



Australian Capital Territory's Submission to the GST Distribution Review

Response to the First and Second Interim Reports

July 2012

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1 Executive Summary

- 1 The ACT welcomes the opportunity to engage further with the Review Panel (the Panel) in the GST Distribution Review and acknowledges the critical role the Panel is tasked with, to report on the GST Distribution and HFE principles.
- 2 The ACT is committed to the fundamental proposition stated in the Terms of Reference (ToR) of the Review, that “the long-standing principle of equalising States’ capacities to provide services and infrastructure to their citizens has served Australia well”.
- 3 The ACT continues to stand by the current Horizontal Fiscal Equalisation (HFE) principle and its underlying pillars¹ which have, to this day, proven a source of stability for the federation:
 - policy neutrality – a State’s² own policy choices do not directly influence its grant share;
 - capacity equalisation – capacities of the States are equalised, not their performance or outcomes; and
 - what States do – States are equalised to standards that reflect what they do on average rather than what they could or should do.
- 4 The findings of the Review have established that the current interpretation and implementation of HFE is not fractured and is able to sustain global and national economic restructuring. The ACT’s view is that HFE is working, and importantly, working effectively. The ACT agrees with the findings that the state of public confidence in the financial inter-relationships within the Federation must be restored. There is a recognition that certain aspects of the system, including its: unpredictability; implementation; and communication are not meeting stakeholder expectations and need to be fixed, even if nothing else in the system changed.
- 5 Changes proposed by the Panel should not be taken lightly, and unproven, unquantified, radical changes should be ruled out. The Panel’s finding that HFE has negligible effects on efficiency reinforces the need for only a refinement, rather than an overhaul of HFE.
- 6 In that context the ACT is reassured by the Panel’s position of not supporting the distribution of the GST pool on an equal per capita basis, nor the premise of arguments put forward by the States of NSW and Victoria regarding efficiency.
- 7 The ACT is willing to provide support for the Commonwealth Grants Commission (CGC) directed through ToR in the future to explore options including:
 - mining related infrastructure - the need to adjust for the up-front costs facing the resource States on the proviso that they would be paid back at a later time;
 - equalising capital payments over a longer period of time to recognise the lasting nature of assets;

¹ Report on GST Revenue Sharing Relativities – 2010 Review, Volume 2 – Assessments of State Fiscal Capacities.

² The word States refers to the States and Territories unless otherwise indicated.

- exploring the option that predictability and stability could be improved with minimal change to the system by ensuring that certain data changes are not ‘backcast’ and providing transitional assistance for large changes in GST shares; and
 - communication proposals.
- 8 Any move from equalisation based on ‘same capacities’ to ‘comparable capacities’ threatens the current existence of HFE and the capacity of the smaller States to provide an average level of service to their citizens. That is, comparable equalisation, based on something other than the current average of all States, would result in recipient States receiving less GST to provide services to residents. The ACT is therefore not supporting a shift in the fundamental goal of the GST distribution from pursuing the same fiscal capacities for jurisdictions towards a broader concept of providing comparable capacities.
- 9 The Panel’s examples of mechanisms to implement equalising to comparable capacities as outlined in the Interim Reports (IRs) are: the use of global or broader indicators; a minimum or lower standard; or an external standard. These approaches fail the fitness-for-purpose test because they do not capture the circumstances of individual States. The primary objective of HFE is equity, and the means for achieving this is through assessments that are fit-for-purpose so that they adequately capture the relative circumstances of the States. Equity should not be traded-off in favour of a secondary objective such as simplicity.
- 10 The ACT also rejects the concept outlined in the supplementary ToR that HFE should be utilised to provide incentives to promote future State policy decisions regarding State taxes and mineral royalties. HFE should not be used as a policy tool to facilitate tax reform. To use the GST distribution process to incentivise States to undertake tax reform is inconsistent with the HFE principles, irrespective of whether reform is multilateral or unilateral.
- 11 The ACT has embarked on tax reform on a unilateral basis within the known operations and implications of the existing HFE process – *A Five Year Reform Plan: A Fairer, Simpler and More Efficient Taxation System* released in conjunction with the ACT’s 2012-13 Budget.
- 12 The Territory does consider that the GST distribution process should not result in unintended disadvantage to a State undertaking unilateral reform, as is currently the case. Options canvassed in the Second IR for compensatory payments (either inside or outside the GST system) to ensure that HFE does not impose disincentives under a multilateral approach, could also be considered in the circumstances of unilateral tax reform.
- 13 Finally, the ACT does not support the donor and recipient approach. Such an approach, which would see the donor States agree to a proportion of GST being set aside for the recipient States and distributed among them, does not support the principles of HFE and would not substantially reduce complexity (due to the need to still identify donor States and define the distribution basis for recipient States).
- 14 Other similar suggestions have included that the ACT receive an equal per capita share of the pool due to its high per capita income or that the ACT and Northern Territory be removed from the equalisation process. Again these approaches lack substantive arguments in their support and are counter to the fundamental HFE principle.

