AUSTRALIAN CAPITAL TERRITORY

Submission to the GST Distribution Review Issues Paper of July 2011

October 2011

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1 Executive summary

The ACT welcomes the *Review of the GST Distribution* (the Review) and remains a strong supporter of the current system of Horizontal Fiscal Equalisation (HFE).

While it is useful to review the efficacy of the existing arrangements on a regular basis and in times of changing environment, the ACT is concerned that some of the arguments for change are poorly informed or incorrectly seek to attribute certain adverse consequences to the current approach to HFE.

The catalyst for seeking a review appears to be the result of HFE responding to changes in the relative economic circumstances of States and Territories (from now on referred to as States unless otherwise specified), in particular the strong increase in mining revenues accruing to Western Australia and to a lesser extent Queensland. This reflects HFE being effective in what it is intended to do.

All federated countries have some form of HFE to support the distribution of federal funds. Australia has possibly the highest level of Vertical Fiscal Imbalance (VFI) among the federated countries. It is no surprise (and is appropriate) that its equalisation process is the most sophisticated. In essence HFE emulates what would happen under a unitary government where all revenues are pooled and expenditure occurs equitably where the need is located.

The ACT considers that the current approach to HFE continues to achieve the goals of the system. It is not surprising that there is friction at the margins, as the system of equalisation inherently involve some trade-offs. HFE is not fundamentally broken. The concerns that have been expressed are at the margin and at most require only minor improvements rather than wholesale change.

The main objective of equalisation is to achieve equity of community access to services. The ACT considers that the efficiency consequences are negligible and well within an acceptable level of 'trade-off'.

There is no evidence that HFE works to discourage economic development and efficiency in service delivery. On the contrary, all States actively pursue economic and population growth, noting that differences in natural endowment lead to differences in the effectiveness of such policies.

Claims that HFE presents a barrier to labour mobility do not appear justified. One of the best aspects of the current approach to equalisation is the use of the average of all States' experiences (revenue / expenditure) as the assessment standard. This means that the assessed expenditure requirements of States is neutral to the actual activity of an individual State, except to the extent that this changes the average.

However, to the extent that a State operates less efficiently than the average of all States, it must fund that inefficiency through higher own source taxation and / or a reduced level of service. A State that is more efficient than average can effectively reduce its own source taxation and / or provide more or better services. Therefore, States can choose to pursue efficiency gains without concern that they will be penalised for being more efficient.

It has also been suggested that HFE should be used as a tool to encourage or facilitate reform. Goods and Services Tax (GST) revenue is allocated to the states in compensation for own-source revenues that States are unable to collect as a consequence of VFI. HFE is designed to provide capacity to States to deliver comparable levels of service without having to apply above average tax rates. HFE is not the appropriate tool for engineering economic reform. There are much more effective ways of encouraging economic reform, without trading-off the principle of equity, such as through direct Commonwealth payments.

The terms of reference also seek consideration of greater simplicity and improved transparency. Significant steps were taken to achieve improved simplicity and transparency in the 2010 Review of GST Relativities (2010 Review). While gains were made in simplicity, it came at the cost of reducing the 'accuracy' of HFE, as a consequence of using broader but less subtle measures of differences and applying arbitrary materiality thresholds. It would be quite easy to simplify the distribution of GST; however, if it did not achieve at least a reasonable approximation of equalisation, it would not be consistent with the *Intergovernmental Agreement on Federal Financial Relations* (IGA). Essentially, the form of equalisation needs to be 'fit for purpose'.

There are, however, some specific areas of the current approach to HFE which could do with some fine tuning. These are, amongst others, the treatment of:

- Commonwealth Grants in lieu of royalties be paid to all States on an equal per capita basis. This would have no change to the outcome of the current approach but would substantially reduce the divergence in assessment relativities.
- Reviewing the Indigeneity assessment. Indigeneity is a significant reason for the diversity in GST shares but is currently based on unreliable data.
- Reviewing the treatment of Net Worth. Such a review should consider if the net worth assessment is necessary at all, but if necessary, whether it should be on the basis of the annualised cost of capital, or if continued in its present form, whether it should include all contributions to net worth including increases in valuations from investment in government trading enterprises. Changes to the Net Worth assessment could address the concerns raised in respect of large one-off Commonwealth capital grants affecting the GST relativities and creating increased volatility in relativities from year to year.

- For those revenue categories where the measure of the base is highly sensitive to the rate of tax (Stamp Duty on Conveyances being the prime example) considering options for either elasticity adjustments or less direct measures of the revenue base. This would address concerns that the existing assessment methods may discourage tax reform.

These matters, however, do not by themselves require a substantial overhaul of the HFE system. They are best dealt with either by a change in the specific assessments or a change in the current Commonwealth-State arrangements.

2 Introduction

1 The ACT Government welcomes the Review and the release of the Issues Paper. This is the first submission by the ACT Government to the Review and it responds to the Issues Paper released by the Review Panel in July 2011.

2 This Submission outlines the ACT's view that the HFE system is not broken. The ACT remains a strong supporter of HFE and the three underlying pillars of equalisation, namely:

- *policy neutrality* principles are integral to the equitable sharing of GST revenue and prevent participants adopting policies that can directly influence outcomes;
- *what States do* encompasses an assessment based on the actual services provided rather than the broader objectives of States' policies; and
- *capacity equalisation* or equalising the fiscal capacity of the States, and not the circumstances of individuals, households or communities.

3 The Submission challenges suggestions that HFE hinders economic growth and reform. In fact, the system has withstood and continued performing through many shocks to the Australian economy.

4 The ACT acknowledges that constructive and measured change could be made in some areas to improve equalisation in light of the changing circumstances that Australia faces.

5 The 'cost to efficiency' argument has been advanced on the basis that HFE is anachronistic in an open economy in a highly globalised world economy. It is argued that HFE as currently practiced adversely impacts on both technical and allocative efficiency. The ACT considers that the technical efficiency argument is weak and this is clearly demonstrated by the Commonwealth Grants Commission's (CGC) Submission

to the Review. While the argument in favour of adverse allocative efficiency is slightly stronger it is quite clear that the impact on the overall economy is negligible.

6 The 'argument for reform of HFE is linked to the major changes in the global economy and the uneven impact on the States. Increasing divergence in States' relative economic strength should be a reason for reinforcing HFE rather than calling for a dilution.

