



**South Australian Government
Response to the GST Distribution
Review Interim Reports**

July 2012

SA Government Response to the GST Distribution Review Interim Reports

1. Introduction

The Government of South Australia strongly supports a system of full fiscal equalisation as required by the terms of reference which state that the Review must be guided by the principle that *‘jurisdictions should have equal capacity to provide infrastructure and services to their citizens.’*

The current, comprehensive, system of fiscal equalisation in Australia is a fundamental strength of the Australian federation, which is a fiscal union as well as a monetary union. As explained by the Review Panel in its First Interim Report,

“States such as Western Australia demanded compensation for the costs they incurred from high external tariffs and other protectionist Commonwealth policies. Today, the strong demand for Australia’s mineral resources means that other industries and regions (such as South Australia) are facing increasing competitive pressure from an appreciating exchange rate”.

As we stated in our first submission:

“Any move away from full equalisation transfers would result in the South Australian economy being exposed to the adverse consequences of currency appreciation without receiving an appropriate sharing of the benefits of the terms of trade boom.”

The common criticisms which are mounted against HFE reflect a misunderstanding of both the objectives and impacts of equalisation. HFE is not detrimental to national economic growth, and does not undermine incentives for States to pursue growth enhancing reforms. Indeed, as demonstrated in the Independent Economics Report titled “Horizontal Fiscal Equalisation: Modelling the welfare and efficiency effects”, the welfare of all Australians would be diminished by any move away from a comprehensive system of fiscal equalisation.

South Australia’s two main concerns with the interim report are:

- the canvassing of a proposal to change the objective to delivering comparable (rather than the same) capacity, and
- the canvassing of the proposed use of “broader” indicators to assess capacity.

Both proposals would generate inferior outcomes when assessed against the objectives of equity, efficiency, simplicity and transparency. There is no dynamic efficiency benefit to be obtained from the use of broader indicators. States with tax-free thresholds for small business or multiple duty rates applying to different values of transactions for stamp duty on conveyances will not move towards a system with only one tax rate if the assessments are changed. It will simply create windfall gains for some states.

South Australia is not opposed to any change in the operation of HFE. There is room to potentially improve the current assessment system in some areas, but any changes must preserve the integrity of a **full** equalisation system.

2. Comparable versus same

*The Panel is investigating whether providing **comparable** capacities for States would be an approach more suitable to current challenges than providing materially the **same** capacities. The Panel has invited submissions on how this concept might be accurately described and effectively implemented¹.*

2.1 Clarification of the context of 'a comparable standard'

The aim of the GST distribution process

The Queensland Government's submission states that '*the aim of the GST distribution process is not precisely clear*'.

The evidence presented for this proposition is an alleged difference between the descriptions used by the Australian Government, the CGC and the Terms of Reference for this Review.

This statement is incorrect.

The aim of the GST distribution is the achievement of Horizontal Fiscal Equalisation. HFE is:

State governments should receive funding from the pool of GST revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency².

The objective of HFE is to advance horizontal equity (i.e. equal treatment of equals), as between households and firms across Australia insofar as that would be otherwise prevented by differences in fiscal capacity of state governments.

Proposed aim

The Queensland Government's submission proposes that the Review could clarify the aim of HFE *by adopting an aim consistent with that used by the Australian Government in 2011*. The submission then proposes that the aim should be *to provide the necessary budget support so that all states have the capacity to provide services at a comparable standard*.

The submission states that the different approaches of the CGC and the Australian Government *seek quite different outcomes*.

This is an invention.

The reference to the 'Australian Government' is in fact a reference to the second paragraph of a sequence of three paragraphs on p. 106 in Budget Paper No3 2011-12, the full text of which reads as follows:

The Commission recommends that GST revenue sharing relativities to be used in calculating each State's entitlement of the GST pool. The relativities determine how much GST each State receives compared with an equal per capita share and are

¹ Pg 23, GST Distribution Review, Interim Report, March 2012

² http://www.cgc.gov.au/fiscal_equalisation/key_information

determined such that, if each State made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each State would have the capacity to provide services and the associated infrastructure at the same standard.

This does not necessarily result in the same standard of government services – just the equalisation of each State’s capacity to provide the same standard of services. In calculating the GST relativities, the Commission takes into account differences in the State’s capacity to raise revenues and differences in the costs the States would incur in providing infrastructure used to deliver those services.

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

In the first and second paragraph of the three, the ‘Australian Government’ clearly refers to equalisation to the *same* standard.

It is then pointed out in the second paragraph that providing the capacity for the same standard does not necessarily result in the same standard of government services. Some states may prefer a higher or lower standard of services, for example, with commensurately higher or lower taxes.

Actual standards are nevertheless likely to be ‘comparable’ because individual state community preferences are likely to be similar.

Review First Interim Report

In Chapter 1 of the first Interim Report, a number of quotes from State submissions are assembled in the sub-section *The goal of the current HFE process (part of Section 1.3 entitled How does HFE apply in Australia?)*. Sub-section 1.3 concludes with the above statements from the Queensland submission, apparently taken as fact that there are differences between the Australian Government and the CGC to resolve.

But there are no such differences to resolve.

2.2 South Australia's views on comparable versus same

The Panel states at the end of Chapter 1 that it is investigating whether providing comparable (rather than same) capacities for States would be a more appropriate objective for HFE as practiced in Australia.

South Australia takes this to imply a significant shift in the objectives of the GST distribution, representing a deliberate departure from a full equalisation outcome (as distinct from the “best endeavours” approach to delivering same capacity as currently applies). Otherwise why would the proposal be floated?

