(This page left intentionally blank)

Contents

Executive Summary

This submission provides the Northern Territory's response to the Supplementary Issues Paper released by the GST Distribution Review Panel in December 2011, which was prepared in response to additional Terms of Reference for the Review of GST Distribution. This submission should be considered in conjunction with the Territory's October 2011 response to the GST Distribution Review Issues Paper.

The supplementary Terms of Reference asks the Review Panel to consider whether Australia's current form of equalisation provides disincentives for states to reform state taxes and whether equalisation should drive tax reform in Australia. The Territory contends that while, in theory, such disincentives may exist at the margins, they are not in any way material determinants of states' tax policies.

In reality, states' taxation policies including decisions to undertake tax reform are not driven by GST revenue considerations, but by a range of other factors including budgetary implications; the broader economic environment; implications for economic growth and living standards; maintaining competitiveness with other states and internationally; and constraints on which taxes are available to the states. The fact that most of the tax reform undertaken by states and territories in the last decade has been unrelated to the Intergovernmental Agreement on Federal Financial Relations (IGA) tax reform initiatives is indicative that tax reform is not driven by GST considerations nor does it require Commonwealth intervention.

The Territory is strongly opposed to any proposal to alter the form of equalisation in an attempt to drive state tax reforms. Such an approach would fail to acknowledge the most significant barrier to comprehensive state tax reform: vertical fiscal imbalance. Significant reforms to state taxes can only be achieved to any meaningful extent by addressing the level of vertical fiscal imbalance in Australia through providing states with access to broader based growth taxes and provide the capacity for more radical changes.

A proposed change to the form of equalisation intended to drive state tax reform includes providing incentives or penalties for certain state tax policy decisions. The Territory's view is that any approach that includes explicit penalties or rewards states for adoption of particular policies would put at risk state governments' abilities to tailor policies to meet the needs of their constituents. This approach would implicitly tie a portion of GST revenue to the achievement of a certain outcome or the adoption of a certain policy, and is inconsistent with the untied nature of GST revenue as agreed by all

governments in the IGA. For these reasons, the Territory does not support an alternative form of equalisation that seeks to provide incentives for states to pursue tax reform.

The Supplementary Terms of Reference also direct the Review Panel to consider options to remove the perceived incentives for states to reduce Mineral Resource Rent Tax (MRRT) or Petroleum Resource Rent Tax (PRRT) revenue through increasing state mineral royalties. The unintended interaction between state mineral royalty rates and the Commonwealth's MRRT and PRRT are the result of Commonwealth policy design, not the equalisation process. Attempts to resolve this interaction by effectively placing a cap on state royalty rates is an inappropriate response to this issue. Such an approach would place further constraints on states' revenue raising capacities and fiscal autonomy, exacerbating the increasing level of vertical fiscal imbalance in Australia. The Territory contends that states should continue to have full discretion to determine mineral royalty rates on the resources within state boundaries.

S1 HFE: a disincentive to reform state taxes?

Consultation Question:

Q1. Does horizontal fiscal equalisation (HFE) provide a disincentive for states to undertake tax reform?

Q2. If so, how could an alternative form of GST distribution be designed that would remove (or at least reduce) this effect? Would this alternative arrangement be desirable overall?

Q3. Several submissions have suggested the use of broad indicators to assess revenue raising capacity. If this was to be done, what indicators should be used?

Q1. Does HFE provide a disincentive for states to undertake tax reform?

1.1 Equalisation does not directly reward or penalise states for independent policy decisions. Although there may be unintended GST implications, these are unlikely to be major considerations in the formulation of state policy, or act as disincentives for states to undertake tax reform. Rather, state taxation policies are influenced by a combination of factors outside of the equalisation process, including:

- budgetary implications;
- the broader economic environment and implications for economic growth;
- competitiveness with other states and internationally; and
- constraints on which taxes are available to the states.

