New South Wales

Third Submission to the GST Distribution Review

August 2012

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1. Executive Summary

In its first submission to the GST Distribution Review, New South Wales concluded that the Australian Horizontal Fiscal Equalisation (HFE) system requires fundamental reform. New South Wales continues to hold this view.

The current HFE system does not position Australia to meet the challenges of demographic, technological and structural change or to address long-standing social issues such as indigenous disadvantage.

The current system is unable to effectively cater for the current extent of interstate diversity. It depends on equalisation assessments that depend on arbitrary decisions and that are unstable because of methodological choice and unexpected data revisions. The current system produces equalisation outcomes that penalise state economic and tax reform.

The current system is complex and opaque.

Confidence in the current system is fragile at best, as it is more a lucky dip than a coherent, reliable and predictable system.

Radical change to the HFE system is required to address these issues.

In its second submission, New South Wales objected to the attempt by the Commonwealth, in issuing supplementary terms of reference for the Review, to refashion the HFE system as a tool for unilaterally imposing its own policy objectives on the states.

The Commonwealth's motives run counter to the provisions of the Intergovernmental Agreement that the GST is untied, would be positively detrimental to improving Australia's HFE arrangements and would further destroy confidence in the system. These proposals would be inimical to good intergovernmental relations and would ultimately be counterproductive to the achievement of more forward looking, dynamic and efficient government in Australia.

The GST revenue must remain untied and available to the States[1] in full as agreed at the time the GST was introduced. Further, clarity must be restored to Commonwealth funding arrangements more generally to promote accountability at all levels of government.

In both previous submissions, New South Wales emphasised the disincentive effects of the current HFE system on state tax reform. Commonwealth coercion of the states to adopt policy or tax reform by withholding part of the GST revenue is no substitute for reform of the HFE system. Tax reform at Commonwealth and State levels requires constructive discussion and agreement by both levels of government and needs to be underpinned by an HFE system which is, at the very least, neutral in its impact on state tax policy decisions.

[1] 'States' refers to all States and Territories.

A system of distributing GST revenue in Australia which does not provide disincentives for state policy changes would make policy reform easier. The GST distribution system should encourage and enable reform to be pursued. Having to consider the indirect impact on the GST distribution can weaken the case for reform.

In its first Interim Report, the Panel noted that the challenge for the designers of the system for the distribution of the GST revenue was to make the distribution 'fair', despite the inherently subjective nature of the concept of 'fairness'.

The terms of reference for the Review also require the Panel to have regard for efficiency, simplicity, predictability and stability and to ensure that confidence in the system is maintained.

The supplementary terms of reference add the requirement that the Panel consider reform of the HFE system to ensure that it does not create disincentives for state tax reform, to enable it to be utilised to provide incentives and disincentives for state policy and to address the interaction between state royalties and the Commonwealth's resource rent taxes (RRTs).

At a fundamental level, the challenge is to decide precisely what fiscal equalisation, as a tool of government policy, is intended to achieve in terms of actual outcomes for the Australian community and what distribution system will best deliver those outcomes.

New South Wales continues to believe that the Review provides an opportunity for genuine reform of the HFE system and, ultimately, for tax reform.

New South Wales recommends an equal per capita (EPC) distribution of the GST revenue, with any further equalisation funding necessary provided by the Commonwealth, as the best way forward. New South Wales acknowledges that it may not be possible to realize this objective in the short term, but EPC and federation payments should be endorsed as the objective to be achieved over a five to ten year time horizon. Transitional arrangements should also be diligently considered in the lead up to the adoption of an EPC distribution system.

A number of the issues raised in the Review's two interim reports, for example, the treatment of tax free thresholds, comments about individual revenue assessments and the capital assessment and the treatment of Commonwealth payments, reflect problems with the current equalisation approach. These are issues which would normally be addressed in the Commonwealth Grants Commission's (CGC) periodic methodology reviews. New South Wales does not believe that these are issues which should be raised with, or in any case can be resolved by, the Review Panel.

This submission is structured as an overview providing a summary of New South Wales views on the GST distribution process and an attachment which addresses the specific issues raised in the Review's two interim reports.

2. Vertical Fiscal Imbalance

The prominence afforded to HFE in Australia reflects the high level of vertical fiscal imbalance (VFI) between the Commonwealth and the states. The Commonwealth collects around 85 per cent (including the GST) of combined Commonwealth and state tax revenues but is responsible for only about 56 per cent of combined spending. The states collect around 15 per cent of combined Commonwealth and state tax revenue, but are responsible for around 44 per cent of the combined government expenditure.

The high level of VFI in Australia creates a high level of dependency by the states on Commonwealth funding. Successive Commonwealth governments have chosen to address this mismatch through grants from the Commonwealth to the states rather than any fundamental examination of matching revenue raising capability and efficiency with roles and responsibilities. Current grants comprise:

- GST of $48 billion in 2012-13
- Specific purpose payments of $41 billion in 2012-13

The amount, distribution, reliability and predictability of this funding are critically important to the states yet uncertainty continues to prevail. This uncertainty is a disincentive for states to abolish their most inefficient taxes because inefficiency is overridden by policy ownership, certainty and control. The interaction between the HFE system and state policy decisions on tax reform aggravates these tensions.

The introduction of the GST as a dedicated source of revenue for the states has not proved to be the 'growth tax' originally envisaged. Without control of this tax base, the states are unable to address the shortfall in the absence of cooperation from the Commonwealth. The erosion of the GST tax base is also compounding the difficulties states face in reducing their dependence on their least efficient taxes.

The recent introduction of the Commonwealth's Mineral Resources Rent Tax (MRRT) and the growing concerns that the Commonwealth is seeking to displace states in the area of mining taxation further serve to exacerbate states' concerns regarding dependence on the Commonwealth and the impact of tax reform, while undermining Commonwealth-state relations more generally. The introduction of the carbon tax, with its associated costs to the NSW Budget and with no Commonwealth offer of any compensation, is another example of Commonwealth policy undermining Commonwealth-state relations.

It is against this background that the Panel is considering how to reform the HFE system in Australia and addressing its interaction with the reform of state taxes.

3. Objectives of fiscal equalisation

Australian governments adopt a range of policies designed to promote equity. However, these policies are not designed to provide exactly the same standards in the way attempted by the current HFE system. This attempt leads to the complexity, data requirements and the use of judgement in the current system, leading to a spurious degree of accuracy in the outcomes. A more realistic objective for HFE is necessary.

In its 2012-13 Budget Paper No. 3, the Commonwealth described HFE in the following terms:

> Horizontal fiscal equalisation provides the necessary budget support so that all States have the capacity to provide services at a comparable standard, while ensuring that the interstate transfers are not so large that they would significantly distort economic behaviour and reduce productivity growth.[2]

New South Wales recommends that this definition be adopted by the Review as an appropriate statement of the objectives of HFE. This would provide scope for the introduction of a practical approach that promotes a better balance between equalisation and efficiency. Australia would then be better placed to meet the fiscal and social challenges ahead.

4. Distribution of the GST revenue

New South Wales considers that the GST revenue should be distributed to the states in full, untied and on an equal per capita (EPC) basis.

An EPC distribution automatically includes an element of funds transfer from stronger to weaker states. It is administratively simple, transparent and more predictable. It is more contemporaneous than the current system and is relatively stable over time. An EPC distribution would not have the data requirements of the current system. Importantly an EPC system is policy neutral, providing no disincentives for tax or service delivery reform.

Adoption of an EPC model would strengthen the framework for intergovernmental financial relations, clarify the operation of funding agreements and government accountability, and restore confidence in the system. It would establish a sound basis for interstate comparison of government services, bringing pressure to bear on the efficiency of state government service delivery.

An EPC distribution would focus States on good spending and revenue raising decisions rather than having to consider possible impacts on GST share from policy decisions.

An EPC distribution would be contemporaneous. It would not depend on data which can only be produced with, at least, a two-year lag. It would use, as does the current system, current year ABS population estimates, with ex-post adjustment, as is also currently the case for variation of outcomes from population estimates.

2 Commonwealth Government, *Australia's Federal Relations*, 2012-13 Budget Paper No. 3, p. 123.

Most significantly, though contemporaneous, an EPC system would be stable. Being objective and dependent on economic data, its outcomes would not be affected by changing financial or political influences and judgements. Any judgements can then be reserved for the nature, extent and any applicable conditions for additional support for the smaller states and territories.

The Commonwealth should support this objective through taking responsibility for funding any additional financial assistance to the fiscally weaker states so no state is worse off. Based on the results of the current HFE system, the magnitude of such payments would not exceed one per cent of total Australian tax revenue.

The Commonwealth's fiscal position is far stronger than the States'. The Commonwealth is forecasting total receipts of $369 billion in 2012-13 and expects this to grow by 7.5 per cent per annum over the budget and forward estimates period. High revenue growth will see Commonwealth general government net debt eliminated by 2020-21. Medium term projections suggest the Commonwealth's taxation share of GDP will rise above its committed cap of 23.7 per cent by around 2018-19.

The Commonwealth could translate this strong revenue position into increased support for service delivery in the States. Assuming that an EPC system would need to be phased in over a five to ten year time horizon, any immediate commitments by the Commonwealth for equalisation payments would be limited.

Furthermore, the Commonwealth receives a fiscal dividend from productivity enhancing reforms, including through its broad tax bases. This was recognised by the Review Panel in its second interim report in the context of State tax reform, and applies equally to HFE reform.

5. Transitional Measures

New South Wales recommends moving to an EPC distribution of the GST pool, with the Commonwealth providing any additional assistance necessary to the fiscally weaker states. However, New South Wales recognises that this may not be able to be achieved immediately. Accordingly, transitional measures may be necessary in the lead up to our preferred outcome. Possible transitional measures include:

- distribute a proportion of the GST pool EPC with the remainder distributed using relativities
- partial equalisation based on a 'comparable' level of services
- separate funding for Indigeneity.

Partial equalisation based on a smaller pool

> Something considerably less than pursuit of absolute equality between jurisdictions can result in a fair outcome and produce confidence in Federal financing arrangements.[3]

This review provides the opportunity to commence the long run transition to an EPC distribution by dividing the GST pool into two parts, one of which would be distributed by applying relativities, while the other is distributed EPC. The EPC component could be progressively increased to achieve the long term goal of the whole pool being distributed EPC, with the Commonwealth contributing to redistribution funding.

As a starting point, the 'FAGS component' of the GST pool has been on average around 60 per cent of the total GST pool since 2000. This proportion of the pool could be subject to relativities (calculated using 100 per cent of the pool) with the remaining 40 per cent returned on a population share basis.

The share that is distributed EPC can then increase to 60 per cent, with 40 per cent distributed using relativities.

The share that is distributed on an equal per capita basis can be progressively increased to achieve the long term goal of the whole pool being distributed equal per capita, with the Commonwealth contributing to the redistribution.

Partial Equalisation based on a 'comparable' level of services

Changing the equalisation objective, so that equalisation is directed towards enabling states to deliver services of 'comparable' standards rather than the 'same' standard, would offer an alternative transition path. Under this alternative, minimum acceptable service standards would be adopted as equalisation benchmarks.

An approach based on a comparable level of services would better place Australia to meet the economic and social challenges it is facing. This approach would promote a better balance of equalisation and efficiency considerations and encourage greater State responsibility and self-sufficiency.

This could be achieved by setting the standard for determining the redistribution of GST revenue across all assessments at the minimum levels of effort of jurisdictions in major expense categories and redistributing GST to meet that standard, rather than the average standard.

This standard would base the GST redistribution on minimum standards and minimum efforts, scaling down assessed expenses and revenues, thereby reducing the amount of GST redistributed. Revenues as well as expenses would need to be subject to the same discount to ensure the balance between the two is retained.

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3 GST Distribution Review, *First Interim Report*, p. 22.

It is important to note that a jurisdiction with the 'minimum' effort does not necessarily mean that that State has a lower standard of service outcome. It may mean that the State achieves the service standards of the other States more efficiently.

This would provide an incentive for efficiency, but still allow all jurisdictions to fund service provision consistent with acceptable levels.

Separate funding for Indigeneity

Under the current HFE system, the major difference in expense relativities reflects the influence of the 'Indigeneity' disability factor.   For 2012-13, this disability factor is estimated to redistribute $2,360 million of GST revenue among the states.[4]

However, there are difficulties in the current system in obtaining reliable and comparable data relating to the Indigeneity disability factors. It is also arguable whether HFE is the best approach for addressing long term, entrenched disadvantage in one section of the community or whether alternative funding arrangements might provide better outcomes.

New South Wales considers that funding for services to Indigenous people needs to be better targeted to address indigenous disadvantage and so achieve the most effective outcomes. The Commonwealth has clear responsibility for Indigenous matters and should provide direct funding for this purpose, subject to full consultation between governments and Indigenous communities.

Removing the Indigeneity disability factor from HFE assessments would provide a useful transition step towards an EPC distribution, which could be taken in its own right or coupled with one of the transition paths outlined above.

An alternative to removing the Indigeneity factor would be to remove the Northern Territory in its entirety from the HFE system, with the Commonwealth directly funding the Territory.

6. Tax reform

The adoption of NSW preferred option for the EPC distribution of the GST would remove all disincentives from the HFE system for tax reform. The adoption of suitable arrangements for the transition to the EPC model could also remove the major disincentives to state tax reform well before the transition to an EPC distribution of the GST revenue is achieved. This would open the door to unilateral state tax reform and would facilitate agreement on a uniform approach to multi-lateral reform.

[4] Commonwealth Grants Commission (CGC), *2012 Update*, Table 7, p. 12. This figure, and similar figures used throughout this submission, is based on the CGC's 2012 Update. Since the Update's release, the Commonwealth has revised down the estimate of the GST pool in 2012-13.

Failing that, tax reform will create winners and losers under the HFE system, making agreement difficult to achieve in the absence of Commonwealth incentive funding. Commonwealth attempts to coerce the states would be likely to create a backlash that could ultimately prove counterproductive.

7. Governance arrangements

In its 2010 Review, the CGC stated:

> In the absence of an objective basis …, we have continued to set the scope of equalisation using the definition of general government activities applied by the ABS in its Government Finance Statistics. However, we understand the ABS is reviewing its definitions of the general government sector and PTEs. It may be necessary to review the scope of equalisation in the light of the outcome of that work.[5]
>
> Equalisation does not attempt to equalise the capacity of States to provide services to a standard required to achieve an external policy objective — for example, reducing hospital waiting lists or increasing literacy and numeracy levels. Such an approach would require judgments about matters that are the province of Government. Governments have not asked us to do that.[6]
>
> Equalisation is not intended to provide States with the capacity to implement policies they do not, on average, already follow.[7]

These quotations highlight a fundamental problem with the current system, namely that, in the absence of government directives, the CGC devises its own definitions, standards and equalisation objectives. This problem is not solved by a simple change to the definition of fiscal equalisation.

Governments should have the responsibility of setting the objectives of HFE and ensuring that the HFE process is meeting those objectives in an appropriate way. In defining those objectives, governments will need to be more detailed than they have been in the past, where the process has largely been left to the CGC. The CGC should have the role of implementing the objectives of the governments. The governing body also needs to commission independent reviews of the system from time to time to inform its understanding of how the system is functioning.

