketable securities also increase the cost of share trading. Combined with debits tax and FID, stamp duties on marketable securities adversely affect Australia's ability to develop as a financial centre in competition with others in our region and around the world.

THE COMMONWEALTH'S PROPOSAL

The principal objectives of the Commonwealth-State reforms proposed in ANTS are to:

- achieve a more efficient national tax system, including the elimination of a number of existing taxes which are impeding economic activity; and
- improve the financial position of all State Governments by providing access to a more robust tax base that can be expected to grow over time. This enhanced revenue security will ensure that the States can provide a sustainable level of quality services — such as hospitals, schools, and law enforcement — into the future.

The Commonwealth is proposing to levy a broad based value-added tax, the GST, on behalf of the States. The GST will be a 'State tax' that provides the States with a robust source of revenue, reducing their reliance on grants from the Commonwealth and allowing them to abolish a range of inefficient taxes, including bank transaction taxes and certain stamp duties.

INTERGOVERNMENTAL AGREEMENT

Agreed reforms

At the 9 April 1999 Premiers' Conference, Heads of Governments signed the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* which gives effect to the following reform measures:

- The Commonwealth will cease to apply the Wholesales Sales Tax from 1 July 2000 and will not reintroduce it or a similar tax in the future.
- From 1 July 2000, the Commonwealth will appropriate all of the GST revenues to the States on a monthly basis. GST revenues will be distributed amongst the States on the basis of horizontal fiscal equalisation (HFE) principles. These principles are currently used to distribute FAGs to the States and are designed to ensure that all States have the capacity to provide a broadly equal level of services to their residents. (As part of the transitional arrangements, there will be some departure from pure HFE principles during the first two years following the introduction of the GST.)
- FAGs and Commonwealth collections of taxation from alcohol, petrol and tobacco on behalf of the States (Revenue Replacement Payments) will cease from 1 July 2000.
- The States will adjust their gambling tax arrangements to take account of the impact of the GST on gambling operators from 1 July 2000 and abolish:

- bed taxes from 1 July 2000;
- FID and debits tax from 1 January 2001;
- a number of business-related stamp duties from 1 July 2001; and
- stamp duty on non-residential conveyances on real property from a date to be determined.

The States will not reintroduce these taxes, or similar taxes, in the future.

- The States' receipt of the GST revenue is also subject to their meeting other obligations.
 - The States will fund and administer a First Home Owners Scheme from 1 July 2000 to offset the impact of the GST on house prices for first home buyers. The Scheme will involve the provision of \$7,000 to eligible applicants who are buying or building their first home as their principal place of residence.
 - The States will assume responsibility for local government funding.
 - The States will compensate the Commonwealth for the cost of administering the GST. To promote accountability between the parties, the States and the Australian Taxation Office (ATO) will develop a performance agreement that establishes an agreed basis against which the administration of the GST by the ATO and its agents can be assessed.
- As the GST revenues will not be sufficient initially to fund the States' current expenditure and the new responsibilities they are assuming, the Commonwealth has guaranteed that in each of the transitional years following the introduction of the GST, each States' budgetary position will be no worse off under the new arrangements.

Although these reforms are far reaching there is unanimous agreement on their implementation among all Governments. This agreement reflects a shared view that the reforms will afford substantial gains to the States over time which will allow them to better fund States services while also abolishing inefficient taxes.

Specific Purpose Payments

A little under half of the total financial assistance which the Commonwealth currently provides to the States takes the form of Specific Purpose Payments. These are payments for policy purposes related to specific functions, such as health and education. As part of the Intergovernmental Agreement, the Commonwealth has undertaken to continue to provide Specific Purpose Payments to the States and has committed that it has no intention of cutting these payments in aggregate as part of the reform process. This commitment is consistent with the objective of the States being financially better off under the new arrangements.

