

# Queensland Government Submission to the Review of GST Distribution

---

October 2011



## **EXECUTIVE SUMMARY**

Queensland would welcome improvements to the GST distribution process that:

- clarify the aim of the process;
- address the problems with the current assessment of mining revenue;
- simplify the assessment process; and
- focus on providing appropriate support to those States that genuinely require it.

### **The aim of the GST distribution process**

The aim of the GST distribution process is not precisely clear, as demonstrated by the differences between the descriptions used by the Australian Government, the Commonwealth Grants Commission and the Terms of Reference for this Review.

Without clarity about the purpose of the process, there cannot be clarity about whether the existing process achieves its purpose, or how it might better do so.

This Review could clarify the aim of the GST distribution by adopting an aim consistent with that used by the Australian Government in 2011, and articulated in the Review's Terms of Reference (GST Distribution Review 2011, clause 3) and the Review Panel's Issues Paper (GST Distribution Review 2011a, p. 1). That is, the aim of the GST distribution process should be to provide the necessary budget support so that all States have the capacity to provide services at a comparable standard.

### **Issues with the current assessment of mining revenue**

The assessment of mining revenue is an example of how the current approach to assessing "what States do" does not function properly when applied to cases where the base is dominated by a few States.

The revenues from mining represent more than three quarters of the GST distributed due to revenue assessments, despite comprising less than a tenth of all State revenue. In the current assessment process, resource States end up retaining less revenue per capita than non-resource States following equalisation.

The assessment of mining revenue also produces outcomes that do not seem appropriate, particularly when compared with other assessments, and with revenue raising effort. Additionally, the redistribution fails to take account of the costs of developing and maintaining associated economic and social infrastructure borne by the resource States.

Collectively these issues can create serious incentive problems, undermining the principle of policy neutrality, that is, the principle that a State's own policies should not directly affect its share of GST.

There are number of approaches the Review could further explore to address these issues, including:

- assessment of a proportion of total mining revenue;
- assessment of a proportion of the growth in mining revenue; and
- treating mining revenue separately from the broader assessment process.

## **Simplifying the GST distribution process**

The current process involves highly detailed and complex assessments of “what States do”, based on the assumption these are necessary to recognise the true differences between States. In reality however, the frequent use of judgement in the current process due to concerns about data consistency between States suggests it may not recognise these differences any better than a simpler method.

There are a number of approaches the Review could further explore to simplify the process, including:

- global measures of revenue and/or expenditure; and
- a single aggregated revenue base for the assessment of mining revenue.

## **Focus on providing appropriate support to States that require it**

The current process produces large transfers between the four large States (New South Wales, Victoria, Western Australia and Queensland) with a relatively small net result. Despite their scale, these transfers have a minimal impact on the final budget positions of these States suggesting they do not currently require substantial additional budget support.

There are a number of approaches the Review could further explore to address this, including:

- focusing on redistributing a proportion of the GST pool from “donor” to “recipient” States;
- treating Indigenous assessments separately from the broader process;
- treating the ACT and the Northern Territory separately from the broader process; and
- using the ‘minimum level of effort’ defined by the State with the lowest expenditure effort in an area of service delivery to set a base. This allows States to deliver services at a comparable standard and focus expenditure to priority areas rather focusing on the same level of services.

## **Conclusion**

Queensland believes addressing all of the issues identified in this submission would improve the transparency, reliability and equalisation outcomes of the GST distribution process. However, the fundamental issues that must be addressed by this Review are those associated with the assessment of mining revenue.

As these issues cannot be addressed within the current assessment, a priority of this Review must be to consider alternative approaches to assessing mining revenue. Without this, the outcome of this Review will not deliver a simpler, fairer, more predictable and more efficient distribution of the GST to the States.

## INTRODUCTION

1. In 2011-12, approximately 21% (\$9.139 billion) of Queensland's revenue will be sourced from GST payments. The process for determining how the GST is distributed between States is therefore of great concern, as GST represents a major source of funding for health, education, transport and other vital services and infrastructure for the Queensland community.
2. In this submission, Queensland highlights the importance of considering the distribution of GST in the broader context of Federal Financial Relations, and of clearly establishing the desired outcome of the process. The submission draws attention to a number of issues with the existing process, and suggests possible approaches to addressing them by:
  - clarifying the aim of the GST distribution process;
  - addressing the problems with the current assessment of mining revenue;
  - simplifying the assessment process; and
  - focusing on providing appropriate support to those States that genuinely require it.

## CONTEXT

3. Queensland believes it is important for the Review of GST distribution to be considered within the broader context of Federal Financial Relations in Australia. That is, to recognise the distribution of GST forms one part of a wider framework of Federal Financial Relations, the various elements of which all have a part to play in achieving horizontal fiscal equalisation.
4. The *Intergovernmental Agreement on Federal Financial Relations*, introduced in 2009, provides the framework for the Australian Government's financial support for States' and Territories' (hereafter States) service delivery efforts through:
  - general revenue assistance, including the on-going provision of GST payments, to be used by the States for any purpose;
  - National Specific Purpose Payments (SPPs) to be spent in the key service delivery sectors; and
  - National Partnership payments to support the delivery of specified outputs or projects, to facilitate reforms, or to reward those States that deliver on nationally significant reforms.
5. It is important to recognise the GST distribution process, of itself, may not be the best means of addressing all issues arising from the existing process, or indeed of achieving horizontal fiscal equalisation. Queensland believes this Review should give due consideration to the other mechanisms within the Federal Financial Relations framework in determining the form the GST distribution process should take.
6. To determine what the GST distribution process should be doing, and what may be better addressed through other mechanisms, it is important to establish the aim of the GST distribution process. That is, what the desired outcome or endpoint of the process is.

