Tasmania's main concern, however, is that the new terms of reference imply that HFE should be used as a mechanism to create incentives or disincentives for states to behave in particular ways, employ particular policies or raise revenue in a given manner. It is highly questionable whether it is desirable to pursue these goals in the first place – even more so whether HFE is an appropriate mechanism to do so.

The Tasmanian Premier and Treasurer, Lara Giddings MP, wrote to her Commonwealth counterpart in December 2011, expressing her disappointment at the revised terms of reference and noting that these may undermine the integrity of the process and diminish the credibility of the Review outcomes. A copy of this letter is enclosed as an attachment to this submission

HFE as a policy instrument

Tasmania is strongly opposed to suggestions that HFE be used to achieve other exogenous policy objectives. This would substantially complicate HFE, overburden the system and lead to compromised outcomes. It would involve impossible judgements and debate about what is, or is not, desirable policy. It would significantly restrict the ability of a state's residents to elect a government to deliver policy in line with their preferences, defeating the purpose of a federal system of government

If the Commonwealth and all states agree that a particular policy objective is desirable, then it should be pursued outside the HFE system. The recent *National Health Reform Agreement* and the *Intergovernmental Agreement on Federal Financial Relations* demonstrate that the Commonwealth and the states can cooperatively agree on, and pursue, shared policy objectives. At no stage has any party made a convincing case that HFE could be used to enhance this process or better achieve these objectives.

Likewise, if there is a demonstrated need for large scale state tax reform, this should be pursued cooperatively and as part of a completely separate process. Entangling tax reform with the HFE process would reduce transparency, making it much harder for the public, and even for governments, to understand proposed reforms or their expected outcomes.

RESPONSE TO SUPPLEMENTARY ISSUES PAPER QUESTIONS

1) Does HFE provide a disincentive for States to undertake State tax reform?

Tasmania does not consider that HFE acts as a disincentive to tax reform. There is a much stronger argument that, by promoting risk sharing and equalising incentives, HFE actually encourages tax reform by reducing the associated risks.

In its previous submission, Tasmania noted that HFE is efficiency neutral. This is because HFE allows states to provide equal services when operating at average efficiency. If a state can deliver services or raise revenue more efficiently than the average, it retains most or all of the savings associated with this. Likewise, a state with poor efficiency bears the full cost of this.

HFE is also policy neutral. Only those disabilities that are clearly outside of a state's control are assessed under the CGC's methods. If a state implements policies that result in economic growth, the HFE process will *not* compensate that state for the greater demand on its services that will result. In contrast, if a state has an above average proportion of a particular population group, and if it has been demonstrated nationally that this group is a greater user of government services, the CGC may undertake an assessment recognising this. States therefore bear the cost of poor policy decisions, and retain the benefits of effective policy and best practice.

This is also true in respect of revenue policy. For most revenue sources, where a state chooses to make an above average effort in raising revenue, by applying a higher tax rate, it retains this additional revenue. There is no direct impact on its GST share, except through its influence on the Australian average tax rate. Likewise, low taxing states are not compensated through additional GST revenue, and their choice to apply low tax rates has no direct impact on their assessed revenue raising capacity.

In some cases, taxation policy can indirectly affect the size of a state's revenue raising capacity. For example, a mineral rich state which significantly increases state royalty rates for minerals may reduce mining profitability, leading to less mining activity and a smaller mining revenue base. Conversely, reduced tax rates can theoretically boost a state's mining revenue base. This does not mean that there are situations in which revenue policy can indirectly affect a state's GST revenue share.

However, even in such cases, it is unlikely that the indirect GST impacts would influence the behaviour of governments in setting tax rates. Governments generally have multiple objectives in mind in setting tax policy. For example, in setting mining revenue policy, as well as raising revenue, a state government might be seeking to promote economic development and growth, to encourage regional development and to provide employment opportunities for workers leaving less buoyant sectors, such as manufacturing. The specific objectives of a state government's taxation policy will be heavily influenced by the preferences of the electorate. These considerations directly influence the living standards and wellbeing of a state's residents, and therefore drive tax policy. The indirect GST impacts of changes in tax policy on any one state are generally very minor and not readily quantifiable. It seems unlikely that such GST impacts would be a major consideration in developing tax policy, and even less likely that they would alter tax design.

The principle of policy neutrality also applies to tax reform. If a state unilaterally introduces a new tax, expands the scope of a tax base, or removes a common exemption, this will have no impact on its assessed revenue raising capacity. The reverse is also true. For example, the CGC continues to assess the Northern Territory's revenue raising capacity for land tax, despite the Territory's choice not to levy this tax. The Territory bears the full cost of this decision – if it were to suddenly introduce land tax, it would receive the additional revenue through this measure, but its GST share would remain virtually unchanged.

