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Mr Nick Greiner, Mr John Brumby, Mr Bruce Carter
Review of GST Distribution Panel
GST Distribution Review
The Treasury
Langton Crescent
Parkes ACT 2600

Nick, John & Bruce
Dear Mr Greiner, Mr Brumby and Mr Carter

I am pleased to provide you with the Northern Territory's Submission to the Review of GST Distribution, which responds in detail to the Issues Paper released in July 2011. The Northern Territory welcomes the opportunity to provide input to the Review.

The Northern Territory Government affirms its support for the distribution of GST based on the principle of horizontal fiscal equalisation. This is an important feature of intergovernmental relations in Australia and supports the long standing tenet that all Australians should have access to a comparable standard of services no matter where they live.

The Territory considers that the current system of GST distribution has served Australia well. It is a dynamic system capable of meeting Australia's future economic challenges, and ensures that benefits of Australia's economic growth are shared by all Australians.

Most importantly, equalisation provides vital financial support to the small states, in particular the Territory. Without this support, Territorians would not enjoy the same access to and quality of services that are afforded other Australians.

I trust that you will give due consideration to the Territory's submission. I look forward to the Review Panel's Interim Report and the further opportunity to contribute to the Review of GST Distribution.

Yours sincerely

DELIA LAWRIE

20.10.11

Northern Territory Government

Northern Territory Government

REVIEW OF GST DISTRIBUTION

NORTHERN TERRITORY GOVERNMENT

SUBMISSION TO ISSUES PAPER

OCTOBER 2011

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1.c. Since the introduction of the goods and services tax (GST), the level of funds redistributed through the equalisation process has been relatively stable at about 8 per cent of the total GST pool.

1.d. The amount of GST redistributed equates to about 0.3 per cent of Australia's gross domestic product (GDP). The impact of a financial flow of this size on the national economy is comparatively small, however the redistribution is essential, and underpins states' capacities to provide comparable levels of services across Australia.

1.e. Equalisation is essential in Australia due to the combined effect of vertical fiscal imbalance between the Commonwealth and the states, and importantly the differences in population demographics, geography, natural resource endowments and economic circumstances between states.

1.f. Examining the impact of equalisation on states' GST shares in isolation can be misleading as it does not provide an indication of changes in states' total revenue. Since 2004-05, the composition of Western Australia's revenue has changed with an increasing reliance on mining royalties, offsetting its declining share of GST. Western Australia's total per capita taxation, mining royalty and GST revenue has increased relative to other jurisdictions since 2004-05.

2. Governance and Administration

2.a. Commonwealth and state governments each have a role in determining the principles and objectives of equalisation in Australia.

2.b. It is important that governments and particularly the Commonwealth defend the principles used to distribute the GST amongst the states.

2.c. The Northern Territory (the Territory) supports the role of the Commission as an independent body responsible for recommending the distribution of GST revenue between states.

3. Efficiency

3.a. $3.6 billion of the $45 billion GST pool is redistributed between states, which equates to 0.3 per cent of Australia's $1.3 trillion GDP. In this context, it is unlikely that the equalisation process has a material impact on allocative and dynamic efficiency in the Australian economy however, the redistribution is essential in underpinning the small states' capacities to provide the national average level of services.

3.b. The national average cost of delivering services is largely influenced by the level of efficiency in the largest states. Smaller states are unable to exert any significant influence on national average costs.

3.c. Equalisation provides incentives for states to pursue efficiencies in services delivery. If states can provide services at below the national average cost per service, they retain the difference between their actual costs, and their assessed needs.

3.d. Over the last thirty years, all governments have actively participated in and implemented comprehensive and broad ranging national reforms. This demonstrates that equalisation has not impeded states from pursuing efficiency enhancing national reforms.

3.e. The pillars supporting equalisation – 'what states do' and policy neutrality – limit the potential for grant design inefficiency.

4. Equity

4.a. The principle that all Australians should have access to the average level of services no matter where they live has served Australia well and should continue to be the main objective of equalisation.

4.b. Full fiscal equalisation is appropriate in the Australian context for two reasons:

  i. the relative heterogeneity of states, in terms of population characteristics, geographic location, size and structure of economies and natural resource endowments; and

  ii. the level of vertical fiscal imbalance (VFI) in Australia, which severely limits revenue sources available to the states.

4.c. Equalisation is the best means available for achieving equity in service provision between jurisdictions.

5. Simplification

5.a. Equity should continue to be the primary objective of equalisation, with simplification a key consideration for the methodology adopted.

5.b. Consideration needs to be given to achieving greater simplification where possible, but also whether simplification has produced results that are not consistent with equity objectives or not reliable. The mining assessment is one where the pursuit of simplicity has not led to an improved outcome.

5.c. The Territory contends that most Australians support the underlying principle of equalisation – that is, all Australians should have access to comparable services wherever they live. However, much of the public commentary about the equalisation system is neither comprehensive nor balanced. A better understanding by the public of the equalisation system is desirable but that requires a balanced debate of the benefits that Australia derives from equalisation. Understanding by the public of the Commission's methodology at the individual assessment level is not critical nor does it occur in other areas of funding.

5.d. Public understanding of the equalisation process would be improved if changes in states' shares of GST revenue were considered in the broader context of states' aggregate revenue positions.

5.e. Locking in expenditure factors would reduce the considerable effort required in each major review associated with the re-examination of expenditure methodologies, allowing the Commission to focus on the revenue assessments which drive volatility in the GST distribution.

5.f. Removing the Territory from the equalisation process would not aid simplification, would impede the Territory's sovereignty and would have significant implications for the Territory's objectives of statehood.

6. Stability and Predictability

6.a. There are trade-offs between stability and responsiveness of the equalisation framework to changes in the Australian economy.

6.b. Volatility in relativities has been largely driven by the revenue assessments.

6.c. States' total revenue (including taxation, mining royalty and GST revenue) has been relatively stable and growing at similar rates over the period 2000-01 to 2009-10. Although total state revenues have been growing at a similar rate, the composition of revenue for each state has changed, which shows that equalisation responds to divergence between states' economic circumstances and results in the sharing of the revenue effects of economic booms or burdens amongst states.

6.d. The Territory contends that the current three-year averaging process provides an appropriate balance between stability in relativities, while ensuring they reasonably reflect state circumstances.

6.e. Locking-in relativities between major reviews or introducing a floor on relativities would lead to inequitable financial outcomes between states unless there was no change in relative state circumstances over that period.

7. Indigenous Influences

7.a. The national 2010 Indigenous Expenditure Report found that the Territory spent $2.16 billion on services related to Indigenous people in 2008-09. This equates to 53.9 per cent of the Territory's total general government budget and compares to an Indigenous population share of 30 per cent.

7.b. In the Territory much of the Indigenous-related expenditure is delivered through mainstream services. Indigenous-related services cannot be separated from mainstream services.

7.c. Removing Indigenous influences from equalisation and funding Indigenous services separately would create significant complexity in intergovernmental relations and is unlikely to lead to any of the intended results such as improving outcomes for Indigenous Australians. If Indigenous influences were removed from equalisation it would need to be removed for all states, not just for the Territory.

7.d. Removing Indigenous influences would result in differences in the way services are funded for Indigenous and non-Indigenous people, potentially creating segregated service arrangements such as separate Indigenous and non-Indigenous schools, hospitals, community health clinics and police services.

1 Equalisation in Australia

Key Points:

1.a. The principle that all Australians should have access to comparable standards of services no matter where they live, has been a long standing tenet of Australians and their governments.

1.b. The Australian economy has had to respond to many different shocks over the past thirty years and importantly, has been able to do so without significant dislocation of any particular state or regional community because of the equalisation arrangements that exist. The experience of the last thirty years suggests that equalisation will continue to work effectively in response to expected and unexpected future changes in international, national and regional economies.

1.c. Since the introduction of the GST, the level of funds redistributed through the equalisation process has been relatively stable at about 8 per cent of the total GST pool.

1.d. The amount of GST redistributed equates to about 0.3 per cent of Australia's GDP. The impact of a financial flow of this size on the national economy is comparatively small, however the redistribution is essential, and underpins states' capacities to provide comparable levels of services across Australia.

1.e. Equalisation is essential in Australia due to the combined effect of vertical fiscal imbalance between the Commonwealth and the states, and importantly the differences in population demographics, geography, natural resource endowments and economic circumstances between states.

1.f. Examining the impact of equalisation on states' GST shares in isolation can be misleading as it does not provide an indication of changes in states' total revenue. Since 2004-05, the composition of Western Australia's revenue has changed with an increasing reliance on mining royalties, offsetting its declining share of GST. Western Australia's total per capita taxation, mining royalty and GST revenue has increased relative to other jurisdictions since 2004-05.

1.1 Fiscal transfers from the Commonwealth Government (Commonwealth) to the states and territories (states) have existed since Federation and have evolved from a system whereby the Commonwealth provided special one-off grants to claimant states, to a system of fiscal equalisation of all states. While Australia's mode of fiscal equalisation has evolved over time in response to changed intergovernmental arrangements, equity has remained the overarching objective.

1.2 Since the Territory's inclusion in the equalisation process in 1987, it has been a recipient state. Prior to then, the Territory's financial arrangements were modelled on the states but were outside of the pool of financial assistance. The Territory receives more than its population share of GST revenue mainly because of the high costs of servicing its population, which is small and widely dispersed over a large and isolated landmass and its higher need for government services arising from its relatively large Indigenous population.

1.3 In 2010-11, the Territory received $2385 million in GST revenue, compared with its equal per capita share of $470 million. This redistribution ($1.9 billion in 2010-11) ensures that the Territory can provide services of a comparable standard to those in other jurisdictions, including:

- public hospitals in Darwin, Alice Springs, Katherine, Tennant Creek and Gove, ensuring that Territorians have reasonable access to a range of hospital services;
- 54 remote health clinics, in communities where there are no alternative private health providers. These clinics provide a wide range of health and community support services including primary clinical care, 24-hour emergency care, immunisation, antenatal care, population health screening, growth assessment and action checks for children under 5 years, provision of essential medications and management of chronic illness to name a few;
- aero medical services that provide emergency medical evacuations for Territorians in distant remote areas, some of which would otherwise be inaccessible for up to six months of the year;
- a law and order network that can respond to public order and safety needs, road accidents and other emergencies across the Territory's large and diverse landmass within a reasonable time;
- 198 government schools and Homeland Learning Centres to ensure that all Territory children have access to quality education, as is afforded other Australian children;
- the infrastructure required to provide essential services, including electricity, water and sewerage to all remote communities across the Territory;
- a rural road network of 38 672 kilometres (31 067 kilometres of which is unsealed), which enables community access to essential items such as food, fuel, building materials, medical supplies and government services. On a

per capita basis, the Territory's rural road length is eight times longer than the national average;

- culturally appropriate services to Indigenous Territorians, including Aboriginal Community Police Officers, Aboriginal Health Workers, circuit courts, Aboriginal Interpreter Service and Indigenous Assistant Teachers, Aboriginal Mental Health Workers and gender appropriate services for example the provision of separate health facilities and consulting and treatment areas for Indigenous men and women.

1.4 Equalisation (or the amount of GST revenue redistributed to the Territory above its population share) provides the Territory with about 40 per cent of its total revenue. This amount ($1.9 billion) equates to the total budget of the Territory's Departments of Education and Health.

1.5 It follows that without equalisation, Territorians would not have the reasonable access to services that other Australians enjoy. Without equalisation of untied grants, over half of the Territory's remaining revenue would comprise tied Commonwealth grants. This would impede on its sovereignty and severely restrict its ability to determine expenditure priorities. Further, with only 60 per cent of its current revenue, the Territory would have to make significant cuts to its budget. For example, it would need to close down at least three of the five Territory hospitals; there would be virtually no schools, police stations or, health clinics in remote communities; tourism, and sporting and cultural facilities in the Territory would be minimal; and the Territory would not be in a position to provide support to its key industries, such as the minerals and energy industry, in order to promote economic growth and create employment opportunities. In such an environment, staffing the remaining facilities would be exceptionally difficult.

1.6 While the amount of GST redistributed between states is relatively small in the national context ($3.6 billion or 0.3 per cent of Australia's GDP), it provides vital financial support to the small states. The redistribution of GST revenue is currently the only means of providing states with the fiscal capacity to deliver comparable levels of services.

1.7 The Territory strongly supports the current form of equalisation and the objective of providing states with the fiscal capacity to deliver a comparable level of services, particularly to Australians living in regional areas. Much of the criticism levelled at the equalisation process, such as claims that equalisation is impeding Australia's economic growth, distorting labour mobility, distorting government decision making and impeding states from pursuing efficiency-enhancing reforms has not been substantiated and is not borne out of experience. These arguments fail to acknowledge that the prime purpose of equalisation is to achieve equity between states.

Structure of the Australian economy

1.8 The Review of GST Distribution has been asked to consider whether the current form of equalisation will allow Australia to meet future challenges including structural changes and shocks to the Australian and global economies.

1.9 Australia's current form of equalisation has been in place since 1983. Since this time there have been significant structural changes in the Australian economy. These include the recessions of the 1980s and 1990s, deregulation of financial markets, relaxation of trade barriers and controls on the exchange rate, the implementation of National Competition Policy (NCP), the Asian financial crisis, taxation reforms and property and commodities booms.

1.10 More recently, the global financial crisis has highlighted Australia's exposure to external shocks and changes in the economic performance of its trading partners. The most significant structural change in the Australian economy in recent times is its record terms of trade, driven by unprecedented growth in the demand for, and prices of, Australian resources.

1.11 Throughout this volatility over the last thirty years, Australia's system of equalisation has been refined to respond appropriately and consistently to changes in economic circumstances.

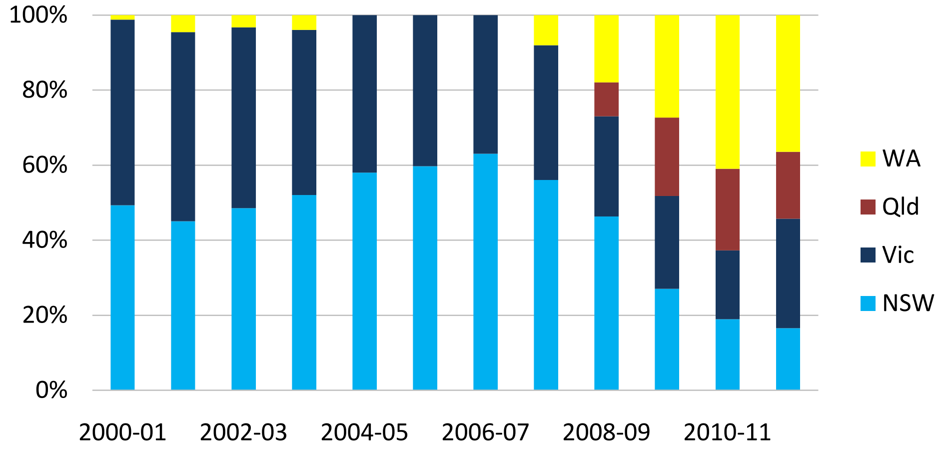
1.12 Equalisation provides a stabiliser within the Australian economy. It responds to divergence between states' economic circumstances, caused by external shocks or structural changes in the economy by distributing the effects of economic booms or burdens across states. The current form of equalisation has evolved to effectively operate in an open economy subject to global volatility. There is a real risk that an alternative form of equalisation would not be so effective.

1.13 The Review is asked to consider whether the fiscal equalisation system is a passive and reactive mechanism, and whether it should or can be a more active and dynamic policy tool.

1.14 Australia's form of equalisation is a passive but dynamic mechanism, which responds to changes in the Australian and global economies that affect states' own-source revenues and expense requirements. Evidence of these features of equalisation can be seen in the redistribution of GST revenue over the past ten years. Since 2000-01, Australia has experienced several property booms, the global financial crisis, record terms of trade and is currently managing the effects of a two- speed economy. These influences have impacted individual states differentially. Equalisation has responded to the structural changes in the Australian economy and the flow on impacts this has had on states' relative fiscal capacities.

1.15 Figure 1.1 shows the changes to state contributions to the redistribution of GST revenue since 2000-01. It shows that the decline in Western Australia's and Queensland's share of GST revenue, an impetus for the GST Distribution Review, is a recent phenomenon. Up until 2006-07, New South Wales and Victoria were the dominant contributors to the GST redistribution. Western Australia was a recipient state between 2004-05 and 2006-07, while Queensland was a recipient state until 2008-09. Since 2006-07, Western Australia and Queensland have experienced above average growth in their respective revenue-raising capacities, primarily driven by growth in mining royalty collections. Appropriately, in line with the increase in own-source revenues, the equalisation process has resulted in an increase in Western Australia's and Queensland's contribution to the GST redistribution.

