Queensland Government Submission to the Review of GST Distribution - Supplementary issues

April 2012

Queensland Government

EXECUTIVE SUMMARY

The Queensland Government's October 2011 submission established what it considers the key priorities for the GST Distribution Review (the Review):

- clarifying and better focusing the aim of the GST distribution process;
- addressing the problems with the current assessment of mining revenue; and
- simplifying the assessment process.

The Queensland Government believes that these should remain the priorities of the Review and is concerned that the incorporation of the additional terms of reference issued by the Australian Government on 17 November 2011 could detract from the Review's ability to address these key priorities.

Policy neutrality is a longstanding and widely-accepted principle of horizontal fiscal equalisation (HFE) which requires that a State's own policies should not directly affect its share of grant funding, in this case GST. Queensland believes that this principle is an important cornerstone of the HFE process.

Violation of this principle can undermine the ability of the HFE process to deliver outcomes that are consistent with the Review's core objectives of efficiency, equity, simplicity, predictability and stability. This is most obvious in relation to the current assessment of mining revenue, but also to a lesser degree in relation to other assessments that could be associated with tax policy change. These design flaws should be addressed.

Use of the HFE process to leverage taxation policy decisions can undermine the principle of policy neutrality, weakening the ability of the process to deliver its core objectives. The Queensland Government believes that this approach is, as a matter of principle, misguided.

There are better ways, based on agreement amongst the members of the Australian federation, for tax policy objectives to be achieved. The Queensland Government believes these approaches should be explored rather than journey down a path that would risk subverting the goals and objectives of the existing Review process.

INTRODUCTION

1. In its October submission on the original terms of reference of the GST Distribution Review, Queensland highlighted the importance of considering the distribution of GST in the broader context of federal financial relations, and of clearly establishing the desired outcome of the process.

2. The submission set the following priorities for the Review as being:

   - clarifying the aim of the GST distribution process – the aim of the GST distribution process needs to be clear and focused on providing the necessary budget support so that all States have the capacity to provide services at a comparable standard. In doing so, Queensland questioned the need for full equalisation, arguing that the focus of horizontal fiscal equalisation (HFE) should simply be to provide appropriate financial support to those States that genuinely require it – the current process should focus more on producing appropriate GST outcomes for the four smaller States and Territories rather than the redistribution of GST amongst the four larger and wealthier States;
   - addressing the problems with the current assessment of mining revenue – the current assessment creates inappropriate outcomes and serious incentive problems for the two major resource States that undermine the principle of policy neutrality; and
   - simplifying the assessment process – the current process is highly complex, leading to the frequent use of unreliable or incomparable data and judgement, resulting in outcomes that may not be any better than those produced by a simpler method.

3. The Queensland Government believes that these should remain the priorities of the Review and is concerned that the incorporation of additional terms of reference will detract from the Review's ability to address these priorities.

ADDITIONAL TERMS OF REFERENCE

4. Additional terms of reference issued by the Australian Government on 17 November 2011 ask the Review to examine and make recommendations on possible changes to the form of equalisation to achieve the following objectives:

   - ensure that HFE does not provide a disincentive to State tax reform;
   - utilise HFE to provide incentives and disincentives to promote future State policy decisions which improve the efficiency of State taxes and mineral royalties; and
   - examine the incentives for States to reduce Minerals Resource Rent Tax (MRRT) or Petroleum Resource Rent Tax (PRRT) revenue through increasing State mineral royalties.

5. A common thread through these additional terms of reference is the HFE principle of policy neutrality – that is, the principle that a State's own policies should not directly affect its share of grant funding, in this case GST. The first additional term of reference seeks to preserve and strengthen it, the latter two seek to diminish it and to incorporate grant design features into the HFE process that will direct state policies in certain directions.

6. The Queensland Government's view is that the principle of policy neutrality is an important cornerstone of the HFE process. Weakening it will reduce the process's capacity to deliver outcomes that are consistent with the Review's core objectives of efficiency, equity, simplicity, predictability and stability. It is also likely to undermine the confidence of the States and Territories in the system.