If confidence in the system is to be re-established and maintained, a key element of these governance processes is the full involvement of the states. This could be achieved, for example, by assigning the governance role for HFE to the Standing Council for Federal Financial Relations.

[5] CGC, *Report on GST Revenue Sharing Relativities – 2010 Review*, Vol. 1, p. 32.

[6] CGC, *2010 Review*, Vol. 1, p. 36.

[7] CGC, *2010 Review*, Vol. 1, p. 36.

8. Concluding remarks

New South Wales considers that the Review provides a rare opportunity to address the issues that have adversely affected confidence in the HFE system for many years and intensified as divergences between states' fiscal capacities have widened. The Panel has a choice between recommending fundamental change that will stand the test of time and provide a pillar for the reshaping of federal financial relations in Australia or of recommending changes within the current HFE framework of the type often considered, and usually rejected, by the CGC in the course of its reviews of state relativities. New South Wales urges the Panel to adopt the former.

Comments on Interim Report Views

FIRST INTERIM REPORT

The Role and Purpose of HFE

The Panel's view on the proper role and purpose of the GST distribution

*The Panel intends to investigate whether providing **comparable** capacities for States would be an approach more suitable to current challenges than providing materially the **same** capacities.*

The Panel therefore invites submissions on how this concept might be accurately described and effectively implemented.

An approach based on a comparable level of services would better place Australia to meet the economic and social challenges it is facing. This approach would promote a better balance of equalisation and efficiency considerations and encourage greater State responsibility and self-sufficiency.

This approach would also reduce complexity and data requirements and be more transparent.

In its Budget Papers, the Commonwealth Government describes HFE in terms that are consistent with providing a comparable level of services:

> Horizontal fiscal equalisation provides the necessary budget support so that all States have the capacity to provide services at a comparable standard, while ensuring that the interstate transfers are not so large that they would significantly distort economic behaviour and reduce productivity growth.[8]

New South Wales considers that this description provides the basic concepts for an appropriate definition of HFE and recommends its adoption by the Review.

All states provide core services to a satisfactory standard. The standard could be determined by selecting the state making the lowest 'effort'. Because of efficiency differences between states, this standard would not necessarily represent the lowest level of service provided (i.e. the minimum service level to which all Australians have access regardless of where they live). However, it does represent the minimum level of service that would be provided if all states maintained their level of spending while matching or exceeding the level of efficiency of the state making the lowest 'effort'.

This standard would base the GST redistribution on minimum standards and minimum efforts, scaling down assessed expenses and revenues, thereby reducing the amount of GST

[8] 2012-13 Commonwealth Budget Paper No. 3, p. 123.

redistributed. Revenues as well as expenses would need to be subject to the same discount to ensure the balance between the two is retained.

Predictability and Stability of HFE Outcomes

The Panel's view on the consequences of the lag

The Panel notes the various calculations of the value of the lag effect, but also notes that, when a State's relative fiscal capacity returns to its starting point, the lag effects will be completely reversed. While, on balance, lag effects provide a benefit to States with increasing fiscal capacities, this is difficult to assess far into the future with any certainty. This may change if the present strength of mining continues without being balanced by other factors.

The Panel notes that the most direct way to address lag effects — an advances and completions approach — was considered by the CGC at the 2010 Review, but not adopted. The Panel agrees with the CGC's decision, but is open to any views on how an advances and completions approach could be implemented without a negative effect on either predictability or simplicity.

Under an EPC distribution of the GST revenue, lags are minimal and cease to be a major issue for consideration.

NSW does not agree that 'when a State's relative fiscal capacity returns to its starting point, the lag effects will be completely reversed'.

In practice, all manner of events may intervene to prevent complete reversal. These events include:

- shifts in the relative proportions of specific purpose and general revenue assistance from the Commonwealth
- changes in methods of assessment adopted by the CGC in its reviews
- data revisions and decisions on whether or not to back-cast such revisions
- changes to the length of the period over which annual relativities are averaged
- changes in state policies which affect whether or how a particular item is assessed
- directives to the CGC in terms of reference which influence the assessment of specific items
- the adoption of transition arrangements to smooth changes and so on.

New South Wales considers that the impact of lags in the system should not be dismissed. All such lags should be made as short as possible, consistent with the need to avoid imposing unacceptable levels of administrative complexity or disrupting states' planning processes.

In this context, New South Wales notes that proposals for fixing relativities for an extended time period or for limiting the extent or speed of changes in relativities are, in effect, proposals for extending the lags in the system and are often framed in such a way as to prevent or reduce the likelihood of eventual reversal of their effects. New South Wales considers that such measures should be avoided wherever possible and should certainly not be used in circumstances that may confer a persistent advantage or disadvantage on particular states.

The advances and completions approach considered by the CGC in its 2010 Review would not have addressed the lags in the system since the 'advances' payment would have to be based on forecasts and the full effect of lags (and forecasting errors) would be felt in the 'completions' stage. In essence, an advances and completions approach must rely on the ability to forecast outcomes accurately so that the 'completions' payment is small. The ability to accurately predict the outcome, however, is precisely what is lacking in the current system, with the result that the 'completions' payment could come as a significant shock.

New South Wales considers that the CGC was right to reject this concept because it does not represent a solution to the problem – it merely casts it in a different form. If the GST distribution could be accurately predicted, an advances and completions approach could function well, but the need for it would be correspondingly reduced by the ability to accurately predict future GST revenue.

The Panel's view on changing the averaging period

The Panel notes States' views that the three year average provides a practical and appropriate balance between the benefits of stability and contemporaneity. The Panel is not convinced that a further change to the averaging period would be advantageous at this time, particularly since this could have further unintended consequences in the transitional years for some States.

Under an EPC distribution no averaging is necessary and the outcomes are essentially contemporaneous.

The averaging process used in the current HFE system slows the adjustment of relativities to changes in state circumstances. The averaging process can operate pro cyclically, boosting revenues after as an economy recovers and lowering revenues as a cyclical upturn passes. This can exacerbate fiscal pressures for a state. Three year averaging is better than five year averaging in reducing these effects, but a contemporaneous assessment, such as EPC, would remove any pro cyclical behaviour.

The Panel's view on fixing annual relativities

The Panel sees merit in approaches that lead to increased predictability and stability in the GST distribution, especially where this can be delivered without substantial effects on overall outcomes. A default approach where data changes are not back cast may deliver this, although flexibility should be retained to allow revisions on a case-by-case basis.

The magnitude of revisions to equalisation outcomes attributable to data revisions highlights the dependence of the current equalisation system on unreliable data. The most appropriate remedy is to reduce such dependence by adopting an alternative approach.

Table 1 shows the effect of data revisions on the relativities for the three years 2010-11 to 2012-13. Relativities for 2010-11 are affected by both data revisions and changes to assessment methods arising from the 2010 Review (excluding the shortening of the review period from 5 to 3 years). For 2011-12, the figures reflect primarily the effect of back casting from the then recently available update to the Survey of Education and Training (SET) data for the calculation of relative state wage rate disabilities. For 2012-13, the figures reflects the use of newly available data on Commonwealth and privately funded service provision in the community and other health assessment, the correction of several errors and other data revisions.

Table 1: GST Impact of Data Revisions

	NSW $m	Vic $m	Qld $m	WA $m	SA $m	Tas $m	ACT $m	NT $m	Redis $m
2010-11[(a)]	-701	-35	879	108	21	-1	-84	-186	1,007
2011-12	-385	-219	99	345	52	26	-1	83	605
2012-13	-235	251	32	-77	17	7	5	1	312
Cumulative Impact	-1,321	-4	1,009	375	89	32	-79	-101	1,505

(a) Includes effect of 2010 Review changes to assessment methods, not including the effect of changing to a 3 year averaging period.

Source: CGC, *2010 Review*, *2011 Update*, *2012 Update.*

The absolute impact on state relativities has been significant, with a total negative impact on New South Wales' GST share of $1.3 billion over three years. The largest per capita impact was on the Northern Territory in 2010-11, with a reduction in GST revenue of more than $800 per capita in that year.

As the Panel indicates, a key effect of such data revisions is to reduce states' ability to predict GST revenues. States should be reasonably confident of their forecast relativities for the next year because it is based on an average of three assessment years, two of which have already been dealt with by the CGC. However, data revisions have the effect of undercutting certainty for those two years.

The use of new data, coupled with back casting, has the effect of shifting estimated relativities for the three assessment years in the same direction, with the result that the smoothing effect of the three year averaging process is largely negated.

When data (such as the SET data used for the calculation of relative state wages disabilities) that are available only at widely spaced intervals are used in assessments, the result is, in effect, a partial 'freezing' of the relativities. When new data become available, there is then likely to be a disproportionate shift.

If back casting is used, calculated relativities which may be subject to back casting can only be regarded as provisional. This has similarities with the 'advances and completions' approach considered and rejected by the CGC in the course of its 2010 Review. The provisional nature of the initial assessment of relativities means that the full force of any discrepancy is felt in the 'completions' stage when the back-casting 'corrects' the 'error' in the earlier data.

The Panel's view on limiting relativity changes

While the Panel sees merit in exploring approaches that lead to increased predictability and stability in the distribution of GST revenue, it considers that there is no compelling case for adopting a floor at present. Moreover, a relativity floor of 0.75 would cause a major disparity in the fiscal positions of the States in the very near future.

On the other hand, an approach that manages reductions in GST payments received by States, perhaps by ensuring that a State does not receive a lower nominal amount of GST revenue than in the previous year (in years when the GST revenue pool grows), could increase stability without such extreme consequences.

Furthermore, the Panel notes that other approaches (dealt with in Chapter 6) might address some of Western Australia's concerns.

The imposition of a relativities floor would not address the underlying problems in the current HFE system. Moreover, the level of the floor will always be arbitrary. There is no objective standard against which to judge the appropriateness of a particular floor.

Sharp movements in assessed relativities can affect any state and their magnitude may be quite unrelated to the level of the state's relativity. While a relativities floor may offset an inappropriate movement in a state's relativity if that relativity is an outlier, it does nothing to correct for inappropriate movements or levels in relativities for states whose relativity lies significantly above the floor.

New South Wales is not attracted to any proposals of the type considered in the Interim Report. They have the effect of complicating the system, do not treat the underlying causes of the problems and have adverse consequence for the working of the system.

Simplicity: Can the GST distribution process be made simpler?

The Panel's view on freezing expenditure disabilities

The Panel sees the merit in freezing expenditure disabilities, but notes that it would represent only a minor improvement by simplifying the CGC's annual update process and would not address the major causes of underlying complexity.

New South Wales agrees that freezing expenditure disabilities would not fundamentally address the underlying complexity of equalisation assessments under the current HFE system.

The Panel's view on simplifying complex disability assessments

The Panel considers that the CGC would be the appropriate body to consider disability assessments, such as the one raised above.

New South Wales considers that the focus of the Review should be on the overall structure and operation of the HFE system and possible alternative systems, rather than individual assessments. While the Panel needs to be aware of the main technical problems within the current system, its task is not to fix these directly.

Any recommendations to the CGC on particular assessments should be based on an objective appraisal of all the CGC's assessments, rather than on State views on particular assessments. A thorough appraisal of the entire system would give the Panel a broader view of the problems associated with many of the current assessments, and a better indication of the need for an overall system that is simpler, more transparent, based on more objective criteria and less influenced by subjective judgement.

The Panel's view on higher materiality thresholds at the disability level

The Panel accepts the principle of increasing materiality thresholds to achieve further simplification, but notes that a large increase in the threshold for disabilities would be required in order to reduce the number of assessments significantly. Furthermore, the CGC would still need to collect data and do the analysis to determine whether the disability met a materiality threshold.

New South Wales notes that the introduction of materiality thresholds for the CGC's 2010 Review substantially reduced the level of complexity in equalisation assessments. New South Wales agrees with the Panel's view that a large increase in the threshold for disabilities would be required in order to further reduce the number of assessments significantly and that, because of the need to check whether a particular disability level meets a materiality threshold, a further increase in these thresholds would provide limited simplification gains.

New South Wales is also concerned that the impact of materiality thresholds on the complexity of assessments ultimately depends on the classification scheme for assessment categories adopted by the CGC. For this reason, New South Wales considers that, to be effective, an increase in materiality thresholds would need to be coupled with measures designed to reduce the number of assessment categories.

The Panel's view on removing adjustments for tax differences

The Panel recognises that removing adjustments for tax differences would represent a move away from 'what States collectively do'. However, the approach would offer simplification *benefits and could address concerns about policy neutrality. The approach will be considered further in the Panel's second Interim Report.*

New South Wales notes that the equalisation concept underlying the current HFE system relates to states' capacities, but that the application of the principle of 'what states do' in equalisation assessments makes measured capacities dependent on states' policy choices. NSW considers that a reduction in the use of this principle would be desirable in any changes to the current system and would promote greater policy neutrality.

Historically, the CGC examined state practice to determine the equalisation standards it should apply. This provided an effective way for the Commission, in the absence of explicit directives from government, to minimise the need for arbitrary or normative judgements. The application of the 'what states do' principle to tax assessments, however, takes its application well beyond this original need and leads to distorted equalisation outcomes.

For example, where a majority of states apply a threshold for a particular tax, the CGC calculates an 'average tax threshold' and excludes taxpayers falling below this average threshold from its assessed tax base. That is, the 'common threshold' is assumed to reduce the tax base available to the states. However, if only a minority of states apply a threshold, the tax base is not reduced – the states applying the threshold are considered as simply applying a zero tax rate to entities below the threshold.

This application of 'what states do' to determine an 'average' threshold not only adds considerable complexity to the assessments, it unnecessarily compromises the neutrality of the HFE system and sets the stage for state policy decisions to produce 'tipping points'. Ultimately, the tax rate scale adopted by a state reflects a number of considerations, including the state's revenue objective and the structure and capacity to pay of entities forming the tax base. Confronted by differences in tax bases, states with the same revenue objective and policies on how the tax burden should fall on taxpayers may end up with quite different tax rate scales.

New South Wales considers removing such adjustments for tax differences would make revenue assessments simpler and more policy neutral. The principle of 'what states do' in this context distorts, rather than improves, equalisation outcomes. Moreover, the adoption of more appropriate governance arrangements or agreement among the states on closer tax harmonisation could also dramatically reduce the need for the CGC to apply the 'what states do' principle.

However, the main objective should be move from the current system to a system where these types of considerations are not necessary.

The Panel's view on simplifying the capital assessments

The Panel agrees that the capital assessments could be simplified. However, these issues are of a methodological nature and the CGC would be the appropriate body to consider how to further simplify these assessments.

New South Wales agrees that this review is not the appropriate body to consider assessment issues of a methodological nature. The Review should concentrate on more fundamental reform of the GST distribution arrangements rather than limited changes to particular components of the current arrangements.

