

### Productivity Commission Inquiry into Australia's system of Horizontal Fiscal Equalisation

Submission from the Government of South Australia

June 2017





# South Australian submission to the Productivity Commission Inquiry into Australia's system of Horizontal Fiscal Equalisation

The Terms of Reference for this review ask the Productivity Commission (PC) to consider two broad aspects of Australia's system of Horizontal Fiscal Equalisation (HFE). The first aspect is focused on national productivity or how the current HFE arrangements impact on states' decisions to pursue economic development opportunities (especially mining related activities), labour mobility and incentives for states to implement efficiency enhancing measures. The second aspect is whether more contemporaneous assessment approaches can or should be pursued.

South Australia strongly supports the current objective of Australia's system of HFE which is to provide states and territories with the capacity to provide services and the associated infrastructure at the same standard – or in other words, **full equalisation**. Full HFE ensures that regardless of which state in Australia you are born, live in or travel to, your access to services such as healthcare, education, housing, police protection and justice remains much the same. This is a clear and unambiguous objective for the Commonwealth Grants Commission (CGC) to achieve.

The primary question before the PC is whether there are detriments to national productivity or economic inefficiencies that arise from HFE and, specifically, whether there are disincentives to natural resource development. South Australia strongly believes that this is not the case, either statically, dynamically or in practice.

The efficiency impacts of the current system of HFE were the subject of a detailed review undertaken by Independent Economics (IE) (commissioned by the South Australian Government) for consideration in the Greiner Review. The report prepared by IE (principal author, Chris Murphy) found that there would be a significant loss in overall national economic productivity if there was a departure from full HFE. This was a very important finding and represented a breakthrough in quantitative modelling in the Australian context. Although HFE has equity as a core objective, it also promotes economic efficiency by enabling businesses and people to locate where their productivity is maximised rather than on the basis of where services are greatest and taxation is lowest due to the arbitrary nature of the location of resource endowments or demographic profiles.

In practice, there is no evidence that HFE distorts government decision making in an efficiency-detracting way. For example South Australia has:

- Actively promoted the exploration and development of our natural resources through significant investment in geological mapping and creating regulatory certainty.
- Used evidence-based science to support the potential to develop unconventional gasfields
- Supported, through case management and environmental assessment, the major expansion of the Olympic Dam mine (which has not proceeded because of global developments affecting investment financing and estimated investment returns).

- Implemented significant efficiency-enhancing changes to its state tax system through the progressive abolition of a range of highly distorting stamp duties on business transactions.
- Pursued improvements in the efficiency of its services such as reducing the length of hospital stays.

There will always be examples where state governments have maintained policies that detract from pure economic efficiency, whether in relation to natural resource development (e.g. fracking bans) or other sectors of the economy (e.g. highly regulated taxi industries). These policies are determined on the basis of a wide range of economic, social, and environmental considerations and community input often reflecting localised concerns. There is no evidence that HFE plays a role in such decisions given these broader considerations. HFE is certainly not a factor in these decisions in South Australia.

Moreover, it needs to be recognised that the economic forces that are causing disparities in the revenue raising capacity and expenditure needs of states and territories are well beyond the capacity of state governments to influence. The closure of the automotive industry, the rise and fall in mineral commodity prices and associated fluctuations in the Australian dollar in recent years are the result of global influences and have had differential impacts on states and territories given industry composition and natural endowments vary. Even if it were warranted to adjust HFE assessments for state government economic policy decisions, the impacts would be marginal and impossible to disentangle from these broader forces.

If there are concerns that state governments (or even the Commonwealth Government) are not giving sufficient weight to productivity growth and economic efficiency in their decision making, HFE is not the cause and nor is it the tool to address these concerns. Other policy tools including market deregulation, direct industry assistance/intervention and taxation reform could be used as alternative policy levers.

It would be an inappropriate and retrograde step to use HFE as some sort of vehicle to remedy productivity or efficiency "problems" (to the extent they exist), given that HFE has been demonstrated to be productivity-enhancing and given that it would be highly inefficient to burden a single instrument (HFE) with multiple objectives.

Although the Terms of Reference have not asked that the current objective and definition of HFE be reconsidered, placing additional policy objectives on the current HFE system or implementing alternative assessment methods would, by default, alter the objective of HFE.

If significant changes were recommended to the current practice of HFE, there would need to be an alternative objective. If the alternative "system" is to involve less than full equalisation, then what objective is it trying to achieve? In what circumstances, to what extent and for how long is it deemed appropriate for residents of some jurisdictions to receive lower standards of schooling and health care than those in other jurisdictions? And why would this unequal treatment be restricted to services delivered by state governments – why wouldn't aged pensions or pharmaceutical subsidies be higher in jurisdictions with more minerals or fewer elderly people?

Less than full equalisation would be an unacceptable and arbitrary outcome. The HFE system needs to have a clear and unambiguous objective and not be burdened by other goals which can be better pursued through other mechanisms.

The PC needs to be aware that critics of HFE in Australia are likely to be motivated by vested interests, not the pursuit of any higher order principle. All governments implicitly practise equalisation in their own sphere.

We note that people living in suburban Perth enjoy the economic benefits of mining revenues generated thousands of kilometres away in the Pilbara. The principle of intra-state equity has also been at the centre of the NSW government's commentary recently, which has emphasised a commitment to equity within the state, where regardless of their postcode citizens should receive a fair share of services and infrastructure. This intra-state argument is the same foundational principle that drives our current HFE system, and it is inconsistent to suggest that it should apply to intrastate government spending and service delivery but not a national approach.

The NSW government has also asserted that its recent strong economic growth is due to its own policy choices and that it deserves to fully reap the benefits as a result. South Australia is not aware of any evidence that would support this view. What are the specific or unique policy decisions and choices that the NSW Government has made to generate this growth? If these decisions are identifiable, all states could implement them to deliver stronger growth, regardless of any HFE implications.

Further the principle of borderless equity is a core principle that the Commonwealth recognise is expected by the Australian community. This was demonstrated as recently as 2 May in Sydney when discussing the Commonwealth government's recent education reforms, the Prime Minister said:

It will ensure that the same student with the same needs will be treated exactly the same in terms of Commonwealth funding no matter which state they reside in or the school system in which they're being educated.

This was further supported by the Education Minister:

At present, in the schooling sector, we contribute wildly different shares of school funding to different states and territories... We're fixing that by getting all states to the same position under the same needs-based formula, to ensure that in the future everyone, every student, every school is treated fairly and equitably.

This principle of equity, whether applied to national policy and funding or intra-state arrangements is the foundational principle of how Australian governments are run, and what Australian communities expect. It is the foundation of our current HFE arrangements, and arguments to change it by other jurisdictions are hypocritical in the face of their intra-state decision making and commitments.