THE IMPORTANCE OF POLICY NEUTRALITY

7. Policy neutrality has been a long-standing and widely accepted principle of HFE. Arguments to weaken the policy neutrality principle have been made before but always rejected.

8. Policy neutrality has been considered a fundamental feature of HFE because it reinforces the key criteria by which revenue policy should be judged and which are incorporated in the Review's terms of reference:

    - efficiency – policy neutrality helps ensure that government policy decision-making is not distorted by the HFE process, that policy decisions are based purely on the merits of the policy options and not influenced by the gain or loss of grant funding. Moreover, policy neutrality reduces the potential for 'game-playing' by governments whereby grant design flaws in the HFE process have the potential to drive public policy decision-making;
    - equity – policy neutrality ensures that policy settings adopted by governments will not detract from the key equity objective of the HFE process, which is to provide the necessary budget support so that all States have the capacity to deliver services at a comparable standard;
    - simplicity – the addition of considerations other than those relating to HFE will necessarily make the assessment of the GST distribution even more complex than it is now; and
    - predictability and stability – policy neutrality, by definition, means that individual governments cannot influence the distribution of GST through their own policy settings. To weaken this to allow State policies to change the GST distribution would make individual policy action another contributing factor influencing the GST distribution, in addition to economic, social and demographic changes. This would make the GST distribution less predictable and less stable.

9. The clearest example of the principle of policy neutrality being violated relates to the mining assessment.

10. The revenue base for mining activity is dominated by two States, Queensland and Western Australia. This feature appears to impact on the existing process in a number of ways, producing outcomes that are arguably inappropriate, and which compromise the policy neutrality of the assessment.

11. Mining revenue comprises around 9% of all State revenue in aggregate, yet represents 85% of the GST redistributed as a result of revenue assessments. In net terms, the majority of mining royalties raised by Queensland and Western Australia were offset by the redistribution in the Commonwealth Grants Commission's *2012 Update*. As a result, all other States gained more from mining royalties than Queensland and Western Australia on a per capita basis.

12. Two examples of the way the current mining assessment adversely impacts on policy neutrality are:

    - in 2010 Western Australia, the majority producer of iron ore fines, removed certain concessions on the mineral. This had the effect of increasing the average national royalty rate above the 5% threshold for low royalty rate minerals set by the Commonwealth Grants Commission. The current methodology for the assessment of mining revenue would have caused Western Australia to lose far more revenue from the GST distribution than would have been raised from the increased royalties, were it not for a terms of reference directive introduced in 2011 to alter the methodology.

      Subsequent royalty rate changes announced in Western Australia’s 2011-12 State Budget go beyond these changes. In the absence of future terms of reference directives, Western Australia may indeed lose more revenue from the GST distribution than it will collect from increased royalties; and

    - in 2011 NSW announced an increase in coal royalties. Because of the design of the current assessment of the mining royalty revenue, NSW will receive additional GST revenue equivalent to around 10 to 15 per cent of the additional royalty revenue from the royalty rate increase.

13. Grant design flaws also impact on Queensland. For example, if Queensland increased its coal royalty rate, between 30% and 50% of the additional revenue raised would effectively be passed to other States through changes in the distribution of GST revenue.

Policy neutrality and State taxation

14. The Review has been tasked to examine whether the HFE process can discourage state tax policy changes[1].

15. Queensland Treasury analysis suggests that changes to tax policy settings can impact on the distribution of GST. However, the analysis suggests that, in contrast to the mining assessment[2]:

    - the scale of such State tax impacts are relatively small in most cases. For an individual State seeking to undertake a particular tax change, the impact on that State’s share of GST usually represents less than 5% of the tax revenue involved (that is, foregone or raised) in the change. Moreover, the full impact will be delayed by around five years because of the lag in data usage and the application of three year averaging; and

    - the impacts can act as both incentives and disincentives for policy changes. The resultant GST redistribution can create incentives as well as disincentives for tax changes, depending whether the particular state has above or below average capacities in the taxes under question. As a general rule, for every disincentive to a certain tax change facing a State, a comparable incentive

[1] For the purposes of this section, tax policy changes exclude changes to the mining royalty regime.