3 Why is HFE important

3.1 HFE takes differing circumstances into account

7 The Issues Paper highlights that 'this Review is not a debate about whether HFE should continue. HFE has and will continue to serve Australia well.' [1] The ACT strongly endorses this view.

8 The total redistribution (compared with an equal per capita distribution) of GST revenue as a result of the application of HFE is only around 8 per cent. Of that small redistribution, around 56 per cent of the amount redistributed goes to the Northern Territory and around 36 per cent is provided by Western Australia. The ACT receives just over 2 per cent of the total amount redistributed. By comparison with many other countries, living standards are high in all jurisdictions and the disparities are relatively compressed.

9 Factors which contribute to differences among the jurisdictions in their capacity to provide comparable government services include differences in the capacity to raise taxes from limited tax bases. The capacity to raise payroll tax, for example, is likely to be greater in those States which have a relatively larger number of big enterprises. Similarly, the relative expenditures of the jurisdictions will reflect, among other things, differences in population size, age structure and dispersion, differences in the degree of urbanisation and differences in the physical and economic environment. An outline of the specific circumstances of the ACT is attached at appendix A.

10 HFE adjusts for these differences between the States. However, it does not adjust for differences in policies, such as differences in tax rates or service delivery standards.

11 Some States for various reasons are unable to provide services as efficiently as others, for example, it is not possible for small States to achieve the economies of scale that are available to the larger States. The current assessments recognise this and make allowances in the relevant assessments. Similarly, the assessments compensate States

[1] GST Distribution Review, Issues Paper, July 2011, page 1.

for the scale effects of delivering services in sparsely populated areas. What should be the appropriate allowances for these disadvantages is a matter for the specific assessments.

3.2 HFE's key purpose is equity

12 In a federal system equity requires the equal treatment of equals or equal treatment for persons different in no relevant respect. [2] This underlying principle of equitable treatment is an important value to all Australians.

13 Australia's equalisation system is world-leading. Its objective, to allow each State to provide comparable services and infrastructure to every Australian citizen no matter where they reside is an egalitarian and equity driven approach.

14 This interpretation of HFE is shared internationally:

> *'the primary objective of fiscal equalisation is horizontal equity among the residents of different jurisdictions, i.e. ensuring that, subject to local preferences, all persons or firms in a country can obtain comparable public services at comparable tax rates.'* [3]

15 States should have the same fiscal capacity for services to their citizens irrespective of the varying policies. Such fiscal equity is fundamental to a civilised federation and is described as 'essential as a guide to the operations of a liberal democratic state, stemming from the same base as the principle of equality of individuals before the law'. [4]

16 Equity is **the** primary objective for equalisation employed in many other countries, such as Canada, Germany, Italy, Mexico, Spain, Switzerland, Denmark, Finland, Greece, Japan, Norway, Poland, Portugal, Sweden, Turkey and the United Kingdom. There appears to be no justification for Australia walking away from the principle of fiscal equity.

17 Equalisation in Australia, at least, is not far removed from what would occur in a unitary system with one level of government accessing all revenues and meeting all expenditure responsibilities. By and large all revenues would be pooled, regardless of where the tax base was located and expenditure would be incurred on the basis of where the need was located. This is the basic approach underlying HFE as currently practiced, with the additional element of providing democratically elected sub-national governments a degree of autonomy over how expenditure is allocated.

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[2] J. Buchanan, *Federalism and Fiscal Equity (1950),* American Economic Review 40, page 583-99.

[3] *Fiscal Equalisation*, Hansjörg Blöchliger and Claire Charbit, OECD Economic Studies No. 44, 2008/1 – OECD 2008, page 2.

[4] J. Buchanan, *Federalism and Fiscal Equity (1950),* American Economic Review 40, page 583-99.

18 One of the major benefits of providing State Governments with the same capacity to provide comparable services to their residents has been the reduction in the impact of divergent inter-regional disparities.

19 Major disparities between sub-national governments can lead to significant social problems. However, HFE has ensured that Australia is a strong federation with a population dispersed across the continent, leading to a virtual elimination of fiscal disparity akin to other countries such as Germany and Sweden. [5]

20 Figure 1 provides a table of the fiscal disparities of OECD sub-central governments before and after equalisation, and is divided into two sections, one for federal countries and the other for unitary countries. The Table highlights that in most countries the effect of equalisation is substantial in reducing disparities. On average, disparities, as measured by the coefficient of variation of fiscal capacity before and after equalisation, decreased by almost two thirds, from 29.9 per cent to 9.7 per cent. Similar effects are shown by the Gini coefficient which was reduced from 14.3 per cent to 5.2 per cent. [6]

[5] Ibid.

[6] *Fiscal Equalisation*, Hansjörg Blöchliger and Claire Charbit, OECD Economic Studies No. 44, 2008/1 – OECD 2008, page 7.

Figure 1: Fiscal disparities and the disparity reducing effect of fiscal equalisation

	Before equalisation (in per cent)				After equalisation (in per cent)				Equalisation effect (difference pre/post-equalisation, percentage points)	
	Variation coefficient	Gini coefficient	Highest capacity	Lowest capacity	Variation coefficient	Gini coefficient	Highest capacity	Lowest capacity	Variation coefficient	Gini coefficient
Federal/regional countries										
Australia	16.8	5.0	103.8	79.8	0.0	0.0	100.0	100.0	16.8	5.0
Austria					4.2	2.0	106.9	93.2		
Canada	29.8	10.0	177.1	75.0	20.1	7.0	156.9	92.9	9.7	3.0
Germany (2005)	13.0	6.0	116.5	67.2	2.7	2.0	104.5	97.4	10.3	4.0
Italy	39.0	21.0	146.0	24.0	6.0	10.0	115.0	89.0	33.0	11.0
Spain	26.5	15.0	142.2	67.2	10.1	4.0	117.4	83.7	16.4	11.0
Switzerland	31.8	15.0	173.0	46.0	23.2	11.0	159.0	64.0	8.7	4.0
Unitary countries										
Denmark	16.0	8.0	134.0	62.0	6.0	4.0	175.4	86.4	10.0	4.0
Finland	17.7	11.0	143.0	78.8	4.2	3.0	104.8	95.3	13.4	8.0
Japan	36.0	20.0	183.0	58.0						
Norway	23.0	13.0	142.0	64.0	8.0	5.0	118.0	93.0	15.0	8.0
Portugal	90.0	34.0	331.0	26.0	28.0	14.0	138.0	65.0	62.0	20.0
Sweden	10.0	6.0	118.0	84.0	0.0	0.0	103.0	91.0	10.0	6.0
Turkey	39.0	22.0	130.0	2.0	14.0	6.0	107.0	64.0	25.0	16.0
Average	29.9	14.3	156.9	56.5	9.7	5.2	123.5	85.8	19.2	9.1

Source: Fiscal Equalisation, Hansjörg Blöchliger and Claire Charbit, OECD Economic Studies No. 44, 2008/1 – OECD 2008.