Figure 1.1: Contribution to the redistribution of GST revenue



Source: Commonwealth Grants Commission

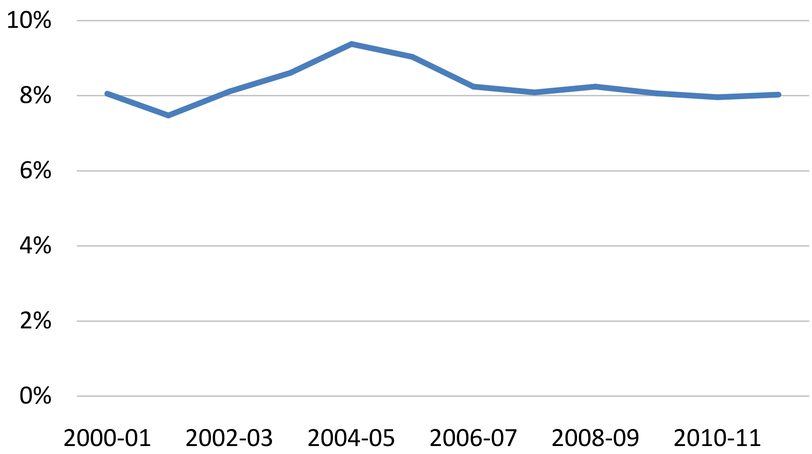
1.16 Figure 1.1 shows that equalisation is dynamic (reflecting underlying changes in the relative economic and other circumstances of states) and due to the lag in the Commonwealth Grants Commission's (the Commission) assessments, it is also reactive. These are desirable features of equalisation.

1.17 An alternative is equalisation becoming an active policy tool. If equalisation was an active mechanism, it would require the Commission to predict changes in the Australian and global economies, potentially leading to significant errors. For example, an active equalisation process would require the Commission to predict changes in the current commodities boom, both in terms of changing demand and spot prices and contracted prices for commodities. It is difficult to conceive that any Australian government entity, including the Commission, would be in a position to perform this role reliably and it would inevitably introduce a high level of uncertainty and unpredictability into the process.

Size of the redistribution

1.18 Although equalisation is responsive to changes in the structure of the economy, as reflected by changes in states' shares of GST revenue, the total amount redistributed each year is relatively stable and small. Since the introduction of the GST, the amount of revenue redistributed as proportion of the total GST pool, has remained reasonably stable at about 8 per cent (see Figure 1.2).

Figure 1.2: Total redistribution as a proportion of the GST pool



Source: Commonwealth Budget Papers

1.19 Debate about the appropriateness of Australia's current form of equalisation has included concerns regarding the size of the GST redistribution and the potential impact on the Australian economy. In 2010-11, the estimated amount of GST revenue redistributed between states was $3.6 billion, which equates to 0.3 per cent of Australia's GDP. To put this amount in context, the GST redistribution (aimed at achieving horizontal equity) pales into insignificance when compared to the $93 billion spent by the Commonwealth on social security income assistance in 2008-09.

1.20 While the amount of GST redistributed is small relative to the size of the Australian economy, it provides vital financial support to the small states (Queensland and Western Australia have both been recipients in recent times as well as in the last 30 years). The amount of GST redistributed to the small states (about $3.9 billion in 2011-12) is comparable with the combined total of payroll tax, land tax, stamp duty on conveyances and insurance tax revenue raised in South Australia, Tasmania, the Australian Capital Territory and the Northern Territory in 2009-10.

1.21 The amount of GST redistributed to the small states could not be replaced without these states significantly increasing the tax burden on their citizens or businesses, and/or reducing standards of services. Either of these approaches would have a deleterious economic impact on these states and the national economy.

International comparisons

1.22 Australia's federal financial system is characterised by a high level of vertical fiscal imbalance (VFI) between levels of government. The Commonwealth's revenue-raising capacity far exceeds its expenditure responsibilities while the inverse is true for the states. The Commonwealth raises about 80 per cent of total taxation and mining revenue in Australia, with 20 per cent raised by states. If GST was classified as a state tax, states' share of the national taxation and mining royalty revenue base would increase to around 33 per cent. Despite the states' small share of taxation and mining revenue, states have primary responsibility for core government services such as health, education and law and order.

1.23 International comparisons show that the amount of GST redistributed in Australia is modest. The redistribution in Australia (0.3 per cent of GDP) is comparable to Germany (0.3 per cent of GDP) and less than in Canada (0.9 per cent of GDP). This is despite the higher level of vertical fiscal imbalance that exists in Australia, and the heterogeneity of sub-national jurisdictions in Australia compared with other federal systems.

1.24 Germany and Canada do not exhibit the same level of vertical fiscal imbalance as Australia. The state-equivalent governments in Germany and Canada have access to the largest revenue bases, including personal income tax, corporate tax, value-added taxes and excise taxes (see Table 1.1).

Table 1.1: Comparison of own-source revenue base for the state-equivalent governments in Australia, Germany and Canada

	Australia	Germany	Canada
Personal income tax	No	Yes	Yes
Corporate income tax	No	Yes	Yes
GST/VAT	No	Yes	Yes
Excise taxes	No	No	Yes
Total redistribution as a proportion of GDP, 2009-10	0.3%	0.3%	0.9%

Source: Australian Bureau of Statistics; Werner, J and Shah, A, Fiscal Equalisation in Germany, 2005; Statistics Canada, Consolidated provincial and territorial government revenue and expenditures, 2009

1.25 Australia equalises for both expenditure needs and revenue-raising capacity, known as full equalisation. This is different from other federal systems which adopt partial equalisation – only equalising on the basis of revenue needs. Equalising on the expenditure side is appropriate in Australia because of states' limited own-source revenues and the diversity of states' population characteristics and economic circumstances. Canadian sub-national jurisdictions exhibit similar levels of diversity as Australian states, however the level of redistribution as a proportion of GDP in Canada is much higher than in Australia, at 0.9 per cent despite Canada only equalising for revenue needs.

1.26 In Germany, sub-national jurisdictions are relatively homogeneous and are located within a land mass that is less than half of the size of New South Wales. Despite German sub-national governments having access to a broader tax base, being more homogeneous than Australian states, and Germany only implementing partial equalisation, the size of the redistribution as a proportion of GDP in Germany is equivalent to that in Australia.

Objectives of equalisation in Australia

1.27 The Commission is responsible for recommending to the Commonwealth the distribution of GST revenue between states. The Commission's recommendations are based on the principle of horizontal fiscal equalisation which is defined as:

State governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.[1]

1.28 In implementing equalisation in Australia the Commission is guided by the supporting principles of: policy neutrality; what states do; contemporaneity; and practicality.

1.29 Equalisation is designed to compensate states for unavoidable differences in their costs of delivering services, and capacities to raise revenues. Equalisation provides states with the fiscal capacity to deliver the national average level of services to their constituents, no more, no less.

1.30 The Commission's assessments are based around the supporting principle of policy neutrality. This ensures that individual state policies do not directly influence GST shares, and that the equalisation process does not provide incentives for states to vary their policies. Importantly, equalisation neither rewards nor penalises states for differences in policy decisions, which is consistent with the untied nature of GST revenue.

1.31 There are a number of misconceptions as to the purpose of or results arising from equalisation.

1.32 A common misconception is that equalisation provides states with the capacity to address unmet needs. This is incorrect. Equalisation provides states with the fiscal

[1] Commonwealth Grants Commission 2011 Update

capacity to deliver the average level of government services, and not the fiscal capacity to address the backlog in service provision. This was affirmed by the former Chairman of the Commission, Mr Alan Morris, who stated:

Giving [the Territory] the same fiscal capacity as other states to deliver services to its citizens means maintaining any pre-existing differentials. If this capacity has to be applied to communities facing very different circumstances… and this is what we see in the Territory – outcomes will not narrow over time. The Territory's financial support does not provide it with catch up capacity.[2]

1.33 For example, government services in remote areas are not as comprehensive as those provided in urban areas. Equalisation does not provide states with the fiscal capacity to provide the same level of services to their residents in remote areas as the level of services in urban areas. Rather equalisation maintains these differences because equalisation is based on 'what states do'. It does, however, provide states with the fiscal capacity to deliver the same standard of services to citizens in comparable regions across Australia.

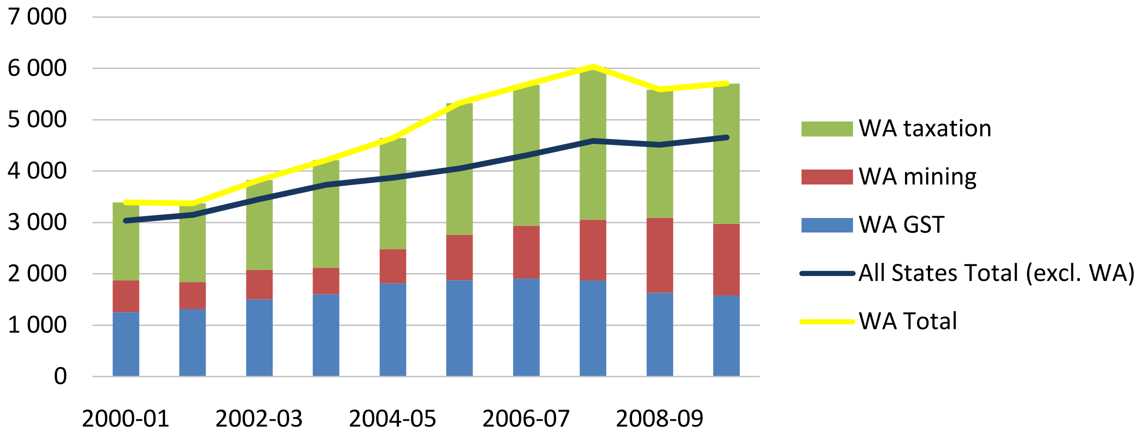
1.34 An impetus for the Review is Western's Australia's declining GST share. Concerns have been raised that Western Australia's relativity could fall to 0.3 and that this would not be an appropriate outcome, particularly given the contribution that Western Australia is expected to make to Australia's future growth.

1.35 Examining changes in states' shares of GST over time in isolation from other state revenues does not provide a comprehensive assessment of each state's overall fiscal position. For example, the implication is that Western Australia's falling GST share would lead to an unreasonable reduction in its fiscal capacity. This is incorrect when considered within the total revenues available to Western Australia.

1.36 In considering the impact of equalisation, it is important to examine a state's overall revenue position in per capita terms, and how this compares with other states. Figure 1.3 compares Western Australia's total revenue, and the composition of its revenue sources, with the average of the seven other states.

[2] Morris, A, *Powerhouse or Mendicant?*, Charles Darwin University Symposium 2003

Figure 1.3: Composition of total taxation, mining royalty and GST revenue, Western Australia and all states (excluding Western Australia), $ per capita

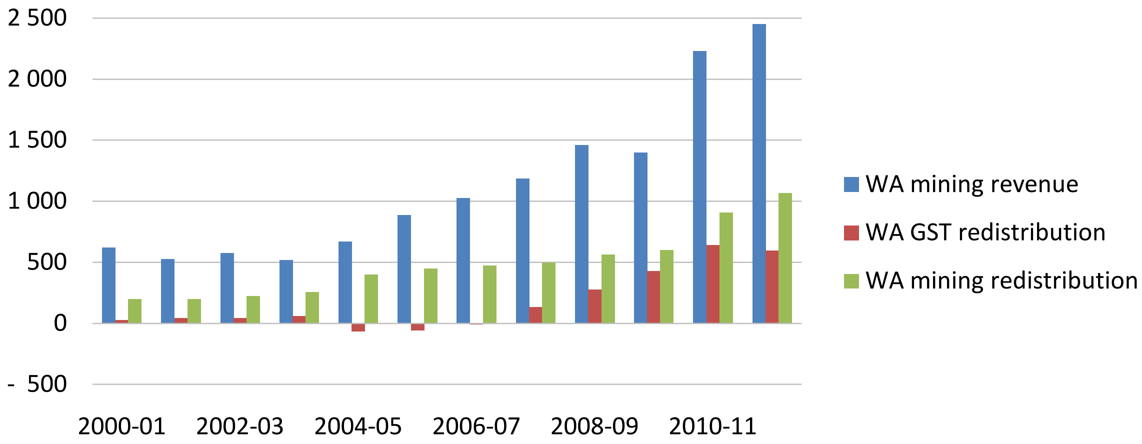


Source: Commonwealth Grants Commission, Australian Bureau of Statistics, Commonwealth Budget Papers

1.37 Figure 1.3 shows that the composition of Western Australia's revenue has changed over time. Since 2004-05, Western Australia's reliance on GST revenue has declined, as mining royalty revenue increases as a proportion of its total revenue. Despite these compositional changes, Western Australia's total revenue has increased over time, and Western Australia's per capita revenue position has grown relative to the average of the seven other states.

1.38 It is also asserted that additional mining royalties accruing to Western Australia as a result of the commodities boom are fully offset through the equalisation process. This is incorrect. Figure 1.4 compares Western Australia's mining royalties, the total GST redistribution away from Western Australia and the redistribution of GST away from Western Australia as a result of the mining revenue assessment. It shows that despite the equalisation process, Western Australia retains the majority of its mining royalties.

Figure 1.4: Mining revenue and GST redistribution, Western Australia, $ per capita



Source: Commonwealth Grants Commission, Commonwealth Budget Papers, and Western Australia Budget Papers

1.39 There are also misconceptions surrounding relativities and what they mean, particularly for the Territory. The Territory's relativity of 5.35 is often misunderstood as an indication that it costs 5.35 times more than other states to provide services in the Territory. This is incorrect.

1.40 Table 1.2 provides the calculation of GST relativities for New South Wales and the Territory. It shows that the per capita cost of providing the average level of services in the Territory is about 2.15 times the national average. The Territory has a relativity of 5.35 because the funds available to achieve equalisation are limited to the redistribution of GST revenue (which represents only half of states' total revenue) rather than redistributing total state revenue.

Table 1.2: Calculation of 2011-12 relativities, $ per capita

	NSW	NT	Average
Assessed expenditure	7 821	17 254	8 027
Expenditure relativity	*0.97*	*2.15*	*1.00*
Less			
Assessed revenue	4 090	4 143	4 232
Revenue relativity	*0.97*	*0.98*	*1.00*
Plus			
Assessed net lending	-460	-424	-441
Assessed investment	520	1 089	557
Assessed CW payments	-1 915	-3 291	-1 953
Equals			
GST requirement	1 876	10 485	1 958
GST relativity	**0.96**	**5.35**	**1.00**

Source: Commonwealth Grants Commission, Northern Territory Treasury

2 Governance and Administration

Key Points:

2.a. Commonwealth and state governments each have a role in determining the principles and objectives of equalisation in Australia.

2.b. It is important that governments and particularly the Commonwealth defend the principles used to distribute the GST amongst the states.

2.c. The Territory supports the role of the Commission as an independent body responsible for recommending the distribution of GST revenue between states.

2.1 GST is the single most important revenue source for all states. As such, all states have a keen interest in how it is shared. The system of equalisation in Australia has evolved over time, guided by Terms of Reference, changes in intergovernmental arrangements between the Commonwealth and the states and importantly, the work of the Commission with significant input from states through review processes.

2.2 In addition to the requirements of its Terms of Reference, at the start of each Review the Commission considers which of its existing methods requires detailed review. In the 2010 Review, the simplification requirement meant that all aspects of the previous methodology were examined and most assessments were altered.

2.3 The Review Panel has asked whether governments pay sufficient attention to the form of equalisation that underlies the dollar impacts. The focus of states has generally been on the way the GST distribution affects their jurisdiction. This primary focus has intensified as GST revenue has grown in importance as a proportion of total state revenue and the commodities boom has an increasingly divergent influence on states economies and their own-source revenues.

2.4 However, the sharp focus on the dollar effects of the GST distribution appears to have been at the expense of an appreciation for the broader effects of any move away from the full or comprehensive methodology that has been the basis of equalisation in Australia for three decades. It is essential that governments, particularly through advocacy by the Commonwealth, acknowledge the importance of equalisation to the development of all regions and the benefits of equity and fairness in the allocation of government services that it provides.

Role of governments

2.5 The principle of horizontal fiscal equalisation is central to the distribution of grants between the states. It is enshrined in Commonwealth legislation and in the Intergovernmental Agreement on Federal Financial Relations (IGA) and has enabled the simplification of distribution of specific purpose payments (SPPs) since 2008 and, importantly, in the recent health reform negotiations because of the way equalisation arrangements will be applied.

2.6 However, equalisation is from time to time subject to public criticism based on particular elements of the equalisation process without regard to its broader aspects. When this occurs, there are generally no defences of equalisation made by the Commonwealth even though it is a central element of the revenue distribution processes agreed by governments. The objective of this review is to enable once again these issues to be exposed to public debate and consideration. When this review is completed, and preferably sooner it is important that governments, particularly the Commonwealth, publicly defend the equalisation process.

2.7 Commonwealth and state governments have important but different roles in the equalisation process. The Commonwealth has two primary functions: after consultation with the states, to provide guidance to the Commission on the objectives and broad methodology for implementing equalisation through terms of reference; and to make the final determination on the distribution of GST revenue between states, in deciding whether or not to adopt the Commission's recommendations.

2.8 States' role is to provide input into the methodology for distributing GST revenue. The onus is on states to prove the existence of material and unavoidable disabilities, through the provision of data, evidence and conceptual arguments that the disability be assessed by the Commission. The Commission's open and consultative review process ensures accountability and transparency in the methodology used to determine the distribution of GST revenue between states.