#### Contemporaneity

The PC has also been asked to consider the "lag" in the HFE system. South Australia acknowledges that the lag means that full equalisation is not immediately achieved in practice. The CGC has, and is continuing to examine ways to make the assessments more contemporary. South Australia is strongly supportive of full equalisation, and any changes to the operation of HFE must preserve its integrity. The impact of the lag on budget planning and decision making should not be problematic for a well informed and well managed government.

Since the beginning of Federation, the States have been divided over the appropriate distribution of Commonwealth resources among them with some states, most notably Western Australia, shifting their views with their changing fiscal circumstances. The CGC, the independent expert arbiter, along with its clear mandate to ensure HFE is best placed to oversee the distribution of GST funds among the states and territories.

The current system of HFE is the best way of seeking to ensure that all Australians are treated equitably and have reasonable access to services and infrastructure of the same standard, regardless of what state they live in. While there will always be the need for minor practical improvements within the current system, there is a thorough review system available through the CGC in consultation with the states and territories to ensure these matters are appropriately considered.

South Australia believes that the Greiner Review comprehensively covered the issues being considered by the PC. We note the Greiner Review was given eighteen months rather than a nine month inquiry period and hope that the compressed timeframe does not compromise the PC's conclusions.

If the PC's recommendations or findings conflict with those of the Greiner Review, South Australia would expect to see strong and conclusive new evidence in addition to that considered by the Greiner Review.

Notwithstanding this, South Australia will be fully participating in this review process through the preparation of this submission and further submissions.

This submission broadly follows the structure of the PC's guidance paper but groups like issues together.

## How does the current HFE system impact the Australian community, economy and State and Territory governments?

Is the current HFE system getting in the way of States pursuing higher economic growth and productivity, and at the expense of higher national prosperity? If so, how?

Does the current HFE system influence State policies to facilitate, restrict or tax the development of economic activity, and in particular energy and mineral resources?

What evidence is there for the HFE system affecting State policy choices relating to resource extraction (including regulatory restrictions on development)?

The PC is well respected for the quality and independent advice it provides to governments, particularly in the area of economic advice. This provides it with a strong framework for judging the behaviour of and incentives influencing individuals and businesses. Given this strong background, the PC would be conscious of not conflating the behaviour of individuals and businesses with those of governments as well as acknowledging the different incentives that apply.

The priorities of governments are quite different to those of individuals and businesses. Decisions to pursue productivity-enhancing projects or reforms are predominantly influenced by the economic and social benefits to the community. Typically, state governments consider

productivity-enhancing proposals with reference to a broad cost-benefits analysis, improvements in per capita incomes, generation of more highly paid employment opportunities and opportunities to reduce unemployment (particularly if the development occurs in a region with underutilised labour). These considerations are balanced against environmental impacts, impacts on specific communities, protection of heritage and other social factors. Fiscal equalisation impacts are not a driver in the decision making processes.

There is no evidence that fast growing states have limited their economic development activities because of GST redistributions. Similarly there is no evidence that states which have slower growth are not pursuing economic development because it may reduce their GST share.

The Western Australian Government has raised concerns with the impact that HFE has on incentives to pursue mining development in other jurisdictions. It is true that the Western Australian Government has long supported the mining of iron ore. On the other hand, the Government has also decided to ban the development of new uranium mines. These policy differences cannot be explained by HFE. In addition, it is not sensible to suggest that Western Australia's relatively limited coal mining royalties capacity is a result of its policy choices.

It is acknowledged that the mining revenue assessment is a problematic area for the CGC from a policy neutrality perspective due to the dominance of the mining revenue base by a couple of jurisdictions. The CGC summarised the issue as follows<sup>1</sup>:

The biggest concern in developing a mining assessment is finding an appropriate balance between fiscal capacity, what states collectively do and policy neutrality. If policy neutrality is not an issue, a mineral by mineral assessment accurately captures differences in states' mining revenue capacities. If policy neutrality is the sole issue, grouping minerals together addresses policy neutrality, but at a cost of producing an assessment that does not reflect the underlying differences in states' capacities.

The CGC was given specific directions in the Terms of Reference for the 2015 Methodology Review to consider the mining revenue assessment. The assessment was comprehensively considered in this process and resulted in the move to the current mineral-by-mineral assessment.

South Australia is doubtful whether further examination of the mining assessment will result in any new approaches being uncovered that can simultaneously address all of the well-documented issues.

The South Australian Government has actively pursued expansion of mining through investments in geological mapping and creating regulatory certainty – even though additional royalties would be shared with other states through HFE.

South Australia actively pursued the expansion of the Olympic Dam mine through creation of inter-departmental task forces, accelerated environmental assessment processes and other streamlined approval processes. Ultimately a decision was made by the private sector not to pursue expansion at this stage due to lower commodity prices. HFE was not a significant consideration in this process.

<sup>&</sup>lt;sup>1</sup> Commonwealth Grants Commission, Report on GST Revenue Sharing Relativities 2015 Review – Volume 2 – Assessment of State Fiscal Capacities, page 107.

South Australia's support for the Olympic Dam expansion was part of broader efforts by the State to develop its mining industry, including under the Plan for Accelerating Exploration (PACE), which has been widely recognised as a key contributor to a significant increase in mining activity in South Australia. For example, the 2012 Victorian Parliamentary Inquiry into Greenfields Mineral Exploration and Project Development in Victoria cited the following evidence regarding the mining policy settings in South Australia:

SA offers a regulatory and policy environment that is generally supportive to mineral exploration. This includes:

- engagement with multiple Departments and government agencies to ensure consistent and compatible policy;
- low compliance/administration costs/requirements on industry; and
- a flexible understanding of the time required to reach certain project milestones.

SA – in part due to a strong communication campaign that leveraged off of outputs produced by PACE – is perceived as being highly prospective. This has helped unlock the value of the outputs produced.<sup>2</sup>

#### The Parliamentary Inquiry also noted that:

PACE was repeatedly recognised in evidence as a successful program for attracting investment in exploration projects. The MCA's [Minerals Council of Australia] submission stated that PACE 'led the nation with regards to partners with industry to explore'.<sup>3</sup>

#### Consequently, that Parliamentary Inquiry recommended:

That the Victorian Government considers facilitating the establishment of a framework for an integrated mineral resources initiative such as South Australia's Plan for Accelerating Exploration, to drive new minerals exploration to encourage investment and economic development in Victoria.<sup>4</sup>

Due to PACE and other South Australian initiatives aimed at supporting and growing the State's mining industry, South Australia is regarded as an attractive destination for investment in the resources sector both nationally and internationally. For example, South Australia regularly ranks highly in the Fraser Institute's annual Survey of Mining Companies, which assesses how mineral endowments and public policy factors such as taxation and regulation affect exploration investment. In the 2016 edition, South Australia was ranked the third most attractive Australian jurisdiction for mining investment and 13<sup>th</sup> in the world (out of 104 jurisdictions)<sup>5</sup>. This is based on an assessment of both the mineral potential and policy influences of each jurisdiction.

When only the policy influences are assessed (as measured through the Policy Perception Index), South Australia ranked second in Australia and 21<sup>st</sup> in the world, as shown in Table 1.