That said, New South Wales' views on the capital assessments were set out in a submission to the CGC in 2009, which concluded that the CGC's approach is inconsistent with what states do and is inappropriate for spending which is not 'annual' in nature.[9] New South Wales, along with other states, favoured an approach that recognised that the annual costs of capital in the provision of government services lies in the use of physical capital each year (depreciation) and the user cost of capital, rather than the cash expenditure incurred in its purchase.

At a more general level, the capital assessment provides a prime example of the misunderstanding, confusion and lack of confidence that can occur when the distribution system pursues false precision and detail, requiring heavy reliance on judgement, rather than being based on objective and easily measurable criteria.

If the Review Panel is proposing to make recommendations to the CGC on particular assessments, such recommendations should be based on an objective appraisal of all the CGC's assessments, rather than on state views on particular assessments. A thorough appraisal of the entire system would give the Panel a broader view of the problems associated with many of the current assessments, and a better indication of the need for an overall system that is simpler, more transparent, based on more objective criteria and less influenced by subjective judgement.

New South Wales has particular concerns with a number of expense assessments, in addition to the capital assessments.

- The administrative scale assessment redistributed $830 million in GST revenue in 2012-13, and took $411 million from New South Wales.[10] The assessment of 'the minimum level of administration' before a unit of service is delivered is not based on an objective minimum level of administration, but on the observed minimum bureaucratic scale of the smallest jurisdictions, the Australian Capital Territory and the Northern Territory, and therefore related to the scale of service provision those jurisdictions face. Estimates of administrative scale costs come from the 1999 Review, as discounted in the 2004 Review, and extrapolated using one index in the 2004 Review and a different index in the 2010 Review.
- The community and other health expenses redistributed $882 million in 2011-12 ($570 million from New South Wales), and $997 million in 2012-13 ($737 million from New

9 New South Wales, *Submission on the Draft Report*, September 2009, pp. 19-36 and Attachment 19, pp. 176-210.

10 CGC, *2010 Review*, Vol. 2, p. 492, and *2012 Update*, p. 65.

South Wales).[11] The assessment assumes that Commonwealth, private health fund and individual provision on the one hand and State provision on the other are perfect substitutes for each other, i.e., that a dollar of spending in the former area relieves a State of the need to spend a dollar. This assumption is arguable given the different price signals facing consumers in these 'market' segments. The data on which the assessment is based also can be quite dated and change significantly over time, producing large changes in outcomes when later data becomes available.

- The interstate non-wage costs factor redistributed $87 million in 2010-11 ($43 million from New South Wales). Given the availability of 'no comprehensive, comparable data that would allow … a reliable policy neutral measure of the disabilities', the assessment is based on data from ABS National Accounts Input Output tables to estimate total freight costs for 'State government type industries', a judgement that relevant interstate freight is half that number, judgements of States' shares of that number, and heavy discounting of the results to reflect strong concerns about data uncertainty.[12]
- The insurance tax assessment where the size of a state's tax base (premiums paid) are clearly heavily influenced by the state's policy on the rate of duty.

[11] CGC website, cgc.gov.au/publications, data downloads accompanying 2011 and 2012 Updates, $ million – Analysis of Relativities – Difference from EPC.xlsx, Table S4-2, expense.

[12] CGC, *2010 Review*, Vol. 2, pp. 509, 523.

The Panel's view on the use of broader indicators

The Panel is highly attracted to the use of broader indicators, as they could offer significant simplification and may equalise to a similar extent as at present. Broader indicators would also reduce the scope for State policy changes to affect the GST distribution (see Chapter 4). However, the Panel recognises that using broader indicators could be seen by some States as a less precise measure of 'what States collectively do'.

The Panel therefore seeks further information, evidence and views from States about:

- *what broader indicators could apply, especially on the expenditure side, where the proposals are less well developed, and*
- *on the revenue side, why broader indicators, such as those described above, would not produce appropriate outcomes.*

New South Wales considers that one of the difficulties in prescribing the use of broader indicators – defined by the Panel as 'indicators that are … closely linked to States' current revenue bases and expenditure responsibilities' – is that, as in the current approach to equalisation assessments, there will be perpetual pressure to make adjustments for factors that these broad indicators are claimed not to adequately reflect.

The simplification exercise undertaken in the lead-up to the CGC's 2010 Review can be viewed, at least in part, as an attempt to prevent this accretion of detail by setting materiality thresholds. But it was only partly successful in this. Without further mechanisms to limit complexity, it is difficult to see how an edict to use broader indicators would solve the underlying problem. There is a risk, however, that the introduction of such mechanisms could limit flexibility to an unacceptable extent.

New South Wales considers that the effective use of broad indicators probably requires the category structure used by the CGC to classify budget items to be revisited. For example, broader indicators reflecting the capacity to pay of those on whom state taxes are incident could be a useful way of assessing states' revenue capacities. This would also require a shift of focus to the entities on which the burden of tax falls and away from the current focus on statutory tax bases.[13] Such an approach would remove the current dependence of equalisation outcomes on state policy decisions regarding their tax mix and would be more consistent with widely accepted economic principles and the approach taken by the AFTS.

[13] This approach was suggested by the Commonwealth Treasury in its October 2011 submission to the GST Distribution Review.

The Panel's view on equalising only for major items

The Panel sees potential difficulties with equalising for major revenue and expense items only. For example, in both scenarios above, roads and transport would not be assessed, but if roads and transport were grouped together, they would be. Therefore, if this approach is to be used, the CGC's current categorisation might have to be regarded as a guide only.

The Panel would like proponents of this approach to provide further suggestions and information on the implementation of the approach.

As the Panel notes, potential difficulties could arise in equalising only for major revenue and expense items because of the interaction between the CGC's current 'categorisation' framework and the materiality threshold.

In its first submission to the Review, New South Wales recommended that, if the Review were to favour only incremental change, HFE expenditure assessments should be based on a limited number of 'core services of national importance'.[14] The intention here was not to define 'core services' in terms of a materiality criterion. Rather, the concept was that equalisation should be applied only to those services for which there is a general expectation of universal access to broadly comparable services by the Australian community – i.e. services to which access could be regarded as part of being Australian. Thus, for example, education and health would be included as core services, but assistance to specific industries in specific locations would not.

In our view, the CGC's practice of creating heterogeneous categories for equalisation purposes, such as the 'Services to Industry' category, generates equalisation outcomes that are, to a large extent, artifacts of the classification structure. This practice weakens confidence in the overall system.

As an interim arrangement, the Panel might consider reducing the categorisation problem by making CGC expenditure categories consistent with the categories used for National Agreements. Limiting expenditure assessments to only those categories constituting more than 10 per cent of total state expenditure would then provide a simple mechanism for restricting equalisation assessments approximately to core services only.

[14] The expression 'core services of national importance' is used on p. 50 of the submission. On p. 4 and p. 43 it is abbreviated simply to 'core services'.

The Panel's view on simplifying at the 'total budget' level

While the Panel is keen to explore the use of global indicators, it acknowledges potential difficulties with the approach. For example, if GSP per capita was used as a proxy for States' fiscal capacity, would States with lower GSP per capita receive additional GST payments? Alternatively, if growth in GSP was the proxy, would States with high rates of GSP growth, and possibly greater infrastructure demands, need additional GST payments?

The Panel would like proponents of the use of global indicators to provide further ideas and information on the implementation of the approach, and how it could achieve appropriate outcomes.

The use of global indicators could provide a transitional arrangement leading into more fundamental reform of the GST distribution, although NSW preference is for transitional methods based on partial equalisation.

A possible measure would be 'Inverse GSP per capita'. GSP is a comprehensive measure of a state's capacity to raise revenue. Its use would immediately remove the current problems associated with non-neutrality of the assessments and disincentives to tax reform.

As an interim measure, the use of inverse GSP per capita is preferred to the use of growth in GSP as it will adjust over time reflecting growth in GSP and reflects the level of a state's broad capacity, not changes in the level, which may be more indicative of a low base.

The Panel's view on moving to a donor and recipient approach

The Panel is receptive to a donor and recipient approach as it appears it could offer significant simplification gains, particularly to donor States, while still providing support to the recipient States. However, depending on how this approach was implemented, it could result in recipient States having a stronger fiscal capacity than some donor States. Ideally, the donor States would develop a proposal to be put to the recipient States for their consideration and approval, as a donor and recipient approach will only prove workable if there is genuine consensus amongst States.

The Panel seeks further details from States on the design of a donor and recipient approach, including how to determine the size of the GST pool allocated to the recipient States, how best to measure the fiscal capacity of recipient States and when a recipient State could become a donor State (and vice versa).

New South Wales considers that a donor and recipient approach could provide a useful transition arrangement towards an ultimate full EPC approach to HFE. However, a donor and recipient model would only be supported if the Commonwealth provided additional funding for the equalisation requirements of the recipient states. Otherwise, a relatively fiscally weak donor state would bear a disproportionate share of the burden of subsidising the recipient states.

The Panel's view on moving the GST distribution to an EPC basis

While the Panel acknowledges that moving the GST distribution to an EPC basis would simplify the distribution of the GST significantly, it is practically not achievable in the absence of a further funding source.

If further funds were available and similar processes and institutions were required to determine how to distribute those other payments, the simplification benefits of the proposal may be limited.

In its first submission to the Review, New South Wales recommended the adoption of an equal per capita distribution of GST revenue over the long term, with top-up funding provided by the Commonwealth for the fiscally weaker states. This remains our preferred option. It is simpler, more transparent and more predictable. It is policy neutral, providing neither incentives nor disincentives for tax or service delivery reform.

An EPC system is more contemporaneous than the current system and would not require amendment as a result of structural change in the economy.

The Commonwealth, which raises more than 80 per cent of all tax revenues in Australia, has the fiscal capacity to contribute additional funding for equalisation purposes. Given the likelihood that an EPC distribution would be phased in over a five to ten year period, the requirement for additional Commonwealth funding is likely to be limited in the near term.

Adoption of an EPC model would strengthen the framework for intergovernmental financial relations, clarify the operation of funding agreements and government accountability, and restore confidence in the system.

The adoption of an EPC model, with additional funding provided by the Commonwealth, also provides the opportunity for the Commonwealth to review and simplify the assessment arrangements with the recipient states and to contract with the recipient states for desired outcomes.

The Panel's concluding comment on simplification

The Panel believes that the GST distribution process should be able to produce fair and reasonable outcomes more simply. Any simplification that would facilitate broader understanding of the distribution process and, in turn, foster greater confidence in the distribution outcomes, would be a significant achievement.

While some of the approaches above seek simplification with the same outcomes as present, the Panel considers that equalising States to 'comparable' rather than the 'same' level of services (as discussed in Chapter 1) would facilitate moves towards even simpler, more transparent and more easily understandable arrangements.

Recognising that many States have not had the opportunity to comment on the majority of ideas in this Chapter, the Panel seeks comments and feedback on which, if any, of the simplification proposals are worth pursuing.

New South Wales considers that lasting reform of the HFE system can only be achieved by addressing the fundamentals of the equalisation process and the thinking that gives rise to the current anomalies.

There is no justification for the form of 'full' equalisation currently pursued in Australia. In any case, the ideal equalising distribution is unobservable and unattainable in practice and its on-going pursuit has added considerably to the complexity not only of the current equalisation system, but also to the pursuit of Commonwealth-State reform in a number of areas. Adoption of a definition of equalisation based on achieving 'comparable' standards would constitute an important step towards simplification.

Enhanced governance arrangements, under which governments, including state governments, provide guidance to the CGC on the objectives, definition, scope, classification structure and standards of equalisation would constitute a further important step towards simplification of equalisation assessments.

HFE and efficiency

The Panel's view on the effect of HFE on States' policy choices
The Panel notes the diverse views about the process and outcome effects of HFE on States' policy choices.
While the Panel cannot conclude that the incentive effects of HFE in any particular case (other than mining) are large, the concerns are so widespread that all practical options to reduce or eliminate them must be fully explored, especially in the light of the Panel's new Terms of Reference requiring it to consider incentives for tax reform.
The Panel's priority for exploring options will be on tax changes, as the arguments have been made more convincingly and the effects are likely to be more significant in that context than for expenditures.

In its first submission to the Review, New South Wales sought to illustrate the disincentive effects of the current HFE system on state tax reform by reference to actual events and hypothetical examples of potential reform. These examples were based purely on the workings of the HFE system itself. Even if the impacts are not considered large by the Panel (which we would disagree with), the Panel should recognise that the cumulative impact is material.

Given the additional terms of reference issued to the Review since that time, however, it seems worthwhile to consider a further example which is consistent with the methods employed by the Australia's Future Tax System (AFTS) Report and which demonstrates more starkly the magnitude of the disincentives to state tax reform as well as the inconsistency between the findings of the AFTS and the CGC methodology.

The Second Interim Report raises the issue of tax base elasticity effects in the context of unilateral state tax reform but considers that 'calculating and adjusting for specific elasticity effects are strictly matters for the CGC'.[15] The Panel includes a quote from the CGC's submission to the Review which says, in part, that the CGC currently does not make elasticity adjustments in its revenue assessments because reliable data are not available for the calculation of the relevant elasticities.[16]

The AFTS, however, provides estimates of average and marginal efficiency for each state tax, which requires similar calculations. Using these results, it is possible to obtain approximate estimates of the impact of a unilateral change to a state's tax rates on its GST revenue.

Table 2.6 of the Second Interim Report presents, as a case study, the calculations used by the CGC to assess insurances taxes. These calculations show that the insurance taxes assessment for 2008-09 in the 2012 Update had the effect of redistributing $113 million away from New South Wales to the other states. This result reflects the much higher tax base per capita available to New South Wales.

15 *Second Interim Report*, p. 32.

16 *Second Interim Report*, p. 31.

However, the findings of the AFTS show that insurances taxes are very inefficient, i.e. in distorting economic decision making the tax itself has a large impact on the tax base. That is, New South Wales policy to levy a lower insurance tax rate compared to the other states is an important factor behind the State's assessed higher tax base. Adjusting for this effect – an effect which is entirely policy induced – using the AFTS findings, indicates that New South Wales taxing capacity is not materially different from the state average, and no significant transfer of GST revenue away from New South Wales is justified.

Given the high level of economic inefficiency of insurance taxes, NSW application of a generally lower tax rate than other states is clearly in the national interest. But not only does this mean a sacrifice of tax revenue, New South Wales GST revenue is also reduced by more than $100 million per annum. A similar calculation shows that if New South Wales were to abolish its insurance taxes unilaterally, its tax base would expand to such an extent that it would lose a further $300 million of GST revenue under the current HFE system. These are significant penalties for policies that increase the overall efficiency of the Australian economy and are powerful disincentives to unilateral state tax reform.

This example highlights another common misunderstanding regarding the CGC's current methodology. Just because an assessment is based on reliable data does not mean that the assessment itself is reliable.

The CGC used its judgement to reject adjusting the tax base for the elasticity effect on the grounds that the data required was unreliable. However, by neglecting to incorporate the elasticity effect on the tax base, the assessment significantly distorted the equalisation outcome.

While the actual calculation of tax base elasticities may be an issue for the CGC, as the Panel suggests the effect of the CGC's judgements and decisions go to the heart of states' confidence in the HFE system and need to be carefully considered by the Review.