2 Introduction

15 The Panel has presented two IRs:

- the IR of March 2012 (First IR) outlines the Panel's thoughts on parties' views on whether the current arrangements for implementing HFE can be improved, in light of the major structural changes shaping the Australian economy both now and into the future (initial ToR); and
- the IR of June 2012 (Second IR) outlines the Panel's thoughts on parties' views on the use of the GST distribution system to promote efficiency in tax design or reform (the supplementary ToR).

16 This final Submission to the Review responds to the issues raised in both IRs, highlighting the ACT's stance in relation to the presented suggestions and preferred options.

3 Simplicity - moving away from the current approach to equalisation

17 In the First IR, the Panel has outlined its in principle support for a move away from detailed measures that capture relative service provision costs and the capacities of the States to raise revenues by:

- using broader indicators or global indicators; or
- varying the standard – moving away from the national average using all States ('exact' or 'same' equalisation) to adopting a standard based on something other than the average of 'what States do' ('comparable' equalisation), through a mechanism such as:
 - a minimum standard e.g. standard based on the lowest taxing or spending State, or the State that is closest to, but below the national average; or
 - an external standard (the "most efficient" State has been mooted in HFE forums in the past).

18 According to the Panel, both international and Australia's own past practice show that something less than pursuit of equality between jurisdictions may result in a fair outcome and can produce confidence in federal financing arrangements. It is asserted that a move from same to comparable capacities may facilitate simpler, more transparent and more understandable arrangements. The Panel also appears to be concerned about the perceived adverse impacts of the system on economic efficiency.

19 The concept adopted by the Panel is not well defined and by implication appears to be broadly influenced by the Canadian system of equalisation. There are, however, some critical differences between the Canadian and Australian systems of equalisation. The main differences are that the Canadian system:

- equalises only revenue, not expenses;

- excludes 50% of natural resource revenue; and
- equalises only to bring below-average provinces up to the average, funded by the Federal government's general revenue.

20 Another key element of difference is that equalisation payments in Canada are a much smaller component of provincial budgets than they are for Australian States. Provincial governments in Canada have access to a wide range of revenue sources, including personal and business income tax, which are not available to Australia's State governments.

21 Any move to adopt elements of the Canadian model should be treated with caution. In particular, modifying revenue assessments to exclude all or part of mining royalties would materially weaken fiscal equalisation and should not be supported. Other material provided to the Review Panel indicates that the Canadian system of partial equalisation involves locational efficiency costs which would actually be reduced by moving to full equalisation of net fiscal benefits. However, the ACT has indicated its support in this submission for rationalisation of the two-rate structure of mining assessments and for changed treatment to the equalisation of capital payments, which would assist in addressing the type of problems which the Canadian approach is designed to deal with.

22 The ACT's view is that equity should remain the primary goal. The greater the move away from tailored and detailed measures³ employed by the CGC to capture States' relative circumstances, the greater the degree to which equity will be traded-off in favour of other less important goals such as simplicity.

23 In terms of the efficiency effects, the Panel breaks these down into three broad categories - policy effects, location effects and administration costs⁴. The Panel concludes that:

- the policy effects of HFE are not large (other than in relation to mining);
- HFE may have effects on 'location efficiency', however, the magnitude and significance of the effects are disputed and unclear; and
- given the small size of the current administration cost, amending it would not produce significant gains.

24 The Panel notes that it is not convinced that efficiency concerns provide grounds for radical changes to the HFE process. This view was supported by the Commonwealth Treasury in its submission to the First IR⁵. Further support for this position is given by a substantial modelling study carried out by Independent Economics (*Horizontal Fiscal Equalisation: Modelling the welfare and efficiency effects*; Independent Economics; Feb 2012) for the SA Department of Treasury and Finance and submitted to the Review, which concluded that HFE enhances both

³ The CGC often uses broad indicators for expenditure categories that have been tailored and adjusted for intensity of use and cost, and are thus equivalent to detailed measures. Similarly, for revenues, broad indicators are sometimes used, such as compensation of employees, which is adjusted for tax free thresholds; progressive tax rates; PTEs and Higher Education Institutions and other adjustments.

⁴ First Interim Report, page 71.

