GST Distribution Review

Tasmanian Government Submission in response to the First and Second Interim Reports

July 2012

Tasmania
Explore the possibilities

KEY POINTS

- Horizontal Fiscal Equalisation (HFE), as practised in Australia, has been shown to be robust and fair. This view is borne out by the Review Panel's findings in its Interim Reports, which make it clear that there is not much wrong with the current arrangements. It is also supported by previous reviews.

- Tasmania accepts that there is room for refinement and improvement in the way HFE is implemented in Australia, but there is no compelling case for mandating significant change. Such improvements should be made within the current construct of HFE through the normal Commonwealth Grants Commission (CGC) methodological review process. Tasmania suggests that the Review Panel's final report should be conveyed formally by governments to the CGC for active consideration, with a view to making the recommended changes where consistent with the HFE principle and related elements of their methodology.

- The overriding principle of the GST Distribution Review (the Review) should be the achievement of equity – that is, state governments should be given materially equal capacities to provide services and infrastructure to their residents.

- For this reason, Tasmania does not support:

  - recommendations that fundamentally dilute the HFE system such as proposals to equalise to a discounted, minimum or external standard;

  - suggestions that HFE be used to achieve other exogenous policy objectives, such as tax reform;

  - any other recommendation that substantially complicates and overburdens HFE, reduces transparency, involves contentious judgements about desirable policy, and materially undermines the purpose of a federal system of government;

  - initiatives which place constraints or conditions on the untied nature of the GST funding pool; and

  - the concept of a reward pool to assist States to improve efficiency, particularly in light of the Review Panel's stated lack of conviction that efficiency concerns provide grounds for radical changes to the HFE process.

- For the same reason, Tasmania welcomes the Review Panel's conclusions about the undesirability of using the GST distribution to penalise states for increasing their mining royalties and agrees that the appropriate solution is for the states and the Commonwealth to negotiate a sharing of the royalty base.

- Tasmania supports the Review Panel's vision for multilateral cooperative tax reform, with GST effects explicitly dealt with as part of the reform process (if necessary) and fiscal benefits shared between the states and the Commonwealth.

- Tasmania does not believe it necessary or practically possible to separate responsibility for defining HFE from the responsibility for implementing HFE (that is, through the CGC). However, the objectives of the GST distribution – which guide the CGC's role - should always sit with governments.

INTRODUCTION

Tasmania once again welcomes the opportunity to contribute to the GST Distribution Review (the Review), as it has always been willing to argue the merits of the current principles and practice of Horizontal Fiscal Equalisation (HFE) in Australia against the alternatives.

Tasmania has always considered HFE, as practised in Australia, to be robust and fair. This view has been borne out by the Review Panel's findings in its Interim Reports which make it clear that there is not much wrong with the current arrangements. This has also been supported in previous independent reviews which have been conducted from time to time.

The instigation of the Review was driven by the complaints of some states that the current system of HFE is not "fair". The Review Panel was appointed as an independent body to examine these allegations.

Tasmania strongly supports the Review's preliminary conclusions that, while there are some discrete issues that could be addressed, overall the system of HFE is performing appropriately.

In relation to HFE and efficiency effects, even for mining, the Review Panel found little hard evidence to support material efficiency effects on state decision making with respect to the willingness of states to undertake reforms, disincentives for reform, or states "gaming" the equalisation system by making policy choices for specific tax reforms that would result in favourable GST treatment.

Given this, Tasmania is very concerned about the Review Panel's conclusion that it considers that "all practical options to reduce or eliminate" these effects must be explored.

Tasmania considers the real problem behind the instigation of this Review is perception and vested interests, not HFE. That is, this is essentially a political argument by vested interests, but the noise it has generated has created the perception of the need for change, specifically that something needs to be seen to be "done" about the current HFE system.

Tasmania accepts that there is room for improvement in the way HFE is implemented in Australia. However, these improvements can be made within the current construct of HFE through the normal Commonwealth Grants Commission (CGC) methodological review process.