Because the CGC is guided by "what states do" in establishing its assessment methods, cooperative state tax reform can have an impact on the CGC's assessments. For example, if all states agreed to implement a new tax to address increasing costs associated with the ageing population, this would lead to a new CGC assessment of this tax. If there were differences between the states in capacity to raise revenue from the new tax, then the assessment would redistribute some GST revenue so that, ultimately, all states could enjoy the same benefits from the new tax, if they applied average effort and efficiency.

The fact that the new tax would be subject to equalisation would actually increase, rather than decrease, the likelihood that states would jointly undertake tax reform. The equalisation process ensures that, in the long run, each state has the capacity to raise its population share of any revenue source. This means that, provided it applies average tax rates to its own base, every state has an equal incentive to apply a particular tax. In this sense, HFE ensures that all states always have an incentive to introduce a new tax, regardless of expected differences in revenue raising capacity. This may seem counter-intuitive until it is considered that, without HFE, states would have unequal incentives to introduce a new tax as some states would be able to raise more revenue from it than others.

This logic is just as applicable to the decision to abolish or reduce taxation. If all states elect to abolish an inefficient tax, they will each bear similar costs in terms of overall lost revenue (own-source revenue plus or minus their net GST redistribution), but they will all gain the local economic benefits associated with the reform.

In practice, states apply varying rates to their tax bases and this will mean that their incentives to introduce or abolish a tax will not be perfectly equal. However, HFE ensures that the incentives will be more equal than would otherwise be the case.

In addition, relative revenue raising capacity changes over time and is driven very much by local conditions, so that it is quite possible for a state to be assessed as having above average capacity in one year and below average capacity in another. The knowledge that HFE promotes such risk sharing can actually act as an additional incentive to undertake cooperative tax reform, rather than as a deterrent.

It is possible to argue that, in specific circumstances, some states can face a situation in which a tax policy change would result in an increase or decrease in their GST. For example, a state could be in a position where its decision to abolish a tax would result in that tax no longer being average state policy, leading to the CGC ceasing its assessment. This may result in a redistribution of GST revenue to or from this state, meaning that the state has a theoretical incentive or disincentive to abolish the tax.

Arguments such as this generally ignore the fact that there are many far more important factors that influence state tax policy decisions. Even minor adjustments to tax rates and policies can have significant economic and community impacts. In considering tax reform, a government is far more likely to be concerned with the impact on current and potential taxpayers. Any theoretical HFE impacts of tax reform, assuming they could even be identified or quantified, would clearly operate at the margin. It is difficult to envisage a situation in which HFE impacts would alter a government's eventual decision in relation to tax reform.

This is demonstrated through historical experience. There have been occasions in the past where the GST impacts of tax reform have been identified and considered by states. For example, states were aware of the GST distribution impacts of the taxes scheduled for abolition under the 1999 IGA. At the time, some states arguably had an incentive or disincentive to abolish or retain these taxes which, in theory, may have affected their decisions. In practice, the states and the Commonwealth agreed to a schedule for abolition of inefficient taxes with the broad HFE impact of abolishing these taxes considered and compensated accordingly. However, this did not deter some states from subsequently abolishing taxes ahead of schedule, despite the fact that the HFE impacts of early abolition were not compensated.

Most of the debate that ensued in the years that followed the 1999 IGA related to whether "review" taxes (ie those taxes scheduled for review rather than abolition) should be abolished. States were far more concerned about the direct budgetary impacts of abolishing (or not) a tax, and these budgetary impacts were the primary factor which determined the timing of the abolition of these taxes. HFE did not, at any point, act as a barrier to agreeing and implementing the 1999 IGA, nor did it slow the process of reform.

HFE has been practised in Australia, in one form or another, since the 1930s. States have continually made both major and incremental changes to tax policy over this period. Some important recent reforms include, as mentioned above, the abolition of inefficient taxes under the 1999 IGA (including the abolition of some taxes ahead of schedule), payroll tax harmonisation, and the introduction of stamp duty concessions and other incentives for first home buyers.

Wide scale tax reform is challenging and there are many significant factors which can act as a barrier, including taxpayer inertia, the role and influence of interest groups, administrative and legal complexity, cost, and many others. HFE is not one of these factors.

It is noted that New South Wales has argued in this forum that HFE provides a disincentive to alter its tax mix from less efficient to more efficient taxes, noting that it would lose GST revenue were it to abolish conveyance duty and replace this with higher land tax rates. Tasmania considers it much more likely that the factors mentioned above are a more significant barrier to states changing their tax mix. Any change in tax policy, even when it is revenue neutral from a government perspective, creates winners and losers. Losers typically demand compensation for such changes, and it is rarely feasible for a government to fund such compensation from the proceeds accruing to the winners of any reform. These are the factors that challenge governments when undertaking tax reform, rather than the theoretical HFE impacts.

Tasmania's decision to cancel its own unilateral State Tax Review was influenced by current economic and fiscal circumstances in Tasmania and the difficulty of implementing significant tax reform under these conditions. At no stage was HFE a consideration in initiating this review or in the decision to cancel it.