2.9 The most important feature of the governance arrangements for equalisation is the Commission's role as an independent body and its ability to recommend the distribution of GST free from political influence.

Role of Commonwealth Grants Commission

2.10 The Territory supports the role of the Commission as an independent and impartial national body responsible for recommending the distribution of GST revenue between states to the Commonwealth. The Commission has the expertise and technical knowledge, accumulated since its establishment in the 1930s to provide impartial, transparent and independent advice to the Commonwealth on the distribution of GST revenue among the states.

2.11 The Commission has effectively balanced the conflicting views of states, particularly given the zero sum nature of GST distribution, and has provided an equitable distribution of GST revenue within the confines of its terms of reference.

2.12 The independence of the Commission from all governments is a positive feature of Australia’s approach to equalisation. Alternative arrangements such as equalisation being administrated by joint government bodies would be unlikely to result in more accepted outcomes. This option would be unworkable because states are unlikely to reach consensus positions on each state’s share of GST revenue. Furthermore, this option may require greater involvement of the Commonwealth, as the umpire to rule on contentions issues between states.

3 Efficiency

Key Points:

3.a. $3.6 billion of the $45 billion GST pool is redistributed between states, which equates to 0.3 per cent of Australia's $1.3 trillion GDP. In this context, it is unlikely that the equalisation process has a material impact on allocative and dynamic efficiency in the Australian economy however, the redistribution is essential in underpinning the small states' capacities to provide the national average level of services.

3.b. The national average cost of delivering services is largely influenced by the level of efficiency in the largest states. Smaller states are unable to exert any significant influence on national average costs.

3.c. Equalisation provides incentives for states to pursue efficiencies in services delivery. If states can provide services at below the national average cost per service, they retain the difference between their actual costs, and their assessed needs.

3.d. Over the last thirty years, all governments have actively participated in and implemented comprehensive and broad ranging national reforms. This demonstrates that equalisation has not impeded states from pursuing efficiency enhancing national reforms.

3.e. The pillars supporting equalisation – 'what states do' and policy neutrality – limit the potential for grant design inefficiency.

Government participation in national reforms

3.1 The Issues Paper seeks views on whether or not the current fiscal equalisation process complements or encourages or discourages productivity enhancing reforms by the states. The Territory contends that equalisation is not designed to either actively encourage or discourage states from pursuing productivity enhancing reforms, and that equalisation does not get in the way of decisions to pursue reform.

3.2 Historically, national reforms in Australia have been pursued through multilateral and bilateral arrangements, negotiated by Heads of Governments or Treasurers and more recently through the Council of Australian Governments (COAG). These arrangements have proven to be an effective way of achieving a large range of nationally beneficial reforms.

3.3 Over the last thirty years, Australia has implemented a comprehensive and broad ranging series of national reforms, including:

- NCP, which included reforms to ports and electricity;
- taxation reform;
- labour market reform;
- financial services and banking reform;
- tariff reform;
- business regulation reform;
- superannuation reform;
- national health and hospital reform;
- heavy vehicle reform;
- water reform;
- industry reforms and policies;
- privatisation of government business enterprises; and
- tertiary education and training reform.

3.4 Across the range of national reforms, states have participated consistently and fully. In some instances the Commonwealth has provided limited financial incentives to support reforms, although these have not reflected the level of benefits that have accrued to Australia or the Commonwealth as a result of the reforms.

3.5 Under NCP a range of structural and regulatory reforms were introduced. These included reform of electricity and water supply and commercial passenger vehicle industries and the introduction of formal third-party access regimes for electricity network, gas pipeline and rail infrastructure. All states agreed to commercialise and corporatise government owned businesses and review and reform legislation, including the implementation of a regulation gate-keeping framework.

3.6 In the Territory's case all of these obligations were met including reviewing 80 pieces of legislation. The National Competition Council assessed the Territory as largely complying with its NCP commitments and received the bulk of its competition payment entitlement.

3.7 Along with all other jurisdictions, the Territory is a signatory to the National Partnership Agreement towards a Seamless National Economy. Implementation is still in progress and noteworthy initiatives underway include reform of the regulatory framework for the Darwin Port, payroll tax administration, workplace health and safety and occupational licensing.

3.8 Claims that equalisation has discouraged states from pursuing microeconomic reform are not supported by evidence. This is the case even when the administrative costs of reform relative to the benefits received from implementation can vary significantly between jurisdictions. For example, for most reforms implementation costs are relatively high in the Territory, and as a result of small and fragmented markets the associated benefits are more diffuse. However, this has not prevented the Territory from being an active participant in national microeconomic reform initiatives.

3.9 Equalisation has resulted in simplification of some elements of state participation in national reforms. National reforms pursued through national agreements are less likely to be delayed by states debating shares of funding because this is largely determined on a needs basis through the equalisation process. This was evident during the negotiation of the National Health Reform Agreement, whereby all states agreed that $16.4 billion funding guarantee will be allocated on a population basis, and for the funding guarantee to be treated by inclusion in the Commission’s methodology.

Efficiency impacts of equalisation on economic welfare

3.10 The Review has been asked to consider whether the current form of equalisation distorts efficient economic activity and the efficient allocation of resources throughout the Australian economy and, if so, whether there are alternative forms of equalisation that could minimise these distortions?

Equalisation and economic growth

3.11 It is important to consider the size of the redistribution in the context of the Australian economy. While the entire GST pool is used for equalisation purposes, only $3.6 billion of the $45 billion GST pool (in 2009-10) is actually redistributed between states compared with a population-based distribution. The amount redistributed equates to 0.3 per cent of Australia’s $1.3 trillion GDP. In this context, it is unlikely that the equalisation process has a material impact on efficiency in the Australian economy.

3.12 In its considerations of the impact of equalisation on efficiency, the Commission stated that:

equalisation did affect the allocation of resources, but the effects were not serious enough to warrant changes in the way equalisation was implemented … any equalisation system would have implications for efficiency, but a study done for it suggested that the effects would be small.[3]

3.13 The study referenced in the above relates to consultancy work undertaken by Institute of Applied Economic and Social Research for the Commission in 1990. Although the analysis was undertaken some time ago, the findings of the study remain valid and the principles underpinning equalisation remain largely unchanged. In addition, there is a lack of published research that attempts to quantify the impacts of equalisation on efficiency. The key findings from the study follow.

- Replacing horizontal fiscal equalisation with an equal per capita distribution of general revenue assistance could reduce economic activity in the Territory by about 20 per cent and by about 4 per cent in Tasmania. On the other hand, economic activity could increase by about 1.5 per cent in both New South Wales and Victoria.
- The report states that *"proponents of changes [to the distribution of general revenue assistance] should feel obliged to argue that the eventual gains from a better allocation of resources are sufficiently large that the losers from the process of change could be compensated while leaving no-one worse-off"*.
- The estimated efficiency cost of including location disability allowances in the distribution formula for general revenue assistance was $29.8 million in 1988-89 (equivalent to $56.4 million in 2010-11 dollars). The Territory contends that the efficiency cost of this size is negligible given the large equity gains arising from the inclusion of location disabilities.

3.14 While the amount of GST redistributed between states is relatively small in the national context, it is significant to state budgets. Partial equalisation or an equal per capita distribution of GST would pose a critical risk to small states' capacities to deliver the national average level of services and would have a crippling effect on economic growth and employment in these states.

3.15 For example, the amount of GST redistributed to the Territory compared with an equal per capita share represents about 40 per cent of the Territory's total revenue ($1.9 billion in 2010-11). This revenue is essential for ensuring that services are provided to the entire Territory population. Without this critical budget support,

[3] Commonwealth Grants Commission – The Last 25 Years

the Territory would be unable to provide many services, particularly to its remote population.

3.16 The Australian economy is among the most stable and prosperous in the world (highlighted in particular by Australia's continued economic growth and stability despite recent global economic volatility and uncertainty). Australia also has the most comprehensive form of fiscal equalisation in the world. There is no evidence to suggest that equalisation has impeded upon Australia's economic wellbeing, and perhaps, the stability in the Australian economy is in part due to its system of equalisation, which provides fiscal sustainability to the states. Fiscal sustainability is a determinant of investor confidence, necessary to drive long-term growth and development.

3.17 The objective of the current form of equalisation is equity with efficiency considerations having a strong influence on the achievement of equity. An alternative is to include efficiency as a co-objective of equalisation. The Territory's view is that if efficiency was to be given a greater weight this would have to be done at the expense of equity.

3.18 The equity component of equalisation directs GST revenue towards those states that face the highest costs of delivering services, due to influences outside of their control and/or those states that have a lower capacity to raise own-source revenues.

3.19 The Territory contends that equalisation is the best means of achieving equity between jurisdictions, and that efficiency is already embedded in the process. Efficiency was rigorously pursued in the 2010 Review through the use of materiality thresholds and the requirement for national and independently derived data. These requirements are embedded in the current methodology and will continue to be reinforced during future reviews. As such, equalisation is currently tasked with achieving equity in the most efficient way possible.

3.20 If efficiency and equity were co-objectives of equalisation, the terms of reference would need to specify the 'cut-off point' for the provision of 'inefficient' services, whether it be minimum population size, distance from main centre or a particular population sub-group. The issue would then be whether the responsibility for the provision of services to those excluded from the equalisation process would fall to the Commonwealth or whether services to all other residents of a state would need to be reduced in order to maintain services previously funded through the equalisation process.

Allocative efficiency

3.21 It has been argued that equalisation distorts settlement decisions by providing less productive states with the fiscal capacity to provide the same level of services as the most productive states, therefore providing fewer incentives for people to relocate to more productive areas, and encouraging government investment in infrastructure in less productive areas.

3.22 In the current economic climate, the issue regarding population mobility primarily relates to movement of labour to northern Western Australia and remote areas of Queensland to work in the energy and resource industries. Other states, including the Territory and South Australia, face similar challenges in recruiting and retaining workers not only to work in remote mining areas but importantly to provide essential government services, particularly in health, education and law and order.

3.23 While it is argued that equalisation blunts incentives for people to move, the Territory contends that equalisation is not the root cause, or a major factor for the current labour shortage facing resource projects. It is mining companies, not state governments that are responsible for recruiting and retaining workers for resource projects. Often, the funds they expend in doing so, particularly through generous remuneration, can distort usual operating conditions in rural and remote locations making it more difficult for state and local governments to deliver services. Changing the method of GST redistribution is unlikely to have any meaningful effect on the attraction of labour to resource projects.

3.24 However, as resource projects develop the issue that will increasingly confront states is how to encourage workers to take government jobs in remote areas often at a substantially lower level of remuneration than a job in the mining sector. Equalisation gives states capacity to provide services outside of major centres, however if government costs rise in remote areas due to competition from resource projects, current methods would be unlikely to reflect these additional costs.

3.25 Equalisation provides capacity for the Territory to provide services and infrastructure at standards that are comparable to other jurisdictions, this reduces the extent to which such factors influence investment decisions. For example, the availability of social infrastructure and human capital in the Territory, at levels approaching national averages, means that the major investment projects can proceed in accordance with economic imperatives.

Influence of equalisation on government decision making

3.26 The Commission's methodology has inbuilt mechanisms to reduce scope for grant design inefficiency. The supporting principles of policy neutrality and 'what states do' underpin the definition of equalisation in Australia and reduce the potential for incentives for states to vary, or game, policies in order to directly influence the GST distribution.

3.27 The procedures for governments to consider changes in policy or requests for additional resources are through a Cabinet or budget process. Consideration is primarily given to the cost and benefits of proposals in terms of economic, social and environmental impacts. Most governments' guidelines are similar and require details on how proposals will affect:

- agency budget and resources;
- legislation and regulation;
- employment and training;
- Australian, state and local government relations;
- strategic policy alignment; and
- impacts on important considerations such as environment and climate change.

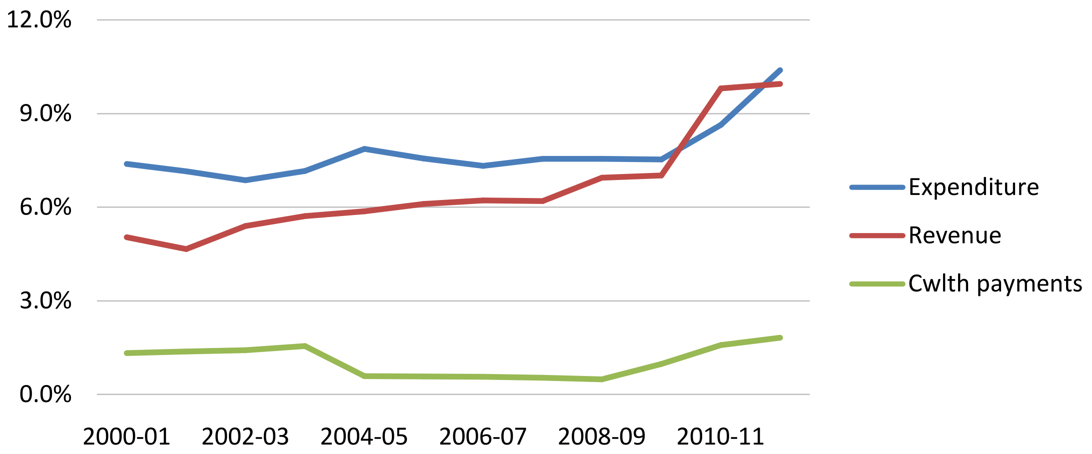
3.28 In the Territory there are also requirements to consider land rights and native title issues, Indigenous matters and the Territory's constitutional status. The central concerns for governments in forming policies, revenue-raising or allocating funding do not include second round GST implications, which may or may not occur.

3.29 One area where GST implications are pertinent is the consideration of whether or not to negotiate Commonwealth tied payments. Commonwealth payments are generally treated by inclusion in the Commission's process and the amount that each state receives in tied funding affects its assessed GST needs.

3.30 While GST implications of Commonwealth tied funding is a logical consideration, not since the days of Joh Bjelke-Peterson has this been a determinant of governments' acceptance of tied funding. The key issues considered are: whether the objectives of the tied funding are consistent with state policies; state matching requirements; reporting and administrative requirements; future funding obligations when the agreement expires; and whether the funding is commensurate with the objectives of the agreement. The 2009 Heads of Treasuries Review of National Agreements, National Partnership Agreements and Implementation Plans did not consider the GST implications of tied Commonwealth funding arrangements.

3.31 Figure 3.1 shows the total redistribution of GST revenue arising from Commonwealth payments, as a proportion of the GST pool. In 2011-12, the redistribution arising from Commonwealth payments is estimated to be 1.8 per cent of the GST pool, compared with 9.9 per cent and 10.4 per cent arising from the revenue and expenditure assessments, respectively. The Territory is the largest contributor to the redistribution arising from Commonwealth payments with about $950 per person of GST revenue being redistributed away from the Territory.

Figure 3.1: Total redistribution arising from expenditure assessments, revenue assessments and Commonwealth payments as a proportion of the GST pool



Source: Commonwealth Grants Commission

3.32 The Commission's default approach is to treat all tied Commonwealth payments by inclusion. The Commission has also developed guidelines to determine whether a payment should be excluded from its assessments, therefore having no impact on relativities. These guidelines ensure consistent treatment of Commonwealth payments and limit the scope for political gaming. These arrangements have simplified the distribution of SPPs between the states and have contributed to the resolution of the recent National Health Reform Agreement. The alternative is for a 'scatter gun' approach to the treatment of tied Commonwealth payments, which would undermine the fairness of the system and greatly increase the administrative costs and complexity of tied funding distribution arrangements.

Does HFE provide incentives for states to deliver services inefficiently?

3.33 The impact of equalisation on the efficient provision of government services can be considered both in the context of providing incentives for governments to reduce the unit costs of government services, or increase the effectiveness of government expenditure through output-based benchmarks or efficiency dividends. The latter are considered in the 'equity' section of this submission.

3.34 There is an implicit efficiency mechanism built-in to the current equalisation process. Under the current definition of equalisation, it is assumed that states operate at the same level of efficiency. Consequently, states that are able to deliver services below the average unit cost are able to retain the benefits, while states that are unable to provide services at average cost are not compensated with additional GST revenue to fund the shortfall.

3.35 It has been argued that equalisation provides incentives for states to oversupply or undersupply services to certain population groups in order to secure a larger share of GST revenue. For example, it has been suggested that equalisation provides incentives for the Territory to maintain high service delivery costs, or oversupply government services in remote areas.

3.36 The notion that equalisation provides incentives for states to oversupply or undersupply services in order to attract a higher GST share is not credible. The Commission uses an internal standard approach to assess the amount of GST each state would need to provide the national average level of services. The internal standard is calculated as the national average per capita expenditure for each government function. To the extent that the most populous states contribute to a greater share of total national expenditure, the cost at which these states deliver services drives the average.

3.37 For example, across virtually all government services, expenditure in New South Wales and Victoria equates to over 50 per cent of total expenditure. Including Queensland, the proportion increases to over 70 per cent. Table 3.1 shows that New South Wales and Victoria comprise of 54.7 per cent of total expenditure in school education, if Queensland is included this proportion increases to 74.5 per cent. Assuming that the most populous states are able to achieve efficiencies in government services delivery through economies of scale, these efficiencies are built into the standard.