21 Clearly equalisation plays an important role in ensuring residents of different sub-national governments receive comparable services. Internationally, disparities between governments of many countries is reduced by ensuring that sub-national governments are given the same capacity (via comparable tax rates) to deliver comparable services[7].

22 It is to be expected that a system designed to achieve equity would have efficiency consequences. The relevant questions are: (a) what are the efficiency costs, and (b) what is an acceptable efficiency trade-off. The ACT contends that the efficiency costs are negligible and well within an acceptable level given the benefits of equalisation.

[7] The Australian equalisation process actually goes further than most countries as expenditures, Commonwealth payments and infrastructure are also equalised in addition to revenues.

4 The current HFE system is not broken

23 The preamble to the Review suggests that HFE is in disarray, and that States face penalties for economic growth and rewards for economic underperformance.

24 The purpose of equalisation is not about providing incentives for reform. There are other and considerably more effective policy tools for modifying States' behaviour than HFE, including the current system of tied grants.

25 Australia's fiscal equalisation system has underpinned the social fabric of the federation, giving governments the fiscal capacity to provide comparable services to their citizens, as a former CGC Chairman states:

> *'Largely as a result of the Commission's work, the Australian federation does not consist of an amalgam of wealthy States with low taxes and generous social services on the one hand and poor States with high levels of taxation on the other. Differences in the standards of government services as between States can be identified as the result of differences in policy rather than in fiscal capacity.'* [8]

26 It is this equity that must be preserved, and a fair and equitable outcome achieved by the Review. The ACT notes the reference in the preamble to the need to ensure that smaller States continue to receive a fair share of GST revenue. However, what constitutes a 'fair share' is obviously a point of contention. The ACT considers that the CGC, over a long period, has got this measure more or less right.

4.1 The Review as a result of pressure from the resource-rich States

27 The Review stems from Western Australia and Queensland arguing for changes to HFE on efficiency grounds, claiming that the mining States are being 'penalised'. That is, a substantial proportion of their mining revenues 'being redistributed away to other States', reducing their share of GST funding. It is claimed that this acts as a disincentive to encourage increased mining activity or to increase royalty rates.

28 In addition, Western Australia has claimed the State gets back only 68 cents from every dollar contributed to the GST.[9] This argument is misleading as Western Australia's relativity of 0.68298,[10] has no direct dollar value as it is merely a weighting which relates back to the Australian average (equal per capita) distribution of 1.00000. GST relativity does not represent the proportion of GST returned to a State.

[8] *Equality in Diversity, Fifty Years of the Commonwealth Grants Commission*, Australian Government Publishing Service, Canberra, 1983, foreword.

[9] 720 ABC Perth, *Premier Pushes for Minimum GST Return*, ABC News (Australia), 30 March 2011.

[10] 2010 Review relativity.

29 Such commentary adds to the public misunderstanding of what the GST relativities represent. It is not possible to calculate the actual GST contributed in each jurisdiction because the location of lodging tax returns is frequently different to the location at which the GST is collected. The mining industry is largely exempt from GST due to it exporting much of its product. On the other hand it is able to claim credit for GST paid on its significant capital investment. Therefore, the overall GST contributed by the Western Australian economy is likely to be lower than average.

30 Overall, these concerns relate to the mining assessment method rather than being a valid case for an overhaul of HFE. Central to this issue is the fact that mining activity is heavily concentrated in two or three jurisdictions. This means that the policies of these jurisdictions are heavily weighted in the average policy of all jurisdictions. For other revenues where the disparity in revenue capacity is much less, any disincentives are much less pronounced and in actuality do not exist. This issue is best dealt with a change in the mining assessment method rather than a wholesale change in HFE.

31 However, when making any changes to the form of HFE, it is important to consider that the mining boom may be temporary. As such, the form of HFE needs to be fit for purpose in its ability to respond to the changing economic circumstances of the States over time, including during years of a mining boom and also when there is a downturn in the demand for mining. For example, a discounted mining assessment would preserve a larger share of mining revenue for Western Australia and Queensland now, but in the event of a downturn would reduce the flow of GST compensation to those States.

32 There is an argument for extending the HFE system. There are many unmeasured yet significant factors that affect States' prosperity that are not currently included in the equalisation process. For example, Commonwealth recurrent and capital payments paid as subsidies to specific industries such as to the agriculture, defence, automotive, and textile, clothing and footwear manufacturing industries. These payments are not evenly distributed among the States and, as they are often direct to industry, do not appear on State government budgets, but nonetheless provide valuable economic stimulus to some States.

4.2 The current HFE system has adapted to change and volatility

33 Historically, HFE has responded properly to all manner of influences that have affected State taxation and service delivery arrangements. The equalisation system has developed in response to its changing contextual environment, and has managed the changes that have occurred, from the time of federation when the Australian economy was relatively isolated from the instability of world affairs, to the present complex and interconnected world economy.

34 The equalisation framework has aptly taken into account the impact on States of changing circumstances stemming from both domestic and international events. Australia effectively became an open economy in 1983 when the Australia dollar was floated. Since that time the equalisation process has dealt with major changes in recent years including:

- the recession of the early 1990s;
- a gradual decline in the importance of rural exports and a shift to commodity exports;
- substantial volatility in the exchange rates and trade-weighted index;
- changes in the roles and responsibilities of the Commonwealth and the States, including transfer of revenue raising responsibilities for corporations tax and business franchise fees;
- the introduction of the GST in July 2001 which had major implications for HFE, including the recalculation of the relativities and the abolition of a raft of State business taxes over time; and
- the global financial crisis.