[2] This analysis is based on the impact of tax changes on the average States’ tax rate used by the Commonwealth Grants Commission in its assessments. It does not include the impact of tax changes on States’ tax bases, which could also affect assessments, as the size and direction of impacts are difficult to determine, particularly for revenue neutral reforms. It is very likely that, overall, this impact will also be small.

exists for another State. However, policy neutrality considerations suggest that both incentives and disincentives should be avoided as they can both distort policy decision-making.

16. For example, if NSW or Victoria reduced their conveyance duty revenue by $1 billion, and offset the reduction by a compensating increase in land tax revenue, their GST distribution would increase by around $35 million.[3]

17. While grant design effects exist in relation to tax changes, their smaller scale suggests that policy neutrality is a less significant issue for tax changes than in relation to mining royalty revenue.

18. To the extent such grant design effects exist, they should be considered undesirable and it is preferable that they be addressed for the reasons discussed earlier.

19. Queensland's October 2011 submission suggested a number of avenues that could be explored to strengthen policy neutrality.

20. Three approaches that particularly merit further examination are use of:

    - *global measures of revenue*. Rather than assessing relatively disaggregated revenue categories, this approach would assess State revenues in aggregate, using broad indicators to determine differences in capacity. Since more global or broader indicators are generally less sensitive to policy changes than disaggregated ones, a higher level of policy neutrality is likely to be achieved. Gross state product or household disposal income could be the basis of such aggregate measures;

    - *partial assessments*. A general discount factor could be applied to expense and revenue categories to reduce the amount of redistribution to a level that would still allow jurisdictions to provide comparable, albeit not necessarily equal, levels of services. For example, pursuing a redistribution that allows jurisdictions to achieve adequate and acceptable levels of service provision may be preferable to the current redistribution which is intended to allow jurisdictions to achieve average levels of service provision. A more measured level of redistribution would reduce grant design effects and enhance policy neutrality; and

    - *discounts for the mining assessment.* As discussed above, the mining assessment is particularly susceptible to grant design effects. Application of a discount could enhance policy neutrality. For example, the current mining assessment shares the government revenues from mining industry, but not the costs. A discount factor correlated to the growth of the mining sector would both compensate mining States for the social and infrastructure costs associated with the sector's development, and increase the incentive (or reduce the current disincentive) for application of policies to assist the beneficial development of States' mining sectors.

[3] The scale of the GST distributional impacts increases if all States concurrently undertake a similar tax change. This could arguably impede a national tax policy initiative requiring the assent of every State, as the States which would suffer an adverse GST redistribution may reject the change.

USING THE GST DISTRIBUTION PROCESS TO LEVERAGE TAX POLICY CHANGE

21. The first of the additional terms of reference suggests a desire to redress grant design effects that discourage tax policy change, that is, to strengthen the principle of policy neutrality. In contrast, the latter two carry a very different policy implication – these suggest the use of the GST distribution process to achieve certain policy objectives other than HFE.

22. Given the longevity and widespread acceptance of the policy neutrality principle as a fundamental feature of HFE, serious consideration should be given to the consequences of its abandonment.

23. The Queensland Government's view is that using the GST distribution to achieve specific policy objectives in relation to state tax and mineral royalties is, as a matter of principle, misguided. It therefore believes that the Review should carefully consider whether:

    - the HFE process should be used to provide incentives to promote specific State taxes and royalties policy decisions; and
    - the existence of incentives for States to reduce MRRT and PRRT through increasing State mineral royalties is pertinent to the issues under consideration by the Review. The HFE process should not be used to correct extraneous issues that can be addressed through policy redesign or intergovernmental agreement.