## AIM OF THE GST DISTRIBUTION PROCESS

7. Queensland believes it is important to clearly establish the aim of the GST distribution process, as this drives the form of the process, and can determine the scope of any review of that process.
8. As seen in the Commonwealth Grants Commission's *2010 Review*, proposals for changes to the process can be constrained by the objective that is adopted. In a number of cases, that review discounted suggested options because they were not consistent with the specified objective of the GST distribution process.
9. Queensland notes there are inconsistencies between the aim of the GST distribution process specified by the Commonwealth Grants Commission, the Australian Government, and the Terms of Reference for this Review (see Box 1).

### Box 1: Aim of the GST distribution process

#### Commonwealth Grants Commission

**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 (Commonwealth Grants Commission 2010, p. 34, emphasis added).

#### Australian Government

**Horizontal fiscal equalisation provides the necessary budget support so that all States have the capacity to provide services at a comparable standard**, while ensuring that the interstate transfers are not so large that they would significantly distort economic behaviour and reduce productivity growth (Australian Government 2011, p. 106, emphasis added).

#### Terms of Reference for this Review

The GST will continue to be distributed to the States on the basis of equalising payments to the States, consistent with the principle that **jurisdictions should have equal capacity to provide infrastructure and services to their citizens** (GST Distribution Review 2011, clause 6b, emphasis added).

10. The intent of the three statements in Box 1 is for all States to have the capacity to provide services to their residents. However, the statements differ in the suggested standard for these services. The Review's Terms of Reference do not refer to standards, the Commonwealth Grants Commission refers to "the same standard", and the Australian Government refers to "a comparable standard". While the difference between the approaches of the Commonwealth Grants Commission and the Australian Government may appear to be a matter of semantics, in practice they seek quite different outcomes.
11. For example, in terms of outcomes, the difference between these two approaches may be for governments to be able to deliver an educational experience for Year 10 students in Darwin and inner Sydney that is alike in every way (i.e. "the same standard"), or that is similar, perhaps within agreed and/or acceptable thresholds or ranges, but not necessarily identical (i.e. "a comparable standard").

12. In a country as diverse as Australia the reality is that services are delivered to “a comparable standard” both within and across States, as it may be appropriate to tailor service delivery to specific local and regional needs. Seeking the delivery of services at “same standard” may not be practical, efficient or cost effective.
13. Additionally, in no area of Australian public policy does a desire for absolute equality of outcomes override all other considerations. Governments do not provide identical levels of services to every resident. The tax and transfer system does not equalise net incomes for all Australians. This is because other objectives – efficiency, fairness, simplicity – need to be taken into consideration to produce an optimal outcome.

### **Proposed aim**

14. Implicit in the Terms of Reference for this Review is a question about what the GST distribution process should aim to achieve, that is for States to be able to “deliver broadly equivalent levels of services and infrastructure to their residents” (GST Distribution Review 2011, clause 3).
15. Queensland believes this Review should seek to clarify the aim of the GST distribution process, and recommends the aim that is adopted be consistent with that specified by the Australian Government in 2011, and articulated in the Review’s Terms of Reference (GST Distribution Review 2011, clause 3) and the Review Panel’s Issues Paper (GST Distribution Review 2011a, p. 1). That is, the aim of the GST distribution process should be to provide the necessary budget support so that all States have the capacity to provide services at a comparable standard.
16. Queensland believes consistent adoption of this aim would allow a wider consideration of approaches to GST distribution that provide the best outcome in terms of efficiency, equity, simplicity, predictability, and stability.
17. Queensland also believes that in recent years the application of the GST distribution process has been overly focused on the equalisation of total fiscal capacity, that is on full equalisation across the States. Queensland believes this is an overly narrow interpretation of the aim of the process and that it is possible to provide all States with the capacity to provide services without needing to equalise all revenues. Accordingly, Queensland supports exploration of “partial” equalisation approaches in this Review as a means of achieving a better balance of the efficiency, equity, simplicity, predictability, and stability criteria.
18. In addition, Queensland believes there is an opportunity to consider whether “a comparable standard” should be defined in terms of the average activity of States, as occurs currently, or whether an alternative definition may be appropriate.

### **SIMPLIFICATION**

19. Queensland welcomes consideration of approaches that seek to simplify the process, with the aim of reducing complexity and increasing transparency. Noting any consideration of simplification in this Review should be in terms of the simplest means of determining “the necessary budget support” for States.

20. The Commonwealth Grants Commission's *2010 Review* achieved some simplification of the process by reducing the number of categories from 52 to 22 (not including user charges). However, the current system still involves complex assessments within these categories, and the system as a whole remains complex due to the current interpretation of "what States collectively do".