There is no compelling case for significant change.

Further, interfering with an HFE system which is not "broken" poses significant risks for the Australian Federation.

That Australia can be characterised as a stable, integrated political, economic and fiscal union, in contrast to the European Union, is in no small part due to the role that HFE performs at the state level.

In the absence of the current comprehensive system of fiscal transfers to support financially weaker states, the same disparity of performance that is evident in Europe could be expected to develop between Australian states, with the consequent social unrest and political turmoil.

Tasmania welcomes in this context the Review Panel's recognition of the importance of HFE to the Australian Federation and the role that it plays in addressing the ongoing needs of fiscally weaker states.

Tasmania considers that the overriding principle should be the achievement of equity – that is, state governments should have materially equal capacities to provide services and infrastructure to their residents.

Tasmania strongly opposes suggestions that future HFE arrangements be based on a lesser form of equalisation, or used to achieve other exogenous policy objectives, such as tax reform. This would substantially complicate and overburden HFE, reduce transparency, involve contentious judgements about desirable policy, and materially undermine the purpose of a federal system of government.

Tasmania has previously provided detailed submissions to the Review Panel's two Issue Papers. These earlier submissions contained detailed arguments on issues raised in both the first and second Interim Report. The focus of this submission is not to cover old ground but instead to respond specifically to issues where the Review Panel has explicitly indicated that it is seeking further comment on areas of concern to Tasmania.

RESPONSE TO SPECIFIC ISSUES IDENTIFIED IN THE INTERIM REPORTS

(1) Mining revenue assessment and the treatment of mining costs

The Review Panel indicated in its first Interim Report that it is not inclined to recommend excluding mining revenue from equalisation. Tasmania strongly endorses this preliminary conclusion. Mining revenue is an important source of revenue to state governments in the same sense as other revenue sources such as conveyance duty or payroll tax. That some states have larger resource endowments than others is simply a gift of geography and not a reason to exclude this revenue from equalisation (notwithstanding mining–specific assessment method issues discussed below).

However, the Review Panel has indicated that it is sympathetic to claims of the resource states that the current mining revenue assessment approach is seriously flawed (specifically the current two-rate structure and the apparent absence of recognition of mining-related infrastructure and non-infrastructure costs which underpin realisation of this revenue).

In this context, the Review Panel has sought further advice on: the disability that is not currently being recognised; the costs faced by the resource states because of this disability; and, whether a policy neutral method could be devised to account for this.

In the event that a policy neutral approach is unable to be devised, the Review Panel has flagged it would consider recommending alternative approaches, such as: discounting the mining revenue assessment; excluding some mining revenue; or, temporary use of the part of the GST pool to address established but unmeasured needs for mining related expenditure and infrastructure.

Tasmania accepts the argument that there is scope for changes within the current HFE system with respect to the treatment of mining. It supports, in this context, the Review Panel recommendations for review of the existing mining treatment (both the two rate structure and the treatment of mining-related expenditure).

If there is material mining-related expenditure that is not currently assessed, Tasmania agrees, in principle, that a means of bringing this expenditure within the CGC's assessments should be devised, if possible.

This is strongly preferred to the alternatives suggested by the Review Panel of discounting, or removing, mining revenue from the assessment, either of which would compromise the internal integrity of the current HFE process.

However, the onus is on the resource states to document the infrastructure and non-infrastructure related mining development disabilities incurred that are not already appropriately captured within the existing HFE system. It is noted that the resource states were unable to substantiate these claims in previous CGC methodological review, which is why the CGC does not currently assess these expenditures.

(2) Treatment of Commonwealth payments for infrastructure

As a general principle, Tasmania considers that equalisation is best served by inclusion of all Commonwealth payments, including capital payments, to the extent that the Commonwealth funding effectively substitutes for State Government funding in an area of assessed needs.