The Review Panel states in its First Interim Report,

“Australia currently adopts an approach that is closer to ‘full’ equalisation than any other country. Australia’s approach to equalisation can be considered ‘full’ in two ways. First, it seeks to equalise States to materially the ‘same’ capacity—it does not merely seek to act, for example, as a safety net bringing weak States up to a

*minimum standard. Secondly, it is broad in scope (including revenues, expenses, and capital) and deep in detail (in each of its assessments).*³

South Australia vehemently opposes any move away from the principle of **full** horizontal fiscal equalisation and away from a system that provides equalisation of net fiscal benefits. 'To provide comparable capacities' has no clear, unambiguous meaning so any adoption of this concept must imply a watering down of HFE – or as the Western Australian Treasurer so aptly put it - be the first nail in the coffin of HFE.

South Australia reiterates the point made in its first submission that full HFE is vital to the healthy functioning of the federation and support for a rational approach to the division of roles and responsibilities between the Commonwealth and the States. If there is a motivation for equality in access to Government services across Australia a dilution of HFE may prompt or trigger proposals for greater Commonwealth intervention in funding or even delivery of services which are the responsibility of the States (eg greater use of tied funding).

With full and reliable HFE the resolution of various questions about the role and responsibilities of states and the Commonwealth can be considered on their merits. If there is a case for local administration, a State community with relatively large demographic or socioeconomic needs should be comfortable with the notion that states rather than the Commonwealth have responsibility for the provision of services. Full and undiluted HFE is both pro equality and unequivocally supportive of the role of State governments.

South Australia questions the purpose of this proposal and asks what could it achieve that is in any way better than the full equalisation system that we have at present? The question is assessed below in respect of the key criteria of equity, efficiency, simplicity and predictability/stability which the Review is required to take into account.

- *It would not improve equity*

The principle of Horizontal Fiscal Equalization means that like should be treated alike within a federation or nation, and, all else being equal, citizens should be provided the same level of services.

A significant shift in the objective of HFE away from delivering equal capacity would mean that citizens who were otherwise equal would be disadvantaged according to where they live. While State policy differences can result in citizens in different States having different access to services currently, the outcome is based on deliberate choices by the electorate.

Wilson (2007) states,

“In a unitary state residents are treated equitably by the state with like residents paying the same taxes and receiving the same levels of public goods and services. This may not be the case in a federation, where sub-federal levels of government are likely to differ in their abilities to provide such goods and services. A system of equalisation transfers is necessary to ensure that like people are treated in a similar fashion by the government.”⁴

³ Pg 7, GST Distribution Review, Interim Report, March 2012

⁴ Pg 340, “Macro formulas for equalization” by L.S.Wilson, in *Intergovernmental Fiscal Transfers – Principles and Practice* edited by R. Boadway and A, Shah, The World Bank, 2007

Victoria, NSW and Queensland, respectively, state in their submissions to the GST Distribution Review that,

“the goal of making sure individuals are not disadvantaged has been superseded to a large degree by the federal welfare and tax systems” (Victoria),

the current system *“.....seeks to achieve full equalisation of state governments fiscal capacities.... This contrasts with the income tax/welfare system in Australia which aims only to moderate the income distribution of individuals”* (NSW), and

“Additionally, in no area of Australian public policy does a desire for absolute equality of outcomes override all other considerations. Governments do not provide identical levels of services to every resident. The tax and transfer system does not equalise net incomes for all Australians. This is because other objectives — efficiency, fairness, simplicity — need to be taken into consideration to produce an optimal outcome” (Queensland).

The quotes from the Victorian, NSW and Queensland Governments’ submissions either deliberately or mistakenly confuse or obscure the equity case for HFE. HFE delivers horizontal equity, that like should be treated alike. For example it ensures that there is a capacity to provide the same access to public health services to otherwise identical individuals who live in different States. It is not about distributing between the rich and the poor, which is vertical equity. If vertical equity were at stake there would be legitimate differences of opinion about how much equity is desirable. However, this is not what HFE does. HFE ensures that no-one is necessarily disadvantaged because of their state of residence, just as the Federal Government does not subsidise prescription drugs at different rates depending on where someone lives. GST revenue is redistributed between the states and territories to ensure that Australian citizens are not disadvantaged because of the state in which they live. The goal of making sure individuals are not disadvantaged has not been superseded by the federal welfare and tax systems as some might propose.

If there were to be a move away from equalisation to the same capacity (as implied in the Panel’s finding) there would need to be an explicit recognition within the Federation of Australia that there are to be differences in the level of services that can be provided depending solely on a persons State of residence. As we stated in our submission to the Review,

“..... partial equalisation would represent an arbitrary approach, requiring some form of national compact as to the acceptability or desirability of jurisdictions not having equal capacity to provide the same standard of all services (and which services should reflect an equal capacity principle and which should not)”⁵.

Although HFE is about horizontal equity the motivation for horizontal equity is heightened by the fact that State services do contribute to the achievement of vertical equity. *In kind* social transfers are critical to the achievement of vertical equity. Box 1 highlights their importance in an Australian context. Through the P.B.S., the Australian Government subsidises the cost of prescription medicine, making it more affordable for all Australians. However, it is the States that provide most *in kind* social transfers such as public schools, hospitals and housing. HFE, however, does not establish the extent to which States pursue vertical equity objectives through such *in kind* transfers – it merely takes the average of what States do in this regard, and ensures that each State has an equal capacity to deliver services to that average standard.

⁵ South Australian submission to the GST Distribution Review, September 2011, page 7

The principle that individuals should not be disadvantaged because of the State in which they live can only be upheld if all State Governments have equal capacity to provide the same level of essential services to their citizens. This is why we still need a fair distribution of GST revenue. This is an outcome which has served the Federation well and should continue to do so.

Fiscal equalisation simply ensures that all States are placed on an equal footing in terms of what they actually do. It equalises for things which are out of the control of State governments.

The South Australian Budget currently suffers a relative disadvantage on account of a lack of mining resources, an older age population, relatively low socio economic status of our population, and the diseconomies of scale in service delivery faced by a smaller state.

HFE acts as a natural hedge to correct for those disadvantages and prevents South Australian tax rates having to be higher - or health, education and policing standards lower - than other States. The gap required to be filled would be \$1 billion per annum. Should circumstances change then the knock-on effect of HFE would be to reduce the amount of revenue redistributed.

