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CHAMBER OF COMMERCE AND INDUSTRY WESTERN AUSTRALIA

GST Distribution Review

Submission

CCI Advocacy – October 2011

Making it easier to do business

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Introduction

CCI is the peak organisation representing business in Western Australia. It is the second largest organisation of its kind in Australia, with a membership of over 6,500 businesses across all sectors of the economy.

In March 2011, the Federal Government announced a comprehensive review of the GST Distribution Process, to be conducted by the Hon Nick Greiner, the Hon John Brumby and Bruce Carter. The review aims to consider whether the current approach to sharing the GST among the states will ensure that Australia is best placed to respond to the challenges that lie ahead, and to ensure confidence remains in Commonwealth-State financial relations.

The allocation of GST revenue has typically been a source of tension among the states, and CCI has held concerns about the process for some time now. Much of this tension stems from the significant degree of Vertical Fiscal Imbalance (VFI) that exists in the Australian Federation, which has meant that the states are reliant upon GST revenue to fund the services and infrastructure required.

Addressing this imbalance should play a central role in the reform of the GST distribution process; however it is acknowledged that this is beyond the scope of the current review.

Nonetheless, CCI believes that substantial improvements can be made to the current methodology, which will deliver a more appropriate allocation of GST revenue, while helping to make the system simpler and more transparent. At the heart of this will be to lessen the extent of equalisation, and to ensure that resources are directed to their most productive use.

The need to reform the system is pressing given the significant opportunities and challenges that lie ahead for the nation.

Executive Summary

The current process for distributing GST revenue is based upon the principles of Horizontal Fiscal Equalisation (HFE), and aims to ensure the states and territories have the capacity to provide a similar level of services to their citizens.

While CCI supports the commitment to fairness and equality across the federation, there are a number of issues with the methodology that have the potential to limit the nation's growth prospects over the longer term if left unaddressed.

Western Australia is on the cusp of a new phase of strong economic growth, on the back of demand for the state's key commodities from the world's fastest growing region in developing Asia. However, the projected decline in the state's GST revenue has the potential to put the break on growth by limiting the State Government's ability to adequately invest in infrastructure and services, and to undertake reforms to maximise the opportunities that lie ahead. Analysis by the WA State Treasury found that the state's GST relativity could fall as low as 0.33 by 2014–15, with a significant equalisation of own-source revenue the main driver. This will not only impact upon the state's growth, but will also have implications for the nation as a whole, as Western Australia continues to increase its contribution to the national economy.

Much of the tension that surrounds the GST distribution process reflects the high level of Vertical Fiscal Imbalance (VFI) in Australia's federation, which means that State Governments are forced to rely on Commonwealth funding for over half of their revenue; with the GST representing a large portion of this. In this regard, easing VFI is an important part of addressing the issues created by the current distribution methodology. Unless this occurs, tensions will continue to exist over the process into the future.

CCI has a number of concerns with the current methodology used to distribute GST revenue to the states:

- **The system is complex, technical and not transparent.** The process considers over 110 measures, and is based upon complex and subjective submissions from State Governments.
- **The treatment of revenue is inequitable.** Not all sources of state revenue are considered in the process. For example, gambling tax revenue does not impact on equalisation, while resource royalties do. The inclusion of Commonwealth payments, including SPPs and NPPs, in the equalisation process also adds significant complexity and administrative costs.
- **The GST distribution process excessively favours equity over efficiency.** While equity is an important objective, the current system allocated revenue to activities that may not be the most productive use, and therefore may limit the nation's growth potential. The process also dulls the incentive for reforms that will improve the productive capacity of the states, as much of the gain is equalised away.
- **The methodology penalises economic performance and doesn't adequately reflect the industry base and infrastructure needs of state economies.** States are in essence penalised for economic growth through a reduction in GST grants. Western Australia is a prime example, with strong economic growth in recent years leading to a reduction in grants. The current process also does not adequately take into account the infrastructure and investment needs of the states.
- **Perverse incentives.** The current methodology creates perverse incentives for states to behave in ways that are contrary to their constituent's best interests in order to capture more grant revenue.

There are a number of reforms to the current methodology that will help address the issues identified above, which can be accomplished under the existing framework of federalism in Australia.

However, as a starting point, addressing the level of VFI would potentially solve a number of issues, by taking the pressure off the GST as a source of funding for the states. This would ideally involve providing states access to the income tax base. This issue has been discussed in more detail in CCI's recently released discussion paper, *Tax Reform: Building the Foundations for a Strong Economy*, which was presented to the Commonwealth Tax Forum in October 2011.

A number of reforms could also be made within the boundaries of the current system that will deliver a more appropriate allocation of revenue, improve transparency and reduce complexity.

- **Move to revenue-only equalisation.** This is the simplest and most objective method of equalisation, and is in line with international standards. Revenue equalisation would need to include all own-source revenue, including that which the Grants Commission has been reluctant to assess such as gambling taxes.
- **Discounting of mining revenue.** Ensures states can retain a reasonable share of mining revenue generated locally and will ensure the incentive to develop their resources base at a time where demand is at an all-time high is retained. This is particularly important, given the significant costs involved in developing the industry, and the benefits to the nation overall.
- **Exclusion of Commonwealth payments from equalisation.** Excluding Commonwealth payments would cut out one of the most complex and subjective parts of the methodology, while reducing the administrative burden created by the double-handling of payments.