However, Tasmania considers that the equalisation of large one-off capital payments since the 2010 Review is creating equalisation issues due to the "lumpy" nature of such payments.

The issue can best be illustrated by considering the case, under the current methodologies, of a large capital grant for a major development, such as a hospital which may be a one in say 50 year investment. The current methodology can significantly reduce recurrent capacities in the years immediately following the receipt of a large Commonwealth capital grant such as this. Exactly this situation has occurred in Tasmania. At the same time as a substantial reduction in GST revenue estimates due to pool increases not meeting expectations, Tasmania received a reduced relativity outcome driven largely by the treatment of capital grants from the Commonwealth for the Royal Hobart Hospital (as well as economic stimulus funding). While this has a very significant impact on Tasmania's recurrent budget capacity in the immediate years following the grant, if the objective is to equalise the capacity to provide services over time, the capital grants should be amortised over the economic life of the asset, and this amortised amount – rather than the capital amount – should be reflected in the relativities.

Therefore, Tasmania is open to considering modifications to the way that large one-off Commonwealth payments are treated within the CGC's assessments.

The Review Panel's proposal that such payments be assessed over a longer timeframe is preferred to the alternative proposal of excluding "nationally significant" payments.

Equalising capital payments over a longer timeframe, rather than as a lump sum in the year of receipt, could provide a constructive means to reduce single year impacts but would also give rise to new methodology issues. The instigation of a differing time frame for treatment of capital receipts would entail equivalent adjustments to the timing of capital expenditure recognition requiring method changes with respect to the current capital treatment to maintain internal system integrity. Transitional treatment issues also arise. For example, payments which are currently fully recognised in the (assessment) year of receipt, would need to be spread across a number of assessment years. This creates a disconnection between the past and future equalisation of

payments falling within this transitional time frame, potentially resulting in some states becoming under-equalised and others over-equalised in respect of these capital payments.

In Tasmania's view, the resolution of these issues, should be appropriately left to the CGC within the context of a methodology review.

With respect to the alternative proposal to systematically exclude certain payments, pragmatically, it is likely to be difficult to consistently and transparently identify payments for projects of "national significance."

Any process that seeks to quarantine some part of Commonwealth capital payments from equalisation (whether on the basis of "national significance" or other set criteria) will inevitably become a labelling target for any bilateral capital funding agreement, regardless of fitness for purpose or goodness of fit.

In this context, Tasmania considers that the Commonwealth Government is best placed to identify its policy intention when making a bilateral agreement for one-off capital funding with a given state and so determine whether an explicit instruction as to the CGC treatment of that payment needs to be made. Tasmania does not see a role for the Review Panel to determine systematic exclusion criteria.

(3) Simplification proposals

In relation to some of the more minor simplification proposals on which the Review Panel is seeking views, the proposal to freeze expenditure disabilities or not backcast data revisions between reviews may merit further consideration.

While having relatively minor impacts overall, freezing expenditure disabilities or not backcasting data revisions between reviews may lead to reduced year on year volatility in relativity outcomes. This may be prioritised as a desirable objective for state governments seeking to more accurately forecast their budgetary circumstances.

However, the countering argument is that the relativities, at least in principle, move in line with changes in states relative budgetary needs, such that, when taken as a whole, the revenue outcome is actually fairer and more predictable when relativities are allowed to adjust to reflect changes in circumstances.

In this context, Tasmania would not oppose minor elements being fixed between reviews where states were agreed that the resulting gains in terms of simplicity and predictability sufficiently outweighed the compromised equalisation outcomes.

The first Interim Report recognises a number of the practical difficulties with the donor-recipient model. Tasmania fails to see how adopting a donor-recipient model could achieve any meaningful simplification.

Past CGC methodology reviews have consistently rejected equalising major revenue and expense items only. The GST is provided as untied revenue to support provision of all state services. Equalising some components of service provision and not others is to impose partial equalisation arbitrarily.