<sup>&</sup>lt;sup>2</sup> Allen Consulting Group, *Review of Victoria's earth resources programs: Report to the Victorian Department of Primary Industries*, 2011, as cited in the Victorian Parliament's *Inquiry into Greenfields Mineral Exploration and Project Development in Victoria Final Report*, 2012, p.261

<sup>&</sup>lt;sup>3</sup> Parliament of Victoria, *Inquiry into Greenfields Mineral Exploration and Project Development in Victoria Final Report* 2012, pp.261-262

<sup>&</sup>lt;sup>4</sup> Recommendation 23

Recommendation 23

Table 1: Policy Perception Index (PPI), Australian States, 2016

	PPI score		
State	(out of 100)	Aust. ranking	World ranking
NSW	63.9	7	66
Vic	73.8	6	42
Qld	78.5	5	36
WA	93.2	1	9
SA	87.0	2	21
Tas	81.5	4	32
NT	85.7	3	22

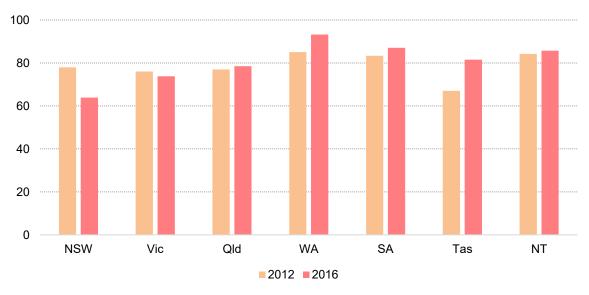
Source: Fraser Institute

The outcomes of the survey demonstrate that:

- despite being a net beneficiary of HFE in financial terms, South Australia is implementing policies that support mining investment and the growth of the sector in the state; and
- more broadly, Australian states collectively are highly regarded compared to other locations in the world in terms of the extent to which their policies contribute to the attractiveness of mining investment.

There is no evidence to suggest that HFE is hindering states from pursuing and facilitating the growth of their mining industries. In fact, historical data published in the 2016 survey shows that the PPI scores of all but two states have increased since 2012 (Figure 1).

Figure 1: State PPI scores, 2012 and 2016



Source: Fraser Institute

The Queensland Government has actively pursued the development of the Carmichael coal mine in the central part of that state being proposed by the Indian mining company, Adani. It is expected that this project will create thousands of new jobs and produce 25 million tonnes of coal per year in its first phase. The Queensland Government has also faced significant

opposition to the project from environmental activists and the Australia Greens from both within and outside Queensland.

Although a royalty holiday may be part of the final arrangements to facilitate the project, the new mine will ultimately increase Queensland's mining royalty income. This ultimate increase in royalty revenue will have HFE impacts but has not deterred the Queensland Government from actively pursuing the development. Decisions about royalty relief for this project are purely a policy choice by the Queensland Government.

There are restrictions on on-shore unconventional gas exploration (fracking) in New South Wales, Victoria and the Northern Territory. States should have the autonomy to decide on the appropriate balance of competing economic, environmental and community concerns. It is our understanding that the decisions to ban fracking have been driven primarily by concerns regarding environmental issues and the potential impact such activities could have on agricultural farming land.

South Australia, on the other hand, has actively supported fracking and has announced a PACE Royalty Return initiative that will share 10 per cent of royalties with landowners whose property overlies a petroleum field that is brought into production. This illustrates strong support for gas exploration and development.

Separate to mining activity, states regularly compete with each other to attract major events or the location of head offices even though they are often fiscally detrimental. This would be the case with or without HFE.

What evidence is available on whether and how the current HFE system affects the movement of labour and capital across State borders, particularly if a region is experiencing high labour demand?

HFE supports the efficient movement of labour across state borders as opposed to movement motivated by fiscal effects that can arise from accidental variations in the location of natural resources and variations in human resource characteristics.

HFE transfers are needed to produce the same distributional outcome that would be obtained with the implicit equalisation that would occur in a national or unitary system of government. Implicit area fiscal equalisation occurs automatically within the scope of Commonwealth expenditures. Use of Commonwealth-provided services like Medicare and the Pharmaceutical Benefits Scheme varies between jurisdictions due to differences in demographic profiles and socio-economic status. HFE addresses the effects of the arbitrary location of sub-national government boundaries in a federation as compared with the outcomes which arise implicitly in a unitary nation.

Application of full HFE helps limit population migration motivated by fiscal incentives which would arise if there were a requirement that revenues generated in a state matched expenditures in the same state.

In the absence of equalisation, net fiscal benefits available to an individual (broadly taxes paid vs. services/benefits received) will differ between jurisdictions due to the accidental location of mineral and other resources or differences in demographic structures.

The existence of these differences would promote inefficient migration unrelated to underlying private returns. For example, if two jurisdictions were identical apart from the fact that one had a greater proportion of elderly people (and lower proportion of working age people), the jurisdiction with the older population would have higher service delivery needs and have to impose higher taxes to finance this. This would create incentives for people to migrate to the other jurisdiction to benefit from lower taxes even though their productivity was higher in their home jurisdiction.

From this perspective, equalisation is designed to achieve an outcome where labour and capital moves between regions in response to returns based on marginal productivity, and removes any fiscal incentives for migration.

It is possible that economic growth could be higher in jurisdictions with stronger fiscal capacity in the absence of HFE. However, it may not be the case that this would be an efficient (or welfare enhancing) outcome from a national perspective, as it would involve movements of capital and labour that would be in response to fiscal incentives, not underlying productivity.

In the absence of HFE, Western Australia may become a much more attractive location for certain manufacturing or service industry investment enticed by a lower payroll tax rate and better public services funded through royalty incomes.

However, if for example, a new state was created by dividing Western Australia into north and south, Perth may no longer be such an attractive destination and industry would be enticed north. Such movements would not increase the amount of national economic activity, only its location.

HFE ensures that location decisions in a federation are independent of the fiscal effects that arise from accidental variations in regional physical and human resource endowments, and that those location decisions can instead be driven by inter-regional variations in marginal productivity for particular resources as in a unitary nation.

The interstate pattern of Australia's population is quite fluid, in part because of the importance of overseas migration, but even if population was judged to be immobile and location decisions not likely to be greatly affected by different rates of state tax in the absence of HFE, the fair treatment of firms and households would be affected.

Economic efficiency would be damaged if the Commonwealth treated households and firms differently merely on account of the geographical source of taxes collected or the differing socioeconomic or demographic makeup of areas within Australia. Similarly national economic efficiency would be damaged if state taxpayers and users of tax funded services were treated differently merely on account of the amount of revenues collected and expenditures incurred within state boundaries resulting from factors not in the control of state governments.

Does the current HFE system create perverse incentives or unintended consequences for reform at the State level? What evidence is there on how these incentives affect State policies and ultimately outcomes for the Australian community?