### **Interpretation of "what States collectively do"**

21. For any attempt at simplification to be successful, Queensland believes the current interpretation of the principle of reflecting "what States collectively do" (Commonwealth Grants Commission 2010, p. 35) needs to be considered.
22. The current interpretation of this principle assumes Government service delivery and revenue effort need to be emulated in as detailed a way as possible (subject to materiality thresholds) for equalisation outcomes to be conceptually valid. This is usually considered to be conceptually sound because it recognises the causes of differences in State circumstances are often complex. However, this approach can create a preference for making an assessment wherever there is a conceptual case for doing so, despite inadequate data or concerns over the accuracy, or reliability of outcomes and comparability of data.
23. As seen in the Commonwealth Grants Commission's *2010 Review*, this emphasis on a detailed interpretation of "what States do" can lead to cases where:
- assessments are based on data known to be unreliable or not comparable. For example:
    - the data used to construct the revenue base for land tax has significant known comparability issues
    - 4-digit government purpose classifications (GPCs) continue to be used in most assessments despite advice from the Australian Bureau of Statistics that this level of disaggregation can be unreliable;
  - judgement is used to make assessments based on partial or anecdotal evidence. For example:
    - the welfare and housing assessment constructed a complex socio-demographic disability primarily based on data from a single State
    - the interstate non-wage assessment was based to a large degree on judgement; and
  - discounts are applied to assessments because of a lack of confidence in the methods, data, or outcomes. The Commonwealth Grants Commission's *2010 Review* applied 14 different discounts, some of which were applied to almost every expense assessment.
24. This raises questions about whether assessment methods with relatively high levels of complexity do in fact measure true underlying differences in capacities with relatively greater accuracy. Although complexity creates the impression of rigour, it may be that the outcomes are actually less reliable than they seem. The frequent application of discounts (use of judgement) arising from concerns about the quality of the data and the complexity of the methodology suggests there is little reason to believe the current approach produces a better equalisation outcome than a broader assessment would.



### **Determining and providing “the necessary budget support”**

25. It may be possible to determine what constitutes “the necessary budget support” for States to have the capacity to provide services at a comparable standard with far less detailed assessments than are currently undertaken.
26. It may also be possible to provide States with “the necessary budget support” without needing to equalise all revenues. Such “partial” equalisation approaches could also reduce the level of detail required to assess State service delivery and/or revenue effort without detracting from the overall aim of the process.

### **Transfers between large States**

27. The current process produces large transfers with a relatively small net result. Specifically, it involves large transfers from Western Australia and Queensland to New South Wales and Victoria from revenue, and large transfers from Victoria and New South Wales to Queensland and Western Australia from expenses.
28. This raises questions about the effectiveness of the current process in achieving its overall aim. The relatively smaller impact on the final budget positions of these four States, despite the scale of these transfers, suggests they do not currently require substantial additional budget support. It may therefore be more effective for the process to focus on delivering transfers from these relatively wealthier States to those States that genuinely require additional support.

### **Advantages of simpler methodologies**

29. Regardless of the form of the GST distribution process adopted, Queensland believes this Review could improve the reliability, transparency and equalisation outcomes of the process through further simplification. Simpler methodologies:
  - can be more robust and reliable, producing more stable and repeatable results. For example, methodologies that focus on fewer indicators with clear conceptual links to revenue raising capacity or service delivery are more likely to be reliable than those that attempt to measure a large number of detailed factors;
  - are less likely to require the use of data that are unreliable, partial or not comparable; and
  - could potentially better reflect the essential causes of differences in State circumstances without the aggregation of error inherent in using many individual measurements, many of which may be fundamentally flawed.

### **PREDICTABILITY AND STABILITY**

30. Queensland welcomes the consideration of approaches that seek to increase the predictability and stability of outcomes, with the aim of better supporting long-term decision-making and reform by governments. Noting any consideration of predictability and stability in this Review should be in terms of the best way of determining “the necessary budget support” for States.
31. As noted previously, one of the principles of the existing process is that it should “reflect what States collectively do”. However, this principle does not function properly when applied to cases without a similar base in every State. This is

particularly apparent in cases where the base is dominated by a few States, for example the assessment of mining revenue. These cases arguably have issues in terms of consistency, robustness and responsiveness, creating problems in terms of predictability and stability for the GST distribution process as a whole.

### Assessment of mining revenue

32. The revenue base for mining activity is dominated by two States, Queensland and Western Australia. This domination appears to impact on the existing process in a number of ways, producing outcomes that are arguably inappropriate, and which compromise the policy neutrality (the principle that a State's own policies should not directly affect its share of GST) of the assessment.

### Level of redistribution

33. As noted in the Queensland 2011-12 Budget, mining revenue comprises around 7% of all State revenue in aggregate, yet represents 76% of the GST redistributed as a result of revenue assessments. This suggests the current approach places undue emphasis on mining revenue, when other revenues, such as stamp duty on conveyances and payroll tax, are arguably more important sources of State revenue.
34. Table 1 compares the actual mining revenue collected from 2007-08 to 2009-10 with the GST redistribution that was based on States' relative capacities to raise revenue from mining in these years.
35. As shown in Table 1, in net terms, the majority of mining royalties raised by Queensland and Western Australia were offset by the redistribution in the Commonwealth Grants Commission's *2011 Update*. As a result, all other States gained more from mining royalties than Queensland and Western Australia on a per capita basis.

**Table 1 – Comparison of mining revenue and GST distribution**

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	AUST
<b>Mining revenue<sup>1</sup></b> <b>(\$ million)</b>	946	44	2,242	2,973	140	35	..	168	6,550
<b>2011-12 GST redistribution<sup>2</sup></b> <b>(\$ million)</b>	1,325	1,845	-1,213	-2,520	379	127	125	-69	3,802
<b>Net mining revenue</b> <b>(\$ million)</b>	2,271	1,889	1,029	453	519	162	125	99	
<b>Net mining revenue<sup>3</sup></b> <b>(\$ per capita)</b>	322	352	236	206	322	324	359	446	

Notes:

1. Figures are the average mining revenue from 2007-08 to 2009-10 and do not therefore reflect changes to mining royalties announced in the Western Australian Government's 2011-12 Budget.
2. Commonwealth Grants Commission's redistribution for mining revenue based on average assessed revenue raising capacity from 2007-08 to 2009-10.
3. Calculated using 2007-08 to 2009-10 average populations.

