South Australian Government Submission to the GST Distribution Review Panel

September 2011

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Key messages

- SA strongly supports the continuation of horizontal fiscal equalisation. The current, comprehensive, system of fiscal equalisation in Australia is a fundamental strength of the Australian federation.
- The terms of reference requires the Review to be guided by the principle that "*jurisdictions should have equal capacity to provide infrastructure and services to their citizens*".
- The Government of South Australia would strongly oppose any Review recommendations which were at odds with this principle. Proposals such as placing a "floor" under relativities on some 'numerological' basis, or engaging in "partial" equalisation (even if under the banner of 'simplification') would not be consistent with the terms of reference – they would clearly not deliver equal capacity.
- Criticisms which are mounted against HFE reflect a misunderstanding of both the objectives and impacts of equalisation.
- The purpose of HFE is to provide Governments with equal capacity to deliver services to their citizens. Government services are provided to those who need them, not just to those who generate the tax revenue which funds them. HFE allows all State Governments to fulfil this role to an equal extent.
- HFE is not detrimental to national economic growth, and does not undermine incentives for States to pursue growth enhancing reforms. In the absence of HFE, or under less than full equalisation, households and firms could be given incentives to make location decisions on the basis of fiscal incentives rather than underlying productivity – undermining the efficiency of the national economy.
- Similarly States have incentives to pursue greater efficiency in service delivery under HFE. If more active incentives for public sector efficiency are desired, national agreements can be structured to more directly target mutually agreed efficiency objectives. HFE should remain focussed on the equal capacity objective - multiple objectives would significantly undermine its ability to achieve that.

- South Australia does not consider that CGC methodologies are unnecessarily complex given the magnitude and importance of the equalisation objective. The primary objective should be to achieve equalisation, and efforts to simplify the assessments should not undermine that principle. Fringe benefits tax and capital gains tax may add to complexity but they are necessary for overall efficiency and equity of income tax.
- Relativity movements are a counterpart to own source revenue trends for each State and as such each State's overall revenue volatility should be similar. Relativity changes are predictable, but there may be benefit in a joint relativity forecasting arrangement involving all Treasuries.
- The main deficiency in current arrangements is a lack of contemporaneity. The lags in the system mean that mining revenues in their current growth phase are not being fully equalised. This needs to be addressed.
- Local Government HFE is also deficient.

The rationale for Horizontal Fiscal Equalisation

Horizontal fiscal equalisation (HFE) is essentially a reflection of what Governments do.

All Governments provide services to those who need them. This involves a redistribution from those who contribute taxation revenue to those who benefit from public services - this happens from Vaucluse to Blacktown, from Peppermint Grove to Kwinana, from companies to individuals.

Fiscal equalisation ensures that all States are placed on an equal footing in this regard. It makes sure that each jurisdiction has an equal capacity to deliver services to the same standard for comparable cost locations through financial transfers between jurisdictions depending on their relative fiscal capacity. Those transfers equalise capacity in terms of relative advantages and disadvantages which are beyond the control of State Governments. The key principle involved is that:

> HFE transfers overcome the constraints which would otherwise arise from (state) area matching of revenue raising and service delivery expense on account of arbitrary factors within state jurisdictions

There is a strong case on grounds of both equity and efficiency for HFE.

HFE transfers are needed to allow the same efficient and equitable result as is obtained with implicit area equalisation from uniform tax rates and equal service standards for comparable cost locations in a national or unitary setting. Implicit area fiscal equalisation occurs automatically (and unremarked upon) within the scope of the Commonwealth Budget. It would also occur in the hypothetical scenario of a unitary nation. HFE can be said to attack, at source, the effects of the arbitrary location of sub national government boundaries in a federation as compared with the outcomes which arise implicitly in a unitary nation.

With full HFE, no merely fiscal incentives for population migration arise - whereas they would do if there were a requirement that revenues in an area matched expenditures in the same area.

In the absence of equalisation, net fiscal benefits[1] will differ between jurisdictions for "accidental" or unavoidable reasons such as differences in demographic structure and natural resource endowments, and the existence of these differences would promote inefficient migration unrelated to underlying private returns. For example, if two jurisdictions were identical apart from the fact that one had a greater proportion of elderly people (and lower proportion of working age people), the jurisdiction with the older population would have higher service delivery needs and have to impose higher taxes to finance this. This would create incentives for people to migrate to the other jurisdiction to benefit from lower taxes even though their productivity was higher in their home jurisdiction. From this perspective, equalisation is designed to achieve an outcome where labour and capital moves between regions in response to returns based on marginal productivity, and removes any fiscal incentives for migration.