35 The changing nature of the geopolitical environment and the emergence of strong Asian economies have dramatically influenced the relative economic strengths of the States. The resource driven growth of Western Australia, Queensland and to a lesser extent the Northern Territory, has advantaged these States relative to the others. Recent announcements of mining expansion in South Australia would suggest its relative situation could improve over the coming years. Looking forward it will be essential that Australia has a comprehensive equalisation system to deal with growing disparities.

36 If equalisation was to be simplified such that only those relative differences between the States that are of highest priority were taken into account, the differences in natural endowments would be at the top of the list of priorities.

4.3 Full equalisation is the only appropriate goal of HFE

37 Some States would argue that certain revenues or expenditures should be either left out of the scope of equalisation or included only in part. Generally the reasons for these exclusions do not relate to equalisation but to other objectives such as efficiency or positively stimulating the national economy. The selective exclusion of specific revenue or expenditures would not achieve equalisation. Such arguments effectively trade-off equity against other objectives. For example, if mining revenues were excluded in full or part, those States which are well endowed with natural resources would have a much stronger fiscal position than those not so well endowed.

38 A framework or criteria for determining which elements are excluded would need to be established to ensure that exclusion is not arbitrary or political. However, pursuing this reform path would result in a significant change of the objective of equalisation. Instead, HFE would transition to a complex and ineffective tool for achieving broader economic objectives rather than fiscal equity.

39 It is important that equalisation is undertaken such that it achieves its objective. It would, for example, be quite easy to simplify the distribution of GST. However, if it did not achieve at least a reasonable approximation of equalisation, it would not be consistent with the IGA. The form of equalisation needs to be 'fit for purpose'.

40 Equalisation is not an exact science. The absence of comprehensive data and difficulties with the measurement of the impact of non-policy influences on government activities means that estimation and judgment will always be a part of the equalisation process. Accordingly, equalisation (the relativities) will be inexact. The important concern is that the outcome is within the bounds of reasonableness.

5 HFE does not distort States' behaviour

5.1 HFE does not impede efficiency reforms

41 The joint Review press release by the Prime Minister and Treasurer highlights that one area for improvement under the current arrangements is that there is:

> *'not enough incentive for reform – currently underperformance in service delivery and economic growth can be rewarded. As far as possible, States should not be put in the position where they can be penalised for investing in economic growth and improved service delivery'.* [11]

42 The press release also notes that 'States should have an incentive to invest in economic reform; they shouldn't be unfairly punished for success'.

43 There is no evidence that HFE currently distorts States' behaviour in relation to economic development and efficiency in service delivery. On the contrary, all States actively pursue economic and population growth, noting that differences in natural endowment lead to differences in the effectiveness of such policies.

44 In any case, HFE is not an appropriate instrument for providing incentives for reform because, as a passive mechanism, it has not been developed with that purpose in mind. The GST funding to States is designed to address VFI by providing the States with an 'untied' revenue source to support their expenditure responsibilities. HFE is

[11] Joint Press release, Prime Minister and Treasurer, *Review of the GST Distribution* 30 March 2011.

the mechanism by which the GST revenue is shared between the States, and by and large is determined according to fiscal need. However, incentivising growth and reform is not consistent with this purpose, as the funding is untied and it is the prerogative of any jurisdiction to spend its share in this way.

45 One of the best aspects of the current approach to equalisation is the use of the average of all States' experience (revenue / expenditure) as the assessment standard. This means that the assessed expenditure requirements of States is neutral to the actual activity of an individual State, except to the extent that this changes the average.

46 This means that the current approach neither encourages nor discourages efficiency improvement. However, to the extent that a State operates less efficiently than the average of all States, it must fund that inefficiency through higher own source taxation and / or a reduced level of service. A State that is more efficient than average can effectively reduce its own source taxation and / or provide more or better services. Therefore, States can choose to pursue efficiency gains without concern that they will be penalised for being more efficient.

47 The view that funding a State's disadvantage will encourage that State to increase its expenditure on that disadvantage, in order to increase its GST share, is not based on rational thinking or actual evidence. Grattan Institute director Saul Eslake notes that 'States that pursue efficiency gains and economic growth are still better off in absolute terms, even if they may lose some of their gains to other States through the Grants Commission process. [12]

48 Where revenue bases or expenditure demands are concentrated in a State or a number of States the policy choices of these States can influence average State policy. It would be possible under these circumstances for States to influence their share of the GST. However, the ACT suggests that even under these circumstances States make choices that are not aligned with increased GST funding. The recent increase in mining royalties by Western Australia is a notable example.

49 A similar line of argument would suggest that it would be in the Northern Territory's best interest to continually increase its expenditure on Indigenous persons as it has a high weight in the average policy. In fact, based on the gap between its assessed expenditure and actual expenditure, it would appear that it spends much less than it is assessed to need. The theoretical argument that States make policy choices driven by grant design is not supported by the empirical evidence.

[12] Saul Eslake quoted in David Uren and Joe Kelly, *We won't be short-changed, says Giddings*, The Australian (Australia), 1 April 2011, National Affairs.

5.2 HFE does not encourage grant-seeking

50 Garnaut and FitzGerald (on behalf of New South Wales, Victoria and Western Australia) have claimed that the HFE system provides incentives for States to engage in grant-seeking behaviour.[13] Essentially they argue that fiscal equalisation has a distortionary effect on government decision making.

51 Interestingly, Garnaut and FitzGerald have stated that the incentives to grant-seek are likely to be modest because:

- large changes in taxation and/or expenditure would be required to generate small changes in grant shares; and
- any change to taxation and/or expenditure carries a risk that the expected improvement in grant share will not materialise. [14]

52 Whilst under the CGC's approach there is potential for States to increase their GST share by promoting their difficulties in raising revenues and delivering services, in reality grant-seeking behaviour is *highly unlikely* because:

- State Governments spend according to the priorities of the government of the day, and these priorities do not necessarily align with those assessments that are favourable to grant-seeking behaviour;
- State Governments are often 'locked' into the Australian Government's priorities such as the recent GFC stimulus package initiatives on housing, and the *Building the Education Revolution*;
- small States are unlikely to grant-seek as their weight in determining the Australian average is small, and thus any impact would be marginal; and
- a category assessment that may be favourable to a State in one review will not necessarily be favourable in the next review, and thus grants seeking represents a significant risk.