Sources: Queensland Treasury, Commonwealth Grants Commission *Report on GST Revenue Sharing Relativities – 2011 Update*.

Comparison to revenue raising effort

36. In the current assessment process, differences in the mining revenue raised by States can be caused by differences in:
- underlying revenue raising capacity (level of mineral wealth); or
  - revenue raising effort (the actual royalty rates chosen by States).
37. Because the intention of the current assessment process is to equalise for differences in capacity only, the differences in net mining revenue could be due to differences in the actual royalty rates of States (their level of revenue “effort”). That is, States with lower net mining revenue could simply be setting their royalty rates at lower levels than those with higher net mining revenue. However, this does not appear to be the case.
38. As shown in Table 2, Queensland and Western Australia dominate the average mining royalty rate, yet both States are well below the average net revenue per capita.

**Table 2 – Comparison of net revenue and revenue raising effort ratios for mining and stamp duty on conveyances**

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	AUST
<b>Mining</b>									
Net revenue per capita (\$)	322.0	351.9	236.6	205.6	322.0	324.3	359.8	446.6	<b>302.3</b>
Revenue raising effort ratio <sup>1,2</sup>	<i>92.1</i>	<i>61.9</i>	94.7	<i>107.8</i>	85.6	84.9	100.0	131.3	<b>100.0</b>
<b>Stamp duty on conveyances</b>									
Net revenue per capita (\$)	515.9	621.2	403.1	610.1	682.7	576.2	693.1	617.7	<b>546.6</b>
Revenue raising effort ratio <sup>1</sup>	93.1	113.6	80.5	110.9	130.1	101.9	126.5	112.0	<b>100.0</b>

Notes:

1. Average revenue raising effort ratio 2007-08 to 2009-10. A value of 100 indicates the State average level of effort. Values over 100 indicate a higher than average level of effort.
2. The ACT’s ratio is set to 100 as it has no mining activity.

Source: Australian Government Budget 2011-12, and Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities — 2011 Update*.

39. For most States (shown in italics in Table 2), the difference from average net revenue per capita is in the opposite direction than that implied by effort ratios. For example, Western Australia’s net revenue per capita is far lower than the Australian average, yet its average revenue raising effort is higher than the Australian average. Queensland’s revenue raising effort ratio is slightly below average, but its net revenue per capita is far below the average.
40. Similarly, States with lower than average mineral wealth, such as Victoria, have higher than average net revenue per capita despite a far lower than average revenue raising effort.
41. This suggests the current assessment of mining revenue is overemphasising the revenue raising capacity of States with high levels of mineral wealth.

42. As shown in Table 2, a similar analysis of the Stamp Duty on Conveyances assessment (where every State has a similar revenue base) does not display the same problems. Where a State's "net revenue per capita" is lower than the Australian average so is its average revenue raising effort ratio (New South Wales and Queensland), and vice versa.
43. A reasonable conclusion is that the current processes are generally functioning as intended, but that they do not work for cases such as mining, where the revenue base is dominated by a small number of States.

#### Policy neutrality and grant design effects

44. As well as producing inappropriate outcomes, a situation where resource States end up retaining less revenue per capita than the non-resource States following equalisation creates some serious incentive problems, and undermines equity, transparency and simplicity.
45. An examination of the impact of policy changes by the resource States demonstrates further policy neutrality issues in the assessment of mining revenue and the incentives (or "grant design effects") they create.
46. For example, in the lead up to the Commonwealth Grants Commission's *2011 Update*, Western Australia, the majority producer of iron ore fines, removed some concessions on the mineral. This had the effect of increasing the average national royalty rate above the 5% threshold for low royalty rate minerals set by the Commonwealth Grants Commission. The current methodology for the assessment of mining revenue would have caused Western Australia to lose far more revenue from the GST distribution than would have been raised from the increased royalties, were it not for a Terms of Reference directive (Commonwealth Grants Commission 2011, p. vii, clause 11) to alter the methodology.
47. This highlights one of the critical issues with the assessment of mining revenue, that the current design of the assessment can influence the policy choices of States. This is particularly relevant given subsequent royalty rate changes recently announced in Western Australia's 2011-12 State Budget that go beyond the changes incorporated in the Commonwealth Grants Commission's *2011 Update*, released in February 2011.

#### Cost of economic and social infrastructure

48. Another issue with consistency is how assessments deal with the costs of both economic infrastructure (infrastructure that relates directly to the economic activity, e.g. for mining - roads, railways and ports) and social infrastructure (infrastructure for the people undertaking the activity, e.g. schools and health facilities).
49. When an assessment has a common base in every State it can be assumed that where there are costs arising from the required development and maintenance of associated economic and social infrastructure, each State will have borne these costs. In these cases, it is not relevant whether the assessment process considers these costs as the treatment will be consistent across States. However, it is

relevant in cases such as the assessment of mining revenue, where two States have significant costs from the development and maintenance of associated economic and social infrastructure. If the assessment process does not consider these costs, as is currently the case, these States are effectively treated inconsistently.