⁵ Commonwealth Treasury Submission to the GST Distribution Review, October 2011, page 44.

equity and location efficiency, with an estimated national loss in welfare of \$295 million per annum (in 2009-10 terms) from moving to equal per capita grants of GST.

3.1 Simplicity

i. Use of Broad and Global Indicators

25 Global or broader indicators should only be adopted to the extent they support the fundamental objective of equalisation. This means that the assessments must be based on the relative fiscal capacities of the States. This approach, by definition, must capture the individual circumstances of the States, that is, in the words of the CGC, be ‘fit-for-purpose’.

26 The ACT considers that the general use of global or broader indicators fail the fitness-for-purpose test. In its 2010 Review, the CGC found that, without this requirement, disabilities or fiscal capacities cannot be assessed adequately to the satisfaction of all parties. The ACT does not support the use of global or broader indicators.

27 A number of States, and in particular the ACT, have continually expressed concerns with the use of global indicators for revenue assessments as favoured by the Panel because they are very poor measures of States’ revenue raising capacities. Stakeholders generally accept that the current approach to revenue assessments is comprehensive and largely transparent, with the drivers (revenue bases) leading to the redistribution of GST funding being clear.

28 In terms of broader indicators, these need to be tailored to reflect the conditions of the States. The CGC has, in many cases, used a broader indicator and adjusted it for State circumstances so that it achieves HFE, and in effect, turned them into ‘detailed indicators’.

29 For the expenditure assessments, broader indicators are adjusted with the deliberate objective of accounting for significant use and cost factors which are outside the direct control of the States. On the revenue side, adjustments are made for tax free thresholds and exemptions, progressive tax rates and a range of other modifications to reflect specific revenue raising circumstances of the States, including, for example, the inability of the ACT to tax the largest employer in the Territory – the Commonwealth.

30 In relation to the expenditure assessments, there is some scope for simplification, but this should be done by examining each expenditure category on a case by case basis. There are some categories where complexity has led to ambiguity, namely the welfare and housing category and the schools education category. In regard to the latter, the use of actual enrolments for all years of schooling rather than the overly complicated approach currently used is suggested.⁶

31 The adoption of broad indicators without adjustment to capture the specific circumstances of each State involves trading-off equity in favour of simplicity. The ACT does not support this trade-off.

⁶ For more details on the ACT views on these assessments, refer to the ACT’s submission to the GST Distribution Review Issues Paper of July 2011.

ii. Equalising to an external standard

32 The ACT does not support equalising to an external standard. The use of internal standards which reflect 'what States currently do' is supported because it eliminates the requirement for judgements. These are properly decisions for the State and should not be subject to judgements of the Commission or any other governance body.

33 The use of external standards based on 'what States should do', the circumstances they 'should operate in', an 'ideal' level of service, efficiency,⁷ or some other concept requires extensive value judgements to be made. Such an approach directly undermines one of the three pillars of the HFE system. As a consequence of such an approach, the impartiality of the process is lost. It amounts to directing States to spend funding, and levy taxes in certain areas and would potentially result in an inefficient allocation of resources.

34 In addition, such an approach is also contrary to the principles of the current Intergovernmental Agreement, under which GST revenue grants are untied and available for any purpose. Indeed, it would ultimately reflect on State rights.

iii. Equalising to a minimum (or lower average) standard

35 The ACT does not support equalising to a minimum (or lower than average) standard. The use of a minimum or lower standard moves away from 'What States do' on average. This is controversial as, similar to the issue raised above with the external average, the adoption of a minimum standard would require value judgements. It is not clear how an objective means of determining the minimum standard would be achieved.

36 The options proposed:

- introduce increased levels of judgement and subjectivity; and
- put at risk equity being achieved - the greater the degree to which the average is minimised, the less the degree of equity which is achieved.

37 Based on 2012 Update data, the option of choosing a State immediately below the average to strike the standard will, in a number of categories, result in the standard falling only marginally. In other categories it will fall substantially. For example, the standard for roads falls by \$1.82 per capita or 0.7 per cent, whilst the mining standard falls by \$255.14 per capita, or 59.9 per cent.⁸

38 This will have a dramatic impact on the ACT, and it is estimated that the result of moving from the current standard to a standard based on the State that is closest to, but below the average

⁷ The use of external standards could equate to delivering services to what the most efficient States does as one option suggested is to set the standard to the second lowest State. The second lowest State is often one of the more populous States (NSW, Victoria or Queensland) which is able to drive and achieve efficiencies given economies of scale the smaller jurisdictions are unable to attain. As such, equalisation would in effect be driven by efficiency, not equity.