It is possible that economic growth could be higher in jurisdictions with stronger fiscal capacity in the absence of HFE. However, it may not be the case that this would be an efficient (or welfare enhancing) outcome from a national perspective, as it would involve movements of capital and labour that would be in response to fiscal incentives, not underlying productivity. In the absence of HFE, Perth may become a much more attractive location for footloose manufacturing or service industry investment enticed by a lower payroll tax rate and better public services

[1] The impact of government actions on individuals can be considered in terms of the (varying) net fiscal benefits conferred on different segments of the community. Net fiscal benefits represent the difference between the value of transfers and services delivered to an individual and the contributions that an individual is required to make directly and indirectly to governments in the form of taxes and other compulsory non user charges.

funded through royalty incomes generated by the WA Government. If a new State were subsequently created dividing WA into north and south, Perth would no longer be such an attractive destination and industry would be enticed north. Such movements would not increase the amount of national economic activity, only its location, and for reasons that were unrelated to the underlying private returns which could be generated.

<u>HFE ensures that location decisions in a federation are independent of the fiscal effects that arise from accidental variations in regional physical and human resource endowments, and that those location decisions can instead be driven by inter-regional variations in marginal productivity for particular resources as in a unitary nation.</u>

While there may be some efficiency losses associated with State Government actions which emphasise objectives other than efficiency[2], such costs arise from the fiscal instruments and settings approved by parliaments, not from HFE which only ensures a relative uniformity of their application across the nation.

Explicit HFE in relation to the activities of separately governed jurisdictions (States), delivers the same outcome and the same spatial pattern of population and mobile resource location as implicit area fiscal equalisation (subject to the possibility of some variable effects being introduced, if variations in local preferences exist which are unable to be politically expressed at a national level but are able to be expressed in a federation).

The interstate pattern of Australia's population is quite fluid, in part because of the importance of overseas migration, but even if population were judged to be immobile and location decisions not likely to be greatly affected by different rates of State tax in the absence of HFE, the fair treatment of firms and households would be affected.

HFE ensures that otherwise similar households and firms in an integrated national economy, within the Australian federation, are not treated as different class citizens and entities merely on account of the accidents of natural resource location and circumstances of fellow residents within state borders.

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[2] For example tax settings may impact on incentives to work, or non uniform commodity taxation such as taxes on insurance premiums may deter households taking out insurance, or payroll tax free thresholds may cause firm sizes to be less than optimal, or welfare/housing assistance for vulnerable groups may discourage self provision.

The case for HFE in a federation by analogy with a unitary or fluid national context where service delivery levels are not constrained by revenues raised in the same area, is set out in Attachment A.

Form and scope of HFE

The CGC assessments are conducted on the basis of comparison against an average of what all States do. The standards are derived by observing State actions. The assessment makes no judgments about what services should be provided, desirable service standards, what taxes States should levy or the severity of those taxes (see Attachment B for more detail on scope of HFE).

Alternatives to this approach have been suggested. They include basing assessments on what is done by the most efficient providers of services, or some "ideal" level of services or tax policy. It is difficult to envisage that such proposals are practically achievable. There are no conceptual arguments in favour of such approaches in any event.

Other suggestions as to the scope of HFE include:

- Equalisation of revenue capacity only - without assessment of expenditure needs. This would represent a movement away from a comprehensive equalisation system and one which maintained fiscal differences between jurisdictions which reflected socioeconomic, demographic and other factors beyond their control. Variations on this theme include restricting the scope of the expenditure assessments to disabilities that reflect differences in demand for services – omitting differences in the unit cost of providing services – or omitting disabilities which reflect the location of services delivered.
- "Capping" of relativities or a "floor" (minimum relativity 66.6 could be indicated by some texts) below which no jurisdiction would fall. This would inevitably be an arbitrary adjustment, and a move away from a comprehensive equalisation system.

The terms of reference do not provide scope for alternative "forms" of equalisation to be recommended unless they achieve <u>equal </u>capacity - terms of reference 6 (b) says ""*jurisdictions should have <u>equal</u> capacity to provide infrastructure and services to their citizens*". The above approaches would be inconsistent with the terms of reference requirement and represent arbitrary modifications when tested against principles of efficiency and equity. The proposition that a floor be placed under the relativities is totally arbitrary and unprincipled. How far WA's relativity falls is totally a reflection of how much extra revenue they can generate from mining. A relativity floor would be an inefficient outcome from a national perspective as discussed in the preceding

section. Similarly, partial equalisation would represent an arbitrary approach, requiring some form of national compact as to the acceptability or desirability of jurisdictions not having equal capacity to provide the same standard of all services (and which services should reflect an equal capacity principle and which should not). Even if such an agreement could be reached in relation to the equity shortfall involved, the outcome would be inefficient.

The Government of South Australia would strongly oppose any Review recommendations which were at odds with the principle of achieving equal capacity as required by the Terms of Reference.

HFE in the context of emerging structural change

The first term of reference for the Review places its deliberations in the context of longer term trends forcing structural change in the Australian economy – including factors such as the rise of China and India, the challenge of climate change, population growth and ageing, and continuing technological change.