While the rationale for this suggestion is presented as "simplification" what its proponents are really seeking to do is to limit the assessment of needs to areas where there is the greatest uniformity across states and hence limit the degree of GST redistribution.

From a simplification perspective, while it may result in reduced "moving parts assessed", a reduced scope makes the degree to which equalisation is actually achieved less transparent.

Tasmania considers that removing adjustments for tax differences makes little sense as a stand-alone recommendation, as at best it achieves arbitrary piecemeal simplification. States, with one or two exceptions, previously opposed this (2004 and 2010 Reviews) as not reflecting states revenue practice (for example, all states offer a small business payroll exemption).

However, in tandem with, for example, the adoption of a broader indicator there may be an argument that, in some circumstances, this could result in a more robust assessment of revenue capacity, where it replaces state-provided own source revenue otherwise considered subject to material data quality issues. This would need to be assessed on merit within a case-specific context.

Arguments advanced in support of broad revenue indicators include simplicity, policy neutrality and efficiency, as broad indicators are independent of state taxes actually imposed.

In terms of simplicity, the use of broad indicators within HFE would arguably 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. Conversely, Tasmania would argue that the state tax base approach, while detailed in its application, relies on a simple concept. Nor is the state base tax approach unique to Australia, but rather reflects the general conceptual approach to revenue equalisation in federations globally.

Further, as supported by the Review Panel's own conclusions within the first Interim Report, there is no convincing evidence that the current assessment of state revenue bases has any material impact on state behaviour, decision making or tax policy. Hence, there appears to be little justification to mandate the use of broad indicators on efficiency or policy neutrality grounds, since these will not deliver greater efficiency or policy neutrality.

At the practical application level, past history suggests that revenue and expenditure indicators which do not reflect states actual revenue raising capacities or expenditure needs do not engender confidence in the assessment outcome and, as a result, are not adopted.

The inherent zero-sum nature of the GST distribution encourages all parties to seek precision as a precursor to confidence in the fairness of the equalisation outcome. Relative to the state tax base approach, the fundamental problem with broad indicators is that they do not reflect states relative capacities to raise revenue, specifically the practical, legal and constitutional constraints that states face in accessing their implied tax base in combination with the interstate differences in industry structure (such as mining activity), income distribution, wealth or the extent to which non-residents pay state taxes.

Pragmatically, since at least the 1999 Review, each CGC methodology review has evaluated options for broader indicators to replace state own source revenue bases with mixed results. Typically, this comes down to a judgement as to the better of two "second-best" alternatives within the given revenue category context.

Past reviews have canvassed a range of broad revenue measures, including: gross state product; household disposable income, ABS housing finance data, and elements of business income as alternatives to current or past revenue bases in use.

Broader tax measures have been adopted within individual revenue categories where these have been found viable (for example, the ABS compensation of employees data is now used within the payroll tax assessment and household disposable income was used in the gambling revenue assessment prior to the 2010 Review). However, other measures, such as the use of ABS housing finance data as an indicator of conveyance duty revenue capacity have previously been rejected as less reliable, on balance, than the state-sourced conveyance data.

Tasmania has previously documented its concerns with gross state product as a broad indicator of revenue capacity, most specifically for small states (refer the Tasmanian Government Submission in response to the Supplementary Issues Paper, March 2012, pages 11-12).

As previously documented, the use of gross state product as a broad indicator of revenue capacity would result in materially different revenue capacity assessments for a number of jurisdictions relative to the existing assessments. As a statistical measure, gross state product is unreliable, particularly for small states; it is also highly volatile as it is subject to frequent and material revisions. As a number of other potential broad indicators (for example, total factor income, household disposable income) also derive from the ABS national accounts, it is probable that they too share at least some of these data deficiencies, particularly in relation to the smaller states.