1.2 In reality, the primary constraint on states' ability to pursue tax reform is the narrow range of taxes that states can legally apply. Table 1 shows that states' share of total taxation revenue in Australia has declined since Federation. In 2010-11, it is estimated that 75 per cent of all taxes in Australia were collected under Commonwealth legislation, compared with 46.6 per cent prior to World War II.

Table 1.1: Proportion of revenue collected under Commonwealth and state legislation

	Proportion collected under Cwlth legislation	Proportion collected under state legislation	Proportion of all state revenue from Cwlth transfers
	%	%	%
1901-02	41.0	59.0	36.7
1938-39	46.6	53.4	13.9
1946-47	84.9	15.1	46.1
1980-81	78.3	21.7	62.0
2010-11	75.5	24.5	50.0

Source: Commonwealth Grants Commission, *2012 Update*

1.3 States' attempts to broaden state tax bases have been unsuccessful both due to legal barriers, for example the High Court's ruling on franchise fees, and due to practical limitations such as maintaining competitiveness with other states and internationally.

1.4 Reforms to state taxes should be focused on redressing the level of vertical fiscal imbalance in Australia, which can only be achieved to any meaningful extent if states have access to broader based growth taxes. This approach would provide greater incentives for states to pursue tax reform with associated benefits for the national economy than changes to the GST distribution, which would not redress vertical fiscal imbalance between the Commonwealth and state governments.

1.5 States levy a range of taxes at rates that are tailored to state populations and are based on historical taxation policy, natural factor endowments and the structure of the state economy and the views of state constituents. Any financial disincentives to reform arising from the equalisation process are marginal, and in reality, do not have a bearing on state taxation policy.

1.6 The Independent Economics Report *Horizontal Fiscal Equalisation: Modelling the welfare and efficiency effects*[1], found that incentives for states to adopt particular policies in order to maximise GST revenue may exist in theory, however these incentives are not significant determinants of state tax policies, or states' decisions to reform. Any marginal GST revenue gains are insignificant to states compared with broader economic objectives, such as economic growth.

1.7 For example, the Independent Economics Report notes that under the current form of equalisation, Western Australia and Queensland could constrain growth in their mining tax bases by limiting new mine approvals, which would reduce these states'

[1] Independent Economics, *Horizontal Fiscal Equalisation: Modelling the welfare and efficiency effects,* 2012

assessed capacities to raise mineral royalty revenue, increasing their GST shares. However, neither state has pursued this approach because 'the main economic motivation for the Western Australian and Queensland governments to encourage mining development is the large benefits to the private sector, including higher household incomes.'[2]

1.8 The Territory's policies on land tax and mineral royalties, which set it apart from the policies that apply generally in other jurisdictions, provide further examples of the lack of influence that equalisation has on states' adoption of particular revenue policies. The Territory alone applies a profits-based royalty system to minerals and is the only jurisdiction that does not levy a land tax, despite being assessed through the equalisation process as though it does raise land tax revenue.

1.9 The Commonwealth Grants Commission (the Commission) assessed the Territory as having the capacity to raise $41 million in land tax in 2009-10[3], even though the Territory raised no revenue from land tax. Importantly from an equalisation view point, the Territory is not rewarded or penalised through a higher or lower GST share for its policy decision not to levy a land tax. This is consistent with the principles supporting the equalisation process: policy neutrality and 'what states do'. A relevant consideration is that due to the Territory's small population and economy relative to other jurisdictions, the Territory has virtually no influence on 'what states do' (the national average).

1.10 Similarly, HFE has not influenced the structure or rate of the Territory's mineral royalty regime. As noted in the Territory's submission to the GST Distribution Review Issues Paper, the Territory is the only jurisdiction to adopt a profit-based mineral royalty regime, even though according to the Commission's assessment, prior to the recent commodities boom the Territory could have raised more revenue if it adopted the average state policy of an ad valorem mineral royalty regime.

1.11 A primary objective of the Territory's profit-based regime is to facilitate the establishment of new mines by reducing the taxation burden on mines in the initial stages of construction and development. The regime applies a uniform tariff once mines are established and operating profitability. A profit-based royalty regime for non-renewable resources was a key recommendation in the final report of the Australia's Future Tax System Review.