⁸ Source: ACT Treasury - based on moving from the current standard to a standard based on the State that is closest to, but below the average using 2012 Update, 2010-11 data.

would result in a loss of approximately \$283.25 per capita, or \$100 million per annum. To put this into perspective, this is equivalent to \$2.04 billion for NSW:⁹

- of the \$100 million redistributed, approximately \$92 million is due to the mining assessment, which entails a large reduction in the standard due to the disparate levels of mining activity among the States; and
- consideration would probably need to be given to some form of adjustment across the assessment categories to smooth out such variations, further increasing the complexity of the system.

iv. Simplicity – Freezing expenditure disabilities

39 The ACT does not support the freezing of expenditure disabilities and supports the view of the Panel that such an approach would represent only a minor improvement in simplifying the CGC's annual update process. It does not address the major causes of underlying complexity.

4 Tax Reform and HFE

4.1 Ensuring that HFE does not provide a disincentive to State tax reform

40 The ACT does not agree with the use of incentives or disincentives within the HFE system to encourage State tax reform. HFE should not be used as a policy tool to facilitate tax reform.

41 The ACT agrees in principle with the Panel that an optimal way to pursue State tax reform is on a multilateral basis to maximise the benefits of reforms. However, the ACT considers that unilateral reform may also be appropriately advanced by a State, based on its own particular circumstances.

42 Where a multilateral approach is adopted, based on consultation between the Commonwealth and the States with agreed timelines for the abolition of a tax for the majority of States, the GST distribution would provide neither incentives nor disincentives for tax reform. For example, modification of the RRC of a State that abolishes an agreed tax will not affect the allocation of the GST if the *majority* of States¹⁰ actually abolish the tax in question at the same time under a multilateral agreement, as the tax will not be assessed as part of HFE (no longer average State policy).

43 The ACT would support consideration of incentives from either inside or outside the GST pool, where a multilateral tax reform agreement is entered into between the Commonwealth and the States, as this approach would not contravene HFE principles.

⁹ Source: ACT Treasury - based on moving from the current standard to a standard based on the State that is closest to, but below the average using 2012 Update, 2010-11 data.

¹⁰ The average for the revenue categories is defined by the CGC to be four or more States or those States with the majority of the revenues collected for a tax.

44 The HFE system should not penalise or create unintended disadvantage for a State that takes the initiative to progress tax reform unilaterally.

45 In conjunction with its 2012-13 Budget, the ACT released *A fairer, simpler and more efficient taxation system: 5 Year Reform Plan* which sets out a plan for pursuing tax reform based on the efficiency and equity benefits which would result for the Territory. The Plan reaffirms the Commonwealth's *Australia Future Tax System* report findings regarding the efficacy of some of the major State taxes. Based on these findings, the Reform Plan seeks to reduce the share of transaction taxes from 29 per cent of total taxation to 23 per cent by the end of the forward estimates period.

46 The key reforms from the 5 Year Reform Plan are:

- abolish duty on general and life insurance over the next five years, reduced by 20 per cent every year from 2012-13;
- phasing out of duty on conveyances will commence;
- revenue replacement for reforms will be funded through General Rates for both the residential and commercial sectors;
- the progressivity of the General rates system is being improved to make the revenue substitution more equitable;
- commercial land tax is being abolished and substituted by an increase in commercial General Rates revenue on a cost neutral basis;
- the tax-free threshold for Payroll Tax is being increased to \$1.750 million; and
- a number of legislative amendments are included to improve the functioning and operations of various taxes.

47 Given that the ACT is assessed to have an above average revenue raising capacity for stamp duty on conveyances, despite reducing conveyancing tax (and abolishing it over time), the Territory will also continue to have GST funding redistributed away from it, for so long as conveyancing duty remains average State policy. Further, the very act of reducing conveyancing duty would be expected to result in an increase in transactions, with the revenue raising capacity of the ACT being assessed as higher again by consequence.

48 The cost of acting unilaterally and completely abolishing conveyancing duty in the ACT is estimated to result in a reduction of \$45m p.a. in GST funding, reflecting both of these effects.¹¹

49 The Panel has proposed options, both inside and outside the GST pool, that aim to ensure that HFE does not impose disincentives under a multilateral approach to tax reform. The ACT considers that the same options should be considered in the circumstances of unilateral tax reform.

¹¹ Source: ACT Treasury modelling. The estimated reduction in the ACT's GST share is based on the CGC's stamp duty on conveyances assessment using 2009-10 data from the CGC's Report on GST Revenue Sharing Relativities 2011 Update.