3.38 Given the Territory's small population size, the cost of delivering services in the Territory has virtually no bearing on the standard, the benchmark against which states GST needs are assessed. This is demonstrated in Table 3.1. If the Territory increased its school expenditure by 20 per cent, the average expenditure (or standard) would only increase by $6 per capita. On the other hand, if New South Wales increased its spending on school education by 20 per cent, the average expenditure would increase by $111 per capita. This is indicative of the weighting that larger states have on the average level of services, which is also the basis used by the Commission to calculate states' fiscal needs.

Table 3.1: Calculation of average school education expenditure, 2009-10

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
Actual, $B	12.3	8.9	7.6	4.6	3.0	0.9	0.6	0.7	38.6
% of total	*31.7%*	*23.0%*	19.8%	11.9%	7.7%	2.4%	1.7%	1.7%	100%
Standard, $pc									**1 741**
Scenario 1: 20% increase in NT school education expenditure									
Revised, $B	12.3	8.9	7.6	4.6	3.0	0.9	0.6	0.8	38.7
% of total	*31.6%*	*22.9%*	19.7%	11.9%	7.7%	2.4%	1.7%	2.0%	100%
Standard, $pc									**1 747**
Scenario 2: 20% increase in NSW school education expenditure									
Revised, $B	14.7	8.9	7.6	4.6	3.0	0.9	0.6	0.7	41.0
% of total	*35.8%*	*21.7%*	18.6%	11.2%	7.3%	2.3%	1.6%	1.6%	100%
Standard, $pc									**1 852**

Source: Commonwealth Grants Commission, Northern Territory Treasury

Equalisation impacts on incentives for states to raise revenue efficiently

3.39 The issues paper seeks views on whether equalisation provides disincentives for states to fully exploit their own-source revenue bases and/or levy taxes efficiently.

3.40 State government decisions to reform taxation policy are most heavily influenced by other factors, such as the size of the relevant tax base, the implications for economic growth, the broader economic environment, competitiveness with other states and the budgetary implications of the reform.

3.41 It is argued that equalisation provides disincentives for states to pursue unilateral tax reform. The example often given is there are GST disincentives for states to abolish conveyance duty (which is considered to be an inefficient tax) and replace the revenue through a broad-based land tax (that is apply land tax to all properties including principal place of residence).

3.42 The Territory has undertaken modelling on the GST implications for New South Wales and South Australia if either of these states replaced conveyance duties with a broadened land tax. New South Wales is assessed as having an above-average capacity to raise conveyance duty, while South Australia is assessed as having a below-average capacity. The model assumed that the Commission would treat a broadened land tax base as non-average state policy, and therefore it would be assessed on an equal per capita basis in the ‘other revenue’ category.

3.43 The Territory’s modelling shows that if New South Wales abolished conveyance duty and broadened its land tax base, it would result in a $43 million, or $5.95 per capita increase in its GST revenue. On the other hand, if South Australia abolished its conveyance duty and broadened its land tax base, its GST revenue would decrease by $14 million, or $8.58 per capita.

3.44 The results indicate that GST implications are not significant impediments to one-state tax reforms. Tax reform is difficult on many levels, including politically, implementation complexities and issues in timing the phasing in of a new tax while phasing out the old tax. It is therefore unlikely that GST impacts of one-state tax reform are a significant barrier to states pursuing more efficient taxation regimes. This reinforces the need to approach taxation reforms at the national level, rather than unilaterally.

3.45 It has been suggested that equalisation provides states with disincentives to fully exploit their revenue bases. For example, that states that receive more than their per capita share of GST revenue have a reduced need to raise revenue from their own sources.

3.46 Table 3.2 shows the total revenue-raising effort of all jurisdictions. It shows that there is no direct relationship between states that receive more than their per capita share of GST revenue and their revenue-raising effort. Indeed, the Australian Capital Territory and the Northern Territory, which are beneficiaries of the equalisation process, are assessed as making the highest effort to exploit their respective revenue bases.

Table 3.2: Total revenue-raising effort

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	%	%	%	%	%	%	%	%	%
2006-07	95.8	105.0	101.6	93.2	106.9	88.1	135.5	102.3	100.0
2007-08	98.1	103.2	90.1	99.1	116.0	91.0	161.1	135.5	100.0
2008-09	98.4	100.0	100.5	89.3	113.8	99.8	157.2	115.8	100.0
2009-10	99.5	100.3	100.9	89.3	112.2	87.3	142.6	117.5	100.0

Source: Commonwealth Grants Commission

3.47 In formulating state tax policies, equalisation is not a significant influence on government decisions. An example of this is the Territory's policy not to levy a land tax, despite being assessed by the Commission as though it does.

3.48 In 2009-10, the Territory was assessed as though it raised $41 million in land tax revenue although it raised none. The Territory is not compensated through the GST process for its policy decision not to levy a land tax. The GST redistribution to the Territory arising from the land tax assessment reflects the difference between the Territory's capacity (not effort) to raise land tax relative to the national average. For example, in 2009-10, national land tax revenue was $262 per capita. If the Territory applied average land tax rates it is assessed as though it could raise $180 per capita. The difference of $82 per capita or $18.6 million represents the amount of GST redistributed to the Territory from the land tax assessment due to the Territory's relative capacity, not its policy, to levy a land tax.

3.49 Similarly, the Territory applies a profit-based regime to levy mineral royalties, and is the only jurisdiction to do so. This approach was adopted on the basis that it is the most economically efficient method. It facilitates the establishment of new mines in the initial stage of production where there are high start-up costs and it applies a higher effective rate of tax to mines when they are established and operating profitably. Adopting a profit-based regime across Australia was a key recommendation of the Henry Tax review.

3.50 The Commission's method assumes that the Territory levies mineral royalties under an ad valorem regime because this is average state policy. However, the Territory continues to apply a profit-based regime because it is the most efficient way of levying mineral royalties and to support Territory miners, disregarding any GST implications.

Unintentional penalties or rewards arising from equalisation

3.51 The issues paper asks whether equalisation actually or unintentionally penalises or rewards states. The example that has been provided in relation to this issue is the decision by Victoria to abolish mortgage duty, agreed under the former Intergovernmental Agreement on Commonwealth-State Financial Relations, ahead of other states. The fiscal impact on Victoria related to the fact that Victoria was still assessed as though it raised mortgage duty because this was considered to be average policy. It should be noted that the Territory abolished mortgage duty in the 1990s, prior to the national tax reforms and independent of other states. Consistent with average policy at the time, the Territory was assessed as though it did raise mortgage duty.

3.52 The Commission has had a long standing practice for the treatment of differences between the states in accessing own-source revenue bases. When the Commission was required to assess relativities following the commencement of National Tax Reform, it set out its proposed approach and provided all states and the Commonwealth with the opportunity to comment before it determined its methodology. The majority of states supported the Commission continuing with its past practice. The Commonwealth provided no direction otherwise. Arguably if the Commonwealth considered that the Commission's proposed approach was inconsistent with the National Tax Reform objectives it would have conveyed this to the Commission.

3.53 While equalisation does not intentionally reward or penalise states for independent policy decisions, there may be unintended GST implications. For example, the Territory is not rewarded or penalised through a higher or lower GST share for its decision not to levy a land tax, although it is assessed as though it raises land tax. These treatments are consistent with the supporting principles of policy neutrality and what states do.

Alternate forms of equalisation that may better achieve efficiency, and provide incentives to the states to have growth-enhancing policy settings?

3.54 The Territory contends that altering the form of equalisation in an attempt to drive efficiency in the Australian economy is not achievable if equalisation is also intended to provide states with the capacity to provide the same level of services to people in comparable areas. This would be asking too much of the equalisation process. The inclusion of both equity and efficiency as objectives of the equalisation process would result in neither objective being achieved satisfactorily.

3.55 The primary objective of equalisation should continue to be the equalisation of state fiscal capacities. There are no suitable alternatives in intergovernmental financial relations to achieve this goal. There are, however, more effective means of achieving efficiencies in the Australian economy than through limiting the scope of equalisation. History has shown that national reforms, implemented through multilateral and/or bilateral agreements between governments, have been effective at achieving intended efficiency outcomes.

3.56 There is no evidence to suggest that an alternate form of equalisation would have a material impact on enhancing the efficiency of the Australian economy or that the current form of equalisation impedes efficiency in the Australian economy. The Territory's view is that further pursuit of efficiency for Australia is better addressed outside of the equalisation process, and that equalisation is the most appropriate means for providing states with the capacity to deliver comparable services.

4 Equity

Key Points:

4.a. The principle that all Australians should have access to the average level of services no matter where they live has served Australia well and should continue to be the main objective of equalisation.

4.b. Full fiscal equalisation is appropriate in the Australian context for two reasons:

i. the relative heterogeneity of states, in terms of population characteristics, geographic location, size and structure of economies and natural resource endowments; and

ii. the level of VFI in Australia, which severely limits revenue sources available to the states.

4.c. Equalisation is the best means available for achieving equity in service provision between jurisdictions.

The Territory Government is committed to making sure every Territorian has the same opportunities in life. Territory Together is about creating a society where everyone, no matter what their circumstance, background or culture, can be a full and active participant in society… By engaging the whole community, the government is making sure all Territorians get a fair go.[4]

4.1 The central theme of the criticism of the equalisation process is the perceived inefficiencies arising from the way in which GST revenue is distributed between states. The validity of these arguments, and the materiality of these influences, is the subject of much debate. As previously stated, the Territory is not aware of any robust analysis or reports that is able to substantiate these claims.

4.2 What is ignored is the effect on equity if equalisation was diminished. Equalisation is not intended to be a policy tool for promoting growth in the Australian economy. It is not designed to provide incentives for states to pursue economic reform, nor is it intended to overtly influence population mobility between states and/or between regions. It would be nonsensical to limit equalisation based on the notion

[4] Northern Territory Government, *Territory Together Initiative*

that it may impede the efficient allocation of resources across the Australian economy even though the data indicates that the efficiency gains would not be material. The inevitable outcome of such action would be an increase in the level of inequity between regions in Australia, requiring intervention that would come at a greater cost to the Commonwealth and Australia's economic growth than the current system of equalisation.

4.3 The IGA outlines the basis for the provision of GST payments to the states, and has only one stated objective for the distribution of GST payments – *"equalisation of fiscal capacities between states and territories"*.[5]

4.4 The current method of GST distribution ensures that states share in the economic growth of Australia, such as the revenues generated from the resources boom, as well as sharing the financial risks of Australia's exposure to external shocks, such as extreme weather events. This is consistent with the Commonwealth's Social Inclusion Policy which states that "*as our economy grows, we should invest to make sure that the whole community can contribute to and benefit from the resulting prosperity"*[6].

4.5 The principle of equalisation also acts as a stabiliser between jurisdictions by redistributing revenue towards states with higher expenses, or reduced revenue-raising capacity in a given period, from states whose fiscal capacities are comparatively more robust. It does not remove all benefits of economic growth from those states.

4.6 The promotion of equity and fairness has been a central objective of Australian governments, and are long standing tenets of Australian society. Examples of major government policies where equity is the core theme include the following.

- Australia's personal tax and transfer system – *"Under Australia's progressive tax system, those with a higher capacity to pay bear a greater than proportional share of the tax burden…Transfers provide financial assistance to individuals who are unable, or not expected, to fully support themselves, and to families to help meet the costs of raising children"*[7].
- Under the National Healthcare Agreement, all governments agreed to *"provide all Australians with timely access to quality health services based on their needs, not ability to pay, regardless of where they live in the country"*.
- Medicare, which ensures that all Australians are entitled to have access to free or low cost medical, optical and hospital care.

[5] Intergovernmental Agreement on Federal Financial Relations
[6] Commonwealth, *A Stronger, Fairer Australia*, 2009
[7] Commonwealth, *Architecture of Australia's tax and transfer system*

- The Pharmaceutical Benefits Scheme, which provides affordable access to necessary medications for all Australians.
- Free school education for all Australian children and assistance to non-government schools for those who do not choose public education.
- Funding for university education- the Commonwealth Minister for Tertiary Education, Skills and Jobs, Senator Chris Evans, stated that *"every student should have access to a world-class education and quality training no matter where they live"*[8].
- COAG's National Indigenous Reform Agreement (Closing the Gap), which is aimed at improving the outcomes of Indigenous people through a multi-faceted approach directed across seven building blocks: early childhood; schooling; health; economic participation; healthy homes; safe communities; and governance and leadership.

4.7 The distribution of GST revenue under the principle of fiscal equalisation is the only means whereby all states have the capacity to provide the average level of services. Without this the achievement of national policies that seek to achieve equity would be undermined. For example, the policy of free access to hospital services would not be effective if states did not have the capacity to provide similar range of hospital services to citizens in comparable locations.

4.8 The distribution of GST revenue based on the principle of fiscal equalisation is only one policy measure underpinning all governments' objective of achieving equity for all Australians, but it is an integral component. Equalisation is intended to provide horizontal equity between states, which complements other government policies aimed at vertical equity. It complements government policy addressing unmet need and to improve outcomes by providing a foundation of services for all Australians to access, no matter what their income.

'Full' equalisation in Australia

4.9 Australia's form of equalisation is often described as 'full' or 'comprehensive' because it equalises both expenditure and revenue. In comparison, other federal systems adopt partial equalisation, either revenue only equalisation or equalising for comparable level of services rather than for the same standard of services.

4.10 As stated in Chapter 1, comprehensive equalisation is the only form of equalisation appropriate to Australia's needs due to the relative heterogeneity of states, in terms of population characteristics, geographic location, size and structure of economies and natural resource endowments, and the level of VFI between the

[8] Commonwealth, *Higher education, skills and training for regional Australians*, media release

Commonwealth and the states. These circumstances lead to significant disparity of expenditure needs and revenue capacities between Australian states.

4.11 Full equalisation is consistent with the Commonwealth's Social Inclusion Policy and the similar initiatives that exist in Queensland, South Australia, Tasmania, the Australian Capital Territory and Northern Territory. The Commonwealth's Social Inclusion Policy is built on a supporting principle that:

Quality services: delivering world-class services that meet the needs of every Australian in crucial areas like education and training, health, housing and social support, and targeting extra support to the communities where it can do the most good, most notably disadvantaged Indigenous communities. If Australia is to remain a fair country, everyone should have similar opportunities so they can aim for their own goals and succeed according to their own talents and abilities. For most Australians this means the opportunity to participate fully in society and work.[9]

4.12 While Australia is said to have 'full' equalisation, there is a misunderstanding about what this implies. The misconception is that full equalisation means that all unavoidable differences in the cost of delivering services are fully recognised and accounted for.

4.13 While all state expenditures and revenues are considered by the Commission, there are a large number of disability factors and expenditure items in the Commission's methodology that are either assessed on an equal per capita basis or, not fully recognised through methods such as discounting. The effect of an equal per capita assessment is the same as the expenditure or revenue being outside of the assessment, that is, it has no impact on relativities. This approach was extended significantly in the 2010 Review. Under the current methodology:

- The 'other revenue' category, which equates to $46 billion or 47 per cent of total state revenue, is assessed on an equal per capita basis. This amount of revenue is seven times greater than total mining royalties raised in all states.
- About $15 billion of total state expenditure is assessed on an equal per capita basis in the 'other expenditure' category.
- The Commission does not assess a disability factors for all unavoidable differences between states for a number of reasons, including lack of data and materiality. For example, despite New South Wales and Victoria making a case for an urbanisation allowance, the Commission did not make an assessment due to lack of supporting evidence on the existence of this factor and its materiality.
- The Commission discounts factors in order to minimise the impact of an assessment where it has concerns regarding the supporting data or when

[9] Commonwealth, *A Stronger, Fairer Australia*, 2009

nationally comparable data is not available. However, caution is always applied such that the factor assessed is less than the disability calculation would suggest. This methodology is statistically biased towards an equal per capita assessment.

- Western Australia argues that the Commission equalises its mining revenue but does not equalise differences in expenditure to support the energy and resource industry, such as the investing in infrastructure to support mining companies. This will become an increasingly important issue as resource development expenditure become more significant.

4.14 While the Australian system is based on full equalisation, the Commission applies its assessment judiciously and with a high regard for efficiency. Notwithstanding, the Territory strongly supports the full and comprehensive approach to equalisation in Australia but acknowledges that capturing all unavoidable differences between states would add complexity and data requirements.

4.15 Full equalisation is based on the principle that persons living in comparable locations should expect similar access to government services. The concept of social citizenship at the national level should continue to be the primary objective of equalisation in Australia. A move away from full equalisation would imply that Australians living in similar regions of different states do not deserve the same access to government services.

Partial equalisation in Australia

4.16 Partial equalisation could be considered in an environment where states have greater capacity to raise own source revenue, or where states' demographic composition and economic circumstances are similar. However this is not the case in Australia. Partial equalisation would not sufficiently recognise the underlying differences between the states in relation to both expenditure needs and revenue-raising capacity. These differences reflect circumstances that are beyond the control of individual states and not influenced by individual state policies.