Further, it is notable that the Australian Government, which is not bound by the supposed disincentives of HFE, elected not to implement most of the recommendations of the AFTS Review.

Common arguments in other submissions

In response to the Review's July 2011 Issues Paper, some submissions raised concerns about the influence of HFE on tax efficiency and policy. As some of these arguments are related to discussions about disincentives and tax reform, Tasmania has summarised the common arguments, and provided comments in response.

Some submissions argued that HFE acts as a disincentive to tax reform, since any reform which increases a state's tax revenue or tax base is equalised away.

For the reasons outlined above, Tasmania does not agree with this claim.

In dissecting these arguments, it is important to distinguish between policies that result in changes in the rate of taxation, and changes in the revenue base.

A state's policy decision to change its tax rates usually has no direct influence on its GST share. By adjusting a tax rate, a state is simply varying its revenue raising effort, with no likely impact on the tax base. As noted above, this has no impact on the GST redistribution except through its minimal influence on the Australian average tax rate.

There may be circumstances where tax rate changes can have a small indirect impact on the revenue base. For example, the CGC has previously acknowledged that mining royalty rates can affect mining activity, and has hence made an elasticity adjustment in the past. Likewise, there are other policy changes which can affect the size of a state's tax base. Generally, the purpose of any substantial tax reform is to expand or contract a government's revenue base. A policy change which does result in a relative change in a state's tax base can influence its GST share. For this reason it is sometimes argued that states have a disincentive to undertake any policy which may expand its tax base.

This argument neglects the fact that, in practice, states have very limited control over their revenue bases. States do not control the main macroeconomic levers of the Australian economy, meaning their ability to influence their own economies is limited. States can influence some of their revenue bases indirectly through economic development and growth, but there are obviously many benefits associated with economic growth and these benefits appear to be a far greater priority for governments than GST grant seeking behaviour. Perhaps the greatest incentive for pursuing economic growth is that it results in improved living standards and employment prospects for residents. Constituents would be unlikely to tolerate a government which avoided economic growth in order to accrue theoretical, unspecified GST rents three to five years later.

Tasmania is yet to encounter a genuine example of HFE acting as a disincentive to pursuing desired tax policy. Western Australia cited one "real-life" example in its submission, this being its

> "…decision in 2010 to remove a long standing royalty rate concession available to State Agreement Act producers of iron ore 'fines'… Had this led the CGC to reclassify iron ore fines from 'low rate' to 'high rate' Western Australia would have faced a loss in GST grants equal to about three times (about $1 billion per annum) the additional royalty revenue raised (about $300 million per annum)".

Assuming that Western Australia's estimates of the GST revenue impact are correct, Tasmania does not deny that the incentive problem identified is genuine in this case. However, despite the apparent magnitude of the GST impact in this situation, it did not dissuade Western Australia from removing the concession. More importantly, the incentive problem in this situation was not a result of HFE per se. Instead, it was an outcome of a design flaw in the specific CGC assessment method for the mining revenue category. This problem is extremely rare and partly resulted, in Tasmania's view, from attempts to over-simplify the mining assessment. The issue was readily addressed through amendments to the terms of reference for the CGC's annual update. The amendment to the terms of reference were both an acknowledgement that the incentive problems were created by the assessment design and not HFE itself, and an illustration that even the most extreme examples of incentive problems can be readily fixed through small method changes. The design problems with the mining assessment can, and will be, permanently fixed as part CGC's current regular method review. The CGC is vigilant in avoiding the creation of such scenarios, and succeeds in doing so with very few exceptions.

However, the incident above does highlight that there are issues that uniquely affect the assessment of mining revenue. Unlike other revenue sources, the mining revenue base is currently distributed very unequally among states. As a result, a state which has a very large share of the revenue base, such as Western Australia, has a far greater capacity to impact on the assessment results than is normally the case. There is therefore perhaps greater scope and incentive for large mining states to alter their behaviour to affect their GST share than is the case for any other assessment.

The very uneven distribution of natural resource endowments across the states emphasises the importance of undertaking a mining revenue assessment. According to the CGC's assessments, mining revenue is the single greatest source of discrepancies in state fiscal capacity. A mining revenue assessment is therefore essential if states are to have equal capacity to provide services and infrastructure to their residents.

Tasmania does not consider that there is a case for altering the treatment of mining under HFE unless there is evidence that the assessment is influencing state government behaviour to such an extreme extent that it is leading to significant inefficiency or a misallocation of resources.

To date, there is no evidence that the dominance of the mining base by some states influences their behaviour in respect of their revenue base. To the contrary, resource rich states have pursued mining development aggressively, without relent. In regard to tax rates and their influence on the base, we note that Western Australia in particular has actually provided specific tax concessions on some mining activity in the past.