The Panel's conclusion in its first interim report that it cannot conclude that the incentive effects of HFE in any particular case (other than mining) are large also appears to be at odds with its conclusion in the second interim report:

> Under current arrangements, any change by a given state to the design of its taxes or to the tax mix used to raise a set amount of revenue is likely to produce change in GST shares. Major multilateral changes … are almost certain to produce significant shifts in GST shares. Simply put, for any given tax reform, the present system will result in 'winners' and 'losers' and so could be thought of as creating incentives and disincentives.[17]

[17] *Second Interim Report*, page 38.

> ***The Panel's view on the effect of HFE on the efficiency of population distribution***
>
> *HFE may have effects on 'location efficiency', but the magnitude and significance of those effects is disputed and unclear. The Panel is not convinced that HFE should be altered in order to influence inter State migration. If a different pattern of inter State migration is a policy goal, the Panel suggests that be pursued more directly, through appropriately targeted policies.*

HFE currently influences interstate migration. It appears to be a sub optimal solution to suggest that other policies should be used to compensate for the distortionary effects of HFE on population distribution, rather than amend the HFE system to avoid the influence initially.

> ***The Panel's view on administration costs of HFE***
>
> *Based on information provided by the States and the Commonwealth, it is estimated that the administration costs of HFE are in the range of $10-15 million per annum.*
>
> *While the Panel will be alert for administrative savings, it does not see how this avenue alone could produce significant gains.*

New South Wales agrees that the direct administrative costs of HFE do not, in themselves, constitute a significant issue for the Review.

The more important consideration, however, is the indirect costs in terms of the diversion of senior management time, dealing with fiscal surprises, the time spent discussing HFE issues in intergovernmental forums, in preparing for those meetings, in agencies preparing data and so on. The opportunity cost of diverting the attention and talents of senior bureaucrats from other areas of policy to HFE issues is, in our view, currently much more than should be necessary.

> ***The Panel's summary view on alternative approaches to address efficiency concerns***
>
> *While the Panel is not convinced that efficiency concerns provide grounds for radical changes to the HFE process, it is interested in views on whether any of the approaches outlined above would address concerns about the relationship between HFE and efficiency.*
>
> *As previously noted, the Panel intends to investigate whether providing comparable capacities for States would be an approach more suitable to current challenges than the present one of providing materially the same capacities. This would improve efficiency by reducing the size of any capacity effects as well as the ability of States to influence average policy. Further, the Panel would be keen to explore the practicalities of equalising to an external standard, or a standard below the average of all States.*
>
> *Finally, the Panel will explore the concept of creating a reward pool to assist States improve efficiency and consider this further in the Panel's second Interim Report.*

New South Wales agrees that the adoption of an approach to equalisation based on 'comparable' standards of service would be an important step towards creating a more efficient HFE system. It would promote a better balance between equalisation and efficiency, would encourage greater

State responsibility and self-sufficiency and would better place Australia to meet economic and social challenges.

The current revenue assessments are unreliable, perverse and provide strong disincentives to unilateral state tax reform. This leads to the persistence of inefficient state taxes. New South Wales considers that the only realistic solution is to adopt a fundamentally different approach to equalisation assessments that is directed towards achieving outcomes that are broadly correct and truly policy neutral.

Providing states with 'comparable capacities' as a transitional arrangement on the path to an EPC distribution would support the necessary change in focus.

New South Wales does not agree that a reward pool should be created to assist states to improve efficiency. It would be preferable to have an equalisation system which allows states that undertake reform to retain the benefits of those reforms.

HFE and Commonwealth payments to the States

The Panel's view on equalising capital payments over a longer time

The Panel considers that equalising capital payments over a longer period would reduce the impact of capital payments on GST shares in any one year, without adding much complexity. The Panel notes that equalising capital payments over a longer period would be consistent with a capital assessment that also recognises States' capital needs over time.

New South Wales considers that the treatment of Commonwealth payments is largely a methodological issue.

The Panel's view on excluding payments from the Building Australia Fund, Education Investment Fund, Health and Hospital Fund and COAG Reform Fund

The Panel doubts that only excluding payments from the designated funds would address all the concerns raised in submissions about the current treatment of capital payments and is concerned that it may introduce other difficulties, such as placing great weight on the labelling of programs, or casting doubt on the merit of projects not financed through the designated funds and programs. However, these particular payments could be part of a broader group of capital payments to be excluded from the equalisation process.

The treatment of these payments is largely a methodological issue.

In principle, there may be valid reasons to exclude from equalisation payments Commonwealth capital funding for projects which an independent body – such as Infrastructure Australia – has judged to be a high priority in the national interest. Equalisation, by offsetting those payments through the GST distribution, defeats the purpose for which the payments are thought necessary.

On the other hand, quarantining the payments defeats the purpose of equalisation, since the payments are made in pursuit of normal State functions in the provision of infrastructure. Indeed redistributing Commonwealth capital payments between the States via the GST distribution is seen by some as a way to ensure Commonwealth infrastructure funding is distributed equitably among jurisdictions.[18]

If GST payments were distributed equal per capita between the States the methodological argument about the treatment of capital payments in the detailed assessment of fiscal capacity would disappear.

States still would argue about the amount of capital funding they should receive, but this could be based more objectively on robust benefit-cost analysis undertaken by a body such as Infrastructure Australia on proposals put forward by the States.

The Panel's view on excluding capital payments to promote future economic development

The Panel notes that the difficulties associated with measuring economic development infrastructure needs mean that the equalisation process does not fully recognise State expenditure needs in this area.

The Panel sees potential in excluding capital payments to promote future economic development, but notes that there may be considerable difficulty in identifying relevant payments, as precisely what constitutes 'economic development' would prove problematic in the absence of an agreed definition or process for determining eligible payments.

The Panel's view on excluding capital payments for nationally significant infrastructure projects

The Panel recognises that the current assessments do not recognise all the complex and multi-faceted factors that influence State infrastructure spending. This is more likely to create problems for infrastructure projects that seek to deliver national benefits or outcomes rather State specific benefits or outcomes. However, a difficulty with excluding these payments is that a satisfactory process to identify eligible projects does not currently exist. While the Infrastructure Australia priority list is a useful starting point, it cannot be regarded as a comprehensive list of all nationally significant projects.

The Panel sees potential in excluding capital payments for nationally significant infrastructure projects provided a workable process for identifying eligible projects could be developed.

This is largely a methodological issue.

However, New South Wales considers that there also are issues of principle involved. There is not only the difficulty of 'measuring' economic development infrastructure needs, but the deeper issue of conceptualising whether one State will have relatively greater 'economic development needs' than another.

[18] Commonwealth Treasury, noted in Interim Report March 2012, p. 89.

There are difficulties in determining the 'disabilities' that make one State 'need' to spend more per capita on 'economic development' than another State. Some States, for example, seem to argue that the existence of vast mineral deposits is a disability, given the 'need' to provide infrastructure to develop the resources. For other States, the absence of vast mineral deposits could create 'needs' to invest in infrastructure to encourage other sources of economic development.

The provision of economic development infrastructure and services is subject to much greater policy differences between the States than the provision of basic services like education, health, public transport and safety and emergency services. 'Economic development' infrastructure and the services derived from it are not provided to individuals, but to an 'economy' or firms.

The Panel's view on excluding capital payments for transport infrastructure projects

The Panel notes that, unlike some of the approaches considered above, identifying Commonwealth payments for transport infrastructure would be straightforward. A case may exist to exclude these payments due to the difficulty in measuring transport infrastructure spending requirements.

The Panel's view on excluding all capital payments

While excluding all capital payments would eliminate any funding difficulties, it would add complexity to the equalisation process because all related expenditure would also need to be excluded. Also, needs for the State funded part of projects jointly funded by the Commonwealth and the States would continue to be assessed and this would result in different treatments of expenditures from different funding sources.

Moreover, the Panel is concerned that the long term workability of this approach would depend completely on the Commonwealth Government ensuring that capital payments are distributed equitably among jurisdictions. If the Commonwealth felt it was necessary to adopt a process that relied on a needs assessment to determine where payments should be made and how much, the apparent benefit of excluding the payments in the first place would be largely undone.

These are largely methodological issues.

New South Wales agrees there are problems with the current capital assessments. We are not convinced that these problems are more likely to create problems for infrastructure projects that seek to deliver national benefits or outcomes rather than State specific benefits or outcomes. In our view the problems are likely to affect all infrastructure projects.

The exclusion of some Commonwealth payments – whether they are for 'nationally significant' infrastructure projects or transport infrastructure projects – creates the same issues as raised in the consideration of excluding broader capital payments or capital payments supporting economic development.

The case for excluding certain capital payments is largely based on notions of efficiency: it is not appropriate that some payments be equalised if the payments are intended to meet some 'specific need' in the States receiving the payments. This case for including the payments is largely based on notions of equity: equalising the payments through their inclusion in the GST distribution ensures that these 'specific need' payments are distributed equitably among jurisdictions.

The Panel seems in the end to be tending towards the equity arguments in saying that 'the long term workability of excluding all capital payments would depend on the Commonwealth Government ensuring that capital payments are distributed equitably among jurisdictions.' In other words, the long term workability of distributing capital payments based on where they would contribute most to Australia's national or total economic efficiency would depend on an 'equitable' distribution of the capital payments.

In those circumstances, New South Wales considers that an equal per capita distribution of capital and GST payments is the only method that can in the long term succeed in balancing the aims of efficiency and equity.

It is not clear why these arguments should apply any more to capital payments than current payments. The purpose of investing in infrastructure is to provide services; the purpose of current payments is to provide services. The two methods of providing services should be treated in a consistent manner.

There are also difficulties in defining the particular types of payments that should be excluded; and the risks that excluding some payments and not others will encourage States to have payments included in a particular category.

The Panel's overview on the treatment of Commonwealth payments

Of the various approaches considered to overcome the difficulties experienced by States when large one-off capital payments for expenditure on assets of lasting value are redistributed, the Panel sees most merit in:

- *equalising all capital payments, but doing so over a longer time frame to recognise the lasting nature of the asset being funded and reduce the impact of the payments on GST shares in any one year, or*
- *equalising most capital payments, but excluding capital payments for nationally significant projects.*

If capital payments for nationally significant projects are to be excluded, a process for identifying the precise scope of these projects will need to be determined. The Panel seeks views on the appropriate way to identify these projects.

Aside from the problems noted above, the main problem with these proposed treatments of the difficulties associated with the current equalisation system is that they are very much piecemeal solutions to one aspect of the current arrangements. Moreover, there are likely to be as many problems in the solutions as already exist in the issues they are trying to fix.

In our view, the current problems in the GST distribution arrangements cannot be solved by amending individual assessments or treatments. The problems of the current system – the volatile and unpredictable outcomes, the complexity and difficulty in understanding, the discouragement to economic reform and policies designed to boost a state's fiscal capacity, the reliance on the use of data of questionable quality and consequent need for judgement in many instances – require more fundamental solutions that address the underlying cause of the problems.

Amending the current system will not produce a robust distribution system that will withstand pressures for change whenever State circumstances change in the future.

An EPC distribution of GST revenue, supported by Commonwealth Government provision of equalisation payments to the smaller States calculated through a much simpler mechanism, would be fair, easily understood at all levels (simple and transparent), allow States to plan budgets with greater certainty (predictable), be neutral for State policies, cost no more than it needs to and would not detract from States' confidence in the Federation.

In addition to these ideal qualities listed by the Review Panel, EPC is contemporaneous, stable and equalising.

HFE and the mining boom

The Panel's view on the consequences of the two-rate structure of the current mining revenue assessment

The Panel notes that the current mining revenue assessment has the potential for Western Australia to lose more revenue than it raises from a change to its royalty rate for iron ore fines, with effect from the 2014 Update, if the CGC chooses to move iron fines into the high rate category. Whatever the original justification for the two rate structure, this outcome seems to be a perverse and inappropriate result.

The Panel encourages the CGC and other stakeholders to review the current mining revenue assessment method at the earliest opportunity. This may involve reconsidering whether the two rate model is appropriate.

Notwithstanding this suggestion, this Review will report before the results of any CGC decisions on movement between rates need to take effect, and some of the Panel's recommendations (whether about mining, infrastructure or generally) may lessen the impact of the current mining revenue assessment on changes to GST shares.

This is largely a methodological issue, and arises from a specific set of circumstances. In that sense it should not be a significant focus of the Review Panel. However, the concerns expressed by some states over the mining issue raise some general points that emphasise the need for more fundamental reform of the current GST distribution arrangements.

The Review panel notes that 'the two-rate structure of the assessment of mining revenue in the current HFE system can have extreme consequences for certain rate change decisions by States.'[19]

New South considers that it is not the particular form of the mining revenue assessment that can have extreme consequences for certain rate change decisions by States. Rather the fact that key minerals are mainly located in only a few States means that, however the mining revenue assessment is structured, rate change decisions in those key States can have significant ramifications for the assessment as a whole.

This is an issue that arises to an extreme degree in the mining revenue assessment, but which may occur to a lesser degree in other assessments. It arises in any assessment where States have an ability to influence their assessed revenue base or their assessed spending need.

As the Review Panel notes 97 per cent of iron ore production occurs in Western Australia and 96 per cent of black coal production occurs in New South Wales and Queensland.[20] An equalisation system that assesses revenue using average revenues and average tax and royalty rates will not perform well when one or a few States dominate the average because of the impact of those states on the average.

[19] *Interim Report March 2012*, p. 96.

[20] *Interim Report March 2012*, p. 96.

The example noted by the Review Panel as producing perverse effects is Western Australia's abolition of concessional iron ore fines royalty rates (and prospective increases to its iron ore fines royalty rates).

Iron ore fines were classified in the low royalty rate group because their 'average' royalty rate at the time of the 2010 Review was less than 5 per cent, the arbitrary dividing point between the high and low royalty rate groups. The general WA royalty rate for iron ore fines at that time, applying to eight of the ten producers, was 5.625 per cent. A concessional rate of 3.75 per cent applied to two producers, accounting for around 50 per cent of fines production, and this reduced the average royalty rate below 5 per cent.

Removing the royalty rate concessions enjoyed by two producers from 1 July 2010 increased the average rate to the general rate of 5.625 per cent (and further planned increases in the general rate of duty for iron ore fines will lift it, in two steps, to the general rate applying to lump iron ore, 7.5 per cent, from 1 July 2013).

However, if the CGC moves iron ore fines from the low royalty rate to the high royalty rate group of minerals Western Australia will lose more in GST revenue than it will gain in royalty revenue from the increase in the iron ore fines royalty rate. This is because a significant proportion of its mineral production would then be assessed at a higher average royalty rate, thereby increasing its assessed mineral revenue and decreasing the GST revenue Western Australia needs to achieve the average State fiscal capacity.

This situation would have been avoided had iron ore fines been classified in the high royalty rate group at the outset. The generally applicable iron ore fines royalty rate – rather than the combination of the general and concessional rates – should have determined the royalty rate category into which iron ore fines was placed. Providing concessions on the generally applicable rate to two producers only was Western Australia's policy choice. No other State provided iron ore royalty concessions to particular producers so, even though no other States were significant producers of iron ore, it could not be regarded as general State policy to do so.