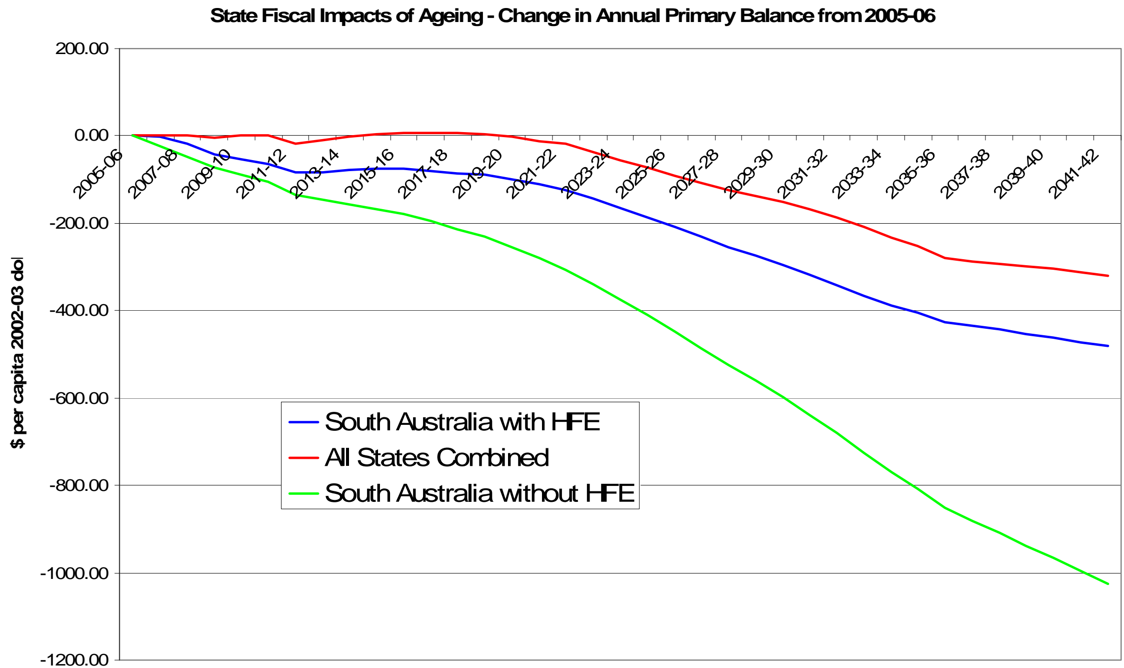
These are all factors beyond the control of State Governments and which are affecting the States in different ways. This strengthens, rather than diminishes, the importance of a robust and full equalisation system – to fully equalise increasingly diverging fiscal capacities and avoid incentives for efficiency detracting migration of capital and labour.

As a result of the strong global demand for Australia's mineral resources, other industries and regions (such as SA and Victoria) are facing increasing competitive pressures from an appreciating exchange rate. Being part of a Federation means that the South Australian economy wears this consequence of the terms of trade boom. There is a potential for these forces to reduce South Australia's relative revenue raising capacity. In a Federation the benefits of the terms of trade boom are shared throughout the nation through a range of mechanisms, including through HFE. Any move away from full equalisation transfers would result in the South Australian economy being exposed to the adverse consequences of currency appreciation without receiving an appropriate sharing of the benefits of the terms of trade boom.

The South Australian Budget currently suffers a relative disadvantage on account of a lack of mining resources, an older age population, relatively low socio economic status of our population, and the diseconomies of scale in service delivery faced by a smaller state. HFE corrects for this and prevents SA tax rates having to be higher - or health, education and policing standards lower - than other States. The gap required to be filled would be $1 billion per annum.

Having some or all of that $1 billion taken away through changes to the current equalisation system would not only be inequitable, it would also be inefficient.

South Australia's current relativity position is likely to change over time in response to the issues identified as key contextual issues for the Review. Some of the structural changes will improve South Australia's relative fiscal capacity, others will diminish it. In the medium to longer term South Australia's relativity may fall due to growth in mining revenues - not just the Olympic Dam expansion but other new mine developments particularly iron ore. While SA may eventually get to the point of being around neutral in the mining assessment (i.e. no longer a recipient in that category), overall SA's relativity is likely to remain above 1 because of fixed costs of government (diseconomies of small scale) and an increasingly ageing population. The South Australian Department of Treasury and Finance undertook some intergenerational fiscal modelling in the middle part of the last decade which assessed the impacts of an ageing population on the Budget position. On a no policy change basis the population projections at the time pointed to growing fiscal pressures for all States, primarily the result of growing demand for health services with an ageing population. For South Australia the population ageing trend is more pronounced than average. In the absence of HFE this would lead to a much greater deterioration in South Australia's budget position than other States on average (see chart below), which would in turn require higher taxes or reduced service standards relative to other jurisdictions. HFE ensures that the distribution of GST revenues responds to relative differences in demographic trends between jurisdictions to the extent that they result in differential impacts on revenue capacity and service delivery, and ensures that capacity to deliver a same standard of services is maintained. Of course, jurisdictions may in practice decide to provide a higher or lower standard of access to services in particular areas, or overall. In South Australia current policy directs a higher effort towards health service provision than in other jurisdictions on average. As indicated in the chart below, even with HFE South Australia is exposed to greater than average fiscal pressure due to projected demographic change, but purely on account of a deliberate policy choice (assuming no policy change over time) to provide a relatively greater standard of health services, not because of the demographic trends themselves which are beyond the States' control.