Some submissions argued that some states have grown their tax bases through their own efforts and at considerable cost. HFE redistributes the additional revenue base to other states but not these costs. This creates a disincentive to invest in infrastructure to grow these bases.

There is no evidence that states with strong fiscal capacity have achieved this through any extraordinary State Government effort. All states spend significant sums of money on economic development and providing economic infrastructure. However, each state's relative fiscal capacity has far more to do with its geographic, population and natural endowments than economic development activity. Those states with fewer natural endowments arguably face a greater task in developing other sectors of their economy.

Mining is often cited as an example in this instance, given the infrastructure requirements of large mining projects. It is questionable whether the provision of infrastructure for private mining activity is really a public responsibility. Most of the benefits of mining production accrue to private mining companies – this was an important consideration underlying the AFTS Review's recommendation to introduce a resource rent tax for mining. Much of the investment in mining in the resource-rich states is actually comprised of private investment.

Recent ABS national accounts data clearly demonstrates that private investment is rapidly being drawn to the resource sector from other sectors.[1] Private investment in mining is forecast to exceed investment in all other sectors by 2012. The rapid growth of the resources sector is so significant that it is severely affecting the allocation of economic resources in Australia, at the expense of most non-resource sectors (and hence less resource endowed states).

[1] Australian Bureau of Statistics, *Australian National Accounts: State Accounts* (cat no 5220.0).

The CGC's investment assessment, introduced in the 2010 Review, recognises each state's infrastructure needs *upfront*. The assessment redistributes a very significant amount of GST revenue from non-resource states (which generally have relatively slow-growing populations) to the resource rich states (which have faster growing populations due to the influx of labour). This provides fast growing states such as Western Australia and Queensland with sufficient funding to ensure that they are able to invest in infrastructure in line with growth in their population.

If there is a case that mining states have to incur additional costs, these should be captured within the regular CGC process. During the 2010 Review, Western Australia argued that it incurred mining-related economic development expenses over and above those of other states. The CGC did not undertake an assessment of these costs because Western Australia was unable to produce any evidence that this was the case.

Some submissions claimed that HFE creates incentives to game, including in tax policy (for example, a state can increase its payroll tax rate with the aim of reducing its base and therefore receiving increased GST revenue).

This is similar to previous arguments that HFE acts as a disincentive to tax reform given the theoretical impacts of changes in tax policy. As noted above, such arguments are highly theoretical and completely at odds with evidence and the way governments actually think or act. There are many more important considerations affecting tax policy, including the very significant economic, employment and political impacts of any tax policy changes.

In reality, if a state wanted to influence its GST revenue share, the easiest and most certain way to achieve this would be through refusing to accept Commonwealth National Partnership Payments. For every dollar in tied funding that a state receives from an NPP, it loses all but its population share of the same amount in GST revenue at a future point. From an individual state's point of view, there is a theoretical incentive to refuse tied funding through NPPs in order to maximise untied funding through additional GST revenue. Of course, states do not engage in such behaviour. On the contrary, state governments and public sector agencies actively pursue Commonwealth funding, despite the adverse impacts on their GST revenue shares.

If a state government was misguided enough to engage in gaming behaviour, we note that there would be a delay of three to five years before the GST distribution would reward such gaming – a period longer than the electoral cycle. Moreover, there is no certainty that this gaming would be successful, because of the many unpredictable factors which influence a state's GST revenue and which could counter the impact of gaming behaviour, including the actions of the other seven states.

2) 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?

As explained above, Tasmania does not consider that these effects or incentives exist in practice. Moreover, Tasmania considers that equity should be the overriding objective of the GST distribution and that alternative forms of the GST distribution are likely to erode this objective. While HFE is focussed on equalising the capacity of states, importantly it is not about redistributing capacity from high income/wealth states to low income/wealth states. Rather, it ensures that citizens of Australia have access to comparable levels of government services regardless of which state they live in.

The Review terms of reference state that the GST distribution will continue to provide the states with equal capacity to provide infrastructure and services, and that GST payments will remain untied. It is difficult to see how these principles could be preserved under many of the alternative GST distribution arrangements so far suggested. For example, if a segment of GST revenue was conditional upon a state undertaking prescribed revenue policy actions, it could no longer be argued that GST payments are untied. Instead, the GST pool may begin to resemble a specific purpose payment.

All of the alternative models for the GST distribution proposed so far would significantly reduce the transparency of HFE and increase its complexity, despite complexity being a chief criticism of HFE from its detractors.

The additional terms of reference for the Review imply that at some point, someone (as yet un-nominated) would be required to make arbitrary judgement about what is, or is not, desirable tax policy and practice. This would be a hugely contested task, and it is unlikely that states would agree on all points.

Cooperative and sensible state tax reform is a desirable objective in itself and should be pursued outside of the HFE process. Not only does this preserve the integrity of the tax reform process, but it is also far more likely that states would agree on a program of collective state tax reform if this can be separated from debates about the principles and practice of HFE. Tasmania simply cannot see any advantage in entangling state tax reform or other aspects of tax policy with the HFE process.

