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Productivity Commission
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Dear Mr Banks

REVIEW OF NATIONAL COMPETITION POLICY ARRANGEMENTS
IMPACT OF FISCAL EQUALISATION ON STATE TAXATION REFORM

The Insurance Council of Australia, in the attached extract from its submission to the Productivity Commission Review of National Competition Policy Arrangements, has argued that Horizontal Fiscal Equalisation (HFE) methodology creates a disincentive for the States to reduce stamp duty on insurance, because it penalises a State with low rates of duty.

I am writing because that argument appears to be based on a misunderstanding of the HFE methodology.

Fiscal equalisation is a concept adopted in most of the world's major federations and in many unitary countries. In Australia, the Commonwealth Grants Commission implements fiscal equalisation between the States based on the following principle.

> **State governments should receive funding from the pool of goods and services tax revenue and health care grants such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.**

This principle is about equalising the fiscal capacity of State governments to provide services. An essential feature of capacity equalisation is that there should be no incentive or disincentive for States to follow any particular policies on either side of their budgets — a feature that follows from the untied nature of the GST funds. To achieve that end, the Commission's calculations are based on the assumption that all States follow standard policies in delivering services or raising revenue. Those standard policies are set at the national average of the policies applied by the States.

The outcome is that a State's own policies on the services it provides or the revenues it raises should not directly influence the level of grants it receives. The calculations are neutral to the specific policies of any particular State.

This approach of applying standard policies ensures that:

(i) additional costs incurred by a State because of its decisions to reduce its rates of taxes or duties below the national average (or to provide services at standards above the national average) are not in part funded by residents of other States through changes in GST shares; and

(ii) additional revenues collected by a State because of its decisions to impose above average rates of taxes and charges (or cost savings arising from decisions to provide below average standards of service or the use of service delivery methods that are more efficient than the average) are not redistributed to other States.

If the Commission's calculations were to be guided by the actual rates of taxes or duties in each State, taken to the extreme, there could be a perverse incentive for a State to abolish State taxes or duties altogether in the expectation of a larger share of GST funds. This would be an inequitable outcome. In addition, there would be incentives for other States to follow suit with the result that States would collectively have less revenues to provide services. In this situation, some States may receive a bigger share of the GST pool, but would still be financially worse off.

Under the equalisation methods applied by the Commission, State shares of the GST revenue are predominantly determined by differences between States in factors that are beyond the direct control of individual State governments. Those factors stem from features of State populations, economies, and geography.

The ICA submission is correct in noting that the Commission 'focuses on the capacity it has identified'. In the specific case of State taxes on insurance, the Commission's calculations focus on the relative size of the tax base in each State (measured in terms of insurance premiums paid in each State). It is the interstate differences in the per capita values of premiums that affect the State shares of GST. New South Wales is assessed to have an above average capacity to raise revenue from insurance taxation because it has the highest per capita value of premiums of all States.

The fact that New South Wales has below average tax rates which result in below average per capita revenue from insurance tax does not directly affect its GST share. The policy decisions of the New South Wales Government to impose below average tax rates do, of course, affect the State's budget. Similarly, any decision to reduce rates would affect the State budget through the consequential reduction in tax collections but it would not substantially affect the State's GST revenue[1]. That is, the burden on the State budget would be only the direct effect of its decision to reduce tax rates. Equalisation methods would not magnify the effects of that decision. Equalisation does not create an incentive or disincentive to tax reform.

In summary, the Commission considers that the application of equalisation does not affect the main issues States consider in reaching decisions on tax reform.

Malcolm Nicholas
Acting Secretary

10 September 2004

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1 There will be some small effects because the reduced tax rate would reduce the average tax effort all States are assumed to apply. This would, in turn, reduce the importance of insurance taxation within the overall calculation of grant shares. This effect could create a theoretical incentive for New South Wales (or any State) to reduce its tax rates for taxes for which it has an above average capacity (such as insurance taxation) because the impact of that above average capacity on its grant share would fall. But it would be short-sighted to do so because the increase in GST revenue would be a small proportion of the reduction in its own revenues.

ATTACHMENT

EXTRACT FROM
ICA submission to the National Competition Policy Inquiry June 2004,
Insurance Council of Australia,
Page 10

5.2.3 The CGC's HFE Methodology as a disincentive to state taxation reform

HFE is a process through which the CGC purports to provide the States[13] with equal *capacity* to provide services. States with below average revenue-raising capacity or above average spending needs may receive a larger share of GST. HFE redistributes resources from the states that the CGC deems as having above-average capacity to provide services, to those it deems with below-average capacity to provide services.

In determining how much capacity there is and what is "above" and "below" average revenue raising capacity the CGC looks at a weighted average of revenues on a per capita basis by State.

It is essential to note that HFE looks only at capacity to raise revenue – not what actually occurs.

HFE is supposed to be "policy neutral" in a revenue sense.

The problem with this is that it discourages the reform of state taxes

Looking at stamp duty on insurance specifically, it is easy to see how the use of a national weighted average discriminates against a state with low levels of stamp duty. Despite being the largest single "market" in Australia, NSW stamp duty revenue is invariably below the national average (when expressed on a per-capita percentage basis).

As such, when the CGC applies HFE it does so on the basis that NSW is collecting more stamp duty on insurance than it actually is. That is, the CGC focuses on the capacity it has identified and ignores what actually happens.

The current system creates a clear disincentive on all States for reducing stamp duty on insurance unilaterally as any reduction would only either bring them towards the national weighted average, or (in the case of a jurisdiction like NSW which is already below average) move them further away from the national average.

The disincentive exists because under the current HFE methodology, any State that is below average is deemed to be collecting more revenue than they actually do and, other things being equal, therefore have a reduced need for GST.

Similarly, states with above-average levels of stamp duty are better off.

13 States meaning "States and Territories"