50 This is consistent with the Supplementary ToR, which require that unintended disincentives to tax reform through HFE are removed, irrespective of the form that the reform takes, that is, whether it is unilateral or multilateral:

“The Review should examine and make recommendations on possible changes to the form of equalisation to achieve the following objectives:

(a) ensure that HFE does not provide a disincentive to tax reform, ...”¹²

4.2 Examining the incentives for State to reduce MRRT and PRRT revenue through increasing State mineral royalties.

51 The ACT agrees with the recommendation that the most appropriate way forward regarding mining is a negotiated agreement between the Commonwealth and the States. However, the ACT has concerns with two of the options posed by the Panel:

- *‘removing royalties’*, notwithstanding that it is difficult to see the States agreeing to the removal of royalties altogether, this would lead to the removal of mining from HFE and the loss of substantial GST funding for States with a lack of mineral resources, such as -\$1.9b p.a. for Victoria and -\$131m p.a. for the ACT;¹³ and
- *‘fixing royalties’* - this limits the growth of the mining revenue average under equalisation to the extent that there is growth in the quantity of minerals produced, as the royalties are effectively ‘locked-in’, and thus the GST equalised will be limited:
 - whilst the Panel notes that ‘States (resource States) might only be willing to give such an undertaking that would reduce their policy autonomy in return for some additional benefit’¹⁴, the non-resource States¹⁵ would want to see additional benefits in lieu of GST payments if either of these options were negotiated between the Commonwealth and the resource States.

52 The Final Report by the Panel should include reference to the impact of the recommended options on HFE for non-resource States, given that the Panel is bound by the Supplementary ToR to make recommendations on possible changes to the form of equalisation in regard to MRRT or PRRT revenue that affects not only the resource States, but also the non-resource States.

5 ACT’s position on other reform options identified by the Panel and States as having merit

5.1 Revising the mining assessment

53 The ACT acknowledges that the current two-rate structure of the mining assessment (low and high royalty rate structure), and its interaction with State policy, appears to produce

¹² GST Distribution Review, Additional Terms of Reference – 6A.

¹³ Source: ACT Treasury calculations based on the Report on GST Revenue Sharing Relativities 2012 Update - mining assessment 3 year average.

¹⁴ GST Distribution Review, 2nd Interim Report, June 2012, page 75.

¹⁵ States with little or no resources.

inappropriate outcomes. Such outcomes do not occur in other assessments, that is, they do not produce outcomes whereby a State loses more revenue than is raised, or loses more expenditure than is actually spent. Therefore, there are grounds for reviewing the CGC's rationale for the structure of this assessment.

5.2 Excluding some parts of mining assessments

54 While the ACT is willing to have further explored the inclusion of parts of expenditure associated with mining activities, we strongly support the Panel's view that mining revenue should be included in HFE as this is consistent with including all recurrent general purpose revenue of the States. It is also critical that mining is included due to the large disparity in revenue that exists between the States because of their varying access to mineral resources.

55 In terms of a mining related infrastructure adjustment, the ACT believes it would be in the national interest to consider a proposal that would assist in meeting the up-front costs facing the resource States. This position is premised on the understanding that any such adjustment would be paid back at a later time. That is, States recoup the costs at a later date via user charges or alternative payment mechanisms (the adjustment is in effect a timing issue).

56 If an adjustment was adopted within the HFE process without any pay-back adjustment, then the mining related infrastructure costs would effectively be 'double equalised', once through the HFE process, and again when the State receives a payment through a user-charge or alternative payment mechanism.

57 The ACT's view is that economic development (ED) costs, if they are to be considered within the HFE process at all, cannot be seen narrowly in the context of any one State's situation, but should be viewed on a national basis. In particular, exploitation of Australia's resource endowment has significant consequences for States which have few or no mineral or energy resources, as well as for those that do.

58 As has been well documented, the mining boom which has particularly benefited Western Australia and Queensland has exacerbated major structural problems for other States of the federation. In that context, any allowance for the ED requirements of the resource-rich States should be balanced by an adjustment which recognises the ED costs of other States, that is, their claim to ED disabilities because of a lack of access to natural resources.

59 Were the Panel to recommend the assessment of ED costs, it would have to recognise the enormous difficulty of reliably assessing such costs, and that the CGC has stated that:

- firstly, they cannot be reliably defined, measured or assessed; and
- secondly, those functions which have a development objective should not be subject to disability assessments.¹⁶ The economic efficiency criterion requires that resources flow towards those projects and regions which have better development prospects. If those

¹⁶ The CGC upheld the conclusions it reached in its *Report on Issues in Fiscal Equalisation, 1990* that economic development should be assessed on an equal per capita basis.

States with lower development potential were judged to have higher disability factors, that would run counter to economic efficiency.

60 Therefore, the ACT considers that ED costs should be addressed by means outside the HFE system as they cannot be reliably defined, measured or assessed.