While these are CCI's preferred reforms, a number of other options may also address these concerns, but would require further analysis as to the impact on the overall federation:

- **Removing territories from the equalisation pool.** Provide top-up funding to the territories rather than direct compensation through the GST distribution process.
- **Floors and ceilings on relativities.** Limit the degree of deviation away from an equal per capita relativity.
- **Forward-looking recognition of investment needs.** Introduce a better assessment of investment requirements that involves stronger economic rationale.
- **Cost equalisation**. Retain expenditure equalisation in the process, but in a much more high-level way capturing the main drivers of cost differences as opposed to the current complex approach.
- **Reform incentives.** Provides incentives for states to reform their economies. However, it introduces federal control over untied revenue, which is not desirable.

Economic Context

Western Australia has undergone a period of significant expansion over the past decade, and has made an increasing contribution to the national economy over this period. However, the ability to make the most of the state's potential will be limited by the projected fall in the state's share of GST revenue.

The state economy, as measured by Gross State Product, has grown by an average of 4.4 per cent per year since 2000–01, making it the fastest growing jurisdiction in Australia. The strong growth profile also compares favourably to the nation as a whole, which has expanded by just over three per cent per annum over this period. As a result, Western Australia's contribution to national GDP has increased from 12.6 per cent to 14.6 per cent – well above its population share (Chart 1).

Western Australia accounts for a significant proportion of national investment activity. About one quarter of all national business investment expenditure occurs in WA per annum, a figure which has doubled over the past decade on the back of strong investment in the resources sector.

The investment in the minerals and resources sector has flowed through into higher export returns. Over the past decade, the volume of exports leaving Western Australian ports has grown by 46 per cent, relative to national volumes which grew by half of this amount. However, the value of these exports has grown exponentially, with over $110 billion worth of merchandise exported from WA in the 2010–11 financial year – almost half of total national earnings, and up from 25 per cent a decade ago.

China has played a central role in WA's outstanding performance, as its rapid growth and development has demanded mineral and resource commodities. This has seen WA's exports to China grow from just 8.8 per cent (or $2.7 billion) of total earnings in 2000–01 to 42.1 per cent (or $47 billion) in 2010–11; with the state accounting for almost three quarters of national trade with China.

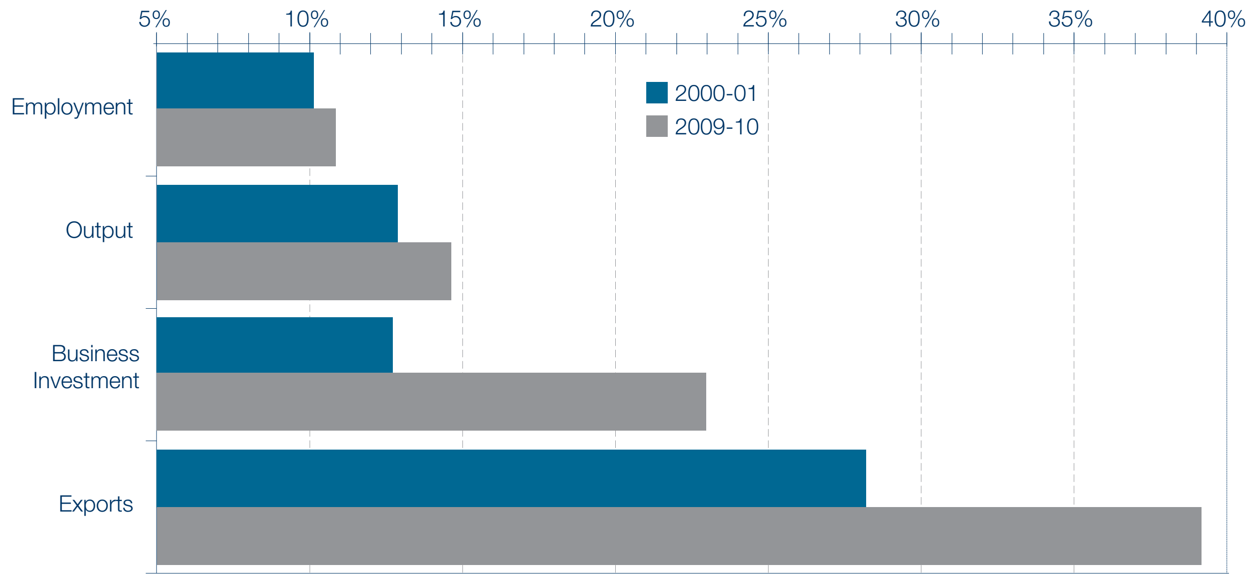
The rapid urbanisation of China and other Asian economies will continue to drive the performance of WA and national economies for many years to come. CCI forecasts Gross State Product will grow by 6½ per cent in 2011–12, increasing to seven per cent in 2012–13.

Over the longer term, growth will be driven by the $230 billion of dollars worth of projects either already under construction or in the planning phase at present. These projects will continue to drive growth in the Western Australian economy as they move into the construction and production phases.

While the future for WA is bright, the ability to make the most of the opportunities that lie ahead will be limited by the state's diminishing share of GST revenues. According to analysis included in the 2011–12 WA State Budget, the ramp up in growth across the state will see Western Australia's GST relativity fall as low as 0.33 by 2014–15. The move to this level over the period from 2010–11 to 2014–15 will cost the state a total of $12.3 billion in funding relative to the equal per capita share – funding that could be used to invest in critical economic and social infrastructure.