> *For non-renewable resources that are expected to generate significant amounts of economic rent, a rent-based tax is the most suitable charging mechanism, as the potential economic efficiency and revenue gains are*

[2] Ibid
[3] Commonwealth Grants Commission, 2011 Update

likely to outweigh the higher administration and compliance costs of this tax compared with output-based royalties and income-based taxes.[4]

Q2. How could an alternative form of GST distribution be designed that would remove (or at least reduce) this effect? Would this alternative arrangement be desirable overall?

2.1 The Territory contends that the current form of equalisation does not provide disincentives for states to undertake tax reform or to levy taxes efficiently.

2.2 The Territory is aware that this view is not shared by all states, with some jurisdictions arguing that the current form of equalisation provides disincentives for states to:

- pursue unilateral tax reform, for example, it has been suggested that HFE provides disincentives for states to replace conveyance duty with a broad based land tax;
- implement tax reform earlier than other states – for example, it has been argued that Victoria was unintentionally penalised through equalisation for its decision to abolish mortgage duty ahead of the agreed schedule under the IGA; and
- fully exploit state tax bases because the additional revenue could be redistributed through the GST process to other states – for example it has been suggested that additional mining royalties accruing to Western Australia are fully offset through the equalisation process.

2.3 The Territory's response to the claim that GST provides a disincentive for states to pursue unilateral tax reform was outlined in its submission to the Issues Paper. In summary, the Territory argued that:

- Territory analysis indicated that GST implications are not significant impediments to unilateral state tax reform. If New South Wales abolished conveyance duty and broadened its land tax base independent of other states, it would result in a $43 million, or $5.95 per capita increase in its GST revenue. Conversely, if South Australia adopted these tax reforms its GST revenue would decrease by $14 million or $8.58 per capita; and
- tax reform is difficult and requires the support of government, the Parliament and the community. Implementation of tax reform itself has distributional effects and complexities surrounding the timing of phasing in of a new tax while phasing out the old tax. These are more likely to be priority areas for consideration by governments when deciding whether or not to pursue tax reform than any potential GST revenue implications.

[4] Commonwealth Government, *Australia's Future Tax System Review Final Report* 2009

2.4 An example which demonstrates that equalisation does not provide a disincentive for a state to reform its tax base is payroll tax reform. A key finding of the Australia's Future Tax System Review was that 'existing payroll taxes are more complex and less efficient than they could be because of tax-free thresholds and other exemptions.'[5]

2.5 If one state abolished its payroll tax threshold, it would not be penalised through the equalisation process - the additional revenue raised would not impact on its assessed revenue base or its assessed capacity to raise payroll tax. Rather, the Commission would continue to assess that state as though it applied the average payroll tax threshold, and therefore the state's share of GST revenue would not change as a result of the reform.

2.6 If more than one state adopted the same reform, causing the assessed national average policy to change, states' assessed revenue capacities could change, causing changes in GST revenue shares. However, it is appropriate that the Commission's assessment reflects changes in states' circumstances and average state policies over time.

2.7 Victoria has suggested that HFE penalises states for pursuing tax reform, citing its reduced GST share following its decision to abolish mortgage duty ahead of the national schedule agreed under the IGA. The Territory abolished mortgage duty in 1994-95. This decision was made independent of other states and before the commitment made by governments under the IGA. Consistent with average policy at the time, the Territory was assessed as though it did raise mortgage duty.

2.8 An option to avoid the abolition of mortgage duty from disadvantaging Victoria would have been for the Commission to assess a nil capacity to raise mortgage duty for Victoria and the Territory, avoiding any GST 'disadvantage' from abolishing the tax ahead of the agreed schedule. A major drawback of this option is that Victoria and the Territory would have effectively been compensated for the loss in mortgage duty revenue arising from the policy decision through higher GST shares. This option was considered along with others by the Commission at the time with all jurisdictions providing relevant arguments to the Commission. The Commission determined an option that was consistent with long standing practice and was supported by the majority of states and territories.