50. In 2004, Bob Searle, former Secretary of the Commonwealth Grants Commission, highlighted a number of challenges with determining the impact of natural resources on infrastructure requirements. In his presentation to the conference on the Challenges in the Design of Fiscal Equalization and Intergovernmental Transfers, Searle noted that all activities that utilise natural resources require infrastructure that has a public benefit.
51. He noted that one of the particular challenges in assessing the costs of this infrastructure is that it may not be located where the economic activity is. For example, a mine may be in one location, roads and railways pass through several others and the port is in another. This is also true of social infrastructure, which may not be located in the direct proximity of the mining area, but rather in an alternative location that serves as a “base” for mine staff and their families.
52. In addition, costs can differ from case to case based on the permanent or temporary nature of the infrastructure, and the point at which the costs for development and/or maintenance are borne by governments. This also has potential flow on effects for the delivery of other infrastructure within a State.
53. Bearing this in mind, there are any number of transport projects that are directly related to support of the mining industry and that have incurred costs to the State that will not be subject to cost recovery, for example:
  - replacement and duplication of Forgan Bridge over the Pioneer River in Mackay and supporting infrastructure at a cost of \$148 million, completed in August 2011;
  - realignment of the Calliope range connecting coal resources in the Callide Valley to Gladstone, to be completed in November 2011, at a cost of \$70 million; and
  - a number of construction projects over the next four years on the Peak Downs Highway, the main artery for shipping fuel and other supplies to the coalmines of the Bowen Basin, totalling approximately \$106.5 million.A large number of similar projects are currently being completed across Queensland’s mining regions.
54. Alongside State-funded road infrastructure, there are high costs to the State to provide rail, ports and other transportation infrastructure to link regional mining activity to the rest of the State and export markets. Although cost recovery is implemented for some of these projects over time, upfront costs affect Queensland’s capacity to provide infrastructure in other areas.
55. Additionally, there are increased costs to the State in provision of planning for these regions and the assessment and review of the environmental impact of mining projects and supporting infrastructure.

56. The mining industry also increases activity in regional areas, which in turn places additional stress on the social infrastructure, such as hospitals, schools and community services, of these communities. In Queensland, cities such as Gladstone, Mackay and Mt. Isa provide a “base” for services to workers in the surrounding mining regions. Delivery of services in these regional centres can cost more than in highly accessible cities such as Brisbane, Melbourne and Sydney.
57. Although the current process includes an assessment of infrastructure costs, this is based on the relative growth of each State’s total population, and does not sufficiently take into account the additional costs of projects that directly support the mining industry, or of regional growth related to mining.
58. Should further investigation and quantification of these costs be required to support the Review, Queensland would be willing to undertake these.
59. Queensland believes there is no way to address the issues identified above within the current assessment. Given this, a priority of the Review should be to consider alternative approaches to the assessment of mining revenue, including dealing with these revenues outside of the current process.

#### **Indigeneity assessments**

60. Expenses relating to Indigenous service provision are another example of an assessment where application of the principle of reflecting “what States collectively do” may not be appropriate. Additional expense requirements relating to Indigenous services do not affect every State in the same way due to the significant differences in the number and proportion of Indigenous people in each State.
61. Further, the redistribution of the GST for Indigenous expenditure may not be the most appropriate mechanism through which to address Indigenous issues. Arguably, the current GST distribution process does not necessarily enhance the delivery of Council of Australian Governments (COAG) initiatives such as *Closing the Gap*, and may not be the best means of improving outcomes for Indigenous Australians. Indigenous expenditure is an issue of individual and community equity, which may be dealt with more appropriately through payments for specific purposes rather than untied funding.

#### **SUGGESTED APPROACHES**

62. There are a number of ways the issues raised above could be addressed. The following section provides a number of approaches Queensland believes warrant further consideration in this Review.

#### **Treatment of outlier assessments**

63. This approach would involve separate treatment for assessments that do not have a common base across all States, “outlier assessments”. As noted above, such assessments can be responsible for a disproportionate amount of the GST redistribution between States, resulting in distortion of equalisation outcomes.

Examples of such assessments include the assessment of mining revenue and the treatment of Indigeneity.

64. Outlier assessments could be assessed externally from the general Commonwealth Grants Commission process, or excluded from the GST distribution process entirely with differences in State capacities addressed using mechanisms other than the GST.

### Mining

65. As detailed above, as a result of the domination of the mining revenue base by Queensland and Western Australia, the current approach to this assessment produces inappropriate outcomes.
66. Alternative approaches to mining need to ensure that:
  - the revenue raising capacity of the resource States is not overstated;
  - policy neutrality (the principle that a State's own policies should not directly affect its share of GST) is significantly improved;
  - incentive problems are reduced; and
  - the cost of economic and social infrastructure to the resource States is recognised.
67. An external assessment of mining revenue could take into account the burden on States of providing necessary infrastructure. These costs are particularly relevant given the current strength of the resource sector internationally and requirements to meet increasing demands for resource related infrastructure. This approach would also recognise the numerous social costs relating to the resource sector that are overlooked in the current treatment of mining revenue.
68. At a minimum, this could be mitigated by assessing only part of mining revenue.
69. In 2006 the Canadian Expert Panel on Equalization and Territorial Formula Financing recommended a partial assessment of natural resource revenue in Canada on the basis that:

First and foremost is the fact that, constitutionally, provinces own natural resources within their boundaries. As owners, the provinces determine when and under what conditions a particular natural resource will be developed. This is very different from other sources of revenues that are owned privately and simply taxed by a provincial government.