Does the HFE system impede the efficiency of State service delivery, infrastructure investment and policies affecting where people live? If so, how and to what extent?

South Australia believes that HFE does not impede state governments from pursuing more efficient approaches to deliver services. States generally receive the full benefit of any service delivery efficiency savings achieved and wear the cost of inefficiencies.

The CGC "standard" approach for expenditure assessments, with only two exceptions (native title settlements and net natural disaster expenditures), is to assess needs through consideration of independent variables rather than actual spending levels. Therefore, if a jurisdiction is able to reduce its spending in a particular service delivery area through more efficient practices, this would not impact on the assessment of their needs and the relativities (unless their spending was able to significantly impact on the average level of spending across all jurisdictions – which is unlikely to any material degree). As such, the full benefit of the efficiency gain should accrue to that jurisdiction

In order for state actions to influence the assessments they would need to be able to materially influence the national average spending or taxing level.

In practice, this generally means that only larger jurisdictions can undertake actions which have a material impact on the average expenditure or revenue for a category. Or a State which dominates a particular assessment could take actions to influence the assessment.

However such actions would involve budgetary costs as well as benefits (e.g. spending more to obtain a greater share of GST grants) and the net impact will not be sufficiently large to motivate such behaviour.

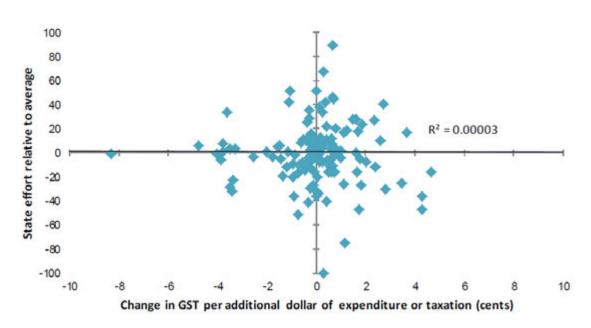
In situations where one state dominates an assessment category the CGC usually attempts to address this by looking for a more neutral base.

There is in fact strong evidence that states are not influenced by the share of GST revenues they receive. If they were, states would adjust their policies to increase their grants share. States could decrease their level of tax or spending in areas where they have above average capacity and increase them in areas where they have below average capacity to influence the average policy. For example, a state with a lower than average capacity in raising payroll tax but a higher than average capacity in raising insurance taxes could have higher than average payroll tax rates and lower than average insurance tax rates so the state is extracting less revenue from its citizens and effectively more revenue from the citizens of other jurisdictions. These actions would presumably result in a discernible relationship between state effort and the impact of policy decisions on a state's GST share. That is, on average, states that would have their grant share reduced by increasing their effort in an assessment area would have lower than average effort; states that would have their grant share increased would have higher than average effort. As shown in the graph below prepared by the CGC, there is no discernible relationship.

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<sup>&</sup>lt;sup>6</sup> South Australia has a lower than average capacity in raising payroll tax but a higher than average capacity in raising insurance taxes, but has lower than average payroll taxes and higher than average insurance tax rates.

Figure 2: Correlation between effort and average policy incentives in all tax and expenditure categories, 2010-11



Source: GST Distribution Review, 2012

In recent years, South Australia has actively pursued reforms that will improve its healthcare system. The changes to specific health service areas include better services for veterans, comprehensive rehabilitation services, better access to stroke services and a clearer distinction between hospitals that are best equipped for major life-saving emergencies and those best suited to minor emergencies. Since the commencement of this reform process, South Australia has seen a reduction in the average length of stay in our metropolitan hospitals despite there being an increase in admissions. HFE has in no way influenced decisions to undertake these reforms.

The ability of current HFE arrangements to create perverse incentives was considered in the Greiner Review. The final report (Page 135, Final Report) noted:

"...the Panel has formed the view that the current system can and does create perverse incentives in theory, but there is no evidence of those incentives having any effect in the real world. In particular, there is no evidence that HFE acts as a material disincentive to State tax reform.

While there may be some merit in addressing perverse incentives on principle alone, after exploring the alternatives, the Panel has concluded that they cannot be meaningfully reduced without significant reductions in equalisation outcomes. As there is little evidence of real world efficiency loss, the Panel is not convinced that this would be a worthwhile trade-off."

South Australia is not aware of any evidence that demonstrates a systematic correlation between the direction of HFE transfers and differences between jurisdictions in their efficiency in delivering services.

Does the HFE system impede State tax reform over time, including States' decisions on developing their revenue bases and rates? If so, how and to what extent?

HFE does not create disincentives to reform state taxes, a conclusion supported in the Greiner Review and noted in the Henry Tax Review.

If a state unilaterally reduces reliance on a revenue base in order to exploit an alternative tax base the CGC assessments will be only slightly affected. Any impacts would be the result of the impacts on standard revenue collections, which are likely to be marginal unless a larger state (or a state which dominates a particular revenue assessment) undertook a very large tax mix switch.

A national tax reform initiative could affect the CGC assessments where it results in a tax being abolished and no longer part of the assessment of what states do, and/or a new revenue base being assessed. State GST shares would be altered by this but the effects would be the mirror of the changes in each state's relative revenue raising capacity resulting from the tax mix switch. Ignoring differences in tax effort (which are a policy choice), such a scenario would leave state shares of combined own source tax revenue and GST grants unchanged.

The final report of the *Australia's Future Tax System* review (the Henry Tax Review) confirmed HFE's relative neutrality in relation to tax reform. This review highlighted that HFE ensured that states had no incentives to "resist or favour" tax reform proposals on the basis of differing tax capacities.

"A change in tax mix adopted by all States will change their relative revenue-raising capacities, therefore affecting the distribution of GST revenue. A change in tax mix might be revenue-neutral to the States in an aggregate sense, but an individual State might have one of their relatively stronger bases replaced with a relatively weaker base, such that revenue from their own taxes is lower. However, this loss in revenue could be made up through the HFE process, as the loss of their relatively stronger tax base means that their revenue needs are higher. In theory, if all States apply the same revenue-raising effort, no State would have a financial incentive to resist or favour a revenue-neutral reform of State tax base composition on the basis of the local strength or weakness of particular tax bases.

In practice, however, the States will be affected differently because they apply different policies to their existing tax bases and are likely to continue to do so in regard to tax bases they have access to in the future. The redistribution of GST revenue will not take into account the impact of changes to tax bases on a State where it does not apply the average policy. That is, if a State is raising more than the average revenue off a base that is abolished, HFE will not compensate for revenue lost above the average, just as if a State was making a below-average effort that State would not be penalised. This may cause difficulties for some States, particularly if the States do not have the same ability to raise marginal revenue from the new tax base as they did with the old one."<sup>7</sup>

The above quote highlights the fact that states may still face hurdles in respect of particular tax reform options on account of differences in tax policy (effort) for relevant taxes. This is not, however, a consequence of HFE.