Ministerial Council

The Intergovernmental Agreement provides for the establishment of a Ministerial Council from 1 July 1999, comprising Commonwealth and State Treasurers, to oversight the implementation and operation of the Intergovernmental Agreement and to ensure compliance with its terms. The Ministerial Council will also provide a forum for the discussion of the Commonwealth Grants Commission per capita relativities to apply to the distribution of the GST revenue among the States and obviate the need for the annual Premiers' Conference process. These relativities will be used to distribute GST revenue on the basis of horizontal fiscal equalisation principles.

Local government funding

At present the Commonwealth provides the majority of the funding for local government in the form of financial assistance grants and identified road funding. The increased State revenues resulting from access to the GST will permit the States to assume responsibility for the funding of local government. This transfer of funding responsibility is consistent with the States' general responsibility for local government. In order to ensure funding certainty for local government, the Intergovernmental Agreement requires that States continue to maintain the growth in general purpose assistance to local government on a real per capita basis and to meet existing Commonwealth conditions on the payment of assistance to local government

Legislation

The reforms to Commonwealth-State financial arrangements require the passage of legislation by both the Commonwealth and the States. The States have agreed to enact legislation to fulfil their commitments including the abolition of certain indirect taxes, the provision of funding to local government and the introduction of a First Home Owners Scheme. It is intended that the Intergovernmental Agreement will be attached as a schedule to relevant Commonwealth and State legislation.

On 31 March 1999 the Commonwealth House of Representatives passed two Bills to give effect to the Commonwealth's commitments: A New Tax System (Commonwealth-State Financial Arrangements) Bill 1999; and A New Tax System (Commonwealth-State Financial Arrangements — Consequential Provisions) Bill 1999.

The A New Tax System (Commonwealth-State Financial Arrangements) Bill 1999 (the Bill) fulfils the Government's commitment to appropriate all GST revenue to the States and provides for the distribution of the GST revenues to the States on the basis of horizontal fiscal equalisation principles.

The Bill also provides for Commonwealth transitional assistance to the States to offset any revenue shortfalls in the initial years following the introduction of the reforms. This transitional assistance will ensure that no State budget will be worse off as a result of the reforms to Commonwealth-State financial arrangements and will take the form of one-year interest-free loans to the States in 2000-01 and grants to the States in subsequent years. On Budget estimates, the Commonwealth will provide loans to the States of some \$1,119 million in 2000-01 (repaid by the States in 2001-02) and grants of \$1,218 million in 2001-02 and \$517 million in 2002-03.

In addition, the Bill establishes arrangements which 'lock-in' the GST rate and base. Consistent with the Intergovernmental Agreement, the Bill records the Commonwealth's intention that the GST rate and, in most cases, the GST base cannot be altered without the unanimous support of all State Governments. These provisions are designed to address community concerns that the Commonwealth could increase the GST revenues in the future by unilaterally increasing the GST rate or expanding the tax base.

In order to facilitate the administration of the GST in the initial months of operation, the Commonwealth has reserved the right to make unilateral changes to the GST base in the first 12 months of operation. These changes will have to be of an administrative nature, necessary to facilitate minor adjustments to the GST and made having regard to the need to protect the revenue of the States. From July 2001, changes to the GST base of an administrative nature will require the majority support of the Commonwealth and States.

Finally, the Bill maintains the States' entitlement to competition payments and the protection provided by the franchise fees windfall tax from 1 July 2000 following the repeal of the existing *States Grants (General Purposes) Act 1994*.

With the commencement of the new arrangements, the legislation governing current arrangements for the provision of Commonwealth financial assistance to the States and local government — the *States Grants (General Purposes) Act 1994* and the *Local Government (Financial Assistance) Act 1995* — will need to be repealed. The A New Tax System (Commonwealth-State Financial Arrangements — Consequential Provisions) Bill 1999 repeals these two Acts.

Commencement

The *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* will commence on 1 July 1999, unless otherwise agreed by the Parties, with most reform measures taking effect from 1 July 2000.