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Mr Peter Harris AO  
Chairman  
Productivity Commission  
Locked Bag 2, Collins St East  
Melbourne VIC 8003



Dear Mr Harris

## Productivity Commission's inquiry into Horizontal Fiscal Equalisation

I am writing to you with some thoughts on the Productivity Commission's inquiry into Horizontal Fiscal Equalisation.

With the active participation of its members, the Australian Bankers' Association (**ABA**) provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

This inquiry has been prompted by a perception of growing inequality in the distribution of Goods and Services Tax (**GST**) revenue between states and territories (**states**). This has led to consideration of new revenue sources, such as the South Australian move to introduce a new major bank tax in direct contravention of the original GST agreement, with potentially serious negative consequences for the competitive position of that state.

The ABA acknowledges that this review is primarily focussed on horizontal equalisation and the GST. However, the issues being addressed are part of a broader debate about the sustainability of budgets and how governments can continue to source sufficient funding to provide the essential services that the Australian people need.

### Introductory comments

The process for reform of the Australian taxation system is broken. Recent changes to the taxation system have been piecemeal, lacking a clear economic rationale, with inadequate consideration of the impacts on investment, growth and jobs, and with insufficient consultation with stakeholders. The South Australian major bank tax – following the bad example set by the Commonwealth Government – are obvious cases in point.

These developments have placed the issue of tax reform now firmly back on the table as a legitimate issue for banks to enter the public debate.

Australia needs well-considered, evidence-based holistic reform of the taxation system which focuses on driving economic incentive, investment, economic activity and jobs, and which promotes higher productivity and a higher standard of living for all Australians. Reform of the taxation system should be considered an integral part of a government's strategy to drive national prosperity.

This should include a review of the various types of taxation across all three levels of government, including corporate and personal income taxes, the GST, excise duties, royalties, payroll, and property taxes to ensure they remain fit for purpose and to ensure all governments have the certainty that they will be provided with the revenue they need.



There needs to be a renewed focus on the purpose of taxation – either to raise the revenue required to fund the essential services and income support that Australians need – or to create incentives for economic decisions that benefit society.

On this point the ABA observes that taxation reform cannot be assessed in isolation. It is just one half of budget reform and should be done hand in glove with a reappraisal of government against the available revenue base. Rightsizing expenditure would involve the establishment of clear priorities and an assessment of what spending can best be done by government and what is more appropriately provided by the private sector.

Some states employ the principle of user pays for the provision of services, including toll roads and some utilities. In other areas of service provision there is partial user pays, including public transport, motor vehicle registration fees, licences for some activities (driving and fishing) and so on. Extension of this principle, where appropriate, would ease the pressure on the public purse.

The point of these observations is that it is time for a comprehensive all-encompassing root and branch rethink on the funding and provision of public sector services across Australia. Consideration of horizontal fiscal equalisation is only one part – albeit an important part – of this broader review.

### Observations on horizontal fiscal equalisation

The ABA strongly supports the principle of horizontal fiscal equalisation – Australia is one country and all Australians should have equal access to publicly funded services.

The ABA acknowledges that the GST was designed as a ‘top up’ tax to facilitate the principle of ‘horizontal fiscal equalisation’ by ensuring all states and territories had recourse to sufficient total revenue to be able to provide equivalent services. The idea was that Australians could enjoy the same standards of health care and education and transport infrastructure no matter where they live. The GST was to be used to contribute more revenue to states that were unable to raise sufficient from their own means – with the money coming from the states with greater capacity for self-funding – to ensure the equivalent provision of services.

The ABA believes that over the past 17 years some unintended and undesirable consequences have emerged, primarily relating to the mechanism for distributing the GST to achieve this principle. There is some legitimacy to the view that the GST is not working in the way that was envisaged at the time the Intergovernmental Agreement was signed in 2000.

It is now appropriate to re-examine the methodology to address these issues.