61 The Panel has also outlined alternative avenues for recognising mining costs. For example, the use of a temporary part of the GST pool to address unmeasured needs for mining related infrastructure and expenditure could be triggered if direct methods of measuring needs cannot be undertaken. The ACT opposes this approach as it does not meet any burden of proof requirements and discards the objectivity and evidence based foundations of the current assessment process.

5.3 Donor/Recipient Model

i. Overall

62 This approach for simplicity suggests a system where the donor/recipient dynamic is more formalised. This would see the donor States agree to a proportion of GST being set aside for the recipient States and then being split between them.

63 This is predicated on the argument principally by WA and Victoria who both argue that the current way of distribution stretches too far.

64 The ACT rejects the approach referred to as the 'donor and recipient' model on the grounds that it would be a move to partial equalisation and a substantial softening and departure from the fundamental principles of HFE. The Panel has sought further views on the design of the model, suggesting that the approach could offer 'significant' simplification gains.

65 The ACT argues that there would be no real simplicity gains as the CGC would still be required to assess all States to ensure the GST pool was appropriately distributed. However, if the suggested design were to eliminate the assessment of donor States, equalisation would be undertaken upon the average of only the recipient States.

66 Assessing fiscal capacities based solely on recipient States would result in an unrealistic picture of actual capacities.

67 Furthermore, judgement on the appropriate split between recipient and donor States would have to be exercised, introducing a non objective opinion.

ii. Victoria's Suggested Model

68 The ACT does not support Victoria's suggested donor and recipient model of HFE. Victoria's suggestion that the ACT should be excluded because it has the highest per capita income in Australia disregards the range of other circumstances which legitimately impact on a State's entitlement to GST revenues.

69 The impact of having the highest per capita income in Australia is already reflected in the HFE assessments, with the ACT losing substantial funding through assessments that capture population characteristics, including income and socio-economic status (SES). In the *2012 Update Report on GST Revenue Sharing Relativities*, the ACT lost \$246 million for SES, Indigeneity and other socio-demographic effects.¹⁷ Despite this, the ACT was still a recipient State predominantly because of its low capacity to raise revenue.

70 Victoria's arguments focus solely on the expense side of HFE, that is, remoteness, diseconomies of scale and disadvantaged population groups. Unfortunately the arguments were not developed enough to recognise that in the 2012 Update the majority of the ACT's redistribution is due to revenue disabilities. These stem from issues such as the:

- inability to tax the largest employer in the ACT – the Commonwealth;
- lack of significant business activity from large taxable corporations;
- a dearth of resource wealth, such as minerals, petroleum and gas; and
- a lack of locational advantage resulting in high wealth bases, such as that accumulated in real estate property.

71 While the ACT does have the highest per capita income in Australia, the Victorian Government would well be aware that State governments do not have access to the personal income tax as a tax base. If the suggestion is insinuating that ACT residents have a greater capacity to be more heavily taxed than residents of other jurisdictions, we refer to the CGC's *Report on GST Revenue Relativities: 2012 Update* calculations which show that the ACT's revenue raising effort is currently higher than any other jurisdiction. In fact, the ACT's total assessed revenue raising effort ratio¹⁸ for 2010-11 is 154.64 per cent of the average.

72 The Victorian proposal disregards the unique circumstances facing the ACT as a small jurisdiction housing the majority of the Commonwealth government. For example, 50 per cent of the ACT's workforce is not liable for the application of payroll tax to their wages. To put this into perspective, this would be similar to reducing Victoria's tax take by over \$2.4 billion dollars¹⁹ in the 2012-13 year alone. This simple calculation shows the dramatically different circumstances under which the ACT operates compared with other jurisdictions.

5.4 Equalising capital payments to the States

73 As outlined in the ACT's first submission to the Review, the extension of the scope of the investment assessment to include net financial worth has added considerable complexity and has been controversial as it ignores that States with faster growing populations have higher levels of revaluations. If net worth is considered to be necessary, thought should be given to whether it should be on the basis of the annualised cost of capital.

¹⁷ Source: ACT Treasury modelling. Based on CGC Report on GST Revenue Sharing Relativities 2012 Update.

¹⁸ The CGC defines the assessed revenue raising effort ratio of a States as "the ratio of a State's actual revenue per capita to its assessed revenue per capita. A ratio greater than 100 indicates the State raised more revenue than the average. A ratio below 100 indicates below average effort."

¹⁹ Victorian Budget Paper – Table 4.2 Taxes on employers' payroll and labour force 2012-13 Budget is estimated at \$4,812.2 million.