Second, provinces that benefit from natural resources face considerable uncertainty due to large swings in prices (for oil and gas in particular), wide variations in costs of production, uncertainty over the potential volume of production, and significant changes in profitability. On top of that, there are public costs involved in providing the necessary infrastructure to develop natural resources as well as in monitoring and regulating environmental impacts. Provinces with resource revenues reap not only the benefits but also must pay the costs for development, regulation, and management of their natural resource sectors.

Third, based on the principle of policy neutrality, the Equalization program should not provide incentives or disincentives for provinces to develop natural resources or adjust their royalty programs. If receiving provinces with resource revenues are allowed to "keep" more of those revenues without seeing them offset by corresponding reductions in Equalization, there is a greater likelihood that they will

fully develop their resources and tax them appropriately. (Finance Canada 2006, p. 57)

70. These arguments also apply to Australia. A partial approach to the assessment of mining revenue would address many of the critical problems with the current assessment. It would ensure that the infrastructure and social costs of the mining sector are recognised and that the net revenue benefit to non-resource States of the resource sector is not overstated. Further, there would be an improvement in policy neutrality and a reduced distortion to incentives.
71. A partial assessment of mining revenue could take a number of forms. One option would be to only assess a proportion of mining revenue. Alternatively, a proportion of the growth in mining revenue could be excluded from equalisation in each year.
72. Any alternative approach to the assessment of mining revenue would also need to address policy neutrality issues within the current structure. This could be achieved by broadening the treatment of mining. For example, by aggregating the assessments of high and low royalty rate minerals.
73. Assessing mining revenue using a single aggregated revenue base would reduce the impact of policy decisions on State GST shares and would remove some of the incentive problems in the current assessment. For example, the removal of Western Australia's iron ore fines concessions would have only redistributed a small proportion of Western Australia's revenue gains if the revenue base had been aggregated, with no need for a Terms of Reference directive.

#### Indigeneity assessments

74. The current treatment of Indigeneity may not necessarily be the best mechanism to support the objectives of national initiatives such as Closing the Gap. Where unique circumstances prevail, such as issues pertaining to Indigeneity in the Northern Territory, the GST distribution process may not be the best means of facilitating spending on a specific area to promote equitable access to services. Excluding the Indigeneity assessments from the process may allow them to be addressed through Specific Purpose Payments or National Partnership payments targeted at particular sectors or initiatives, which are arguably more appropriate mechanisms.

#### **Treatment of Territories**

75. One possible approach could be to remove the ACT and the Northern Territory from the assessment process, on the basis that the Territories face unique situations and issues that may distort the current process, and which could potentially be addressed more effectively through other means. It must be recognised that the Territories have legitimate aspirations that are served by their being in the broader process.
76. For example, the Northern Territory has a much greater requirement for Indigenous service provision than any other State, and the ACT has unique cross-



border issues. Both Territories face issues of economies of scale that are greater than those experienced in other States.

77. Excluding the Territories' redistribution from the process could allow the Australian Government to directly address the issues facing the Territories and tailor funding arrangements to their needs. Similar to the removal of Indigeneity assessments option discussed above, addressing Territory issues through alternative funding arrangements may provide a more direct link between funding and outcomes, especially in the context of achieving national objectives such as the COAG *Closing the Gap* initiative.
78. Removing the Territories from the equalisation process also has implications for the GST redistribution process applied to the remaining States. Greater simplicity would be achieved through the removal of factors that are only material for the Territories and which may be distorting the current process. Assessments, such as administrative scale, are also heavily skewed in the current process by the Territories' small populations.
79. There are a number of possible variations for this approach. The first would involve the Australian Government taking separate responsibility for all additional funding for the Territories (currently \$2.4 billion). Alternatively, the Australian Government could take responsibility for funding for the Northern Territory's Indigenous service provision (currently \$1.5 billion), and for funding the ACT (currently \$0.1 billion). In both alternatives, the GST pool would remain unchanged and the Territories could receive an equal per capita share of it.

#### **Provide support for the needs of States with relatively lower fiscal capacities**

80. This approach seeks to provide "the necessary budget support" to States with relatively lower fiscal capacities while reducing the redistribution of GST between States with relatively higher fiscal capacities.
81. On a structural level, there are underlying, long-term differences in States' circumstances that are central to determining their fiscal capacities. For example, New South Wales and Victoria are historically wealthy and developed States that have grown in a similar way through a commercial/manufacturing base. Queensland and Western Australia have high revenue capacities as a result of their mineral wealth, but also have population characteristics that result in relatively higher expense requirements. These four States could be expected to remain net contributors (or "donors") to the GST redistribution in the longer term.
82. The other States can be expected to remain net recipients of GST due to population characteristics that create greater expense needs, a relatively small share of State revenue bases, and diseconomies of scale.
83. As noted above, the current process produces large transfers between the donor States with a relatively small net result, raising questions about the effectiveness and efficiency of the current process in achieving its overall aim. In addition, the proportion of GST received by the recipient States has remained fairly constant (at around 20%) since the introduction of the GST.