Having some or all of that \$1 billion taken away through changes to the current equalisation system would be unquestionably inequitable, and it would also be inefficient if we had to increase taxes with the effect that some business would be driven out of the state or closed as a result.

- *It would be less efficient*

Wilson (2007) states that there is a second argument for the equalisation of net fiscal benefits,

“the notion that equalisation will improve efficiency. If equalisation is not maintained, factors of production (labor and capital) will have an incentive to move to provinces with the largest net fiscal benefits. Since these net fiscal benefits will not be related to productivity differences, factors may be misallocated”⁶.

The fact that equalisation will improve efficiency is demonstrated in the results from the Independent Economics modelling undertaken for SA which shows that migration decisions are most efficient when based on productivity and amenity and not distorted by fiscal incentives.

“In general, migration leads to the highest possible level of welfare when it is responding to underlying economic differences between states, such as a mining boom or differences in amenity levels. For example, if a state is experiencing a mining boom, then it would be beneficial for households to move there to earn a higher wage.

⁶ Pg 340, “Macro formulas for equalization” by L.S.Wilson, in *Intergovernmental Fiscal Transfers – Principles and Practice* edited by R. Boadway and A, Shah, The World Bank, 2007

Box 1

The OECD report *Growing Unequal? Income Distribution and Poverty in OECD Countries*, finds that, the reduction of income inequality from the publicly provided services of health, education and social housing is greater in Australia than the OECD average, as seen below in Table 1. In the Australia specific notes of the report it states, “...In Australia, publicly provided services in the health, education and social housing sectors reduce income inequality by more than in most countries. ”

The money income inter-quintile share ratio is calculated by dividing the fifth (highest) income quintile by first (lowest) income quintile. Australia has a money income inter-quintile ratio of 5.2, which is reduced to 3.7 once public services have been included. This means that, in Australia, the fifth quintile earns an income, augmented for the inclusion of public services, which is 3.7 times higher than that of the first quintile. The reduction in Australia’s inter-quintile share ratio of 1.5 is higher than the OECD average of 1.3. It is the provision of public health, education and social housing services by the States that makes such an important contribution to the reduction in income inequality in Australia.

Table 1. Inter-quintile share ratio before and after inclusion of public services

	Money (disposable) income	Income plus health, education and social housing services	Difference
Denmark	3.1	2.4	0.7
Finland	3.6	2.9	0.6
Sweden	3.6	2.6	0.9
Austria	3.6	2.8	0.9
Germany	3.7	2.9	0.8
Netherlands	3.7	2.8	0.9
Luxembourg	3.8	3.2	0.5
France	4.1	3.0	1.1
Belgium	4.1	3.2	0.9
Italy	4.9	3.2	1.7
Canada	4.9	3.7	1.2
Ireland	4.9	3.4	1.4
United Kingdom	5.0	3.5	1.6
Australia	5.2	3.7	1.5
Greece	5.7	4.1	1.6
Spain	6.0	4.1	1.9
Portugal	6.5	4.0	2.5
United States	7.1	4.6	2.6
<i>Average</i>	4.6	3.3	1.3

Source: *Growing Unequal?* OECD 2008

On the other hand, this report has shown that migration reduces welfare if it is simply responding to differences in the fiscal benefits in each state. For example, simply because there is a mining resource within its borders, a state can tax this resource and provide any given level of government services at lower tax rates. This would artificially attract migrants to a state with a large mining sector (per capita). This type of inward migration reduces welfare because greater labour supply in a state puts downward pressure on wages”⁷.

Hence a move away from full equalisation would result in migration of people and businesses in response to fiscal incentives which would be a less efficient outcome.

Proponents of less than full equalisation, display a fundamental misunderstanding of HFE in their submissions which deliberately ignore the efficiency argument for the equalisation of net fiscal benefits.

“A system which enables states to achieve identical service standards rather than comparable standards or a minimum standard can create efficiency costs without commensurate equity benefits.”⁸ (Victoria)

“There is little in the current HFE system to ensure that the pursuit of equity is not too great a cost to overall economic efficiency.”⁹ (NSW)

Full fiscal equalisation clearly contributes to economic efficiency systematically. As stated in the Independent Economics report,

“Whether or not prevailing circumstances give rise to a smaller or larger efficiency effect calculation from time to time, the continuing operation of full HFE clearly contributes to economic efficiency systematically. The effect on equalisation transfers from any departures from full HFE will be efficiency reducing (and adverse to equity in the standard analysis).”¹⁰ and

“To summarise, welfare is lower in all states if the current HFE system were changed to a system that distributed GST revenue on a modified EPC basis (i.e. equal per capita except for needs relating to indigeneity).”¹¹

- *It would not be simpler and less transparent*

The lack of clarity around a benchmark based on comparability would make the CGC’s job considerably more difficult and produce much greater potential for divisive argument among States in relation to assessments. At present the CGC works to a “materially the same”

⁷ Pg 46, Independent Economics, “Horizontal Fiscal Equalisation: Modelling the welfare and efficiency effects”, 16 February 2012

⁸ Pg 19, GST Distribution Review – Interim Report, March 2012.

⁹ *Ibid*

¹⁰ Pg ix, Independent Economics, “Horizontal Fiscal Equalisation: Modelling the welfare and efficiency effects”, 16 February 2012

¹¹ Pg viii, Independent Economics, “Horizontal Fiscal Equalisation: Modelling the welfare and efficiency effects”, 16 February 2012

standard. Who determines what comparable means? How is it measured – how comparable?

- *It would not be any more predictable and stable*

Indeed a comparable standard could be considerably less predictable and stable than the current system given the potential for the boundaries of comparability to be tested and shifted over time.

3. Methodological issues

Consistent with the views expressed in our initial submission, South Australia does not consider that the CGC methodologies and processes are unnecessarily complex given the magnitude and the importance of the equalisation task.