"While the future for WA is bright, the ability to make the most of the opportunities that lie ahead will be limited by the state's diminishing share of GST revenues"

Chart 1
WA Contribution to National Economy
Percentage of Total in Year Specified



Source: ABS Cat. 5220.0, 6202.0

The Imperative for Reform

The current Commonwealth Grants Commission process for distributing GST revenues amongst the states and territories of Australia was developed on the principles of Horizontal Fiscal Equalisation (HFE).

In Australia, HFE is aimed at ensuring the states and territories have equal capacity to provide similar levels of service to their citizens, by compensating those jurisdictions with below average capacity using GST revenue redirected from jurisdictions with above average capacity. The Commonwealth Grants Commission, the institution charged with making these assessments, conducts a lengthy, technical process of calculating each jurisdictions relative ability to provide services. This process takes into account both what states do (average policy) and factors that are beyond state control (such as demographic differences, wage costs and population density).

A short summary of the process is below:

- A "standard budget" is developed, which is designed to give a point of comparison with which to assess state revenue and expenditure policies against. This budget is made up of an average level of dollars of revenue or expenditure for roughly 110 assessment criteria; from payroll tax revenue to depreciation expenditure. These assessment criteria are broken up into five separate categories: own-source revenue, expenditure, investment expenditure, net lending and Commonwealth payments.
- States are then assessed against this standard budget in terms of their ability to "meet" each line relative to each other. This process involves defining what constitutes an "assessment base" and what constitutes "state policy" with a significant level of discussion between the states and the Grants Commission occurring. States are also able to debate whether there are circumstances which are beyond their control, such as demographics or population density, that impact their fiscal capacity. These are compensated for as part of the process.
- A relativity is assigned for each line item, and a weight applied to each relativity to reflect its importance to the standard budget. These weighted relativities are added up under each category to determine the overall relativity for revenue, expenditure, investment expenditure and net lending.
- Once all of these four headline relativities are calculated, they are applied to the standard budget for each jurisdiction, which produces a "relative budget" for each jurisdiction. This is calculated by adding expenditure, investment expenditure and net lending together and subtracting own-source revenue; which produces an "assessed Commonwealth funding requirement". The funding requirement is always positive, due to the high vertical fiscal imbalance prevalent in the Australian federal system.
- Then, the assessed Commonwealth payments category is added to the budget, reflecting the current level of federal funding allocated to the state to fund expenditure. This creates the "assessed GST funding requirement" figure, which reflects how much GST the state needs to fulfil the standard budget.
- Finally, the overall relativity is calculated, by dividing the "assessed GST funding requirement" for a particular jurisdiction by the state's population, and dividing that by the Equal Per Capita (EPC) level of GST funding per head for the jurisdiction – with the difference between this figure and the EPC figure representing the distribution to or away from the jurisdiction.

Table 1

Illustrative calculation of state relatives 2008–2009

A table taken from the 2010 Review is presented below summarising the "standard budget" process:

	Dollars per capita					
	NSW	**Vic**	**Qld**	**WA**	**SA**	**Tas**
Assessed net lending	-505.76	-482.01	-457.29	-432.84	-516.49	-524.13
Plus: assessed expenses	7 737.16	7 398.19	7 968.74	8 405.20	8 048.31	8 500.57
Plus: assessed investment	461.34	401.90	633.82	608.59	382.43	352.12
Less: assessed revenue	3 843.79	3 670.51	4 432.89	5 437.14	3 377.79	3 189.23
Total requirement for Commonwealth Payments	3 848.95	3 647.57	3 712.37	3 143.88	4 536.47	5 139.35
Less: revenue from Commonwealth Payments	1 971.69	1 815.86	2 134.71	1 903.96	2 086.16	1 980.74
Assessed GST requirement	1 877.26	1 831.71	1 577.66	1 239.92	2 450.30	3 158.61
Relativity	0.98635	0.96242	0.82893	0.65148	1.28743	1.65959

Source: Commonwealth Grants Commission 2010 Review

There is typically much tension surrounding the process for distributing revenue. Notably, some of the tension surrounding the distribution process may be eased if the states were less reliant on Commonwealth funding as a source of revenue.

In the 110 years since federation, there has been repeated conflict between the states and Commonwealth over jurisdictional boundaries, and in general, an increase in the power of the central government relative to the states. This has created significant imbalances between the funding and responsibilities of the states and territories, known as Vertical Fiscal Imbalance (VFI). States and territories simply do not have access to a large enough tax base to be able to meet their expenditure responsibilities without receiving top up funding from the Commonwealth Government. Today, the Commonwealth Government raises about three quarters of all tax revenues collected, but the states are responsible for about half of government expenditure.

While VFI is a key issue in Australia's Commonwealth-State financial relations, CCI also has a number of concerns with the methodology currently used to distribute GST revenue. These concerns are detailed in the following section.

The current system of GST distribution is complex and not transparent

Despite recent attempts to simplify the process, the current methodology for determining the relativities which inform the GST distribution process is complex, technical and not transparent.

A key issue is that a defined practise of equalisation is not in place – rather, the methodology and the inputs into the formula are subject to change on an annual basis. State Governments are required each year to submit lengthy, complex recommendations to annual relativity reviews in relation to 110 assessment criteria, with the Commission rarely (according to its own reports) changing the methodology despite these.

There are also concerns about the data used by the CGC. The data used is not consistent or timely, an issue which has been acknowledged by both the Commission and the states. The determination of which data to use, much like the development of assessment criteria, is too subjective. There is little regard given to the potential impacts of using poor quality data; a poignant example is located in the 2010 Review, Chapter 14:

> …we needed to make a number of adjustments and assumptions to use some data in our assessments. In particular, the data from Victoria and South Australia on the sources of income of users of family and child services were found to produce a result that was not representative of the situation in states with large remote Indigenous populations. Adjustments were introduced to make it so. With these adjustments and assumptions, we consider the method and data sufficiently reliable for our purposes.