24. The undesirability of using the HFE process to promote certain tax changes should be clear from the earlier discussion on the importance of policy neutrality as a fundamental principle of HFE.

25. In summary, using the HFE process in this way will reduce:

    - efficiency – policy decisions will no longer be based purely on the merits of the policy proposal and will increase the potential for 'gaming the GST distribution system';
    - equity – attempts to induce certain tax changes will distract from the key equity objective of providing the necessary budget support so that all States have the capacity to provide services at a comparable standard;
    - simplicity – additional considerations will necessarily make the assessment of the GST distribution even more complex than it is now; and
    - predictability and stability – the GST distribution will be affected by States' tax and mining royalty decisions, making the GST distribution both less predictable and less stable.

26. Also undesirable is the need to employ and resource what in effect would become a parallel assessment process, probably requiring an associated or parallel bureaucracy. The policy change objective is clearly distinct from the HFE objective and requires the asking of different questions mainly focussing on what States 'should do' rather than what they actually do. Additional assessments would need to be based on the policy settings of States, which would open up a different set of methodological issues than is currently considered by the current focus on capacities.

27. Best practice in resource charging suggests that royalty regimes should not be static and should have the ability to adjust with changes to industry conditions, mining practices and technologies, and the structure and composition of resource development in the state. This could include changes to the explicit or effective royalty rates – it would be undesirable for States to be dissuaded from worthwhile policy changes by adjustments to the GST distribution.

28. Such a project would also likely be unworkable since political, economic and technical judgements will permeate the process, and each is likely to be contestable. Without doubt, the current Commonwealth Grants Commission process also suffers in this way at times. However, the problems would be a magnitude greater with a process that is based around questions of what States 'should do', as is the case with the proposal to use the GST distribution process to promote tax policy changes.

29. It is unlikely that a consensus could be achieved that would allow the process to engender the confidence of States required for the GST distribution process to work.

30. *The policy objective will need to be clearly defined*. While there are shades of different meanings of the term 'horizontal fiscal equalisation', there is broad agreement as to its general intent, which is to ensure that all Australians, regardless of where they reside, have access to a comparable level of services. The question of what constitutes 'tax reform' is much more contested, as the recent Tax Forum made clear. For example, for the States, tax reform involves a deeper examination of the appropriate assignment of taxes across the levels of government than is suggested by the Australian Government's emphasis on altering the mix and design of existing state taxes.

31. *The basis and level of 'rewards' and 'penalties' will need to be established* – it could be movements from a current baseline, or the deviation from an 'optimal' mix of taxes. If the former, States with a high starting level of undesirable taxes will have a greater capacity to reap rewards than states with fewer undesirable taxes; if the latter, the question of what constitutes the optimal tax mix arises.

32. *Assessments of what constitutes 'desirable' and 'undesirable' taxes will need to be made*. However, the desirability and undesirability of particular taxes will always remain an open issue that will be able to be contested. While the additional terms of reference indicate that the Australia's Future Tax System Review should be a guide, it would be inappropriate that the findings of an Australian Government review, with limited examination of state tax issues, limited State input and conducted at a particular point in time, should be the main determinant of the objectives of state tax policy for possibly years to come.

33. In determining the desirability of a tax, a number of criteria need to be assessed including its efficiency, equity, simplicity, sustainability and stability. Such assessments require economic and political judgement. Even a largely technical issue such as the efficiency of a particular tax depends on decisions on the form of modelling used and the assumptions to be applied. The other criteria will allow even broader scope for judgement. Then weightings based on a judgement of the relative importance of each criterion need to be applied before an overall assessment of a tax can be made.