Finally, the use of broad indicators within a global context 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 event that there were significant errors in broad indicator data, these could affect the entire revenue assessment, moving the outcome even further from the appropriate equalisation outcome.

Tasmania notes the specific suggestions put forward, for example, by Commonwealth and Queensland Treasuries regarding an "economic incidence" or "economic base" approach to revenue assessment; or the proposal by ACT Treasury to target a broader indicator approach within the stamp duty on conveyances and mining assessments.

Tasmania is open to considering all such suggestions on their merits. However, we consider that the CGC review cycle is the appropriate avenue to address all such suggestions in a rigorous targeted way from within the existing framework, rather than ex-ante mandating a holistic change of approach to address what are fundamentally discrete issues within a robust system.

(4) Equalisation to a "substantially similar" rather than the "same" standard

Tasmania does not support any Review Panel recommendation that would seek to fundamentally change the HFE construct.

Proposals to equalise to a standard other than "materially the same" standard, such as a discounted standard, a minimum standard or an external standard, would fundamentally change the HFE construct.

In the IGA, the states agreed to give up a range of state taxes in exchange for access to the GST pool to be distributed on the basis of HFE, understood to be equalisation to "the same standard", not differential standards. Importantly, this was not only a feature of the original IGA signed in

1999, but the revised IGA signed in 2008, after significant consideration was given to the meaning of the IGA provisions in the CGC's 2004 Review. The efforts of vested interests to now change that contract to one where not all states would be equalised to the same standard would result in an effective breach of that contract.

Arguably, HFE already equalises to a "comparable" standard, rather than the "same" standard, due in part to the practical limitations inherent in the data available to the CGC to assess HFE needs, particularly since the 2010 Review introduction of materiality thresholds and stronger reliability criteria.

The current standard based on the mathematical national average of what states do, provides a simple, unambiguous standard measure which is easy to calculate and apply.

The basis for the Review Panel's suggested move to a lesser standard in its first Interim Report appears to be rooted primarily in a desire to address the perception of efficiency and reform disincentives in the current HFE assessment approach, rather than a material real issue.

However, even for mining, the Review Panel found little hard evidence to support material efficiency effects on state decision making, either with respect to: "capacity" effects (willingness to undertake reforms/disincentives for reform); or, average policy effects (states "gaming" the equalisation system by making policy choices for specific tax reforms that will result in favourable GST treatment).

In the specific case of mining, the circumstances may justify specific consideration, but the real problem in relation to efficiency and reform incentives is perception and vested interests, not HFE.

Nor can the adoption of a lesser standard be justified by reference to simplification or greater confidence in the HFE outcomes.

Adoption of a minimum standard or an external standard is likely to be more complicated raising questions such as: Who sets the minimum? How do you then measure relative needs? It is also likely to be: far more controversial, giving rise to another area of contention in an already contentious field; contribute to greater uncertainty; and result in material increases in resourcing effort.

For example, Victoria and Queensland have both argued that the minimum standard could be set to reflect the revenue or expenditure practice of the lowest taxing or spending state. Victoria reasoned this would encourage reform and improvements in productivity while Queensland argued this would result in an increased level of policy neutrality.

In reality, a minimum standard would undermine the conceptual basis of HFE. Implicitly, these minimum standard arguments are premised on the presumption that the lowest tax or expenditure policy reflects "efficient" best practice. However, a state can be the lowest taxing or lowest spending state within a particular category due to policy choice, higher revenue capacity or endowments, and/or lower expenditure needs. There can be no presumption that this reflects efficiencies or that it will generate incentives to create efficiencies or stimulate reform. Rather what it is likely to do is severely complicate the assessment of disabilities as the "standard" set by a single state becomes an additional point of contention.

Logically, this is likely to contribute to increased distrust, rather than increased confidence in the equalisation outcome. Similar issues arise with respect to an "external standard".

Justifying equalisation to a lesser standard by reference to earlier pre-GST practices, or as practised in some other federations, is also inappropriate to Australia's current circumstances.