4.17 Proponents of partial equalisation argue that reducing the aim of equalisation from providing the same standard of services to people in comparable locations, to 'not appreciably different' level of services, would drive efficiency in state service delivery.

4.18 Proponents of partial equalisation focus on the potential benefits that may accrue from greater efficiency in government service delivery, however they understate or ignore the benefits that do accrue from full equalisation. As stated above, full equalisation contributes to social inclusion in Australia by providing states with the fiscal capacity to deliver comparable level of services to citizens in similar locations.

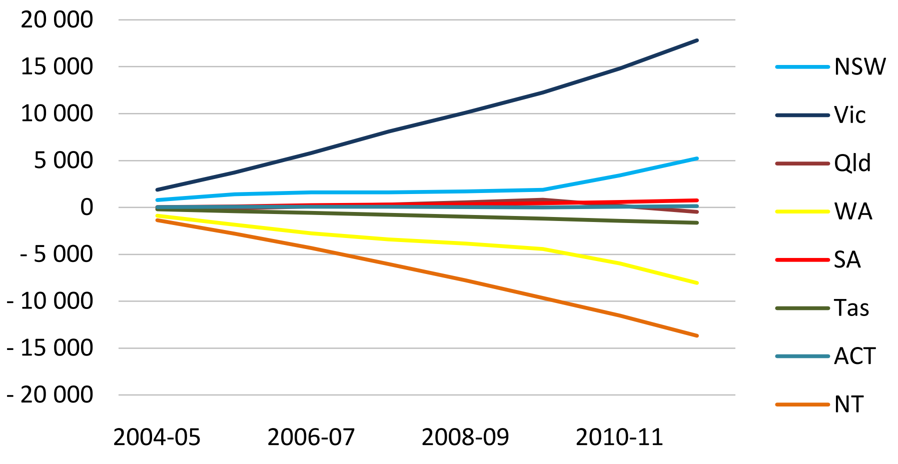
4.19 Full equalisation enhances states ability to promote social inclusion, and economic participation of disadvantaged or at risk population groups. It follows that the impact of partial equalisation would reduce the smaller states' capacities to promote greater social inclusion, which would have negative spill-over effects, as outlined below:

The costs of this social disadvantage are high, to individuals, communities and the nation. The costs of social exclusion to our nation are high. Social disadvantage results in costs to:

- *the budget – through costs in health care, welfare and justice;*
- *the economy – from lower workforce participation and productivity;*
- *the community – through higher crime rates and lower levels of social capital; and*
- *individuals and families – through financial hardship, social and physical isolation, chronic or persistent health problems, family breakdown, and missed opportunities.*[10]

4.20 One form of partial equalisation that has been suggested is to equalise states' revenue only. Figure 4.1 shows the cumulative impact on states' budgets if a revenue only assessment was adopted in Australian between 2004-05 and 2011-12. Equalising on the revenue only would have resulted in very different GST shares between states, leading to disparity between states' abilities to deliver the average level of services.

Figure 4.1: Cumulative impact of equalising only revenue, $ million



Source: Commonwealth Grants Commission, Commonwealth Budget Papers, Northern Territory Treasury

4.21 The estimated cumulative impact of applying partial equalisation for revenue only between 2004-05 and 2011-12 only is a $14 billion decrease in the Territory's revenue. This equates to $62 282 per capita less GST revenue to the Territory over

[10] Commonwealth, *Stronger, Fairer Australia* 2009

the period than under the current approach. Western Australia would also be a significant loser from a revenue only equalisation, with cumulative impact of -$8 billion or -$3664 per capita over the period. Western Australia's relativity under revenue only equalisation approach is estimated to be 0.31 in 2011-12 compared with 0.72 under the current equalisation method.

4.22 The Territory would not support an alternative form of equalisation that results in citizens in smaller jurisdictions not having the opportunity to access to services comparable to those in the rest of Australia.

Should equalisation specify a standard or outcome?

4.23 The current form of equalisation provides states with the same capacity to deliver services, which is defined as the average of what states do. It does not specify a standard of services that states should provide, nor should it. The current form of equalisation, which has been in place since 1983, maintains state sovereignty, recognising the need for states to tailor services to their constituents, while having the capacity to provide the national average level of services.

4.24 The notion of an equalisation process that could drive a standard or set of outcomes sounds to be a well-intended proposition. However, there are a number of issues and challenges that prevent equalisation from being the appropriate mechanism to achieve this. Tasking equalisation to drive an external standard would:

- be inconsistent with the untied nature of GST revenue, as agreed by all governments under the IGA;
- impede on state sovereignty;
- create complexities surrounding how benchmarks would be determined, and whether there should be a national benchmark, or individual state standards;
- require complex analysis and calculations to quantify the amount of funding that each state would require to achieve the benchmark; and
- require consideration of the different baseline measures that are likely to exist between states, and whether states would be rewarded or penalised for the different starting points.

4.25 Expanding the role of equalisation to provide incentives for states to achieve specified outcomes is beyond its scope. Alternative arrangements outside of the equalisation process, which address specific government priorities and outcome objectives that can be tailored to local state populations, are preferable to the Commission specifying a standard.

4.26 There are incentive mechanisms in place in tied funding arrangements through the provision of reward payments for states that are able to implement nationally significant reforms or service delivery improvements.

Does the principle of 'what states do' limit the capacity of equalisation to facilitate equitable access to government services?

4.27 A common misconception is that equalisation provides states with the fiscal capacity to narrow outcomes between population groups and regions over time. This is incorrect. The equalisation process provides states with the capacity to deliver the average level of services, thereby maintaining any pre-existing outcome differentials. This is due to the application of the equalisation pillar of 'what states do'. This was affirmed in the Commission's submission to the Senate Inquiry on Government expenditure on Indigenous Affairs and Social Services in the Northern Territory, which noted that:

"the Commission makes no independent assessment of what would need to be spent to address disadvantage. At an extreme, if the average policy of the states was to cease assisting a particular disadvantage group then the problems of that group would have no impact on the distribution of the pool".

4.28 The issue is whether the equalisation process should enable states capacity to address unmet need, for example whether equalisation is an appropriate mechanism to achieve the national objectives such as closing the gap between Indigenous and non-Indigenous outcomes. This would require equalisation to go beyond its current scope.

4.29 An alternative is to simplify the equalisation process and achieve equity through tied funding arrangements. This would add significant complexity to the distribution of tied funding. It would require the Commonwealth to determine the needs of each state in a process that is akin to that of the Commission's current methodology.

4.30 For example, all SPPs are currently transitioning to an equal per capita distribution. This is made possible by the treatment by inclusion of these payments in the Commission's methodology. If equalisation was achieved through tied funding arrangements, it would require the Commonwealth to assess and quantify; the different costs of providing services to different population subgroups, account for higher costs associated with location and scale and define what it is the Commonwealth is trying to achieve with each tied funding agreement. This complexity would be multiplied by the need for the Commonwealth to undertake these analyses for each agreement.

5 Simplification

Key Points:

5.a. Equity should continue to be the primary objective of equalisation, with simplification a key consideration for the methodology adopted.

5.b. Consideration needs to be given to achieving greater simplification where possible, but also whether simplification has produced results that are not consistent with equity objectives or not reliable. The mining assessment is one where the pursuit of simplicity has not led to an improved outcome.

5.c. The Territory contends that most Australians support the underlying principle of equalisation – that is, all Australians should have access to comparable services wherever they live. However, much of the public commentary about the equalisation system is neither comprehensive nor balanced. A better understanding by the public of the equalisation system is desirable but that requires a balanced debate of the benefits that Australia derives from equalisation. Understanding by the public of the Commission's methodology at the individual assessment level is not critical nor does it occur in other areas of funding.

5.d. Public understanding of the equalisation process would be improved if changes in states' shares of GST revenue were considered in the broader context of states' aggregate revenue positions.

5.e. Locking in expenditure factors would reduce the considerable effort required in each major review associated with the re-examination of expenditure methodologies, allowing the Commission to focus on the revenue assessments which drive volatility in the GST distribution.

5.f. Removing the Territory from the equalisation process would not aid simplification, would impede the Territory's sovereignty and would have significant implications for the Territory's objectives of Statehood.

5.1 Simplification is a desirable feature of equalisation if it leads to greater transparency, accountability, reduced scope for policy influence and enables the methodology to be more readily understood. However, simplification must be applied so that it does not lead to a deterioration of equalisation outcomes by a reduction in inter-jurisdictional equity or being less responsive to changes in state circumstances.

5.2 The variables that influence the costs of, and demand for, government services are complex and multi-faceted. The simplification process has limited the number of variables considered in the equalisation process and the Territory view is that maintenance of the current level of detail in the Commission's assessments is necessary to capture the material cost and capacity differences between states in the cost of delivering average services or revenue-raising capacity. Without this level of detail, material disabilities could be understated or ignored to the extent that equalisation would be compromised.

5.3 Complexity should not be confused with detail. Adding an additional layer of detail to an assessment does not necessarily add an additional layer of complexity. For example, the number of value ranges used in the conveyance duty assessment is intended to recognise that conveyance duty is a progressive tax. States currently collect information on individual transactions by value and amount raised. Including a threshold adjustment does not place an additional data burden on the states, nor does it result in additional complexity. Rather, the detailed value of transaction threshold adjustment ensures more robust outcomes and makes the assessment more understandable.

5.4 Similarly, a detailed mining revenue assessment that examines states' capacity to raise mining royalties by mineral type would not result in added complexity or significantly increase the data burden as most of the necessary information is already collected, but would go a long way to overcoming many of the current concerns surrounding the mining revenue assessment. In fact, the 2010 Review mining revenue assessment is an example of where simplification has not led to a better outcome or a greater acceptance of the outcome.

5.5 Simplification may not necessarily lead to increased transparency. For example, in the 2010 Review, the Commission engaged a consultant to calculate road length for each state using a mapping algorithm. This was intended to overcome Commission concerns regarding the comparability of state road data and policy differences between the states.

5.6 Table 5.1 compares the length of unsealed roads in each state using a synthetic mapping approach and from data provided by states. Table 5.1 shows that a synthetic road measure would increase Victoria's unsealed rural road length by 3.8 times, and conversely reduce Tasmania's by about 80 per cent compared with state-provided data.

Table 5.1: Length of unsealed rural roads, kilometres

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Synthetic road length	1 454	1 364	4 711	3 578	1 399	39	0	2 215
State data	1 520	362	5 840	3 473	468	169	0	3 639

Source: Commonwealth Grants Commission

5.7 It is arguable whether attempting to remove the policy influence from roads in each jurisdiction is reasonable given the limited capacity that state governments have in changing a road system where the majority of it has been in place for a significant number of decades.

Number of assessment categories in the equalisation system

5.8 In response to concerns raised by the Commission in its 2004 Review Report, the Ministerial Council for Federal Financial Relations developed a range of simplification options for consideration by the Commission as part of the 2010 Review. These options were set out in the 2010 Review Terms of Reference, and directed the Commission to simplify its assessments, providing that to do so is consistent with the principle of horizontal fiscal equalisation, by:

- aggregating existing assessment categories, components and factors;
- eliminating category assessments found unreliable because of unsatisfactory data or methodology;
- applying materiality thresholds to current and future assessments; and
- considering developing mechanisms to maintain simplification once achieved.

5.9 For the 2010 Review, the Commission made significant progress in reducing the number of assessments and assessment components, including:

- reducing the number of assessment categories from 29 to 13;
- reducing the number of assessment components from 171 to 43; and
- reducing the number of disabilities from 344 to 93.

5.10 Given the extensive simplification program that the Commission undertook as part of the 2010 Review, the Territory contends that the current number of assessments categories in the equalisation system is reasonable. In addition, the guidelines adopted by the Commission to maintain simplification should ensure that the number of categories and assessments is kept to a reasonable amount.

Has simplification worked?

5.11 There are limits to how far simplification of the Commission's methodology can be sustained before leading to the deterioration of equalisation outcomes. Despite the attention given by the Commission to simplification in the 2010 Review, there remains differing opinions as to whether the Commission has achieved an acceptable balance between simplicity and equity.

5.12 Arguably the most contentious assessment at present is mining revenue, which was significantly simplified in the 2010 Review. Previously, the mining assessment was detailed, based on individual mineral types better reflecting the distribution of minerals between states. In the 2010 Review, the various components were aggregated to two categories based on the average effective royalty rate (high or low). This increased level of simplification has not led to greater acceptance of the outcomes of that assessment. In fact, this new method has been criticised on the basis that it could unreasonably influence government decisions about royalty rates. This sort of criticism has not been made for many years and indicates that a risk of simplification is introducing grant design inefficiencies that had previously been eliminated.

5.13 Similarly, simplification in the 2010 Review has resulted in concerns from some states that material expenditure disabilities have been either ignored or underestimated, such as cultural and linguistic diversity and location influences. In examining simplicity options, consideration needs to be given to where further simplification can be achieved but also where simplification has not led to improved outcomes and should be wound back. These approaches are not mutually exclusive.

Importance of the equalisation process being readily understood

5.14 Part of the criticism of the Commission's methodology is the apparent lack of public understanding of equalisation and the method for determining states' shares of the GST pool. While it is important that there is general understanding by the public of equalisation and its importance, there seems no need for this to extend to detailed appreciation at the individual assessment level.

5.15 For example, there is public understanding that the Consumer Price Index (CPI) measures changes in prices of goods and services in the Australian economy. However, it is highly unlikely and unexpected that this understanding extends to an appreciation that the CPI regimen covers a wide range of goods and services grouped into 11 categories and 90 subgroups with price data intervals collected monthly or annually depending on the volatility of the price of the good or service.

5.16 Across all intergovernmental financial arrangements or national reforms there is a limited understanding of detailed aspects of these arrangements. However, the objective is for there to be public understanding of what these reforms are trying to achieve.

5.17 An approach to improving public understanding of the equalisation process is through the reporting of equalisation outcomes. While material currently included in the Commission's Main Reports and Supporting Volumes provide useful information to the states, a more accessible introduction or summary volume could be added, with the general public as the target audience. The summary volume would provide for:

- a greater emphasis on the objectives of equalisation and its principles;
- a more detailed description of the different circumstances that affect the cost of delivering services in each state; and
- a reduced focus on comparisons between equal per capita and assessed GST distribution;
- a reduced focus on the notional impact of annual changes in relativities for each state.

5.18 An example of the difficulty in interpreting the results of equalisation stems from the way the Commission presents the calculation of each state's GST needs. Table 5.2 sets out the current approach as per the 2011 Update Report, which focuses on the changes from an equal per capita distribution.

Table 5.2: Calculation of the Territory's assessed GST needs, current layout in Commission reports

	$ million	$ per capita
Equal per capita share	464	1 974
Effect of assessed:		
Expenses	2 065	8 782
Investment	115	489
Net lending	4	16
Revenue	22	94
Commonwealth payments	-205	-870
Assessed GST	**2 466**	**10 485**

Source: Commonwealth Grants Commission, Northern Territory Treasury

5.19 The Territory's proposed alternative presentation (Table 5.3) focuses on the assessed per capita amount each state would need to spend in order to provide the average level of services, and the revenue sources that contribute to this amount. This approach may enhance public understanding that the GST is intended to fill the gap between assessed expenditure needs, in order to deliver the average level of services, and the amount of revenue that states raise from their own sources and receive in Commonwealth payments.

Table 5.3: Calculation of the Territory's assessed GST needs, proposed layout

	$ million	$ per capita
Expenditure required to provide average level of services[1]	4 215	17 919
Less Assessed revenues		
Own source revenue	974	4 143
Commonwealth payments	774	3 291
***Equals* Assessed GST**	**2 466**	**10 485**

1. Includes expenditure, net lending and investment requirements.
Source: Commonwealth Grants Commission, Northern Territory Treasury

5.20 Public understanding of the equalisation process would be improved if changes in states' shares of GST revenue were considered in the broader context of states' aggregate revenue positions. For example, there would be greater public understanding of the reasons for Western Australia's declining GST share if this was put into context of its overall revenue position. This would show that Western Australia's overall revenue position has improved relative to other states, and that the decline in GST shares has been offset by increasing mining royalties.

Data quality and the use of judgement

5.21 Some states have argued that simplification will address data quality issues through either the adoption of broad measures or removing assessments. On the other hand, some states argue that if there is a strong conceptual case for an assessment, and it is material, it should be assessed despite the data limitations in order to improve equalisation outcomes.

5.22 The Commission has made concerted efforts to improve data quality. However, the Commission is constrained by timing of release of data, the availability of data, data coverage (for example survey data can exclude remote areas) and comparability issues with state data. The Commission has introduced protocols to improve data provided by states including the development of guidelines for testing whether data is fit for purpose and of suitable quality.

5.23 If there is a strong conceptual case that there are unavoidable differences between states in the costs of providing the average level of a service or capacity to raise revenue, and that difference is material, the Commission should account for these differences through a disability assessment. This is consistent with principles of equalisation.