53 In terms of resource projects, the ACT does not consider that State Governments look at the CGC relativity impacts before deciding on committing to large projects given that:

- there are a range of capital pressures facing State Governments, for example, population growth and ageing, and when combined with constrained budgets States are reliant on the Commonwealth's contribution to capital funding;
- capital expenditure is lumpy and is paid over a number of years, and often there is no certainty of when the payments will be made, and thus when they will flow into the CGC's assessments;

[13] Garnaut, Ross and Fitzgerald, Vince (2002), *Review of Commonwealth State Funding (Final Report)*, NSW Treasury, Victoria Treasury, WA Treasury.
[14] Garnaut, Ross and Fitzgerald, Vince (2002), *Review of Commonwealth State Funding (Final Report)*, NSW Treasury, Victoria Treasury, WA Treasury, pages 135, 140-1, 153.

- the impacts are lagged given that the historical data precede the application year by between two and six years;
- there is no guarantee of whether the GST result will be positive or negative;
- Commonwealth payments assessed actual per capita are a relatively small component contributing to the overall calculation of a State's GST funding - in the 2011 Update they comprised 11.4 per cent of the total standard budget; and
- the CGC's assessments are complex, with some roads being fully equalised and others only partially equalised and urban transport capital expenditure being treated quite differently to other forms of capital as most expenditure is on the expansion of infrastructure.

5.3 HFE does not cause gross misallocation of resources

54 It has been suggested that HFE results in the misallocation of resources to locations with lower productivity. This is premised on the conclusion that over the long term the significant differences in economic growth between States are indicative of underlying differences in long-term productivity and that HFE has shifted resources into the two lowest productivity States, discouraging the flow of population to more productive regions. [15]

55 However, differences in long term growth between the States could be explained by factors other than labour productivity. Differences in the level of taxation or service provision standards represent a very small part of the overall net fiscal benefit / cost that households consider in making locational choices.

56 Claims that the current HFE methodology gives States an incentive to be inefficient in terms of service provision are not supported by evidence. All State Governments have economic and political incentives to promote growth through increased efficiency. The benefits of increased efficiency far outweigh partial cost recovery of being an inefficient State through the HFE process.

5.4 HFE does not discourage States from pursuing tax / economic reform

57 Some States have put forward the view that the current form of HFE can distort a State's policy choices and provide a disincentive for a State to undertake tax reform. Changes in State taxes have an indirect effect on GST shares through changes in the average revenue. As a consequence there is a small incentive for a State to:

- reduce revenue from a source in which it is assessed to have an above average revenue capacity; or

[15] Garnaut, Ross and Fitzgerald, Vince (2002), *Review of Commonwealth State Funding (Final Report)*, NSW Treasury, Victoria Treasury, WA Treasury, pages 148 and 153.

- increase revenue from a source in which it is assessed to have a below average revenue capacity.

58 However, any such gain in GST share would be much less than the actual revenue forgone by abolishing the tax. Tax reform is far more likely to be influenced by other factors, such as: competition with other States, harmonisation, business attraction and other political issues.

59 Some States have also argued that HFE discourages economic development because to the extent that such development increases own source revenue it results in lower GST revenues. That is, the effort and expense of economic development in effect has a net result of zero or minimal revenue.

60 It is possible that tax or economic reform by a State can influence its GST share. For the most part the influence of the current form of HFE on economic reform is relatively minor. The impact occurs through changes in the average circumstances of the States.

61 However, there is at least theoretically a possibility that larger changes could influence decisions. For example, a policy action by a State to significantly reduce the tax rate for conveyancing would lead to an increase in the value of property transferred. Since the measure of revenue raising capacity (RRC) is the value of property transferred, a reduction in conveyance duty rates would result in a higher measure of RRC and consequently a reduced GST share.

62 Changes in GST share alone, however, are unlikely to be the determinants of the reform. Reform of such scale and significance has much broader benefits and wider considerations. It is noteworthy that Western Australia went ahead with an increase in its mining royalty rate despite the knowledge that this would result in the loss of GST revenue in excess of the extra mining revenue gained. This demonstrates that the impact of policy changes on HFE is but one of many influences which must be weighed by governments in reaching policy decisions.

63 Some States have argued that HFE discourages economic development because to the extent that such development increases own source revenue it results in lower GST revenues. That is, the effort and expense of economic development in effect has a net result of zero or minimal revenue. However, States' shares of GST are not only affected by the calculated relativity but also their share of the total national population. Generally economic development leads to population growth higher than it would be in the absence of economic development and therefore a higher share of GST revenue.

64 In practice, HFE does not appear to have discouraged States from pursuing economic development and in fact competing for investment or encouraging population

growth. On the contrary, all States actively pursue growth, noting that difference in natural endowment lead to differences in the effectiveness of such policies. Growth in State economies provides benefits for State government expenditure through improved economies of scale.

6 Improving the system

65 The ACT suggests that there are some specific areas of the current approach to HFE which require some fine tuning. These matters would be expected to be raised as part of a normal methodological review. However, in the interests of clarity the ACT has put these suggestions to the Panel to consider.

6.1 Mining assessment

66 The CGC's revenue base for assessing States' revenue raising capacity in the mining assessment is the:

- value of production for high royalty minerals (royalty rates above five per cent) - minerals in this group are onshore oil and gas, export coal, lump iron ore and bauxite;
- value of production for low royalty minerals (less than five per cent) — the remaining minerals; and
- actual grants received in lieu of royalties.

67 Western Australia receives from the Commonwealth a share of the revenue from offshore oil and gas production from the North-West Shelf and the Northern Territory receives a share of revenue from uranium mining. Grants in lieu of royalties are the revenues received under revenue sharing arrangements with the Commonwealth.

68 For the purposes of the CGC's calculations, grants in lieu of royalties are based on the actual per capita revenue received because State shares are determined by the Commonwealth. In the 2011 Update, Western Australia's three year average assessed grants in lieu of royalties were $892.9m (out of a total of $2,770.8m in assessed royalties). [16]

69 An option to address the low GST relativity for Western Australia arising from the mining assessment is for each State to receive an equal per capita share of WA's grants in lieu of royalties, rather than Western Australia receiving the entire amount of the grant.