A GST model that seeks to control state tax policy limits the right of voters in any state to elect a government which delivers a tax system, policies, and services consistent with their preferences. This right is one of the main purposes of a federal system of government. It is questionable whether Australia's federal system could still function under circumstances in which these rights were removed or usurped.

Proposed alternatives in other submissions

In response to the Review's July 2011 Issues Paper, some states suggested alternative GST distribution models, some of which the Panel may examine in relation to this latest question. Tasmania has summarised potentially relevant models suggested, and provided comments in response.

Some submissions proposed partial equalisation, such as equalisation that delivers comparable services.

Tasmania does not support a model of HFE which seeks to deliver partial equalisation. This implies that other principles, such as efficiency or simplicity, should override the principle of equity. This is inconsistent with the guiding principles of the terms of reference for the review, which instruct that states must have capacity to deliver equal infrastructure and services.

Tasmania acknowledges that equalisation operates in an imperfect world, and that it is not possible to achieve exact equalisation. Materiality thresholds, data limitations and simplification mean that, in effect, partial equalisation is already practised. The CGC has previously acknowledged this:

> "Commissions have always sought to achieve equalisation subject to the quality of the analysis and data available to them. They have implemented proximate equalisation in practice. They have sought to provide all States with the same capacity to deliver services after recognising material disabilities. We do not think equalisation would be improved by including disabilities that cannot be proven, cannot be measured with sufficient confidence, or which make only marginal changes to how the pool is distributed, at the cost of greater complexity and possibly reduced transparency."[2]

In this sense, practical concessions are already made in the HFE process to maximise transparency and avoid unnecessary complexity. Tasmania does not consider that HFE could be further simplified under a partial equalisation objective without making considerable tradeoffs in terms of achieving equity.

Some submissions proposed relativity floors.

Tasmania strongly opposes the concept of a relativity floor. This arrangement would not deliver equity and would therefore be inconsistent with the Review terms of reference.

In addition to eroding the achievement of equity under HFE, a relativity floor introduces an asymmetry into the equalisation process which clearly advantages some states over others. It creates a situation in which two states in equal circumstances may not be treated equally due to timing issues. For example, a state which experiences a major increase in its fiscal capacity for one year (and therefore falls below the floor) would receive more than its required share of GST revenue, while a state with a similar increase in fiscal capacity, but spread over a longer period (and therefore not falling below the floor for any given year) receives a different treatment. Such asymmetrical scenarios are highly likely to occur under such a model given the currently very strong fiscal capacities of the resource rich states.

The strong variation and rapid rate of change in relativities in recent years is actually a demonstration that HFE works effectively and responds appropriately to changing state circumstances, albeit with a lag. The decline in the relativities of Western Australia and Queensland are completely unsurprising in the context of the exponential boom in mining investment and production in these states in recent years.

Some submissions advocated removing the mining assessment from the HFE process.

Tasmania strongly opposes removing the mining assessment, or other material revenue or expense assessment, from the HFE process. This would mean that equity would not be achieved. It would also reduce the transparency from the HFE process without resulting in any simplification

Similar to the comments above about a relativity floor model, the removal of the mining assessment would introduce significant asymmetry into the HFE process, completely distorting the delivery of equity.

[2] Commonwealth Grants Commission, *Principles, Interpretation and Scope of Horizontal Fiscal Equalisation,* Commission Information Paper 2007/12.