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<sup>&</sup>lt;sup>7</sup> Australia's future tax system, Report to the Treasurer, December 2009, Part Two Volume 2, page 685

The Henry Tax Review concluded that many state taxes are highly inefficient including insurance taxes and stamp duties because they are narrowly based transaction taxes, and payroll tax because of the narrowing of the tax base due to the small business tax exemption.

The existence of these taxes in their current form reflects a range of factors, notwithstanding the fact that numerous reviews by economists and other taxation experts have routinely concluded that they have negative efficiency consequences. These factors include:

- community acceptance for example the <u>relative</u> acceptability of incurring an irregular, albeit large, tax liability when purchasing a property - given that this occurs at a time of liquidity as compared with a regular annual tax impost imposed on the site value of the family home;
- perceived equity motivations (for example, as between small and large businesses);
- revenue issues (for example, the relative stability associated with a sales based royalty regime as compared with the more volatile and unpredictable revenue streams associated with a mineral rent tax); and
- the difficult transitional issues associated with large scale reform, including compensating those who suffer adverse impacts.

As part of its 2015-16 Budget, South Australia announced a major business tax reform package designed to make the state the best place to do business and to encourage investment and job creation. The package, when fully implemented, will see the abolition of stamp duty on non-quoted marketable securities, non-real property transfers, non-residential real property transfers and transfers of units in unit trusts. The package also expanded the stamp duty concession for mining exploration tenements to include retention tenements – a pro-mineral development initiative. This tax reform package will see the abolition of taxes that are commonly acknowledged as being the most inefficient. South Australia was the first state to announce the abolition of many of these taxes and HFE was absolutely not a factor in developing this reform package.

In its 2012-13 Budget, the ACT Government announced a major tax reform package that when fully implemented will see the abolition of stamp duties on general insurance and life insurance, abolition of conveyance duty and abolition of commercial land tax. Revenue will be replaced through the ACT's general rates system. This reform followed an ACT tax review and the Henry Tax Review. Current HFE arrangements did not obstruct this reform process.

Is policy neutrality adequately addressed under the average state policy approach? Why or why not?

The policy neutrality principle aims to ensure that no state can directly influence its GST share through its revenue or expenditure policy choices and that the GST distribution methodology does not create incentives or disincentives for states to choose one policy over another.

The issue of policy neutrality, particularly its application in assessing revenue raising capacity for iron ore, was a key area of discussion in the both the Greiner Review and the CGC's 2015 Review.

Policy neutrality is generally not an issue in most assessment areas as most states' approaches to service delivery or revenue raising are similar. Issues arise when one state

raises significantly more than its population share of a particular revenue or accounts for significantly more than its population share of an expenditure category. Obvious examples are mining revenues (Western Australia) and Indigenous expenditure (Northern Territory).

Issues with the mining revenue assessment have already been discussed.

CGC staff are aware of the policy neutrality issues that exist in certain (limited) assessments and continually assess and consider ways of addressing these issues as part of methodology reviews. South Australia believes that this process is the best way of improving assessments so they are to greatest extent possible, policy neutral.

How does the current CGC relativity process affect States' fiscal management from year to year and over time? How does this affect policy outcomes and economic activity in each State?

Does the current process impact the ability and propensity for States to manage budgets through cycles, especially for those states relatively more reliant on large and volatile revenue streams?

How does data reliability and the three-year averaging process affect fiscal management?

Is there a better trade-off between GST relativity precision and timeliness?

What is the ability (and track record to date) of States to project and anticipate their own GST relativities, including any impacts of major State initiatives?

#### **Budgetary and fiscal management**

HFE is first and foremost about the equalisation of states' fiscal capacities (recognising the average revenue and expenditure policies of states). HFE is not about attempting to correct or respond to states' cyclical budgetary circumstances that incorporate revenue and expenditure policy choices.

Notwithstanding the main objective of HFE, the CGC's assessment method is well established and understood by state Treasury officials and the estimated GST impacts of changes in states' circumstances are incorporated into states' GST revenue forecasts.

Concerns have been raised about the predictability of relativity changes from one year to the next but the current three year averaging approach does moderate sudden changes in states' circumstances.

Changes in GST relativities are usually the mirror of changes in state circumstances, albeit with a lag (for example, when a state's capacity to raise own-source revenue increases, its GST grant will fall, all other things being equal).

South Australia accepts that, as with any other budget item, no state can predict its future GST revenue with absolute accuracy. However, states are able to anticipate the trajectory of their GST shares into the future by taking into account observed and expected changes in states' revenue and expenditure patterns.

A range of factors influence the movements in relativities in annual updates, in particular:

- revenue updates reflecting differential emerging growth in revenue raising capacity between jurisdictions, particularly in relation to royalties and conveyance duty;
- emerging state shares of impacting Commonwealth grants; and
- data updates (for example the Characteristics of Employment data underpinning the wage costs assessment).

The first two sources of change in relativities should be able to be anticipated by state Treasuries because they are observable from published documents including Budget documents released prior to the CGC's annual update reports. The impact of data updates and other assessment factors may be less readily anticipated by state Treasuries, although the CGC does endeavour to notify the States of emerging developments.

States, including those that rely on large and volatile revenues, generally take these considerations into account when forecasting relativities as part of the budget development process. For example, in its 2013-14 State Budget, Western Australia predicted the impact of its significantly above-average capacity to raise mining revenue on its future GST grants:

Overall, GST grants are forecast to decline from \$2.9 billion in 2012-13 to just \$500 million in 2016-17, mainly due to the significant increase in Western Australia's mining royalties in recent years and the full 'equalisation' of these royalties over time by the CGC (i.e. with lags).

Western Australia's projections of its GST share over the forward estimates period differ significantly from those published by the Commonwealth, due to our more detailed forecasting methodology and associated differences in assumptions made.<sup>8</sup>

While Western Australia's GST forecasts appear, in hindsight, to be rather conservative (for example, Western Australia's GST share in 2016-17 will likely be around \$2 billion rather than \$500 million), that state clearly anticipated the trajectory of its GST relativities over time, as shown in Figure 3.9

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<sup>&</sup>lt;sup>8</sup> Western Australian 2013-14 State Budget, Paper No.3, p.96

<sup>&</sup>lt;sup>9</sup> While this discussion focuses on the forecasting of GST relativities, GST revenue forecasts also reflect assumptions on population shares and changes in the GST pool.