5.24 In circumstances where data supporting an assessment are not available from the majority of states, the Commission could relax its current guidelines and consider using data from only one or two states, where that data is of high quality and meets Commission guidelines. Such an approach may encourage other states to provide comparable data, as the onus would fall on them to provide evidence if they considered that a proposed disability assessment did not accurately reflect states' circumstances. If quality data were not available, the Commission could consider options to improve data quality, investigate alternative proxy measures or use its judgement to develop a sound assessment, consistent with the objective of equalisation.

5.25 It should be noted that simplicity is not a priority for other areas of intergovernmental relations. For example the performance reporting aspects of national agreements under the IGA. The focus is the development of national data sets and improving data quality over time. Where there are data deficiencies in the Commission's methodology, the priority should be to address the data quality rather than ignore or discount unavoidable disabilities because of data limitations.

Locking in expenditure factors

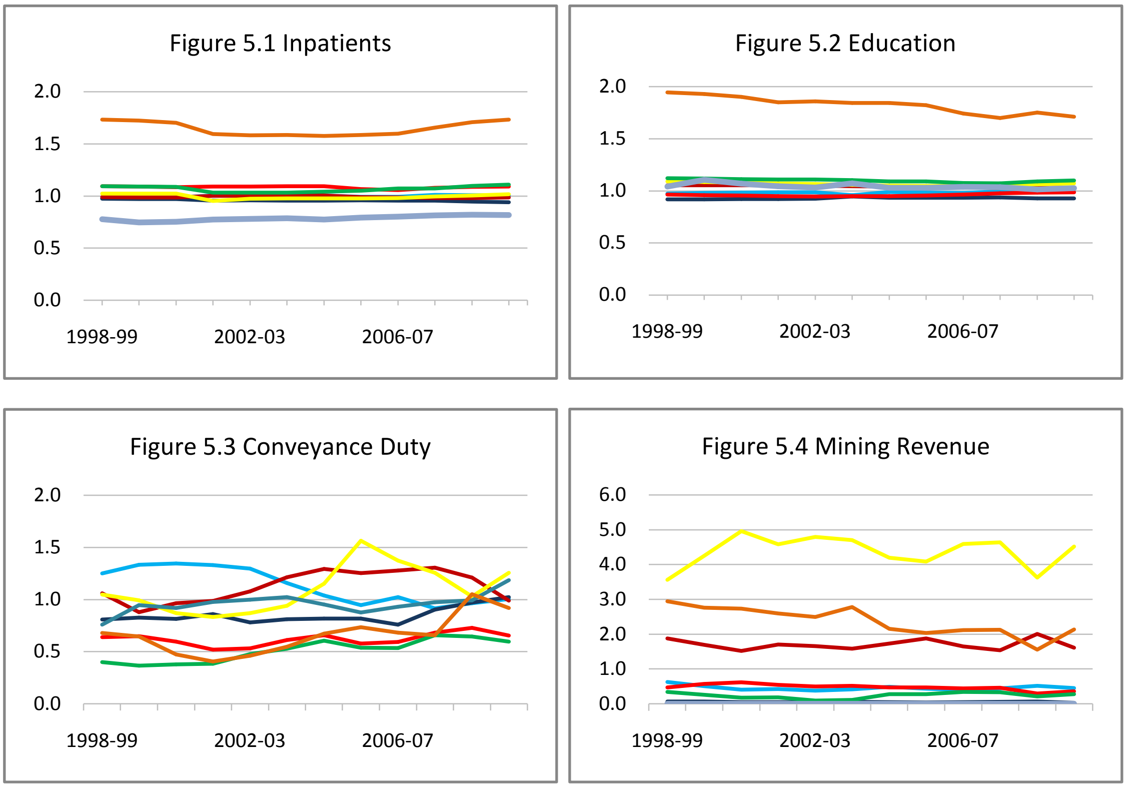
5.26 Much of the perceived complexity surrounding the Commission's methodology relates to the expenditure assessments. Capturing differences in states' expenditure needs is more difficult than revenue needs because of the range of state government services, regional differences and the number of factors that influence cost.

5.27 Changes in the redistribution as a result of expenditure assessments are due to either changes in state budget priorities (for example an increase in expenditure on admitted patient services as a proportion of total state budgets will result in a higher amount of GST revenue being redistributed to states that have above average needs in this area) or changes in category factors. Category factors can vary due to either a change in method or data updates.

5.28 While there is a significant amount of effort required to develop an expenditure assessment, once an approach has been derived, the expenditure factors are relatively stable, unlike revenue factors, which can be volatile depending on states' economic circumstances. Therefore, consideration could be given to locking in category factors as an option to achieve greater simplification. Annual changes in expenditure categories would continue to incorporate changes in state expenditure patterns.

5.29 Figures 5.1 to 5.4 show changes in category factors for two key expenditure and two key revenue assessments over time. They show that the inpatient and education factors have been relatively stable over time, while the conveyance duty and mining royalty revenue factors have exhibited considerable volatility. This lends support to the option of locking in expenditure factors over an extended period of time.

Figures 5.1 to 5.4: Changes in category factors from 1998-99 to 2009-10, by state



Source: Commonwealth Grants Commission

5.30 The amount of effort required to update expenditure factors on a regular basis is high, however the effect of annual changes in expenditure factors on states' assessed needs is minimal. Locking in expenditure factors between methodology reviews would reduce the considerable effort allocated to expenditure assessments, allowing the Commission to focus on the revenue assessments that drive volatility in the GST distribution.

5.31 The option to lock in expenditure factors may not apply to the investment and net lending assessments. These assessments have the potential to be volatile from year to year. The fluctuations in these assessments are more difficult to foresee and understand than the revenue or expenditure assessments. These categories are likely to require more detailed analysis to develop a robust and stable assessment method.

Broad or proxy measures

5.32 Broad measures have been considered in past Commission reviews, primarily as a measure of revenue capacity. However, broad measures were generally not adopted because these measures do not accurately reflect states' actual revenue bases or practices.

5.33 For example, early in the 2010 Review, the Commission considered a proposal to use gross state product (GSP) as a measure of states' revenue capacities. This has also been examined in most major reviews in the last two decades. However, this approach was rejected because there was no direct relationship between changes in GSP and changes in states' capacities to raise own-source revenue. In addition, a significant proportion of some states GSP, including the Territory's, includes off-shore mining production which is outside the scope of state taxes, and therefore a GSP measure would exaggerate the Territory's revenue-raising capacity relative to other states.

5.34 The current approach, which has been used throughout the last thirty years, utilises states' actual tax base with adjustment for differences in policies. This approach provides a more accurate indication of differences between states own-source revenue-raising capacities.

5.35 Broad measures may be applicable in circumstances where there are significant policy differences between states on regulatory and related matters that affect interstate comparability of data. For example, state policies vary significantly in relation to gambling taxation. The revenue base for many types of gambling does not align with state boundaries but reflects national and sometimes international activity. To ensure a policy neutral approach and to overcome issues regarding the drivers of gambling revenue, the Commission appropriately adopted a broad measure for gambling taxation. However, there are limited opportunities to appropriately adopt broad measures within the current equalisation framework.

Removing the Northern Territory from the equalisation process

5.36 It has been suggested that equalisation works well when states are relatively homogeneous. This gives rise to questions as to whether or not equalisation can cope with outlier jurisdictions such as the Territory. The premise for the Territory being an outlier is the fact that Territory has the highest relativity of all jurisdictions. An option that has been proposed is to remove the Territory from the equalisation process, and either fund it from a dedicated portion of the GST pool, or through alternative funding arrangements with the Commonwealth. The Territory does not support either of these options.

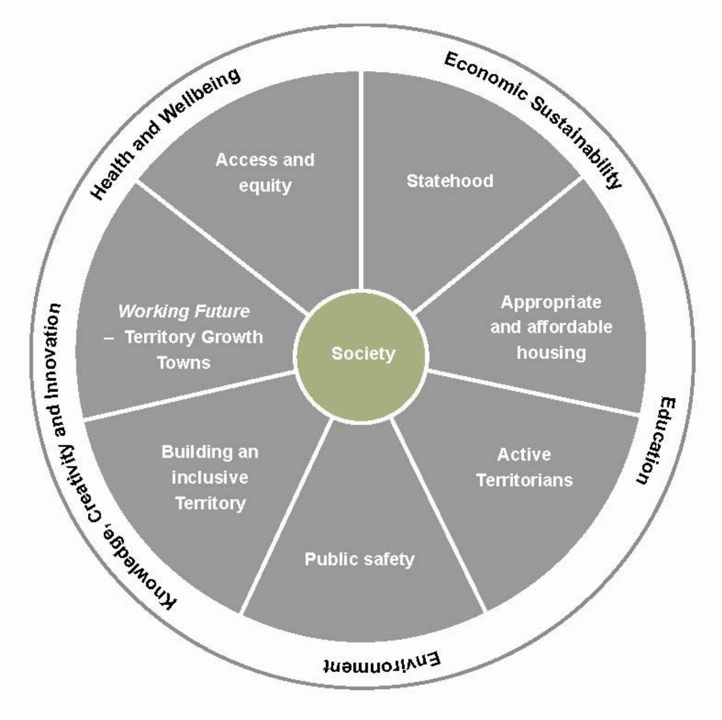
5.37 Under the current equalisation framework, the Territory is treated the same as every jurisdiction. This is an essential concept recognising the need to treat residents of Australia on an equal footing. The proposal to remove the Territory from the equalisation process and fund on a separate basis would impede the Territory's sovereignty and would draw distinctions between Territorians and all other Australians based purely on jurisdictional borders.

5.38 Removing the Territory would also not reduce complexity as there would need to be a system operating in parallel with equalisation for all other jurisdictions to assess the Territory's financial basis, presumably on a basis comparable with the states.

5.39 Funding the Territory in isolation from all other jurisdictions would undo much of the progress in the intergovernmental arena made by the Territory since achieving self-government in 1978 and, and more recently in its progress towards statehood, which is a key platform in the Territory's 2030 Strategic Plan (see Figure 5.5) and is supported by the main political parties in the Territory.

5.40 Statehood would provide the Territory Government and its constituents with the same political rights as the states. Equal treatment would be compromised should the Territory be funded on a different basis to the states and the Australian Capital Territory. Under its 2030 Plan, the Northern Territory Government is committed to achieving statehood by 2020 or earlier.

Figure 5.5: Territory 2030 Strategic Plan



Source: Northern Territory Government 2030 Strategic Plan

5.41 Removing the Territory from the equalisation process would also create additional complexity including determining:

- How much GST should be dedicated to the Territory?
- How would the needs of the Territory be calculated and funded and how would the concept of horizontal fiscal equalisation apply?
- Should it be a fixed amount or fixed share of the GST pool?
- How will the arrangements be reviewed?

- Should other states also be excluded?

Removing the mining revenue assessment from the equalisation process

5.42 Due to the divergence of states' relative abilities to raise mining royalties, it has been suggested that the mining revenue assessment could be removed from the equalisation process, in order to minimise volatility in the relativities, remove grant design inefficiency and to simplify the equalisation process.

5.43 There are two options to remove the influence of mining royalties from the equalisation process. Either an amount of GST could be quarantined and distributed in recognition of states' abilities to raise mining revenue, or all state mining revenue could be pooled, and redistributed on an equal per capita basis.

5.44 Neither approach is likely to result in increased simplicity. The first approach would require a decision on the amount of GST to be dedicated, how this amount would be indexed, and how often this would be reviewed, while it is highly unlikely that mineral resource-rich states would agree to the second approach, which would also require a significant level of negotiation and legislative amendment by all states to reach consensus agreement.

6 Stability and Predictability

Key Points:

6.a. There are trade-offs between stability and responsiveness of the equalisation framework to changes in the Australian economy.

6.b. Volatility in relativities has been largely driven by the revenue assessments.

6.c. States' total revenue (including taxation, mining royalty and GST revenue) has been relatively stable and growing at similar rates over the period 2000-01 to 2009-10. Although total state revenues have been growing at a similar rate, the composition of revenue for each state has changed, which shows that equalisation responds to divergence between states' economic circumstances and results in the sharing of the revenue effects of economic booms or burdens amongst states.

6.d. The Territory contends that the current three year averaging process provides an appropriate balance between stability in relativities, while ensuring they reasonably reflect state circumstances.

6.e. Locking-in relativities between major reviews or introducing a floor on relativities would lead to inequitable financial outcomes between states unless there was no change in relative state circumstances over that period.

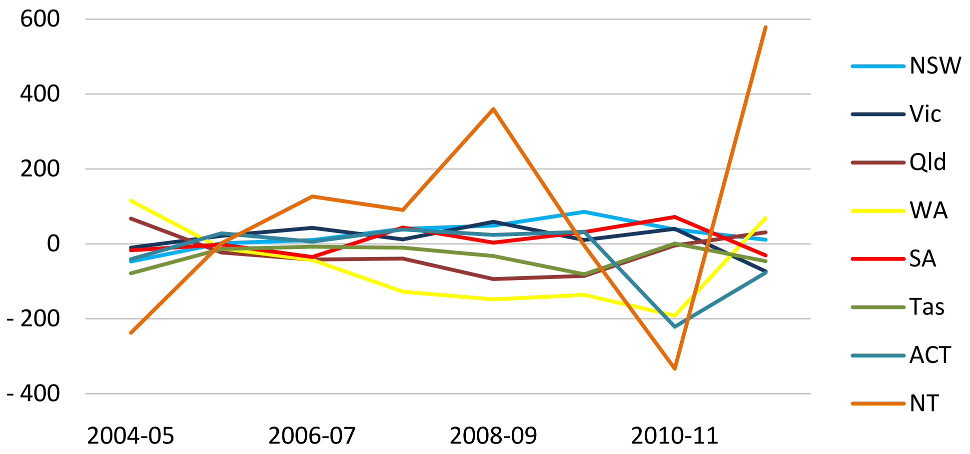
6.1 Stability, sustainability and predictability of GST revenue are important issues for governments. However, this concern applies to all revenue sources not only GST. While stable revenues make budget planning more predictable, if this was done through limiting the responsiveness of equalisation to economic changes, states fiscal position could be expected to diverge significantly.

6.2 While stability and predictability are desirable features they are not essential nor are they consistent with a dynamic system that responds to economic change. The Territory's view is that the current form of equalisation provides an appropriate balance between achieving equalisation, by balancing responsiveness with stability achieved through the three year averaging process.

6.3 Figure 6.1 shows the effect on GST redistribution of applying relativities to the GST pool and population estimates from the previous year. On a per capita basis, the

Territory experienced the greatest level of volatility in its GST revenue as a result of annual changes in relativities.

Figure 6.1: Impact of annual changes in relativities, $ per capita



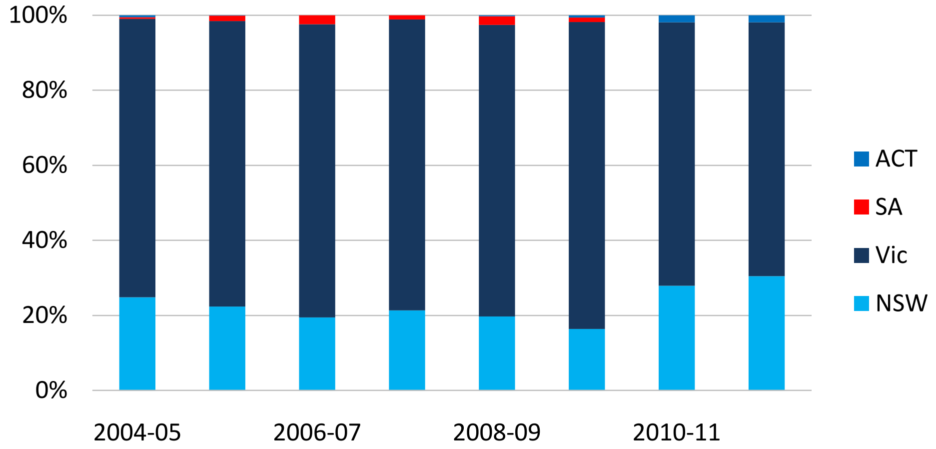
Source: Commonwealth Grants Commission

6.4 The issues associated with the volatility in GST revenue are exacerbated by the Territory's reliance on GST revenue (GST usually represents about 60 per cent of its total revenue) and the size of its budget. Small changes in the Territory's revenue will have a greater effect on the volatility of the Territory's budget and its ability to plan. Despite this, the Territory has coped with the volatility in GST revenue, which would suggest that other states should also be able to manage variations in GST revenue.

Causes of changes in relativities

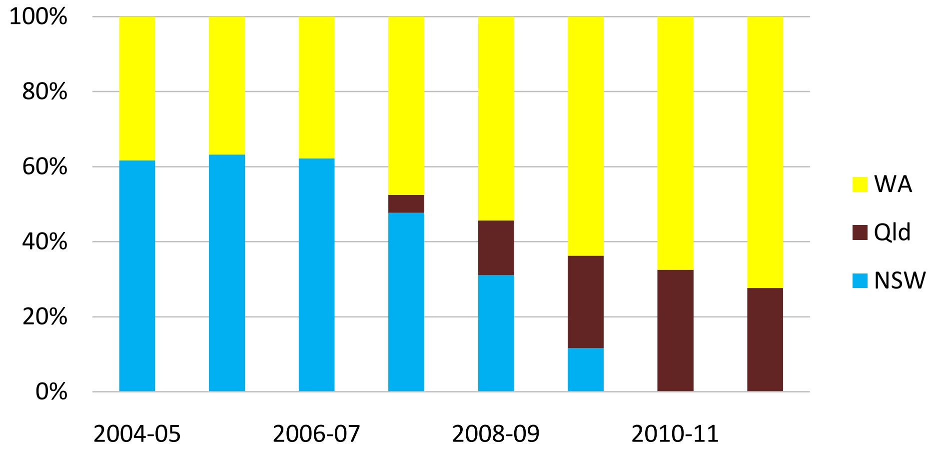
6.5 The level of volatility in states' shares of GST revenue is related to the timing of changes in state circumstances. Figures 6.2 and 6.3 show changes in states' contributions to the redistribution of GST revenue arising from the expenditure and revenue assessments.