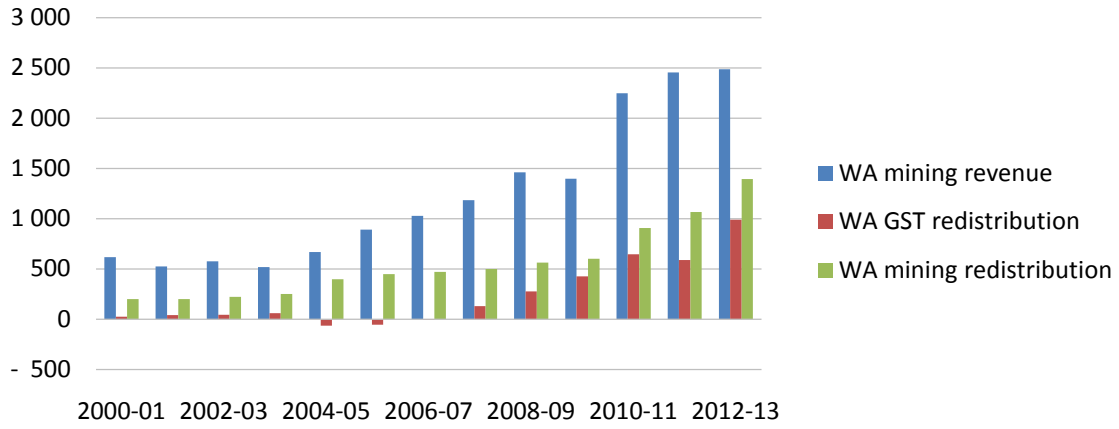
2.9 Victoria and the Territory were assessed as though they raised mortgage duty because of the supporting principles of HFE: what states do and policy neutrality. Some states have suggested that these supporting principles provide a constraint on equalisation and are the root cause of the disincentives for states to reform state tax bases. The Territory disagrees with this notion.

[5] *Australia's Future Tax System – Final Report*, 2010

2.10 Such a course of action would have broader implications for grant design inefficiencies. It would provide states with incentives to abolish taxes ahead of schedule, with the knowledge that the revenue forgone would be offset by increased GST revenue. For example, this approach would result in the Territory being 'rewarded' for its decision not to levy a land tax through an increase in its GST revenue commensurate with the amount it could raise if it applied the average policy and levied a land tax. This is a highly undesirable outcome from a policy-neutrality perspective and for this reason the Territory does not support this approach.

2.11 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. In the Territory's submission to the Issues Paper, it provided a graph that compared Western Australia's mining royalties, with 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. The same chart appears below, but has been updated to include the results of the 2012 Update. It shows that despite the equalisation process, Western Australia continues to retain the majority of its mining royalties.

Figure 1: Mining revenue and GST redistribution, Western Australia, $ per capita



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

Q3. Several submissions have suggested the use of broader indicators to assess revenue raising capacity. If this was to be done, what indicators should be used?

3.1 In past reviews, the Commission, in consultation with states, has considered the feasibility of applying broad indicators to assess states' revenue raising capacity. While broad indicators may result in greater stability in relativities and potentially simpler assessments, this approach to assessing each state's revenue raising capacity was not adopted because broad indicators do not accurately reflect states' actual revenue bases or practices.

3.2 Broad indicators suggested for consideration in past Commission reviews include: population, gross state product, state final demand, gross household income and gross household disposable income.

3.3 Broad indicators do not accurately reflect states' tax bases because measures such as household disposable income and Gross State Product are measures of national income, and are better determinants of Commonwealth taxes such as capital gains, income tax and company tax. Furthermore, the ABS attributes offshore mining activity in its measurement of GSP despite the fact that states have no taxation powers over offshore areas.

3.4 The Commission has consistently argued that by adopting global indicators rather than focusing on how states actually raised revenue, the global approach would measure states' revenue raising advantages and disadvantages on a theoretical basis, rather than in the context of the practical constraints faced by the states in raising revenue and the tax instruments they used.