So it was not the two category structure, but the classification of iron ore fines in the low royalty category that caused this particular reclassification problem. Had iron ore fines been placed in the high royalty rate mineral category to start with, Western Australia's removal of concessions for two companies would not have required any reclassification producing such a perverse effect.

However, even this observation misses the point to some extent. Had iron ore fines originally been classified in the high royalty rate category, Western Australia could presumably have gained more GST revenue than royalty revenue lost by reducing its iron ore fines royalty rates so that iron ores fines was shifted to the low royalty rate category.

That is the key point: given Western Australia's dominance in iron ore production, and, with Queensland and to a lesser extent New South Wales dominant in the case of black coal production, mineral production is concentrated in a small number of states. Any change to these states' royalty rates is likely to significantly affect mining revenue assessment outcomes, whether the assessment is structured as one, two or many categories.

With domination of the average comes an ability to influence the average, but influencing the average can be more subtle than that.

An example of even small states potentially influencing an average is the payroll tax assessment. In the payroll tax assessment, state payroll tax bases are assessed having regard to an average payroll tax-free threshold. Since all States have a payroll-tax free threshold, the CGC regards it as average policy. The result of including an average is that certain percentages of states' total compensation of employees – that proportion paid in firms that are below the average payroll tax threshold and that proportion of payroll tax liable firms' payrolls under the tax free threshold – are deducted from the states' assessed payroll tax base.

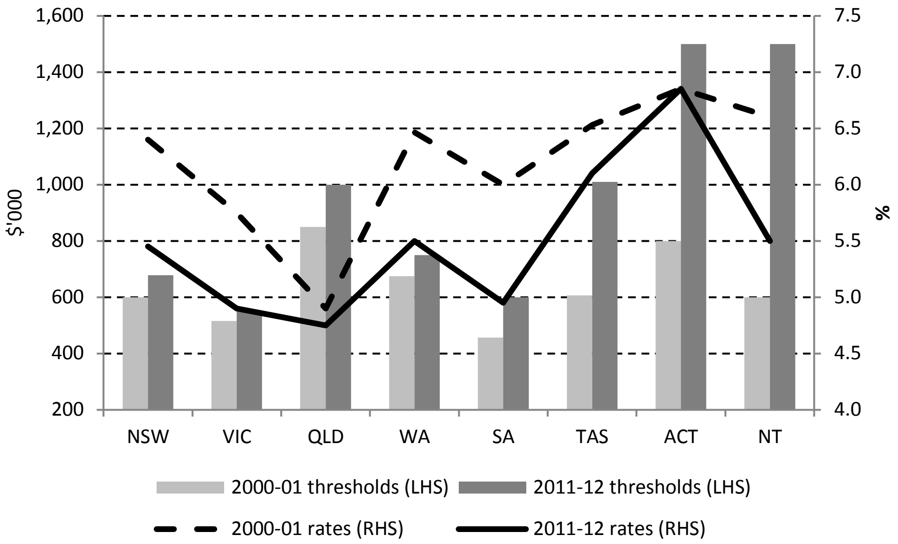
The average payroll tax-free threshold applied to all States is calculated as the weighted average of actual state tax-free thresholds, with the weights based on the total remuneration paid in each State. The percentage of a state's total remuneration above the average tax-free threshold is based on ABS advice.

The higher the average tax-free threshold, the lower the proportion of states' total compensation of employees that will be included in the assessed tax base. This proportion is not the same in all states, since smaller firms employ relatively more workers in some states compared to others.

Even for small states with relatively small shares of total Australian employee compensation, a change in a tax-free threshold of $250,000 would affect the average tax-free threshold by $2,500 to $7,000. Increasing the average threshold by this amount has the potential to reduce a state's assessed tax base by a degree sufficient to produce higher GST revenue, depending on the relative effects on states' taxable proportions of payrolls.

Given the relative effect of an increase in the average threshold on small states' taxable proportions of payrolls is likely to be higher than for large States, small states might have an incentive to pursue payroll tax reductions through increases in their tax free thresholds rather than cuts to payroll tax rates, which would have a much smaller impact on GST payments.

Chart 1: Payroll tax rates and tax-free thresholds, 2000-01 and 2011-12



Sources: NSW Treasury, *Interstate Comparison of Taxes 2000-01* (TRP00-3, December 2000), p. 9, and *Interstate Comparison of Taxes 2011-12* (TRP11-01, November 2011), p. 11. In 2000-01 Western Australia used a multiple marginal rate system for payroll tax – the representative rate shown is the simple average of the marginal rates; in 2001-12, Western Australia used a single marginal rate.

Chart 1 shows that the smaller states generally have higher payroll tax rates and higher payroll tax-free thresholds than the larger states, and that the smaller states have generally increased these thresholds by much more than the larger States since 2000-01.

This could simply reflect the greater significance of smaller employers in the smaller states; in the 2010 Review an average threshold of $720,000 in 2008-09 produced taxable proportions of private sector payrolls of between 62.40 and 65.64 per cent in the three smallest jurisdictions, compared to over 69 per cent in New South Wales and Victoria.[21]

However, this pattern is also understandable in light of the potential incentives provided by the CGC's payroll tax assessment. Queensland is an exception in having a tax-free threshold closer to the three smallest jurisdictions and a lower tax rate than the larger States; however, smaller employers are relatively more important in Queensland than in the other large States – its taxable proportion of private sector compensation was 64.58 per cent in 2008-09 – and it uses a deduction system for payroll taxation, under which the tax free threshold is gradually clawed back for payrolls in excess of $1 million (in 2011-12), with no deduction for payrolls of $5 million or more. The Northern Territory also introduced a deduction system in 2011-12.

A 2004 academic study concluded that '… [t]he CGC's present procedures discourage States from adopting efficiency enhancing pay-roll tax designs that are free of thresholds.'[22] The CGC's

21 CGC, *2010 Review*, Vol. 2, p. 81.

22 Peter B Dixon, Mark R Picton and Maureen T Rimmer, 'Payroll Taxes: Thresholds, Firm Sizes, Dead-Weight Losses and Commonwealth Grants Commission Funding', *The Economic Record*, Vol. 80, No. 250, September 2004, p. 301.

present procedures may be encouraging small States in particular to increase their tax free thresholds, rather than reduce tax rates, when contemplating payroll tax reductions.

An EPC distribution of GST would circumvent the need for detailed revenue assessments for revenues where a small number of States dominate the assessment and for revenues where States may be able to influence the assessment averages in more subtle ways.

The Panel's view on mining related infrastructure

The Panel recognises the importance of States having the capacity to provide infrastructure to enable development of mineral resources.

While the current system includes an assessment of infrastructure costs, this primarily recognises the relative growth of each State's total population. This assessment of infrastructure costs does not therefore directly account for the costs borne by States for mining related infrastructure, particularly when it is not recorded in the General Government sector.

The Panel is inclined to the view that changes to the current arrangements are required to ensure that all mining related infrastructure is appropriately recognised. The Panel therefore seeks more detailed information from the States on these costs and ways an alternative or improved assessment might be implemented.

This is a methodological issue.

As noted previously, New South Wales does not support the CGC's current capital assessment. However, according to the CGC:

- the investment assessment and the assessment of depreciation expenses include transactions relating to the use, ownership and acquisition of infrastructure owned by State general government sectors[23]
- while relative State population growth plays an important role in the investment assessment, other 'key drivers of the need for investment in new infrastructure' are also taken into account. The CGC's assessments are:

  > …based on the view that each State needs the average stock of infrastructure per capita, adjusted for its infrastructure stock disabilities, to deliver the average per capita services. Those disabilities recognise differences between the States in the quantity of infrastructure required to provide average services and the unit cost of providing that infrastructure[24]

- the current investment assessment '… assesses State infrastructure needs up front when State circumstances change and new assets are acquired instead of providing States with the capacity to fund their infrastructure over time…'.[25] The CGC, supported by Queensland, Western Australia and the Northern Territory argued this was a key advantage of the direct

[23] *2010 Review*, Vol. 2, p. 432.

[24] *2010 Review*, Vol. 1, pp. 57 and 59.

[25] *2010 Review*, Vol. 1, p. 59.

approach to the investment assessment over the holding cost approach favoured by the other States

- more broadly, Queensland, Western Australia and the Northern Territory argued strongly in the 2010 Review that '… past capital assessments did not adequately address State infrastructure needs resulting from changing State circumstances and population growth' and strongly supported the CGC's alternative approach.[26] , Queensland, Western Australia and the Northern Territory have been the beneficiaries of the new capital assessments introduced in the 2010 Review, by an estimated $1.6 billion, $1.2 billion and $318 million respectively in the three years to 2012-13.

In relation to the current investment assessment not accounting for mining-related infrastructure costs, particularly when the costs are not recorded in the general government sector, the direct spending of, and revenue raised by, State PTEs are excluded from all CGC assessments. PTEs operate with a broadly commercial orientation and user charges represent a significant proportion of their revenue.

These methodological arguments are a striking example of the drawbacks of the current HFE arrangements.

The Panel's view on non-infrastructure mining related expenditure

From the information presently available, the Panel believes that non-infrastructure mining related expenditure is not fully accounted for in the current system of fiscal equalisation. The Panel notes the practical difficulties in equalising other mining related expenditure, but seeks further input from States on ways to recognise the costs incurred in pursuing mining activity.

This is methodological issue. The Review Panel suggests the services to industry category in the current equalisation system '… could potentially include an assessment of at least some of the issues resource rich States claim they face'.[27]

The services to industry category includes expenses on the regulation and support of businesses and industries and some associated labour force and other expenses. The CGC estimates that in the three years to 2012-13 the services to industry category has redistributed, compared to EPC, a total of over $500 million, generally from the three most populous States to the other States (see Table 2).

[26] *2010 Review*, Vol. 1, p. 55.

[27] *Interim Report*, March 2012, p. 101.

Table 2: Services to industry category contribution to difference between equalisation and equal per capita distribution of GST

	NSW	Vic	QLD	WA	SA	TAS	ACT	NT	TOTAL
	$m	$m	$m	$m	$m	$m	$m	$m	$m
2010-11	-63.1	-63.3	-5.2	52.9	30.7	22	-1.1	27	132.7
2011-12	-126.2	-54.9	-13.6	96.6	39.4	29.9	0.1	28.6	194.7
2012-13	-100.1	-64.4	-16.1	60.4	48.1	37.1	2.3	32.6	180.6
Total	-289.4	-182.6	-34.9	209.9	118.2	89.0	1.4	88.2	508.0

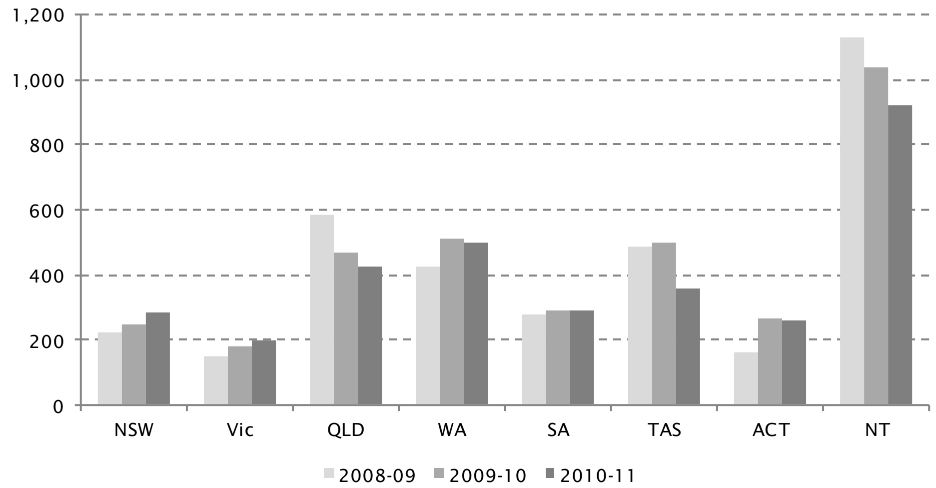
Sources: CGC, cgc.gov.au/publications/data downloads accompanying 2011 and 2012 Updates, $ million – Analysis of Relativities – Difference from EPC, Table S4-2, expense; *2010 Review Report*, Vol. 3, Table 4-3, p.44.

Chart 2 shows that State spending per capita in this category varies significantly between States, from under $200 a year in Victoria to close to or over $1,000 a year in the Northern Territory.

Western Australia argues that 'as a young, developing economy with much of its natural resource endowment untapped, it needed to invest to promote development of its endowment … [A]ssessing State capacities to raise revenue without recognising the needs associated with expenses incurred in promoting and supporting the underlying economic activity was inappropriate and asymmetrical.'[28]

However, economic development spending can take many forms; the amount of spending varies greatly from State to State, possibly reflecting the inclusion of different forms of spending but also likely due to significantly varying policies between States. The underlying drivers of policy are arguable: does the existence of large natural resource deposits indicate a need to spend relatively more on their development, or does the lack of natural resources indicate a need to spend relatively more in the attempt to find some, or to spend relatively more developing industries other than mining?

Chart 2: Estimated State spending per capita on services to industry, 2008-09 to 2010-11, $ per capita



Source: CGC, cgc,gov.au/publications/2012 Update/data downloads/The Adjusted Budget – operating expenses

28 CGC, *2010 Review*, Vol. 2, p. 400.

If the Review Panel is considering making recommendations about particular assessments in the current HFE arrangements it should do so only on the basis of an objective and considered review of all assessments, rather than on State views on particular assessments. A thorough appraisal of the entire system also would give the Panel a broader view of the problems associated with many of the current assessments, and a better indication of the need for an overall system that is simpler, more transparent, based on more objective criteria and less influenced by subjective judgement.

The Panel's view on changes to mining outside the current system

While the Panel recognises the superficial appeal of taking mining outside the current system, such an approach would merely transfer concerns to another process.

If direct methods of measuring the needs cannot be found, the Panel sees some potential in the temporary use of part of the GST pool to address established, but unmeasured needs for mining related infrastructure and expenditure.

New South Wales considers the temporary use of part of the GST pool to address 'established, but unmeasured needs for mining related infrastructure and expenditure' would worsen the existing HFE system rather than improve it.

Using a part of the GST pool to address 'established' but unmeasured needs for mining related infrastructure and expenditure would add an additional layer of subjective judgement to arrangements that already are overburdened with judgements. States 'needs' for mining related infrastructure and expenditure have by no means been 'established'; if the 'needs' do exist it is by no means clear that they are not being met through the existing capital and services to industry assessments; if they are 'unmeasured', and perhaps unmeasurable, it is by no means clear what 'part' of the GST pool should be set aside to address them.

Criticisms of the current HFE arrangements go well beyond the 'fairness' of the redistribution from the mining revenue assessment. Nevertheless, it is true that the mining revenue assessment currently is redistributing significant amounts of GST revenue. Though the amount of the redistribution from the mining revenue assessment is indirectly influenced by the importance (or weight) of mining revenue in State budgets, that is not the yardstick against which the 'fairness' of the redistribution should be judged.