A full equalisation arrangement will appropriately respond to these factors, both positive and negative, in relation to South Australia's emerging relative fiscal capacity.

The current system of HFE does respond to emerging cyclical and structural changes with a lag however. This means, for example that mining revenues in their current growth phase are not being fully equalised. It is estimated that, over the period 2005-06 to 2009-10, less than complete contemporaneity in the HFE process has resulted in Western Australia retaining in the order of $3.0 billion in monies that would otherwise have been redistributed as shown in the following table[3]. It is noted that Western Australia's 2011-12 Budget Papers estimate that royalty revenues will grow from around $2.3 billion in 2009-10, to $4.2 billion in 2010-11 and to $5.3 billion in 2014-15. Given the continued and strengthening growth in mining revenues it is

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[3] SA Department of Treasury and Finance calculation. Estimates compare actual HFE transfers associated with the mining assessment implicit in a given years' GST grant (assuming a three year averaging period applied) to the most recent calculated HFE transfers for the year corresponding to the GST grant (more detail can be provided if required). It is acknowledged that the move from a 5 year averaging period to a 3 year averaging period in the CGC's 2010 Review was a move towards contemporaneity. However, as illustrated, the inherent lag in the system still substantially hinders actual equalisation.

likely that the $3 billion figure will more than double over the forward estimates period[4].

	2005-06 Estimate	2006-07 Estimate	2007-08 Estimate	2008-09 Estimate	2009-10 Estimate
Est. HFE transfers assuming 3 year averaging period, escalated for growth in the GST pool up to the GST application year ($m)	-953	-985	-1,150	-1,356	-1,635
Contemporary HFE transfers for that year ($m)	-1,232	-1,548	-1,751	-2,192	-2,373
Gain (loss) from less contemporary distribution ($m)	279	563	601	836	738
Cumulative gain (loss) ($m)	279	842	1,443	2,279	3,017

Efficiency Incentives

HFE doesn't deter good decision making.

State budgets receive the full benefit of any service delivery efficiency savings achieved and vice versa. The CGC generally assesses needs through observations of independent variables rather than actual spending levels. Therefore if a jurisdiction was able to reduce its spending in a particular service delivery area through more efficient practices, this should not impact on the assessment of their needs and the relativities (unless their spending was able to significantly impact on the average level of spending across all jurisdictions – which is unlikely to any material degree). As such, the full benefit of the efficiency gain should accrue to that jurisdiction. In practice there is no evidence of a systematic correlation between the direction of HFE transfers and differences between jurisdictions in their efficiency in delivering services. For example according to the 2011 Report on Government Services, South Australia, a recipient State under HFE, appears to be more efficient than average in the delivery of corrective services (operating expenditure per prisoner 10% below the national average). For police services South Australia's recurrent expenditure per head of population was 5 % below the national average in 2009-10 even though SA had the highest number of operational police staff per 100 000 people apart from the NT. On the other hand South Australia has historically had a higher cost VET services system, with recurrent expenditure per curriculum hour 6.7% above the national average in 2009. The South Australian Government has recently put in place significant reforms to the VET sector, which aim to improve training

[4] One way for this to be addressed is to continually correct for departures from contemporary equalisation, when revealed from analysis of assessment years, by way of adjustments to net worth population dilution needs. Without such an adjustment States are unable to hold average opening balances of net worth per capita.

outcomes and improve efficiency. The reforms change the funding arrangements for vocational education and training delivery to allow all training providers access to public funds by increasing contestability and competition in the training market. A demand-driven system for VET will be introduced allowing students to have their choice of training provider. The system will operate in a similar manner to the User Choice program for apprenticeship training. HFE does not lead to inefficiency in service delivery in recipient States, nor does it inhibit efficiency enhancing reforms.

While HFE is clearly not detrimental to efficiency, one of the 'key questions' asked in the Issues Paper is whether HFE is a passive and reactive mechanism and whether it could be a more 'dynamic policy tool'? This would confuse or tangle the fundamental objective of HFE (ie to equalise fiscal capacity) with other possible policy objectives. Loading the equalisation system with multiple objectives would significantly undermine its ability to achieve any of those objectives fully or satisfactorily. If there are other policy objectives (eg actively improving efficiency), specific policies and strategies can be developed to address these challenges without undermining longstanding equalisation arrangements. For example, national agreements can be structured to more directly target mutually agreed efficiency objectives, and provide mechanisms to share the benefits of efficiency gains and provide appropriate targeted incentives.