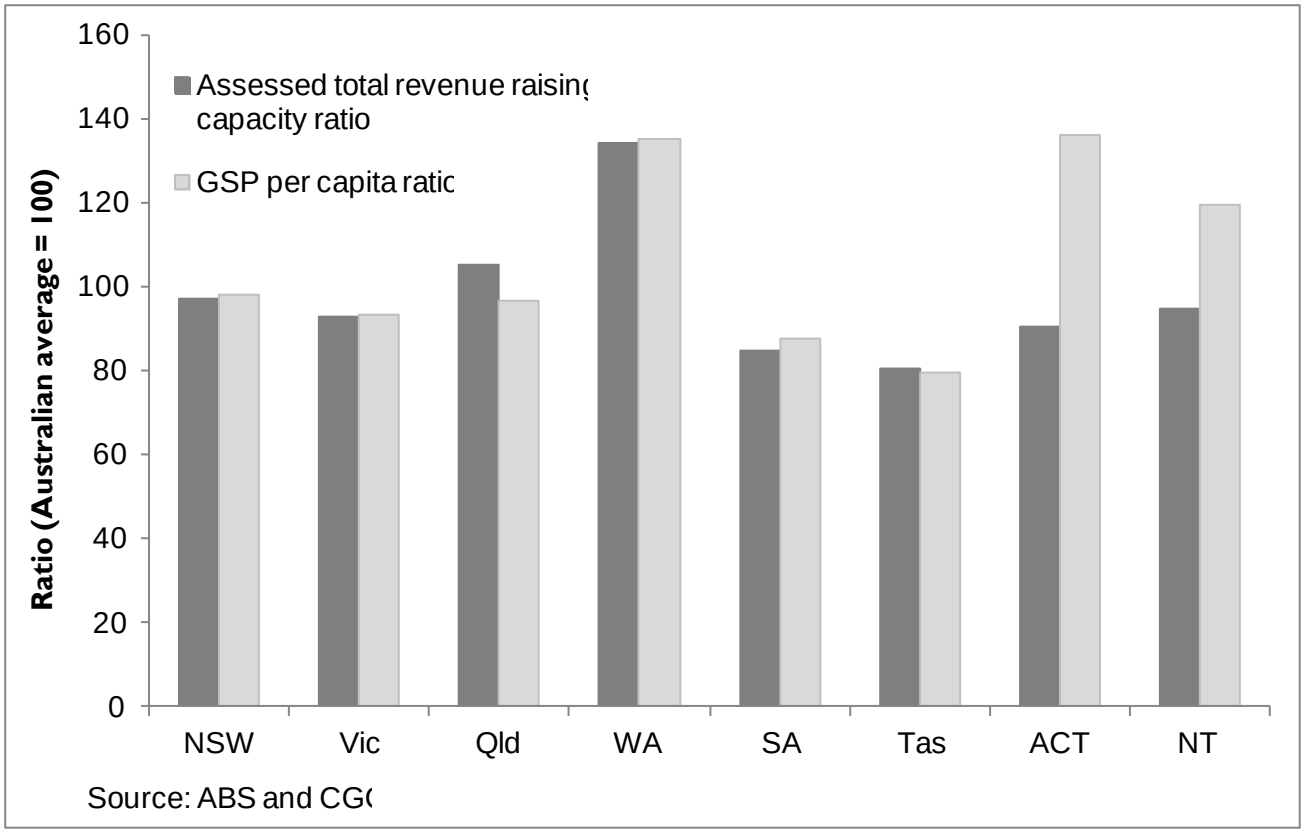
While Tasmania acknowledges that it is more difficult to design a perfectly policy neutral mining assessment, there is nothing special that distinguishes mining revenue from any other state revenue source. From an equity point of view, it is clearly inequitable to have an arrangement in which a state with a strong conveyance duty base in any year sees a portion of this base redistributed to a resource rich state with more modest conveyance duty receipts, but in which the resource rich state's mining revenue base is not subject to equalisation. This would completely undermine the fairness principle that underpins HFE.

3) 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?

Tasmania does not support the use of broad indicators to assess revenue raising capacity. Broad indicators simply do not capture, even in a rough way, the differing fiscal capacities of States. It would not be possible for an HFE process based on broad indicators to deliver equity.

The use of broad indicators would be appropriate if states actually raised revenue from these bases. But this is not what states do, nor is it something they can do. For constitutional and practical reasons, the range of tax bases available to states is very narrow. Broad indicators, such as gross state product or household income, do not have a strong relationship to these narrow and irregular bases (Chart 1).

Chart 1 – Per capita ratios of state revenue raising capacity and GSP, average from 2006–07 to 2010–11



While GSP per capita appears to link closely to the revenue raising capacities of a number of states, it significantly overstates the capacities of the Australian Capital Territory and the Northern Territory. Even the difference between revenue raising capacity and GSP for Queensland, while it may appear relatively small on this chart, would translate to millions of dollars difference in terms of GST revenue redistributed. This would suggest that GSP as a broad indicator would not deliver an accurate equalisation outcome.

The CGC's current revenue assessments are robust. States sometimes identify comparability issues in tax policy or data, but in most cases the CGC is able to readily address these and most such instances are minor and operate at the margin. Therefore, the outcomes of these assessments are highly accurate and reliable and the fact that broad indicators would produce significantly different results for several states demonstrates that broad indicators would not achieve equity. As such, the use of broad indicators is inconsistent with the Review terms of reference.

One argument for the use of broad indicators is that they are less affected by state policy, and therefore provide a more policy neutral indicator. It is also argued that they are more efficient, since they are less likely to influence state behaviour or impede efficient state tax policy.

In reality, a state can influence GSP, household income and other indicators, arguably at least as much as it can influence its land tax, payroll tax or mining revenue bases. State tax policy can itself influence GSP, by increasing or reducing economic efficiency in a state's economy.

As noted previously, there is no convincing evidence that the current assessment of state revenue bases has any impact on state behaviour, decision making or tax policy. Hence, there appears to be no justification for moving to the use of broad indicators, since these will not deliver greater efficiency or policy neutrality.

Because broad indicators have no relationship to what states do, their use would reduce the transparency of the process. Broad indicators add another layer of "logic" to the CGC process and make it more difficult, rather than easier, for a non-specialist to understand.