3.5 The Commission identified the following conceptual problems with adopting broad measures as an indication of states' revenue capacity that do not occur under a tax by tax approach:

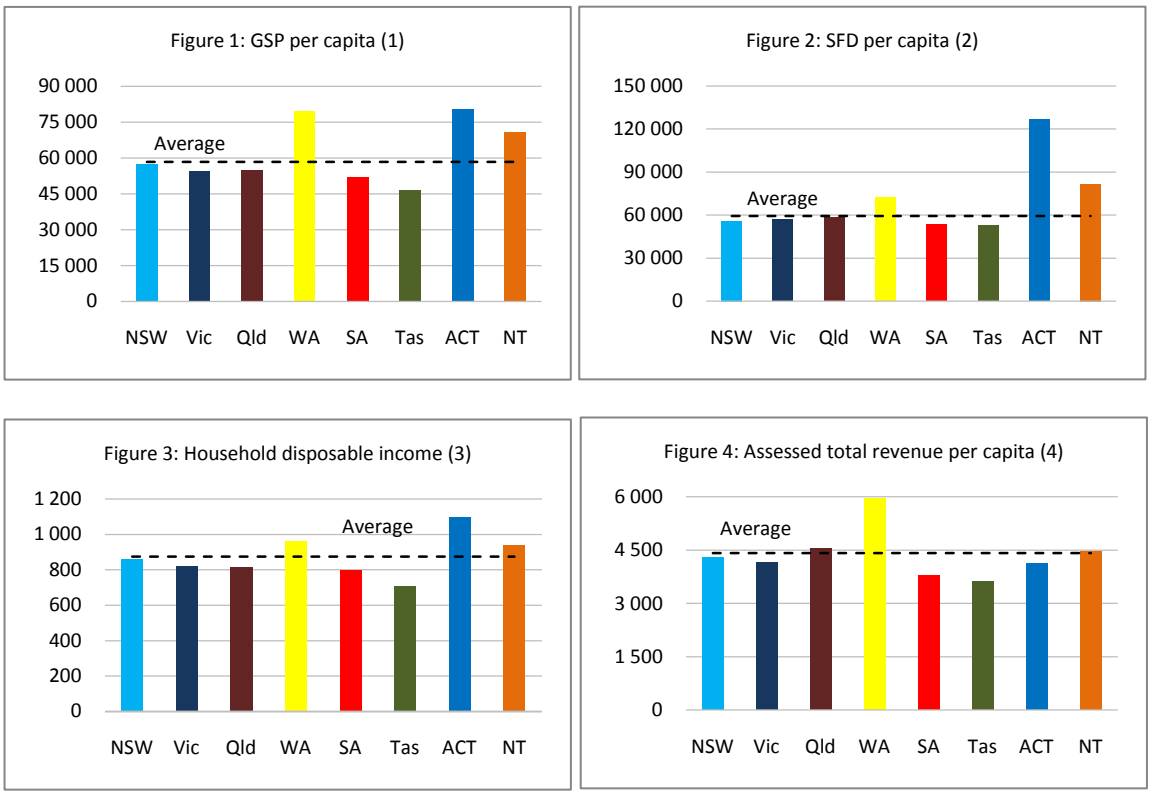
- industry structure was hidden in an aggregate measure but may be relevant to the capacity of an economy to pay taxes from production;
- differences between states in the distribution of income among their residents did not show up in the aggregate measures, but they were relevant to capacity to pay taxes because many taxes are progressive;
- GSP and GHI measured the annual value of production in each state or the annual income of residents of a state — they may not adequately reflect the effects of the stock of wealth on capacity to pay;
- non-residents paid taxes (for example gambling and property taxes) and some state taxes were paid by companies that passed them on to their consumers, some of whom may live in other states — a state-based global measure may not reflect this exporting of taxes; and
- it may be difficult to remove the effects of other taxes, such as income tax and company tax from income measures, and there was also the problem of how to deal with undistributed profits.[6]

3.6 Figures 1 to 3 show each state's revenue raising capacity relative to other jurisdictions under each broad measure. Figure 4 shows each state's assessed revenue raising capacity under the current approach.