84. An approach that simply redistributes a proportion of the GST pool from the donor to the recipient States could therefore provide “the necessary budget support” without the need for a full annual assessment process.
85. The large States’ shares of the redistribution to the smaller States could be based on long-term structural influences. These could be informed by the average of relativities since the introduction of the GST, or could take account of major structural adjustments, such as the increase in mining revenue for Western Australia. It would not be useful for this approach to focus on the current relativities as fluctuations caused by the continuing recovery from the global financial crisis and recent natural disasters may mean these are not reflective of the underlying , longer-term, relative positions of States.
86. Equally, recipient State shares of the redistributed GST could be based on either long-term averages or structural adjustments, or continue to be assessed by the Commonwealth Grants Commission to ensure responsiveness to changing circumstances.
87. This approach would greatly improve the predictability of the outcome for all States. At the same time, it could allow sufficient flexibility for the changing circumstances of recipient States to be recognised through their shares of the redistributed GST. As donor States are expected to have sufficient revenue capacity to meet their expense requirements, it is arguably less critical for the system to respond to short term changes in their circumstances, provided that underlying, long-term differences are recognised.
88. The potential simplicity, policy neutrality and stability benefits provided by this approach suggest that it would be useful for this Review to investigate this approach further.

#### **Global measure of revenue/expenditure**

89. This approach seeks to determine what constitutes “the necessary budget support” for States to have the capacity to provide services at a comparable standard with far less detailed assessments than are currently undertaken.
90. This approach considers the application of global measures of revenue and/or expenditure. Rather than assessing individual revenue bases and expenses by purpose, this approach would assess State revenues and expenses in aggregate, using broad indicators to determine differences in capacity. This global assessment could potentially produce a measure of States’ relative capacities which is arguably no less robust than the current process, but which has a significantly simplified methodology.
91. As noted above, the current approach can create a preference for making a detailed assessment wherever there is a conceptual case for doing so, despite inadequate data or serious concerns over the accuracy or reliability of outcomes.

### Revenue

92. There are a number of possible approaches to the development of a global revenue assessment.
93. A combination of different proxies could be used to link the assessment of revenue capacities to the parts of the economy taxed by States and the extent to which different segments are taxed. This could be approached in a variety of ways, for example:
  - in relation to economic bases, State taxation may be grouped into taxes on labour, capital and land/resources; or
  - from a capacity to pay perspective, groupings could potentially be condensed to taxes on households and taxes on corporations.
94. Revenue capacity from taxes on corporations could be measured using a proxy based on corporate profitability, total factor income or a similar measure.
95. An assessment of revenue raised from households could use a broad measure of household capacity to pay tax, such as household disposable income.
96. Total assessed revenue for the States could be derived in a similar way to the calculation of individual revenue assessments in the current process. States' relative per capita shares of the proxy indicator and the total revenue raised could be used to determine each State's revenue capacity compared to the standard.

### Expenses

97. On the expenditure side, a global assessment could continue to assess disabilities in service delivery, but at a broader level than the current process.
98. This kind of approach has the potential to significantly improve policy neutrality and simplicity, while still producing an outcome that captures the inherent differences in State service delivery requirements.
99. Instead of categorising expenses by purpose and assessing individual disabilities in each category, the assessment could focus on factors that affect the cost of service delivery globally, across a broad range of State government functions. Some global factors are already included in the current process, such as difference in wage levels, remoteness and administrative scale.
100. Many other disabilities in the current process, such as those relating to socio-economic and other demographic influences, are applied in a range of categories using similar methodology, and could be combined into a single measure.

### **Using the minimum effort to “set the standard”**

101. This approach recognises the aim of the GST distribution process is to ensure that States have the capacity to provide comparable, rather than the same level of services. If we agree that all Australians should have access to at least a minimum standard of services, instead of defining the standard as the average, assessed revenue or expenses could be defined as the revenue that would have been raised

(or expenditure that would have been required) at the minimum level of assessed effort.

102. The minimum assessed effort could be defined as the actual assessed effort of the State with the lowest effort. Each State's assessed expenses would then become the expenditure that would have been incurred by that State at the lowest effort measured (and likewise for revenues).
103. In this way, States would be provided with enough support to ensure they have the capability to provide an acceptable, comparable level of services. As every State faces the reasonable public expectation that they will provide an acceptable standard of services, the assessment process is unlikely to be unduly affected by outliers (States whose standard of service delivery is significantly different to that of other States). In the case of an outlier, the method could be flexible to allow the next minimum State to be used as the standard.
104. The current definition of the standard as the mean per capita State revenue or expenditure creates a number of policy neutrality issues. In the current process, the standard is effectively set by the policy choices of large States, or by States with outlier revenues or disabilities (in the case of assessments such as Indigeneity and mining). Changes to the policies of these States can have a significant effect on their GST outcome, which may create unintended policy incentives.
105. One of the main benefits of this method is an increased level of policy neutrality, as an individual State's decision to provide a higher level of services or make a greater revenue effort does not impact on their GST share unless they are the State with the lowest effort. For that individual State, there is still little scope for policy choices to affect the GST distribution as:
  - the COAG process of setting standards and outcomes for service delivery through National Agreements and National Partnership agreements ensures that no State's effort is unacceptably low and that States do not significantly reduce their effort; and
  - the effort level of the next lowest State is an effective ceiling on the potential impact of the minimum State's policy change, as increases to effort by the minimum State (increasing the standard and level of redistribution) would simply result in another State setting the standard.
106. In most cases, the relative effort levels of States at a category level are not widely spread, so a change from the average standard to the minimum standard is not likely to produce an outcome that is substantially different from that of the current process.

## **SUMMARY**

107. There are a number of issues Queensland would like addressed through this review. Specifically, Queensland would welcome improvements to the GST distribution process that:
  - clarify the aim of the process;
  - address the problems with the current assessment of mining revenue;
  - simplify the assessment process; and

- focus on providing appropriate support to those States that genuinely require it.