Figure 6.2: Contribution of expenditure assessments to the redistribution of GST



Source: Commonwealth Grants Commission

Figure 6.3: Contribution of revenue assessments to the redistribution of GST



Source: Commonwealth Grants Commission

6.6 Figure 6.2 shows that the relative differences between states in costs of delivering services are reasonably stable over time. This is because expenditure disabilities do not change rapidly, rather they change gradually over time as a result of changes in national spending patterns, demographic changes, new technology or service delivery methods or divergence in the growth of the costs of inputs between states. For example, states' relative shares of the Indigenous population do not change significantly over time. However, growth in national average expenditure on Indigenous people relative to non-Indigenous people has been increasing in line with the national commitment to 'closing the gap'. This increase in expenditure by all states is the dominant reason for changes in the redistribution due to Indigenous influences.

6.7 Figure 6.3 indicates that there has been significant volatility in states' assessed revenue capacities over time. Between 2004-05 and 2006-07, New South Wales and Western Australia were the only jurisdictions that were assessed as having above average capacity to raise own-source revenue. Since 2006-07, there has been a shift towards Western Australia and Queensland as the only states with above average capacity to raise own-source revenue primarily driven by the commodities boom. This above average increase in revenue capacity of Western Australia and Queensland is the primary cause of the decline in the relativities of these states over the past five years.

6.8 Taken together, Figures 6.2 and 6.3 indicate that the volatility in relativities is predominantly due to changes in states' assessed revenue-raising capacities as a result of changing economic circumstances. While the public focus has been on the volatility in GST shares, the reason this has occurred is that there has been even greater volatility in state own-source revenue collections. When a state's GST share and own-source revenue are considered together, the volatility is far less. Consequently, while options aimed at providing greater stability of relativities should focus on revenue assessments in the first instance, they also need to consider the total revenue available to each state.

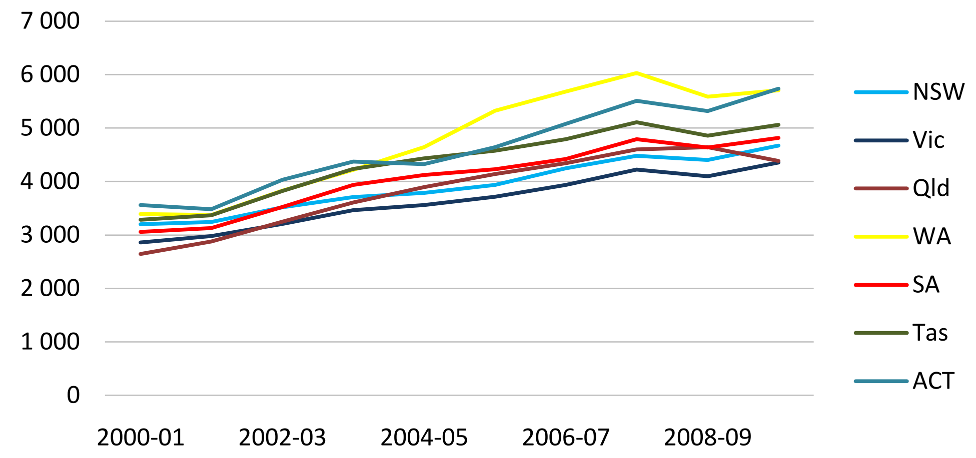
6.9 The Territory believes that the current process has resulted in an appropriate level of:

- predictability because equalisation has responded consistently and appropriately to changes in fiscal circumstances between states; and
- stability through the three year averaging process, while maintaining a level of responsiveness to economic changes.

6.10 When GST shares are considered in the context of total revenue available to each state, the GST volatility largely offsets changes in other revenues and contributes to comparatively stable total revenues.

6.11 Much has been made regarding the volatility in GST revenue. However, aggregate state revenue (taxation, mining royalties and GST) has been relatively stable and growing at similar rates over the period 2000-01 to 2009-10 (see Figure 6.4). It shows that equalisation responds to divergence between states' economic circumstances, and results in the sharing of the revenue effects of economic booms or burdens amongst states.

Figure 6.4: State taxation, mining royalty and GST revenue, $ per capita



Source: Commonwealth Grants Commission, Commonwealth Budget Papers, Australian Bureau of Statistics

Averaging process

6.12 The Commission's methodology currently has an inbuilt stability mechanism through the use of a three-year averaging process. The 2010 Review adopted a three-year averaging process in order to better balance stability and contemporaneity of relativities. The Commission's view was that the rapid change in some states own source revenue meant that the previous five-year averaging process produced relativities that were well out of date.

6.13 The Territory contends that the current three-year averaging process provides sufficient stability in relativities, while still allowing equalisation to respond to changes in state circumstances in a timely manner. The Territory's view is that volatility in relativities is a positive feature of equalisation. It demonstrates that equalisation is working and that it is adapting to changes in the structure of the Australian economy. However, the effect of the relativities must be considered in the context of the total revenues available to states rather than simply focussing on the GST share.

State provided data

6.14 The current equalisation process is reliant on the provision of state data, particularly for the latest assessment period. While state provided data used in the Commission's methodology is subject to revisions, these revisions have not been a material contributor to volatility.

6.15 The main data that is sourced directly from the states is revenue and expenditure by function for the latest assessment period. State data on expenditure by function is subject to review and possible change as part of the consistency and checking process by the Australian Bureau of Statistics, however these changes only affect the calculation of the national average per capita spending.

6.16 State-provided data on revenue collected and the revenue base can impact on relativities. Revenue data is generally reliable and is generally not subject to revisions. There may be concerns regarding consistency of the revenue based between states, although this is predominantly addressed by the Commission before being used.

Forward estimates

6.17 For the purpose of reporting in budget papers, the Commonwealth and the states are required to estimate relativities over the forward years. Currently, there is no agreed uniform approach, nor is there any requirement for the Commission to produce estimates of relativities over the forward years.

6.18 Commonwealth and states' estimates of relativities over the forward years can vary significantly. For example, the estimate of Western Australia's relativity in 2014-15 is 0.65 in the Commonwealth 2011-12 Budget and 0.33 in Western Australia's 2011-12 Budget.

6.19 An option to provide a more consistent basis for calculating forward estimates of relativities is for treasuries to agree on a uniform approach. This methodology could then be used by the Commonwealth to calculate relativities and provided to the states prior to the release of budgets. However, ultimately states would have the final decision on which estimates to adopt.

Locking in relativities

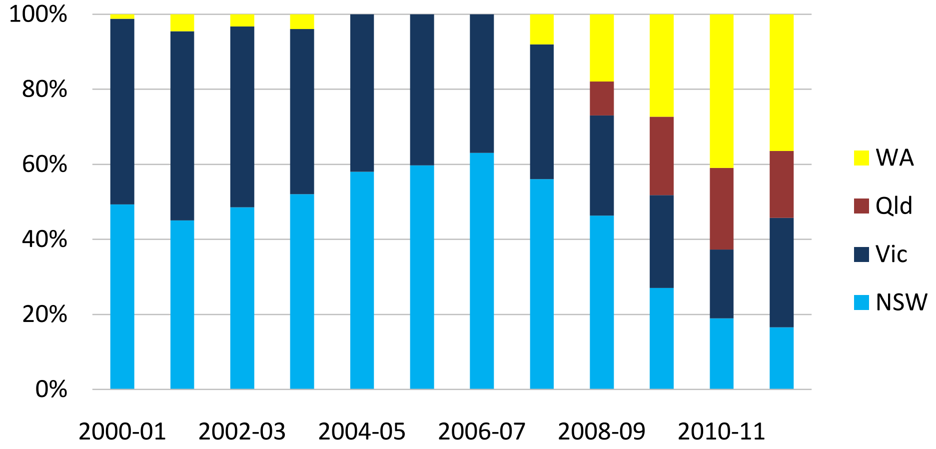
6.20 One option to provide greater stability is to 'lock-in' relativities and review (say) every five years. The advantages of this option are that it would provide greater certainty in state GST revenue shares and it would reduce the burden of updating relativities on an annual basis.

6.21 Locking in relativities can be a viable option if the relative fiscal positions of the states do not vary significantly over time or the fluctuations in each state's relativities offset each other over the period in which relativities are fixed. However, if these conditions do not hold states will be differentially impacted by fixing relativities. The following analysis shows that locking in relativities would not have been a viable option since the introduction of the GST, and that it would have resulted in significant variations from equalisation in states' fiscal positions.

6.22 Figure 6.5 shows changes in states' contributions to the redistribution of GST revenue. Since the introduction of the GST, states' shares of GST revenue have varied from year to year, reflecting changes in state circumstances primarily states' capacities to raise own-source revenue. Consequently, locking in relativities would result in inequitable impacts on states' fiscal capacities. For example, in 2006-07

Western Australia was not a contributor to the GST redistribution but is expected to be the major contributor in 2011-12.

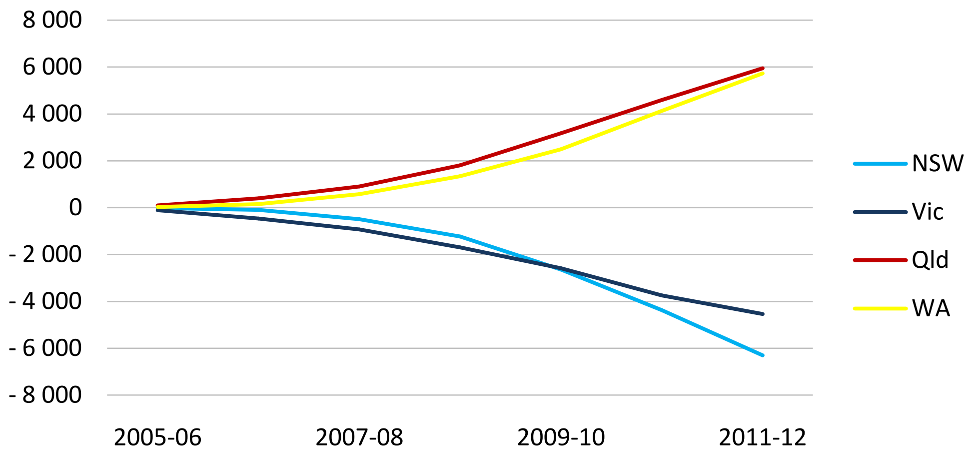
Figure 6.5: Contribution to the redistribution of GST revenue



Source: Commonwealth Grants Commission

6.23 Figure 6.6 shows the cumulative impact of locking in relativities at the 2004-05 level between 2004-05 and 2011-12. Under this approach, New South Wales and Victoria would have been $6.3 billion and $4.5 billion respectively worse off over the period. On the other hand, Western Australia and Queensland's fiscal position would have improved by about $6.0 billion each. Subsequently, the fiscal capacities of the four largest states would have been markedly different over a relatively short timeframe if the option to lock in relativities were adopted in Australia's equalisation process. Western Australia and Queensland would have the capacity to provide a greater level of services at the expense of New South Wales and Victoria, creating horizontal inequity.

Figure 6.6: Cumulative impact of locking in relativities at the 2004-05 level between 2004-05 and 2011-12, $ million



Source: Commonwealth Budget Papers, Northern Territory Treasury

6.24 As states' economic circumstances change, states are likely to seek reviews of states' relativities to ensure that states' GST shares reflect current circumstances. In addition, locking in relativities with review every (say) five years is likely to result in greater one-off changes in relativities, which could have more of an impact on state budgets than the annual updates currently undertaken.

6.25 To highlight the impact of one-off large changes in relativities between review periods, Western Australia's relativity would have dropped from 1.01 (which was fixed during the 2004 Review period, 2004-05 to 2009-10) to 0.68 in 2010-11 following the outcomes of the 2010 Review. This relativity impact would have been a $1.6 billion reduction in Western Australia's GST revenue between 2009-10 and 2010-11. Such one-off changes are likely to be more difficult to manage, and more difficult to foresee than the annual changes that occur under the current methodology.

6.26 In this context, it is useful to recall that annual updates were not introduced until 1989-90. Prior to this, the Commission conducted triennial reviews and determined the relativities to apply over the next three years. For example, the 1982-83 to 1984-85 relativities were derived in 1982. This approach was abandoned because dislocation associated with the change to new relativities was so great that annual updates were introduced to smooth the transition of Commission reviews.

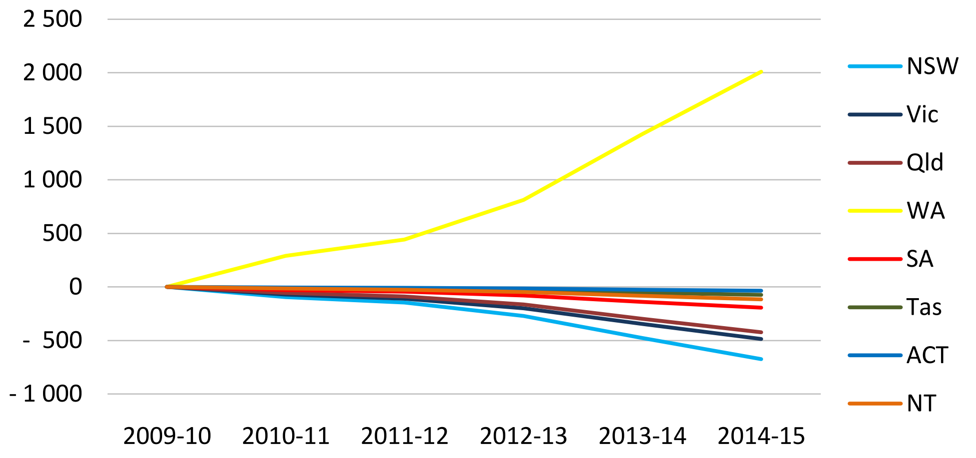
Floor in relativities

6.27 Introducing a floor in relativities has recently been proposed as a means of preventing states' GST shares from becoming 'unreasonably' low. The advantage of this option is described as providing a minimum guaranteed share of GST revenue for states whose relativities were likely to fall below the floor, therefore providing greater budget certainty.

6.28 As discussed elsewhere in this submission, an important consideration related to this issue is that the additional mining royalties flowing to Western Australia from the commodities boom are not fully offset through the equalisation process, and that Western Australia's aggregate revenue position (in terms of total per capita taxation, mining royalties and GST revenue) has improved relative to the other jurisdictions and will continue to do so even if there is no change to the GST distribution methodology.

6.29 The option to introduce a floor on relativities would result in disparity between state fiscal capacities to deliver the average level of services. Figure 6.7 shows that if a relativity floor of 0.75 was adopted, Western Australia would be $2 billion better off by 2014-15, and given the zero sum nature of the GST distribution, all other states would have to contribute to Western Australia's additional GST revenue, which would reduce all other states' capacities to deliver the average level of services.

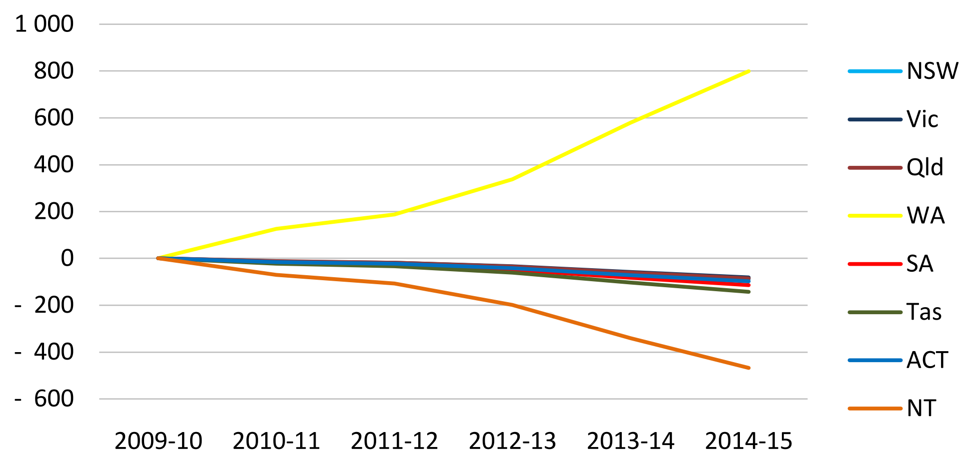
Figure 6.7: Cumulative impact of applying a 0.75 floor in relativities, $ million



Source: Commonwealth Budget Papers, Northern Territory Treasury

6.30 On a per capita basis, the Territory would be the biggest loser as a result of a relativity floor, with an estimated $472 per capita being redistributed away from the Territory and towards Western Australia (see Figure 6.8).