The mining assessment currently is redistributing significant amounts of GST revenue simply because the location of mineral deposits, and hence the benefits of mineral royalty revenues, are concentrated disproportionately in States with middle-sized populations. Table 3 shows the mining revenue assessment for 2010-11 from the 2012 Update.

- Western Australia accounted for 10.3 per cent of Australia's population in 2010-11, but accounted for 54.4 per cent of actual mining revenue and 52.1 per cent of assessed revenue.

- Queensland accounted for 20.2 per cent of Australia's population, but accounted for 28.2 per cent of actual mining revenue and 28.5 per cent of assessed revenue.
- The other States combined accounted for 69.6 per cent of Australia's population, but only 17.4 per cent and 19.3 per cent of actual and assessed mining revenue respectively.

Table 3: Mining revenue assessment, 2010-11

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	TOTAL
Actual revenue, $m	1,240.3	56.4	2,698.3	5,203.4	154.9	49.0	0.0	158.6	9,561.0
Assessed revenue, $m	1,316.3	55.5	2,727.4	4,985.7	294.2	58.6	0.0	123.3	9,561.0
Population	7,261.1	5,579.6	4,540.7	2,314.1	1,649.9	509.0	362.0	229.4	22,445.8
Assessed revenue per capita, $	181.28	9.94	600.66	2,154.46	178.34	115.12	0.00	537.48	425.96
Assessed difference per capita, $	244.68	416.02	-174.70	-1,728.50	247.62	310.84	425.96	-111.52	0.00
Assessed difference, $m	1,776.7	2,321.2	-793.2	-4,000.0	408.6	158.2	154.2	-25.6	4,818.8

Sources: CGC, cgc.gov.au/publications/2012 Update/data downloads/The Assessed Budget/Mining Revenue, and data downloads/Population Data Supporting the Assessments.

That produces very large differences in assessed revenues per capita: $2,154 per capita for Western Australia, $601 for Queensland and a weighted average of $120 for the rest of Australia, against total Australian average per capita revenue of $426 per capita. Those large differences against the Australian average drive the extent of the redistribution, which totaled $4.8 billion in the 2010-11 assessment year.[29]

However, if New South Wales and Victoria (ie, the large population states) had been the States gaining the large amounts of mining royalty revenue in 2010-11, the GST redistribution arising from the mining revenue assessment would have been less than half that calculated by the CGC for 2010-11 in the 2012 Update.

If a part of the GST pool is temporarily put aside to address the 'unfairness' of the mining assessment redistribution, it would be difficult to wind back the arrangement when circumstances change.

There is a further difficulty with any approach which seeks to change the mining revenue assessment to make it 'fairer', connected to the lag with which changes in State circumstances feed into the current HFE arrangements.

- In 2010-11 the application of the GST relativities that were calculated on the 2006-07, 2007-08 and 2008-09 assessment years resulted in a GST redistribution on account of the mining revenue assessment of $3.1 billion, $2.1 billion of which came from Western Australia.[30]
- However, when the GST distribution that would have been necessary to achieve fiscal equalisation in 2010-11 was calculated for the 2012 Update, it was found that the mining

[29] This data relates to the 2010-11 assessment year, which was averaged in the 2012 Update with data from 2008-09 and 2009-10 to produce relativities for application in 2012-13. The GST redistribution applied in 2010-11 (based on data from the 2006-07, 2007-08 and 2008-09 assessment years) is estimated to have redistributed GST of $3.1 billion on account of the mining revenue assessment, rather than $4.8 billion.

[30] CGC, *2010 Review*, Vol. 3, Table 4-1, p. 43.

assessment should have redistributed $4.8 billion, $4.0 billion of which should have come from Western Australia.

This lag in the individual assessments carries through into the overall relativities. The relativity applied to Western Australia in 2010-11 was 0.68298; the relativity calculated for 2010-11 in the 2012 Update was 0.29564. The total GST redistribution (compared to a population share) away from Western Australia in 2010-11 was $1.5 billion; based on the GST Western Australia was assessed in the 2012 Update to need in 2010-11 to achieve fiscal equalisation, the redistribution away from Western Australia should have been $3.3 billion.

If all that eventuates from this Review is some adjustments to assessments to meet Western Australia's concerns that the mining assessment is unfair, then Western Australia will have benefited in the upswing and potentially avoided any losses on the downswing when the resources boom has peaked. Other States will be left to face the full GST consequences of booms and busts in other revenue sources, such as conveyances (property transfer) duty, in the future.

The Panel's view on making the mining redistribution more contemporary

As explained in Chapter 2, the Panel does not favour increasing contemporaneity at the expense of creating further unpredictability and instability of State GST shares. Moreover, the Panel has concerns about applying this approach to mining only.

In the present circumstances, greater contemporaneity would be likely to exacerbate the concerns of the revenue-rich States about the fairness of current arrangements.

The Panel's view on discounting or assessing only a proportion of the growth in mining revenue

The Panel considers that discounting the mining revenue assessment, or excluding some of the mining revenue and/or mining revenue base, could potentially address some of the concerns about unmeasured needs in relation to mining related infrastructure and other mining related expenditure. This approach could also be seen as addressing efficiency concerns, and has the potential to reduce the current policy neutrality issue. This approach could be scaled if the discount is not fixed, but can be adjusted to reflect changing circumstances. The Panel seeks views on how a discount rate could be determined and how and under what circumstances it should be applied.

The Panel's view on temporarily loading the mining assessment

The Panel sees some merit in the temporary nature of such an arrangement, but recognises that there are practical issues with the approach, including determining an appropriate trigger and ensuring the mining revenue is used to develop the mining industry. Further, with this type of approach the rationale for having the mechanism could become lost over time, or be challenged or overturned in the course of a CGC review of methodology.

All these approaches are methodological in nature, and suggest 'special' treatment for one particular revenue assessment.

Within the context of the current HFE system the mining revenue assessment should not be regarded as 'special'.

- The assessment redistributes a lot of revenue, but only because the distribution of mining resources among the States, and the associated mining revenue, also are distributed unevenly, with the majority of revenue in States with middle-sized populations.
- The mining revenue assessment has typically redistributed the most revenue of all the individual assessments. However, the transfer (conveyance) duty revenue assessment in the past has also redistributed a lot of revenue, close to or over $1 billion from 2005-06 (2005 Update) to 2010-11 (2010 Review).
- The mining revenue assessment attracts attention because of the amount of revenue it redistributes, but the underlying effects it may have on efficiency are probably little different in a qualitative sense than many of the other assessments.

New South Wales considers that providing special treatment for one particular assessment would not resolve the many problems associated with the current HFE arrangements. In some ways it would make the current arrangements worse, by adding to the subjectivity inherent in them.

Judgement would be needed in deciding when to apply the special conditions. Judgement would be needed in deciding when any other assessments might need special treatment based on the amounts of GST revenue they are redistributing.

New South Wales considers the current circumstances of the mining assessment merely illustrate more starkly the general problems associated with the current HFE arrangements. If it is considered that this issues need to be 'fixed', we consider they should be fixed in a general sense, rather than in this assessment alone.

The Panel's view on the CGC recognising costs associated with mining

While this approach would be consistent with the current HFE system, the Panel recognises the practical limitations the CGC faces in attempting to measure and equalise for these needs. For this approach to be viable, more detailed information from the States on what these costs are and how an alternative assessment might be implemented is required.

In particular, the Panel seeks further advice from States on:

- *the disability that is being recognised*
- *the costs faced by States because of the disability, and*
- *whether a policy neutral assessment method could be devised.*

New South Wales has commented on this general issue in relation to the Panel's previous observations on mining related infrastructure and non-infrastructure mining related expenditure.

Recognition of the costs associated with mining in the current assessments used to distribute GST revenue among the States is a methodological issue. New South Wales sees no reason why the costs of mining related infrastructure would not be adequately covered in the current investment assessment and the inclusion of depreciation expenses in the expenses assessments. We see no reason why the costs on non-infrastructure mining expenses would not be covered in the services to industry assessment.

Adapting particular assessments to the 'unique' circumstances of particular States is part of the problem of the current HFE arrangements rather than the solution. Recent efforts have been directed toward making the assessments simpler and more transparent.

The attempt to take into account States' 'unique' circumstances to achieve a detailed and full equalisation makes the GST distribution more complicated and subjective than it needs to be. That reduces the adaptability of the process to changing circumstances and reduces confidence in the system as a whole.

The pressure for detail does not necessarily produce accuracy in the assessments. Often the pursuit of detail produces a need for judgement or dependence on data of questionable quality. In the end the overall result can only ever be an approximation. Reviews over the years often have significantly changed the outcomes of HFE, with each thought to be appropriate at the time.

If the Review Panel is considering making recommendations about particular assessments in the current HFE arrangements it should do so only on the basis of an objective and considered review of all assessments, rather than on State views on particular assessments. A thorough appraisal of the entire system also would give the Panel a broader view of the problems associated with many of the current assessments, and a better indication of the need for an overall system that is simpler, more transparent, based on more objective criteria and less influenced by subjective judgement.

The Panel's overview on HFE and the mining boom

The Panel is not inclined to recommend excluding mining revenue from equalisation because, as explained in Chapters 2 and 5, in principle, all sources of recurrent general purpose revenue should be considered when gauging the impact on State Budgets of GST payments.

While it seems clear that all States accept that the benefits of mining should be shared, the extent to which this currently occurs, and how it is done, needs to be reconsidered. Specifically, the Panel is inclined to the view that not all mining related infrastructure, mining expenses and economic development costs are appropriately recognised in current arrangements. As the degree and effect of this omission is open to debate, the Panel has identified more detailed information that could be provided by States on these costs and ways an alternative assessment might be implemented.

Should it not prove possible to adequately recognise the costs faced by resource - rich States within the current system, the Panel would be inclined to further investigate other possible approaches in this Chapter that might indirectly achieve that aim.

The Panel also notes that some approaches considered in other Chapters relating to other objectives may also address issues relating to the mining assessment.

New South Wales can understand the problems the current mining revenue assessment is causing for Western Australia, in relation to the volatility of its GST payments outcomes.

New South Wales faced this issue in the 2000s, when the transfer (conveyances) duty assessment reduced NSW GST revenue payments substantially below what they otherwise would have been. Moreover, given the lags in the GST distribution process, the reductions in NSW GST revenue payments hit precisely at the time the property market boom subsided, providing GST payments reductions due to declining GST relativities at the same time transfer duty revenue was declining.

The mining revenue assessment attracts attention because it redistributes large amounts of revenue. This is inevitable in a resources boom given the concentration of mineral resources, and related State mineral royalty revenues, in two States with mid-sized populations. With the geographic concentration of mineral resources in some States, it also is inevitable that those

States' royalty policies will have a large influence on any mining revenue assessment based on 'average' policies.

However the mining revenue assessment, in the context of the current HFE arrangements, should not be considered 'special' or deserving of any special arrangements. In general, the more mining royalty revenue a State is assessed to be capable of raising based on 'average' policies, the less GST revenue it will need to have the 'average' fiscal capacity. In this sense, there is nothing 'unfair' about the current arrangements.

Altering assessments to ameliorate the current large revenue impacts of the resources boom would be more 'unfair'. It would produce a more subjective and less transparent GST distribution arrangement rather than simpler arrangements. It would produce an arrangement less adaptable to changing circumstances, in the sense that any 'temporary' arrangements would have to be unwound when circumstances change.

New South Wales urges the Review Panel not to make recommendations for changing some assessments based solely on the views of some States. In the Terms of Reference for the Review, the Australia Government provided guidance that the Review was 'not intended … [to] … consider detailed methodological and data issues...'[31] New South Wales believes this guidance serves a sound purpose in freeing the Review to look more at the fundamental issues of what Australia is seeking to achieve by fiscal equalisation and whether the current arrangements are the best way to achieve it rather than becoming bogged down in the ongoing disagreements between States on methodological issues.

Recommendations for changes to assessments should be based on a thorough appraisal of the entire distribution system. That also would give the Panel a broader view of the problems associated with many of the current assessments, and a better indication of the need for an overall system that is simpler, more transparent, based on more objective criteria and less influenced by subjective judgement.

[31] GST Distribution Review Terms of Reference, clause 6.e.

HFE and the costs of services to the Indigenous population

> ***The Panel's view on Indigeneity and HFE***
>
> *While the Panel recognises Western Australia's interest in a more comprehensive assessment of Indigenous costs and cost weights, to do this would increase complexity, could lead to further claims of false precision and, if additional costs were found, would actually increase the amount redistributed because of Indigeneity. The CGC would be the appropriate body to determine the merits of these arguments.*
>
> *The Panel also encourages the CGC to explore whether assessments could be developed to more directly measure needs due to disabilities than the category of spending approach currently adopted.*
>
> *The Panel believes that Indigeneity (and, indeed, the Territories) should continue to remain in the HFE system, noting that the Terms of Reference state that GST revenue will continue to be distributed to the States as untied payments.*
>
> *The Panel considers that where additional measures to address disadvantage are required, these measures would best be undertaken outside the HFE system through other mechanisms.*

The current HFE system is not directed towards addressing Indigenous disadvantage. While indigenous disabilities are used in assessing GST relativities, GST revenue is untied and can be used for any state purpose. There is no requirement on states to use GST funds for any particular purpose.

New South Wales considers that the need to achieve rapid, effective and sustainable progress in addressing indigenous disadvantage is paramount and that consistent, focused funding is required. The Commonwealth has clear responsibility for addressing indigenous disadvantage and should do so directly and in the most effective and efficient manner possible.

The Indigeneity disability factor should be removed from the HFE system and funding to address indigenous disadvantage should be achieved via Commonwealth payments, subject to full consultation between governments and indigenous communities.

Governance and communication

> ***The Panel's view on improved governance***
>
> *The Panel sees merit in separating responsibility for determining the objectives of the GST distribution and the definition of HFE from the responsibility for interpreting and implementing HFE. The Panel also sees merit in subjecting HFE outcomes to independent review from time to time.*
>
> *Different reform options will have different governance implications, and these will be considered in more detail in the final report.*

New South Wales agrees with the need to improve the governance structure around the assessment process.

In its 2010 Review, the CGC states:

> In the absence of an objective basis for sub-dividing PTEs, we have continued to set the scope of equalisation using the definition of general government activities applied by the ABS in its Government Finance Statistics. However, we understand the ABS is reviewing its definitions of the general government sector and PTEs. It may be necessary to review the scope of equalisation in the light of the outcome of that work.[32]
>
> Equalisation does not attempt to equalise the capacity of States to provide services to a standard required to achieve an external policy objective — for example, reducing hospital waiting lists or increasing literacy and numeracy levels. Such an approach would require judgments about matters that are the province of Government. Governments have not asked us to do that.[33]
>
> Equalisation is not intended to provide States with the capacity to implement policies they do not, on average, already follow.[34]

These quotations highlight a fundamental problem with the current system, namely that, in the absence of government directives, the CGC devises its own definitions, standards and equalisation objectives.