In addition, the GST relativities are often revised in the years following a particular budget year as new data is released and revised, which alters the relativities and forces states to pay back money received in the previous year's allocation.

The treatment of revenue is inequitable

Under the current GST distribution methodology, the treatment of revenue, particularly own-source revenue, is inequitable in that not all lines of own-source revenue are equalised. Under the current system, the sources of revenue that are subject to equalisation include:

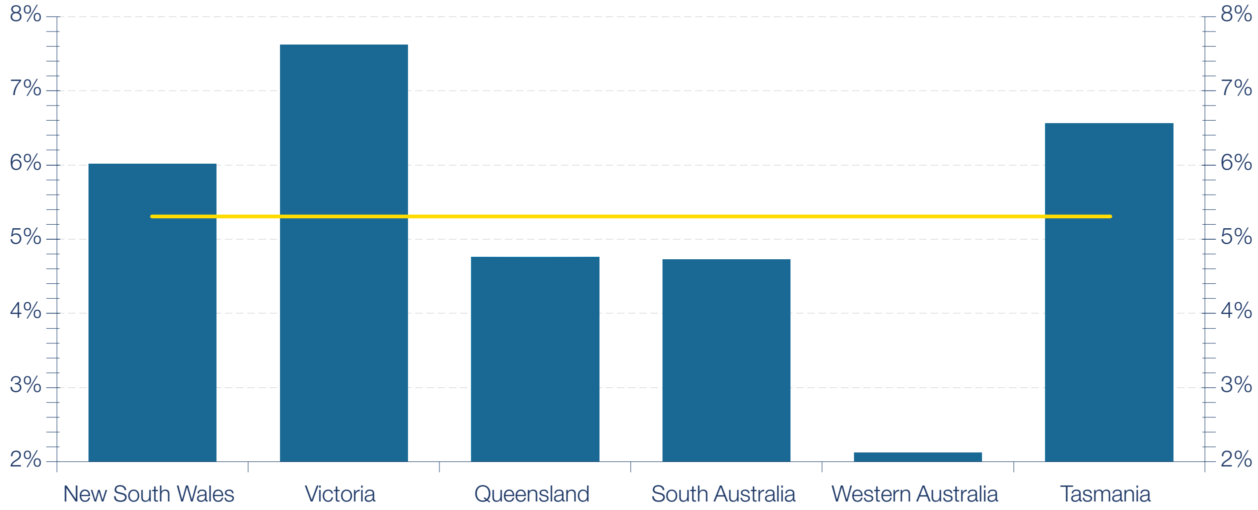
- Payroll tax;
- Land tax;
- Transfer duty on conveyances;
- Insurance tax;
- Motor vehicle taxes;
- Mining revenue (royalties); and,
- Other revenue.

However, "other revenue" is assessed as part of the process, but does not affect the overall GST relativities. The asymmetric treatment of revenue can create distortions, because not all states collect revenue from the same sources. For example, gambling taxes are not included in the equalisation process, despite representing as much as eight per cent of own-source revenue in some jurisdictions, compared to 2.1 per cent for WA (Chart 2). However, mining royalties, which represent over one fifth of WA's own-source revenue compared to one fifth of one per cent in Victoria, are included in the process.

In essence, under the current methodology, Western Australia is penalised for not having a significant gambling presence in the state; while simultaneously being penalised for the development of a strong minerals and resources industry. This is both inequitable (given that other taxes such as land tax are included but not levied equally, or at all, by each jurisdiction) and at odds with the full equalisation ideology of the current Grants Commission process.

Another concern about the treatment of revenue is that conditional federal grants, such as specific purpose payments and National Partnership Payments, are included in the assessment of fiscal capacities. These grants are almost always conditional on expenditure, and so by including them in the process, the Grants Commission is effectively taking away some of the revenue provided to fund services and giving it to other states, while the spending requirements of the conditional grants remain in place. It also imposes an unnecessary administrative burden across the federation, with this revenue essentially being subject to two different sets of government hands before being handed over to the states.

Chart 2
Gambling Tax
Share of own-source revenue, 2009–10



Source: Relevant State Budgets

The GST distribution process excessively favours equity over efficiency

While the current methodology for GST distribution focuses on improving equity across the states and territories, this is achieved to the detriment of efficiency, as funds are not necessarily allocated to activities that will deliver the greatest benefit to the nation.

Since the GST was introduced, some $35 billion in funding has been redirected from the four larger jurisdictions with, on average, stronger growth (New South Wales, Victoria, Queensland and Western Australia) to the four smaller jurisdictions with weaker growth (South Australia, Tasmania, the ACT and the Northern Territory). This transfer occurs for a number of reasons, mostly due to lower capacities to raise revenue – particularly in the case of South Australia, Tasmania and the Northern Territory; but also due to expenditure differences – particularly for the Northern Territory.

While this helps the smaller states and territories supply services, the opportunity cost of this allocation is potentially significant as it directs funds away from further industry infrastructure development in stronger states, which could build the productive capacity and growth prospects for the nation over the longer term.

The efficiency impacts of the process have also been reflected in empirical studies, which have found that the current system distorts allocative efficiency within the federation, as funding to smaller states is more likely to be spent in a relatively inefficient manner. Both Petchey (2009) and Dixon, Picton and Rimmer (2005) analysed the system and found, in a theoretical and analytical setting, that Australia's system is geared excessively in favour of equity at the expense of efficiency.