Figure 6.8: Cumulative impact of applying a 0.75 floor in relativities, $ per capita



Source: Commonwealth Budget Papers, Northern Territory Treasury

Would alternative forms of equalisation better address stability and predictability?

6.31 As stated earlier in this chapter, equity is a higher order priority than stability and predictability. The Territory does not support consideration of alternative forms of equalisation to better address stability and predictability if this results in a deterioration of equalisation outcomes. Further, when total revenue rather than only GST revenue is considered, stability and predictability requirements are generally met.

Equal per capita distribution

6.32 An equal per capita distribution would provide greater stability and predictability in state GST revenue. Changes in GST revenue would only be caused by changes in national GST collections and/or changes in states' shares of the national population. However, equal per capita distribution would not achieve equalisation outcomes and would result in significant disparities between states in fiscal capacity to deliver an average level of services.

Partial equalisation

6.33 Partial equalisation, which only equalises for states' revenue-raising capacities, would not result in greater stability and predictability compared with the current approach. As stated earlier in this chapter, the volatility in relativities is predominantly due to changes in states' assessed revenue-raising capacities as a result of changing economic circumstances. The potential stability and predictability gains from partial equalisation process would be far less than losses to equalisation outcomes.

7 Indigenous influences

Key Points:

7.a. The national 2010 Indigenous Expenditure Report found that the Territory spent $2.16 billion on services related to Indigenous people in 2008-09. This equates to 53.9 per cent of the Territory's total general government budget and compares to an Indigenous population share of 30 per cent.

7.b. In the Territory much of the Indigenous-related expenditure is delivered through mainstream services. Indigenous-related services cannot be separated from mainstream services.

7.c. Removing Indigenous influences from equalisation and funding Indigenous services separately would create significant complexity in intergovernmental relations and is unlikely to lead to any of the intended results such as improving outcomes for Indigenous Australians. If Indigenous influences were removed from equalisation it would need to be removed for all states, not just for the Territory.

7.d. Removing Indigenous influences would result in differences in the way services are funded for Indigenous and non-Indigenous people, potentially creating segregated service arrangements such as separate Indigenous and non-Indigenous schools, hospitals, community health clinics and police services.

7.1 In 2011-12, the Indigenous influence factor is expected to redistribute $2.6 billion in GST revenue, second only to the mining assessment ($3.8 billion). Of the total amount of GST redistributed arising from the Indigenous factor, $1.5 billion is redistributed to the Territory. The redistribution arising from Indigenous influences is intuitive and reflects:

- the large differences between states in Indigenous population shares (as shown in Table 7.1);
- the more intensive provision of government services to the Indigenous population as a result of poorer Indigenous education and health outcomes; and
- the high proportion of Indigenous people residing in remote/very remote areas, which increases the cost of government service provision.

Table 7.1: Indigenous population shares

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
	%	%	%	%	%	%	%	%
Indigenous share of state population	2.3	0.7	3.5	3.4	1.8	3.9	1.3	30.0
Share of national Indigenous population	29.4	6.5	28.4	13.6	5.4	3.6	0.9	12.3

Source: Commonwealth Grants Commission, Australian Bureau of Statistics

7.2 Under the current form of equalisation the Indigenous influences factor applies equally to across all states. The redistribution to the Territory arising from Indigenous influences is the result of national use and cost weightings, applied to the Territory's above average Indigenous population. Indigenous Territorians do not attract a higher per capita amount of GST revenue than Indigenous Australian in comparable regions in other states. For example, an Indigenous person in Bourke, New South Wales, attracts the same use and cost weights as an Indigenous person in Papunya, Northern Territory.

7.3 It has been suggested that equalisation can not cope with addressing Indigenous disadvantage and as such, Indigenous factors should be either removed from the equalisation process and funded separately, or funded through dedicated GST. The Territory strenuously objects to this proposition.

Indigenous-related expenditure

7.4 It is sometimes alleged that the Territory receives additional GST revenue as a result of its large Indigenous population but spends these funds in Darwin or on services and infrastructure not directly related to Indigenous people. These criticisms are used to support proposals for Indigenous influences to be removed from the equalisation process and funded separately.

7.5 In February 2011, the Indigenous Expenditure Report Steering Committee released the 2010 Indigenous Expenditure Report (IER). The 2010 IER is the first comprehensive analysis of expenditure on services for Indigenous people on a comparable basis for all governments.

7.6 The IER Steering Committee was chaired by Commonwealth Treasury and comprised officials from state and territory treasuries and various Commonwealth departments, including the Commission, the Australian Institute of Health and Welfare, the Australian Bureau of Statistics, the Department of Families, Housing, Community Services and Indigenous Affairs. The Productivity Commission provided the secretariat function for the steering committee.

7.7 The main findings from the 2010 IER for the Territory were:

- $2.16 billion was spent on services related to Indigenous people in 2008-09. This equates to 53.9 per cent of the Territory's total general government budget and compares to an Indigenous population share of 30 per cent.
- On a per capita basis, Indigenous-related expenditure in the Territory was $32 230 per Indigenous person, the highest of all jurisdictions and 17 per cent higher than Western Australia, the second highest jurisdiction.
- The ratio of Indigenous to non-Indigenous per capita spending in the Territory was 2.7, the fourth highest of all governments. Despite having the highest per capita spending on Indigenous people, the Territory's per capita ratio reflects the higher costs of providing services to all Territorians resulting from higher fixed costs, service delivery scale and remoteness of the Territory.
- Table 7.2 shows the ratio of Indigenous to non-Indigenous per capita spending for each state by function.

Table 7.2: Ratio of Indigenous to non-Indigenous per capita expenditure

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Cwlth
Education	2.5	2.1	2.4	2.9	3.1	1.9	2.3	2.6	2.0
Healthy lives	1.7	2.1	2.3	2.8	3.4	0.7	2.4	3.6	1.5
Economic participation	1.1	1.4	2.2	0.9	1.2	0.9	1.0	1.2	1.8
Home environment	1.6	1.8	2.0	2.5	2.0	1.5	1.6	3.1	2.7
Safe and supportive communities	4.8	6.5	4.8	7.3	6.1	2.1	5.2	3.9	2.9
Other	1.0	1.0	1.5	1.4	1.3	1.0	1.0	1.1	1.0
Total expenditure	**2.4**	**2.9**	**2.5**	**3.4**	**3.3**	**1.4**	**2.5**	**2.7**	**1.7**
Indigenous share of total expenditure	5.2%	1.9%	8.5%	10.7%	5.7%	5.4%	3.2%	53.9%	4.1%

Source: 2010 Indigenous Expenditure Report

7.8 The Territory has completed two Indigenous Expenditure Reviews (NTIERs). A key difference from the national IER is that the NTIER examined both revenue and expenditure attributable to the Indigenous population. The 2006-07 NTIER found that Indigenous-related expenditure exceeded revenue by eight percentage points or around $248 million.

Removing Indigenous influences from equalisation

7.9 The Territory contends that removing Indigenous influences from the equalisation process would not result in improved equalisation outcomes or greater simplicity. If the Indigenous influence factor was removed, this would need to be removed for all jurisdictions. Such an approach could lead to consequences including Commonwealth taking full responsibility for the provision of government services to Indigenous Australians, which could lead to significant difficulties in determining funding responsibility between the Commonwealth and the states for the use of the same service.

7.10 This would also add significant complexity to intergovernmental relations. It is likely that the Commonwealth would seek to fully fund this responsibility by clawing back GST revenue that equates to total state government expenditure related to Indigenous people, which is significantly greater than the amount of GST redistributed arising from Indigenous influences.

7.11 It is important to note that Indigenous people do not only reside in remote areas. Table 7.3 shows that about 58 per cent of Indigenous Australians reside in New South Wales and Queensland. While only 12.3 per cent of Indigenous Australians reside in the Territory, representing about 30 per cent of the Territory's total population.

Table 7.3: Indigenous population

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
Indigenous population (000)	161.9	35.9	156.5	74.9	29.8	19.6	4.6	67.4	550.6
Share of national Indigenous population	29.4	6.5	28.4	13.6	5.4	3.6	0.9	12.3	100.0

Source: Commonwealth Grants Commission

7.12 Due to the relative size of the Indigenous population in the Territory, the majority of government services for Indigenous Australians are delivered through mainstream programs. Indigenous Australians are overrepresented across virtually all government services and, in many instances, are the majority users of services, for example Indigenous people represent[11]:

- 57 per cent of admitted patients in Territory public hospitals;
- 62 per cent of community health patients;
- 47 per cent of children in government primary schools;
- over 60 per cent of technical and further education students;
- over 70 per cent of children in protection and support services;

7.13 Consequently, removing Indigenous influences from equalisation and funding Indigenous services separately would create significant complexity in intergovernmental relations and is unlikely to lead to any of the intended results

[11] 2010 Indigenous Expenditure Report

such as improving outcomes for Indigenous Australians. It would result in differences in the way services are funded for Indigenous and non-Indigenous people, potentially creating segregated service arrangements such as separate Indigenous and non-Indigenous schools, hospitals, community health clinics et cetera.

Dedicating GST pool to Indigenous influences

7.14 An alternative proposal has been to fund Indigenous influences from a dedicated, separate GST pool. Dedicating a proportion of the GST pool for Indigenous purposes would create additional complexity in the equalisation process, including determining:

- How much GST should be dedicated to Indigenous influences?
- Should it be a fixed amount or fixed share of the GST pool?
- How will the arrangements be reviewed?
- Should this approach be extended to other large redistributive factors such as the mining assessment, wages input costs, location and socio-economic status?

7.15 This proposal would not reduce complexity or increase transparency. Rather, it would have the reverse effect. The proposal would mean that when determining how equalisation between the states is achieved, Indigenous issues are not considered. This is not appropriate and the proposal should not be countenanced.

A Issues Paper Questions

The fiscal equalisation system and governance

Q1. Has fiscal equalisation system evolved to effectively operate in an open economy subject to global volatility?

Paragraphs 1.8 to 1.21

Q2. Is the fiscal equalisation system a passive and reactive mechanism? Should it, or can it, be a more active and dynamic policy tool?

Paragraphs 1.12 to 1.16

Q3. While the level of interest in equalisation outcomes is high, do governments pay sufficient attention to the form of equalisation that underlies the dollar impacts?

Paragraphs 2.1 to 2.4

Q4. Is greater clarify required in the ‘governance’ of fiscal equalisation? Should governments determine aims, objectives and definitions and leave administration only to the responsible public sector agency?

Paragraphs 2.5 to 2.9

Q5. Should the body that administers equalisation be an Australian Government, joint state government or joint Australian and state government body?

Paragraphs 2.10 to 2.12

Scope of fiscal equalisation

Q6. Does an alternative form of equalisation need to be ‘full’ equalisation?

Paragraphs 1.1 to 1.7, 1.22 to 1.26, 4.9 to 4.15, 7.1 to 7.15

Q7. If partial equalisation occurred, what elements of ‘full’ equalisation should be removed?

Paragraphs 4.18 to 4.25, 4.16 to 4.22, 7.9 to 7.15

Q8. Would a move away from ‘full’ equalisation significantly lessen the ability of the current definition of fiscal equalisation to be achieved?

Paragraphs 4.1 to 4.30, 7.1 to 7.15

Efficiency issues

Q9. Does the current fiscal equalisation process complement or encourage or discourage productivity reforms by the states?

Paragraphs 3.1 to 3.9

Q10. Economic analysis suggests the efficiency impacts of equalisation on economic welfare are small (less than +/-0.05 per cent of GDP). Are efficiency impacts material and can such impacts be modelled effectively?

Paragraphs 3.10 to 3.16, 3.21 to 3.25,

Q11. Does fiscal equalisation in its current form have a neutral or distortionary effect on government decision making, for example, on large infrastructure projects? Does equalisation lead to governments over/undersupplying services to particular population groups?

Paragraphs 3.26 to 3.38

Q12. What influence does the current form of fiscal equalisation have on the incentives for states to fully exploit their own source revenue bases and/or levy taxes efficiently?

Paragraphs 3.39 to 3.50

Q13. Does the current form of fiscal equalisation actually or unintentionally penalise or reward states?

Paragraphs 3.51 to 3.53

Q14. What would be the characteristics of an alternative form of equalisation that might better address efficiency issues and provide incentives to the states to have growth enhancing policy settings?

Paragraphs 3.17 to 3.20, 3.54 to 3.56

Equity issues

Q15. In considering any alternatives, how important is it that state governments in Australia have the same capacity to provide comparable services to their residents?

Paragraphs 4.1 to 4.8

Q16. Equalisation provides for the states to have the same capacity to deliver services, but does not specify the standard of those services states provide. Does this mean that the process creates an opportunity which may not be realised in practice?

Paragraphs 4.23 to 4.26

Q17. The current process equalises state government fiscal capacities so that comparable government services can be access in comparable locations in different states (for example, Brisbane and Adelaide) but it does not address differential levels of services across regions (for example, Sydney to Broken Hill), as it is based on 'what states do'. Does this limit the capacity of the process to facilitate equitable access to government services?

Paragraphs 4.27 to 4.30

Q18. What would be the characteristics of an alternative form that might better address equity issues?

Paragraphs 4.1 to 4.30

Simplicity issues

Q19. Fiscal equalisation currently redistributes around $4 billion of an estimated $48 billion of GST (in 2011-12) away from an equal per capita outcome. Is the level of complexity in the current system consistent with this amount of transfer?

Paragraphs 5.1 to 5.7

Q20. Should there be fewer assessment categories in the equalisation system?

Paragraphs 5.8 to 5.10

Q21. Is full fiscal equalisation required of is there a form of partial equalisation that can sufficiently recognise underlying differences amongst the states?

Paragraphs 5.11 to 5.13

Q22. What is the appropriate balance between complexity and transparency in achieving fiscal equalisation? How important is it that the process be readily understood?

Paragraphs 5.14 to 5.20

Q23. Should a 'reasonableness' test be applied to assessments to ensure outcomes based on available data and modelling also take into account intuitive expectations?

Paragraphs 2.8 to 2.11, 7.1

Q24. Is the data used fit for purpose and of sufficiently quality, that is, relevant, reliable, timely, accurate and comparable?

Paragraphs 5.21 to 5.25

Q25. Where there is insufficient or poor quality data, is the basis for the use of judgement appropriate? Does it give rise to false precision?

Paragraphs 5.21 to 5.25

Q26. What would be the characteristics of an alternative form that might better address simplicity issues?

Paragraphs 5.26 to 5.44

Predictability and stability issues

Q27. Do the outcomes of the current process result in an appropriate level of predictability and stability in the determination of GST shares?

Paragraphs 6.1 to 6.11

Q28. Does the current averaging process result in an appropriate balance between achieving equalisation and reducing volatility?

Paragraphs 6.12 and 6.13

Q29. As the current equalisation process is heavily reliant on the provision of data from states could more be done to address the quality of state data?

Paragraphs 6.14 to 6.16

Q30. Could more be done to improve forward estimates of GST distribution outcomes? To what extent should state take responsibility for forecasting future GST shares?

Paragraphs 6.17 to 6.19

Q31. Should some form of limit, or other transitional approach, be used to minimise the volatility of these outcomes on state budgets?

Paragraphs 6.20 to 6.30

Q32. What would be the characteristics of an alternative form that might better address predictability and stability issues?

Paragraphs 6.31 to 6.33

B Equal Per Capita

B.1 There are misinterpretations regarding the meaning of 'equal per capita'. For example, Commonwealth welfare payments made to comparable individuals do not differ, which could mistakenly interpreted as the Commonwealth distributing welfare on an equal per capita basis. An equal per capita distribution is not the same as an equal payment per recipient distribution.

B.2 For example, the amount of age pension payments to individuals is fixed across Australia, however this does not constitute an equal per capita distribution of pension payments in each state.

B.3 Table 4.1 shows states' shares of the national population and population aged 65 years and over. If age pension payments were distributed on an equal per capita basis, then total payments in a state would equal only that states' share of the national population.

B.4 For example, South Australia comprises 7.37 per cent of Australia's total population. An equal per capita distribution of pension payments would mean that 7.37 per cent of all pension payments made by the Commonwealth would be distributed in South Australia. However, South Australia has 8.55 per cent of Australia's pension-aged population. Under the current method, which is akin to an equalisation approach, South Australia receives 8.55 per cent of total pension payments (assuming all pension age people receive the pension payment).

Table 4.1: State share of total population and total pension-aged population

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	%	%	%	%	%	%	%	%	%
Total population	32.39	24.85	20.21	10.27	7.37	2.28	1.61	1.03	100.00
Pension-aged population	33.84	25.27	18.86	9.20	8.55	2.63	1.24	0.42	100.00

Source: Australian Bureau of Statistics

B.5 It should also be noted, that under the current form of equalisation, disability factors apply equally to relevant population groups in all states. The higher cost of providing services and higher use of services by remote Indigenous people apply uniformly to remote Indigenous people in all jurisdictions, based on national use and cost averages.