In doing so, it often relies on ‘external’ sources and mechanical principles – the classification system used by the ABS and the ‘average’ practice of the states – in order to answer basic questions about what to equalise and what standards to set. This is far from ideal. The ABS classification system was not designed to satisfy equalisation objectives.

The limited role played by the States is a critical issue in the current HFE system. An increased role for the States, possibly through the Standing Council for Federal Financial Relations, would be consistent with an improved model of federalism in Australia.

The Commonwealth controls the relevant legislation, appoints the Commissioners, frames the terms of reference for CGC reviews and makes the final determination of the GST distribution.

States’ input into the terms of reference for CGC inquiries is limited and controlled by the Commonwealth. The terms of reference do not provide adequate direction to the CGC on what they should do. Consultations with the CGC during the course of its methodology reviews are effectively restricted to data and methodological issues and, by the time the Treasurer consults with the States on the recommended relativities, it is too late for meaningful change.

This marginalization of effective State involvement in the system weakens State ‘ownership’ and support.

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[32] CGC, *2010 Review*, Vol. 1, p. 32.

[33] CGC, *2010 Review*, Vol. 1, p. 36.

[34] CGC, *2010 Review*, Vol. 1, p. 36.

The lack of direction given to the CGC by governments has meant the CGC is the chief architect and de facto custodian of the HFE framework. It determines the definition of HFE, oversees the implementation of processes for the calculation of GST relativities based on principles and models of its own choosing, and makes decisions that materially affect equalisation outcomes, often justification based on limited evidence.

Governments – especially State governments – should have the clear responsibility to determine the objectives of HFE, to ensure that the system is actually meeting the objectives laid down for it and, where this is not the case, to determine what action is required.

More specifically, a strengthened governance system should be designed to:

- ensure greater and more effective input by State governments into the formulation of the objectives of the HFE system and its relationship to other aspects of the system of federal financial relations
- provide independent periodic reviews of CGC processes and models to assess whether the methodologies meet appropriate standards.

The Panel's view on improving communication

The Panel does not believe that changes in the method of presenting or explaining GST shares could be a substitute for meaningful reform.

However, a more transparent presentation of outcomes (whether by expressing outcomes in dollars, ensuring that relativities relate to the appropriate pool size, or making clearer distinctions between numbers used by various levels of government) would be good for public confidence in the system. Alternative presentations could enable debate to focus more directly on any underlying concerns with the GST distribution system.

As noted in Chapter 2, the Panel also considers that if the CGC were to include in its New Issues paper as accurate an estimate as possible of the effect on States' GST payments of possible Commission decisions, it may help reduce uncertainty and increase predictability of outcomes. In addition, there could be considerable benefit in the CGC engaging with State governments more broadly, especially in key areas such as health and education.

New South Wales agrees that the presentation of equalisation outcomes could be improved considerably and that this would assist understanding and analysis. In particular, New South Wales considers that major gains could be achieved by shifting the focus of the CGC's reports away from the mechanics and theory of equalisation and the arguments put forward by the states in the course of reviews, towards providing more informative discussion on the evolution of state disabilities and the drivers of these disabilities.

Drawing ideas together

The Panel's view on the direction of future work

As the suite of issues being considered is large and many of the issues are extraordinarily complex, in this interim report the Panel has outlined its present thinking, informed by consultations and submissions to date.

The Panel welcomes reactions to the contents of this interim report, noting that its work in respect of incentives for tax reform is still to come. In particular, the Panel welcomes submissions on which proposals highlighted in this Chapter have most merit, taking into account the Panel's Terms of Reference.

To ensure that the Panel is fully informed before making its final recommendations, the Panel has called for more information on a range of other proposals identified throughout the report that seem attractive, but are, at this stage, somewhat underdeveloped. In particular, the Panel seeks information with respect to:

- *mining costs and alternative approaches to the mining assessment*
- *the treatment of Commonwealth payments for infrastructure (including how to determine which are nationally significant projects)*
- *a range of simplification ideas including ways to overcome perceived difficulties with global indicators and processes for selecting appropriate broader indicators, and*
- *adopting a standard other than the average of 'what States collectively do'.*

These issues have been addressed throughout this submission.

Does HFE provide a disincentive to State tax reform?

The Panel's view on the effect of the current HFE system on tax reform

Under current arrangements, any change by a given State to the design of its taxes or to the tax mix used to raise a set amount of revenue is likely to produce changes in GST shares. Major multilateral changes — as could be expected during a tax reform exercise — are almost certain to produce significant shifts in GST shares. Simply put, for any given tax reform, the present system will result in 'winners' and 'losers' and so could be thought of as creating incentives and disincentives.

Some States argue that the present HFE system actually removes disincentives for tax reform by offsetting differences in State revenue raising capacity, but others disagree.

While there is no hard evidence to prove whether GST share effects influence State tax decisions, the Panel doubts that these effects are the deciding factor. Nevertheless, we conclude that there is value in exploring alternatives that would allow any potential disincentives from the current system to be minimised.

New South Wales discussed the effect of the current HFE system on tax reform in its initial submission to the Review. It concluded that the current form of HFE produces disincentives for:

- unilateral state abolition of inefficient taxes
- action by a state to alter its tax mix
- joint state tax reform, including adherence to agreed implementation timetables.

The current practice of the CGC of making separate assessments for component tax categories (payroll tax, land tax, conveyance duty, insurance taxes, motor vehicle taxes, mining taxes and other revenues) is a key source of these disincentive effects, because states gain a higher GST share by favouring the use of taxes for which they have the lowest assessed 'capacity' to raise revenue.

In its second submission to the Review, New South Wales drew attention to the fact that the CGC's use of statutory tax bases as the key indicator of states' relative revenue raising capacities lacks robust conceptual underpinnings because:

- state policies, including the tax rate applied, may affect the value of the tax base
- the economic incidence of the tax is ignored, but these 'incident tax bases' may have a very different interstate distribution from the statutory tax bases
- the capacity to pay of the economic agents on which the tax burden falls is ignored.

A further example of the impact of the current approach is provided below. This is based on the assessment of insurance taxes for the year 2010-11 provided as a case study in the Review's Second Interim Report. Table 2.6 of that report reproduces the CGC's calculations, which show that NSW is the only state to have an above average revenue raising capacity for insurance taxes. As a result, $113 million of GST revenue is redistributed away from NSW to the other states.

According to the AFTS report, insurance taxes are highly inefficient, with a marginal excess burden (deadweight loss) for each additional dollar of revenue raised of 67 cents. As the Panel illustrates in Figure 1.3 of its Second Interim Report[35], this deadweight loss arises because the application of the tax causes the tax base to shrink (in responses to the higher price for the product after the tax is levied). The application of different tax rates by different states causes different amounts of shrinkage in their tax bases. Table 4, which is based on Table 2.6 of the AFTS Report, shows what happens to the insurance tax assessment when the tax base is adjusted to remove these policy-induced differences in state tax bases.

Table 4: Insurance tax assessment with policy-neutral tax base

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Actual revenue ($m)	918	912	546	468	371	49	45	33	3,342
Revenue base ($m)	10,456	6,783	5,706	2,978	2,146	517	426	255	29,267
Average tax (%)	8.78	13.45	9.57	15.72	17.29	9.48	10.56	12.94	11.42
Difference from Average (% pts)	-2.64	2.03	-1.85	4.30	5.87	-1.94	-0.86	1.52	0.00
Impact on revenue base ($m)(a)	-970	483	-371	450	443	-35	-13	14	0
Pol. Neutral Revenue Base ($m)	9,486	7,266	5,335	3,428	2,589	482	413	269	29,267
Assessed Revenue ($m)	1083	830	609	391	296	55	47	31	3342
Population (mill)	7.3	5.6	4.5	2.3	1.6	0.5	0.4	0.2	22.4
Assessed Revenue ($pc)	149.19	148.70	134.17	169.13	179.15	108.08	130.34	133.70	148.89
Revenue Capacity	1.00197	0.99873	0.90111	1.13593	1.20320	0.72590	0.87542	0.89798	1.00000
GST effect ($m)	-2	1	67	-47	-50	21	7	3	0
CGC Result ($m)	-113	56	25	5	1	17	5	5	0
Difference ($m)	111	-55	42	-52	-51	4	2	-2	0

(a) Based on the AFTS estimate of marginal excess burden of 0.67.

The current insurance duty assessment leads to a redistribution of $113 million away from New South Wales.

However, NSW tax rate is significantly less than the average, which, ceteris paribus, leads to a larger tax base. The fourth line in the table shows that the NSW tax rate is 2.64 percentage points below the average rate applied by all the states. Tasmania, Queensland and the ACT also apply below-average rates.

Adjusting the tax base for the impact of the below average tax rate in New South Wales leads to a reduction in the NSW tax base of $970 million. The lower tax base leads to a much lower redistribution. After adjusting to allow for the policy-induced effect of the tax rate on the tax

[35] *Second Interim Report*, p. 6.

base, the revised assessment shows that only $2 million of GST revenue should be redistributed away from NSW. This is $111 million more in GST revenue than assessed by the CGC.

If New South Wales were to unilaterally abolish insurance taxes, its capacity to raise revenue from these taxes would continue to be assessed by the CGC. According to the AFTS, the average excess burden of insurance taxes is 47 cents for each dollar of revenue raised. This means that the abolition of insurance taxes by New South Wales would lead to a doubling in the size of its tax base over time. The effect of this on NSW assessed GST revenue is shown in Table 5.

Table 5: Insurance tax assessment with insurance taxes abolished in New South Wales

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Revenue after abolition ($m)	0	912	546	468	371	49	45	33	2424
Adjusted Revenue Base ($m)(a)	18,404	6,783	5,706	2,978	2,146	517	426	255	37,215
Tax Rate (%)	0.00	13.45	9.57	15.72	17.29	9.48	10.56	12.94	6.51
Assessed Revenue ($m)	1199	442	372	194	140	34	28	17	2424
Population (mill)	7.3	5.6	4.5	2.3	1.6	0.5	0.4	0.2	22.4
Assessed Revenue ($pc)	165.09	79.18	81.85	83.82	84.72	66.16	76.65	72.39	107.99
Revenue Capacity	1.52870	0.73323	0.75794	0.77618	0.78448	0.61266	0.70980	0.67035	1.00000
GST effect ($m)	-415	161	119	56	38	21	11	8	0
CGC Result ($m)	-113	56	25	5	1	17	5	5	0
Difference ($m)	-302	105	94	51	37	4	6	3	0

(a) Based on the AFTS estimate of average tax burden of 0.47.

The net effect would be to redistribute a further $302 million away from New South Wales to other states. This is a considerable disincentive to tax reform.

The CGC recognises that these ‘elasticity’ effects should be taken into account in its tax assessments, but has not done so because it regards the data necessary for the calculations to be unreliable. The result in the case of insurance taxes, however, is to produce an equalisation outcome that is further away from its ideal than an EPC assessment would be.

New South Wales considers that the disincentive effects of HFE can only realistically be removed by the adoption of a new approach that does not rely on category-by-category assessments. In the absence of fundamental reform to the HFE system, tax reform will create winners and losers, making agreement difficult in the absence of additional Commonwealth incentive funding.

State mineral royalties and the Commonwealth's resource tax reforms

The Panel's view on the design of resource taxation regimes

The Panel accepts the finding of the Australia's Future Tax System (AFTS) review that well-designed rent based taxes are likely to be more economically efficient than royalties applied on the basis of value or volume, particularly in periods of low commodity prices or high costs.

The Panel also agrees with the AFTS review's assessment and States' views that other factors, such as the size, variability and timing of the return received by government, as well as relative administration and compliance costs, are important considerations when evaluating any particular resource charging regime.

The Panel is mindful of the depth of concern amongst States regarding their historical role in charging for the right to mine under their soils. However, the Commonwealth has a similarly well-established position in the field of taxation. The challenge is therefore to find a way to reconcile these two competing interests.

The state receives its return on mining activity through the imposition of volume or values based royalties.

The Commonwealth did not negotiate with the states on the design of its MRRT and its interaction with state royalties. Having made state royalties fully deductible for the purposes of the MRRT, the Commonwealth is now concerned that states may raise their own royalty rates, thereby reducing the Commonwealth's expected revenue from its MRRT.

New South Wales agrees with the Panel's conclusion that a negotiated reform of mining taxes is required but insists that that can only be successful if the Commonwealth recognises that there are legitimate economic reasons for states to impose their own mining taxes.

New South Wales announced a supplementary royalty to be paid by NSW firms subject to the MRRT as compensation for the negative fiscal effects of the carbon tax on the NSW Budget. New South Wales remains prepared to negotiate with the Commonwealth over the increased royalties announced on NSW firms subject to the MRRT and alternative forms of compensation for the fiscal effects of the carbon tax.

The Panel's view on whether the interaction between the MRRT, PRRT and State royalties creates an incentive for States to increase royalties

The Commonwealth's decision to fully credit State royalties under the MRRT and PRRT has created an opportunity for States to seek to increase their revenue at the expense of the Commonwealth.

While States will no doubt continue to determine their royalty policies based on a range of considerations, one State has already expressly cited this incentive as the basis for its royalty increase.

As indicated in our second submission to the Review, this aspect of the design of these Commonwealth taxes is not consistent with the usual approach to shared tax bases between different levels of government. Efficient tax base sharing requires that the taxes applied by the different governments are independent and visible. This promotes government accountability and minimises the possibility for distortions arising from the interaction of the taxes.

New South Wales considers that the nexus between state royalties and Commonwealth revenue from the MRRT and PRRT needs to be considered further and stands ready to discuss this issue with the Commonwealth. New South Wales notes that it is only applying the supplementary royalty because it is not being compensated for the budget effects of the carbon tax.

The Panel's view on the unsustainability of the current interaction between the MRRT, PRRT and State royalties

The Panel accepts the States' position that the new incentive that exists for them to increase royalties is the product of the way in which the Commonwealth has designed its own resource tax reforms.

However, if it is unreasonable for the Commonwealth to expect the States to relinquish their discretion over royalty policy, it is equally unrealistic for the States to expect the Commonwealth to allow them to capture the revenue stream generated by the Commonwealth's undertaking of a significant and challenging reform. The current situation is not sustainable and needs to be resolved.

New South Wales considers that the resolution of the current situation lies primarily with the Commonwealth.

In our view, this situation has arisen because the Commonwealth did not engage in proper negotiations with the states prior to the design of the MRRT and PRRT. New South Wales believes that the situation could be resolved through a process of negotiations in good faith between the Commonwealth and the states.

The Panel's view on the Commonwealth penalising States for increasing Royalties

The Panel agrees with the States that it would not be desirable for the Commonwealth to adjust the GST distribution system to penalise States for increasing their royalties. Not only might this not achieve the Commonwealth's goals, the zero sum nature of the GST distribution system would result in a corresponding unintended reward for other States.

As pointed out earlier, while the Commonwealth continues to provide significant non-GST revenues to the States, there are other means at the Commonwealth's disposal to prevent States from eroding its resource rent tax revenue base. However, use of these means would be an unfortunate alternative to a cooperative solution.

New South Wales considers that any attempts by the Commonwealth to coerce the states to adopt limitations on their ability to raise revenue through the application of mining royalties would severely damage Commonwealth-state relations.