HFE does not reduce incentives for States to promote economic growth. If per capita tax bases expand relative to other States, a State may lose some revenue through HFE but retain its population share if it is charging average tax rates. Economic development policy decisions are however influenced by the economic and social benefits to the community not fiscal impacts (eg increasing per capita incomes in the State through the generation of more highly paid employment opportunities, and possibly reduced unemployment particularly if the development occurs in a region with underutilised labour).

In practice the South Australian Government has actively pursued expansion of mining through investments in geological mapping and regulatory certainty and efficiency – even though additional royalties would be shared with other States through HFE. According to the Fraser Institute South Australia is the highest ranked Australian jurisdiction in relation to Government policy support for mining and the 10th highest ranked in the world.

Many States compete with each other to attract major events – even though they are often fiscally detrimental (and this would be the case with or without HFE).

It has also been suggested that HFE creates disincentives to reform inefficient State taxes. This is not the case. If a State unilaterally reduces reliance on a revenue base in order to exploit an alternative tax base the CGC assessments will be only slightly affected. Any impacts would be the result of the impacts on standard revenue collections, which are likely to be marginal unless a larger State (or a State which dominated a particular revenue assessment) undertook a very large tax mix switch. A national tax reform initiative could affect the CGC assessments where it results in a tax being abolished and no longer part of the assessment of what States do, and/or a new revenue base being assessed. State GST shares would be altered by this, but the effects would be the mirror of the changes in each States relative revenue raising capacity resulting from the tax mix switch. Ignoring differences in tax effort (which are a policy choice), such a scenario would leave State shares of combined own source tax revenue and GST grants unchanged. The Henry Tax Review report confirmed this point, highlighting that HFE ensured that States had no incentives to "resist or favour" tax reform proposals on the basis of differing tax capacities.

> *"A change in tax mix adopted by all States will change their relative revenue-raising capacities, therefore affecting the distribution of GST revenue. A change in tax mix might be revenue-neutral to the States in an aggregate sense, but an individual State might have one of their relatively stronger bases replaced with a relatively weaker base, such that revenue from their own taxes is lower. However, this loss in revenue could be made up through the HFE process, as the loss of their relatively stronger tax base means that their revenue needs are higher. In theory, if all States apply the same revenue-raising effort, no State would have a financial incentive to resist or favour a revenue-neutral reform of State tax base composition on the basis of the local strength or weakness of particular tax bases.*
>
> *In practice, however, the States will be affected differently because they apply different policies to their existing tax bases and are likely to continue to do so in regard to tax bases they have access to in the future. The redistribution of GST revenue will not take into account the impact of changes to tax bases on a State where it does not apply the average policy. That is, if a State is raising more than the average revenue off a base that is abolished, HFE will not compensate for revenue lost above the average, just as if a State was making a below-average effort that State would not be penalised. This may cause difficulties for some States, particularly if the States do not have the same*

> *ability to raise marginal revenue from the new tax base as they did with the old one."*[5]

The above quote highlights the fact that States may still face hurdles in respect of particular tax reform options on account of differences in tax policy (effort) for relevant taxes. This is not, however, a consequence of HFE.

It is sometimes argued that HFE can create "grant design inefficiencies" - that is, State Government policy decisions are distorted by incentives to influence the CGC assessments. The CGC assessments are based on the average of what States do. In order for State actions to influence the assessments they would need to be able to influence the national average spending or taxing level. This generally means that only larger jurisdictions could undertake actions which had a material impact on the average expenditure or revenue for a category. Or a State which dominated a particular assessment could take actions to influence the assessment. However such actions would involve budgetary costs as well as benefits (eg spending more to obtain a greater share of GST grants) and the net impact may not be sufficiently large to motivate such behaviour. The treatment, for the most part, of Commonwealth specific purpose grants by inclusion also removes incentives for States to seek to "game" their share of overall financial transfers from the Commonwealth.

The current mining revenue assessment does raise some difficult issues given the dominant position of WA in respect of total revenue collections. However royalty policy decisions by the WA Government indicate no perverse incentives effects arising from HFE.

Infrastructure

Much of the infrastructure requirements associated with economic development, such as ports, electricity or water supply for mining projects, are out of scope of the CGC assessments because they are either provided by the private sector or are delivered through Government business enterprises under commercial user pay arrangements. Infrastructure spending of this type is funded from borrowings and a full rate of return on total investment will be recovered from user charges and as such doesn't impact on State Government budget in the long term.

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[5] Australia's future tax system, Report to the Treasurer, December 2009, Part Two Volume 2, page 685

Other infrastructure needs which pertain to general government functions (roads, schools, hospitals, water supplied through community service obligation arrangements etc) are reflected in the CGC assessments, mainly through a depreciation assessment which reflects needs as infrastructure is used but also through an additional net investment assessment.

If there is a national economic interest in accelerating the removal of mining development bottlenecks in a targeted way, the Commonwealth can assist that directly.

Complexity

South Australia does not consider that the CGC methodologies and processes are unnecessarily complex given the magnitude and the importance of the equalisation task.