The system also reduces the incentive for recipient states to reform their economies and improve productivity. Since the introduction of the GST, the share of federal revenue in Western Australia's total revenue has fallen from 46 per cent in 2000–01 to 33 per cent in 2010–11; while other jurisdictions have seen their shares increase as high as 58 per cent in the case of Tasmania. This excessive reliance on federal funding has the potential to reduce the appetite for reform and innovation among the recipient states, as it will likely lead to lower grant revenue.

In particular, the current system may also reduce the ability to deliver tax reform at the state level, due to the state's reliance on Commonwealth revenue. As states have a limited revenue-raising capacity, reduction in GST funding allocations limits the donor state's ability to abolish or reform their most distortionary and inefficient taxes such as stamp duty and payroll tax.

"The system also reduces the incentive for recipient states to reform their economies and improve productivity"

The current system of GST distribution overly penalises economic performance

The current methodology for GST distribution in Australia effectively penalises states and territories that outperform, and doesn't account for the infrastructure and investment needs of these fast growing states. States that grow faster than the average, and as a result have faster growing pools of own-source revenue, see their level of GST funding erode as a result.

This reallocation of resources away from the stronger performing states limits the ability for these states to continue to grow and support the national economy over the longer term.

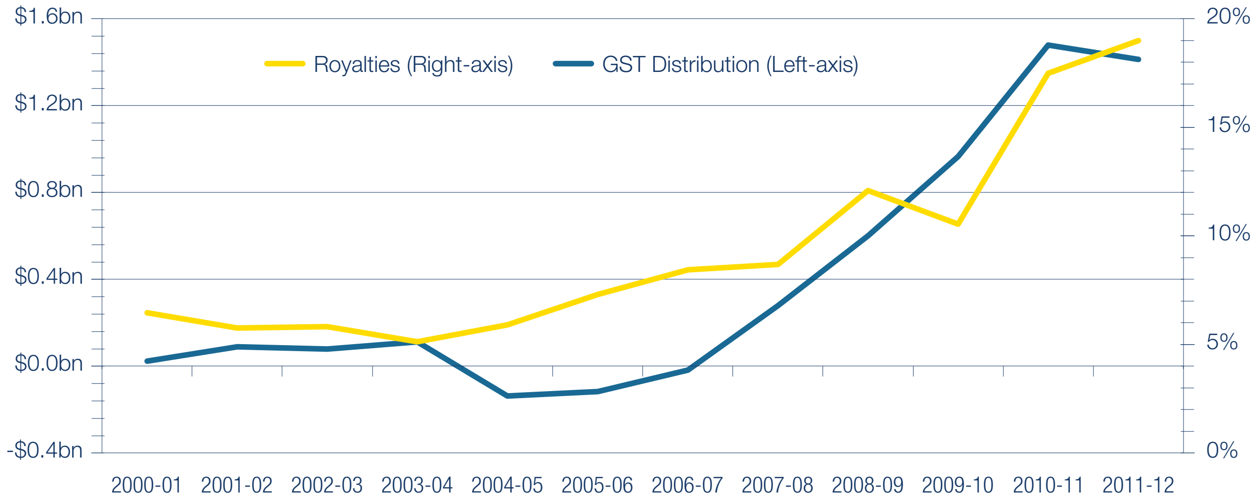
This has been the case for WA in recent years. Western Australia's recent economic success has flowed through to the State Government's budget in the form of higher tax and royalty revenue. However, this improvement in own-source revenue has seen the state's share of GST revenue erode, as the CGC process has deemed the state's fiscal capacity has improved. In eight of the 11 years since the GST distribution system has been operating, WA has been a donor, with movements away from the equal per capita share outcome totalling $4.8 billion; just behind the two most populous states in New South Wales ($16.2 billion) and Victoria ($13.2 billion). However, most of this distribution away from WA has occurred in the last three years worth of relativities, as mining royalties have become an increasingly important component to Western Australia's revenue (Chart 3).

The sole reason for the significant distribution away from Western Australia in recent times has been the increase in revenue-raising capacity, with WA a net beneficiary of the expense, investment, net lending and Commonwealth payments categories (although expense equalisation is the only one which causes a significant shift in GST funding to the state). The rapidly growing wages of Western Australians versus the rest of the country, a by-product of the boom, have also meant that more funding is directed to the state.

With strong growth in WA expected to continue in the years ahead, the state's GST grant share is expected to deteriorate even further over the period ahead. Analysis by Western Australia's Department of Treasury included in the 2011–12 State Budget concluded that based on current trends, WA's GST relativity could drop as low as one third of the EPC level in 2014–15. This would present a significant challenge to the State Government in meeting the needs of a rapidly growing state, and maximising the state's economic potential.

There have also been concerns that the relativities are not timely, given the Grants Commission uses a three year average of relativities to determine the current year's allocating of GST revenue. This approach can mean states are penalised for past economic performance, with strong own-source revenue growth for three consecutive years followed by a year of weaker growth potentially blowing a hole in a jurisdiction's budget – which can then have longer-term implications for relativities into the future. It is noted, however, that in the most recent review the averaging period was reduced from five years to three, which did go some way to addressing this issue.

Chart 3
WA mining royalties and GST distribution
Royalties as a share of total revenue & WA's net gst contribution, 2000–01 to 2010–11*



Source: Commonwealth Grants Commission & Successive WA State Budgets

…and doesn't adequately address infrastructure needs.