70 This would mean that WA would have its population share added to its revenue base rather than receiving the entire grants in lieu of royalties ($892.9m). It is estimated

[16] Based on data downloaded from the 2011 Update Online Assessment System for the mining assessment

that this would increase Western Australia's 2011 Update relativity from 0.71729 to 0.87161. [17]

6.1.1 The Canadian system is not an appropriate model to adopt

71 Some parties have suggested that mining royalties could be removed from equalisation, given that Canada removes, or partially removes these royalties from its equalisation formula. Professor Jeff Petchey, Commissioner of the CGC, has also stated that:

> *'...Canada's approach of removing mining royalties from the formula for redistributions was worthy of consideration. That's one option, if you had a model that recognised that growth States maybe needed to keep more of their revenue base to fund infrastructure.'* [18]

72 Canada's equalisation system and its treatment of natural resources are not applicable to Australia's HFE system given the fundamental differences between the two arrangements.

73 In general terms, to determine provincial payments each province's per capita fiscal capacity in each of four revenue categories is compared to the average fiscal capacity of the ten provinces. Where the province has a below-average ability to generate own-source revenues it qualifies for equalisation to make up the difference:

- per capita fiscal capacity is assessed on the capacity to raise revenue from four revenue categories (personal income tax, business income tax, property tax, and sales taxes) plus the actual amount of natural resource revenues received.

74 The formula provides two options for calculating equalisation payments. One option excludes natural resources entirely, while the other bases equalisation payments on a calculation that excludes 50 per cent of natural resource revenues. In practice, provinces automatically receive payments according to the option which yields the largest per capita entitlement.

75 While under the Australian equalisation, States share a fixed pool of GST revenue, Canadian provinces that *qualify* for equalisation payments share in federal government general revenue that grows in line with the economy based on a three year moving average of GDP. Only those States that have a below national per capita RRC receive equalisation payments. Therefore, removing natural resources payments,

[17] As noted the NT receives grants in lieu for uranium mining from the Australian government. These payments have been assessed for the NT on an actual per capita basis as per the current assessment approach. The equal per capita allocation of the North-West Shelf grants in lieu of royalties has also been added to the NT's revenue base.

[18] *Grants Commissioner says let brakes off boom economies*, The Australian, 30August 2011.

either partially or fully, only affects qualifying provinces, unlike in the Australian system where the removal of mining revenues would affect all States.

76 In addition, Canadian provinces have access to a much wider revenue base than the Australian States (reduced level of VFI), including personal income tax, business income tax, property tax and sales taxes plus natural resource revenues where applicable. As such, excluding natural resources from the equalisation formula as occurs in Canada is not as crucial as it is in Australia where the revenue base is narrower and the assessed relativities are more disparate.

77 The Canadian system also excludes the Territories from the general equalisation program given major differences in their RRC and socio-economic conditions relative to the other provinces. If the same model was applied to Australia, the NT would be excluded given its relativity is an outlier, currently 5.35708 in the 2011 Update. If the Australian Government were to fund the Northern Territory separately (as occurs for the Territories under the Canadian model because their RRC and socio-economic conditions are so different to the provinces), this would result in a material redistribution back to the other States, notwithstanding that the Northern Territory currently loses funding from the mining assessment given its above average RRC.

78 It should also be borne in mind that the decision to adopt a formula for the first time and include either zero or 50 per cent of natural resource revenues when calculating equalisation payments was a result of the political nature of the Canadian system, which unlike Australia, does not have an independent statutory body to oversee equalisation:

- this formula resulted from a compromise on the federal government's pre-2006 election commitment and the implementation of the recommendations of the O'Brien report (Expert Panel on Equalization and Territorial Financing) which amongst other things recommended a 'rules-based, formula-driven' technique that would remove federal political whim from driving equalisation. [19]

79 Given the underlying differences that exist between the Canadian and Australian equalisation systems, the Canadian model should not be used as a basis for rationalising the removal of mining royalties from HFE.

6.2 Revenue assessments

80 As discussed earlier in Section 5.4, the form of HFE on the incentives for States to fully exploit their own source revenue bases may be of concern where a revenue base is highly influenced by the policy actions of a State.

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[19] Canada West Foundation Occasional Paper 2007-1, *Equalization and the Fiscal imbalance - Options for Moving Forward*, Ken Boessenkool and Evan Wilson, February 2007.

81 As a way forward, changing the CGC's mining and stamp duty on conveyances assessments may be appropriate and it is recommended that the CGC's assessments be adjusted by:

- using more indirect measures for revenue bases that would be less sensitive to the policy choices made by States; and
- capturing tax elasticity effects within the measures of relative RRC. [This approach was previously practised by the CGC, however was discontinued in the name of simplicity.]

82 The ACT does not support the use of global measures as a means of simplifying revenue assessments.

83 The tax bases of the States are relatively limited, as the Constitution combined with current intergovernmental arrangements does not provide States with access to broad based income or consumption taxes. Accordingly, States are constrained to taxes based on payrolls, land, resources and various transactions. The capacity to collect revenue from these sources depends very much on the mix of economic activity rather than the aggregate level of activity. For example, a large proportion of economic activity in the ACT is undertaken by the Commonwealth Government, which is exempt from paying payroll tax.

84 As a further example, the use of Household Disposable Income (HDI) as a broad measure of capacity to pay has three significant problems:

- it is a measure of income alone and does not take account of wealth ;
- it does not reflect the propensity of households to engage in taxable activities; and
- it does not allow for the fact that taxes are often exported to jurisdictions other than the one in which they are paid.

6.3 Reviewing the Indigeneity Assessment

85 The ACT suggests reviewing the Indigeneity assessment as it is a significant source of disparity in the relativities but is currently based on unreliable data.

86 In the absence of reliable data, HFE is an inappropriate and ineffective tool for addressing Indigenous disadvantage.

87 The ACT suggests removing Indigeneity from the scope of equalisation. As pointed out earlier, the Australian system of equalisation provides fiscal equity through untied funding distributions. The principles underpinning HFE and the tools used to implement those principles are not conducive to active policy making. To appropriately address Indigenous disadvantage, dynamic and active policy making is required.

88 This alternative approach would achieve greater equity, particularly for Indigenous Australians, by better and more appropriately addressing disadvantage through active policy making, consistent with the goals agreed by all jurisdictions under the auspices of the Council of Australian Governments (COAG).

89 Consistent with this approach, any Specific Purpose Payments and National Partnership Payments for Indigenous purposes should also be excluded and incorporated as part of a separate funding mechanism.