The Interim Report presents several criticisms of the current HFE methodology regarding complexity and proposes options that could be considered to simplify the process. The criticisms can be summarised as:

- the general view that the current methodology is overly complex; and
- the current process leads to “false precision” – including the interpretation of “what states collectively do” and “comparable” service levels as opposed to the “same” level of service.

In fact, there is no “false precision” in the CGC processes and no connection with “comparable” service levels. States still need to have equal capacity to deliver the same level of services in similar situations.

Complexity should not be confused with predictability. The latter could be enhanced and greater consistency in States’ budget estimates achieved through the development of an estimating tool that could be used by all jurisdictions. It is suggested that the Commonwealth Treasury should lead the development of the estimating tool and that it should form an agreed basis for State forward estimates of GST Revenue grants.

3.1 The current methodology is not overly complex

The 2010 CGC Review included a major simplification exercise that resulted in the CGC reducing the number of assessment categories from 59 to 26, recognised fewer influences on the cost and use of services, placed greater reliance on nationally based and independently sourced data and reduced the assessment averaging period from five years to three years.

The CGC responded appropriately to the simplification aims in the terms of reference for the 2010 Review but there is a limit on how far simplification can be taken without undermining HFE’s equity objectives. The CGC stated:

“The importance of capturing the inherent complexity of delivering services to a wide range of residents living in very different circumstances as well as differing abilities to raise revenue has constrained the extent to which simplification could be achieved”¹².

¹² CGC 2010 Review, Volume 1 – Main Report, page 8.

Less complexity should not be an end in itself. It is not clear that the degree of complexity in the current system has any specific adverse consequences for stakeholders. The amount of redistribution arising from the methodology should not be seen as bearing any relationship to the degree of complexity that is appropriate. The overall relativities are the result of numerous individual assessments which, for each jurisdiction, involve positive and negative transfers. Even if these assessments were exactly offsetting, for all jurisdictions, this would still justify the exercise because in the absence of the assessment we would not be able to conclude that the equal capacity objective has been achieved.

3.2 The current process does not lead to false precision – “what states do”

Some propose that the current process has created a sense of “false precision” or, in other words, attempts to capture “what states do” to an excessive level of detail without the necessary supporting data to support analysis at such a level.

Contrary to this position, South Australia believes that the “what states do” approach does not add to complexity but actually simplifies the approach for considering what revenues and expenditures should impact on HFE by having an objective benchmark.

If a “what states do” approach was not used, an alternative benchmark would be necessary (e.g. “what states should do” or minimum service levels) which would require a higher-degree of subjective judgement by the CGC and greater contestability in submissions by stakeholders.

This line of argument also leads some jurisdictions to the position that a move away from current approach of basing assessments on achieving capacity to deliver the “same” level of service to a “comparable” level of service would assist in simplifying the overall process.

As previously discussed, a move to “comparable” service standards would lead to increased subjectivity and the need for the CGC to exercise more judgement in the assessment process. The CGC would have to determine and define what comparable means in the context of HFE and this would ultimately undermine transparency and weaken the integrity of the HFE process.

South Australia recognises that in some expenditure and revenue assessments no suitable data is available, available data is not of sufficient quality to be relied upon or the distribution resulting from an assessment would be immaterial. This is also recognised by the CGC and one of their key roles is to assess the quality of data and make judgements about the use of data, especially when there are quality, scope and reliability issues. There are several examples of where the CGC has decided not to differentially assess a revenue or expenditure category, including gambling revenue, environmental protection expenditure, sport and recreation expenditure and cultural and linguistic diversity.

3.3 Other methodological issues

The first interim report raised a number of specific methodological issues that are discussed below:

- *Simplification of the capital assessment*

Although detailed methodology issues are matters best resolved by the CGC in the context of a contested process, South Australia notes that the Review is (possibly inevitably) delving into issues of methodology.

If simplification and transparency is to be the motivation of any of the recommendations of this Review then it is the capital assessment which warrants primary consideration.

The 'upfront' aspect of the capital assessment introduced in the 2010 Review constitutes primarily a population growth needs assessment. For example, higher population growth states such as Western Australia and Queensland were assessed for the 2012 Update as having needs as follows:

NSW \$m	Vic \$m	Qld \$m	WA \$m	SA \$m	Tas \$m	ACT \$m	NT \$m	Redistribution Amount \$m
-548.5	106.5	386.7	373.5	-220.8	-98.8	3.4	-2.0	870.2

Source: Table 7, pg 12, CGC Report on GST Revenue Sharing Relativities 2012 Update

As the Interim Report implies this assessment could be implemented much more simply. The standard budget framework could then revert to the more accessible and familiar operating statement framework that applied pre 2010. This framework is more relevant to state government service level provision,

This approach is compatible with the inclusion of capital grants either up front or over time. The key Commonwealth capital grants issue which this approach brings to light is whether all Commonwealth capital grants give rise to an actual net (interest) earnings benefit to a State government in future years.

The CGC is to be commended for the conceptual and intellectual breakthrough involved in the 2010 Review. It is in the nature of conceptual breakthroughs that it becomes apparent how the same results may be obtained more simply and transparently once the hard work is done. This seems to be the situation here.

- *Consequences of the lag*

The inherent lag in the system still substantially hinders actual equalisation. This means that mining revenues in their current growth phase are not being fully equalised. SA Department of Treasury and Finance estimates that, over the period 2005-06 to 2010-11, Western Australia has retained almost \$5 billion in monies that would have been redistributed if there was not a lag. Given the continued and strengthening growth in mining revenues it is likely that this windfall gain of \$5 billion will continue to increase over the majority of the forward estimates. Beyond the forward estimates, Queensland is likely to be the beneficiary. This issue was discussed in detail in our first submission.

- *Limiting relativity changes*

South Australia does not support either limiting relativities through placing a "floor" on relativities or limiting relativity changes. These are separate ideas and South Australia does not support either.

A floor on relativities would lead to a widening gap between Western Australia's per capita revenues and the other States' per capita revenues. It is total State revenue that should be the focus of State Governments, not just GST Revenue which is only one component of State Government revenue.