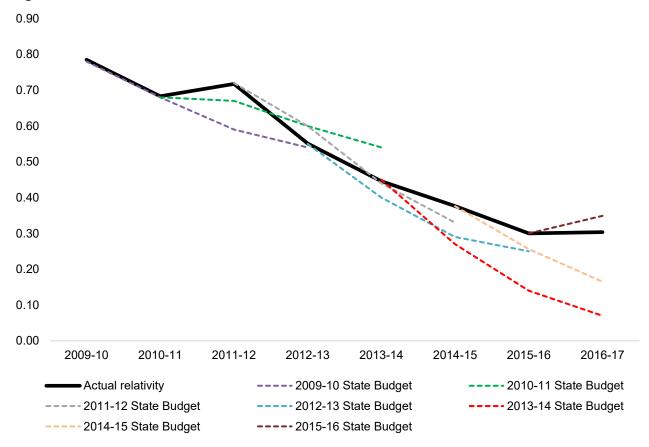


Figure 3: Western Australia's forecast and actual GST relativities over time

Source: Western Australian State Budgets 2009-10 to 2015-16, Commonwealth Final Budget Outcomes 2009-10 to 2015-16, Commonwealth 2017-18 Budget

Similarly, with the recent decline in its revenue raising capacity, Western Australia has started to factor in an increase in its relativity going forward. The change in Western Australia's fiscal capacity will affect all states and the majority of states appear to have factored this into their latest Budget forecasts.<sup>10</sup>

The three-year averaging approach assists and does not hinder the development of realistic GST estimates over a budget cycle as it stabilises GST shares from one year to the next, even in times of revenue or expenditure volatility. This is because a significant change in revenues or expenses in a particular year would only affect the relativities incrementally over a number of years rather than in a single "big hit" in a particular year.

It is widely acknowledged that the lag in the CGC's assessments means that the relativities used to distribute GST revenue in a particular year may not necessarily reflect state circumstances in that year. However, from a budget development perspective, the stability of GST revenue from one year to the next could be viewed as more pertinent than the extent to which the GST relativities accurately reflect fiscal capacities in a given year. This is especially important when a large and unexpected change in revenue or expenses in one state has the

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<sup>&</sup>lt;sup>10</sup> With the exception of the ACT, which holds relativities constant over the forward estimates, all States discuss (to varying degrees of detail) the impact of changes in Western Australia's iron ore revenue capacity on relativities in the future.

potential to significantly affect other states' GST revenues. In the 2015 Review, the CGC noted:

The three year lagged approach also assists States with budget management, in that any State's GST revenue is not immediately subject to volatile outcomes in other States. For example, while the equalisation system will see Queensland compensated by the other States for expenses incurred in addressing natural disasters, States do not bear this cost unexpectedly in the year in which the disasters occur. States can plan to absorb those costs through reductions in GST revenue as the relevant year moves through the equalisation system. States are well aware of this longstanding aspect of the HFE system and manage their budgets accordingly.<sup>11</sup>

While the relativities of the CGC are relatively predictable, the possibility of Commonwealth Government changes to the system of HFE are not. In recent budgets the Commonwealth Government has provided additional infrastructure funding to Western Australia "to ensure that Western Australia's share of the GST is effectively maintained at its 2014-15 levels." This creates the expectation that the Commonwealth will not allow Western Australia's share of GST revenue grants to fall below that level. These transfers and the announcement of the PC inquiry into HFE along with other statements by the Commonwealth Government creates significant uncertainty for states and territories as to the future distribution of GST revenue grants and makes it difficult for states and territories to appropriately manage their fiscal circumstances.

#### Contemporaneity

The contemporaneity supporting principle adopted by the CGC means that, as far as possible, GST relativities should reflect state circumstances in the year in which they are used to distribute GST. The CGC's current approach to achieving this is based on averaged data from the three most recently completed financial years. South Australia supported this approach in the 2015 Review.

In the 2015 Review, the CGC was asked to consider the treatment of large and volatile revenue sources, provide advice on a possible approach that would mitigate the negative effects of revenue volatility and ensure that states' shares of GST for a year are appropriate for their fiscal circumstances in that year. This was effectively a review of the contemporaneity supporting principle.

A number of options for improving the contemporaneity of the CGC's assessments were suggested during this process. The CGC extensively investigated:

- calculating the GST relativities based on forecasts of states' revenue and expenditure
  in the application year, potentially with adjustments to future GST shares to reflect
  actual fiscal capacities once they are known;
- an absorption approach to assessing iron ore revenue, whereby the CGC would calculate relativities for a combined pool of GST and iron ore royalties;

<sup>&</sup>lt;sup>11</sup> Commonwealth Grants Commission, 2015, Response to Commonwealth Treasurer – GST shares in the presence of large and volatile state revenues, pp.4-5

<sup>&</sup>lt;sup>12</sup> Joint Media Release, The Hon Malcolm Turnbull MP, the Hon Scott Morrison MP and Senator the Hon Mathias Cormann, Additional Commonwealth support for infrastructure projects in Western Australia, 10 April 2016, <a href="http://www.financeminister.gov.au/media-release/2016/04/10/additional-commonwealth-support-infrastructure-projects-western-australia">http://www.financeminister.gov.au/media-release/2016/04/10/additional-commonwealth-support-infrastructure-projects-western-australia</a>

- a lagged five-year averaging approach; and
- an advance payment to states affected by a change in large and volatile revenue sources, financed by reductions in the GST shares of all other states; with this advance subsequently reversed over time.

South Australia notes that while there was limited time to consider this issue in the 2015 Review, the work that was done in the available time clearly demonstrated the difficulties of attempting to adjust the assessment framework, especially when there is an aim of producing a favourable GST outcome for a single state. It was also evident at the time, that the suggested changes did not have the broad support of the states.

The CGC found that none of these alternatives would better achieve HFE than the current approach. This was due to a number of concerns, particularly with regards to the reliability of forecasts of state revenue and expenditure, the potential for states to "game" the GST distribution system through their forecasts and the effect on equalisation of an inconsistent approach to assessing revenue capacity. Consequently, the CGC was unable to identify an alternative approach that would be reliable over a span of years. Importantly, the CGC noted that:

While we can appreciate the budgetary pressures facing Western Australia, we do not consider that the HFE system is designed, or can reliably be redesigned, to provide partial responses to year to year budgetary problems and also achieve the objective of HFE.<sup>13</sup>

The CGC concluded that while several options were explored,

... using a three year average, applied consistently to all assessments, provides the most reliable, practical and fair outcome consistent with achieving HFE over a run of years (albeit with a lag since reliable data are only available on a historical basis). This approach balances competing considerations of practicality, data reliability, contemporaneity and policy neutrality, and predictably smooths payment flows over time.

From an equalisation perspective, South Australia notes that despite the lag in the CGC's assessments, the current approach ultimately achieves equalisation (as far as is practical) over a run of years, as changes in States circumstances in a given year flow through the assessments and are reflected in the relativities over time.

We also note that the issue of contemporaneity has been conveniently raised by certain jurisdictions at times when a specific revenue item is experiencing negative growth (or expected to experience negative growth) following a period of rapid or sustained revenue growth. For example, during the mining boom that took place for most of the 2000s, Western Australia enjoyed the benefit of lagged assessments (up to five years lag for much of that period) but when production slowed resulting in negative royalty growth, there was an immediate push for a more contemporaneous assessment. Despite previously being a supporter of the lagged assessment approach, Western Australia successfully lobbied the Commonwealth Government in 2014 to require the CGC to examine contemporaneity for large and volatile revenues as part of its 2015 Methodology Review. The sudden interest in

<sup>&</sup>lt;sup>13</sup> Commonwealth Grants Commission, 2015, Response to Commonwealth Treasurer – GST shares in the presence of large and volatile state revenues, p.14

pursuing a more contemporaneous assessment was not driven by a desire to improve Australia's system of HFE, it was primarily driven by short-term self-interest.