The current process for assessing infrastructure needs does not take into account the industry base and economic prospects of each jurisdiction.

The failure to effectively acknowledge differences in infrastructure needs has been highlighted by State Governments in the past; however changes to the assessment have not proven effective. For example, the abandonment of the debt charges assessment approach, long criticised by state treasuries as archaic, complex and irrelevant, is a step in the right direction. However, shifting the focus to population as the key driver does not reflect state industry bases and the need for a State Government to provide commercial and industrial infrastructure such as ports, road and rail.

While it is appropriate that the Grants Commission does acknowledge there are a number of ways State Governments are able to fund new infrastructure, a number of other technical quirks in the system work against states with high infrastructure holdings or new requirements.

CCI's concerns with the assessment of infrastructure are as follows:

- Conceptually, the treatment of "investment" purely as balance sheet holdings per capita does not give due weight to the role infrastructure and investment in infrastructure plays in growth. For example, a new road in a fast growing state is likely to be more valuable, in an economic sense, than a new road in a low growth state.
- The definition of infrastructure as "road" and "non-road" does not adequately reflect the plethora of investment projects and asset holdings a state may have.
- The assessment of population growth as the key driver behind infrastructure requirements does not take into account both the diverse users of infrastructure within a state and the long-term perspective taken when states invest in infrastructure. Population growth can change from year to year, while investment in new infrastructure may take a number of years to develop, plan and implement. Retrospective assessment is not appropriate when determining investment requirements. Incorporating economic growth into the assessment criteria may go some way to alleviating these concerns.
- The current methodology doesn't take into account the industry base of each jurisdiction. For example, the resources states of Western Australia, Queensland and the Northern Territory need to invest significantly in their economic infrastructure, such as ports, rail and energy, to ensure the continued growth and development of their economies.
- The assessment of balance sheet holdings is subject to state-based valuations of assets, which introduces perverse incentives into the methodology.

However, a clear, simple assessment of infrastructure investment is not self-evident under the current assessment methodology.

Perverse incentives

The current methodology for distributing GST revenue in Australia creates perverse incentives, in that it provides inducements for states to alter their behaviour to maximise their grant revenue; a problem called grant design inefficiency. The system creates incentives to alter behaviour in the following ways:

- The current methodology does not provide an incentive for smaller jurisdictions to grow their own revenue bases as this would lead to a lower level of GST grant revenue. This is called "grant dependency", and a number of states and territories suffer from it.
- The assessment of investment requirements uses financial data supplied by the states, which provides states with an incentive to alter their valuation of assets, or the timing of depreciation expenditure, in order to influence their share of GST revenue.
- In the current relativities formula, "average policy" is determined on a per capita weighted basis. The larger the state, the more influence the state has on the average. As a result, these states have no incentive to reduce their tax rates as they are penalised for doing so through a reduction in their GST grants. This is because a fall in said states tax revenue disproportionately impacts on the average, widening the gap between the states outcome and the average. Indeed, research conducted by Dahlby and Warren (2003) found some evidence that the current methodology may have led some states to set tax rates to levels designed to maximise their GST grants at the expense of lower own-source revenue tax rates, effectively piggy-backing off higher tax rates in other jurisdictions.
- Despite the best efforts of the Grants Commission, the inclusion of expenditure in the equalisation formula introduces incentives to behave in a manner that may not be in the best interest of the jurisdiction. As with the "average policy" approach to revenue equalisation, states that sit with above average capacities have the incentive to reduce their spending on essential services in order to boost their GST grants, while states with below average capacities stand to gain by increasing their expenditure on services.

Perverse incentives are likely to become an increasing problem going forward. As the GST becomes a larger share of revenues for some states, there will be more to gain from changes in behaviour designed to maximise grant revenue.

Reform Priorities

CCI believes that a more appropriate allocation of GST revenue could be achieved though changes to the current Grants Commission methodology. These changes should look to reduce the extent of equalisation, and ensure that GST revenue is used in the most efficient manner.

Addressing Vertical Fiscal Imbalance

Much of the tension surrounding the distribution of GST revenue could be relieved by addressing the high degree of VFI that exists in the Australian federation. This would require reform to the tax system, to provide states with access to a sustainable source of revenue. A tax base sharing arrangement would be an option to achieve this. CCI's recently released discussion paper, Tax Reform: Building the Foundations of a Strong Economy, which was presented to the Commonwealth Tax Forum in October 2011, recommends that providing the states with access to the income tax base would be the best way to achieve this.

Access to income tax would provide the states with a sustainable revenue base, which will increase automatically as the economy expands. It is also constitutionally possible, given that the states collected income tax prior to World War Two.

There are several options for providing the states with access to the income tax base.

Firstly, control of the income tax base could be passed from the Commonwealth to the states. This could be done without changing the existing range of taxes raised, with the Commonwealth instead using GST revenues to finance its own activities.

The alternative option would be for the states to share the income tax base with the Commonwealth. This option is used in other federations, such as Canada, and could apply as a surcharge on the Commonwealth personal income tax base. To prevent the system from becoming overly complex, the states should align their income tax bases with the Commonwealths, and set single tax rates and compete only on those rates. To reduce compliance costs, this should be centrally administered by the Commonwealth.

While income tax would solve the issues associated with the state's narrow revenue base, there would be some practical difficulties associated with such a proposal.

Sharing the income tax base may undermine the Commonwealth's role in redistributing income and its ability to control the degree of progressivity in the income tax system. It could also impede its ability to determine the overall process of redistribution by coordinating the cumulative impacts of progressive income taxes, unemployment and other benefits and social spending.