It is not clear whether the Review Panel is considering limiting relativity changes to limit changes to the GST share or to limit changes to nominal GST revenues. However, regardless of the intended target, limiting the downward movement of GST grants would only compound the contemporaneity problem.

- *Moving to a donor and recipient approach*

South Australia does not support any move towards a donor and recipient approach. As stated by the Review Panel in their first interim report, “...a donor and recipient approach will only prove workable if there is genuine consensus amongst states.”

It is not clear what a donor and recipient approach would entail. Western Australia refers to a situation “not affecting outcomes for non-participant States” but at the same time suggests that there be “A fixed split of the GST pool between the CGC-assessed States and self assessed States”. If recipient States needs were to grow relative to donor States over time the latter does not appear compatible with the former.

A re-adjustment of GST shares between donor states could occur now on a voluntary basis. If the approach was not voluntary there would need to be some form of negotiated compact or enforced view of GST shares. This would be inconsistent with horizontal equity.

If there was consistency over time in the proportion of GST to be distributed amongst donor states as a group, a ‘needs’ assessment would still be required to distribute GST revenue between the donor states so that the citizens of some donor states were not disadvantaged. The distribution system would need to be able to adapt to changing circumstances such as a faster aging population in some donor states. NSW is anticipating that their state’s aged dependency ratio will rise from 20.9 per cent in 2010 to 33.0 per cent by 2029. As the baby boomers retire NSW expects growth in their aged dependency ratio to increase from an average of 0.7 per cent a year over the last decade to 2.5 per cent per annum over the next 18 years¹³. If NSW’s population were to age at a faster rate than other donor States the donor recipient model would not recognise their growing needs.

South Australia is unable to accept that a donor recipient model is compatible with HFE, or able to adapt to the structural changes referred to in the Review’s Terms of Reference.

4. Broad indicators

The Interim Report contains several ‘options’ under the heading of simplifying the HFE assessment process that vary significantly in the degree of change from the current approach. These include freezing expenditure disabilities between reviews, simplifying certain assessments, adopting higher materiality thresholds, use of broader or global indicators, only equalising major revenue and expense items, partial equalisation for donor states and a move to equal per capita.

For several of the methodology simplification proposals put forward the Review Panel has correctly concluded that the CGC would be best placed to consider the merits and practical implications of such proposals. The Review Panel has, however expressed an interest in exploring the use of broad or global indicators. The Panel raised the possibility that the GST distribution process should be able to produce fair and reasonable outcomes more simply with the use of broader indicators to measure fiscal capacity and needs.

South Australia is opposed to the use of broader indicators where they do not reflect “what States do”. As we said in our supplementary submission, the use of broader indicators to measure revenue capacity is likely to simply create winners and losers without achieving any significant simplification, and at the expense of a less equitable and efficient HFE outcome.

¹³ Pg 2-11, NSW Long-term Fiscal Pressures Report – NSW Intergenerational Report 2011-12

The revenue assessments are not complex and there is no evidence that they impede incentives to engage in tax reform. South Australia sees no practical benefits from a shift in assessment methodology from one which is based on indicators of actual tax capacity to one which uses 'broader' or global indicators. The proponents of such a change have produced no evidence of any benefit.

Some states including Victoria and Queensland have suggested that broader indicators could be used in assessments. This view is not consistent with the views put forward by these jurisdictions in submissions during the CGC's 2010 Methodology Review.

In relation to revenue assessments, Victoria stated:

Victoria considers that actual tax base measures should be adopted as a first preference. These measures provide the closest measure of the entire tax base and most closely account for what states do. We consider broad indicators to be second best alternatives that should only be used where it has been proven that the actual tax base measure for a particular tax cannot be used due to unreliable or inconsistent data or excessive policy contamination.¹⁴

In its submission to the CGC's 2010 Methodology Review on proposed methods for revenue assessments, Queensland stated:

Queensland is concerned that some of the proposed changes to revenue assessments do not simplify the assessments or do so at the expense of achieving equalisation and transparency. In particular, some of the proposals use weights, adjustments or broad indicators that lack transparency and do not achieve equalisation.

Queensland believes that an appropriate approach is to use the current methodologies as a starting point and to improve or simplify the assessments by improvements to data quality and comparability.¹⁵

In relation to revenue, assessments based on actual collections that correctly reflect what States do ensure that HFE transfers respond to changes in the actual tax mix or actual tax design. Assessments based on actual collections will reflect revenue movements which might involve expansion or contraction of states' own source revenue as compared with Commonwealth grants.

The Review Panel canvasses the removal of tax-free thresholds or exemptions from tax capacity assessments in its first interim report.¹⁶ This would be detrimental to HFE as it would move HFE transfers away from being responsive to the actual tax mix or actual tax design. There is no dynamic efficiency benefit to be obtained from it - States with tax-free thresholds for small business or multiple duty rates applying to different values of transactions for stamp duty on conveyances will not move towards a system with only one tax rate. It will simply create windfall gains for NSW and

¹⁴ Submission to the 2010 CGC Methodology Review on proposed methods for revenue, native title, administrative scale and ACT and cross border issues, Department of Treasury and Finance, Victoria, July 2007

¹⁵ Queensland Treasury response to Commonwealth Grants Commission Staff Discussion Paper 2007/03-S Proposed Methods for Revenue Assessments, August 2007

¹⁶ Pg 49, GST Distribution Review Interim Report March 2012

Victoria in the case of the payroll tax threshold, and for NSW and Queensland in the case of stamp duty on conveyances.

In addition, it is not appropriate for the Review Panel to reach into the detail of particular CGC assessments and overturn a methodology decision that has already been made by the CGC. Value distribution adjustments for taxes with progressive tax structures were explicitly considered by the CGC as part of its 2010 Review under the terms of reference 4 (c)¹⁷, acknowledged in a footnote in the second interim report¹⁸. Terms of reference 4 (c) states:

“Having regard to the work progressed by HoTs after the 2004 Ministerial Council and providing that to do so is consistent with the principle of Horizontal Fiscal Equalisation, the Commission should consider developing other ways to simplify its assessments, including by reviewing the scope for the use of more general indicators of revenue capacity and expenditure need.”