#### What resources do individual States expend dealing with HFE matters?

The South Australian Department of Treasury and Finance has an intergovernmental relations (IGR) unit comprised of three full-time equivalent staff. The team is part of a Revenue and Intergovernmental Relations team that is also responsible for taxation policy, revenue forecasting and gambling policy. The IGR team is the primary point of contact for all dealings with the CGC and coordinates the collection of data and prepares submissions for methodology reviews and annual update issues.

The IGR team has other responsibilities including the preparation of briefings and other material for Deputy HoTs, HoTs, Council for Federal Financial Relations meetings; preparation of material for the Budget process; managing issues that arise under the Intergovernmental Agreement on Federal Financial Relations; development of new funding agreements and managing the State's involvement in the Intergovernmental Agreement on Competition and Productivity Enhancing Reform.

GST revenue forecasting is undertaken by the revenue forecasting section. Staff from the Department of the Premier and Cabinet are involved in HFE issues from time-to-time when HFE is subject to national reviews or when the current HFE arrangements are criticised by other jurisdictions or the media.

South Australia notes that the resources states and territories expend dealing with HFE matters provides no indication of the resources states and territories may expend on dealing with intergovernmental transfers without HFE. Prior to the adoption of full fiscal equalisation in 1985, the Commonwealth adopted a variety of methods to provide additional revenues to states with lower fiscal capacities. This often resulted in special deals and assistance arrangements of a politically charged nature.<sup>14</sup>

As discussed above, all governments practise fiscal equalisation, whether explicitly or implicitly. Therefore, if HFE were removed it is not unlikely that such deals may again arise. The current arrangements and independent assessment by the CGC arguably result in arrangements that use far less resources in the distribution of Commonwealth transfers than would otherwise be the case. Regardless of whether any changes are made, the apparent instability in Commonwealth policy with regard to the distribution of payments between the states and territories and the regular reviews and discussion of the existing arrangements has resulted in far more resources being spent on dealing with the distribution of intergovernmental transfers than would otherwise be the case.

What preferable alternatives are there to the current HFE system (as adopted by the CGC in its calculation of GST relativities) of equalising States' fiscal capacities?

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<sup>&</sup>lt;sup>14</sup> Jim Hancock and Julie Smith (2001) Financing the Federation

What should be the objective of HFE?

Should HFE address fiscal divergences across States due to both structural factors (beyond State influence) and cyclical factors (beyond State influence)? If so, over what time period should this be achieved?

Should HFE compensate States for fiscal divergences where a State has by choice diverged from efficient tax arrangements and service delivery?

Should past State policy decisions (such as on economic development, revenue bases and rates, or budget provisioning) influence the form or degree of fiscal equalisation? If so, how?

What are the advantages and disadvantages of targeting full versus partial fiscal equalisation across States?

The aim of HFE is first and foremost about equity and is fundamental to ensuring that all states have the capacity to deliver the same level of services and infrastructure. The purpose of HFE is to provide governments with equal capacity to deliver services to their citizens. HFE allows all state governments to fulfil this role to an equal extent.

To achieve this equity objective, HFE must be focused on the equalisation of states' fiscal capacities (recognising the average revenue and expenditure policies of states). This fundamental objective should not be confused with other possible policy objectives. Loading the equalisation system with multiple objectives would significantly undermine its ability to achieve any of those objectives fully or satisfactorily.

If there are other policy objectives (such as achieving a more efficient tax system), specific policies and strategies should be developed to address these challenges without undermining longstanding equalisation arrangements.

HFE does not compensate states for diverging from efficient tax and service delivery choices. Expenditure assessments are not based on actual spending by an individual state. They are based on independent socioeconomic and demographic variables. If a state delivers services less efficiently than average, it will bear the cost and vice versa.

As noted above, HFE does not distort state tax mix choices, in theory or practice.

South Australia believes that the operation of HFE should not in any way be constrained or modified in order to achieve other policy objectives.

#### Structural vs cyclical factors

The current system of HFE does respond to emerging cyclical and structural changes, albeit, with a lag.

The economic rise of China and India, the challenge of climate change, population growth and ageing, and continuing technological change are all structural factors beyond the control of state governments and are affecting the states in different ways. This strengthens, rather than diminishes, the importance of a robust and full equalisation system – to fully equalise

increasingly diverging fiscal capacities and avoid incentives for efficiency detracting migration of capital and labour.

The current system of equalisation has appropriately responded to cyclical changes including the recent strong growth in property values (especially in the eastern states) and the 2000s mining boom and subsequent correction.

The scope and coverage of assessments should not be confused with contemporaneity issues. The achievement of full equalisation requires that all state revenue and expense items be incorporated into the assessment process. Just because a revenue or expense experiences volatility does not mean it should be excluded or treated differently from other items.

#### Fiscal divergences and past policy decisions

Fiscal equalisation should not have the aim of encouraging all state and territory governments to have the same taxation or expenditure policies. Households in some states may have a preference for a higher level of government services and the requisite higher level (or mix) of taxation. Therefore, allowing policy differences between states is important for maximising national welfare, promoting efficiency and innovation. A decentralised system of government is better able to cater for the divergent needs and preferences of their state populations.

Current HFE assessments are generally based on the average policy of what states do rather than attempting to make judgements on what services should be provided, "desirable" service standards or the severity of taxes.

[equalisation] does not penalise efficient States; nor reward inefficient ones. States are funded on the assumption that they can deliver services at the average observed level of efficiency. If a State is more efficient than the average, it retains the benefit. If it has below average efficiency it bears the cost. (CGC 2011, p32)

Adoption of an approach that uses the most efficient service provider as a benchmark would require the CGC to impose value judgements on jurisdictions, undermine states' sovereignty and would be difficult to implement.

State governments do receive the full benefit of service delivery efficiencies because the CGC generally assesses needs through observations of independent variables rather than actual spending levels. If a more active approach to improving efficiency in government service delivery is considered desirable, specific policies and strategies can be developed to address these challenges rather than providing HFE with multiple objectives and potentially undermining its key objective to achieve equalisation.

In terms of economic development, it is impossible to assess the extent to which the economic opportunities available in each jurisdiction are influenced by state government policy decisions. For example, the economic base of South Australia is being fundamentally altered by the closure of Australia's automotive industry, which was in turn the result of global competitive forces over and beyond the control of State Government policy influence.

Similarly, the boom in Western Australia's royalty revenues was the result of strong demand for resources from China, and was associated with a rising exchange rate which reduced the competitiveness of trade exposed industry in other regions. Developments such as these

fundamentally alter the relative capacity of each state to raise their own tax revenues in ways that dwarf the influence of state policy.