[6] Commonwealth Grants Commission, 2010 Review

3.7 States that are above the average are considered to have greater capacity to raise revenue. Figures 1 to 3 show that if the above broad measures were adopted, the Australian Capital Territory would be assessed as having the highest capacity to raise own-source revenue of all jurisdictions. This is counter intuitive given that the Australian Capital Territory does not have capacity to raise mineral royalties and the large government sector in the Australian Capital Territory which is exempt from payroll tax.

Figures 1 to 4: Broad indicators for measuring revenue raising capacity



(1) Source: ABS, *State Accounts*, 2010-11
(2) Source: ABS, *Australian National Accounts: National Income, Expenditure and Product*, 2010-11
(3) Source: ABS, *Household Income and Income Distribution, Australia*, 2009-10
(4) Source: Commonwealth Grants Commission, *2011 Update*, 2009-10

3.8 The Territory position is that there are limited opportunities to adopt broad measures within the current equalisation framework, particularly when there are significant policy differences between states on regulatory and related matters that affect interstate comparability of data, for example gambling taxes.

3.9 The current approach reflects the range of activities, transactions and assets that states actually tax and is conceptually superior to a broad indicator approach. It ensures that differences in states' capacities to raise own-source revenue are more accurately reflected in the GST methodology.

S2 Should HFE drive state tax reform?

Consultation Questions:

Q4. How could the GST distribution be designed in order to provide incentives and disincentives for certain state policy decision?

Q5. If the method of GST distribution was utilised to provide incentives to promote the efficiency of state taxes and mineral royalties, what specific policy decisions should be targeted?

Q6. What would be the appropriate institutional arrangements for determining the state policy to which the incentives would be targeted and assessing states' progress?

Q4. How could the GST distribution be designed in order to provide incentives and disincentives for certain state policy decisions?

4.1 The GST distribution is an entirely inappropriate vehicle through which to influence state adoption of specific taxation policies. The notion that part of the GST pool could be quarantined for distribution on a rewards basis is inconsistent with the untied nature of GST revenue as agreed under the IGA. The proposal to provide financial incentives or disincentives undermines states' autonomy, and would reduce state governments' abilities to tailor tax policies according to the needs of state constituents and prevailing economic conditions of the state. The Territory is therefore strongly opposed to any change in the form of HFE that would provide incentives or disincentives for certain state policy decisions.

Q5. If the method of GST distribution was utilised to provide incentives to promote the efficiency of state taxes and mineral royalties, what specific policy decisions should be targeted?

5.1 As stated above, the Territory is strongly opposed to any change in Australia's form of equalisation that attempts to influence a state's policy decision by dedicating GST revenue, for the purpose of rewards payments or financial penalties, which would require previously untied revenue to be deducted from the GST pool.

Q6. What would be the appropriate institutional arrangements for determining the state policy to which the incentives would be targeted and assessing states' progress?

6.1 State taxation policy and tax mix are decided at the discretion of state governments. The Territory is strongly opposed to any institutional arrangement that would provide states with financial incentives, direct states to pursue a targeted state tax policy, or to financially penalise a state for non-compliance through altering states' otherwise untied GST revenue shares.

6.2 There are existing institutions such as the Council of Australian Governments and the Standing Council for Federal Financial Relations, which are more appropriate forums to pursue national taxation reforms. These forums are conducted in good faith, with membership of all jurisdictions, and were established for the purpose of co-ordinating state and Commonwealth financial relations in a reasonably cooperative and collaborative manner.

6.3 The cooperative and multilateral approach taken to reform of state taxes as part of the introduction of the GST should act as blueprint for future reforms. This approach provided an appropriate balance between the abolition of inefficient state taxes while recognising the reduced revenue available to the states and provided some flexibility to the states in terms of timing of the abolition of these taxes. A critical element to the success of those reforms was that inefficient state taxes were replaced with states having access to a broad based growth tax, the GST.