New South Wales accepts that the current situation needs to be resolved, and stands ready to enter into discussions with the Commonwealth aimed at achieving a satisfactory solution.

The Panel's view on revisiting the design of the MRRT and PRRT

The Panel considers that the Commonwealth unilaterally revisiting the design of the MRRT and PRRT is a fall-back position available to the Commonwealth in the event that it is unable to secure an agreement with the States. As the royalty allowance forms part of the MRRT and PRRT laws, any amendment would be subject to passage through the Commonwealth Parliament.

The Panel's view on the need for the Commonwealth and the States to reach an agreed outcome on resource taxation

The Panel's role is not to pass judgement on the evolution of the Commonwealth's resource tax reforms or the merits of individual States' royalty policy decisions. The Panel considers, though, that the current situation is both undesirable and ultimately unsustainable and strongly endorses the advice of the Australia's Future Tax System review and the Policy Transition Group that the risks and rewards of Australia's resource tax arrangements be the subject of a negotiated agreement between the Commonwealth and the States.

New South Wales agrees with the Panel's judgement that 'the current situation is both undesirable and ultimately unsustainable'. We also agree with that a negotiated agreement between the Commonwealth and the states should be sought. New South Wales stands ready to enter into any negotiations aimed at resolving the current situation in good faith.

The Panel's summary view on resource taxation within the Federation

The Commonwealth has designed the MRRT and the extension of the PRRT in a way that is intended to minimise the economic effects of State royalties, consistent with the AFTS review's findings that these royalties are relatively inefficient. However, this design has also provided the States with an opportunity to erode the MRRT and PRRT revenue base by increasing royalties.

The Panel considers that an agreement between the Commonwealth and the States on the taxation of resource projects would secure, and build upon, the benefits of the resource tax reforms already undertaken.

The Panel believes there are potential solutions which could benefit all parties. For example, a reduction in the rate of ad valorem royalties on iron ore, coal and petroleum, with greater use made of resource rent taxes to deliver a return to the community would:

- *secure the MRRT and PRRT revenue base, allowing the Commonwealth to return to the States the value of foregone royalty revenue*
- *produce a more efficient system overall, by reducing the distortions to production and investment decisions that can be caused by royalties*
- *be expected to deliver a tangible fiscal dividend over time.*

Any such fiscal dividend would be available to be shared between the two levels of government.

New South Wales considers that a negotiated settlement of the current situation is required. Coercion by the Commonwealth would not be in the national interest.

New South Wales believes that a negotiated solution that recognises the legitimate interests of all governments is possible and is willing to enter into such negotiations in good faith.

HFE and State tax reform

The Panel's view on pursuing State tax reform

The Panel sees merit in pursuing State tax reform as a means of advancing the national economy. Meaningful reform should place both the Commonwealth and States in a better position to deal with future challenges.

The Panel's view on promoting State tax reform

The Panel considers the optimal way to pursue State tax reform is on a multilateral basis — amongst the States and including the Commonwealth — to maximise the benefits of reforms. This multilateral, cooperative approach would allow any GST share effects to be identified and appropriately dealt with.

The Panel notes the work underway on State tax reform and encourages the Commonwealth to assist States in their deliberations.

New South Wales agrees. In its submission to the Australian Government's October 2011 Tax Forum, the NSW Government noted:

> Taxation reform is essential to the efficient functioning of the Australian economy and to increasing the overall welfare of Australians.
>
> Some tax reform can be achieved by states unilaterally. However, the nature of the Australian tax system and the linkages in Australian fiscal policy driven by vertical fiscal imbalance (VFI), means that cooperation of all levels of government is necessary to ensure the best outcomes for all Australians.
>
> …
>
> New South Wales believes discussions between the national, state and territory governments concerning detailed proposals for revenue-neutral tax reforms that improve the efficiency of the national tax system would be very worthwhile.
>
> New South Wales considers there is a strong case for improving the efficiency of state taxes, by reducing reliance on inefficient taxes and increasing reliance on efficient taxes. Modelling results indicate a cooperative scheme of tax reforms, involving both state and federal taxes, could increase GDP by more than 1.8 per cent over the long term. State taxes are significantly more inefficient than Commonwealth taxes. Transfer duty and the emergency services levy are particularly inefficient. However, moving to a more efficient tax system will require Commonwealth involvement as the Commonwealth has access to the larger and more efficient taxes.[36]

New South Wales notes the Review Panel's conclusions in relation to the efficiency of State taxes in its Second Interim Report.

First, the Review Panel acknowledges that some State taxes are less efficient than others.[37] Less efficient taxes tend to be high impact narrow-based taxes that impact on economic behaviour; more efficient taxes tend to be taxes levied on a broader base at a lower rate. In the State tax context, taxes on mobile tax bases also are less efficient than taxes on less mobile tax bases, since they can affect decisions on the location of economic activity.

Second, the Review Panel acknowledges that 'States have different assessed revenue raising capacities for each tax. Therefore if a State changes the mix of taxes it uses to raise revenue, there will be GST share effects.'[38]

This allows the possibility that GST share effects have the potential to impact on State tax policy choices and on the efficiency of the States' tax mix if States have an incentive, due to GST share effects, to favour less efficient over more efficient State taxes.

The Review Panel notes:

> While a significant reduction in its GST share might be thought to constitute as major disincentive for any State to embark on tax reform, in practice the story is much more complex than simply one

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[36] *NSW Government Submission to the 2011 Tax Forum*, www.futuretax.gov.au/TaxForum/Statements and Submissions/NSW Government, pp., 1, 9-10.

[37] *Second Interim Report*, p. 77.

[38] *Second Interim Report*, p. 79.

> in which States that would gain GST share are motivated to change and States that would lose GST share are dissuaded from acting.[39]

The Panel is right in suggesting that there are other influences on State tax policies than the impacts on GST shares. However, we have noted earlier the disincentive effects for New South Wales in relation to insurance duty where state tax rates have a significant influence on state tax bases. In this context, New South Wales' experience when it *did* attempt to reduce the impact of insurance taxation is also instructive.

In its 2002-03 Budget, the then NSW Government reduced the insurance duty rate from 10 per cent to 5 per cent from 1 August 2002. The impact for New South Wales was not only to lose own-source revenue from the reduction in the duty rate, but also to be assessed by the CGC to need even less GST revenue than previously on account of our above average capacity to raise insurance duty revenue. The reduction in the duty rate on a very elastic tax base increased New South Wales' assessed tax base – insurance premiums – to such an extent that New South Wales was assessed to need even less GST revenue on this account.

Table 6 shows the effect of New South Wales halving its insurance duty rate was to *nearly double* its loss of GST revenue in the insurance duty assessment. For the 2001-02 year, the CGC calculated New South Wales needed $19.08 less GST revenue per capita ($126 million in total) because of its above average capacity to raise insurance tax revenue. After halving its tax rate for most of the 2002-03 year, New South Wales was assessed to need $37.45 less GST revenue per capita ($249 million in total) in that year.

[39] *Second Interim Report*, p. 34.

Table 6: GST Assessment Impact of New South Wales Insurance Duty Reduction

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
2001-02									
Actual revenue, $m	487.1	503.6	281.4	202.8	169.9	24.6	24.0	16.0	1,709.3
Assessed revenue, $m	704.4	432.2	261.9	132.6	120.5	26.7	18.7	12.2	1,709.3
Assessed revenue, $ per capita	106.60	89.45	71.37	69.29	79.54	56.58	58.47	61.45	87.52
Assessed difference, $ per capita	-19.08	-1.92	16.16	18.24	7.98	30.94	29.05	26.07	0.00
GST needs, $ m	**-126.1**	**-9.3**	**59.3**	**34.9**	**12.1**	**14.6**	**9.3**	**5.2**	**135.3**
2002-03									
Actual revenue, $m	442.4	591.4	322.0	238.6	200.6	29.0	27.4	18.8	1,870.2
Assessed revenue, $m	879.8	417.6	256.2	141.1	120.6	23.5	21.2	10.2	1,870.2
Assessed revenue, $ per capita	132.11	85.49	68.18	72.89	79.18	49.51	65.63	51.54	94.66
Assessed difference, $ per capita	-37.45	9.17	26.48	21.77	15.48	45.15	29.03	43.12	0.00
GST needs, $ m	**-249.4**	**44.8**	**99.5**	**42.2**	**23.6**	**21.4**	**9.4**	**8.5**	**0.0**

Source: CGC, *2007 Update*, Relative Fiscal Capacities of the States, Table D-40, p. 241. Data from the 2007 Update was used because it was the last Update in which 2001-02 appeared as an assessment year, so data was most likely to have been 'final'.

Rather than abolishing or reducing insurance duty, New South Wales actually may have an incentive, other things being equal, to increase insurance duty rates, reduce its premium base and increase its GST needs.

The point is that, all other things equal, State tax policies potentially affect GST shares. Tables 3.1 and 3.2 of the Review Panel's Second Interim Report give an indication of the potential magnitude of those effects.[40]

The impacts on GST shares of tax reform can be significant. However, it is not only on the revenue side that the impacts of policy reform on the GST distribution are an issue for States. In national health reform and disability reform the impact of changed arrangements on the GST distribution have attracted attention.

The GST distribution should not be having such a noticeable impact on policy. New South Wales considers that having to consider the impact on the GST distribution of any meaningful policy changes can impede reform, or at least make it more difficult than it should be.

A more policy-neutral system of distributing GST revenue in Australia would make policy reform easier. An equal per capita GST distribution would mean major Commonwealth-State policy reform in taxation or service delivery could be pursued without having to consider the indirect impact on the GST distribution, in addition to the direct revenue and spending impacts on the different levels of government.

In this sense, the Commonwealth's provision of any equalisation assistance to the smaller States, in addition to an equal per capita share of GST revenue, would 'buy' a much smoother path to

[40] *Second Interim Report*, pp. 30-33.

national policy reform. The indirect impact on those payments to the smaller States of policy reform would still need to be considered if the payments continue to be distributed through a detailed and complex method like the current one. However, if the distribution system to the smaller States was simplified, even that could be avoided.

The Panel's view on providing incentives for State tax reform

When the States and the Commonwealth have agreed on the desired specifications and pace of reform, it may be necessary to provide incentives to ensure that the agreement is acted upon by all parties. There are various ways that the GST distribution or related mechanisms can be used to facilitate this process.

Measures that could be adopted include modifying the current revenue assessments, delaying GST payments until milestones are met, or using a small part of the GST or other Commonwealth funds intended for the States to make reward payments. To the extent that reform results in tangible fiscal benefits these should be shared.

New South Wales considers that the HFE arrangements for the distribution of GST revenue should be policy neutral, that is, they should neither discourage nor encourage any particular State policies.

In NSW Second Submission to the GST Distribution Review, we argued that utilising HFE to provide incentives and disincentives for particular State policy decisions would:

- impinge on States' sovereign rights
- contradict the 'untied' nature of GST payments
- undermine the policy neutrality of the HFE process and
- compromise the simplicity and transparency of the HFE process that the Review Panel has been asked to improve.[41]

The Review Panel notes: 'No State agreed that the GST distribution should be actively used to provide incentives or disincentives for State policy decisions.'[42]

After agreeing this view would be entirely valid if it related to 'a unilateral or imposed use of GST shares to force an external view of reform upon [the States]', the Review Panel argues that:

> … in an environment where the reform direction has been agreed between the Commonwealth and States, using the GST distribution to encourage States to pursue the chosen reform direction must surely be a benefit.[43]

The Panel also does not consider:

[41] New South Wales, *Second Submission to the GST Distribution Review*, March 2012, p. 9.

[42] *Second Interim Report*, p. 84.

[43] *Second Interim Report*, p. 85

- '… making some GST payments 'conditional' on certain actions, such as achieving an agreed reform milestone, would be equivalent to tying GST payments' or
- the 'equalisation' objective of the GST distribution rules out '… including other goals alongside HFE in the GST distribution, for example, facilitating tax reform.'[44]

New South Wales disagrees with any attempt to use the GST distribution to coerce states to undertake tax reform, even for the 'encouragement' of previously agreed reforms.

The underlying principle is States' sovereignty to pursue policies of their own choosing in areas for which they have responsibility, and to be ultimately responsible to their electorates for the policies they pursue.

This policy freedom is a basic principle of the 'untied' payments provided by the Commonwealth to the States to address the large degree of vertical fiscal imbalance in Australia. Signatories to the Intergovernmental Agreement on Federal Financial Relations – the Commonwealth and all State and Territory Governments – agreed that GST payments will be 'freely available for use by the States and Territories for any purpose.'[45] New South Wales considers 'freely available' means no conditions are attached.

Policy neutrality has also been an accepted principle of the HFE process. In operational terms policy neutrality means that policy differences between the States should not affect the GST distribution, and that the GST distribution process itself does not provide the States with incentives to vary their policies. However, it also means that States do not have to implement exactly the same policies – the services States provide and the way that they raise revenue reflect policies of the States' choice. To do otherwise 'would require judgments about matters that are the province of Government.' [46]

The Review Panel argues that these principles would remain intact if the policy choices the GST distribution is being used to 'encourage' have been agreed between the Commonwealth and the States.

However, the Australian environment of a very significant vertical fiscal imbalance impacts on the nature of the agreements that the States can negotiate with the Commonwealth.

In a situation where the Commonwealth already provides such a large proportion of the states' funding it is questionable whether both sides enter negotiations on an equal footing. Moreover, State revenue sources are limited, which means their flexibility in responding to changing fiscal circumstances is very constrained. States cannot commit too far ahead to tax policy changes simply because they do not have the variety of tax revenue sources available to readily compensate for declines in revenue from one source.

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[44] *Second Interim Report*, p. 86.

[45] *Intergovernmental Agreement on Federal Financial Relations*, July 2011, Clause 25, p. 7, (www.federalfinancialrelations.gov.au/Intergovernmental Agreement on Federal Financial Relations).

[46] CGC, *2010 Review*, Vol. 1, p. 36.

Drawing the ideas together

The Panel's view on the direction of future work

The Panel recognises that reforms to State taxes and improvements to the way the nation charges for and taxes its resources will involve consideration of a wide range of significant and complex issues, many beyond the scope of this Review.

Whatever decisions governments make regarding what reform is required and when, the Panel firmly believes that the best chance of genuine reform lies in a cooperative national approach, involving the agreement of all States and the participation of the Commonwealth. This is the case both for State tax reform and changes to the resource-charging system.

While virtually any reforms will have an effect on the GST distribution, if changes are made as part of agreed multilateral reform, these effects can be identified and dealt with. Indeed, it may even be the case that the GST distribution system can be used to help facilitate reform.

The Panel hopes that the proposals outlined in this report make a valuable contribution to the broader discussion of long-term tax reform, and entreats States to engage with each other and the Panel on these matters. In particular, the Panel seeks the States' views on:

- *the three broad approaches towards a possible agreement between States and the Commonwealth on resource-charging, outlined in section 4.7*
- *the proposals to minimise GST share effects of, or create positive incentives for, tax reform outlined in Chapter 5.*

These issues have been addressed throughout this submission.