Much of the suggested broad indicator data is also unreliable, particularly for small states. The ABS GSP series is not intended to provide the same accuracy as the national GDP series. Some components of the series are estimated based on very small sample surveys with high relative standard errors, while other components are estimated using allocators, such as population shares. The GSP(E) series for each state also contains a large "balancing item", which has a significant impact on the estimated level and annual growth in GSP. This balancing item is modelled, based partly on very old data.

As an example of the major problems with the GSP series, note the very significant revisions to historical data that occur each and every year for Tasmania (Table 1). Each row in the Table represents ABS estimates of GSP growth for a particular reference year. Each column refers to the year that a particular growth figure was published.

Table 1 – Tasmanian GSP growth revisions by year of publication

		Year of State Accounts publication											
		1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
	(% change from previous year)												
Annual GSP growth estimate	1999-00	**1.1**	**-0.7**	**-1.4**	**-1.8**	**-1.9**	**-1.6**	**-0.8**	**0.1**	**0.1**	**0.7**	**0.4**	**3.8**
	2000-01		-0.5	-0.5	-0.7	-0.9	-2.2	-1.8	-0.9	-0.9	-1.1	-1.5	1.9
	2001-02			3.3	3.9	4.4	5.5	5.6	4.2	4.2	5.1	5.1	3.9
	2002-03				0.5	2.6	2.7	2.4	2.6	2.7	3.0	3.1	3.2
	2003-04					3.0	3.7	3.3	4.7	4.3	4.2	4.3	4.1
	2004-05						4.0	4.1	3.2	3.4	2.6	2.3	3.2
	2005-06							2.4	2.8	2.1	2.5	2.7	3.0
	2006-07								2.1	2.2	3.1	2.5	3.8
	2007-08									3.4	4.1	4.4	3.8
	2008-09										1.4	3.4	1.4
	2009-10											0.4	2.3
	2010-11												2.1

Source: ABS cat no 5220.0

For example, in 1999–00 (the row in bold), the ABS initially estimated that GSP growth in Tasmania was 1.1 per cent compared to the previous year. However, in the following year's publication, GSP growth for 1999–00 was revised down to minus 0.7 per cent. By the time of the 2003–04 publication the ABS had revised this down further to minus 1.9 per cent. In its latest publication, the ABS estimated that GSP growth in 1999–00 was a very strong 3.8 per cent. The extent of these revisions suggests that GSP is not measured with much accuracy in Tasmania. Therefore, it is doubtful that GSP could accurately capture Tasmania's revenue bases, conceptually or in terms of data quality.

Tasmania doubts that the ABS would declare the quality of the GSP series fit for purpose as a broad indicator, even ignoring the very substantial conceptual problems with such a measure. Until recent years the ABS labelled its GSP series as "experimental". Household income data is likely to be subject to similar issues.

It should be noted that the use of broad indicators magnifies the impact of any data errors. In the unlikely event that state revenue base data contained a significant error, this would only affect the assessment of this particular revenue base. In the likely event that there were significant errors in broad indicator data, these will affect the entire revenue assessment, moving the outcome even further from the appropriate equalisation outcome.

4) How could the GST distribution be designed in order to provide incentives and disincentives for certain State policy decisions?

5) 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?

6) What would be the appropriate institutional arrangements for determining the State policy to which the incentives would be targeted and assessing States' progress?

As noted above, Tasmania does not consider it appropriate to use HFE as an instrument to achieve exogenous policy objectives, such as incentives or disincentives. Tasmania considers that equity must be the overriding principle when examining the system of HFE. Introducing policy incentives and disincentives would likely work against this principle. There is a high risk that using the HFE process as a rewarding or sanctioning tool in this way would overburden the system. It would complicate the HFE, completely unwinding the simplification of the CGC process achieved in recent years.

The additional terms of reference in the Review and the questions outlined in the Supplementary Issues Paper appear to presume that there is something desirable about influencing the policy decisions, particularly tax decisions, of the states. This is highly questionable. The policy control implied in the new terms of reference would significantly impact on the ability of states to deliver services in line with their constituents' preferences. This is particularly the case if the "desirable" policies are imposed by the Australian Government or a national institution, which is likely to ignore regional conditions and preferences. Lack of understanding of local conditions and service delivery models may also mean that there are high efficiency costs under such a model.

Intervention of this nature reduces government transparency and makes it almost impossible for voters to assign accountability.

If the Commonwealth and all states agree that a particular policy objective is desirable, this can and should be pursued outside the HFE system. Major tax reform has been successfully agreed and implemented in the past without the need for adjustments to HFE principles. The most recent example being the introduction of the GST and the abolition of inefficient state taxes under the 1999 IGA. The recent *National Health Reform Agreement* and the *Intergovernmental Agreement on Federal Financial Relations* provide similar examples of cooperative agreements between the Commonwealth and the states in the pursuit of efficiency and other objectives. At no stage has anyone made a convincing case that HFE could be used to enhance this process or better achieve these objectives.