By aligning the tax base with the Commonwealth, the states flexibility to design their own revenue-raising mechanisms will be reduced, and may remove the disincentive for the Commonwealth to contract the income tax base over time, or change its structure so that income was generated in activities only taxed by the Commonwealth (eg. by encouraging incorporation).

Horizontal fiscal equalisation would also prove more effective in a system of income tax sharing, with an increase in state revenue raising autonomy taking the pressure off the GST as a primary source of funding for State Governments. Larger, more successful states would have access to stronger, more reliable tax bases, while smaller states could be subsidised from GST revenues; rather than under the current system where they are subsidised using the small differences between inefficient taxes.

However, it would be necessary to ensure that there are safeguards built into the equalisation methodology that ensures states cannot piggy-back off the strong revenue bases that some states invariably will develop; as is not the case with the current methodology.

Reform Options

While reducing the state's reliance on GST revenue will go part way to address the problem, there are a number of changes that can be made to the current methodology that will improve the GST distribution system. These reforms are aimed at creating a more efficient system, while reducing complexity and delivering a more appropriate allocation of resources.

Shift to revenue-only equalisation

The Commonwealth Grants Commission should move to a system of revenue-only equalisation as the key foundation of the GST distribution methodology. This would involve moving from a system of full, comprehensive equalisation to partial equalisation based on fiscal capacities.

Revenue-only equalisation is the simplest and most pure form of horizontal fiscal equalisation available as a tool for distributing GST revenues amongst the states and territories, as it equalises the fiscal capacities of jurisdictions as opposed to equalising on the basis of creating full equity amongst states.

By removing three components of equalisation, the GST process will become simpler, more objective and less opaque – satisfying a number of the criteria for improvement set out in the Review's official Terms of Reference.

Furthermore, a move from full to partial equalisation will help to tip the equity/efficiency trade-off further towards efficiency; by ensuring that states are not overly penalised for strong financial performance, successful industry development policy or high economic growth (or, indeed a combination of these three).

Revenue-only equalisation is also the most common form of equalisation used in the OECD, with 13 of 18 countries with a form of equalisation utilising a pure revenue equalisation system. Australia is the only country that includes both revenue and cost in a single equalisation formula. Revenue disparities are also the most distinct within Australia's federation, with revenue differences accounting for over 38 per cent of total gross equalisation in 2010–11.

The Grants Commission would be solely responsible for determining the revenue base and effective rate of taxation for each revenue line using simple, timely data metrics.

An important part of a move towards revenue-only equalisation will be to ensure that all own-source revenue is included in the process. This includes gambling tax, which the CGC has been reluctant to assess to this point.

The current methodology relies too heavily on state liaison and debate rather than Grants Commission authority, which creates an environment of gaming against the system in order to achieve self-interested outcome. Revenue-only equalisation works to counter this, as the methodology would be based purely on objective data relating to revenue collected by the states.

Partial exclusion of royalty revenue

Royalty revenue is the leading cause of fiscal differences between state governments within Australia, due almost exclusively to the concentrated nature of mineral deposits across the country. In the 2010 Review, mining royalties accounted for over 20 per cent of gross equalisation, with some $1.9 billion from Western Australia, $912 million from Queensland and $53 million from the Northern Territory being distributed to the other four jurisdictions.

Based on the current methodology, Western Australia effectively keeps just 15.9 per cent ($369 million) of royalty income raised in the state, while still having to manage and develop the industry, along with the pressures it creates in the broader economy. Contrast this to Victoria, who is a $1.4 billion net beneficiary from the mining royalty equalisation formula, despite raising just $0.0467 billion in its own right.

As such, the GST distribution methodology should be adjusted to ensure there remains an incentive to develop the resources industry. This will ensure a more efficient allocation of GST revenue, and deliver long term benefits to the nation. Ensuring that states who choose to develop their mining industries keep a large share of their gains should be a priority, however this must be balanced with the Grants Commission's imperative to ensure states have equal capacity to deliver services to their citizens.

With this in mind, it is recommended that the Grants Commission process should exclude a portion of resource royalties from the equalisation process. This would ensure that resource-rich states such as Western Australia and Queensland capture the majority of the gains from resources that are owned by them, while recognising that all jurisdictions should share some of the fiscal benefit from non-renewable resources. While further modelling is needed to determine the appropriate proportion to be excluded, it should be large enough to ensure that states receive a more appropriate benefit of their resources.

For example, the impact of a 50 per cent royalty exclusion, all other things being equal, on state finances is shown below (for 2009–10). The downside impact is modest for the royalty recipient states, while the upside is strong for royalty donor states.

The selection of a 50 per cent royalty discount factor is based upon the Canadian system of equalisation. Although different to Australia, Canada's equalisation methodology allows provinces to exclude half of their royalties and still be eligible for equalisation payments from the central government.

Providing states with a greater share of GST revenue will also go part way to address the concerns around the current process for assessing infrastructure needs, as resources states would presumably use the retained resource earnings to fund further development in their industries.

Exclusion of Commonwealth payments from equalisation process

Commonwealth payments should be excluded from the equalisation process to reduce the complexity of the system, and alleviate the administrative burden.

Under the current methodology, Commonwealth payments, such as specific purpose payments and national partnership payments, are taken into account when the Grants Commission determines the carve up of the GST, despite generally being tied to expenditure priorities set out by the Commonwealth Government. The inclusion of Commonwealth payments in the equalisation formula, however, is not uniform, with around one third being excluded for various, somewhat arbitrary reasons. This adds to the complexity of the methodology.