In relation to global indicators, we stated in our initial submission that a ‘simplified global’ revenue assessment, possibly based on Gross State Product (GSP) or household income, is conceptually flawed and does not reflect what states do.

Since states do not actually tax GSP or household income, the outcome would depart from the achievement of equal per capita sharing of revenue raised plus states wearing the consequence of their own above or below average effort.

GSP includes corporate profits which States don’t tax. In addition, GSP could be growing at the same time as property transactions, which are taxed, are declining.

In the case of household incomes, States only tax labour incomes (not including Commonwealth employees) and do not tax retirement, investment, or farm incomes. Mining production remains taxed at source by the States whether or not some Australians receive investment income from mining companies.

The Commonwealth Treasury submission considered the grouping of revenue assessments. This could involve assessment of conveyance duty needs based solely on land values (and disregarding transaction volumes) or assessment of payroll tax needs based on ABS household income data.

Taking the payroll tax example, the use of ABS Household Income data as a proxy for the payroll tax base would produce arbitrary and random changes from the current assessment approach (largely based on the actual payroll tax base). Table 2 shows the impact to all jurisdictions for 2010-11 if the payroll tax assessment was based on ABS household income data. WA, Victoria and NSW would be advantaged by the change while SA, ACT, Queensland and the NT would be disadvantaged.

¹⁷ 4(c) Terms of Reference for the 2010 Commonwealth grants Commission Methodology Review, Pg (vi), Vol 1, Main Report, Report on GST Revenue Sharing Relativities – 2010 Review

¹⁸ Pg 14, GST Distribution Review Second Interim Report, June 2012.

Table 2: Determining payroll tax needs with household income – comparison with current methodology

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
2010-11								
Payroll Tax revenue (\$m)								
Population (m)	7,261	5,580	4,541	2,314	1,650	509	362	229
Household Income (\$pc)	41,041	38,269	38,317	44,277	38,893	38,025	65,971	45,875
Household Income Capacity	101.7	94.8	94.9	109.7	96.4	94.2	163.5	113.7
Payroll Tax Capacity	104.9	99.9	90.1	131.8	75.8	67.9	89.7	84.1
Payroll Tax needs (\$m)	-283.6	2.4	359.7	-588.6	320.2	130.7	30.0	29.3
Household Income needs (\$m)	-98.1	231.4	184.0	-179.8	48.0	23.6	-183.9	-25.1
Change (\$m)	185.5	229.0	-175.7	408.8	-272.2	-107.1	-213.8	-54.4

It is not evident what would be gained from changing the assessments to treat the states as if they were taxing household incomes. It is clear, however, that equalisation of fiscal capacity would be undermined and there would be large winners and losers, as shown in table 2. The shifts in GST shares would be arbitrary. They would represent a move away from equalisation, with all its attendant benefits, and with no other apparent gain. No dynamic efficiency incentive benefits necessarily arise, for either the winners or the losers, in relation to any reforms to payroll tax.

In summary, South Australia has not been able to ascertain any advantage from the proposal to use broad indicators to measure fiscal capacity. The proposal would generate inferior outcomes when assessed against the objectives of equity, efficiency, simplicity and transparency.

- *It would not improve equity*

The use of global measures such as household incomes would not improve equity because it confuses households' capacity to pay with States' capacities to raise revenues. As the tax bases available to States are not directly related to incomes then neither is their ability to raise revenues from them. Household income is only at best an indicator of the ability of States to raise revenue from residence-based taxes, not the ability to raise revenue from source-based taxes. A departure from assessments based on what states do would deliver less than full equalisation. It would therefore mean that individuals would be disadvantaged according to the state in which they live.

- *It would be less efficient.*

The broader indicators assessment proposal would not create greater incentives for tax reform. Irrespective of how the CGC assessments are handled, it is the lack of community acceptance of land tax applied to owner occupied housing that is the greatest obstacle to the substitution of conveyance duty with land tax. A move away from full equalisation would diminish the welfare of all Australians as indicated by the Independent Economics Report, "Horizontal Fiscal Equalisation: Modelling the welfare and efficiency effects".

- *It would not be simpler or more transparent.*

The current revenue assessments are not complex or numerous. The non-mining revenue assessments are the least complex assessments currently undertaken. South Australia continues to hold the position that simplification for sake of simplification should not be an overriding objective.

Commonwealth Treasury proposed in its submission to the Review¹⁹ that ABS estimates of gross household income by State be used to assess the relative capacity of each jurisdiction to raise revenue from insurance duty. Gross household income is an example of a proxy indicator that would reduce the transparency of the system as it ignores the significant contribution of commercial insurance in the tax base. SA Department of Treasury and Finance analysis of the 2009-10 Australian Prudential Regulation Authority (APRA) commercial and non-commercial insurance premium revenue data for States indicates that commercial insurance premiums accounted for 45 per cent of gross insurance premium revenue nationally, with the importance of commercial insurance premiums as a source of insurance revenue ranging from 38 per cent to 71 per cent, depending on the jurisdiction²⁰. Hence gross household income would not measure the relative capacity of jurisdictions to raise revenue from commercial insurance premiums.

- *It would not be any more predictable and stable.*

For some States such as South Australia gross household income is a more volatile data series than the ABS compensation of employees data because it includes farm income which is volatile. Moreover, the reliability and validity of the assessments cannot be improved through the use of proxy indicators when the actual statistics are available.

4.1 Expenditure assessments

South Australia does not expect that States will be able to identify how broad indicators can be successfully applied in expenditure assessments. In any event, it is appropriate that the Review should focus on the bigger picture, substantive methodological issues related to such areas as the expansion of the mining industry, population growth, population aging, economic efficiency and productivity.