- 74 It was also stated that if the equalisation system continued to assess State capital expenditure in the year of acquisition, then Commonwealth payments for capital purposes should affect GST shares. However, in the event that the approach to assessing State capital needs is changed (such as to a consumption basis), Commonwealth payments for capital purposes could either be excluded from the GST assessment or, alternatively, included, but equalised over a longer period.
- 75 The Panel has indicated that it sees merit in equalising all capital payments, but doing so over a longer time frame to recognise the lasting nature of the asset being funded and reduce the impact of the payments on GST shares in any one year.
- 76 The ACT supports equalising large, one-off, capital payments over a longer period that more closely matches the life of the assets. The suggested approach is also attractive as it reduces the volatility in the relativities that arises when large, one-off, capital payments made to the States are equalised at the time of receipt.
- 77 As a way forward, a holding cost approach would recognise the financial consequences of infrastructure over its life (year of consumption). This approach would be based on the implicit opportunity cost of the assessed level of infrastructure and recognises differences between the States in the quantity of infrastructure required to provide services and its cost.

i. Excluding certain categories of capital payments

- 78 The ACT does not support equalising *most* capital payments, but excluding prescribed funds, such as ‘nationally significant projects’, as this results in a financial windfall flowing to those States that receive large excluded payments. If a State secures funding that reduces the call on its budget which other States do not benefit from, that funding should be equalised.
- 79 Excluding nationally significant projects will also add complexity and subjectivity to equalisation, as a process for the identification of projects to be excluded will be required. Over time, this process will need to be modified to adapt to changing circumstances as new programs are introduced by Ministers / Federal Governments.
- 80 As indicated by the Panel, this approach may not address a number of outstanding issues such as Victoria’s concerns with 50 per cent of National Network Roads (NNR) projects being equalised, compared with 100 per cent of non-NNR road projects being equalised, as well as 100 per cent of rail construction being equalised.
- 81 The ACT shares Victoria’s concerns with 50 per cent of NNR projects being equalised and the rationale for this. There would appear to be grounds for 100 per cent of NNR road projects being equalised.
- 82 The ACT disagrees that Commonwealth payments for rail construction costs should be anything less than 100 per cent equalised. This is because a number of States benefitted from *Nation Building Plan for the Future – Building Australia Fund* (NBPF) projects that were assessed by Infrastructure Australia (IA). The allocation of funding was based on diverse criteria largely

directed at improving the quality, adequacy and efficiency of transport infrastructure, rather than replacing capital stock.

83 This means that the assessment of needs by IA was not in accordance with the process which would be conducted by the CGC. Accordingly, these payments should be equalised to ensure that individual States do not receive a windfall gain to their budget at the expense of other States.

84 Excluding Commonwealth payments for specific infrastructure projects is also inconsistent with the fact that States fund infrastructure, that the payments are a major component of the CGC's adjusted budget, and with the decision by the CGC to introduce a direct assessment of infrastructure in the 2010 Review, which was one of the most significant assessment changes undertaken.

5.5 Exclusion of the Territories from HFE and changing the treatment of the costs of services to the Indigenous population

85 Queensland has suggested that one possible approach could be to remove the ACT and the NT from the assessment process, on the basis that the Territories face unique situations and issues that may distort the current process, and which could potentially be addressed more effectively through other means.

86 The inclusion of both of the Territories in the HFE system is essential to the legitimacy and integrity of the funding arrangements between the Commonwealth and the States. Removing the two smallest States from the GST pool funding arrangements would undermine the integrity and independence of these two jurisdictions, effectively denying them the capacity to provide an average level of service to their residents. It would place their funding arrangements on a different level from those of the other States.

87 Further, removing the NT from the HFE system should not be seen as a response to the particular issue of measuring Indigenous needs.

88 The ACT supports removing Indigeneity from the HFE process (to address Indigenous disadvantage). However, the ACT does not support removing the other factors such as: socioeconomic status, wage levels, and diseconomies of small scale. These other factors addressed in expense assessments are considered to be beyond the control of States, and compensating for these factors is consistent with the objective of HFE.

5.6 Predictability and stability of HFE outcomes

i. Fixing annual relativities

89 The Panel suggests that predictability and stability could be improved with minimal change to the system by ensuring that certain data changes are not ‘backcast’²⁰, or perhaps even by fixing annual relativities between CGC reviews.

90 Limiting backcasting would allow changed circumstances to flow through to the relativities, but revisions to data would not be made to the earlier two years of data. Alternatively, the Panel suggests while ‘no revisions’ is the default position, revisions could be made if agreed by a body such as HoTs or the Standing Council on Federal Financial Relations.

91 An extension to this option would be to fix the relativities between reviews and not update for any changes in States’ fiscal capacities.