The 2010 Review included a major simplification exercise as required in the terms of reference. As a consequence, the CGC reduced the number of assessment categories from 59 to 26, recognised fewer influences on the cost and use of services, placed greater reliance on nationally based and independently sourced data and reduced the assessment averaging period from five years to three years.

The primary objective is to achieve equalisation. A simplified version of HFE is at great risk of not achieving equal capacity as required by the Terms of Reference for the Review. There are other examples of policy initiatives which have some complexity (eg Goods and Services Tax, Capital Gains Tax, Fringe Benefits Tax) but are nonetheless accepted because of the efficiency and/or equity gains which they achieve.

Less complexity should not be an end in itself. It is not clear that the degree of complexity in the current system has any specific adverse consequences for stakeholders. The amount of redistribution arising from the methodology should not be seen as bearing any relationship to the degree of complexity that is appropriate. The overall relativities are the result of numerous individual assessments which, for each jurisdiction, involve positive and negative transfers. Even if these assessments were exactly offsetting, for all jurisdictions, this would still justify the exercise because in the absence of the assessment we would not be able to conclude that the equal capacity objective has been achieved.

Consider the idea that there might be a ‘simplified global’ revenue assessment for example, possibly based on Gross State Product (GSP) or household income. Since states do not actually tax GSP or household income, the outcome would depart from the achievement of equal per capita sharing of revenue raised plus states wearing the

consequence of their own above or below average effort. GSP includes corporate profits whereas states only tax mining sector profits. In the case of household incomes States only tax labour incomes (not including Commonwealth employees) and do not tax retirement or investment incomes, while mining profits remain taxed at source by the States whether or not some Australians receive investment income from mining companies.

A tax by tax approach based on what States do ensures that the magnitudes of HFE transfers are adapted to changes in actual tax mix or actual tax design, including those which might involve expansion or contraction of states own source revenue as compared with Commonwealth grants, and whether or not tax mix and design decisions are regarded as ideal or preferable.

The same point can be made on the spending side. What would be the logic in applying a hypothetically 'ideal' higher spending level for indigenous spending –say estimated as sufficient to close the morbidity and life expectancy gap with non indigenous? Or a hypothetically ideal more education oriented spending composition than on retiree concessions? Or hypothetically more rail oriented public transport systems consistent with more compact and taller cities as per COAG objectives.

Predictability

Concerns have been raised about the predictability in relativity changes from one year to the next. This is a misconceived argument. Changes in GST relativities are the mirror of changes in State circumstances (eg WA's GST grant falls when its royalties are growing, with offsetting impacts). Because of HFE, each state effectively gets its population share of the total of all states revenues plus or minus variations in local revenue raising effort. This can be more stable than one state's own revenue streams so long as the HFE assessment is not too lagged.

Furthermore State Treasuries may be able to anticipate some of the components of the relativity update changes. A range of factors influence the movements in relativities in annual updates, in particular:

- Revenue updates reflecting differential emerging growth in revenue raising capacity between jurisdictions, particularly in relation to royalties, conveyance duty and payroll tax;

- Emerging State shares of Commonwealth grants treated by inclusion, particularly in recent years as a result of the proliferation of National Partnership payments which to some extent reflected the temporary fiscal stimulus response to the global financial crisis.

- Data updates (eg the Survey of Education and Training data underpinning the wage cost assessment).

The first two sources of change in relativities should be able to be anticipated by State Treasuries because they are observable from published documents including Budget outcomes released prior to the CGC Annual Update reports. The impact of data updates and other assessment factors may be less readily anticipated by State Treasuries, although the CGC does endeavour to notify the States of emerging developments. Anticipating own source revenue update impacts may also be complicated if observed revenue trends reflect a mix of capacity changes and tax policy changes. As such there may be a role for a joint forecasting arrangement involving all Treasuries.

Commonwealth Grants

Most Commonwealth grants provided to States and Territories are treated by "inclusion" in the CGC needs assessment methodology.

This means that such payments are equalised. The practical effect is that where a State receives a specific purpose payment from the Commonwealth, they effectively only retain their population share of that grant (but also receive their population share of the grants provided by the Commonwealth to all other States and Territories). In net terms a redistribution occurs where jurisdictions receive more (or less) than their per capita share of Commonwealth Grants treated by inclusion.

Some grants are not equalised. This generally occurs where the payment is for on-passing to a third party, is a national priority or does not otherwise ameliorate the need for State government spending or revenue raising.

Whether Commonwealth grants are treated by inclusion or excluded from the CGC assessments of needs is a generally a matter for decision by the Commission, although directions may be issued through the annual Terms of Reference agreed by Treasurers.

A failure to include Commonwealth specific purpose grants in the needs assessment would undermine equalisation outcomes. A jurisdiction which has received an above equal per capita share of Commonwealth payments has been granted a fiscal capacity advantage relative to other jurisdictions.