Should other States identify broad indicators for expenditure assessments, South Australia will provide comments on their merits in a late submission.

Non delivery on broad indicators for expenditure assessments should not lead the panel to recommend broad indicators for revenue assessments.

5. Commonwealth capital grants

The Panel considers that equalising capital payments over a longer period would reduce the impact of capital payments on GST shares in any one year, without adding much complexity. The Panel notes that equalising capital payments over a longer period would be consistent with a capital assessment that also recognises States' capital needs over time.

There are two issues under consideration, firstly the time frame for the assessment of capital payments and secondly the treatment of capital grants by the CGC in their assessments.

The Review Panel has accepted the general principle that not including Commonwealth specific purpose payments in the needs assessment would undermine equalisation outcomes. South Australia agrees with this view. Governments should be cognisant of the GST impacts of Commonwealth payments when they are negotiating grants. Recognition of the impact of a new Commonwealth payment on the State's future GST revenues is part of

¹⁹ Pg 65, Australian Treasury, Submission to the GST Distribution Review, October 2011

²⁰ Pg 9, South Australian Government Submission to the GST Distribution Review Panel – response to the supplementary issues paper.

the due diligence process undertaken by the South Australian Government in its assessment of all new Commonwealth funding agreements. This ensures that all expenditure decisions within a State are consistent with State priorities. The appropriate recognition and treatment of Commonwealth funding for certain capital or infrastructure projects is the main area where further examination has been suggested.

It should be recognised that excluding Commonwealth payments will not necessarily reduce the volatility of States' GST revenues. A state's share of a smaller pool may be more volatile than its share of a larger pool and there will be instances where a state receives a larger share of a smaller pool than their population share. This will lead to a drop in the state's relativity. Inclusion of Commonwealth payments over time may minimise the variance from population share.

The Panel considers that equalising capital payments over a longer period would reduce the impact of capital payments on GST shares in any one year without adding much complexity²¹. We note, so long as the investment / population growth needs assessments occur 'upfront', it seems consistent for the receipt of capital grants to also be assessed 'upfront' rather than spread over an extended period.

Nonetheless certain capital payments should be excluded from the assessments. The CGC has existing tests which South Australia believes are appropriate.

"...payments should have a direct impact on the relativities unless:

- *they are a purchase from the Australian government;*
- *they are for programs implemented at the behest of the Australian Government and which lead to above average or unique State outcomes (such as a trial program which is not part of services delivered under average State policy);*
- *they are a payment to a third party that has no impact on State fiscal capacities (States act as an intermediary and the payment does not reduce or increase State needs);*
- *needs have not been able to be assessed for the State expenditures to which the payment relates.*²²

However, there may be a further class of payments which should be excluded on national interest grounds. Identification based solely on where funding has been sourced (e.g. Building Australia Fund or the Education Investment Fund) is not a robust classification mechanism as it relies on the labelling of programs rather than the substance. A better identifier would be that a grant should be excluded on national interest grounds if it relates to a project which has significant spillover effects extending across state borders. Once such a test has been enshrined it should be a matter for the CGC to determine whether individual payments meet such a test.

The new criteria could be modelled on the current treatment of Commonwealth grants for the national roads network where 50 per cent of Commonwealth grants are excluded from the

²¹ Pg 90, GST Distribution Review Interim Report, March 2012

²² Pg 79, CGC, Report on GST Revenue Sharing Relativities – 2010 Review, Volume 1

CGC assessment because of the role of national roads in meeting interstate freight transport needs.

6. Tax reforms

The Panel found that GST share effects did not affect tax decisions but there can be impacts for particular states if they are especially reliant on taxes to be abolished. The Panel raised the possibility that the distribution of the GST be used to ensure follow through on agreed tax reform.

South Australia does not consider that the current HFE system is an impediment to the achievement of a more efficient tax system.

South Australia welcomes the Panel's acknowledgement of the Henry Report argument that HFE actually helps tax reform because it means that states with a weaker relative strength in a more efficient tax base don't have a disincentive to engage in tax reform. Examples are often cited of tax reform scenarios which lead to shifts in GST revenue shares as evidence of purported disincentive effects. These claims do not withstand scrutiny because they only represent a partial analysis of the impact of changes in the tax mix. Any tax mix shift must be viewed on a tax effort neutral basis, otherwise it will reveal impacts that are the result of governments increasing or decreasing the tax burden placed on the community. The Review Panel's Second Interim Report acknowledges this point. Table 3.3 on page 33 shows that when correctly viewed this way HFE ensures neutrality in tax reform decisions (consistent with the Henry Tax Review findings).

There are a range of factors that are important to achieve tax reform - revenue neutrality, community preferences, equity considerations and transitional impacts. South Australia is prepared to explore tax reform options which are beneficial to the community.

It is community acceptance, not HFE that is the main constraint to States abolishing conveyance duty and replaced it with a land tax on the family home or a reduced payroll tax threshold.

Changes to the way these taxes are assessed (or not assessed) would simply provide one off windfall gains and losses and produce no dynamic incentive effects.

South Australia is strongly opposed to any suggestion that the GST distribution system be manipulated to penalise or interfere with states making their own voluntary decisions about tax reform.

South Australia's view is that the best way for State tax reform to be achieved is through multilateral negotiation between the Commonwealth and the States, culminating in an Intergovernmental Agreement which addresses budgetary impacts.

South Australia is opposed to any proposals that attempt to modify HFE to penalise states for not undertaking tax reform by delaying some payments, or reward states that undertake tax reform with some GST revenue that has been redirected to a reward pool²³. The purpose of HFE is to achieve the objective that '*jurisdictions should have equal capacity to provide infrastructure and services to their citizens.*' HFE should not be distorted for other purposes. Using the GST pool to penalise States which do not fulfil certain obligations would create

²³ Pg 88, GST Distribution Review Second Interim Report, June 2012

windfall gains to other States. Once the principle of HFE has been corrupted there will be other calls forthcoming on the States' GST revenue. The Review Panel must be aware of this risk because why else would they have stated "...funds would continue to be untied – there would be no conditions attached to the payment once it is made."²⁴?