S3 MRRT and PRRT revenue

Consultation Questions:

Q7. Do states have an incentive to reduce MRRT or PRRT revenue through increasing state mineral royalties?

Q8. If there are such incentives, should they be removed, and if so, how?

Q9. What factors influence the structure of states' royalty regimes?

Q7. Do states have an incentive to reduce MRRT or PRRT revenue through increasing state mineral royalties?

7.1 As noted above, the Territory is the only jurisdiction that applies a profit-based royalty regime. The Territory's profit-based regime was implemented to facilitate green field mines with low value minerals and where there are high start-up costs. This royalty regime and rate ensures a fair contribution of the mining industry to the long-term welfare of Territorians while providing a flexible regime that contributes to a more viable mining industry in the Territory. The Territory's royalty rate is fixed at 20 per cent of the net value of minerals (that is, total profit comprising gross value of the mineral minus various specified deductions).

7.2 The design of the profit-based royalty system in the Territory means that there are no incentives for the Territory to increase its mineral royalty rate for the purpose of reducing MRRT and/or PRRT revenue.

7.3 A key feature of the Territory's royalty regime is the harmonised royalty rate that applies to virtually all minerals. Increasing the royalty rate in the Territory for the purpose of reducing MRRT and/or PRRT revenue would mean the Territory would raise the royalty rate on all minerals including those outside the scope of the MRRT and PRRT (that is, minerals other than iron ore, coal and oil and gas).

Q8. If there are such incentives, should they be removed, and if so, how?

8.1 The Territory contends that there are no incentives for states to reduce the level of revenue raised under the MRRT and/or PRRT. If a state can influence the level of MRRT and PRRT, this is the result of flawed policy design rather than intentional actions by the states to reduce Commonwealth revenue.

8.2 The terms of reference ask the Review Panel to consider changes to the form of equalisation to remove incentives (if these exist) for states to reduce MRRT and PRRT revenue. This would suggest adopting equalisations models which would effectively place an indirect cap on states' royalty rates by offsetting the perceived incentives with disincentives within the GST process.

8.3 The proposal that there should be a cap on state royalty rates to avoid reducing Commonwealth MRRT or PRRT revenue is entirely inappropriate. This would place further constraints on states' revenue raising capacities, exacerbating the increasing level of vertical fiscal imbalance in Australia. The Territory strongly supports the continued autonomy of state governments to determine state mineral royalty rates and that the Commonwealth should not penalise a state through the GST distribution for exercising this autonomy.

8.4 The GST Distribution Review is not the appropriate forum to address design flaws in Commonwealth policy in relation to MRRT and PRRT. It is important to note interactions between state mineral royalties and Commonwealth MRRT and PRRT revenue are not the result of Australia's form of equalisation.

8.5 The interaction between state royalties and MRRT and PRRT are not the only examples of where state and Commonwealth taxes interact. For example, the rates at which states set payroll tax influences the amount of company tax revenue collected by the Commonwealth. There is no suggestion, and nor should there be, that payroll tax rates should be capped in order to reduce Commonwealth company tax revenue. Further, there is certainly no suggestion that changes in the form of equalisation are required to maintain a certain level of Commonwealth company tax revenue.

Q9. What factors influence the structure of states' royalty regimes?

9.1 The policy imperatives underpinning the Northern Territory *Mineral Royalty Act* ensure that the regime compensates the whole community for allowing the private extraction of the Territory's non-renewable resources while, at the same time, seeking to:

- maintain and foster the resource developer's capacity to pay including sharing the benefits between the resource developer and the community fairly;

- apply a uniform royalty regime across all royalty payers in equal situations and to be competitively neutral across competing resources;
- avoid distorting commercial decisions regarding the levels of capital and other outputs devoted to economic activities which should be made in response to market signals;
- minimise the compliance and administration costs for business and government;
- achieve consistency with broader environmental, social and fiscal objectives such as environmental, social and infrastructure objectives; and
- maintain competitiveness of the Territory within Australia and internationally.