While this conceptual approach is well accepted in relation to grants which underpin the core areas of State service delivery such as education, health and housing, the Commonwealth also provides States with grants for specific projects, such as infrastructure, which are often bilateral arrangements with no related funding flows to any other

jurisdictions. In these instances, a State may receive a grant from the Commonwealth to contribute to the cost of a one off project, but lose all but its population share of the grant through the needs assessment. This is still likely to be the appropriate outcome according to the principles of HFE, to the extent that the Commonwealth funding effectively substitutes for a State Government funding contribution. The issue needs to be considered in a broader context of revenue capacity across the full range of service and infrastructure needs facing State Governments.

It is recognised, however, in relation to capital grants that the treatment by inclusion may result in a large impact on the relativity at the time of income recognition of the grant payment as per GFS accounting standards. Given that the CGC assesses needs for the use of the asset based on depreciation it may be more appropriate for capital grants treated by inclusion to be assessed over a longer timeframe rather than as a lump sum in the year of receipt in line with a revenue and expense matching principle.

Other Issues

Commonwealth funding transfers to States for on passing to local government in Australia are not subject to equalisation (the allocation of grants between individual councils within States is subject to at least some equalisation). The equal per capita distribution of local government grants between States means that fiscal equalisation in Australia is not truly comprehensive.

Attachment A – The Case for HFE

National government and implicit equalisation

The case for HFE starts by considering government spending and revenue raising by a *national* government, and imagining that the national government provided (say) all health services. In the Australian context the Commonwealth Government might be directly providing public hospitals services as well as supporting medical services through Medicare and PBS. The national government might retain payroll tax to help fund those hospital services.

In this situation a national government would apply a uniform payroll tax across the country, and hospital services in similar cost locations might well be provided at a similar standard across the country.

There may be proportionally more old people resident in one region compared with other regions but the standard of health services would not be lower in that region just because of that. In the same region there will also be a lower proportion of working aged people. This region would therefore generate lower payroll tax revenues per capita and higher health service expenditure requirements per capita. But rates of payroll tax would not be set at higher levels locally to offset the higher local expenditure requirement.

Similar service standards for all similar cost locations and uniform tax rates, is a horizontally equitable situation.

It is also economically efficient, other things equal, because people and capital resources would not be provided with a merely fiscal (tax or service) incentive to migrate from their preferred region. People may have emerging productivity related incentives via differing wage rates from region to region, but the absence of a fiscal incentive for migration means that these true productivity incentives are not altered.

(The proportion of school aged dependents might be rising in expanding mining centres (say) but if education costs were funded centrally not locally, migration of workers to those centres motivated by higher wages in mining or mining support is not deterred by public education costs in those areas.)

Explicit interjurisdictional equalisation

Clearly the revenues raised by a national government in a region can exceed its expenditures within the region, and conversely in other regions. Thus there are fiscal transfers between regions.

We can describe this outcome in a national setting as *implicit* regional or area fiscal equalisation.

Imagine now that a high age dependency region and a low age dependency region were constituted as sub national political jurisdictions ie States, with their own payroll tax and public hospital responsibilities.

In this situation, *explicit* interjurisdictional HFE transfers are needed to provide the same efficient and equitable result as with implicit area equalisation in a national setting.

Also consider other revenue types and expenditure responsibilities.

Mining may be subject to additional taxes than apply to business generally; and assume one region is endowed with more mineral resources than the two regions so far considered.