### **Clarifying the aim of the GST distribution process**

108. The aim of the GST distribution process is unclear, as demonstrated by the differences between the descriptions used by the Australian Government, the Commonwealth Grants Commission and the Terms of Reference for this Review.
109. Without clarity about the purpose of the process, there cannot be clarity about whether the existing process achieves its purpose, or how it might better do so. This Review should therefore seek to clarify the aim of the GST distribution process.
110. Queensland suggests this could be done through adoption of an aim that is consistent with that used by the Australian Government in 2011, and articulated in this Review's Terms of Reference (GST Distribution Review 2011, clause 3) and the Review Panel's Issues Paper (GST Distribution Review 2011a, p. 1). That is, the aim of the GST distribution process should be to provide the necessary budget support so that all States have the capacity to provide services at a comparable standard.

### **Addressing issues with the current assessment of mining revenue**

111. The current approach to assessing "what States do" does not function properly when applied to cases where the base is dominated by a few States, for example in the assessment of mining revenue.
112. The revenues from mining represent more than three quarters of the GST distributed due to revenue assessments, despite comprising less than a tenth of all State revenue. In the current assessment process, resource States end up retaining less revenue per capita than non-resource States following equalisation.
113. The assessment of mining revenue also produces outcomes that do not seem appropriate, particularly when compared with other assessments, and with revenue raising effort. Additionally, the redistribution fails to take account of the costs of developing and maintaining associated economic and social infrastructure borne by the resource States.
114. Collectively these issues can create serious incentive problems, undermining the principle of policy neutrality, that is, the principle that a State's own policies should not directly affect its share of GST. This Review should therefore seek to identify approaches that address these issues.
115. Queensland suggests a number of approaches the Review could further explore, including:
  - assessment of a proportion of total mining revenue;
  - assessment of a proportion of the growth in mining revenue; and
  - treating mining revenue separately from the broader assessment process.

### **Simplifying the GST distribution process**

116. The current process involves highly detailed and complex assessments of “what States do”, based on the assumption these are necessary to recognise the true differences between States. In reality however, the frequent use of judgement in the current process due to concerns about data quality (in particular comparability) suggests it may not recognise these differences any better than a simpler method would. This Review should seek to simplify the process with the aim of improving the reliability, transparency and equalisation outcomes.
117. Queensland suggests a number of approaches the Review could further explore, including:
- global measures of revenue and/or expenditure; and
  - a single aggregated revenue base for the assessment of mining revenue.

### **Focus on providing appropriate support to States that require it**

118. The current process produces large transfers between the four large States (New South Wales, Victoria, Western Australia and Queensland) with a relatively small net result. Despite their scale, these transfers have a minimal impact on the final budget positions of these States suggesting they do not currently require substantial additional budget support. The Review should focus on delivering transfers from these relatively wealthier States to those States that genuinely require support.
119. Queensland suggests a number of approaches that the Review could further explore, including:
- focusing on redistributing a proportion of the GST pool from “donor” to “recipient” States;
  - potentially treating Indigenous assessments separately from the broader process to promote better targeted support;
  - treating the ACT and the Northern Territory separately from the broader process; and
  - using the minimum assessed level of effort to set the standard of “what States” do.

### **CONCLUSION**

120. Queensland believes addressing all of the issues identified in this submission would improve the transparency, reliability and equalisation outcomes of the GST distribution process. However, Queensland believes that the fundamental issues that must be addressed by this Review are those associated with the assessment of mining revenue.
121. Queensland believes these issues cannot be addressed within the current assessment. A priority of the Review must therefore be to consider alternative approaches to the assessment of mining revenue, including dealing with these revenues outside of the current process. Alternative approaches need to ensure:
- the revenue raising capacity of the resource States is not overstated;
  - policy neutrality is significantly improved;
  - incentive problems are reduced; and

- the cost of economic and social infrastructure to the resource States is recognised.
122. Without a fundamental change to how mining revenue are assessed the outcome of this Review will not deliver a simpler, fairer, more predictable and more efficient distribution of the GST to States.

## REFERENCES

Australian Government 2011, *2011-12 Australian Government Budget - Budget Paper No. 3*, Treasury, Canberra, Australia.

Commonwealth Grants Commission 2010, *Report on GST Revenue Sharing Relativities — 2010 Review, Volume 1 — Main Report*, Commonwealth Grants Commission, Braddon, Australia.

Commonwealth Grants Commission 2011, *Report on GST Revenue Sharing Relativities — 2011 Update*, Commonwealth Grants Commission, Braddon, Australia

Finance Canada 2006, *Achieving a National Purpose: Putting Equalization Back on Track*

Government of Western Australia 2011, *2011-12 Budget Statements*, Department of Treasury, Perth, Australia

GST Distribution Review 2011, *Review Terms of Reference*, <http://www.gstdistributionreview.gov.au>

GST Distribution Review 2011a, *Issues Paper, July 2011*  
<http://www.gstdistributionreview.gov.au>

*Intergovernmental Agreement on Federal Financial Relations*,  
<http://www.federalfinancialrelations.gov.au>

Searle, S 2004, *Revenue Sharing, Natural Resources and Fiscal Equalization*, Challenges in the Design of Fiscal Equalization and Intergovernmental Transfers Conference, <http://aysps.gsu.edu/isp/2635.html>