6.4 Fine tuning to the HFE system to promote simplicity, predictability and stability

90 Predictability in GST payments is very important for governments in fiscal management. This is more so in times when the GST pool is growing only slowly (such that the growth in the pool is not sufficient to offset a reduction in share). Moreover, some States are more dependent on GST revenues than others due to their lower capacity to raise own source revenues. For these States, reductions in GST payments (either from lower pool growth or reduced shares) is all the more problematic.

91 The changing distribution of national partnership payments has in more recent times also had a large impact on the GST distribution, as in aggregate, they have been moving away from an equal per capita basis. In contrast, specific purpose payments have generally been moving towards an equal per capita basis. Commonwealth payments to the States also increased during the GFC from $28.1 billion in 2006-07 to $53.2 billion in 2009-10 and resulted in muddying the predictability and stability of States' GST shares.

92 Overall, a degree of volatility, particularly on the revenue side, reflects that the relative strengths of States' economies are changing and that HFE is working. It is acknowledged that there is a trade-off between contemporaneity and stability in the assessment results.

93 There is also a trade-off between simplicity and equalisation. Current mechanisms employed to simplify assessments include the use of high materiality thresholds, the aggregation of categories and the use of broad indicators. It is considered that these mechanisms have already been exercised, and pursuing this line further will result in a significant weakening of the degree of equalisation. It is thus suggested that rather than using broad-based mechanisms to achieve simplicity, that each category be considered on a case by case basis.

94 The main issues of concern rest with the expenditure assessments. Parties generally accept that the revenue assessments are comprehensive but rational and they are largely transparent, with the drivers (revenue bases) leading to the redistribution of GST funding being clear.

95 The process, and resources required to complete the process, need to be fit for purpose. The redistribution of $4 billion annually, while a small proportion of the pool by itself, represents a significant amount of funding. As such, the assessments need to capture the substantive differences in demographic, physical and economic circumstances of the smaller States in order to be fit for purpose. The size and rate of growth in the GST pool and the degree of VFI further reinforces the need for a comprehensive system.

96 Reasonableness of the outcome, rather than simplicity in itself should be the main goal. There are, however, some assessments where complexity has led to ambiguity as highlighted below.

6.4.1 Welfare and Housing category

97 An area of significant complexity and ambiguity in assessment methods is the welfare and housing assessment. Most (if not all) States commented on the complexity of the assessment in their discussions with the CGC in their feedback meetings post the 2010 Review. The CGC produced an outline to explain the assessment.

98 At an aggregated level the assessment appears straightforward, being based on the 'number of recipients of Commonwealth benefits and pensions in each State'. However, the adjustments made to better reflect State needs, such as calculating State expenses for recipients for each type of Commonwealth benefit and other source of income, and then the allocation across States according to each State's share of the number of recipients in each group to calculate assessed expenses due to service use is complex and difficult to follow.

99 The calculation of the socio-demographic composition factor, one of the more challenging aspects of the category factor calculation, is particularly difficult. There are also concerns with some of the underpinning data and assumptions on which the disabilities are calculated.

100 Determining any predictability in States' GST shares from this model is also difficult to achieve.

6.4.2 Education category

101 The schools education assessment is overly complicated. The population aged 5 to 17 is used as the broad indicator given the CGC believes that actual enrolments are affected by State policies on commencement and minimum leaving ages. On this premise, school students were divided into three groups:

- pre-compulsory enrolments — students aged 5 and under – notional enrolments are calculated

- compulsory enrolments in all States — students aged 6 to 14 – actual enrolments used; and
- post-compulsory enrolments students — aged 15 and over – complex consultant's regression model used to determine notional enrolments.

102 When use and cost weights for various groups are factored into the assessment, it becomes complex and difficult to follow. Given the recent move by all States to adopt similar leaving age requirements, there is little difference in enrolment policies. The move to a national curriculum is also minimising any State policy differences. As such, there is a strong case for the use of actual enrolments for all years of schooling.

103 As an example of converging policy, Queensland is shifting to the southern State-based system [20] and will transfer year 7 into high school in 2015 and a full-time prep has been introduced since 2007 as an extra year of schooling. This means that school entry age has been raised by six months and that from 2015 more than half the students in year 7 will turn 13 years of age.

6.4.3 Reviewing the Capital Assessments

6.4.3.1Scope

104 The ACT considers that extending the scope of equalisation to include net financial worth to be controversial and highly debatable. In the 2010 Review and 2011 Update, the investment and net lending assessments together redistributed in total more funding than any other expenditure assessment.

105 The ACT considers that the assessment of Net Worth is unduly complex to the point of being incomprehensible. Further options for this assessment need to be explored, including whether or not Net Worth should be included within scope.

106 The scope of equalisation has changed over the past 30 years in an endeavour to keep pace with changes in State finances. It is considered that the long standing interpretation of the scope of the operating budgets of State governments is a reasonable basis for equalisation.

107 In more recent years, however, this relatively simple approach has been complicated by the introduction of accrual accounting in the government sector, which has brought the operating impacts of capital decisions into scope. In the 2010 Review the CGC included within its scope part of the balance sheets of governments through the Investment and Net Lending assessments.

108 States are able to build net worth through the accumulation of operating surpluses and revaluations. Given that over some 30 years States have been equalised in

[20] Comprised of NSW, Victoria, Tasmania and the ACT.

respect of their operating results, the contribution of accumulated surpluses to net worth has by that fact also been equalised.

109 Some States have argued that with faster growing populations, their accumulated net worth has been diluted on a per capita basis. Such an argument ignores the other major aspect of growth in net worth - revaluations. Theory and empirical evidence suggest that States with faster growing populations have higher levels of revaluations. The differential impact of revaluations was not included in the CGC's assessments of net worth. The ACT considers that in future either the differential impact on State finances of revaluations should be included in the CGC's assessments, or taking a much simpler approach, net worth should be excluded altogether from the scope of equalisation.

110 In GFS terms, revaluations include the increase in the value of equity held in government trading enterprises. For the resource rich states, this has been a valuable source of income arising from ownership of government port authorities. These financial gains are currently outside the scope of equalisation, yet provide a growing return on investments made in support of the mining industry.

111 Extending the scope has also introduced considerably greater complexity and volatility, two key issues raised by States which have led to this Review.