A key issue is the time lags in the averaging mechanism for determining the GST allocation. The current distributions are based on a three-year average with, for example, the GST distribution for 2017-18 based on the average fiscal circumstances over 2013-14 through 2015-16. The ABA fully acknowledges the rationale of smoothing short-term fluctuations in revenue and providing greater year-to-year certainty. However, strong volatility in some revenue streams – particularly mining royalties – leads to a situation where the averaging mechanism cannot adjust sufficiently quickly to compensate states for years when their key source revenue declines sharply. This can lead to unplanned budget shortfalls with the attendant pressure on service provision. It can lead to unplanned deficits and impact on financial market confidence.

A solution would be to provide greater responsiveness of GST shares to volatility in own source revenue. This would achieve greater consistency with the Commonwealth Grants Commission (**CGC**) contemporaneity principle.

Another issue is that states and territories derive limited benefit from some sources of revenue raising, particularly for minerals where one state dominates the mineral base. For example, Western Australia (**WA**) loses a large portion of royalties on iron ore as it is the only state with significant quantities of this metal ore, and it effectively sets the national average royalty rate on that mineral. This limits the benefit to WA from tapping this source of revenue and from developing the state’s considerable resources of iron ore. NSW and Qld find themselves in a similar position in respect of their extensive deposits of coal.



More generally this can dissuade states from developing new sources of unique revenue, stifling financial innovation to the detriment of all states and territories.

A solution would be to allow states to keep a minimum portion of unique revenue sources. This would be effected by excluding a minimum percentage amount from the revenue calculations upon which the GST allocation is based.

A third issue is that under the Intergovernmental Agreement<sup>1</sup> signed by all the states and territories in 2000, the GST reform package included the elimination of a number of existing taxes which were impeding economic activity. Two of the taxes the states agreed to eliminate were Financial Institutions Duty and Debits Tax. The states agreed to “not reintroduce them or similar taxes in the future”.

The ABA would argue that the proposal to introduce a major bank levy by South Australia is in contravention of the GST agreement to eliminate financial taxes, and introduces a new source of inefficiency in the overall Australian taxation system. The agreement needs to be enforced. No state should gain a financial benefit from breaking the agreement.

### GST on financial services

A discussion by banks on GST leads inevitably to the issue of GST on financial services.

GST was not imposed on financial services at the introduction of the tax in 2000 because of the difficulty in choosing the taxing point – would the tax be applied to fees and charges, or home loan rates, or the net interest margin and so on? It is complex and difficult and that is why it was not done.

Some countries have studied the feasibility of taxing financial services for GST or Value Added Tax (**VAT**) purposes. However, as far as we are aware, no country has directly fully taxed financial services.

Although GST is not imposed on financial services, banks pay a large amount of GST, in excess of \$1 billion a year. Banks pay GST on their inputs but do not collect GST on the financial services and products they provide. They are not entitled to claim a credit for the GST they pay. This “input taxing” of financial services means that GST becomes a direct cost to financial institutions.

Uniquely, Australia’s GST is designed to limit the circumstances in which financial services are input taxed to restrict the number of taxpayers potentially affected. This is achieved by imposing GST on many ‘intermediary’ services (for example, external providers such as the services of mortgage brokers, fund managers and arrangers of financial transactions) that would be input taxed in other GST and VAT regimes. In order to lower the cost of taxable intermediary services, the GST charged on these services is partially set off by a credit known as a reduced input tax credit (**RITC**). The RITC ensures that GST is not a factor in a financial institution deciding whether or not to outsource to external providers.

A key observation is that a GST on financial services would not be paid by banks. GST is a direct tax on consumers imposed by the Government. Customers (not banks) would pay more for their financial products and services.

In this light the ABA supports retention of the current arrangements.

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<sup>1</sup> Intergovernmental Agreement Implementation (GST) Act 2000



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The ABA believes the issues canvassed in this inquiry are central to preserving equality of opportunity for all Australians while maintaining a fair and efficient taxation system. I would be happy to discuss these issues with you.

Yours sincerely

Anna Bligh AC  
Chief Executive Officer