If there is a demonstrated need for future large scale state tax reform, this should be pursued cooperatively and as part of a completely separate process. Entangling tax reform with the HFE process reduces transparency, making it much harder for the public, and even for governments, to understand any proposed reforms or their expected outcomes. Moreover, it undermines HFE and confidence in equalisation outcomes.

7) Do States have an incentive to reduce MRRT or PRRT revenue through increasing State mineral royalties?

8) If there are such incentives, should they be removed, and if so, how?

9) What factors influence the structure of States' royalty regimes?

States have the incentive to maximise revenue at low economic or other cost. In so doing, states do not have an interest, or an incentive, to reduce the revenue of other governments, such as the Commonwealth. However, in pursuing the objective to maximise their own revenue, an indirect consequence can be a reduction in MRRT or PRRT revenues. Similar to previous arguments about the use of HFE, Tasmania does not consider it appropriate or necessary to adapt the HFE process to address this problem.

The MRRT and PRRT (for simplicity, referred to hereafter as the MRRT) introduce the sharing of a tax base between the Commonwealth and the States. While the taxes applied to the resources base by each level of government are quite different in concept, they affect the same taxpayer and they do interact. In particular, the MRRT provides taxpayers (mining companies) with credits for state mineral royalties already paid in respect of mining projects covered by the MRRT. Unutilised credits can also be carried forward, with generous indexation, to future years. This ultimately means that, if a state increases the royalty rate it applies to highly profitable mining projects, a consequence can be that MRRT collections are less than otherwise.

This result arises due to the design of the MRRT, which allows states to increase royalty collection for some projects without necessarily impacting on mining production or the burden on taxpayers. More broadly, this problem has arisen as a result of the fact that a tax base is being shared between both levels of government.

Note that this is not unique to the MRRT. Because most tax bases are shared in one way or another, almost any increase in a state tax can result in lower receipts of a Commonwealth tax. For example, a large increase in a state's payroll tax rate could be expected to lower the incomes of employed people and businesses in that state, leading to lower Commonwealth collections of income tax. Further, since payroll tax is a deductible expense for corporate income tax purposes, the Commonwealth will indirectly bear a proportion of any payroll tax increase through reduced corporate income tax receipts.

An important difference is the extent to which the MRRT impacts Commonwealth revenues compared to other taxes. For every dollar of additional royalty revenue a state collects from a MRRT liable mine, the Commonwealth effectively loses a full dollar. This is not the case for other tax regimes.

The terms of reference for the Review assert that the MRRT provides a more efficient approach to charging for Australia's non-renewable resources than mineral royalties, and states that the Review should be guided by this principle. It should be noted that, even if a state significantly increases its mineral royalty rates, *this does not decrease the efficiency of the MRRT*. On the contrary, it is the recognition of state royalties as a credit which theoretically ensures that the MRRT is efficient. The design of the MRRT ensures that, from the taxpayer's perspective, an increase in state mineral royalties does not alter any of its incentives regarding production, provided the company is making, or soon expects to make, a sufficient profit. The Supplementary Issues Paper notes that economic rent can be taxed, theoretically at varying rates, without distorting investment behaviour. Under the MRRT, states may be able to increase their royalty revenue collections at the expense of the Australian Government, but this does not affect the behaviour of the taxpayer and therefore does not have any efficiency implications.

Tasmania acknowledges that this represents a revenue risk for the Australian Government. If this problem requires addressing, the logical solution is to address problems with the design of the MRRT. A simple solution would be to cap, at current levels, the state royalty rate that can be treated as a credit for MRRT purposes. Under this scenario, the burden of any increase in state royalty rates then falls upon the taxpayer rather than the Australian Government, although this would have efficiency implications.

Alternatively, the Commonwealth could constrain state access to funding via mining development grants or funds where a state increases mining royalties beyond a predetermined level. Such action was recently announced in relation to the Regional Infrastructure Fund. While Tasmania would not necessarily endorse this approach, it does have the benefit of penalising states rather than taxpayers.

Alternatively, the Australian Government could seek to find another way to share the tax base less likely to influence the behaviour of states.

However, this issue is not related to HFE, and should be addressed outside of the GST distribution system. One implication of the revised terms of reference is that the GST distribution could be used to sanction states which raise royalties or otherwise engage in inefficient tax increases. If it is agreed that such disincentives are required and justified, there are many alternative ways of applying sanctions. The GST distribution would be a highly inappropriate tool for imposing such sanctions, given that it would interfere with HFE's equity objectives, increase complexity, reduce transparency, and set an undesirable precedent in Commonwealth-State relations.

There will be occasions where states will adjust mineral royalty and other tax rates in line with their policy and revenue needs, regardless of the presence or not of the MRRT or other incentives. It is important that states are still provided with flexibility to adjust their own taxation systems in these circumstances.