The national GST pool is sufficiently large that both HFE and vertical fiscal imbalance (VFI) can be accommodated on a full equalisation basis within that pool. This is not the case in other federations and this places practical limitations on the degree to which equalisation has been able to be realised. Such an impediment is not currently present in Australia. The fact that some other federations equalise some states to a lesser standard than others reflects the particular circumstances of those federations.

(5) Incentives or disincentives to be built into the future GST distribution?

Tasmania does not believe that HFE should be burdened with other objectives such as efficiency, with incentives and/or disincentives built into the GST distribution.

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 government to deliver policy in line with its residents' preferences, defeating the purpose of a federal system of government.

If the Commonwealth and all states agree that a particular policy objective is desirable, this can and 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.

In relation to the Minerals Resource Rent Tax (MRRT) and the Petroleum Resource Rent Tax (PRRT), Tasmania welcomes the Review Panel's conclusions about the undesirability of using the GST distribution to penalise states for increasing their mining royalties and agrees that the appropriate solution is for the states and the Commonwealth to negotiate a sharing of the royalty base.

The specifics of how this is achieved (or not) will be a matter for Commonwealth-state negotiation, although it is important to note that states will want to retain some degree of policy flexibility in relation to their royalty base.

Tasmania is open to considering incentives for tax reform based on sharing of fiscal benefits, as part of any cooperative, multi-jurisdictional tax reform. There is past historical precedent for this both in relation to the national competition payments and the *A New Tax System* (ANTS) processes.

The Review Panel's vision for multilateral cooperative tax reform, with GST effects explicitly dealt with as part of the reform process (if necessary) and fiscal benefits shared between the states and the Commonwealth, accords with Tasmania's internal position on multilateral cooperative tax reform.

However, Tasmania is opposed in principle to any initiatives which place constraints or conditions on the untied nature of the GST funding pool.

The original Terms of Reference for the Review clearly state that the GST is to remain untied funding to be distributed on an HFE basis.

The Review Panel has argued in relation to multi-lateral cooperative state tax reform, that tax reform incentive initiatives linked to the GST distribution would not compromise the untied nature of the GST funding.

However, currently GST revenue is untied revenue in two senses - there are no conditions placed on either its receipt or on how it is spent. The Review Panel's specific proposals for modifying the existing revenue assessments or delaying some GST payments would make the GST receipt conditional. Tasmania does not support such an approach and is not comfortable about the precedent this would create.

Tasmania rejects the concept of a reward pool to assist states to improve efficiency (whether in relation to multilateral tax reform or more broadly), particularly in light of the Review Panel's stated lack of conviction that efficiency concerns provide grounds for radical changes to the HFE process.

(6) Governance and communication issues

The Review Panel has indicated that it sees merit in separating responsibility for determining the objectives of the GST distribution and the definition of HFE from the responsibility for interpreting and implementing HFE.

Tasmania does not believe it necessary or practically possible to separate responsibility for defining HFE from the responsibility for interpreting and implementing HFE (that is, through the CGC).

As previously argued, Tasmania supports the current governance arrangements underpinning HFE (refer the Tasmanian Government Submission in response to the Issues Paper, October 2011, page 15). The CGC is the appropriate, independent body, with responsibility for recommending to the Commonwealth Treasurer state GST relativities. The CGC performs this important role, free from the biases, vested interests and uninformed perceptions, such as were part of the reasons for instigating this review. As an independent Australian Government authority it has an interest in securing arrangements that are the best interest of the nation as a whole, and does not have a vested interest in the outcome, in the way that states do.

However, the objectives of the GST distribution – which guide the CGC's role - should always sit with governments. This has been the case historically and should continue to be the case.

Tasmania is broadly supportive of the Review Panel's other suggestions with respect to an ongoing periodic review panel and strategies to better communicate the GST distribution objectives and outcomes to assist a broader community understanding.