112 The investment assessment recognises the financial consequences of new infrastructure in the year it is acquired, rather than the year it is consumed. The disabilities taken into account in assessing the *quantity* of infrastructure required to provide an average level of service are differential population growth and the demand for services on the need for infrastructure. Both of these disability drivers are volatile, and are made more so given they are applied to the stock of infrastructure which is large.

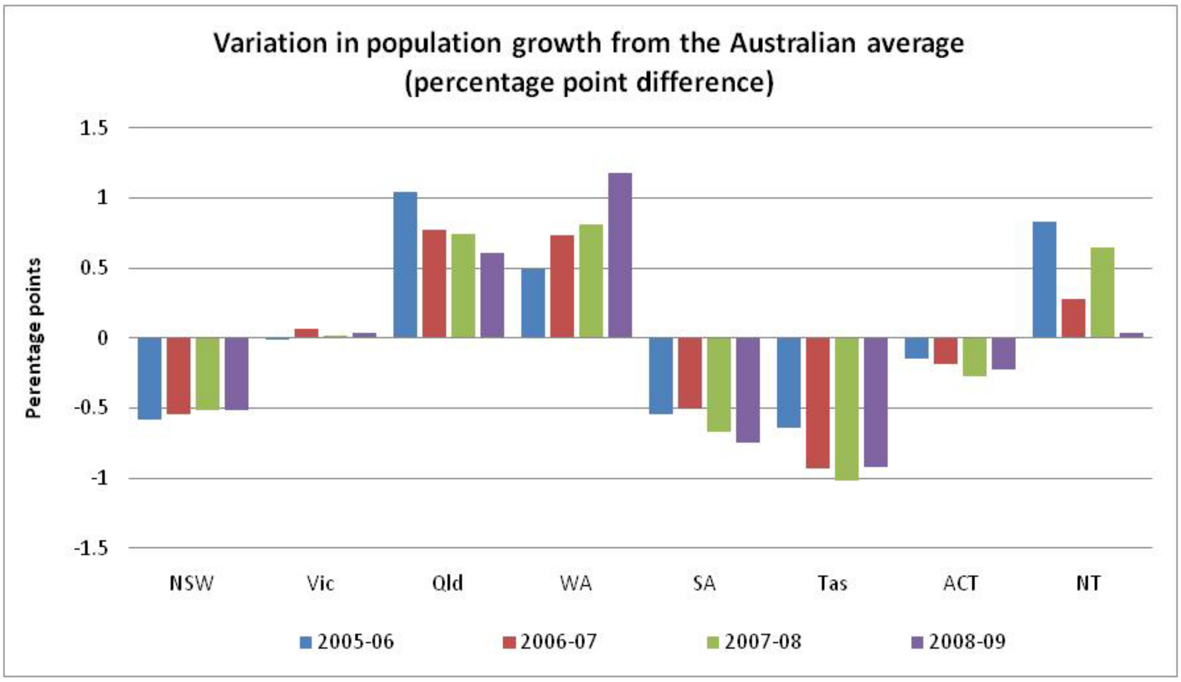
6.4.3.2 Volatility

113 Exacerbating the volatility of the investment category is the treatment of capital grants. The ACT does not support the expansion of the scope of equalisation to include balance sheet assessments of Investment and Net Lending. However, it considers that the inclusion of capital grants is a necessary component of the Investment assessment, given the approach adopted by the CGC. The inclusion of one-off large capital grants which are very unequal in their distribution among the States is a major cause of volatility in the relativities. The ACT recommends that the Review give consideration as to whether the Investment and Net Lending assessments are appropriate or necessary for HFE.

114 One of the key disabilities assessed by the CGC in the investment and net lending assessments is the extent of differences in population growth for each State relative

to Australia. As shown in the following chart, these differences are substantial and demonstrate one reason why the investment assessment distributes a significant amount of GST funding across the States, and why the distribution can be volatile.

Figure 2: Variation in population growth



Source: Commonwealth Grants Commission, Report on GST Revenue Sharing Relativities – 2010 Review, Volume 2 – Assessment of State Fiscal capacities.

6.4.4 Move to a five year average

115 The move from a five year average to a three year average in the 2010 Review, and basing the assessments on more up-to-date data necessarily increased the volatility as short term fluctuations were exacerbated.

6.4.5 Transitional Arrangements for Large Changes in GST Shares

116 The Review should give consideration to some form of limit or transition where States are significantly negatively impacted by a change in GST shares or slow growth in the GST pool. Limits could take the form of:

- a limit to the negative per capita impact of the combined movement in the pool and share; or
- that no State receive a lower nominal amount than in the previous year.

117 Limits would help to ease the volatility of GST payments. Clearly, volatility is more difficult to manage when it is negative than when it is positive.

Appendix A – the ACT's circumstances

The ACT is a recipient State through the HFE process, receiving a 2011 Update per capita relativity which is 11.6% above the national average. This primarily reflects the ACT's narrow tax base, due to the inability to tax Commonwealth agencies and due to a lack of substantial revenue sources available to other States. It also reflects a below average receipt of Commonwealth payments.

Unlike the four most populated States, the ACT is lacking in significant commercial activity from large taxable corporations; substantial resource wealth such as minerals, petroleum and gas; and locational advantage that results in high wealth bases such as accumulated real estate property. This is borne out in the following comparisons:

- 43% of the top ASX-200 companies (in 2011) are located in New South Wales, 23% in Victoria, 20% in Western Australia and just 0.5% in the ACT;
- in 2008-09 Western Australia collected $3.2 billion in royalties, Queensland $3.3 billion, New South Wales $1.3 billion and the ACT $0; and
- in 2008-09 taxable land value was $272.9 billion in New South Wales; $238.5 billion in Victoria; $132.2 billion in Queensland and just $8.3 billion in the ACT.

The positive amount redistributed to the ACT, above its population share, is partly offset by the ACT's lower:

- expenditure requirements, given its below average proportion of Indigenous and socially disadvantaged population; and
- new infrastructure expenditure requirements, as the ACT's population is assessed to require less infrastructure than those from low socio-economic and Indigenous backgrounds.

Importantly, however, HFE recognises a number of the ACT's unique features:

- a land-locked island within New South Wales, thus creating substantial cross border considerations; and
- increased costs as a result of Canberra's role as a national capital / seat of government.

The ACT's also faces:

- above average public sector wage pressure, largely arising from competition with the Commonwealth Government; and
- diseconomies of small scale through needing to supply the same range of services as larger States but for a much smaller population.