92 In this context, while fixing the relativities between reviews goes too far as it ignores contemporaneity, the other two options (limiting backcasting; allowing revisions to data if agreed by HoTs/SCFFR) have a high degree of merit and should be explored further by the Panel for its final report.

ii. Limiting relativity changes

93 The Panel’s view is that there is no compelling case for adopting a relativity floor for Western Australia as it would cause a major disparity in the fiscal positions of the States in the very near future. The ACT endorses this position.

94 The Panel has also highlighted that there could be an approach that manages reductions in GST payments received by States, perhaps by ensuring that a State does not receive a lower nominal amount of GST revenue than in the previous year (in years when the GST revenue pool grows) which could increase stability without extreme consequences.

95 In acknowledging the importance of stability and predictability of State budgets, the ACT could support an approach of adjusting the GST payments of States when they are negatively impacted by a significant change in circumstances, but only as a form of transitional assistance and only for major changes in circumstances that occur as a result of method changes, such as those that may result from the Panel’s recommendations as part of the GST Distribution.

96 Changes in GST funding that occur as part of the annual Update relativities would not be deemed to be the result of major method changes for this purpose.

²⁰ This is not the ‘back casting’ referred to by the CGC, but rather the situation where the first two years of the three year average do not change for revisions to data.

5.7 Governance and Communication

i. Governance

97 The Panel has suggested that the governance of the system would be improved by separating responsibility for determining the objectives of the GST distribution and the definition of HFE from the responsibility for interpreting and implementing HFE, and by adopting means to regularly review the goals and outcomes of the process.

98 It is considered that the current HFE system is robust and has served Australia well. This is reflected by the fact that the CGC has been provided with substantial independence in conducting equalisation, including determining the aims, objectives and definitions as well as interpreting and implementing HFE.

99 The ACT strongly prefers that this role remain with the CGC. This confidence is based on the work done by the CGC over a substantial period of time to develop the funding arrangements under which the ACT was established as an effective self-governing entity, fully integrated with the funding mechanisms applying to the other States. This work clearly established the integrity and independence of the CGC in the minds of the ACT's citizens and their representatives. It is within the scope of governments to be more prescriptive regarding the aims, objectives and definitions through the ToR that are provided to the CGC. However, despite opportunities for States to change the aims, objectives and definitions, States have not chosen to do so in the past.

100 Indeed, the 2004 Commission stated in their final report that the financial architecture of the federation is a matter for governments. And it is a matter for governments to initiate a review of this architecture, if they judge it desirable. The Commission did go on to say that it was their strong view that a review should be undertaken – whether conducted by the Commission or not – and would be best conducted outside the cycle of the Commission's regular review processes.

101 Other countries' equalisation systems, such as that of Canada, have been significantly tarnished by politicisation of the process. The current arrangements in Australia protect the integrity of HFE and the CGC should remain independent and apolitical.

ii. Communication

102 The Panel notes that a more transparent presentation of outcomes by the CGC and others, such as the Commonwealth, could be good for public confidence in the system and may enable debate to focus more directly on any substantive concerns with the GST distribution system. Further, there may be merit in the CGC taking a more active role in educating those outside the various State Treasuries about the principles by which GST is distributed.

103 A more transparent presentation of outcomes designed to enhance public confidence in the HFE system includes expressing outcomes in dollars instead of relativities and ensuring that relativities relate to the appropriate pool size. Alternative presentations could enable debate to focus more directly on any underlying concerns with the GST distribution system.

104 The ACT supports a broader reporting arrangement which would include both the GST and national SPPs in the HFE pool of assistance. This change would have the effect of bringing States' shares of total Commonwealth funding closer to an EPC basis than the GST funding viewed in isolation. Such a presentation may help diminish criticisms of equalisation and place them in a broader perspective.²¹

105 However, the ACT sees little to be gained by expressing HFE outcomes in dollars instead of relativities. This is because:

- while update impacts would not be provided in relativity terms, States could still determine the per capita relativity results, and could use them in a selective way to weaken the credibility of the HFE system; and
- relativities are much clearer explanators than dollars and dispensing with them would reduce the transparency of the HFE process.

106 The ACT considers that, given the need to maintain public confidence in the financial relationships within the Australian Federation, a more widespread program of engagement with States and the public may help to ensure that the equalisation principles are better understood, and therefore, that the GST distribution process is more widely supported.

107 The Panel suggests that there could be considerable benefit in the CGC engaging with State governments more broadly, especially in key areas such as health and education. The ACT supports this.

²¹ The GST would continue to be distributed using the recommended relativity and the National Specific Purpose Payments would be allocated according to their usual formula.