

ALTERNATIVE APPROACH TO FIXING FISCAL EQUALISATION

Over the last decade, there have been clear problems with fiscal equalization between the States and Territories. To get an idea of the sheer magnitude of the problems with the Commonwealth Grants Commission's current fiscal equalization model, the Northern Territory receives approximately fifteen times as much GST revenue per capita as Western Australia does. Little wonder that West Australians think they're being duded by equalisation!

There have also been repeated attempts to fix these problems. Unfortunately, while there have been some marginal reductions in the problems with the Commission's equalization model, in large part they still remain and while the recent draft report by the Productivity Commission will ensure further progress in terms of marginal improvements, two fundamental problems remain.

The two fundamental problems are:

- the potential for the States and Territories to 'game' equalization; and
- using equalization to do something it was never designed to do.

The most obvious example of the potential for 'gaming' equalization is in mining. States with limited mining capacity can boost their GST revenue share by essentially ignoring or handicapping their mining industries (eg Victoria or N.S.W. with natural gas).

One of the jokes at the Grants Commission in the early part of the recent mining boom is the following Q and A: Where would, say, Victoria like to find the world's biggest gold discovery? In Western Australia! The simple fact is that under equalization, Victoria would avoid all the environmental problems and effectively get a large share of the royalty revenues, while WA would be left with an even smaller GST revenue share and would have to cope with the environmental problems.

For States with significant mining potential such as WA, Qld and SA, however, overt restrictions on their mining industries are not feasible. They need these industries too badly. For them, the trick in gaming equalization is to find ways to limit the royalties they collect directly from mining.

Historically, Queensland have been champions at this. Instead of collecting royalties directly from the State's massive high quality thermal and metallurgical coal production, former Premier Joh Bjelke-Peterson was a master at extracting at least part of these royalties indirectly by negotiating higher than economic coal freight rates for the major coal export projects (at the time, the Commonwealth Grants Commission assessed State freight

revenues on an equal per capita or EPC basis, which meant that these revenues did not impact the State's assessed relativity).

The Queensland government is still a champion at gaming the mining assessment. Because of the way royalties are collected on the massive coal seam gas production used to support LNG exports from Gladstone, this production is currently essentially royalty exempt and is likely to remain so for the next few years. Indeed, there may never be any royalties collected on the CSG production used for LNG exported from Gladstone.

Unfortunately for residential and industrial gas consumers in eastern Australia, however, this 'gaming' has created a serious distortion in the domestic east Australian gas market. By exempting CSG from royalties, Qld effectively subsidizing LNG exports from Gladstone and, in turn, effectively **TAXING** gas supplied to consumers in the domestic gas market.

There is no question in my mind that if gas used to produce Gladstone LNG exports were subject to the same dollar royalty charge as natural gas produced and sold into the domestic market, the east Australian gas price would fall *quickly and quite sharply*.

The 'gaming' problem isn't restricted to mining. It also underpins the problems with indigenous policy in the N.T. Equalisation creates a serious disincentive for the NT to implement effective indigenous policies. The result: living, education and health standards for many indigenous Australians (particularly juveniles) in the N.T. are going backwards. Instead, under equalization, successive N.T. governments having relied on their large indigenous funding "needs" to deliver much higher than average per capita GST revenues than received by any other State or Territory. This funding lifeline has not, however, been used to reduce this "need". It has instead been used to fund government services for non-indigenous Territorians living in and around Darwin!

The second fundamental problem was caused by the inclusion of the N.T. and the A.C.T. in fiscal equalisation. Unfortunately, because of the way the Commission's equalization model works, it effectively transferred part of the task of funding of the A.C.T. and N.T. from the Commonwealth to the six States even though equalization was not meant to do this.

For example, the A.C.T. and N.T. do not have a viable payroll tax base, with employment in both Territories dominated by public servants (State and federal). Nor does the NT have full control over their mining royalties, while the ACT only collects very modest mining royalties (if any at all in some years). This continues to be the case.

At the time of inclusion (1985 for the NT and 1993 for the ACT), these revenue problems were not addressed. Over time, however, the lack of strong and reliable revenue bases on the part of the two Territories has resulted in a long-term decline in the fiscal position of the two Territories relative to the six States. As a result, the transfer of funds from the six States to the two Territories has grown.

This transfer problem has also been exacerbated by the growth in the amount of funding covered by equalization. At the time the ACT and NT were included, the funding covered by equalization was relatively modest and hence the problem was not seen as a significant issue. When the GST was introduced, however, it significantly increased the potential transfers between the States and the two Territories.

The funding responsibility problem was also compounded in 2010 when the Grants Commission began equalizing on the basis of net financial worth. The decline in the relative fiscal capacity of the two Territories has reduced their capacity to grow their net financial worth compared to the States.

As well, the ACT and NT have relatively large unfunded pension liabilities for their public servants. These unfunded liabilities have grown relative to those of the States. Over coming years, the two Territories will have to fund these liabilities as their public servants retire and have to be paid their (unfunded) pensions. This will further reduce the net financial worth per capita for the two Territories compared to the six States, thus increasing the GST revenue they receive from the States under fiscal equalization.

Taken all together, inclusion of the ACT and the NT in fiscal equalization could be seen, in a sense, as creating a 'cancer' within equalization that could lead to its eventual collapse. While we have not yet reached this point, the situation of Western Australia indicates that we may well reach this point in the not too distant future unless we take significant action soon.

Full or partial removal of the A.C.T. and the NT from equalization would significantly improve fiscal equalization between the States:

- by eliminating the burden the two Territories impose on the States;
- by removing the N.T., it would force the Commonwealth to address indigenous policy directly rather than leaving it to the N.T. and thus would eliminate the indigenous policy related 'gaming' problem; and
- it would also indirectly reduce the 'gaming' incentive with mining royalties (the A.C.T. has zero mining 'capacity' and hence adds to the mining royalty imbalance).

Of course, the full removal of the A.C.T. and the N.T. from fiscal equalization would impose a significant revenue burden on the two Territories.

A partial solution to GST revenue to this problem would be to allocate GST revenue to the two Territories on an equal per capita basis, with any shortfall between what the A.C.T. and N.T. now get negotiated directly with the Commonwealth (as it should have been ahead of these two Territories, in fiscal equalization).

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