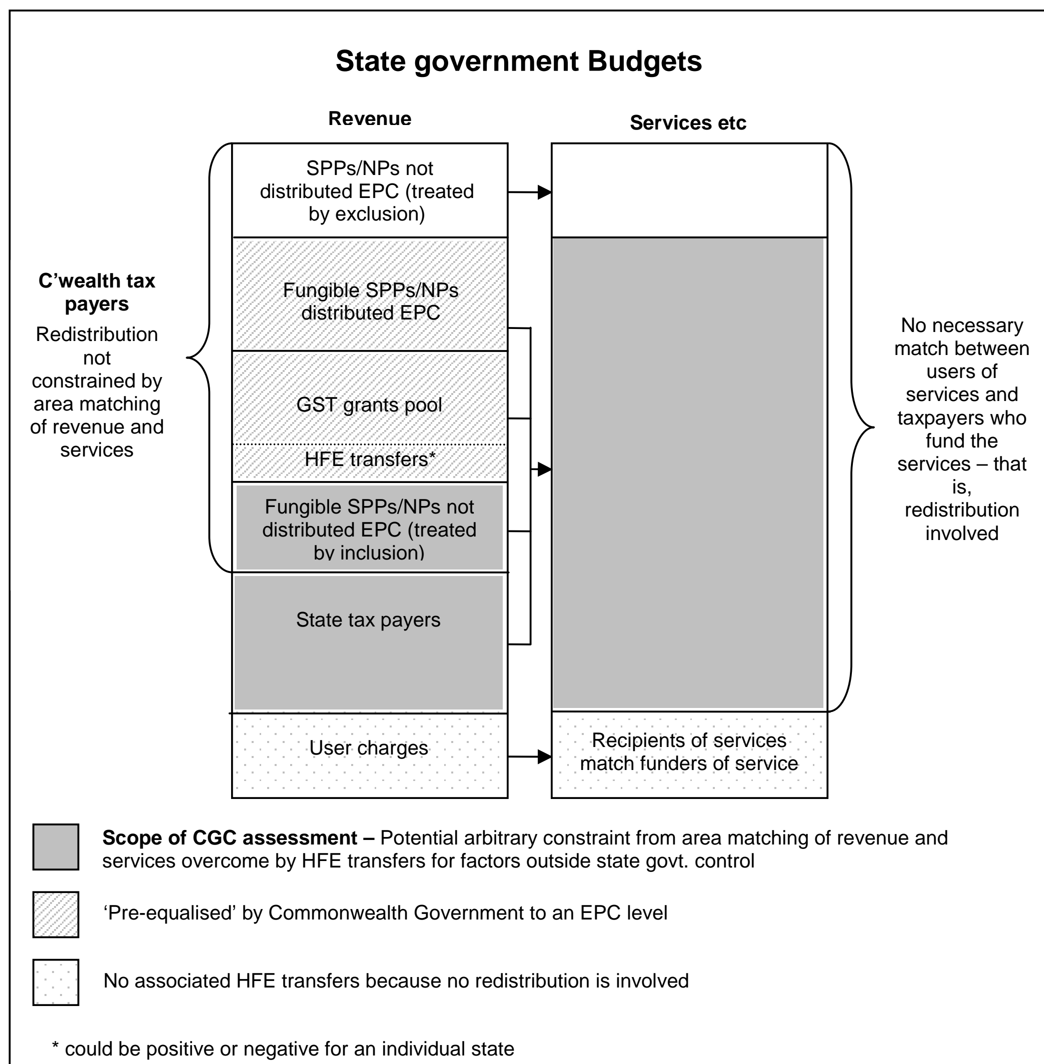
Implicit area equalisation would be occurring in numerous directions. There is no necessary correlation between the directions of transfers. Any net transfer position will reflect the weight of transfers in respect of various characteristics of regions which have specific fiscal implications.

A reasonable hypothesis about the likely state of affairs in a national or unitary setting is that <u>taxes would be applied and services delivered uniformly as between regions irrespective of the local strength of income, consumption and resource tax bases and irrespective of the local extent of expenditure needs of residents arising from youthfulness, old age, disability and other personal circumstances.</u>

Attachment B – Scope of HFE

In terms of the scope of HFE, the relevant revenue raising and service delivery expenses relate to 'what states actually do'. Internal consistency is achieved when HFE transfers relate to what states do. For example on the revenue side, States receive a certain proportion of revenue from royalties, a certain proportion from particular tax bases employing particular tax design, and a certain proportion from Commonwealth Specific Purpose Payments (SPPs), and some user charges. On the expenditure side there is a particular range of expenditure categories with associated cost drivers (eg size of indigenous, older aged and school aged children populations, extent of populations located in remote regions etc).

The scope of HFE assessments is shown in the diagram below



The base GST grant and SPPs are ‘pre –equalised’ to an equal per capita standard. That is to say, whatever is the state of origin of Commonwealth tax revenue that could be said to fund GST and SPP grants, that revenue is shared between states on an equal per capita basis. For State own source taxes, HFE transfers also aim for a per capita sharing of the total of all states revenue from a particular type of tax, plus or minus each state’s above or below average revenue effort for that particular tax, should that differ between states (unlike the GST).

Revenue side HFE transfers reflect the actual composition of state taxes, and consistent overall equalisation is achieved in respect of all revenue items (incl Commonwealth taxes) which affect distributional outcomes for households and firms, arising from the totality of state budgets. Also, each State government is accountable for its above or below average effort/severity in respect of specific taxes.

While there are practical data limitations in measuring fiscal needs precisely, and some subtlety may be needed to identify in some instances what states do in an underlying sense below the surface of things, there is really no stopping point to the potential arbitrariness of the GST distribution if the principle of ‘what states do’, is not adhered to as strongly as practicably possible.

Also, by taking a tax by tax and category by category approach the overall system of federal financial relations is “vertically adaptable”. That is to say, whether a tax or expenditure function is carried out by the Commonwealth or the State level of government can be determined on its merits (considering subsidiarity principles versus national co-ordination for example). In the absence of adequate category by category equalisation one State could be motivated purely on fiscal grounds to seek to hand over a category of expenditure of above average burden to its budget to the Commonwealth while another would be motivated in the other direction. The Northern Territory and Queensland might be motivated to hand over remote indigenous services and other States not. Tasmania might be motivated in favour of Commonwealth takeover of health services and other States not. Victoria might be motivated in favour of Commonwealth mining rent taxation to replace State ad valorem royalties and other States not.

Consideration of the merits of particular vertical assignment of tax and expenditure functions, always difficult in any case, would be further confounded in the absence of reliable and contemporaneous category by category equalisation.