In response to the closure of the automotive industry and the economic challenges facing the state, the South Australian Government has developed an economic development strategy<sup>15</sup> which supports the growth of emerging industries, innovation and an improved business climate.

As a recipient HFE state, South Australia is not dissuaded from improving economic outcomes for its citizens. But the influence of state policy in this sphere is dwarfed by national and global forces and the investment decisions of individual firms.

To what extent should States be held accountable for how they use funds received via equalisation?

States' shares of GST revenues are untied and states can spend it on any purpose they wish.

The objective of HFE is to give states the capacity to provide equal outcomes without reversing or overriding the states' own policy choices. The use of the word capacity in the CGC's definition of HFE emphasises the freedom of states to choose how to spend their money, even if their choices ultimately produce unequal outcomes for various classes of citizens.

The CGC's calculations are based on how much states collectively have spent on each service, and on each population group. States are given the same overall capacity to implement the average policies of all states combined.

However, states are not forced to follow the average. They may spend more, or less, on any function according to their own assessment or priorities. In areas where the Commonwealth wishes to influence the actual state spending, the Commonwealth will usually enter into a joint funding arrangement with the states – a specific purpose program.

There are a number of accountability processes that monitor the performance of state governments. These include annual budget processes, including Estimates Committee hearings, and the PC's annual Report on Government Services publication.

However, state governments are ultimately held to account by the electorate. If there is insufficient transparency to allow voters to make informed decisions, this is not a problem arising from HFE.

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<sup>&</sup>lt;sup>15</sup> More information available at <a href="http://economic.priorities.sa.gov.au/">http://economic.priorities.sa.gov.au/</a>

What are some alternatives to the current system and how would they affect States' incentives to pursue higher prosperity? How would the alternatives perform, relative to the current system, in terms of efficiency, equity and simplicity, and ultimately which approach is best for national productivity and wellbeing?

How do these alternative approaches fit within the wider scheme of federal financial relations? Are some inequalities across States better dealt with outside the HFE system?

What practices in other federations offer pertinent evidence for the Commission's considerations?

#### Alternative approaches and efficiency

The Greiner Review considered a number of different equalisation approaches and classified them into two broad categories – proposals that do "less" equalisation and proposals that perform equalisation in a less precise or more general way.

This classification approach correctly highlights that all alternatives to the current arrangements result in outcomes that will compromise the achievement of full equalisation.

Approaches that give rise to less equalisation include the application of an arbitrary discount to a revenue category (e.g. mining revenue), equalisation to the standard of the state with the minimum revenue effort, application of arbitrary efficiency dividends, use of external standards, use of a seven-state average, distribution of a minimum amount on an EPC basis or establishment of a relativity floor.

Alternative approaches to distributing grants between the states and territories which are prominent in the national debate – such as relativity floors and equal per capita distributions – are an (unstated) attempt to fundamentally alter the current full equalisation objective. They are arbitrary proposals with the aim of improving the budget outcome of a jurisdiction and do not involve a principled objective. They would result in differential and treatment of Australians depending on the accident of the demographic composition of the jurisdiction in which they are born or choose to live. We also note the PC's terms of reference do not require it to reassess the current full equalisation objective per se. The terms of reference are specifically about economic efficiency issues.

The Greiner Review specifically considered approaches that could be viewed as promoting efficiency in response to the views of certain commentators and jurisdictions that the current approach to HFE reduces incentives to deliver services more efficiently.

It has been suggested that using a national average expense as the basis for equalisation sends a signal to all jurisdictions that operating at the average efficiency is acceptable and does not encourage jurisdictions to pursue further efficiency reforms.

Reform activities that seek to improve operational efficiency or improve outcomes can be pursued at the national level or at the state and territory level.

Recent national reform processes include the National Health Reform Agreement (based on activity levels), the National Disability Insurance Scheme (tailored support packages), the National Educational Reform Agreement (needs-based funding) and national water reform initiatives. HFE has not been a major impediment to any of these reform processes.

At the state and territory level, efficiency initiatives targeted at the provision of government services tend to be driven by budgetary decisions. The most common technique is for a government to impose "efficiency dividends" on its agencies. There is no evidence to suggest that HFE considerations play any part in "efficiency dividend" decisions by state and territory governments.

Approaches such as equalising to less than the all-state average or some efficient external standard raises the issue of how these standards would be determined and how they would be adjusted over time. In practice, the setting of standards would be fairly arbitrary in nature. As the Greiner review noted, proponents of these approaches naturally assume that an efficient standard would be lower than the average rather than more.

It also assumes that states with higher than average expenses are automatically less efficient and those with lower than average costs are more efficient. This assumption does not recognise the underlying causes of the higher or lower expenditure level which may be as a result of having a higher or lower proportion of older people or school age children.

Continuation of the use of an average standard has the considerable advantage that it does not require the CGC to exercise judgement about the type and level of services, and the type and rate of taxes, which states actually employ.

This advantage (particularly from the point of view of maintaining simplicity) is lost if the standard is interpreted as an 'ideal' or 'best-practice' level of services/taxes or is based on the 'most efficient' service providers or revenue collectors, however that may be determined.

The level of service provided by each state, and the tax effort made, is best left to be judged by its community.

The Greiner Review concluded at Finding 3.1 that:

Despite our initial desire to provide incentives to States to deliver services more efficiently, the Panel has concluded that the HFE system as currently manifested cannot achieve this through efficiency discounts, as there are factors beyond a State's control that lead to higher than average expenditure. While it might theoretically be possible to overcome this deficiency if the CGC were to fully separate cost and use elements of its assessments, that result is not guaranteed, and the additional process would risk complicating the CGC's assessments further.

The use of a global revenue assessment has also been put forward from time to time. Global revenue assessments are not an appropriate way to assess states' relativity capacity to generate taxation revenue. Payroll tax is based on taxable private sector wages over a threshold while land tax is primarily based on the site-value of land that is not used as a principal place of residence.

No one indicator can be used as a proxy driver for assessing all state taxes and revenues, as noted by Walsh (2011)<sup>16</sup>:

"...it is sometimes suggested that revenue-raising capacity assessments should be based on global or macro measures such as household incomes. The major problem with this suggestion is that it confuses households' capacity to pay with States' capacities to raise revenue, in two senses. First, if the tax bases actually available to the states are not related to incomes, nor will be their actual capacity to raise revenue from them. Second, and perhaps even more significantly, household incomes or any other reasonably measurable macro indicator would, at best, capture only the capacity of States to raise revenue from residence-based taxes. It would not reflect any differences in different States' relative capacities to raise revenue from source-based taxes."

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<sup>&</sup>lt;sup>16</sup> C Walsh, The Equity Case for Equalising Fiscal Capacities: Rationales, value-judgements, compromises and their implications, A discussion paper prepared for the Department of Treasury and Finance, Government of Victoria, September 2011, page 15.