34. Mining royalties provide a useful example. Even if it were accepted that a mining royalty is not as efficient as a resource rent tax (a matter not without dispute), it could be argued that a mining royalty regime can be assessed as very strong when measured against other criteria. It can be more *equitable*, because it gives a return to the State as the resource is being exploited; *simpler*, because it is based on readily available measures of volumes and prices rather than a complex calculation of economic rent; and more *stable*, because volumes and prices are less susceptible to fluctuations than profitability. For State governments, equity, simplicity and stability are likely to be much more important criteria than for the Australian Government, which is not the owner of the resource, has the Australian Tax Office's resources and access to tax information, and has a larger fiscal capacity that can absorb budgetary impacts more readily. Thus, taking a State perspective, a mining royalty may arguably be a more desirable mechanism for resource charging than a resource rent tax.

- In Queensland's case, the use of royalty rates that vary with mineral prices provides some additional sensitivity to profitability while retaining the benefits of traditional royalty regimes.

35. Because of the many judgements that would need to be made in this process, Queensland would be very concerned about any process that limited its ability to be a major influence in the making of these judgements by, for example, delegating them to the Australian Government or third parties. Such a process would infringe the sovereignty of States and would be unlikely to have their confidence, so necessary for the GST distribution process to work well.

36. Finally, better mechanisms to drive policy change already exist.

- The Queensland and NSW Treasurers are already driving a process of state tax reform, sanctioned by the Australian Government Tax Forum. This process will examine ways to further harmonise payroll tax policy and administration, as well as broader state reform issues.

- The *Intergovernmental Agreement on Federal Financial Relations*, signed by all States in 2008, already provides a mechanism to drive and manage reform. National Partnerships allow for agreement among jurisdictions to implement national reforms. Objectives, responsibilities, funding and implementation are negotiated by jurisdictions and specified in individual National Partnership Agreements. COAG Reform Council provides an independent assessment of the progress of reforms and whether individual States have achieved their reform targets. There are currently over fifty National Partnerships covering areas such service delivery, business regulation and natural disaster recovery.

37. Historically, it has been processes and agreements such as these that have successfully achieved worthwhile and enduring policy changes in the Australian federation.

38. They allow for more measured approaches to tax policy change that can balance social, economic and budgetary considerations. Queensland has abolished eight taxes under the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*. Flexibility under these arrangements has allowed these taxes to be abolished when State budgets have had the capacity to accommodate them, allowing tax cuts to be consistent with responsible fiscal management.

Abolition of a ninth tax – duty on core business assets – has been deferred because other state revenues, including GST revenue, have suffered under the impact of the global financial crisis. This decision was based on its policy merits, with Queensland not expected to benefit through any resultant changes in the distribution of the GST. Formulaic approaches to tax policy change cannot accommodate the balancing of such diverse and changing considerations.

39. If the Australian Government has a concern that the States' use of their sovereign right to increase royalty charges on the exploitation of their mineral resources will detract from their resource rent revenues, it is open to the Australian Government to redesign their taxes or undertake negotiations with the States. The HFE process should not be used to generate specific policy outcomes that can be achieved through more appropriate means.

CONCLUSION

40. It is Queensland's concern that concentration on the additional terms of reference risks diminishing the success of the Review by detracting from the Review's ability to address the real priority issues. These priority issues, as articulated in Queensland's October submission and outlined earlier in this submission are:

- clarifying and better focusing the aim of the GST distribution process;
- addressing the problems with the current assessment of mining revenue; and
- simplifying the assessment process.

41. Using the GST distribution process to achieve tax changes to State tax policy is misguided. The problems with the mining assessment will be exacerbated if the changes suggested by the additional terms of reference reinforce the current grant design flaws. The assessment process will become more complex as parallel assessment processes are established. Lastly, the emphasis of the GST distribution process will shift from providing appropriate support to those States that genuinely require it, to other, possibly ill-defined, policy objectives.

42. There are better ways, based on agreement amongst the members of the Australian federation, for the Australian Government's policy objectives to be achieved. The Queensland Government believes these approaches should be explored rather than to journey down a path that would risk subverting the goals and objectives of the existing Review process.