While Commonwealth payments are not directly subject to equalisation, their place in the equalisation process means that they actively impact on the distribution of GST revenues. Upon the calculation of the various budget relativities, a "Total requirement for Commonwealth payments" figure is determined, where the included Commonwealth payments are subtracted from in order to determine the need for GST grants to top up the state's fiscal capacity. This seems counter-intuitive, as Commonwealth payments are generally 'tied' and do not allow for state discretion in expenditures, yet they impact on the amount of untied revenue a state receives.

Removing Commonwealth payments from the equalisation process will also reduce the administrative burden across all levels of government, as payments will not be subject to "double-handling". Under the current methodology, payments are in essence allocated twice, assessed initially on a pure needs basis by the Federal Government and then a second time by the Grants Commission via the GST distribution methodology. By excluding Commonwealth payments from the equalisation process, the CGC will cut out one of the most complex and time consuming parts of the formula, while also reducing the administrative double-up created as a result of including these in the equalisation methodology.

Table 2
Royalty Discounting
Impact on total grants of 50% royalty exclusion

	NSW	Vic	Qld	WA	SA	Tas
Pre-discount Relativity	0.9863	0.9624	0.8289	0.6515	1.2874	1.6596
Post-discount Relativity	0.9434	0.8807	0.9344	0.9259	1.1989	1.5247
Pre-discount Total Grants	$13.2bn	$9.8bn	$6.9bn	$2.7bn	$3.9bn	$1.6bn
Post-discount Total Grants	$12.6bn	$9.0bn	$7.7bn	$3.9bn	$3.7bn	$1.5bn
Difference	-$0.6bn	-$0.8bn	$0.9bn	$1.2bn	-$0.3bn	-$0.1bn
Percentage of Total Revenue	-1.0%	-1.9%	2.2%	5.3%	-1.8%	-2.8%

Source: CCI Analysis, based on data contained in the 2010 Review of Fiscal Capacities

Options requiring further analysis

There are also a number of reform options that may be presented, but would require further examination from the Grants Commission. These options may require changes to the system of fiscal federalism in Australia that aren't necessarily possible under the current Terms of Reference, but could potentially represent improvements to the overall framework with further analysis.

Removing territories from the equalisation pool

The Canadian model of fiscal federalism, although quite different to Australia, equalises the fiscal capacities of its three territories using funding outside of the pool used to equalise provinces (the Canadian equivalent of states) in recognition of the fundamental differences in capacity between the two. This could be an option for Australia, with equalisation funding for both the ACT and Northern Territory provided by the Federal Government rather than the states, recognising that these two jurisdictions have limited ability to fund themselves in their current circumstances without outside assistance.

There are a number of ways this could be achieved, however the most simple would be to equalise the states from a state pool and provide the territories with their equal per capita level of GST funding. The Federal Government would then be required to top up the finances of the Northern Territory and, to a lesser extent, the Australian Capital Territory.

However, it is important that such an arrangement will not increase the overall tax burden. The Federal Government must conduct a review of spending programs to find additional revenue to top up the territories. While this would still indirectly involve a subsidy from the states, through the federal tax system, it will ease some of the pressure on the GST distribution arrangements.

Floors and ceilings

Another option for reducing the level of equalisation is to establish a floor on the headline GST relativity, which would work to ensure a state's relativity does not drop below a certain level.

However the process of establishing a floor would require careful consideration as to the longer-term impact on the way the GST is distributed. In order for a floor to work in a way which does not excessively distort the overall distribution of funding or make the system needlessly complex, a clear, well-defined process of establishing the floor must be developed. Otherwise, a relativity floor just risks making the system more complicated.

Forward-looking recognition of investment needs

The current process for examining investment requirements must be reformed, to ensure the needs of fast growing jurisdictions with high infrastructure requirements are met. If infrastructure needs are to be included in the equalisation process, an assessment should be developed which takes into account the economic value of developing new public assets.

Introducing a measure of economic activity, such as gross state product growth, may assist in determining forward-looking investment requirements. The development of state infrastructure plans may also help in this regard. However, introducing forward-looking investment needs into the equalisation process may prove problematic, due to the subjective nature of investment decisions in the context of a fixed pool of funding. This may create perverse incentives for states to game against the system, which would be against the best interests of the federation.

Cost equalisation

Under the current Grants Commission methodology, expenditure equalisation is by far the most complicated and technical component of the formula. However, it is acknowledged that cost differences can have some impacts on equity within a federation, and if large enough, should be considered in the design of a horizontal fiscal equalisation system.

If cost equalisation is to continue, it must be done in a simpler fashion, taking into account high level demographic and cost differences rather than the fine level of detail currently used in the assessment of state capacities. This would involve an assessment along similar lines as now, but rather than focussing on teasing out every difference in capacities possible, broader, less focussed compensation should be provided to those states with clear, easy to distinguish differences, such as low population density or high relative wages, that actually impact on what states spend.

Reform incentives

The nature of the GST distribution process as a closed pool of funds provides an opportunity to provide a framework for states to compete for revenues. One option to improve the efficiency of the system may be to link GST revenue to economic reforms. However, including effective conditionality on GST grants may work against state autonomy, as states would have to meet certain benchmarks which would likely be set at the federal level, in a sense tying these grants to various expenditure outcomes. As such, including reform incentives in the equalisation methodology would have to be careful to avoid this outcome.

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