7. State mineral royalties and the Commonwealth's resource tax reforms

The Panel proposes in relation to the interaction between the mineral resource rent tax and state royalties that there be an agreement between the Commonwealth Government and State Governments whereby the risks and rewards of Australia's resource tax arrangements be the subject of a negotiated agreement between the Commonwealth and the States.

South Australia is prepared to consider the Review Panel's proposal in relation to the interaction between the mineral resource rent tax and state royalties that there be an agreement between the Commonwealth Government and State Governments focussed on a lower royalty rate / mineral resource rent tax hybrid structure so long as states needs are fully and properly considered and negotiated.

However, a key issue for the states is the preservation of their mining tax policy flexibility to some degree.

8. Services to mining

The Panel is inclined to the view that not all related infrastructure, mining expenses and economic development costs are appropriately recognised in current arrangements. The Panel seeks further advice from States on the disability that is being recognised, the costs faced by States because of the disability, and whether a policy neutral assessment could be devised.

South Australia accepts that expenditure disabilities in relation to services to mining should be recognised if material needs can be demonstrated.

As we stated in our first submission, in South Australia's view much of the infrastructure requirements associated with economic development, such as ports, electricity or water supply for mining projects, should continue to be out of scope of the CGC assessments because they are either provided by the private sector or are delivered through Government business enterprises under commercial user pay arrangements. Infrastructure spending of this type is funded from borrowings and a full rate of return on total investment will be recovered from user charges and as such doesn't impact on State Government budget in the long term.

Other infrastructure needs which pertain to general government functions (roads, schools, hospitals, water supplied through community service obligation arrangements etc) are reflected in the CGC assessments, mainly through a depreciation assessment which reflects needs as infrastructure is used but also through an additional net investment assessment.

Nonetheless there may be significant expenses associated with servicing mining developments and communities which are not presently assessed. The CGC would be best placed to assess the materiality of the any disabilities in this area based on submissions from States and Territories.

²⁴ *Ibid*

Quarantining some portion of mining revenue from equalisation would be strongly opposed by SA. It would not deliver equalisation. On the other hand, recognising legitimate cost disabilities associated with mining would be consistent with equalisation where it can be demonstrated that they exist. Reducing equalisation of royalties would be an arbitrary response to any capacity issues associated with services to mining in quantum and timing (royalty streams are largely generated after any government service requirements are initially imposed).

South Australia accepts that the split in the assessment of capacities for different groups of minerals means that the current mining revenue assessment is problematic when royalty rates are increased for some mineral groups. This is an example of a simplicity initiative that was conceptually flawed. However, in our view this may be less of an issue going forward. While Western Australia would initially be disadvantaged if iron ore fines are reallocated to the high category of the mining assessment, the average tax rate for the category will fall, should the projected increase in iron ore fines production eventuate. *Ceteris paribus*, the compositional change would benefit Western Australia in the longer term as iron ore fines would start to dominate the category.

9. Conditionality

Denying States with lesser revenue raising capacity or with greater expenditure needs the capacity to be able to deliver the same level of services is not the answer to remedying the problem that there is no requirement for States to spend the money they receive based on any perceived disadvantage or addressing that disadvantage. Other policy responses are needed to address this — not the undermining of HFE.

While South Australia has a preference for untied funding of Commonwealth grants the more important issue for South Australia is full equalisation. If tied grants become the vehicle to introduce more conditionality into a system that retains full equalisation then South Australia would be prepared to acquiesce to this requirement.

10. Governance

The Federal Treasurer can give instructions to the CGC in relation to the influence of specific payments on relativities. South Australia strongly supports that CGC and views its assessments as transparent. South Australia does not consider that there is a need for new governance arrangements. However, all Treasurers, including the Commonwealth Treasurer need to be above political processes that seek to undermine HFE and the GST distribution process.

If any further direction is required for the GST distribution process it should come from the Standing Council for Federal Financial Relations.

11. Conclusion

South Australia is not resistant to change or to implementing the findings of the review as long as they are based on sound evidence and sound argument and not motivated to introduce change just for change sake. We would also be strongly opposed to any changes which departed from the objective of providing equal capacity - a significant departure from this objective would not meet the criteria which the Review has been asked to assess its proposals against. In particular it would be damaging to both equity and efficiency.

The attraction of the current form of HFE is that, within our federation, like are treated alike because States are provided the capacity to provide the same level of services. Individuals are not disadvantaged because of the State in which they reside and inefficiencies are not

created by individuals or businesses being enticed to move to a State just because it can charge lower taxes to provide essential services.

Looking to the future, a GST forecasting tool that could be used by all jurisdictions would improve the predictability of GST revenues for all States and provide greater consistency in States' Budget estimates. South Australia strongly supports the development of this tool and suggests that the Commonwealth should lead its development.

The GST Distribution Review has been a major distraction for all States. The review has focussed attention on how the GST is distributed and taken attention away from the important issue of how States can better manage our tax bases and efficient delivery of services.

The GST has turned out to be a much less robust revenue stream than was originally envisaged. At the time when the GST was first introduced, specifically the first full year of collections, the 2001-02 financial year, the GST revenues accounted for 3.6% of GDP. Latest information to 2015-16, suggests this will drop to 3.1% of GDP, which represents a \$8.3 billion loss of revenue from the GST pool. Reforming the design of the G.S.T. and stopping the unintentional leakage from it would benefit all States.

Indeed, one could query whether it makes sense for Commonwealth general purpose grants to the states, who provide the ongoing service delivery for police, teachers and nurses to be linked to a volatile GST collection at all. At the time of its introduction the volatility of the GST was assumed be less and long term bouyancy greater than has proven to be the case. If a moderate real growth path could be genuinely guaranteed and assured for general purpose grants, (protected by the Senate) this may be an alternative scenario to be considered rather than GST based grants.